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14e

Strategic Management

Competitiveness & Globalization

Concepts and Cases

Hitt • Ireland
Hoskisson • Harrison

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Strategic Management: Competitiveness & Globalization: Concepts and Cases,
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To Frankie: You are my partner in life. I love you and look forward to our future together.

—Michael

To Mary Ann: We have reached that place we want to go and we will now walk in the sun. I love you.

—Duane

To Kathy: You are the best and my love for you is eternal. Thanks for all the support and love you've given me and our children throughout our life together.

—Robert

To Marie: You are my best friend, eternal companion, and greatest supporter. I love you forever.

—Jeff

Brief Contents

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Preface

Our goal in writing each edition of this book is to present a new, up-to-date standard for explaining the strategic management process. To reach this goal with the fourteenth edition of our market-leading text, we again present you with an intellectually rich yet thoroughly practical analysis of strategic management.

Before we began working on this new edition, we had a series of meetings in which we created a comprehensive list of topics that needed to be added or revised significantly because of monumental changes in the global business, social, technological, and political environments over the recent past, as well as developments in the academic and practitioner literatures pertaining to strategic management. After creating the list, we thoroughly examined these literatures, which led us to research articles from journals published on six continents and a wide assortment of articles published in the popular business press (e.g., *Wall Street Journal*, *Bloomberg Businessweek*, *Fortune*, *Financial Times*, and *Forbes*, to name a few) and in reliable social media outlets (i.e., blogs associated with professional organizations).

The goal was to ensure that the material in the book is accurate, interesting, and reflects the most important developments in the business world. This process resulted in the inclusion of 1,507 references to works published since the last edition went to press (485 in 2022; 567 in 2021; 305 in 2020; 153 in 2019).

Examining a wide array of sources provided many valuable examples of how companies across the world are using (or not using) the strategic management process. Though many of the hundreds of companies discussed in the book will be familiar to you, some will likely be new. One reason for this diversity is that the book contains examples of companies from around the world to demonstrate the globalized nature of business operations. Some of these firms are fairly large and known by many, while others are small and known primarily to the customers they serve. To facilitate learning, the book uses an Analysis-Strategy-Performance framework; we explain this framework in Chapter 1 and reference it throughout the book.

Several *characteristics* of this fourteenth edition are designed to enhance your learning experience:

- First, this book presents you with the most comprehensive and thorough coverage of strategic management available in the market.
- The research used in this book includes "classics" as well as the most recent contributions to strategic management literature. The historically significant classic research provides the foundation for much of what we know about strategic management, while the most recent contributions reveal insights about how to use strategic management effectively in the complex, global business environment in which firms compete. Although the relevant theory and current research are the foundation for this book, it also is strongly application oriented and presents you with numerous examples and applications of strategic management concepts, techniques, and tools. This edition, for example, uses more than 600 companies to illustrate strategic management in action. Collectively, no other strategic management book presents you with the combination of useful and insightful *research* and *applications* in diverse organizations as does this text.
- Examples you will find in this edition include large U.S.-based firms such as Tesla, Meta Platforms, BlackRock, Costco, Apple, McDonald's, FedEx, Starbucks, Walmart, Walt Disney, General Electric, Intel, Coca-Cola, Netflix, Tupperware, Shaw Industries, Instacart, Harley-Davidson, Patagonia, Publix, Peloton, Kroger, Campbell Soup, Fanatics, Frontier Airlines, Accenture, Pfizer, Google, Target, UPS, Bed Bath & Beyond, and many more.
- In addition, examples of firms based in countries other than the United States include Toshiba, Airbus, Sony, Carrefour, Softbank, Nestlé, Piclo Flex, Tata Group, Rio Tinto Group, Unilever, IKEA, Komatsu, Toyota, Aldi, Honda, Groupe Limagrain, Alibaba, Lenovo, Volkswagen, and Samsung. As these lists suggest, the firms this book examines compete in a wide range of industries and produce a diverse set of goods and services.

- The ideas of many prominent scholars are included in this book, including Ron Adner, Rajshree Agarwal, Ruth Aguilera, Gautam Ahuja, Raffi Amit, Africa Arino, Jay Barney, Paul Beamish, Peter Buckley, Alfred Chandler, Ming-Jer Chen, Russ Coff, Brian Connelly, Rich D'Aveni, Kathy Eisenhardt, Nicolas Foss, Edward Freeman, Gerry George, Javier Gimeno, Luis Gomez-Mejia, Melissa Graebner, Ranjay Gulati, Don Hambrick, Joseph Harrison, Connie Helfat, Amy Hillman, Tomas Hult, Tom Jones, Dave Ketchen, Ryan Krause, Dovev Lavie, Haiyang, Li, Yadong Luo, Shige Makino, Costas Markides, Anita McGahan, Danny Miller, Will Mitchell, Margie Peteraf, Michael Porter, Nandini Rajagopalan, Jeff Reuer, Joan Ricart, Richard Rumelt, Wei Shi, David Sirmon, Ken Smith, Steve Tallman, David Teece, Rosalie Tung, Michael Tushman, Eero Vaara, Margarethe Wiersema, Oliver Williamson, Mike Wright, Anthea Zhang, Shaker Zahara, and Ed Zajac, among many others.

In addition to the book's *characteristics,* let us highlight some specific *features* and *revisions*:

- **New Opening Cases and Strategic Focus Segments** Almost all of the Opening Cases and Strategic Focus segments are new! A very few were updated completely because of their continuing relevance and importance. Many of these application-oriented features deal with companies located outside North America. In addition, the *company-specific examples* included in each chapter are either new or were checked for their continuing relevance and accuracy.
- **Twenty-two New Cases** are included in this edition. Offering an effective mix of organizations headquartered or based in North America and several other countries as well, the cases deal with contemporary and highly important strategic management topics. Many of the cases have full financial data. These timely cases present active learners with opportunities to apply the strategic management process and understand organizational conditions and contexts and to make appropriate recommendations to deal with critical concerns. These cases also appear in MindTap (see description below).
- **New Mini-Cases** appear at the end of each chapter. These cases describe how companies deal with major issues the text highlights. The book includes 13 of these cases, one for each chapter, although some of them can overlap with other chapter content. Students will like their conciseness, but they likewise provide rich content that can serve as a catalyst for individual or group analysis and class discussion. A set of questions, which guide analysis and discussion, follows each Mini-Case.
- **Completely new or expanded content** appears in all of the chapters to reflect the many changes currently taking place in strategic management. Much of this content pertains to ideas found in more than one chapter. Consequently, you will find in the book a continuing, integrated thread for these topics, with references back to the place they were mentioned or defined initially. Chapter 1 introduces many of the new concepts because it lays a foundation for the rest of the book; however, most of them receive thorough treatment in a later chapter. Examples of this content, and the chapters in which it can be found, include:
  - Corporate social responsibility (CSR), sustainability, ESG, and greenwashing (Chapters 1, 2, 6, 8–13)
  - Nonmarket strategies and social capital (Chapters 2, 3, 5)
  - Ecosystems, platform strategies, multi-party alliances, and coopetition (Chapters 2, 5, 9)
  - Deglobalization and protectionism (Chapters 1, 8)
  - Digitalization, digital strategies, big data, and the metaverse (Chapters 1, 2, 4–9, 13)
  - Benefit corporations and B-Corp certification (Chapters 2, 10)
  - Stakeholder perspective and stakeholder-oriented strategic management (Chapters 1, 6, 10, 12)
  - Global supply chains and global value chains (Chapters 1, 8)
  - Cryptocurrencies and blockchain (Chapters 2, 13)
  - Artificial intelligence (Chapters 1, 3)
  - Digital platform organizations and structure (Chapters 4, 8, 11)
  - Cross-border learning (Chapter 8)
  - Inflation (Chapters 2, 8)
  - Global conflict and war (Chapters 2, 8)
  - Global pandemic, COVID-19 (Chapters 1–5, 8)
  - Activist investors and investor "wolf-packs" (Chapters 6, 7, 10)
  - Strategic human capital (Chapters 3, 4)

- Restructuring to create value (Chapters 7, 10)
- Gender and racial diversity on the board and the top management team (Chapters 10, 12)

- **An Exceptional Balance** between current research and up-to-date applications of that research in actual organizations located throughout the world is used in the book. The content has not only the best research documentation but also the largest number of effective real-world examples to help active learners understand the different types of strategies organizations use to achieve their vision and mission and to seek to outperform rivals**.**

Supplements to Accompany This Text

MindTap. MindTap is the digital learning solution that helps instructors engage students and helps students become tomorrow's strategic leaders. All activities are designed to teach students to problem-solve and think like leaders. Through these activities and real-time course analytics, and an accessible reader, MindTap helps you turn cookie cutter into cutting edge, apathy into engagement, and memorizers into higher-level thinkers.

Activities are customized to the specific needs of this course and built to facilitate mastery of chapter content. We've addressed case analysis from cornerstone to capstone with a functional area diagnostic of prior knowledge, guided cases, branching activities, multimedia presentations of real-world companies facing strategic decisions, and a collaborative environment in which students can complete group case analysis projects together synchronously. MindTap for this fourteenth edition includes the following features:

- **Cornerstone to Capstone Diagnostic** assesses students' functional area knowledge in the key discipline areas of Accounting, Finance, Economics, Marketing, and lower-level Management and provides feedback and remediation so that students are up to speed and prepared for the strategic management course material.
- **Learn It Activities** New "Learn It" activities take concepts from the text and distill them into consumable summaries. Learn It activities are designed to reinforce the content in the text and simultaneously offer low-stakes assessment and feedback.
  MindTap eBook: This dynamic eBook brings the value, concepts, and applications of the printed text to life. Using the eBook, students can easily search for content and take highlights and notes to enable engaged learning and studying practices.
- **Apply It Chapter Assignments** assess students' comprehension of the reading material and go further in asking learners to apply and analyze the content within varying contexts.
- **Apply It Case Activities** pair a case from the text with assessment questions that are designed to guide them through basic case analysis. These activities aligned with short chapter-based cases help prepare learners for more advanced case analysis work later in the course.
- **Study It: Flashcards** Digital flashcards serve to help learners become familiar with course terminology.
- **Study It: StudyPods** New to this version of MindTap, StudyPods are audio-based summaries of learning objectives that aim to help learners fit studying into their busy lives. These audio features restate the core material using accessible, everyday language to help learners take in essential content in new and different ways.
- **Study It: Practice Tests** Practice tests offer learners an opportunity to assess themselves on their knowledge of course content before engaging in higher-stakes, graded assessments like midterms and final exams.
- **"You Make the Decision" Activities** These scenario-based activities are included at the part level in MindTap and present challenging business problems that cannot be solved with one specific, correct answer. Students are presented with a series of decisions to be made based upon information they are given about a company. They are scored according to the quality of their decisions.
- **Case Analysis Projects** Case Analysis projects are aligned with the cases written by authors Charles Hill and Melissa Schilling and found within the appendix of the core text. These activities challenge students to think and act like tomorrow's strategic leaders. Use our default case analysis activity, written by seasoned strategic management instructors, or customize the project to suit your class. These activities may be completed by a pair or group of students or independently as instructors see fit.

It is not our intention to suggest that *all* exercises should be used for *every* chapter. Strategic management is taught at both undergraduate and graduate levels, and therefore, we offer a variety of pedagogically designed activities with numerous challenge levels so that instructors can customize MindTap to best suit their teaching style and the course objectives. That said, we have been highly intentional in designing a MindTap learning path that scaffolds learners through the content and offers a multi-modal experience to serve learners of varying preferences and levels.

We have found that our interactive approach to teaching strategic management appeals to students. It also greatly improves the quality of their learning experience. Our approach is more fully discussed in the *Instructor's Resource Manual*.

Teaching and Learning Aids

Instructor Website. Access important teaching resources on this companion website. For your convenience, you can download electronic versions of the instructor supplements from the password-protected section of the site, including Instructor's Resource Manual, Comprehensive Case Notes, Cognero Testing, and PowerPoint® slides. To access these additional course materials and companion resources, please visit www.cengage.com.

- **Instructor's Resource Manual.** The Instructor's Resource Manual, organized around each chapter's knowledge objectives, includes teaching ideas for each chapter and how to reinforce essential principles with extra examples. This support product includes lecture outlines and detailed guides to integrating the MindTap activities into your course with instructions for using each chapter's experiential exercises, branching, and directed cases. Finally, we provide outlines and guidance to help you customize the collaborative work environment and case analysis project to incorporate your approach to case analysis, including creative ideas for using this feature throughout your course for the most powerful learning experience for your class.
- **Case Notes.** These notes include directed assignments, financial analyses, and thorough discussion and exposition of issues in the case. Select cases also have assessment rubrics tied to National Standards (AACSB outcomes) that can be used for grading each case. The Case Notes provide consistent and thorough support for instructors, following the method the author team espouses for preparing an effective case analysis.
- **Cognero Test Bank.** This program is easy-to-use test-creation software that is compatible with Microsoft Windows. Instructors can add or edit questions, instructions, and answers, and select questions by previewing them on the screen, selecting them randomly, or selecting them by number. Instructors can also create and administer quizzes online, whether over the Internet, a local area network (LAN), or a wide area network (WAN). Thoroughly revised and enhanced, test bank questions are linked to each chapter's knowledge objectives and ranked by difficulty and question type. We provide an ample number of application questions throughout, and we have also retained scenario-based questions as a means of adding in-depth problem-solving questions. The questions are also tagged to National Standards (AACSB outcomes), Bloom's Taxonomy, and the Dierdorff/Rubin metrics.
- **PowerPoints®.** An updated PowerPoint presentation provides support for lectures, emphasizing key concepts, key terms, and instructive graphics.

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Michael A. Hitt is a University Distinguished Professor Emeritus at Texas A&M University. Dr. Hitt received his Ph.D. from the University of Colorado. He has co-authored or co-edited 28 books and authored or co-authored many journal articles. A recent article listed him as one of the 10 most cited authors in management over a 25-year period. The *Times Higher Education 2010* listed him among the top scholars in economics, finance, and management based on the number of highly cited articles he has authored. A recent article in the *Academy of Management Perspectives* lists him as one of the top two management scholars in terms of the combined impact of his work both inside (i.e., citations in scholarly journals) and outside of academia. And, a recent article in the *Academy of Management Learning and Education* lists him as the highest cited author in strategic management textbooks. He has served on the editorial review boards of multiple journals and is a former editor of the *Academy of Management Journal,* a former co-editor of the *Strategic Entrepreneurship Journal* and a former editor-in-chief of *Oxford Research Encyclopedia*. He is a fellow in the Academy of Management, the Strategic Management Society, and the Academy of International Business. He has received honorary doctorates (Doctor Honoris Causa) from the Universidad Carlos III de Madrid and from Jonkoping University. He is a former president of both the Academy of Management and the Strategic Management Society. He received awards for the best article published in the *Academy of Management Executive* (1999), *Academy of Management Journal* (2000), *Journal of Management* (2006), and *Family Business Review* (2012). He has received the Irwin Outstanding Educator Award, the Career Achievement Award for Distinguished Service, and the Career Award for Distinguished Educator from the Academy of Management. He received Distinguished Alumnus Awards from Texas Tech University and from the University of Colorado in 2018. In 2014–2022, Dr. Hitt has been listed as a Thomson Reuters Highly Cited Researcher (a listing of the world's most influential researchers).

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Robert E. Hoskisson

Robert E. Hoskisson is the George R. Brown Emeritus Chair of Strategic Management at the Jesse H. Jones Graduate School of Business, Rice University. Dr. Hoskisson received his Ph.D. from the University of California-Irvine. His research topics focus on corporate governance, acquisitions and divestitures, corporate and international diversification, and cooperative strategy. He teaches courses in corporate and international strategic management, cooperative strategy, and strategy consulting. He has co-authored 34 books, including a recent book entitled "Understanding and Managing Strategic Governance" (with Wei Shi, 2021). Dr. Hoskisson has served on several editorial boards for such publications as the *Strategic Management Journal* (Associate Editor), *Academy of Management Journal* (Consulting Editor), *Journal of International Business Studies* (Consulting Editor), *Journal of Management* (Associate Editor), *Organization Science, Journal of Management Studies* (Special Issue Guest Editor). His research has appeared in over 130 publications, including the *Strategic Management Journal*, *Academy of Management Journal*, *Academy of Management Review*, *Organization Science*, *Journal of Management*, *Academy of Management Perspectives*, *Academy of Management Executive*, *Journal of Management Studies*, *Journal of International Business Studies*, *Journal of Business Venturing*, *Leadership Quarterly, Organization Studies, Strategic Management Review, Entrepreneurship Theory and Practice*, *California Management Review,* and *Journal of World Business*. A recent article in the *Academy of Management Learning and Education* lists him among the most highly cited authors in strategic management textbooks. He is listed in the Thomson Reuters Highly Cited Researcher list that catalogues the world's most influential research scholars. Dr. Hoskisson is a fellow of the Academy of Management and a charter member of the Academy of Management Journal's Hall of Fame. He is also a fellow of the Strategic Management Society and has received awards from the American Society for Competitiveness and the William G. Dyer Alumni award from the Marriott School of Management, Brigham Young University. He completed three years of service as a Representative-at-Large on the Board of Governors of the Academy of Management. He also served as President of the Strategic Management Society, and served on the Executive Committee of its Board of Directors for six years.

Jeffrey S. Harrison

Jeffrey S. Harrison is a University Distinguished Educator, University Distinguished Scholar, and the W. David Robbins Chair of Strategic Management at the Robins School of Business, University of Richmond. He is also a recipient of the Virginia State Council of Higher Education (SCHEV) Outstanding Faculty Award. Prior to his current appointment he served as the Fred G. Peelen Professor of Global Hospitality Strategy at Cornell University. His Ph.D. in Strategic Management is from the University of Utah. Dr. Harrison's research interests include stakeholder theory and strategic management. His work has been published in high impact academic journals such as *Strategic Management Journal*, *Academy of Management Journal*, *Academy of Management Review*, *Journal of Management*, *Journal of Management Studies*, *Business Ethics Quarterly*, and *Journal of Business Ethics*. He has published thirteen books (on his own or with co-authors). Dr. Harrison currently serves as editor of the Stakeholder Strategy Section of the *Journal of Business Ethics* and on several editorial boards, including *Strategic Management Journal* and *Business Ethics Quarterly*. He has served as an editor for special issues at several journals, including *Academy of Management Journal*, *Academy of Management Review, Business & Society,* and *Academy of Management Perspectives.* He also served as chair of the Stakeholder Strategy Interest Group at the Strategic Management Society, a group he helped organize. He has co-organized several conferences in North America and Europe that have attracted experts from dozens of nations. In addition, Dr. Harrison has provided consulting and executive training services to many organizations in the U.S. and South America on a wide range of strategic, entrepreneurial, and other business issues. His clients have included Lockheed Martin, Siemens Westinghouse, American Express, Southdown, Volvo, DuPont, Multiple Sclerosis Society, and many others.

Case Title	Manu-facturing	Service	Food/ Retail	High Tech	Internet/ Comm.	International Perspective	Social/ Ethical Issues	Industry Information	COVID-19
Airbus A380	X			X		X		X	
Air France-KLM		X				X		X	
Ant Group		X			X	X	X		
Aventiv Technologies		X			X		X		
Blue Apron		X	X					X	
Gap		X	X				X	X	X
Haier	X			X		X			
Hershey	X		X				X		
Hilton		X						X	X
JIO/Facebook		X			X	X			
Marriott		X			X			X	X
Meta		X		X	X	X	X		
Netflix		X				X			X
NIO vs. Tesla	X	X				X	X		
Pacari Chocolate	X		X				X	X	
Port of Antwerp		X					X	X	
Re: Build Manufacturing	X								
Uber		X			X	X	X		X
Washington Post		X			X				
Waymo		X		X			X	X	
Wellington Brewery	X		X					X	
We Work		X				X			

Case Title	Ch 1	Ch 2	Ch 3	Ch 4	Ch 5	Ch 6	Ch 7	Ch 8	Ch 9	Ch 10	Ch 11	Ch 12	Ch 13
Airbus A380					X			X					X
Air France-KLM					X		X	X					
Ant Group	X	X			X								X
Aventiv Technologies				X			X			X		X	
Blue Apron	X		X	X									
Gap	X	X	X	X								X	X
Haier								X	X		X		X
Hershey	X	X	X									X	
Hilton	X	X	X			X							
JIO/Facebook								X	X				
Marriott		X			X	X							X
Meta		X			X			X				X	X
Netflix		X		X	X			X					
NIO vs. Tesla		X			X			X					
Pacari Chocolate	X	X	X	X				X					
Port of Antwerp		X	X										
Re: Build Manufacturing						X	X			X	X		
Uber		X	X	X	X			X					
Washington Post			X	X								X	X
Waymo		X	X		X						X		
Wellington Brewery	X	X							X				
We Work		X								X		X	

Chapter 1

Strategic Management and Strategic Competitiveness

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

1-1 Define strategic competitiveness, strategy, competitive advantage, above-average returns, and the strategic management process.

1-2 Describe the competitive landscape and explain how globalization, technological changes, and expectations of socially responsible behavior shape it.

1-3 Use the industrial organization (I/O) model to explain how firms can earn above-average returns.

1-4 Use the resource-based model to explain how firms can earn above-average returns.

1-5 Use the stakeholder model to explain how firms can earn above-average returns.

1-6 Describe vision, mission, and values, and explain why they are important.

1-7 Describe strategic leaders and what they do.

1-8 Explain the strategic management process.

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Hertz Has a Wild Ride

The Hertz Corporation, now a subsidiary of Hertz Global Holdings, Inc., began its car rental operations under the leadership of Walter Jacobs with a dozen Ford Model T cars in Chicago in 1918. Called Rent-a-Car, Inc., the company grew rapidly and was purchased by John D. Hertz, owner of Yellow Truck and Coach Manufacturing Company, in 1923. He re-named the company Hertz Drive-Ur-Self System. After three years, the rental car brand was sold to General Motors, which sold the brand back to John Hertz in 1953. The company's stock began trading on the New York Stock Exchange in 1954. Over the years the company has been owned, in addition to General Motors, by Radio Corporation of America, UAL Corporation (later known as Allegis), Ford Motor Company, and a consortium of private equity firms, which ultimately took the company public again in 2006.

In spite of, or perhaps because of, all the changes in ownership, Hertz has a history of innovation. It was the first company to offer a rental charge card, the first to offer one-way rentals, and the first international car rental company to expand into China. In addition, the company partnered with auto manufacturers to develop and rent specialty cars for its fleet, including a Ford GT350H Mustang and a modified Chevrolet Corvette ZH-Z coupe. Hertz was an early innovator in self-service car rental kiosks and hourly car rentals. The company also grew through developing a new brand, Advantage Rent-A-Car, and through the acquisition of Dollar Thrifty Automotive Group, after which the Advantage brand was sold. Hertz also operates the Firefly brand in international markets. In advertising, Hertz was one of the first companies to feature an African American in its commercials.

Jonathan Weiss/Shutterstock.com

Hertz has a long history of being an innovator in the car rental industry

The car rental industry is incredibly competitive. Enterprise Holdings is the largest car rental company in the United States, with over 1 million cars. Internationally, Enterprise has nearly 10,000 car rental locations in approximately 100 countries and territories. In comparison, Hertz has approximately 1,500 airport rental locations in the United States and 2,000 airport rental locations internationally. However, Hertz also has approximately 2,400 off-airport locations in the United States and 6,100 off-airport locations internationally, which makes the company similar in size to Enterprise. Rounding out the largest competitors is Avis Budget Group. These three competitors control over 90 percent of the rental car business in the United States. Competition in the industry is largely based on advertising leading to brand preferences, competitive prices, and loyalty programs. Online services such as Priceline.com, Expedia.com, and Kayak.com mean that consumers have an information advantage over the car rental companies in finding competitive rates, which keeps prices low.

In spite of the pressure to keep prices low, car rental companies still earn profits because of their business models. Most of them buy new cars in fleets at reduced prices directly from manufacturers. They keep the cars for only a short amount of time, which makes the cars very attractive to customers and reduces maintenance costs. When they sell the cars, because the cars have low mileage and were purchased at a discount, car rental companies are able to recoup most or all of the original purchase prices. However, this business model makes car rental companies vulnerable to steep losses if used car prices decline. Car rental companies are also vulnerable to shifts in tourist travel.

Both sources of vulnerability became evident when the COVID-19 pandemic hit the global economy. Tourism dropped to almost nothing, which especially hurt car rental companies as well as airlines and hotels. In addition, there was a drop in demand for used cars, which made selling its fleet difficult. Hertz cut jobs and sold a lot of its fleet in an attempt to pay creditors and remain solvent. The company's sales shrank 46 percent from 2019 to 2020, and the company lost nearly $2 billion. In May 2020, the company was forced to file for Chapter 11 bankruptcy to provide some temporary relief from creditors and buy some time to restructure its debt and its operations. At one point, Hertz shares were selling for under a dollar.

In May of 2021, a group of investors won a bidding contest in bankruptcy court for control of the company, with a plan to modernize the company's technology and improve customer service. They arranged to have a new issue of Hertz stock begin trading in early July, the day after the company exited bankruptcy. Then, in the summer of 2021, good fortune smiled on Hertz. With many COVID-19 travel restrictions being lifted, tourism increased dramatically. The car rental industry was not prepared for it. Demand outstripped supply of rental cars, and it was not unusual for vacationers to pay $275 per day for a SUV in popular locations; $100-per-day rentals on regular cars were common. The restructuring had dramatically reduced Hertz's debt burden, so they were well positioned to take advantage of the uptick in demand.

As Hertz rebounds, innovation is taking front stage again. The company is buying 100,000 electric cars from Tesla for its fleet. It also has a partnership with Uber Technologies focused on autonomous driving and the possibility of developing robotaxi networks. The company wants to play a large role in the modern mobility ecosystem (all the firms that carry out interdependent activities that provide mobility to customers). In an amazing turnaround of fortunes, *Barron's* identified Hertz as one of its 10 top stocks for investment in 2022.

Sources: C. English, 2022, Hertz stock could take off this year. Here's why, *Barron's,* www.barrons.com, January 7; 2022, Financials for Hertz Global Holdings Inc., *Barrons,* www.barrons.com, January 26; 2020, *Hertz Global Holdings Annual Report;* A. Bary, 2021, Here are *Barron's* 10 top stocks for the new year, *Barrons,* www.barrons.com, December 27; A. Bary, 2021, Reorganized Hertz puts investors in driver's seat, *Barrons,* www.barrons.com, June 28; K. G. Pringle, 2021, Hertz could revolutionize rental cars once again, *Barrons*, www.barrons.com, November 10.

Learning Objective

1-1 Define strategic competitiveness, strategy, competitive advantage, above-average returns, and the strategic management process.

1-1 An Overview of Strategy and Strategic Competitiveness

As the Opening Case demonstrates, achieving and maintaining strategic competitiveness in a volatile global economy is indeed challenging. Intense competition among a small group of industry leaders, dependence on tourism, and changing technologies are all strong forces in the auto rental industry. A shock like the COVID-19 pandemic had an especially large negative impact on the industry, but what is most fascinating is that lifting travel restrictions also unleashed strong positive forces that allowed the industry, and Hertz, to recover.

Firms achieve **strategic competitiveness** by successfully formulating and implementing a value-creating strategy. A **strategy** is an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage. When choosing a strategy, firms make choices among competing alternatives as the pathway for deciding how they will pursue strategic competitiveness. In this sense, the chosen strategy indicates what the firm *will do* as well as what the firm *will not do*.

Firms achieve **strategic competitiveness** by successfully formulating and implementing a value creating strategy.

A **strategy** is an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage.

A firm has a **competitive advantage** when, by implementing a chosen strategy, it creates superior value for customers, and when competitors are not able to imitate the value the firm's products create or find it too expensive to attempt imitation.

A firm has a **competitive advantage** when, by implementing a chosen strategy, it creates superior value for customers, and when competitors are not able to imitate the value the firm's products create or find it too expensive to attempt imitation.[1] An organization can be confident that its strategy yields a competitive advantage after competitors' efforts to duplicate it have ceased or failed. In addition, firms must understand that no competitive advantage is permanent. The speed with which competitors are able to acquire the skills needed to duplicate the benefits of a firm's value-creating strategy determines how long the competitive advantage will last.[2] Consider, for example, that although Hertz was often an innovator in the industry, competitors were able to copy Hertz's innovations with relative ease, which means that the company could only enjoy a competitive advantage for a short time.

Possessing a competitive advantage, and understanding how to use it effectively in marketplace competition, is foundational to all firms' efforts to achieve strategic competitiveness and outperform rivals. In essence, a firm creates a competitive advantage by being as different as possible from competitors in ways that are important to customers and in ways that competitors cannot duplicate. Important differences are ones for which customers are willing to pay. In the car rental industry, one of the only sustainable sources of competitive advantage is brand name. A well-known brand such as Hertz, Enterprise, or Avis allows these companies to charge a premium for their car rentals, in spite of the information advantages that consumers have because of access to car rental websites that list all available options and their prices. This means that some of the smaller, less-well-known competitors have to rent their cars at a substantially lower price than the well-known brands.

Almost no competitive advantage is sustainable permanently. In some instances, a firm's advantage no longer creates value for which customers are willing to pay. In other cases, competitors will learn how to create more value for customers with respect to a valued competitive dimension for which they are willing to pay. Thus, to achieve strategic competitiveness across time, a firm must concentrate simultaneously on exploiting the competitive advantage it possesses today while contemplating decisions to make to ensure that it will possess a competitive advantage in the future.

The success with which firms in an industry formulate and implement their value creating strategies determines whether their performance will be above, at, or below average compared to comparable companies. **Above-average returns** are returns in excess of what an investor expects to earn from other investments with a similar amount of risk. **Risk** is an investor's uncertainty about the economic gains or losses that will result from a particular investment. The most successful companies learn how to manage risk effectively; doing so reduces investors' uncertainty about the outcomes of their investments.[3] Firms often use accounting-based metrics, such as return on assets, return on equity, and return on sales to assess their performance. Alternatively, firms can assess their performance in terms of stock market returns. In smaller, new venture firms, returns are sometimes measured in terms of the amount and speed of growth (e.g., annual sales) rather than more traditional profitability measures because new ventures require time to earn acceptable returns for investors.[4]

Above-average returns are returns in excess of what an investor expects to earn from other investments with a similar amount of risk.

Risk is an investor's uncertainty about the economic gains or losses that will result from a particular investment.

Understanding how to exploit a competitive advantage is important for firms seeking to earn above-average returns.[5] Firms without a competitive advantage or that do not compete in an attractive industry earn, at best, average returns. **Average returns** are returns equal to those an investor expects to earn from other investments possessing a similar amount of risk. Over time, an inability to earn at least average returns results first in decline and, eventually, failure.[6] For instance, for a while Hertz was not able to generate enough returns for a company in such a high-risk industry. As a result, they were unable to secure the financing needed to remain solvent. This is typical, as failure occurs when investors withdraw their investments from firms earning less-than-average returns, even if it is an external shock like a pandemic that is the cause of the poor performance.

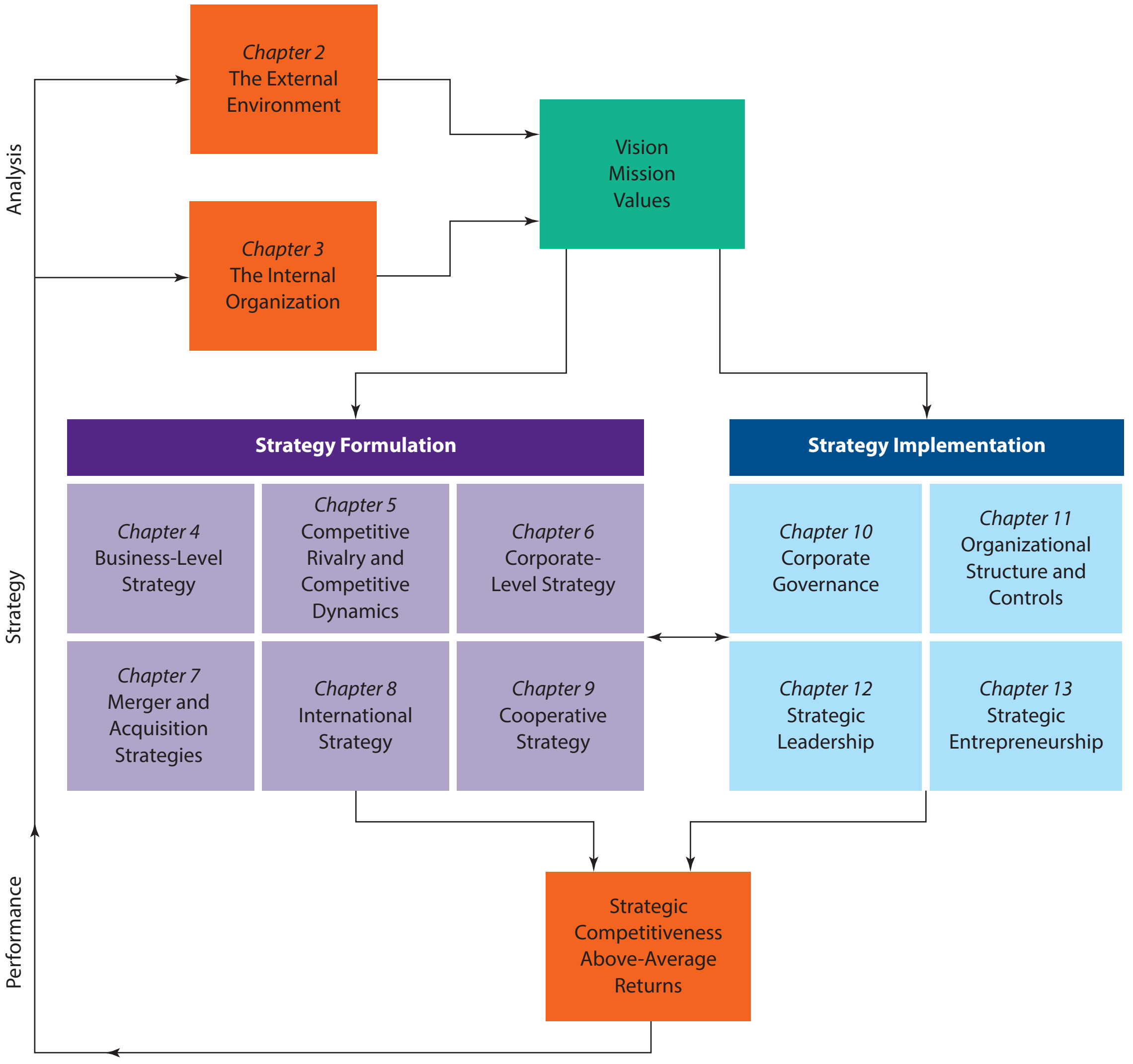
Average returns are returns equal to those an investor expects to earn from other investments with a similar amount of risk.

The **strategic management process** is the full set of commitments, decisions, and actions firms take to achieve strategic competitiveness and earn above-average returns.[7] The process involves analysis, strategy, and performance (the A-S-P model—see Figure 1.1). The firm's first step in the process is to *analyze* its external environment and internal organization to identify external opportunities and threats and to recognize its internal resources, capabilities, and core competencies. The results of these analyses influence the selection of the firm's strategy or strategies. The *strategy* portion of the model entails strategy formulation and strategy implementation.

The **strategic management process** is the full set of commitments, decisions, and actions required for a firm to achieve strategic competitiveness and earn above-average returns.

With the information gained from external and internal analyses, the firm develops its vision, mission, and values, and formulates one or more *strategies*. To implement its strategies, the firm takes actions to enact each one with the intent of achieving strategic competitiveness and above-average returns (*performance*). Effective actions that take place in the context of integrated strategy formulation and implementation efforts result in positive performance. Firms seek to maintain the quality of what is a dynamic strategic management process as a means of dealing successfully with ever-changing markets and evolving internal conditions.[8] In the remaining chapters of this book, we use the strategic management process to explain what firms do to achieve strategic competitiveness and earn above-average returns. We demonstrate why some firms achieve competitive success consistently while others do not.

Figure 1.1 The Strategic Management Process



We begin this chapter with several topics that are important to laying a foundation for the strategic management process. First, we describe the current competitive landscape. Several realities, including the emergence of a global economy, globalization resulting from that economy, and rapid technological changes, influence this landscape. Next, we examine three models that firms use to gather the information and knowledge required to choose and then effectively implement their strategies. The first model (industrial organization or I/O) suggests that the external environment is the primary determinant of a firm's strategic actions. According to this model, identifying and then operating effectively in an attractive (i.e., profitable) industry or segment of an industry are the keys to competitive success.[9] The second model (resource-based) suggests that a firm's unique resources and capabilities are the critical link to strategic competitiveness.[10] The third model is based on the notion that the quality of a firm's relationships with internal and external constituencies (stakeholders) can lead organizations to achieve above-average returns.

The information firms gather as they apply the three models helps firms define their purpose, as reflected in a mission, vision, and values. After a discussion of missions, visions, and values, we close the chapter with a brief introduction to strategic leadership and the elements of the strategic management process.

1-2 The Competitive Landscape

Learning Objective

1-2 Describe the competitive landscape and explain how globalization, technological changes, and expectations of socially responsible behavior shape it.

The fundamental nature of competition in many of the world's industries has changed. *Digitalization*, for example, which is the process of converting something to digital form, is a competitive dimension that is affecting competition in multiple industries throughout the world. Firms committed to becoming digital leaders may be able to distinguish themselves from competitors by producing innovative products that unique groups of customers value. A significant benefit of digitalization is that it allows firms to identify specific customer groups and then serve their personalized and unique needs. Also, the rising generation is "always on" through their smartphones, tablets, gaming systems, and other media. Thus, in today's competitive landscape, a challenge is for firms to understand the strategic implications associated with digitalization and to integrate digitalization effectively into their strategies.

In the current competitive landscape, conventional sources of competitive advantage such as economies of scale and large advertising budgets may not be as effective as they once were in terms of helping firms earn above-average returns. The large plants associated with economies of scale have often been replaced with outsourcing to countries where labor rates are low. Advertising on television and in magazines or other traditional outlets is less effective because of the dramatic increase in media outlets from which consumers receive entertainment and news, a direct result of digitalization. Consequently, managers in many industries must adopt a mind-set that values flexibility, speed, innovation, integration, and the challenges flowing from constantly changing conditions.[11] The conditions of the competitive landscape result in a perilous business world—a world in which the investments necessary to compete on a global scale are enormous and the consequences of failure are severe.[12] Effective use of the strategic management process reduces the likelihood of failure for firms while competing against their rivals.

Hypercompetition is a condition where competitors engage in intense rivalry, markets change quickly and often, and entry barriers are low.

Hypercompetition is a condition in which competitors engage in intense rivalry, markets change quickly and often, and entry barriers are low. In these environments, firms find it difficult to maintain a competitive advantage.[13] Rivalry in hypercompetitive environments tends to occur among global competitors who innovate regularly and successfully.[14] It is a condition of rapidly escalating competition based on price-quality positioning, competition to create new know-how and establish first-mover advantage, and competition to protect or invade established product and/or geographic markets. In a hypercompetitive market, firms often challenge their competitors aggressively to strengthen their market position and ultimately, their performance.[15] The fast-food industry and ecommerce are examples of hypercompetitive markets. However, many industries and markets have some of the characteristics associated with hypercompetition due to the emergence of a global economy, rapid technological changes, and the global push to make businesses accountable for societal outcomes.

Several factors influence the nature of the current competitive landscape.

1-2a The Global Economy

A **global economy** is one in which goods, services, people, skills, and ideas move with limited barriers across geographic borders.

A **global economy** is one in which goods, services, people, skills, and ideas move with limited barriers across geographic borders. Although artificial constraints, such as tariffs, may have a limited impact, the relatively free exchanges that occur in the global economy significantly expand and complicate a firm's competitive environment.[16] Firms must study the global economy carefully as a foundation for learning how to position themselves to be competitive.

An understanding of the size of the economies in which a firm participates is important when studying the global environment. In 2021 for example, the United States was the world's largest economy at an estimated value of approximately $23 trillion. At that time, China was the world's second-largest economy with a value of nearly $17 trillion, while Japan was the third largest at a little over $5 trillion. Following Japan were Germany, the United Kingdom, India, and France.[17] Thus, companies scanning the global economy for opportunities might conclude that markets in the United States, China, and Japan yield potentially significant opportunities for them.

Protectionism involves actions taken by a government to protect its economy from adverse influences due to foreign trade.

Of course, such an analysis also must consider entry barriers to various economies in the form of tariffs. A tariff is a tax imposed by a government on goods imported into their country. It is one of the evidences of what is called **protectionism**, which involves actions taken by a government to protect its economy from adverse influences due to foreign trade.[18] Sometimes tariffs are used as a weapon against a country in an effort to gain concessions in other areas.[19] For example, the U.S. government has used high tariffs on Chinese imports in an effort, in part, to get China to do more to prevent Chinese companies from using the intellectual property of U.S. companies illegally.[20] In addition to tariffs, protectionism can involve a government's use of tools such as trade agreements and quotas on how much of a good can be imported into the country.

Also, when evaluating the attractiveness of a country for expansion, it is important to consider economic growth, since with growth comes increased demand for products and services. In 2021, India, Saudi Arabia, and France grew at a faster pace than most countries, which presented opportunities for firms entering those countries.[21] Emerging economies like India tend to grow faster than developed economies because of an increase in citizens that have disposable income (income that can be spent on things beyond absolute necessities). Important emerging economies include the BRIC countries (Brazil, Russia, India, and China)[22] as well as a few other countries that have been identified as having high growth potential; namely, Vietnam, Indonesia, South Africa, Turkey, Argentina, Colombia, and Egypt.[23]

Globalization

Globalization is the increasing economic interdependence among countries and their organizations as reflected in the flow of products, financial capital, and knowledge across country borders.

A **global supply chain** is a network of firms that spans multiple countries with the purpose of supplying goods and services.

Globalization is the increasing economic interdependence among countries and their organizations as reflected in the flow of products, financial capital, and knowledge across country borders.[24] It is a product of a large number of firms competing against one another in an increasing number of global economies. In globalized markets and industries, firms might obtain financial capital in one national market and use it to buy raw materials in another. Firms might then use manufacturing equipment purchased in a third national market to produce and deliver products that it sells in a fourth market. This phenomenon is described as a global supply chain. A **global supply chain** is a network of firms that spans multiple countries with the purpose of supplying goods and services.[25] Because firms seek out the best and most inexpensive supplies and products regardless of where in the world they are found, practically every industry participates in a global supply chain, at least to some extent.

Overall, globalization has led to higher performance standards with respect to multiple competitive dimensions, including quality, cost, productivity, product introduction time, and operational efficiency. Firms must learn how to deal with the reality that in today's competitive landscape, only companies capable of meeting, if not exceeding, global standards typically earn above-average returns.

Although globalization offers potential benefits to firms, it is not without challenges. One management challenge comes from workers flowing rather freely among global economies. This is important because employees are a key source of competitive advantage.[26] For example, Argentina currently has great difficulty keeping highly skilled tech workers in the country because they are being lured away by companies in the United States and Europe offering them significant pay increases.[27]

Another challenge comes from a *liability of foreignness*, a term that describes the risks of competing outside a firm's domestic markets.[28] The amount of time firms usually require to learn to compete in markets that are new to them is one risk of entering a global market. A firm's performance can suffer until it gains the knowledge needed to compete successfully in a new global market.[29] This is especially true because of cultural differences that are likely to exist between the firm's home market and international markets. In addition, a firm's performance may suffer by entering too many global markets either simultaneously or too quickly. When this happens, the overall organization may lack the skills required to effectively manage all of its diversified global operations.[30] The Strategic Focus demonstrates that global interconnectedness associated with global supply chains also creates problems that would not exist if firms only relied on domestic markets for their productive inputs.

A **global value chain** refers to the processes through which a firm receives raw materials, uses them to *add value* through manufacturing a product that provides greater utility for the consumer, and sells the product to another firm or the ultimate consumer of the product, in a global setting.

Related to global supply chains are global value chains. Whereas a global supply chain pertains simply to the transfer of goods from one party to another across a global network, a **global value chain** refers to the processes through which a firm receives raw materials, uses them to *add value* through manufacturing a product that provides greater utility for the consumer, and sells the product to another firm or the ultimate consumer of the product, in a global setting.[31] In other words, a global supply chain pertains to an industry, whereas a global value chain pertains to an individual firm as it seeks to create value, in part, through its management of a global supply chain. It is a set of interrelated activities that involve companies from multiple countries, coordinated by a particular firm in search of a competitive advantage.

On the surface, a global supply chain and a global value chain may appear the same. The global supply chain describes the steps in production from raw materials to ultimate consumer; however,

Strategic Focus

Global Supply Chains and the Risks of Interconnectedness

Global supply chains are abundant in the global economy. They help companies obtain the very best resources found anywhere in the world, and at the best prices. However, they are not without problems, in part due to their impact on the increased complexity and uncertainty that firms face. Also, participants in global supply chains complain that they do not have full visibility into their supply chains, and many supply chains are plagued by a lack of trust among participants. In addition, some consumers are resistant to globalization, and are reluctant to buy products that are produced largely outside their home countries.

However, one of the biggest problems associated with global supply chains occurs when there is a major shock in one or more parts of the chain. An unexpected event such as a hurricane or earthquake can stop production of components that are necessary to produce products in other countries. One famous example is Toyota, which had to close most of its Japan-based production plants due to supply chain disruptions after an earthquake and tsunami in 2011. The shortage of parts lasted for weeks. Toyota put into place several measures to protect the company from problems in case of a similar event. However, in 2016, a series of earthquakes led to closing down almost all production lines in Japan due to supply shortages. Toyota is a very successful company with highly sophisticated technologies; this example demonstrates how hard it is to mitigate the risks associated with shocks to the global supply chain.

Of course, the COVID-19 pandemic was a shock to the entire global economy and affected virtually every global supply chain. Labor and materials shortages were very harmful to production around the world. Researchers found that the COVID-related disruption to supply chains due to production capacity damage in China had their biggest impact on the United States, South Korea, Japan, and Germany, and especially in the electronics, textiles, machinery, manufacturing, and wholesale trade sectors. However, this is largely because consumers in those countries purchase more non-essential items than consumers in developing economies. Researchers also found that economies that were hurt the worst by supply chain disruptions as a result of COVID-19 were in developing nations—those that could least afford such difficulties.

A military conflict such as Russia's invasion of Ukraine is another type of unexpected event that influences global supply chains. In the run-up to the invasion, oil futures increased because Russia is a large provider of oil. Russia is also the major supplier of natural gas in Europe. Higher energy prices mean higher transportation and manufacturing costs, which increase inflation. Also, Western governments imposed strong sanctions against Russia that reduced the country's ability to conduct business in international markets.

Jenari/Shutterstock.com

Supply chain problems cause far-reaching shortages of products

Overall, the increased efficiency and broader availability of goods and services make global supply chains an attractive part of the global economy. However, they also provide additional uncertainty that makes strategic management difficult because almost all businesses rely on them to some extent for the resources they need.

Sources: Y. Trofimov, A. Cullison, B. Forrest, & A. M. Simmons, 2022, Russians close in on Ukranian capital, *Wall Street Journal*, February 25: A1, A10; I. Talley & M. Colchester, 2022, West imposes stiffer sanctions, *Wall Street Journal*, February 25: A1, A4; C. D. Court, J.-P. Ferreira, G. J. D. Hewings, & M. L. Lahr, 2021, Accounting for global value chains: Rising global inequality in the wake of COVID-19, *International Review of Applied Economics,* 35: 813–831; Y. Kashiwagi, Y. Todo, & P. Matous, 2021, Propogation of economic shocks through global supply chains—Evidence from Hurricane Sandy, *Review of International Economics,* 29: 1186–1220; Y. Chang, E. Iakovou, & W. Shi, 2020, Blockchain in global supply chains and cross border trade: A critical synthesis of the state-of-the-art challenges and opportunities, *International Journal of Production Research,* 58: 2082–2099; M. Qin, X. Liu, & X. Zhou, 2020, COVID-19 shock and global value chains: Is there a substitute for China, *Emerging Markets Finance & Trade,* 56: 3588–3598; J. Webb, 2016, Toyota's 'quake-proof' supply chain that never was, *Forbes,* www.forbes.com, April 26.

it does not describe the integrated processes through which a firm adds value. Innovative firms tend to participate with higher frequency in global value chains.[32] Also, coordinative processes in global value chains have been found to be an effective method for transferring technology to firms in developing economies.[33] However, suppliers in emerging economies that participate in global value chains frequently do not reap many of the economic benefits from their innovations.[34] This is, perhaps, one of the reasons for the increase in protectionism.

Protectionism, the liability of foreignness, and the risks of interconnectedness in global supply chains are all forces that are working to reduce globalization.[35] Firms that are reducing their participation in global supply chains and global value chains are a part of a trend called *deglobalization*.[36] On the other hand, some companies are still increasing their involvement in cross-border activities in an effort to expand markets, purchase the best or lowest cost products, and learn or develop new technologies.

This section demonstrates that success in international markets, even for firms with substantial experience in the global economy, requires effective use of the strategic management process. However, even if a firm is able to compete successfully in global markets, it also needs to commit to remaining competitive in its home market. Firms seek competitiveness in both domestic and international markets, in part, by remaining in tune with technological opportunities and potential disruptions innovations might create.

1-2b Technology and Technological Changes

Increasingly, technology affects all aspects of how companies operate and as such, the strategies they choose to implement. Boston Consulting Group analysts describe technology's impact as follows: "No company can afford to ignore the impact of technology on everything from supply chains to customer engagement, and the advent of even more advanced technologies, such as artificial intelligence (AI) and the Internet of Things, portends more far-reaching change."[37] Information technologies facilitate the integration of enterprises into the global supply chains described previously.[38]

The rate of *technology diffusion*, which is the speed at which new technologies become available to firms and when firms choose to adopt them, is far greater than was the case a decade or two ago. Consider the following rates of technology diffusion:

It took the telephone 35 years to get into 25 percent of all homes in the United States. It took TV 26 years. It took radio 22 years. It took PCs 16 years. It took the Internet 7 years.[39]

The impact of technological changes on individual firms and industries is broad and significant. For example, information technologies have made working at home much more efficient and effective than it was a few years ago, and the COVID-19 pandemic accelerated this trend.[40] Companies that facilitate at-home work—like Zoom and Microsoft—enjoyed tremendous success, and competitors are trying to catch up.[41] In transportation, electric cars are rapidly increasing in popularity and automobile manufacturers are responding, which means that internal combustion engines are being pushed out of the automotive market.[42] Also, innovative firms are working on self-driving cars and air taxis, small, pilotless aircraft designed to carry passengers short distances in and around cities.[43] In addition, cryptocurrencies like Bitcoin are influencing international commerce as well as the investment community.[44] Some believe that the public blockchains that make cryptocurrencies possible hold the potential to build a new decentralized digital economy.[45]

Related to many other technologies is AI, which has already had a significant impact in many areas.[46] AI can be thought of as intelligence that is demonstrated by a machine. For example, a machine exhibiting AI will use sensors to perceive and effectors to respond to its environment.[47] In the not-too-distant future, AI holds the potential to alter the human experience through new technologies, products, and services, as well as the way people work, communicate, and manage businesses.[48] The famous theoretical physicist Stephen Hawking once said, "The rise of powerful AI will be either the best or the worst thing ever to happen to humanity. We do not yet know which."[49]

Perpetual innovation is a term used to describe how rapidly and consistently new, information-intensive technologies replace older ones. The shorter product life cycles resulting from rapid diffusions of new technologies place a competitive premium on being able to quickly introduce new, innovative products into the marketplace.[50] For example, in 2021, Boston Consulting Group identified the 50 most innovative companies in the world. The first five firms on this list are large companies—Apple, Alphabet (Google), Amazon, Microsoft, and Tesla.[51] During the research conducted by Boston Consulting Group in support of the ranking, the company made some interesting discoveries that reinforce the value of innovation in today's businesses. The 1,500 global innovation executives they surveyed found that the COVID-19 experience increased the importance of innovation in their companies. Also, more than 60 percent of companies plan to increase investments in innovative activities in an effort to keep up with technological changes.

Another indicator of rapid technology diffusion is that firms quickly gather information about their competitors' research and development (R&D) and product decisions, sometimes even within days.[52] Also, when rival companies hire personnel from a competing firm, the result is that technological knowledge spills over from one firm to another company.[53] Because of the potential for technology diffusion and knowledge spillovers, firms must move quickly to use their innovations productively. In this sense, the rate of technological diffusion has reduced the competitive benefits of patents.[54] Today, patents may still be an effective way of protecting proprietary technology in a small number of industries such as pharmaceuticals. In contrast, many firms competing in the electronics industry often do not apply for patents to prevent competitors from gaining access to the technological knowledge included in the patent application.

Disruptive technologies—technologies that destroy the value of an existing technology and create new markets—surface frequently in today's competitive markets. [55] Think of the new markets that have been created by the technologies underlying the development of products such as WiFi, the web browser, smartphones, and electric cars. These types of products represent radical or breakthrough innovations (we discuss radical innovations in Chapter 13).[56] A disruptive or radical technology can create what is essentially a new industry or can harm industry incumbents.

Information Technology and Big Data

Knowledge (information, intelligence, and expertise) is the basis of technology and its application. Today, knowledge is a critical organizational resource and an increasingly valuable source of competitive advantage.[57] Individuals acquire knowledge through experience, observation, and inference. Knowledge is an intangible resource (we describe tangible and intangible resources fully in Chapter 3). The value of firms' intangible resources, including knowledge, continues increasing as a proportion of total shareholder value.[58] Knowledge is a key intangible asset that, when diffused quickly throughout a firm, contributes to efforts to outperform rivals.[59] Therefore, firms must develop (e.g., through training programs) and acquire (e.g., by hiring educated and experienced employees) knowledge, integrate it into the organization to create capabilities, and then apply it to gain a competitive advantage.[60]

Information technology is key to acquiring and managing knowledge flows. Firms have begun applying "big data" technologies to help with these processes.[61] *Big data* refers to the data retrieved by firms that are increasing in volume, variety, and frequency. *Big data analytics* is the process of examining huge amounts of data to uncover hidden patterns and other information that can be used to improve decision making. The internet increased low-cost data storage capacity and increased efficient processing technologies have made capturing and processing large volumes of data possible. In fact, "cloud" technologies that link computer servers through the internet mean that many of these processes can be performed offsite rather than on local computers. Amazon Web Services provides big data solutions to other companies. They provide descriptive analytics, which answer the "What happened and why?" questions, as well as predictive analytics, and prescriptive analytics, which provides recommendations regarding what a client firm should do.[62]

Big data analytics combined with internal systems that help information get to parts of the organization where it is most useful can enhance a firm's **strategic flexibility**, a set of capabilities firms use to respond to various demands and opportunities existing in today's dynamic and uncertain competitive environment. Strategic flexibility involves coping with uncertainty and its accompanying risks.[63] Firms should try to develop strategic flexibility in all areas of their operations.

Strategic flexibility is a set of capabilities firms use to respond to various demands and opportunities existing in today's dynamic and uncertain competitive environment.

To be strategically flexible on a continuing basis and to gain the competitive benefits of such flexibility, a firm must also develop the capacity to learn. Continuous learning provides the firm with new and up-to-date skill sets, which allow it to adapt to its environment as it encounters changes.[64] Firms capable of applying quickly what they have learned exhibit the strategic flexibility and the capacity to change in ways that will increase the probability of dealing successfully with uncertain, or even hypercompetitive, environments.

1-2c Social Responsibility

Today's competitive environment is also marked by the need to incorporate social responsibility into a firm's strategic management, often called corporate social responsibility, or CSR.[65] More than ever before, society is holding corporations and other businesses, both large and small, accountable for their actions with regard to a number of societal expectations, including how they treat employees, their records with regard to inclusiveness, the quality and safety of the products they make and services they provide, their environmental records, the absence or existence of legal suits brought by any of their stakeholders, and their philanthropic activities.[66]

Sustainability means that a firm should not deplete or destroy natural elements upon which it depends for survival.

The push for sustainability incorporates many of society's expectations. The basic idea behind **sustainability** is that a firm should not deplete or destroy natural elements upon which it depends for survival.[67] For example, if a forestry company cuts down a tree to create paper pulp, it should plant at least one tree that it can cut down in the future. Sustainability has also been extended into other resource areas beyond the environment, such as human capital, gender equality, global poverty, and innovation. For instance, a firm that develops programs to recruit and train employees that live in poverty is promoting sustainability because these activities will provide important human resources used to produce products and services over the long term.

The corporate social responsibility movement extends beyond a firm's own activities. Often large firms are also held accountable for the actions of the firms with which they do business.[68] One of the most significant manifestations of this phenomenon is the criticism a large corporation receives when it outsources some of its production to firms in other countries that engage in labor practices such as employing minor children or paying meager wages to overworked employees with poor working conditions (sometimes called sweatshops).[69] Apple has been highly criticized for many years for its inability to completely resolve problems like these in its supply chain.[70]

As society embraced the principles underlying CSR, CSP (corporate social performance), and sustainability, so did investors, especially institutional investors.[71] Many of them want to invest in firms that are socially responsible. One of the economic reasons for such investments is that firms that are high in social responsibility are at less risk of legal suits, negative social media, walkouts, and so forth.[72] In addition, research evidence is supportive of a small but positive relationship between corporate social responsibility and economic performance.[73]

As a result of increasing interest in the social responsibility of businesses, many firms have emerged to track this sort of information, most often referred to with the title of ESG (environment, society, and governance). Also, the majority of large corporations publish sustainability reports which outline their activities in these areas. Unfortunately, some of those reports exaggerate the activities of the firm in areas such as protecting the environment, a phenomenon referred to as *greenwashing*.[74] There are organizations that hold businesses to a set of standards when reporting on sustainability, such as the ISO 14000 standards and the Global Reporting Initiative. However, there is not one set of standards that is universally accepted, and typically firms are not required to participate.[75]

We have now discussed the almost overwhelmingly complex global competitive environment that managers face when devising strategies. Fortunately, there are some well-developed models and tools to help managers with these sorts of decisions. In the next three sections, we will examine three different models that managers can use to help their firms to achieve strategic competitiveness and above-average returns.

Learning Objective

1-3 Use the industrial organization (I/O) model to explain how firms can earn above-average returns.

1-3 The I/O Model of Above-Average Returns

From the 1960s through the 1980s, those leading organizations believed that the external environment rather than the internal organization was the strongest influence on the choice of strategy.[76] The industrial organization (I/O) model of above-average returns explains the external environment's dominant influence on the choice of strategy and the actions associated with it. The logic of the I/O model is that a set of industry characteristics, including economies of scale, barriers to market entry, diversification, product differentiation, the degree of concentration of firms in the industry, and market frictions, determine the profitability potential of an industry or a segment of it as well as the actions firms should take to operate profitably.[77] We examine these industry characteristics and explain their influence in Chapter 2.

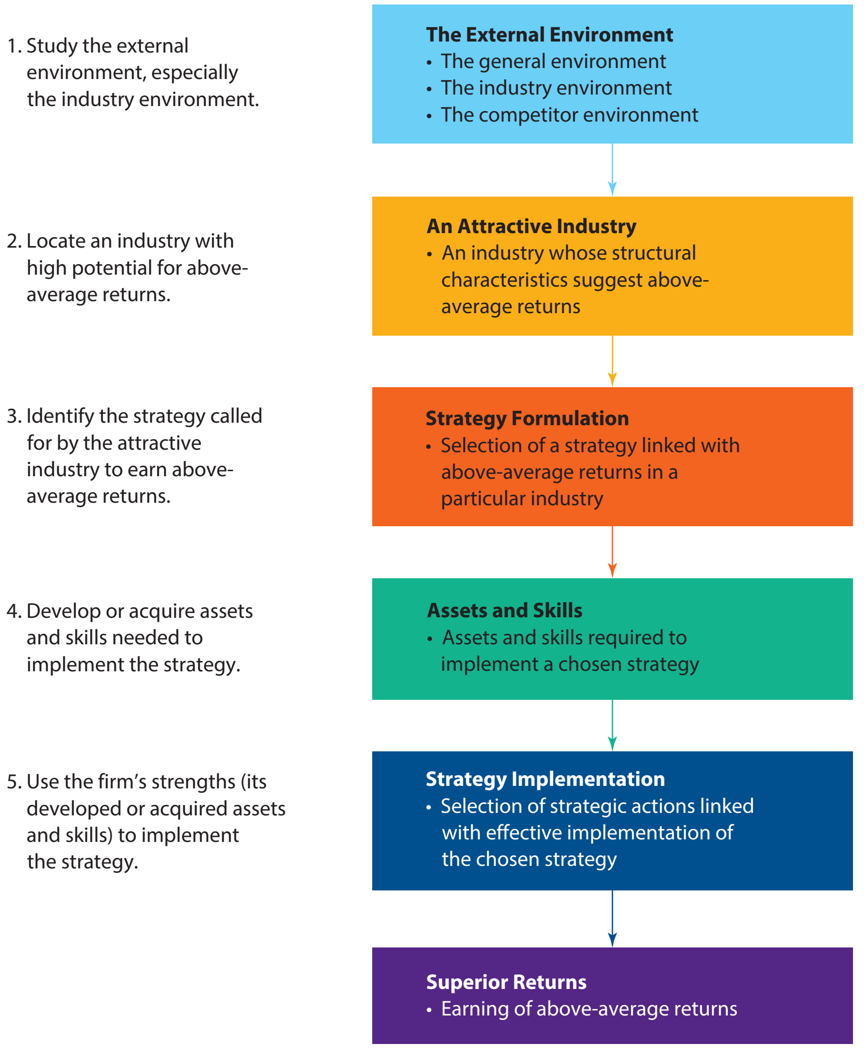
Grounded in economics, four underlying assumptions explain the I/O model. First, the model assumes that the external environment imposes pressures and constraints that determine the strategies that result in above-average returns. Second, most firms competing within an industry or within a segment of that industry are assumed to control similar strategically relevant resources and to pursue similar strategies in light of those resources. Third, resources are highly mobile, meaning that any resource differences that might develop between firms will be short-lived. Fourth, the model assumes that organizational decision makers are rational individuals who are committed to acting in the firm's best interests, as shown by their profit-maximizing behaviors.[78]

The I/O model challenges firms to find the most attractive industry in which to compete, based on the second and third assumptions—that firms possess the same types of valuable resources and that these resources are mobile across companies. This means that a firm is able to increase its performance only when it competes in the industry with the highest profit potential and learns how to use its resources to implement the strategy required by the industry's structural characteristics. The competitive realities associated with the I/O model find firms imitating each other's strategies and actions taken to implement them.[79]

The five forces model of competition is an analytical tool firms use to find the industry that is the most attractive for them. The model (explained in Chapter 2) tries to capture the complexity of competition by suggesting that an industry's profitability is a function of interactions among five forces: suppliers, buyers, competitive rivalry among firms currently in the industry, product substitutes, and potential entrants to the industry.[80] Firms use the five forces model to identify the attractiveness of an industry (as measured by its profitability potential) as well as the most advantageous position for the firm to take in that industry, given the industry's characteristics.[81] The model suggests that firms can earn above-average returns by producing either standardized products at costs below those of competitors (a cost leadership strategy) or by producing differentiated products for which customers are willing to pay a price premium (a differentiation strategy). We discuss the cost leadership and product differentiation strategies fully in Chapter 4.

As shown in Figure 1.2, the I/O model suggests that firms earn above-average returns by studying the external environment effectively as the foundation for identifying an attractive industry and implementing an appropriate strategy in it. For example, in some industries, firms can reduce

Figure 1.2 The I/O Model of Above-Average Returns



competitive rivalry and erect barriers to entry by forming strategic alliances with other companies. In turn, reduced rivalry increases the profitability potential for firms that are collaborating.[82] Companies that develop or acquire the internal skills needed to implement strategies required by the external environment are likely to succeed, while those that do not are likely to fail.[83] Hence, this model suggests that the characteristics of the external environment influence returns more so than do a firm's unique internal resources and capabilities.

Research findings support the I/O model because the industry in which a firm competes explains approximately 20 percent of its profitability. However, research also shows that the firm's resources and capabilities and the actions taken by using them accounts for 36 percent of the variance in firm profitability.[84] Thus, managers' strategic actions affect the firm's performance as do the characteristics of the environment in which the firm competes.[85] These findings suggest that the external environment and a firm's resources, capabilities, core competencies, and competitive advantages (see Chapter 3) influence the company's ability to achieve strategic competitiveness and earn above-average returns.

As shown in Figure 1.2, the I/O model assumes that a firm's strategy is a set of commitments and actions flowing from the characteristics of the industry in which the firm chose to compete. The resource-based model, discussed next, takes a different view of the major influences on a firm's choice of strategy.

Learning Objective

1-4 Use the resource-based model to explain how firms can earn above-average returns.

1-4 The Resource-Based Model of Above-Average Returns

Resources are inputs into a firm's production process, such as capital equipment, the skills of individual employees, patents, finances, and talented managers.

A **capability** is the capacity for a set of resources to perform a task or an activity in an integrative manner.

Core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals.

The resource-based model of above-average returns assumes that each organization is a collection of unique resources and capabilities. The *uniqueness* of resources and capabilities is the basis of a firm's strategy and its ability to earn above-average returns.[86] **Resources** are inputs into a firm's production process, such as capital equipment, the skills of individual employees, patents, finances, and talented managers. Firms use three categories to classify their resources: physical, human, and organizational capital. Described fully in Chapter 3, resources are either tangible or intangible in nature.

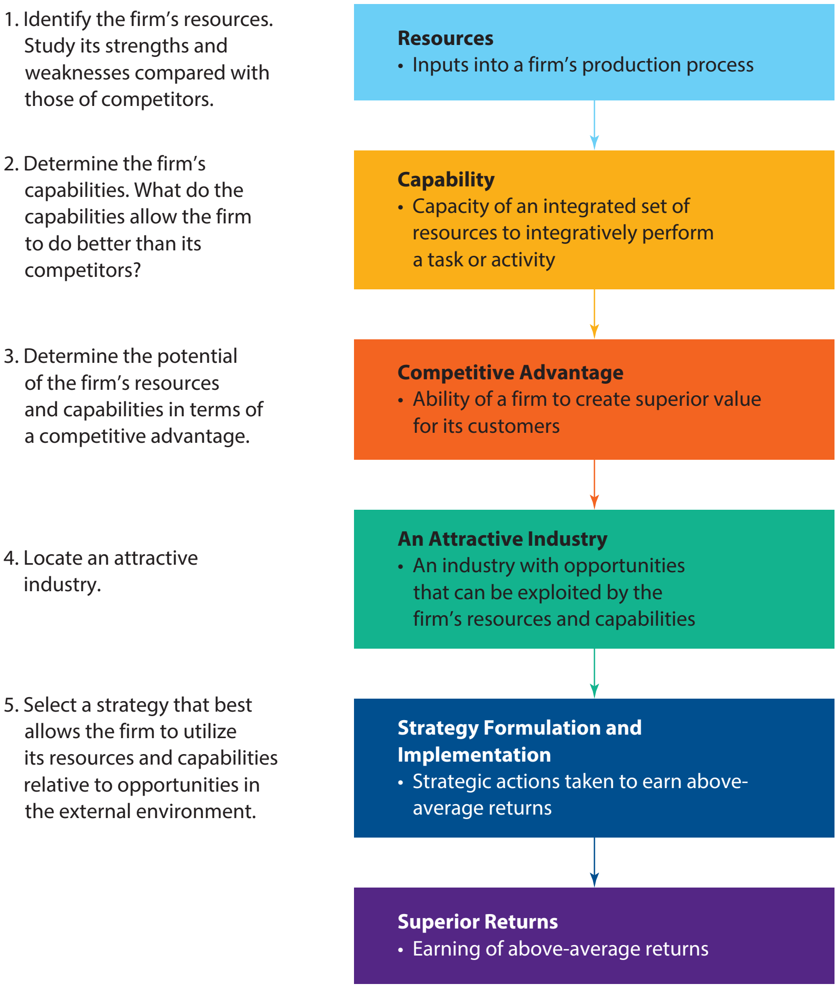
Individual resources alone may not yield a competitive advantage; resources have a greater likelihood of being a source of competitive advantage when integrated to form a capability. A **capability** is the capacity for a set of resources to perform a task or an activity in an integrative manner.[87] **Core competencies** are capabilities that serve as a source of competitive advantage for a firm over its rivals.[88] Core competencies are often visible in the form of organizational functions. For example, Apple's R&D function is one of its core competencies, as is its ability to produce innovative new products that create value for customers. Amazon's distribution function is a core competence while information technology is a core competence for Walmart.

According to the resource-based model, differences in firms' performances across time are due primarily to their unique resources and capabilities rather than the industry's structural characteristics. Through continued use, capabilities become stronger and more difficult for competitors to understand and imitate. As a source of competitive advantage, a capability must not be easily imitated but also not too complex to understand and manage.[89] The resource-based model of above-average returns is found in Figure 1.3. This model suggests that the strategy the firm chooses should allow it to use its competitive advantages in an attractive industry (firms use the I/O model to identify an attractive industry).

Not all of a firm's resources and capabilities have the potential to be the foundation for a competitive advantage. This potential is realized when resources and capabilities are valuable, rare, costly to imitate, and non-substitutable.[90] Resources and capabilities are *valuable* when they allow a firm to take advantage of opportunities or neutralize threats in its external environment. They are *rare* when possessed by few, if any, current and potential competitors. Resources are *costly to imitate* when other firms either cannot obtain them or are at a cost disadvantage in obtaining them compared with a firm that already possesses them. They are *non-substitutable* when they have no practical equivalents.

Over time, competitors find ways to imitate value-creating resources or to create new resources that yield a different type of value for customers. Therefore, it is difficult to achieve and sustain a competitive advantage based on resources alone. Firms integrate individual resources to develop configurations of resources with the potential to build capabilities. Capabilities developed in this manner have a stronger likelihood of becoming a core competence and of leading to a source of competitive advantage.[91]

Figure 1.3 The Resource-Based Model of Above-Average Returns



While the I/O model focuses on industry, which is external to the organization, and the resource-based model focuses on internal resources and capabilities, a third model of above-average returns focuses simultaneously on internal stakeholders (employees) and external stakeholders (customers, suppliers, communities, shareholders), and in particular on the relationships of a firm with these stakeholders. Since all firm resources come from stakeholders, it makes sense that the nature of relationships with those stakeholders will make a big difference in terms of a firm's ability to create and sustain competitive advantages leading to above-average returns. In fact, one of the leading scholars on the resource-based model, Jay Barney, said that if there were no other stakeholders besides shareholders providing resources to the firm that have the potential to earn profits, there would be no profits.[92]

Learning Objective

1-5 Use the stakeholder model to explain how firms can earn above-average returns.

1-5 The Stakeholder Model of Above-Average Returns

Every organization involves a system of stakeholder groups with which it establishes and manages relationships.[93] **Stakeholders** are individuals, groups, and organizations that can both influence and are affected by the objectives, actions, and outcomes of a firm. They are internal and external constituencies that have a strong interest in the activities and outcomes of an organization and upon whom the organization relies on to achieve its own objectives.[94] Internal stakeholders include all of a firm's employees, including both non-managerial and managerial personnel. External stakeholders are a diverse group, and include the major suppliers of a firm's capital as

Stakeholders are individuals, groups, and organizations that can both influence and are affected by the objectives, actions, and outcomes of a firm.

well as product market stakeholders–the firm's customers, suppliers, host communities, and any unions representing the workforce. Also included are regulators and special interest groups or NGOs (non-governmental organizations) that play a role in policing what the firm does.

How can a firm's managers account for all of these different interests when devising competitive strategies? A related question is whether all of these stakeholders are, or should be, equally important when devising strategies to create value and achieve above-average returns. A useful classification between primary and secondary stakeholders helps managers answer both of these questions. **Primary stakeholders** are directly involved in the value-creating processes of the firm. They include suppliers, employees, customers, the communities in which the firm operates, and financiers such as the firm's shareholders and banks. In fact, nearly two hundred CEOs from the largest corporations in the United States released a signed statement through an association called the *Business Roundtable* declaring that the purpose of the corporation is to serve these same five stakeholder groups.[95]

Primary stakeholders are directly involved in the value-creating processes of the firm.

Secondary stakeholders can both influence and are influenced by what the firm does, but they do not contribute directly to the value the firm creates.

Secondary stakeholders can both influence and are influenced by what the firm does, but they do not contribute directly to the value the firm creates. Many successful organizations have learned that taking especially good care of primary stakeholders can lead to competitive advantage and high performance.[96] Some of the sources of competitive advantage, and the value they create, are outlined in Figure 1.4. This sort of management is often called *managing for stakeholders* or *stakeholder-oriented management*.

Figure 1.4 The Stakeholder Model of Above-Average Returns

1. Study external environment to determine which stakeholders are most important to value creating processes.

Stakeholders
- Have a legitimate interest (stake) in what the firm does
- Firm depends on them to achieve its objectives

2. Develop relationships with employees and external stakeholders based on fairness, respect, and trust.

Reciprocity
- Stakeholders want to engage with the firm, are loyal, help the firm achieve its objectives, and are willing to share valuable information

3. Collect valuable information from stakeholders.

Information Useful for Strategic Planning
- Stakeholder needs and wants
- Ideas for improvements to value creation process
- Ideas for product innovation

4. Identify strategies that incorporate information from stakeholders.

Strategy Formulation
- Opportunities to collaborate
- Innovative products
- Enhanced efficiency

5. Develop and carry out plans using collaborations with stakeholders where possible.

Strategy Implementation
- Stakeholder needs and wants
- Ideas for improvements to value creation process
- Potential areas for innovation

Superior Returns
- Earning of above-average returns

Managing for stakeholders implies that more attention and resources are allocated to satisfy the needs of stakeholders than might be necessary simply to retain their participation in the productive activities of the firm.[97] This also means that firms incur greater costs as, for example, they provide better wages and benefits to their employees, give back to the communities in which they operate, and provide high-quality products or outstanding service to customers at prices that are perhaps a little lower than they might otherwise charge. Managing for stakeholders is economically feasible because it leads to behavior on the part of stakeholders that helps the firm create more value than might otherwise be created.[98]

Well-treated stakeholders *reciprocate* by treating the firm and its other stakeholders well in return. One of the fundamental drivers of reciprocity is *fairness*, or what scholars call *organizational justice*.[99] Organizational justice can be divided into three primary types: distributional, procedural, and interactional. *Distributional justice* means that stakeholders feel as though they are receiving value through their relationship with their firm that is commensurate with what they contribute to the firm. For example, an employee who works really hard and provides a lot of good suggestions for firm innovations feels as though they are compensated fairly for the additional value they provide. *Procedural justice* means that the firm listens to stakeholders and considers their positions when making important decisions that are likely to affect them. This does not mean that the firm will always make decisions that have no negative impact on any stakeholder, although this is a worthwhile objective. *Interactional justice* means that all stakeholders are treated with honesty, respect, and integrity. Formal and informal (i.e., promises) contracts are made and kept. Day-to-day transactions with stakeholders typically are positive, and if something goes wrong, the firm does its best to remedy the situation.[100]

Stakeholders that experience this kind of fairness are likely to reciprocate through a higher level of motivation to work with the firm and provide a level of effort and loyalty that they might not provide to another firm in the same industry. Because these sorts of firms tend to develop strong reputations for fairness, new stakeholders will want to be affiliated with them. Communities will welcome expansions, job applications will be higher, and customers will want to buy from and remain loyal to the firm. Suppliers will want to sell to the firm, which means the firm will have more attractive buying propositions and an opportunity to acquire superior resources and develop highly competitive capabilities. In general, stakeholders will be more cooperative with the firm and with each other in value-creating activities.[101]

Organizational justice also leads to higher levels of stakeholder trust, and this means stakeholders will be much more likely to share important information with them. Taking advantage of this sort of trust, companies like Honda and Harley Davidson send out very long surveys to purchasers of their automobiles and motorcycles. The information gathered is tremendously helpful in developing next-generation products, and it would not be made available if customers did not trust that the information they provide would be given attention—that the companies would listen to them. Trust associated with organizational justice is an important source of competitive advantage. In a recent survey, a group reported that "Unlike other online retailers, 67 percent of Amazon customers trust the company to protect their privacy and personal data."[102]

Consider also the advantages from generating feelings of trust among employees. They will be much more likely to share information with management about how to improve products or services, or to improve the efficiency with which they are made and delivered. Also, suppliers who trust a firm will be more willing to invest resources in developing new components for sale to the firm and are also more likely to share information with them that could improve their products and production processes because they believe that the information will not be used opportunistically against them.

These factors can lead to higher levels of innovation, sales growth, and operational efficiency. The contracting process is also more efficient, because high levels of trust mean that contracts will not need to contain as many safeguards or complicated contingency clauses.[103] In addition, because stakeholders are treated well and promises to them are kept, they are much less likely to pursue negative actions such as boycotts, legal suits, walkouts and strikes, lobbying for new regulations, or negative social media activities. This means that a firm that emphasizes organizational justice is a less risky proposition for all of the firm's stakeholders, including those that invest time, material resources, energy, or money in the firm. Also, an enhanced reputation means that potential new stakeholders, such as new customers, new suppliers, and new employees with excellent qualifications, will be attracted to the firm. This can give the firm an edge as it competes with other firms

Strategic Focus

Corporate Social Responsibility, Corporate Social Performance, and ESG

Stakeholder-oriented firms typically exhibit high performance in matters that are important to society, beyond just taking good care of their stakeholders. This sort of performance might be labeled CSR (corporate social responsibility), CSP (corporate social performance), or ESG (environment, society, and governance. These labels are often used interchangeably, which can be confusing even to people who spend their lives studying such phenomena. Regardless of how they are labeled, corporate behaviors associated with social responsibility are very important to many economic actors and a large swath of society.

Scholars who study social responsibility have argued among themselves regarding whether CSR or CSP is a better descriptor of the things a firm does that are either consistent with or go against societal values. However, these same scholars tend to measure the same phenomena in their research, so the debate about terminology is strictly academic. Of course, the term *sustainability*, mentioned previously in this chapter, has also been used in this literature. However, sustainability tends to focus more on environmental issues and a few other issues, whereas CSR and CSP incorporate all areas that are scrutinized by society, which also includes how a firm treats its stakeholders.

Another common label in this literature is ESG. The data provided to the investment community by the firms who track and report information about social responsibility tends to be divided into three categories. The first area is the environment (E), such as the amount of carbon that is released through a firm's operations, the degree to which a firm pollutes in other ways, such as polluting groundwater, and the extent to which its operations destroy or deplete other natural resources such as trees or minerals. In the society (S) category, these firms track a lot of information about how companies treat their stakeholders, their records on matters such as discrimination and inclusion, and whether they engage in "sin" industries such as tobacco or gambling. In the governance (G) area, the rating firms collect information about the firm's board of directors, executive compensation, and reporting transparency. Corporate governance will be discussed in detail in Chapter 10. Over the years, the popular business press and many managers and investors have adopted the ESG label as a descriptor for business activities associated with social responsibility or sustainability.

There is a lot of overlap among the various labels for social responsibility primarily because they measure most of the same things. However, managing for stakeholders is something different. The way a firm manages its stakeholders—how it treats them—is only one component of a measure of CSR, CSP, or ESG. The focus in this section has been on the strategic advantages that can accrue to a firm that treats its stakeholders particularly well, and not on these broader conceptualizations of corporate social responsibility. Although, again, firms that are high on the social responsibility dimensions also tend to take good care of their stakeholders–related, but not the same thing.

Sources: S. Schaltegger, K. L. Christ, J. Wenzig, & R. L. Burritt, 2022, Corporate sustainability management accounting and multi-level links for sustainability–A systematic review, *International Journal of Management Reviews,* in press; J. Mattingly & B. Bailey, 2021, Constructs and measures in stakeholder management research, in M. A. Hitt (ed.), *Oxford Encyclopedia of Business and Management,* New York, Oxford University Press, doi: 10.1093/acrefore/9780190224851.013.316; J. Hörisch, S. Schaltegger, & R. E. Freeman, 2020, Integrating stakeholder theory and sustainability accounting: A conceptual synthesis, *Journal of Cleaner Production,* 275, https://doi.org/10.1016/j.jclepro.2020.124097.

for the most outstanding stakeholders.[104] These sorts of positive outcomes lead to a higher level of value creation than if a firm were to operate in a less fair and trustworthy fashion, especially if noneconomic factors are considered.[105]

As mentioned previously, from an economic perspective, the only way this sort of management pays off is if the economic benefits exceed the additional costs of treating stakeholders better than they need to be treated simply to retain their participation with the firm. Fortunately, research evidence supports the view that firms that manage for stakeholders often enjoy above-average returns compared to firms that do not manage for stakeholders.[106] In addition, as discussed in the Strategic Focus, firms that manage for stakeholders tend also to perform well on related dimensions such as CSR, CSP, and ESG.

1-5a Managing for Stakeholders

Although research confirms a positive relationship between managing for stakeholders and firm performance, not all firms that manage in this way will have above-average returns. This is because stakeholder management is only one important component in the strategic management process. The rest of this book outlines many other important components of devising strategy. Also, situations may occur in which a firm would perform better if they simply engage in what are called *arms-length* transactions with stakeholders.[107] This means that a firm doesn't try to develop close relationships with stakeholders, but simply responds to market forces in buying and selling products and other resources. This approach could be more efficient when innovation, loyalty, and higher levels of stakeholder motivation are not as important, but it doesn't mean the firm should treat stakeholders poorly. Poor treatment of stakeholders is likely to lead to competitive problems over time as stakeholders choose not to engage with the firm.


Ground Picture/Shutterstock.com

Managing for stakeholders can enhance employee motivation and loyalty

Also, the stakeholder model suggests that a firm should treat stakeholders better than competing firms, but does not suggest overzealousness that could lead to "giving away the store." Managers need to be careful in allocating their time, attention, and the firm's resources across their stakeholders. One of the keys to managing for stakeholders is determining how much is too much when it comes to allocations to stakeholders. From an economic efficiency perspective, it is best to offer to each stakeholder a value proposition that is just noticeably better than what they would get if they engage in the same sort of transactions with a competing firm.[108] These sorts of value allocations to a stakeholder can unlock many of the benefits from stakeholder-oriented management, such as loyalty or a higher level of motivation to work with the firm to create additional value. Allocations beyond this level could lead to feelings among some stakeholders that a firm is showing favoritism, thus reducing the sense that the firm is being fair. Or, over time, greatly disparate allocations could mean that the firm has insufficient resources to invest in other important resource areas or stakeholders.

Although organizations have dependency relationships with all their primary stakeholders, they are not equally dependent on all stakeholders at all times. Unequal dependencies mean that stakeholders possess different degrees of ability to influence an organization.[109] The more critical and valued is a stakeholder's participation, the greater is a firm's dependency on that stakeholder. Greater dependence, in turn, gives the stakeholder more potential influence over a firm's commitments, decisions, and actions. Managers must find ways to either accommodate or insulate the organization from the demands of stakeholders controlling critical resources.[110]

The I/O, resource-based, and stakeholder models all help firms devise competitive strategies. They do not contradict each other, but rather view the organization through three different lenses. They are also helping in determining a firm's overall purpose, as reflected in vision, mission, and values, which are the topics of the next section.

1-6 Vision, Mission, and Values

Learning Objective

1-6 Describe vision, mission, and values, and explain why they are important.

After analyzing the external environment, the internal organization, and relationships with stakeholders, the firm has the information required to form its vision, mission, and values (see Figure 1.1). Stakeholders learn a great deal about a firm by studying its vision, mission, and values. Indeed, a key purpose of these statements is to inform stakeholders of what the firm is, what it seeks to accomplish, and who it seeks to serve.

1-6a Vision

Vision is a picture of what the firm wants to be and, in broad terms, what it wants to achieve.[111] Thus, a vision statement articulates the ideal description of an organization and gives shape to its intended future. In other words, a vision statement points the firm in the direction of where it would like to be in the years to come. An effective vision stretches and challenges people as well. In her book about Steve Jobs, Apple's former CEO, Carmine Gallo, argues that Jobs's vision for the firm was a key reason for Apple's innovativeness during his tenure. She suggests that he thought bigger and differently than do most people. To be innovative, she explains that one has to think differently about the firm's products and customers, and create high expectations.[112]

Vision is a picture of what the firm wants to be and, in broad terms, what it wants to ultimately achieve.

As a reflection of values and aspiration, firms hope that their vision statement will capture the heart and mind of each employee and, hopefully, other stakeholders as well. A firm's vision tends to be enduring while its mission can change with new environmental conditions. A vision statement tends to be relatively short and concise, making it easily remembered. Examples of vision statements include the following:

To make this world a mobile, sustainable place with access to all the citizens. (Volkswagen)

Drawing strength from our rich history, we will be the best, most admired, and innovative financial services institution, partnering with our customers, employees, and shareholders in wealth and value creation. (China Bank)

To be the communications leader in an increasingly connected world. (Vodaphone)

As a firm's most important and prominent strategic leader, the CEO is responsible for working with others to form the firm's vision. Experience shows that the most effective vision statement results when the CEO involves a host of stakeholders (e.g., other top-level managers, employees working in different parts of the organization, suppliers, and customers) to develop it. Conditions in the firm's external environment and internal organization influence the forming of a vision statement. Moreover, the decisions and actions of those involved with developing the vision, especially the CEO and the other top-level managers, must be consistent with it.

1-6b Mission

A **mission** specifies the businesses in which the firm intends to compete and the customers it intends to serve.

The vision is the foundation for the firm's mission. A **mission** specifies the businesses in which the film intends to compete and the customers it intends to serve.[113] The firm's mission is more concrete than its vision. However, similar to the vision, a mission should establish a firm's individuality and should be inspiring and relevant to all stakeholders. Together, the vision and mission provide the foundation the firm needs to choose and implement one or more strategies. The probability of forming an effective mission increases when employees have a strong sense of the ethical standards that guide their behaviors as they work to help the firm reach its vision.[114] Thus, business ethics are a vital part of the firm's discussions to decide what it wants to become (its vision) as well as who it intends to serve and how it desires to serve those individuals and groups (its mission).[115]

Even though the final responsibility for forming the firm's mission rests with the CEO, the CEO and other top-level managers often involve other people to develop the mission statement. The main reason for this is that the mission deals more directly with product markets and customers. Compared to a firm's senior-level leaders, middle- and first-level managers and other employees interact frequently with customers and the markets the firm serves. The mission of the American Red Cross is as follows:

The American Red Cross prevents and alleviates human suffering in the face of emergencies by mobilizing the power of volunteers and the generosity of donors.

This mission statement flows from the humanitarian purpose of the Red Cross, but it also provides a clear statement of what it does, who it serves, and how it does it. Likewise, the International Red Cross Committee, an independent organization based in Geneva, Switzerland, has a staff of 20,000 working in more than 100 countries. They also have a very specific mission that focuses primarily on victims of conflict, but also extends into promoting political and social humanitarian law:

The International Committee of the Red Cross is an impartial, neutral and independent organization whose exclusively humanitarian mission is to protect the lives and dignity of victims of armed conflict and other situations of violence and to provide them with assistance. The ICRC also endeavours to prevent suffering by promoting and strengthening humanitarian law and universal humanitarian principles.

Globally, the symbol of a red cross is understood to be associated with humanitarian aid; however, these two noble organizations have a very different mission within this general category of giving aid to those in distress.

The **values** of an organization define what should matter most to managers and employees when they make and implement strategic decisions.

1-6c Values

The **values**—sometimes called core values—of an organization define what should matter most to managers and employees when they make and implement strategic decisions. They also help guide what is rewarded and reinforced in the organization. They are a practical application of business ethics.[116] For instance, if an organization puts a lot of value on treating customers with respect, then behavior that exhibits customer respect should be acknowledged and rewarded.

Values can help a firm define its purpose and answer the fundamental question of what the firm stands for. If they are well communicated and reinforced, they should help determine the way stakeholders are treated and their priority in important decisions. Core values are sometime incorporated into a firm's mission statement, but today more and more firms are putting them in separate statements to reinforce to stakeholders what they stand for. In a world that is ever more vigilant about business behaviors as they relate to social responsibility, this is a wise thing to do. However, firms also need to exhibit behaviors that are consistent with their values or these types of statements can backfire and cause considerable damage to their reputations.[117]

McDonald's is arguably the most successful fast-food chain in the world. McDonald's stated values are:

- *Serve: We put our customers and people first*
- *Inclusion: We open our doors to everyone*
- *Integrity: We do the right thing*
- *Community: We are good neighbors*
- *Family: We get better together*[118]

Clearly, ineffectively developed vision, mission, and values statements fail to provide the direction a firm needs to take appropriate strategic actions. This is undesirable in that, as shown in Figure 1.1, a firm's vision, mission, and values are critical aspects of the *analysis* and the foundation required to engage in *strategic actions* that help to achieve strategic competitiveness and earn above-average returns. Therefore, firms must accept the challenge of forming effective vision, mission, and values statements.

1-7 Strategic Leaders

Learning Objective

1-7 Describe strategic leaders and what they do.

Strategic leaders are people located in different areas and levels of the firm using the strategic management process to select actions that help the firm achieve its vision, fulfill its mission, and adhere to its values. Regardless of their location in the firm, successful strategic leaders are decisive, committed to nurturing those around them, and committed to helping the firm create value for all stakeholder groups.[119]

Strategic leaders are people located in different areas and levels of the firm using the strategic management process to select actions that help the firm achieve its vision, fulfill its mission, and adhere to its values.

When identifying strategic leaders, most of us tend to think of CEOs and other top-level managers. Clearly, these people are strategic leaders. In the final analysis, CEOs are responsible for making certain their firm uses the strategic management process successfully. However, many others help choose a firm's strategy and the actions to implement it.[120] The reason for this is that the realities of twenty-first-century competition mentioned earlier in this chapter (e.g., the global economy, globalization, rapid technological change, emphasis on social responsibility) create a need for those "closest to the action" to play a role in choosing and implementing the firm's strategy. In fact, all managers (as strategic leaders) must think globally and act locally.[121] Thus, the most effective CEOs and top-level managers understand how to delegate strategic responsibilities to people throughout the firm who influence the use of organizational resources.[122]

Strategic leaders' decisions and actions shape a firm's culture. **Organizational culture** refers to the complex set of ideologies, symbols, and core values that individuals throughout the firm share and that influence how the firm conducts business. Organizational culture is the social energy that drives—or fails to drive—the organization.[123] For example, many believe that the culture at Southwest Airlines is unique and valuable. Its culture encourages employees to work hard but also to have fun while doing so. Moreover, its culture entails respect for others—employees and customers alike. The firm also places a premium on service, as suggested by its commitment to provide POS (Positively Outrageous Service) to each customer.

Organizational culture refers to the complex set of ideologies, symbols, and core values that individuals throughout the firm share and that influence how the firm conducts business.

This is just a short introduction to strategic leadership and what strategic leaders do. Chapter 12 explores these topics in depth.

Learning Objective

1-8 Explain the strategic management process.

1-8 The Strategic Management Process

As suggested by Figure 1.1, the strategic management process is a rational approach firms use to achieve strategic competitiveness and earn above-average returns. Figure 1.1 also features the topics we examine in this book to present the strategic management process.

We divide this book into three parts—parts that align with the A-S-P process explained in the beginning of the chapter. In Part 1, we describe the *analyses* (A) firms use to develop strategies. Specifically, we explain how firms analyze their external environment (Chapter 2) and internal organization (Chapter 3). Firms complete these analyses to identify marketplace opportunities and threats in the external environment (Chapter 2) and to decide how to use the resources, capabilities, core competencies, and competitive advantages in their internal organization to pursue opportunities and overcome threats (Chapter 3). Firms use knowledge about their external environment and internal organization to formulate strategies in light of their vision, mission, and values.

The firm's analyses (see Figure 1.1) provide inputs that are the foundation for choosing one or more *strategies* (S) and deciding which one(s) to implement. As suggested in Figure 1.1 by the horizontal arrow linking the two types of strategic actions, firms simultaneously integrate formulation and implementation as a basis for a successful strategic management process. Integration occurs as decision makers review implementation issues when choosing strategies and when considering potential adaptations to a strategy during the implementation process.

In Part 2, we discuss the different strategies firms may choose to use. First, we examine business-level strategies (Chapter 4). A business-level strategy describes actions a firm takes to exploit its competitive advantage(s). A company competing in a single product market (e.g., a locally owned grocery store operating in only one location) has but one business-level strategy, while a diversified firm competing in multiple product markets (e.g., Siemens AG) forms a business-level strategy for each of its businesses. In Chapter 5, we describe the actions and reactions that occur among firms as they engage each other in competition. Competitors typically respond to and try to anticipate each other's actions. The dynamics of competition affect the strategies firms choose as well as how they intend to implement those strategies.[124]

Determining the businesses in which the company intends to compete as well as how it will manage those businesses is the focus of corporate-level strategy (Chapter 6). Companies competing in more than one business experience diversification in the form of products (Chapter 7) and/or geographic markets (Chapter 8). Other topics vital to strategy formulation, particularly in the diversified company, include acquiring other businesses and, as appropriate, restructuring the firm's portfolio of businesses (Chapter 7) and selecting an international strategy (Chapter 8). With cooperative strategies (Chapter 9), firms form a partnership to share their resources and capabilities to develop a competitive advantage.

To examine the actions firms take to implement strategies, we consider several topics in Part 3. First, we examine the different mechanisms companies use to govern themselves (Chapter 10). With different stakeholders (e.g., financial investors and board of directors' members) demanding improved corporate governance today, organizations seek to identify paths to follow to satisfy these demands.[125] In the last three chapters, we address the organizational structure and actions needed to control a firm's operations (Chapter 11), the patterns of strategic leadership appropriate for today's firms and competitive environments (Chapter 12), and strategic entrepreneurship (Chapter 13) as a path to continuous innovation.

As you will discover, the strategic management process we present to you in this book calls for disciplined approaches to serve as the foundation for developing a competitive advantage. Therefore, the process has a major effect on the *performance* (P) of the firm. Mastery of this strategic management process contributes positively to a firm's efforts to achieve strategic competitiveness and, in doing so, to create value for its stakeholders.

Summary

- Firms use the strategic management process to achieve strategic competitiveness and earn above-average returns. Firms *analyze* the external environment and their internal organization, then formulate and implement a *strategy* to achieve a desired level of *performance* (A-S-P). The firm's level of strategic competitiveness and the extent to which it earns above-average returns reflects its performance. Firms achieve strategic competitiveness by developing and implementing a value-creating strategy. Above-average returns (in excess of what investors expect to earn from other investments with similar levels of risk) provide the foundation for satisfying all of a firm's stakeholders simultaneously.
- The fundamental nature of competition is different in the current competitive landscape. As a result, those making strategic decisions must adopt a different mind-set—one that allows them to learn how to compete in highly turbulent and chaotic environments that produce a great deal of uncertainty. The globalization of industries and their markets along with rapid and significant technological changes and an emphasis on social responsibility are primary factors contributing to the turbulence of the competitive landscape.
- Firms use three major models to help develop their vision, mission, and values, while choosing one or more strategies to pursue strategic competitiveness and above-average returns. The core assumption of the I/O model is that the firm's external environment has a larger influence on the choice of strategies than does its internal resources, capabilities, and core competencies. Thus, firms use the I/O model to understand the effects an industry's characteristics can have on them when selecting a strategy or strategies to use to compete against rivals. The logic supporting the I/O model suggests that firms earn above-average returns by locating an attractive industry or part of an attractive industry and then successfully implementing the strategy dictated by that industry's characteristics.
- The core assumption of the resource-based model is that the firm's unique resources, capabilities, and core competencies have more of an influence on selecting and using strategies than does the firm's external environment. When firms use their valuable, rare, costly-to-imitate, and non-substitutable resources and capabilities effectively, when competing against rivals in one or more industries, they earn above-average returns.
- The stakeholder model focuses on the nature of relationships between the firm and its stakeholders. Excellent relationships based on principles associated with organizational justice (fairness) result in a high level of reciprocity from stakeholders and a number of other positive outcomes that result in the firm creating more value for stakeholders, thus producing above-average returns.
- The firm's vision, mission, and values guide its selection of strategies based on the information from analyses of its external environment; internal organization; and stakeholder needs, wants, and other valuable information they provide to the firm. Vision is a picture of what the firm wants to be and, in broad terms, what it wants to achieve ultimately. Flowing from the vision, the mission specifies the business or businesses in which the firm intends to compete and the customers it intends to serve. Values pertain to the purpose of the firm and how it will conduct business. Vision, mission, and values provide direction to the firm and signal important descriptive information to stakeholders.
- Strategic leaders are people located in different areas and levels of the firm using the strategic management process to help the firm achieve its vision and fulfill its mission. In general, CEOs are responsible for making certain that their firms use the strategic management process properly; however, the participation of strategic leaders in all parts of the organization is important. The decisions and actions of strategic leaders help determine the culture of the organization, which in turn influences the effectiveness of the strategic management process.

Key Terms

above-average returns 5
average returns 5
capability 14
competitive advantage 4
core competencies 14
global economy 7
global supply chain 8
global value chain 8
globalization 8
hypercompetition 7
mission 20
organizational culture 21
primary stakeholders 16
protectionism 7
resources 14
risk 5
secondary stakeholders 16
stakeholders 15
strategic competitiveness 4
strategic flexibility 11
strategic leaders 21
strategic management process 5
strategy 4
sustainability 12
values 20
vision 19

Review Questions

1. What are strategic competitiveness, strategy, competitive advantage, above-average returns, and the strategic management process?
2. What are the characteristics of the current competitive landscape? What factors are the primary drivers of this landscape?
3. According to the I/O model, what should a firm do to earn above-average returns?
4. What does the resource-based model suggest a firm should do to earn above-average returns?
5. Based on the stakeholder model, what can a firm do to earn above-average returns?
6. What are vision, mission, and values?
7. How would you describe the work of strategic leaders?
8. What are the elements of the strategic management process? How are they interrelated?

Mini-Case

Kipling Instruments Faces a Severe Economic and Ethical Dilemma

Sherry Ho is the CEO of Kipling Instruments, a 50-year-old company that sells smoke detectors primarily to discount stores and hardware stores across the United States. The company also maintains a website through which the final consumers of the products can buy directly from the company. However, this does not account for many of their sales. Kipling does not sell through online retailers such as Amazon because its primary customers (discount and hardware stores) have expressed the sentiment that doing so would erode their own sales, and Kipling is very loyal to its customers.

Smoke detectors are a part of the consumer electronics industry and, like most firms in this industry, Kipling has been battered by foreign competitors that offer a similar product at a lower price. Kipling has stayed afloat because of its reputation for offering a reliable product and because of its long-term relationships with customers. However, price differentials have eroded Kipling sales. In an effort to stay competitive, 20 years ago Kipling began subcontracting the manufacturing of its products overseas. The company now works with manufacturing companies in Vietnam and Poland, although the Vietnamese company fills most of the orders. All of Kipling's products are still designed in house, and they are carefully inspected and tested when they arrive at the warehouse to make sure they are of the highest quality and reliability.

The company operates out of a leased office and warehouse in a small town in a remote part of the midwestern United States, and has approximate sales of $50 million. Sherry became CEO five years ago when the founder retired. Prior to the appointment, she was with the company for five years as a sales manager and later as the administrative assistant for four years. She got the sales manager job immediately upon graduation from University of Kansas with a B.S. in business. In addition to Sherry, Kipling's 14 employees all include an administrative assistant, four sales managers, an electrical engineer who designs and inspects the detectors, a purchasing agent, a warehouse supervisor, two warehouse employees, a driver, and two custodians, who also handle most of the maintenance of the office and warehouse. The electrical engineer is highly skilled and has a master's degree in mechanical engineering as well as many years of experience. The sales managers have been with the company for a minimum of 10 years. The purchasing agent works part-time for the company on an as-needed basis, and is fluent in English, Vietnamese, Thai, and also knows some Polish. The rest of the employees do not have any special skills or training.

Kipling Instruments is incorporated. The founding family, a 72-year-old retired Polish immigrant and his 80-year-old wife (no children and no relatives in the United States), own 60 percent of the stock. The other 40 percent is owned by employees, who acquired the stock through an Employee Stock Ownership Plan (ESOP) in which they receive 100 shares of stock for each year of service. The stock is not traded on any exchange and the company has been paying a $10 per share dividend on it for the past 10 years. The founding family now relies on these dividends as a primary source of income. For the past five years, the company has been providing financial support to a local community organization that provides meals in the homes of low-income older adults. The company has a strong reputation for integrity and for treating all of its employees well.

The work process is fairly simple. The sales managers have divided the continental United States into four regions. They travel around the country, making calls on the purchasing managers of discount stores and hardware stores throughout their regions. They not only make the initial sales calls, but they follow up to make sure their customers are satisfied. In spite of this outstanding service, the company has not landed a huge account such as Walmart, but it has several large regional chains on its customer list.

The sales managers offer the company's standard line of smoke detectors, but some customers want something a little different. In these cases, if the customer is large enough, the company engineer will design the product and send the specifications to the purchasing agent, who then meets with manufacturers in Vietnam or Poland to secure a contract. The purchasing agent manages all contacts with suppliers and ensures that products are shipped on time and according to specifications. When the smoke detectors arrive at the warehouse, the engineer inspects them for quality. Some are put in inventory and some are shipped immediately to the customer. The warehouse employees manage the inventory and load the outgoing smoke detectors on a company vehicle. The driver then delivers them to customers if they are within a 100-mile radius, but most are delivered to third-party shipping companies in a larger city about 50 miles away. The shipping companies then take responsibility for delivery to customers.

As mentioned previously, intense and growing competition has created some serious financial problems for the company. Sales have remained stable because of excellent customer service and product quality, but competition has forced the company to reduce its prices, especially on the standard products it sells (margins are still good on custom products). Overall, margins have eroded to the point that the company has been losing money in some years. Three years ago, the company began to take on new debt in the form of bank loans to cover some of its operating costs. The local bank was willing to finance this rough spot because of its long-term relationship with the company and a belief that Sherry would figure things out. However, the bank is losing patience because things don't seem to be improving, and recently demanded a large payment on the company's debt. Unfortunately, the company is currently having difficulty paying its employees and other expenses.

In the middle of this difficult situation, there was some hope. Three months ago, a large regional discount department store chain called Way-to-Go placed a very large order for some custom smoke detectors. They followed the same design as one of the basic detectors, but Way-to-Go wanted them in a light brown color instead of white. This was easy to do, but because they were a custom order, the light brown detectors also provided a higher margin. The engineer quickly sent the specifications to the purchasing agent, who secured the contract with a manufacturer in Vietnam. The detectors were shipped and had just arrived. If the detectors are sent out immediately and Way-to-Go pays for the detectors within 30 days or so after delivery, the large sale would provide enough cash to make the payment the bank was requiring, as well as cover other expenses for a few months.

Sherry was wondering if the new account could at least buy the company some time while she figures out what to do. Then she heard a knock on the door. It was Izzy, the engineer. There was a problem during the testing of the new smoke detectors. They worked, but they worked at a level of smoke detection that was too high to be safe. He immediately contacted the purchasing agent in Vietnam, who gave him more bad news. The company that manufactured the detectors had some problems with other accounts, and they went out of business shortly after the detectors were shipped. However, Izzy assured Sherry that there was no chance that Way-to-Go would ever find out that the smoke detectors would not work the way they are supposed to work.

Besides the short-term question about whether to inform the customer, Way-to-Go, about the smoke alarms, Sherry was wondering about the possibility of reshoring (bringing back in house) at least some of their own manufacturing, given their problems with suppliers, the recent trend toward less globalization, supply constraints during the COVID-19 pandemic, and other uncertainties associated with severe political conflicts on the horizon affecting trade between countries. She was also wondering whether, in the longer term, Kipling might use its connections and expertise to diversify into other products, and whether it was time to develop a new approach to digital marketing.

Source: This is a fictional company but reflects the competitive situation of many small, medium-sized, or even some larger companies around the world.

Mini-Case Questions

1. Is Kipling Instruments in an attractive industry? What are the factors that make the industry attractive or unattractive? Based on this analysis, do you think it is easy or difficult to earn above-average returns in this industry?
2. Describe the primary resources Kipling uses in its business. Could any of these resources be considered core competencies leading to a competitive advantage over Kipling's rivals in the industry? If they are, do you believe the competitive advantage is likely to be sustainable?
3. If Sherry decides to tell Way-to-Go about the problem with the smoke detectors, what will be the possible impact on Kipling's primary stakeholders (founder, employees, community, bank, suppliers, customers)? On balance, would a decision to tell Way-to-Go do more harm or good?
4. Assuming that Sherry decides to tell Way-to-Go about the problem, what are some of the short-term actions Sherry can take to try to rescue the company?
5. From a strategic (longer-term) perspective, what should Kipling consider doing to enhance performance and avoid this type of situation in the future?

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Chapter 2

The External Environment: Opportunities, Threats, Industry Competition, and Competitor Analysis

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

2-1 Explain the importance of analyzing and understanding the firm's external environment.

2-2 Define and describe the general environment and the industry environment.

2-3 Discuss the four parts of the external environmental analysis process.

2-4 Name and describe the general environment's seven segments.

2-5 Identify the five competitive forces and explain how they determine an industry's profitability potential.

2-6 Define strategic groups and describe their influence on firms.

2-7 Describe what firms need to know about their competitors and different methods used to collect intelligence about them.

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Tupperware Struggles to Change with the Times

In early 2020, Tupperware Brands Corp. appointed Miguel Fernandez as its new chief executive officer. Miguel has a background in sales, having served in executive positions at Avon Products Inc. and Herbalife Nutrition Ltd. The company hoped that Mr. Fernandez would be able to revitalize a company that has struggled at times to keep up with changes in its environment. Tupperware relies on an independent sales force to host parties and distribute the company's plastic containers and beauty products.

Although Tupperware's signature plastic containers basically created the modern food storage market, consumers now have many options for both food containers and beauty products. In this highly competitive environment, the company has been struggling to find new sellers to reach consumers. In fact, when Mr. Fernandez took over, the number of people who were actively selling Tupperware products had been shrinking, with a 7% annual decline in the United States and Canada, a 16% drop in South America, and a 22% decline in Asia. Worldwide, the company had a little over half a million active sellers. These declines followed years of sagging revenues and profits, as consumers no longer had a strong connection with the brand.

In 2020, things changed. People were spending more time at home due to the COVID-19 pandemic, cooking their own food, and looking for ways to store leftovers. Even as restaurants lost revenue, demand for Tupperware's products increased dramatically. The stock nearly quadrupled in share price in 2020, accompanied by increasing revenues and profits.

Yati Yahaya/Shutterstock.com

Unfortunately, Tupperware's fortunes changed rather quickly as the initial effects from COVID-19 wore off, and the markets in which the company competes normalized. The stock slipped again and company executives began buying up shares. The company also added three board members to help develop a turnaround strategy. To slim down its operations and focus on what is most important, Tupperware began selling some of its non-core businesses, such as its House of Fuller beauty business in Mexico and its Avroy Shain beauty business in South Africa. In addition, the company sold off some of its real estate holdings near its headquarters in Orlando, Florida.

Even as the company was slimming down, it developed ambitious plans for growth. Tupperware had plans to open a global sourcing center in Singapore to manage product innovation and growth into new markets. According to Sandra Harris, chief operations officer, Tupperware is planning to expand beyond its current businesses into new markets that serve more customer needs. It is still uncertain whether the company will regain competitiveness. The industries in which Tupperware competes are flooded with high-end competitors as well as cheap imitations for what the company sells.

Sources: A. Keller, 2022, Tupperware Brands, *Florida Trend,* www.global.factiva.com, February 1; 2021, Tupperware Brands announces new global sourcing and supply chain center of excellence in Singapore, *PR Newswire,* www.global.factiva.com, December 9; E. Lin, 2021, Tupperware stock is slipping, and executives are buying up shares, *Barron's,* www.barrons.com, March 26; M. Maidenberg, 2020, Tupperware brands names new CEO as business looks for traction, *Barron's,* www.barrons.com, March 12; M. Maidenberg, 2020, How Tupperware lost its grip on America's kitchens, *Wall Street Journal,* www.wsj.com, March 8.

Learning Objective

2-1 Explain the importance of analyzing and understanding the firm's external environment.

2-1 Understanding the Firm's External Environment

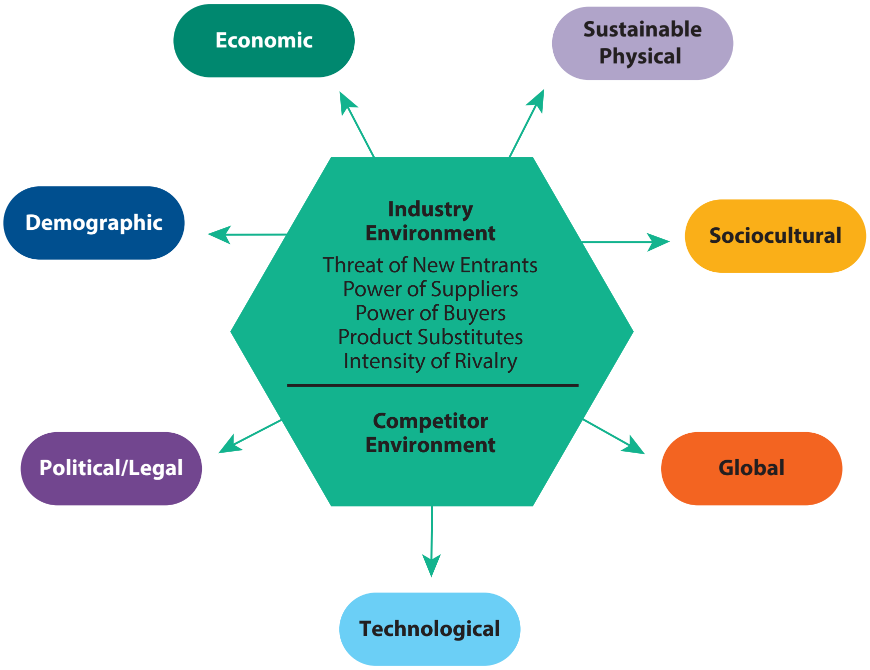
As suggested in the Opening Case, the external environment affects the competitive actions and responses firms take to outperform competitors and earn above-average returns.[1] For example, although Tupperware was a pioneer in creating a market for plastic storage containers worldwide, intense competition eventually eroded their first-mover advantage, and the company was struggling to figure out a way to grow. Tupperware's diversification into beauty products fit nicely with the concept of marketing products through private sellers. However, the beauty products market is also flooded with competitors. For a while it appeared that changes in the environment associated with the pandemic were going to reinvigorate the Tupperware brand; however, growth was fleeting, and now that things have normalized, Tupperware is basically trying to reinvent itself through product innovations and expansion into new markets through its new facility in Singapore.

As noted in Chapter 1, the characteristics of today's external environment differ from historical conditions. For example, technological changes and the continuing growth of information gathering and processing capabilities increase the need for firms to develop effective competitive actions and responses on a timely basis.[2] (We fully discuss competitive actions and responses in Chapter 5). Additionally, the rapid sociological changes occurring in many countries affect labor practices and the nature of products that an increasingly diverse group of consumers demand. Governmental policies and laws also affect where and how firms choose to compete.[3] And, changes to several nations' financial regulatory systems were enacted after the financial crisis in 2008–2009 that increased the complexity of organizations' financial transactions.[4]

Firms understand the external environment by acquiring information about competitors, customers, and other stakeholders to build their own base of knowledge.[5] On the basis of the new information, firms take actions, such as building new capabilities and core competencies, in the hope of buffering themselves from any negative environmental effects and to pursue opportunities to better serve their stakeholders' needs.[6]

A firm's competitive actions and responses are influenced by conditions in the three parts of its external environment—the general environment, the industry environment, and the competitor environment (see Figure 2.1)—and its understanding of those conditions.[7] Next, we fully describe each part of the firm's external environment.

Figure 2.1 The External Environment



2-2 The General and Industry Environments

Learning Objective

2-2 Define and describe the general environment and the industry environment.

The **general environment** is composed of dimensions in the broader society that influence an industry and the firms within it.[8] We group these dimensions into seven environmental *segments*: demographic, economic, political/legal, sociocultural, technological, global, and sustainable physical. Examples of *elements* analyzed in each of these segments are shown in Table 2.1.

Firms cannot directly control the general environment's segments. Accordingly, what a company seeks to do is recognize trends in each segment of the general environment and then *predict* each trend's effect. For example, it has been predicted that over the next 10 to 20 years, millions of people living in emerging market countries will join the middle class. In fact, by 2030, it is predicted that two-thirds of the global middle class, about 525 million people, will live in the Asia-Pacific region of the world.[9] Of course, this is not surprising given that almost 60 percent of the world's population is located in Asia.[10] No firm, including large multinationals, is able to control where growth in potential customers may take place in the next couple of decades. Nonetheless, firms must study this anticipated trend as a foundation for predicting its effects on their ability to identify strategies to use that will allow them to remain successful as market conditions change.

The **industry environment** is the set of factors that directly influences a firm and its competitive actions and responses: the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes, and the intensity of rivalry among competing firms.[11] In total, the interactions among these five factors determine an industry's profitability potential; in turn, the industry's profitability potential influences the choices each firm makes about its competitive actions and responses. The challenge for a firm is to locate a position within an industry where it can favorably influence the five factors or where it can successfully defend itself against their influence. The greater a firm's capacity to favorably influence its industry environment, the greater the likelihood it will earn above-average returns.

In **competitor analysis**, firms gather and interpret information about their competitors. Understanding the firm's competitor environment complements the insights provided

The **general environment** is composed of dimensions in the broader society that influence an industry and the firms within it.

The **industry environment** is the set of factors that directly influences a firm and its competitive actions and responses: the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes, and the intensity of rivalry among competing firms.

In **competitor analysis**, firms gather and interpret information about their competitors.

Table 2.1 The General Environment: Segments and Elements

Demographic segment	• Population size • Age structure • Geographic distribution	• Ethnic mix • Income distribution
Economic segment	• Inflation rates • Interest rates • Trade deficits or surpluses • Budget deficits or surpluses	• Personal savings rate • Business savings rates • Gross domestic product
Political/Legal segment	• Antitrust laws • Taxation laws • Deregulation philosophies	• Labor training laws • Educational philosophies and policies
Sociocultural segment	• Women in the workforce • Workforce diversity • Attitudes about the quality of work life	• Shifts in work and career preferences • Shifts in preferences regarding product and service characteristics
Technological segment	• Product innovations • Applications of knowledge	• Focus of private and government-supported R&D expenditures • New communication technologies
Global segment	• Important political events • Critical global markets	• Newly industrialized countries • Different cultural and institutional attributes
Sustainable physical environment segment	• Energy consumption • Practices used to develop energy sources • Renewable energy efforts • Minimizing a firm's environmental footprint	• Availability of water as a resource • Producing environmentally friendly products • Reacting to natural or man-made disasters

by studying the general and industry environments.[12] This means, for example, that Tupperware needs to do a better job of analyzing and understanding its general and industry environments.

An analysis of the general environment focuses on environmental trends and their implications, an analysis of the industry environment focuses on the factors and conditions influencing an industry's profitability potential, and an analysis of competitors is focused on predicting competitors' actions, responses, and intentions. In combination, the results of these three analyses influence the firm's vision, mission, values, choice of strategies, and the competitive actions and responses it will take to implement those strategies. Although we discuss each analysis separately, the firm can develop and implement a more effective strategy when it successfully integrates the insights provided by analyses of the general environment, the industry environment, and the competitive environment.

Learning Objective

2-3 Discuss the four parts of the external environmental analysis process.

2-3 External Environmental Analysis

Most firms face external environments that are turbulent, complex, and global. These conditions make interpreting environments difficult.[13] To cope with often ambiguous and incomplete environmental data and to increase understanding of the general environment, firms complete an *external environmental analysis*. This analysis has four parts: scanning, monitoring, forecasting, and assessing (see Table 2.2).

An **opportunity** is a condition in the general environment that, if exploited effectively, helps a company reach strategic competitiveness.

A **threat** is a condition in the general environment that may hinder a company's efforts to achieve strategic competitiveness.

Identifying opportunities and threats is an important objective of studying the general environment. An **opportunity** is a condition in the general environment that, if exploited effectively, helps a company achieve strategic competitiveness. For example, an aging population in the United States is providing opportunities for companies in health care and nursing homes, and advances in technology have created opportunities for educational institutions worldwide to offer new programs, even in developing nations.[14] Most companies—and certainly large ones—continuously encounter multiple opportunities as well as threats.

A **threat** is a condition in the general environment that may hinder a company's efforts to achieve strategic competitiveness.[15] Intellectual property protection has become a significant issue not only within a country but also across country borders. For example, during his presidency, President Donald Trump placed tariffs on goods exported from China into the United States. The primary reason given for the tariffs was the theft of U.S. firms' intellectual property by Chinese firms. As is common in these cases, China responded by placing tariffs on a large number of U.S. products exported to China, sparking fears of a potential trade war between the two countries with the largest economies in the world. This type of threat is associated with the political/legal segment.

Firms use multiple sources to analyze the general environment through scanning, monitoring, forecasting, and assessing. Examples of these sources include a wide variety of printed materials (such as trade publications, newspapers, business publications, and the results of academic research and public polls), trade shows, and suppliers, customers, and employees of public-sector organizations. Also, the information available from Internet sources is of increasing importance to a firm's efforts to study the general environment.

Table 2.2 Parts of the External Environment Analysis

Scanning	• Identifying early signals of environmental changes and trends
Monitoring	• Detecting meaning through ongoing observations of environmental changes and trends
Forecasting	• Developing projections of anticipated outcomes based on monitored changes and trends
Assessing	• Determining the timing and importance of environmental changes and trends for firms' strategies and their management

2-3a Scanning

Scanning entails the study of all segments in the general environment. Although challenging, scanning is critically important to the firms' efforts to understand trends in the general environment and to predict their implications. This is particularly the case for companies competing in highly volatile environments.[16]

Through scanning, firms identify early signals of potential changes in the general environment and detect changes that are already under way.[17] Scanning activities must be aligned with the organizational context; a scanning system designed for a volatile environment is inappropriate for a firm in a stable environment.[18] Scanning often reveals ambiguous, incomplete, or unconnected data and information that require careful analysis.

Many firms use special software to help them identify events that are taking place in the environment and that are announced in public sources. For example, news event detection uses information-based systems to categorize text and reduce the trade-off between an important missed event and false alarm rates. Increasingly, these systems are used to study social media outlets as sources of information.[19]

Broadly speaking, the Internet provides a wealth of opportunities for scanning. Amazon.com, for example, records information about individuals visiting its website, particularly if a purchase is made. The firm sends messages to customers about specials and new products similar to those they purchased in previous visits. A number of other companies, such as Netflix, also collect demographic data about their customers in an attempt to identify their unique preferences (demographics is one of the segments in the general environment). Nearly 5 billion people use the Internet in some way, so the Internet represents a healthy opportunity to gather information on users.[20] The information technologies associated with analyzing *big data*, described in Chapter 1, are helpful in acquiring and managing this information.

2-3b Monitoring

When *monitoring*, analysts observe environmental changes to see if an important trend is emerging from among those spotted through scanning.[21] Effective monitoring requires the firm to identify important stakeholders and understand its reputation among these stakeholders as the foundation for serving their unique needs.[22] One means of monitoring major stakeholders is by using directors that serve on other boards of directors (referred to as interlocking directorates). They facilitate information and knowledge transfer from external sources.[23] Monitoring, like scanning, is particularly important when a firm competes in an industry with high technological uncertainty.[24] For example, the pharmaceutical, gaming, and delivery service industries are all experiencing high levels of uncertainty because of technological advances. Scanning and monitoring can also serve as a means of importing knowledge about markets and about how to successfully commercialize the new technologies the firm has developed.[25]

2-3c Forecasting

Scanning and monitoring are concerned with events and trends in the general environment at a point in time. When *forecasting*, analysts develop feasible projections of what might happen, and how quickly, as a result of the events and trends detected through scanning and monitoring.[26] For example, analysts might forecast the time that will be required for a new technology to reach the marketplace, the length of time before different corporate training procedures are required to deal with anticipated changes in the composition of the workforce, or how much time will elapse before changes in governmental taxation policies affect consumers' purchasing patterns. COVID-19 resulted in many changes to the way businesses function, and especially in the work environment.[27] Planning for a post-pandemic business environment should be among a firm's highest planning priorities.

Forecasting events and outcomes accurately is challenging. Forecasting demand for new technological products is difficult because technology trends are continually shortening product life cycles. This is particularly difficult for a firm such as Intel (the semiconductor chip maker), whose products go into many customers' technological products, which are frequently updated. Thus, having access to tools that allow better forecasting of electronic product demand is of value to Intel as the firm studies conditions in its external environment.[28]

2-3d Assessing

When *assessing*, the objective is to determine the timing and significance of the effects of environmental changes and trends that have been identified.[29] Through scanning, monitoring, and forecasting, analysts are able to understand the general environment. The intent of assessment is to specify the implications of that understanding. Without assessment, the firm has data that may be interesting but of unknown competitive relevance.

Accurately assessing the trends expected to take place in the segments of a firm's general environment is important. However, accurately interpreting the meaning of those trends is even more important. In slightly different words, although gathering and organizing information is important, appropriately interpreting that information to determine if an identified trend in the general environment is an opportunity or threat is critical.[30] Then this information can be used to help the firm devise strategies to take advantage of opportunities or overcome threats.

One of the most difficult general environment trends to assess is influence of the increasing use of cryptocurrencies, digital currencies that do not rely on any central authority such as a bank or government.[31] Instead, they are managed through what is known as a distributed ledger (blockchain) that is controlled by a decentralized network of interconnected computer systems. Bitcoin was the first popular decentralized cryptocurrency; however, many other cryptocurrencies have been created. On the surface, it would appear that the use of cryptocurrencies presents an opportunity to businesses because of their ability to increase the efficiency of international economic exchanges. However, there is so much uncertainty that it is hard to predict what is going to happen with cryptocurrencies in the future.[32] Some of the sources of uncertainty include government regulation and taxation as well as the extreme volatility in the value of these currencies, which makes owning them very risky.[33] Also, China has entered this space with its electronic yuan, a government-issued digital currency.[34] Will this become a new trend and, if so, is this a threat or an opportunity?

Learning Objective

2-4 Name and describe the general environment's seven segments.

2-4 Seven Segments of the General Environment

The general environment is composed of segments that are external to the firm (see Table 2.1). Although the degree of impact varies, these environmental segments affect all industries and the firms competing in them. The challenge to each firm is to scan, monitor, forecast, and assess the elements in each segment to predict their effects on it. These activities are vital to the firm's efforts to recognize and evaluate opportunities and threats.

2-4a The Demographic Segment

The **demographic segment** is concerned with a population's size, age structure, geographic distribution, ethnic mix, and income distribution.

The **demographic segment** is concerned with a population's size, age structure, geographic distribution, ethnic mix, and income distribution.[35] Demographic segments are commonly analyzed on a global basis because of their potential effects across countries' borders and because many firms compete in global markets.

Population Size

The world's population doubled (from 3 billion to 6 billion) between 1959 and 1999. Current projections suggest that population growth will continue in the twenty-first century, but at a slower pace. In 2022, the world's population was approximately 8 billion, and is projected to grow at about 1 percent per year for the foreseeable future.[36] In that same year, China was the world's largest country by population with slightly with over 1.4 billion people. India, the second most populous, is growing at a faster rate than China, and will surpass China in population in the near future. Rounding out the top five nations are the United States, Indonesia, and Pakistan. Firms seeking to find growing markets in which to sell their goods and services need to consider the market potential that may exist for them in these five nations.

Age Structure

The most noteworthy aspect of this element of the demographic segment is that the world's population is rapidly aging.[37] Projections suggest life expectancy will surpass 100 in some industrialized countries by the second half of this century—roughly triple the life span of the population in earlier years.[38] In the 1950s, Japan's population was one of the youngest in the world. However, 47 is now the median age in Japan and Germany.[39] By 2050, almost 25 percent of the world's population will be aged 65 or older. These changes in the age of the population have significant implications for availability of qualified labor, health care, retirement policies, and business opportunities among others.[40]

This aging of the population threatens the ability of firms to hire and retain a workforce that meets their needs. Thus, firms are challenged to increase the productivity of their workers and/or to establish additional operations in other nations in order to access the potential working age population. This type of internationalization has been increasing for years, especially in nations such as India, Brazil, or China where labor costs are lower and there are many talented workers.[41] The introductory case described how Tupperware is moving a lot of its innovation and market development activities to Singapore, a small country with a well-educated workforce.

Another potential opportunity is represented by delayed retirements; older workers with extended life expectancies may need to work longer in order to eventually afford retirement. Firms can use their older, more experienced workers to transfer their knowledge to younger employees, helping them to quickly gain valuable skills. In addition, there is an opportunity for firms to more effectively use the talent available in the workforce. For example, moving women into higher-level professional and managerial jobs could offset the challenges created by a decline in overall talent availability. And, based on research, eliminating the "glass ceiling" that keeps women from moving to top leadership positions may even enhance overall performance.[42]

Geographic Distribution

How a population is distributed within countries and regions is subject to change over time. For example, over the last few decades the U.S. population has shifted from states in the Northeast and Great Lakes region to states in the West (California), South (Florida), and Southwest (Texas).[43] These changes are characterized as moving from the "Frost Belt" to the "Sun Belt." Outcomes from these shifts include the fact that the gross domestic product (GDP) of California in 2021 was estimated to be more than $3.1 trillion, an amount that would make California the fifth-largest economy in the world if it were a country. In this same year, at a value of over $1.7 trillion, Texas' GDP was second to that of California.[44]

Firms want to carefully study the patterns of population distributions in countries and regions to identify opportunities and threats. Thus, in the United States, current patterns suggest the possibility of opportunities in states on the West Coast and some in the South and Southwest. In contrast, firms competing in the Northeast and Great Lakes areas may concentrate on identifying threats to their ability to operate profitably in those areas, and then devising strategies to overcome them.

Of course, geographic distribution patterns differ throughout the world. For example, in past years, the majority of the population in China lived in rural areas; however, growth patterns have been shifting to urban communities such as Shanghai and Beijing. In fact, there are now more Chinese living in urban areas than in rural areas.[45] Overall, the geographic distribution patterns in Europe have been reasonably stable.[46]

Ethnic Mix

The ethnic mix of countries' populations continues to change, creating opportunities and threats for many companies as a result. For example, Hispanics have become the largest ethnic minority in the United States.[47] In fact, the U.S. Hispanic market is the third-largest "Latin American" economy behind Brazil and Mexico. Spanish is now the dominant language in parts of the United States such as Texas, California, Florida, and New Mexico. Given these facts, some firms might want to assess how their goods or services could be adapted to serve the unique needs of Hispanic consumers.

Interestingly, the population in the United States is projected to have a majority of minority ethnic members by 2044. And, by 2060, Caucasians are projected to compose approximately 44 percent of the U.S. population.[48] The ethnic diversity of the population is important not only because of consumer needs but also because of the labor force composition. Research has shown that firms with greater ethnic diversity in their managerial teams and workforce are likely to enjoy higher performance.[49]

Additional evidence is of interest to firms when examining this segment. For example, African countries are the most ethnically diverse in the world, with Uganda having the highest ethnic diversity rating and Liberia having the second highest. In contrast, Japan and the Koreas are the least ethnically diversified in their populations. European countries are largely ethnically homogeneous while the Americas are more diverse. "From the United States through Central America down to Brazil, the 'new world' countries, maybe in part because of their histories of relatively open immigration (and, in some cases, intermingling between natives and new arrivals) tend to be pretty diverse."[50]

Income Distribution

Understanding how income is distributed within and across populations informs firms of different groups' purchasing power and discretionary income. Of particular interest to firms are the average incomes of households and individuals. For instance, the increase in dual-career couples has had a notable effect on average incomes. Although real income has been declining in general in some nations, the household income of dual-career couples has increased, as has the number of dual-career couples, especially in the United States.[51] This trend offers opportunities to companies that offer goods and services to people who don't have time to cook, clean, shop, or run errands. For example, Uber has been able to expand from providing ground transportation to providing delivery services for local restaurants through Uber Eats.[52]

The growth of the economy in China has drawn many firms, not only for the low-cost production, but also because of the large potential demand for products, given its large population base. However, in recent times, the amount of China's gross domestic product that makes up domestic consumption is the lowest of any major economy at less than one-third. In comparison, India's domestic consumption of consumer goods accounts for two-thirds of its economy, or twice China's level. For this reason, many Western multinationals are interested in India as a consumption market as its middle class grows; although India has poor infrastructure, its consumers are in a better position to spend. Because of situations such as this, paying attention to the differences between markets based on income distribution can be very important.[53] These differences across nations suggest it is important for firms that operate internationally to identify the economic systems that are most likely to produce the most income growth and market opportunities.[54] Thus, the economic segment is a critically important focus of a firm's environmental analysis.

2-4b The Economic Segment

> The **economic environment** refers to the nature and direction of the economy in which a firm competes or may compete.

The **economic environment** refers to the nature and direction of the economy in which a firm competes or may compete.[55] In general, firms seek to compete in relatively stable economies with strong growth potential. Because nations are interconnected as a result of the global economy, firms must scan, monitor, forecast, and assess the health of their host nation as well as the health of the economies outside it.

It is challenging for firms studying the economic environment to predict economic trends that may occur and their effects on them. Global recessions, like what is sometimes called the "Great Recession" that started late in 2007, can create numerous problems for companies throughout the world, including problems of reduced consumer demand, increases in firms' inventory levels, development of additional governmental regulations, and a tightening of access to financial resources.[56]

Of course, major shocks like the COVID-19 pandemic can be just as difficult for firms as recessions because of supply chain disruptions and dramatic reductions in consumer demand, especially in industries related to travel and hospitality (restaurants, hotels). During the pandemic, tech companies that supply products and services that allow people to work and play at home—such as Microsoft, Apple, and Zoom—thrived. Tupperware, discussed in the Opening Case, and Nestle, the world's largest packaged food maker, also did very well.[57] But for all firms, a high level of uncertainty made management difficult. Research has found that the negative effects of the COVID-19 epidemic on firm performance were greater in countries with more advanced financial systems and better healthcare systems.[58]

Inflation is another factor that needs to be closely monitored. Rapid price increases in both consumer goods and the prices charged to producers for the materials they need can create a lot of economic instability. Producers pass price increases on to consumers, who then reduce their consumption until wages are increased. Higher wages result in more demand for goods and services, which can again increase prices, causing a vicious, self-perpetuating cycle. During a period of high inflation, smaller businesses tend to have a more difficult time than larger businesses because they have fewer resources to draw on to ride out the difficult economic situation.[59]

One of the tools governments use to calm down inflation is increasing interest rates; however, as interest rates increase businesses find new projects less attractive because the costs of financing them increase. Reductions in business investment can reduce economic growth, so governments are cautions.[60] During the COVID-19 pandemic, the U.S. government passed multiple stimulus bills that provided direct payments to individuals and even incentivized unemployed people not to look for work. These payments overstimulated the economy and simultaneous supply chain problems reduced the supply of goods, resulting in demand that outstripped supply. The result was very high inflation.

AP Images/Brennan Linsley

A marijuana budtender sorts strands of marijuana for sale at a retail and medical cannabis dispensary in Boulder, Colorado.

Studying closely and forecasting economic growth and other trends in the economies in which firms operate can help them to determine where the greatest growth opportunities exist. This, in turn, can help them achieve above-average returns.

2-4c The Political/Legal Segment

The **political/legal segment** is the arena in which organizations and interest groups compete for attention, resources, and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and various government agencies.[61] Essentially, this segment is concerned with how organizations try to influence governments and how they try to understand the influences (current and projected) of those governments on their competitive actions and responses. Commonly, firms develop a strategy to specify how they will analyze the political/legal segment in order to develop approaches they can take (such as lobbying efforts) to successfully deal with opportunities and threats that surface within this segment of the environment.[62] This type of strategy is frequently referred to as a *non-market strategy* because it does not deal directly with competition in a particular product market (non-market strategies will be examined in Chapter 5).

The **political/legal segment** is the arena in which organizations and interest groups compete for attention, resources, and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and various local governmental agencies.

Regulations formed in response to new national, regional, state, and/or local laws that are legislated often influence a firm's competitive actions and responses.[63] For example, many states in the United States have now legalized the retail selling of cannabis (also known as marijuana). The immediate concern is the risk that firms take to invest capital in this business, given that it is unknown whether the U.S. Department of Justice will allow the states to proceed without enforcing federal law against the sale of this product. Thus, the relationship between national, regional, and local laws and regulations creates a highly complex environment within which businesses must navigate.[64]

For interactive, technology-based firms such as Facebook, Alphabet (Google), and Amazon, among others, the effort in Europe to adopt the world's strongest data protection laws has significant challenges. Highly restrictive laws about consumer privacy could threaten how these firms conduct business in the European Union. Alternatively, firms must deal with quite different challenges when they operate in countries with weak formal institutions (e.g., weak legal protection of intellectual property). Laws and regulations provide structure to guide strategic and competitive actions; without such structure, it is difficult to identify the best strategic actions.[65]

2-4d The Sociocultural Segment

The **sociocultural segment** is concerned with a society's attitudes and cultural values. Because attitudes and values form the cornerstone of a society, they often drive demographic, economic, political/legal, and technological conditions and changes.

The **sociocultural segment** is concerned with a society's attitudes and cultural values.

Individual societies' attitudes and cultural orientations are relatively stable, but they can and often do change over time. Thus, firms must carefully scan, monitor, forecast, and assess them to recognize and study associated opportunities and threats. Successful firms must also be aware of

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During the height of the Black Lives Matter movement, companies were "expected" by employees and customers to address racial equality and injustice.

changes taking place in the societies and their associated cultural values in which they are competing. Indeed, firms must identify changes in cultural values, norms, and attitudes in order to "adapt to stay ahead of their competitors and stay relevant in the minds of their consumers."[66] Research has shown that sociocultural factors influence entry into new markets and the development of new firms in a country.[67]

Although some social movements, such as the push to reduce global warming and protect the environment (to be discussed later in this chapter), are international in scope, each country has unique sociocultural indicators. *National cultural values* affect behavior in organizations and thus also influence organizational outcomes such as the success associated with differences in managerial styles. Likewise, national culture influences a large portion of the internationalization strategy that firms pursue relative to one's home country.[68]

Knowledge sharing and training is important for dispersing knowledge about what is happening and what is considered acceptable in each of the countries in which a firm operates. This knowledge is essential to successful management. As one example, personal relationships are especially important in China; the concept of *guanxi* (personal relationships or good connections) is important in doing business within the country and for individuals to advance their careers in what is becoming a more open market society. Understanding the importance of guanxi is critical for foreign firms doing business in China.[69]

In the United States, a social movement called "Black Lives Matter" gained strength after a video was released to social media that showed a police officer unjustly taking the life of a black suspect during an arrest. The fight for racial equality is not new to the United States, and it is also a major issue in most Western, and some other, countries. However, the video and subsequent protests and riots re-invigorated the movement. There are many reasons that firms should be sensitive to racial equality and equal justice. Indeed, firms that ignore these issues increase their risk of harmful outcomes such as negative social media, a soiled reputation, boycotts, lost sales, and an inability to attract the best qualified workers.[70]

2-4e The Technological Segment

The **technological segment** includes the institutions and activities involved in creating new knowledge and translating that knowledge into new outputs, products, processes, and materials.

Pervasive and diversified in scope, technological changes affect many parts of societies. These effects occur primarily through new products, processes, and materials. The **technological segment** includes the institutions and activities involved in creating new knowledge and translating that knowledge into new outputs, products, processes, and materials.

Given the rapid pace of technological change and risk of disruption, it is vital for firms to thoroughly study the technological segment.[71] The importance of these efforts is shown by the fact that early adopters of new technology often achieve higher market shares and earn higher returns. Thus, both large and small firms should continuously scan the general environment to identify potential substitutes for technologies that are in current use, as well as to identify newly emerging technologies from which their firms could derive competitive advantage.[72]

New technology and innovations are changing many industries.[73] These changes are exemplified by the change to digital publishing (e.g., electronic books), the adoption of AI technologies in many industries, retail industries moving from brick-and-mortar stores to Internet sales, and the rise of the metaverse, which combines virtual reality, augmented reality, and 3D computing (note also that Facebook is now called Meta Platforms Inc.).[74] As such, firms in all industries must become more innovative in order to survive, and must develop new or at least comparable technology—and continuously improve it.[75] In so doing, most firms must have a sophisticated information system to support their new product development efforts.[76]

The Internet offers firms a remarkable capability in terms of firm efforts to scan, monitor, forecast, and assess conditions in their general environment. Companies continue to study the Internet's capabilities to anticipate how it may allow them to create more value for customers and to anticipate future trends. Additionally, the Internet generates a significant number of opportunities and threats for firms across the world. One of the most significant global changes that has occurred largely because of the Internet is the increase in digital platforms that have led to what is sometimes called the *sharing economy*, a socioeconomic system that uses information technology to link stakeholders to each other.[77] These systems facilitate transfer of information, but they also allow firms to create more value by sharing their excess capacities of products, services, and innovative technologies.

In addition to the Internet's far-reaching effects and the opportunities and threats associated with its potential, wireless communication technology has also become a significant technological opportunity for companies. Handheld devices and other wireless communications equipment are used to access a variety of network-based services. The use of handheld computers (of many types) with wireless network connectivity has become a dominant form of communication and commerce, and additional functionalities and software applications are generating multiple opportunities—and potential threats—for companies of all types.

2-4f The Global Segment

The **global segment** includes relevant new global markets and their critical cultural and institutional characteristics, existing markets that are changing, and important international political events.[78] For example, firms competing in the automobile industry must study the global segment. This is supported by the fact that consumers in multiple nations are willing to buy cars and trucks from wherever they are manufactured, and the best suppliers of parts and components often are not in the same country where an automobile is assembled.

> The **global segment** includes relevant new global markets and their critical cultural and institutional characteristics, existing markets that are changing, and important international political events.

When studying the global segment, firms should recognize that globalization of business markets may create opportunities to enter new markets, as well as threats that new competitors from other economies may also enter their market.[79] In addition, it is challenging to determine how well a firm's products and services will be received in a foreign market, and differences in political and legal systems can also cause difficulties for firms that have globalized. In fact, what a firm does in one international region that provides competitive advantages could lead to competitive disadvantages in another region.[80]

Of course, a firm that has operations in a foreign market is also at risk that a major event could dramatically alter both the political and economic conditions in that country. Consider, for example, what happened when Russia invaded Ukraine in 2022. Western companies like McDonald's, Coca-Cola, and IBM ceased operations in Russia, even as Russian prosecutors warned these companies that their assets could be seized and their leaders arrested. Many banks froze Russian accounts, making trade difficult. Companies that had invested in Russia were at risk of losing their entire investments.[81]

In light of threats associated with participating in international markets, some firms choose to take a more cautious approach to globalization. For example, family business firms, even the larger ones, often take a conservative approach to entering international markets in a manner very similar to how they approach the development and introduction of new technology. They try to manage their risk.[82] These firms participate in what some refer to as *globalfocusing*, in which firms focus on global niche markets.[83] This approach allows firms to build onto and use their core competencies while limiting their risks within the niche market. Another way in which firms limit their risks in international markets is to focus their operations and sales in one region of the world.[84] Success with these efforts lets a firm build knowledge of its markets and relationships with stakeholders, which can lead to successful business expansion in the future.

Firms competing in global markets should recognize each market's sociocultural and institutional attributes.[85] For example, Korean ideology emphasizes communitarianism, a characteristic of many Asian countries. Alternatively, as mentioned previously, the ideology in China calls for an emphasis on *guanxi*—personal connections—while in Japan, the focus is on *wa*—group harmony and social cohesion.[86] The institutional context of China suggests a major emphasis on centralized planning by the government. The Chinese government provides incentives to firms to develop alliances with foreign firms having sophisticated technology, in hope of building knowledge and introducing new technologies to the Chinese markets over time.[87] As such, it is important to analyze the intent of foreign firms when pursuing strategic alliances abroad, especially where the local partners are receiving technology that may in the long run reduce the foreign firms' advantages.[88]

Increasingly, the *informal economy* is another aspect of the global segment requiring analysis. The informal economy refers to economic activities that have market value but are not recorded as part of the activities of registered business organizations.[89] Examples include minibus drivers in Africa, hawkers selling goods all around the world, and *gig workers*—independent contractors who engage in short-term work, often for multiple employers. Approximately 60 percent of the world's population participates in some way in the informal economy.[90] Growing in size, this economy has implications for firms' competitive actions and responses because firms competing in the formal economy find that they are competing against informal economy participants as well.

2-4g The Sustainable Physical Environment Segment

The **sustainable physical environment segment** refers to potential and actual changes in the physical environment as well as business practices that are intended to positively respond to those changes in order to create a sustainable environment.

The **sustainable physical environment segment** refers to potential and actual changes in the physical environment as well as business practices that are intended to positively respond to those changes in order to create a sustainable environment.[91] Concerned with trends that threaten the world's physical environment, such as global climate change, firms recognize that ecological, social, and economic systems interactively influence what happens in this particular segment and that they are part of an interconnected global society.[92] These concerns are magnified by strong social movements that mean firms cannot afford to ignore their impact on the natural environment. Because of its importance to businesses throughout the world, sustainability has been and will continue to be addressed throughout many parts of this book.

Companies across the globe are taking actions to protect the environment, such as reducing their carbon emissions, reforesting areas that have been decimated by industrialization, increasing the efficiency of their operations through new technologies, reducing waste, or increasing their use of sustainable materials.

Certification programs have been developed to help firms understand how to become more sustainable organizations.[93] For example, firms can achieve B Corporation certification (which is not the same as a benefit organization) for meeting high standards of performance in areas associated with sustainability.[94] (B Corp Certification and benefit corporations will be discussed further in Chapter 11.) To achieve this type of certification, firms must verify that their actions are consistent with what they claim. ISO standards are similar in their underlying emphasis on sustainability.[95] These standards are based directly on the Sustainable Development Goals (SDGs) of the United Nations. The International Organization for Standardization (ISO) offers a number of different certification programs.

Almost all large companies are outlining these sorts of activities in reports with names such as "Sustainability" or "Corporate Social Responsibility." However, some firms are using these types of reports, social media, advertising campaigns, and press releases to create a public perception that they are environmentally responsible when, in fact, they have made very few changes that are consistent with this perception. This type of activity, called *greenwashing* (first mentioned in Chapter 1), carries with it some very real risks that stakeholders will figure out what they are doing, thus losing trust in the firm. A loss of trust can be accompanied by negative stakeholder reactions such as lost sales, legal suits, negative social media campaigns, or an unwillingness of suppliers to sell products to the company.[96]

As the Strategic Focus shows, although some companies are using greenwashing to create a perception of social responsibility, others really mean it. Shaw Industries has a competitive advantage due to its reputation for sustainable business practices.

As this discussion shows, identifying changes and trends among segments of the general environment allows firms to identify opportunities and threats. It is necessary to have a top management team with the experience, knowledge, and sensitivity required to effectively analyze conditions in a firm's general environment, as well as other facets such as the industry environment and competitors.[97] Next, we focus on those other important sections of external analysis.

Strategic Focus

Shaw Industries Responds to Environmental Forces by Running Cleaner in the Carpet Manufacturing Industry

Global interest in sustainability is more than just a passing fad. Consumers, regulators, NGOs (non-governmental organizations), media organizations, and other "watch-dog" groups are demanding that companies take more responsibility for cleaning up their operations, reducing their carbon footprints and consumption of non-sustainable inputs, increasing their use of sustainable inputs, and increasing their reporting transparency of the damage they do to the environment. The negative consequences of global climate change are reported daily in a variety of media outlets.

The floor coverings industry has struggled at times due to its image as a "dirty" industry. Carpet manufacturing releases chemicals into the environment and uses a lot of water and energy. Most carpets are made of synthetic or man-made materials such as polyester, nylon, polypropylene, or olefin, which often use oil as a feedstock. In the United States alone, more than 4 billion pounds of carpet ends up in landfills every year, which is 1 percent by weight but 2 percent by volume of all solid waste.

Given the environmental challenges associated with this industry, it is amazing that one of the world's largest carpet manufacturers has made great progress in "greening" its operations. Shaw Industries Group, a subsidiary of Berkshire Hathaway and employer of more than 20,000 people worldwide, is proud of its environmental performance, and uses it to gain advantage through its reputation with consumers. Almost 90 percent of Shaw's products have received Cradle-to-Cradle certification, which focuses on material health, material reutilization, water conservation, renewable energy and carbon management, and social fairness. Shaw also has a carpet take-back program through which carpeting is reclaimed and turned into new carpet or down-cycled into other types of products. Consistent with this emphasis on sustainability, Shaw is also one of signatories of the United Nations Global Compact, principles for upholding human rights, protecting the environment, and fighting corruption.

Shaw engaged in a program to reduce its greenhouse gas emissions by 40 percent by 2030, but achieved the goal nine years early. The company achieved this objective through a combination of reducing energy consumption, switching to cleaner fuels, and producing their own renewable energy in some of their plants. Shaw also ensures that the products it buys from other companies are manufactured with high standards with regard to sustainability. As mentioned previously, companies increasingly are being held accountable not only for their own operations, but also for the operations of other members of their global value chains.

Sources: 2022, More than a flooring company, *Shaw Inc. Home Page*, www.shawinc.com, February 12; 2022, Identifying greener carpet, *Environmental Protection Agency*, www.epa.gov, February 12; 2022, Biggest companies in the carpet mills industry in the US, *IBISWorld*, www.ibisworld.com, February 12; S. A. Rogers, 2020, Buying eco-friendly carpet, *Treehugger*, www.treehugger.com, May 31; 2020, *Sustainability Report 2020, Shaw Industries Group, Inc.*, Dalton, Georgia, USA.

2-5 Industry Environment Analysis: The Five Competitive Forces

Learning Objective

2-5 Identify the five competitive forces and explain how they determine an industry's profitability potential.

An **industry** is a group of firms producing products that are close substitutes.

An **industry** is a group of firms producing products that are close substitutes.[98] In the course of competition, these firms influence one another. Typically, companies use a rich mix of different competitive strategies to pursue above-average returns when competing in a particular industry. An industry's structural characteristics influence a firm's choice of strategies.[99]

Compared with the general environment, the industry environment (measured primarily in the form of its characteristics) has a more direct effect on the competitive actions and responses a firm takes to succeed.[100] To study an industry, the firm examines five forces that affect the ability of all firms to operate profitably within a given industry.[101] Shown in Figure 2.2, the five forces are the threats posed by new entrants, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors.

The five forces of competition model depicted in Figure 2.2 expands the scope of a firm's competitive analysis. Historically, when studying the competitive environment, firms concentrated on companies with which they directly competed. However, firms must search more broadly to recognize current and potential competitors by identifying potential customers as well as the firms serving them. For example, the communications industry is now broadly defined as encompassing media companies, telecoms, entertainment companies, and companies producing devices such as smartphones. In such an environment, firms must study many other industries to identify companies with capabilities (especially technology-based capabilities) that might be the foundation for producing a good or a service that can compete against what they are producing.

Figure 2.2 The Five Forces of Competition Model

When studying the industry environment, firms must also recognize that suppliers can become a firm's competitors (by integrating forward) as can buyers (by integrating backward). For example, several firms have integrated forward in the pharmaceutical industry by acquiring distributors or wholesalers. In addition, firms choosing to enter a new market and those producing products that are adequate substitutes for existing products can become a company's competitors.

Next, we examine the five forces the firm needs to analyze in order to understand the profitability potential within an industry (or a segment of an industry) in which it competes or may choose to compete.

2-5a Threat of New Entrants

Identifying new entrants is important because they can threaten the market share of existing competitors.[102] One reason new entrants pose such a threat is that they bring additional production capacity. Unless the demand for a good or service is increasing, additional capacity holds consumers' costs down, resulting in less revenue and lower returns for competing firms. Often, new entrants have a keen interest in gaining a large market share. As a result, new competitors may force existing firms to be more efficient and to learn how to compete in new dimensions (e.g., using an Internet-based distribution channel).

The likelihood that firms will enter an industry is a function of two factors: barriers to entry and the retaliation expected from current industry participants. Entry barriers make it difficult for new firms to enter an industry and often place them at a competitive disadvantage even when they are able to enter. As such, high entry barriers tend to increase the returns for existing firms in the industry and may allow some firms to dominate the industry.[103] Thus, firms competing successfully in an industry want to maintain high entry barriers to discourage potential competitors from deciding to enter the industry.

Barriers to Entry

Firms competing in an industry (and especially those earning above-average returns) try to develop entry barriers to thwart potential competitors. In general, more is known about entry barriers (with respect to how they are developed as well as paths firms can pursue to overcome them) in industrialized countries such as those in North America and Western Europe. In contrast, relatively little is known about barriers to entry in rapidly emerging markets such as China.

There are different kinds of barriers to entering a market to consider when examining an industry environment. Companies competing within a particular industry study these barriers to determine the degree to which their competitive position reduces the likelihood of new competitors being able to enter the industry to compete against them. Firms considering entering an industry should study entry barriers to determine the likelihood of being able to identify an attractive competitive position within the industry. Next, we discuss several significant entry barriers that may discourage competitors from entering a market and that may facilitate a firm's ability to remain competitive in a market in which it currently competes.

Economies of Scale *Economies of scale* are derived from incremental efficiency improvements through experience as a firm grows larger. Therefore, the cost of producing each unit declines as the quantity of a product produced during a given period increases. A new entrant is unlikely to quickly generate the level of demand for its product that in turn would allow it to develop economies of scale.

Economies of scale can be developed in most business functions, such as marketing, manufacturing, research and development, and purchasing.[104] Firms sometimes form strategic alliances with other companies to gain scale economies. One type of strategic alliance is a *joint venture*, in which two or more firms own part of a company they have formed to achieve a particular strategic purpose; in this case, the purpose is to create economies of scale. Other firms simply acquire rivals in order to build economies of scale in their operations and to increase their market share as well.

Product Differentiation Over time, customers may come to believe that a firm's product is unique. This belief can result from the firm's service to the customer, effective advertising campaigns, or being the first to market a good or service.[105] Greater levels of perceived product uniqueness create customers who consistently purchase a firm's products. To combat the perception of uniqueness, new entrants frequently offer products at lower prices. This decision, however, may result in lower profits or even losses.

The Coca-Cola Company and PepsiCo have established strong brands in the markets in which they compete, and these companies compete against each other in countries throughout the world. Because each of these competitors has allocated a significant amount of resources over many decades to build its brands, customer loyalty is strong for each firm. When considering entry into the soft drink market, a potential entrant would be well advised to pause and determine actions it would take to try to overcome the brand image and consumer loyalty each of these giants possesses.

Capital Requirements Competing in a new industry requires a firm to have resources to invest. In addition to physical facilities, capital is needed for inventories, marketing activities, and other critical business functions. Even when a new industry is attractive, the capital required for successful market entry may not be available to pursue the market opportunity.[106] For example, defense industries are difficult to enter because of the substantial resource investments required to be competitive. In addition, because of the high knowledge requirements of the defense industry, a firm might acquire an existing company as a means of entering this industry, but it must have access to the capital necessary to do this.

Switching Costs *Switching costs* are the one-time costs customers incur when they buy from a different supplier. The costs of buying new ancillary equipment and of retraining employees, and even the psychological costs of ending a relationship, may be incurred in switching to a new supplier. In some cases, switching costs are low, such as when the consumer switches to a different brand of soft drink. Switching costs can vary as a function of time, as shown by the fact that in terms of credit hours toward graduation, the cost to a student to transfer from one university to another as a freshman is much lower than it is when the student is entering their senior year.

Occasionally, a decision made by manufacturers to produce a new, innovative product creates high switching costs for customers. Customer loyalty programs, such as airlines' frequent flyer miles, are intended to increase the customer's switching costs. If switching costs are high, a new entrant must offer either a substantially lower price or a much better product to attract buyers. Usually, the more established the relationships between parties, the greater the switching costs.

Access to Distribution Channels Over time, industry participants commonly learn how to effectively distribute their products. Access to distribution channels can be a strong entry barrier for new entrants, particularly in consumer nondurable goods industries (e.g., in grocery stores where shelf space is limited) and in international markets.[107] New entrants have to persuade distributors to carry their products, either in addition to or in place of those currently distributed. Price breaks and cooperative advertising allowances may be used for this purpose; however, those practices reduce the new entrant's profit potential. Of course, access to distribution channels is less of a barrier for products that can be sold on the Internet.

Cost Disadvantages Independent of Scale Sometimes, established competitors have cost advantages that new entrants cannot duplicate. Proprietary product technology, favorable access to raw materials, desirable locations, and government subsidies are examples. Successful competition requires new entrants to reduce the strategic relevance of these factors. For example, delivering purchases directly to the buyer can counter the advantage of a desirable location; new food establishments in an undesirable location often follow this practice. Business model innovations like this may be the key to survival and success in current retail industries.[108]

Government Policy Through their decisions about issues such as the granting of licenses and permits, governments can also control entry into an industry. Liquor retailing, radio and TV broadcasting, and banking are examples of industries in which government decisions and actions affect entry possibilities. Also, governments often restrict entry into some industries because of the need to provide quality service or the desire to protect jobs. It is not uncommon for governments to attempt to regulate the entry of foreign firms, especially in industries considered critical to the country's economy or important markets within it.[109]

Governmental decisions and policies regarding antitrust issues also affect entry barriers. For example, in the United States, the Antitrust Division of the Justice Department or the Federal Trade Commission (FTC) will sometimes disallow a proposed merger because officials conclude that approving it would create a firm that is too dominant in an industry and would thus create unfair competition. In one such case, the FTC sued to block Lockheed Martin, a major defense contractor, from buying Aerojet Rocketdyne Holdings, claiming that the purchase would harm rival defense contractors and lead to too much industry consolidation in an industry that is vital to national defense.[110]

Expected Retaliation Companies seeking to enter an industry also anticipate the reactions of firms in the industry. An expectation of swift and vigorous competitive responses reduces the likelihood of entry. Vigorous retaliation can be expected when the existing firm has a major stake in the industry (e.g., it has fixed assets with few, if any, alternative uses), when it has substantial resources, and when industry growth is slow or constrained.[111] For example, any firm attempting to enter the airline industry can expect significant retaliation from existing competitors due to overcapacity.

Locating market niches not being served by incumbents allows the new entrant to avoid entry barriers. Small entrepreneurial firms are generally best suited for identifying and serving neglected market segments. When Honda first entered the U.S. motorcycle market, it concentrated on small-engine motorcycles, a market that firms such as Harley-Davidson ignored. By targeting this neglected niche, Honda initially avoided a significant amount of head-to-head competition with well-established competitors. After consolidating its position, Honda used its strength to attack rivals by introducing larger motorcycles and competing in the broader market.

2-5b Bargaining Power of Suppliers

Increasing prices and reducing the quality of their products are potential means suppliers use to exert power over firms competing within an industry. If a firm is unable to recover cost increases by its suppliers through its own pricing structure, its profitability is reduced by its suppliers' actions.[112] A supplier group is powerful when:

- It is dominated by a few large companies and is more concentrated than the industry to which it sells.
- Satisfactory substitute products are not available to industry firms.
- Industry firms are not a significant customer for the supplier group.
- Suppliers' goods are critical to buyers' marketplace success.
- The effectiveness of suppliers' products has created high switching costs for industry firms.
- It poses a credible threat to integrate forward into the buyers' industry. Credibility is enhanced when suppliers have substantial resources and provide a highly differentiated product.[113]

Some buyers attempt to manage or reduce suppliers' power by developing a long-term relationship with them. Although long-term arrangements reduce buyer power, they also increase the suppliers' incentive to be helpful and cooperative in appreciation of the longer-term relationship (guaranteed sales). This is especially true when the partners develop trust in one another.[114]

2-5c Bargaining Power of Buyers

Firms seek to maximize the return on their invested capital. Alternatively, buyers (customers of an industry or a firm) want to buy products at the lowest possible price—the point at which the industry earns the lowest acceptable rate of return on its invested capital. To reduce their costs, buyers bargain for higher quality, greater levels of service, and lower prices.[115] These outcomes are achieved by encouraging competitive battles among the industry's firms. Customers (buyer groups) are powerful when:

- They purchase a large portion of an industry's total output.
- The sales of the product being purchased account for a significant portion of the seller's annual revenues.
- They could switch to another product at little, if any, cost.
- The industry's products are undifferentiated or standardized, and the buyers pose a credible threat if they were to integrate backward into the sellers' industry.[116]

Consumers armed with greater amounts of information about the manufacturer's costs and the power of the Internet as a shopping and distribution alternative have increased their bargaining power in many industries.

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The Internet has given consumers the ability to access news with just the click of a button. This substitute news outlet has made it almost impossible for newspapers to compete.

2-5d Threat of Substitute Products

Substitute products are goods or services from outside a given industry that perform similar or the same functions as a product that the industry produces. For example, as a sugar substitute, NutraSweet (and other sugar substitutes) places an upper limit on sugar manufacturers' prices—NutraSweet and sugar perform the same function, though with different characteristics.

Newspaper firms have experienced significant circulation declines over the past 20 years. The declines are a result of the ready availability of substitute outlets for news including Internet sources and cable television news channels, along with email and cell phone alerts. Likewise, satellite TV and cable and telecommunication companies provide substitute services for basic media services such as television, Internet, and phone. The many electronic devices that provide services overlapping with the personal computer (e.g., laptops) such as tablets, smartphones, smart watches, etc., have changed markets for PCs, with multiple niches in the market.

In general, product substitutes present a strong threat to a firm when customers face few if any switching costs and when the substitute product's price is lower or its quality and performance capabilities are equal to or greater than those of the competing product. Interestingly, some firms that produce substitutes have begun forming brand alliances, which research shows can be effective when the two products are of relatively equal quality. If there is a differential in quality, the firm with the higher quality product will obtain lower returns from such an alliance.[117] Differentiating a product along dimensions that are valuable to customers (such as quality, service after the sale, and location) reduces a substitute's attractiveness.

2-5e Intensity of Rivalry among Competitors

Because an industry's firms are mutually dependent, actions taken by one company usually invite responses. Competitive rivalry intensifies when a firm is challenged by a competitor's actions or when a company recognizes an opportunity to improve its market position.[118]

Firms within industries are rarely homogeneous; they differ in resources and capabilities and seek to differentiate themselves from competitors. Typically, firms seek to differentiate their products from competitors' offerings in ways that customers value and in which the firms have a competitive advantage. Common dimensions on which rivalry is based include price, service after the sale, and innovation. More recently, firms have begun to act quickly (speed a new product to the market) in order to gain a competitive advantage.[119]

Next, we discuss the most prominent factors that experience shows affect the intensity of rivalries among firms.

Numerous or Equally Balanced Competitors

Intense rivalries are common in industries with many companies. With multiple competitors, it is common for a few firms to believe they can act without eliciting a response. However, evidence suggests that other firms generally are aware of competitors' actions, often choosing to respond to them. At the other extreme, industries with only a few firms of equivalent size and power also tend to have strong rivalries. The large and often similar-sized resource bases of these firms permit vigorous actions and responses. The competitive battles between Airbus and Boeing and between Coca-Cola and PepsiCo exemplify intense rivalry between relatively equal competitors.

Slow Industry Growth

When a market is growing, firms try to effectively use resources to serve an expanding customer base. Markets increasing in size reduce the pressure to take customers from competitors. However, rivalry in no-growth or slow-growth markets becomes more intense as firms battle to increase their market shares by attracting competitors' customers. Certainly, this has been the case in the fast-food industry. McDonald's, Wendy's, and Burger King use their resources, capabilities, and core competencies to try to win each other's customers. The instability in the market that results from these competitive engagements may reduce the profitability for all firms engaging in such battles.

High Fixed Costs or High Storage Costs

When fixed costs account for a large part of total costs, as in the airline industry and many manufacturing industries, companies try to maximize the use of their productive capacity. Doing so allows the firm to spread costs across a larger volume of output. However, when many firms attempt to maximize their productive capacity, excess capacity is created on an industry-wide basis. To then reduce inventories, individual companies typically cut the price of their product and offer rebates and other special discounts to customers. Doing this often intensifies competition.

The pattern of excess capacity at the industry level followed by intense rivalry at the firm level is frequently observed in industries with high storage costs. Perishable products, for example, lose their value rapidly with the passage of time. As their inventories grow, producers of perishable goods often use discount pricing strategies to sell products quickly.

Lack of Differentiation or Low Switching Costs

When buyers find a differentiated product that satisfies their needs, they frequently purchase the product loyally over time. Industries with many companies that have successfully differentiated their products have less rivalry, resulting in lower competition for individual firms. Firms that develop and sustain a differentiated product that cannot be easily imitated by competitors often earn higher returns. However, when buyers view products as commodities (i.e., as products with few differentiated features or capabilities), rivalry intensifies. In these instances, buyers' purchasing decisions are based primarily on price and, to a lesser degree, service.

Personal computers are a commodity product, and the cost to switch from a computer manufactured by one firm to another is low. Thus, the rivalry among Dell, Hewlett-Packard, and Lenovo is strong as these companies consistently seek to find ways to differentiate their offerings. On the other hand, Apple computer products have many features that make it harder to switch to the products of other manufacturers. This is one reason why Apple is able to charge higher prices for its personal computers.

High Strategic Stakes

Competitive rivalry is likely to be high when it is important for several of the competitors to perform well in the market. Competing in diverse businesses (such as petrochemicals, fashion, medicine, and plant construction, among others), Samsung is a formidable foe for Apple in the global smartphone market. Samsung has committed a significant amount of resources to develop innovative products as the foundation for its efforts to try to outperform Apple in selling this particular product. Because this market is extremely important to both firms, the smartphone rivalry between them (and others) will likely remain quite intense.

High Exit Barriers

Sometimes companies continue competing in an industry even though the returns on their invested capital are low or even negative. Firms making this choice likely face high exit barriers, which include economic, strategic, and emotional factors, causing them to remain in an industry when the profitability of doing so is questionable.

Common exit barriers that firms face include the following:

- Specialized assets (assets with values linked to a business or location),
- Fixed costs of exit (such as labor agreements),
- Strategic interrelationships (relationships of mutual dependence, such as those between one business and other parts of a company's operations, including shared facilities and access to financial markets).
- Emotional barriers (aversion to economically justified business decisions because of fear for one's own career, loyalty to employees, and so forth), and
- Government and social restrictions (often based on government concerns for job losses and regional economic effects; more common outside the United States).

Exit barriers are especially high in the airline industry. Fortunately, revenues increased following the global pandemic, but even when things were at their worst in this industry none of the major carriers dropped out. Industry consolidation has been a factor for many years, as the airlines have pursued efficiency enhancements through economies of scale and service to more locations through combining routes and acquisitions.[120]

2-5f Interpreting Industry Analyses

Effective industry analyses are products of careful study and interpretation of data and information from multiple sources. A wealth of industry-specific data is available for firms to analyze to better understand an industry's competitive realities. Because of globalization, international markets and rivalries must be included in the firm's analyses. And, because of the development of global markets, a country's borders no longer restrict industry structures. In fact, in general, entering international markets enhances the chances of success for new ventures as well as more established firms.[121]

Analysis of the five forces within a given industry allows the firm to determine the industry's attractiveness in terms of the potential to earn average or above-average returns. In general, the stronger the competitive forces, the lower the potential for firms to generate profits by implementing their strategies. An unattractive industry has low entry barriers, suppliers and buyers with strong bargaining positions, strong competitive threats from product substitutes, and intense rivalry among competitors. These industry characteristics make it difficult for firms to achieve strategic competitiveness and earn above-average returns. Alternatively, an attractive industry has high entry barriers, suppliers and buyers with little bargaining power, few competitive threats from product substitutes, and relatively moderate rivalry.[122]

Next, we explain strategic groups as an aspect of industry competition.

2-6 Strategic Groups and Their Influence

Learning Objective

2-6 Define strategic groups and describe their influence on firms.

A set of firms emphasizing similar strategic dimensions and using a similar strategy is called a **strategic group**.[123] Shaw Industries, featured earlier in this chapter, is a part of a strategic group of flooring manufactures, most of which are also located in Georgia in the United States. The competition between firms within a strategic group is greater than the competition between a member of a strategic group and companies outside that strategic group. Therefore, intra-strategic group competition is more intense than is inter-strategic group competition. The performance leaders within groups can follow strategies similar to those of other firms in the group and yet maintain strategic distinctiveness through differentiating their products as a foundation for earning above-average returns.[124] The extent of technological leadership, product quality, pricing policies, distribution channels, and customer service are examples of strategic dimensions that firms in a strategic group may treat similarly.

A set of firms emphasizing similar strategic dimensions and using a similar strategy is called a **strategic group**.

The notion of strategic groups can be useful for analyzing an industry's competitive structure. Such analyses can be helpful in diagnosing competition, positioning, and the profitability of firms competing within an industry. High mobility barriers, high rivalry, and low resources among the firms within an industry limit the formation of strategic groups.[125] However, after strategic groups are formed, their membership tends to remain relatively stable over time. Using strategic groups to understand an industry's competitive structure requires the firm to plot companies' competitive actions and responses along strategic dimensions, such as pricing decisions, product quality, distribution channels, and so forth. This type of analysis shows the firm how certain companies are competing similarly in terms of how they use similar strategic dimensions.

Strategic groups have several implications. First, because firms within a group offer similar products to the same customers, the competitive rivalry among them can be intense. The more intense the rivalry, the greater the threat to each firm's profitability. Second, the strengths of the five forces differ across strategic groups. Third, the closer the strategic groups are in terms of their strategies, the greater is the likelihood of rivalry between the groups.

Traditional department store retailers are having real problems. Former stalwarts such as Sears, Macy's, and J.C. Penney are all struggling, largely because they ignored competition and it eventually caught up to them. Discount stores such as Walmart and Target eroded their market share as they offered more and higher quality merchandise that was traditionally bought at the more upscale department stores, but the current problem revolves primarily around the formidable Amazon. Amazon has been winning competitive battles against these weakened retailers, and even against Alphabet (Google) and Walmart. The lesson here is that even highly successful firms must continuously analyze and understand their competitors if they are to maintain their market leading positions. If Amazon continues to effectively analyze its competition across industries, the question becomes, can any of its rivals beat it?[126]

Learning Objective

2-7 Describe what firms need to know about their competitors and different methods used to collect intelligence about them.

2-7 Competitor Analysis

The competitor environment is the final part of the external environment requiring study. Competitor analysis focuses on each company against which a firm competes directly. The Coca-Cola Company and PepsiCo, Home Depot and Lowe's, Carrefour SA and Tesco PLC, and Amazon and Alphabet (Google) are examples of competitors that are keenly interested in understanding each other's objectives, strategies, assumptions, and capabilities. Indeed, intense rivalry creates a strong need to understand competitors.[127] In a competitor analysis, the firm seeks to understand the following:

- What drives the competitor, as shown by its *future objectives*.
- What the competitor is doing and can do, as revealed by its *current strategy*.
- What the competitor believes about the industry, as shown by its *assumptions*.
- What the competitor's capabilities are, as shown by its *strengths* and *weaknesses*.[128]

Knowledge about these four dimensions helps the firm prepare an anticipated response profile for each competitor (see Figure 2.3). The results of an effective competitor analysis help a firm understand, interpret, and predict its competitors' actions and responses. Understanding competitors' actions and responses clearly contributes to the firm's ability to compete successfully within the industry.[129] Research suggests that executives often fail to analyze competitors' possible reactions to competitive actions their firm takes, placing their firm at a potential competitive disadvantage as a result.[130] The Strategic Focus on the evolution of the global automobile industry illustrates a very high level of competition among major automobile manufacturers, driven by their strategies and what they are trying to accomplish. It also shows how faulty assumptions about an industry can lead to a loss of competitive advantage.

Critical to an effective competitor analysis is gathering information that can help the firm understand its competitors' intentions and the strategic implications resulting from them.[131] Useful data and information combine to form **competitor intelligence**, which is the set of data and information the firm gathers to better understand and anticipate competitors' objectives, strategies, assumptions, and capabilities. In competitor analysis, the firm gathers intelligence not only about its competitors, but also regarding public policies in countries around the world. Such intelligence facilitates an understanding of the strategic posture of foreign competitors. Through effective competitive and public policy intelligence, the firm gains the insights needed to make effective strategic decisions regarding how to compete against rivals.

Competitor intelligence is the set of data and information the firm gathers to better understand and anticipate competitors' objectives, strategies, assumptions, and capabilities.

When asked to describe competitive intelligence, phrases such as "competitive spying" and "corporate espionage" come to mind for some. These phrases underscore the fact that competitive intelligence appears to involve trade-offs.[132] The reason is that "what is ethical in one country is different from what is ethical in other countries." This position implies that the rules of engagement

Strategic **Focus**

General and Competitive Forces Driving Evolution of the Global Automobile Industry

In the 1950s and 1960s, American automobile manufacturers ruled the industry, especially in the United States. Ford, General Motors, and Chrysler were building large, flashy cars, and competition was based on who was the flashiest. Then, a 1973 oil embargo by members of OPEC (Organization of Petroleum Exporting Countries) led to gasoline shortages and increased prices that shifted consumer attention to efficiency. Fuel-efficient automobiles produced by Japanese companies Honda and Toyota, which were already gaining popularity in the United States and around the world, were in high demand. Consumers were also learning that many automobiles manufactured by non-U.S. companies were of higher quality.

It took literally decades for American automobile manufacturers to learn how to compete head-to-head in quality and efficiency with foreign competitors. The only real advantages American auto manufacturers had in the U.S. market were that some consumers were loyal to American brands and the U.S. government imposed high tariffs on imports. However, the tariff advantage was lost when Honda, Toyota, and other manufacturers started building many of their automobiles in the United States.

Meanwhile, German-based automakers Volkswagen, Daimler (Mercedes), and BMW, as well as Korean auto manufacturer Hyundai, continued to grow worldwide. SAIC Motor, a Chinese state-owned automobile company, also became an important player in the global auto industry, although most of its cars are purchased within China. Competitive forces have driven a lot of consolidation in the industry, as companies have combined to increase market power and provide a wider selection of brands to consumers. For example, Fiat Chrysler and French PSA Group merged to become the ninth-largest auto manufacturer in the world. As a prime example of consolidation, Volkswagen now owns 10 brands, including Audi, Porsche, and Seat.

If we fast forward to 2021, the five largest auto manufacturers by revenue are, in this order, Volkswagen, Toyota, Daimler, Ford, and General Motors. The global auto industry looks quite different than it did 50 years ago. With advances in electrical storage technology and a societal focus on the environment, everyone in the industry is rushing to market with electric vehicles and hybrid vehicles that run on gasoline and batteries. Tesla, a pioneer in electric car technology, is the most valuable carmaker worldwide with a market capitalization of more than $1 trillion in early 2022. Legacy automakers are playing catchup with Tesla after watching the company grow for more than a decade. This late response is reminiscent of the days when U.S. automakers refused to switch from big gas-guzzling cars to slimmer, more efficient cars 40 years ago. Perhaps they did not learn their lesson about assessing and responding to major technological and societal environmental changes. With all the emphasis on the environment and global climate change, wasn't it obvious that electric vehicles would be the wave of the future?

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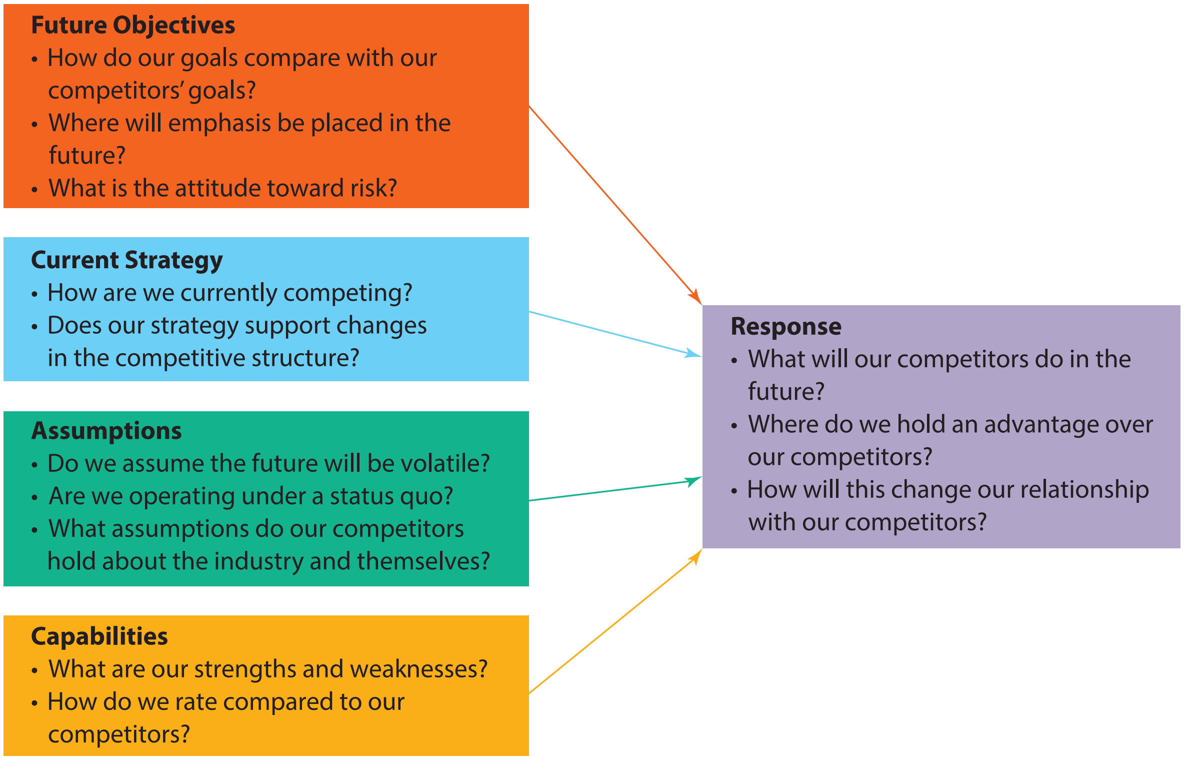
As the popularity of Tesla cars grow, Tesla Super Charging stations are popping up more throughout the United States.

Another interesting development in this industry is the race to provide charging stations for electric vehicles. Companies are adding thousands of charging stations in the United States and around the world. Most of these companies are start-ups, and it is still unclear how profitable these ventures will be. Clearly, a company that provides charging stations is complementary to auto manufacturers who want to sell electric vehicles. Tesla does both, and the U.S. government has expressed an interest in building a national network. With all the uncertainty, the competitive dynamics of this nascent (developing) industry are yet to be determined.

Looking even further into the future, technological advances are making it possible to develop prototypes of a completely autonomous self-driving car. These types of automobiles have the potential to create fundamental changes in the way people and goods are transported. Many manufacturers are already offering features in their automobiles that keep them in the middle of driving lanes, adjust their speeds based on surrounding traffic, and apply the brakes before an impact. Although many hurdles (i.e., safety issues) need to be overcome before cars will be completely autonomous, many experts believe their future existence is certain.

Sources: D. Hull, 2022, Electric vehicles' growing slice of the auto industry pie, *Bloomberg*, www.bloomberg.com, January 5; 2022, Top 10 biggest car manufacturers by revenue, *Thread in Motion*, www.threadinmotion.com, February 12; M. Carlier, 2021, Global market value of carmakers by market cap 2021, *Statista*, www.statista.com, October 26; A. Croft, 2021, The car charging war powers up, *Fortune International (Europe)*, 184: 1; B. C. Kim, H. Rhim, & H. Yang, 2021, Price competition or technology improvement? An investigation of green car technology, *International Journal of Production Research*, 59: 2800–2816.

Figure 2.3 Competitor Analysis Components



to follow when gathering competitive intelligence change in different contexts.[133] To avoid the possibility of legal entanglements and ethical quandaries, firms must govern their competitive intelligence gathering methods by a strict set of legal and ethical guidelines.[134] Ethical behavior and actions, as well as the mandates of relevant laws and regulations, should be the foundation on which a firm's competitive intelligence-gathering process is formed.

When gathering competitive intelligence, a firm must also pay attention to the complementors of its products and strategy.[135] **Complementors** are companies or networks of companies that sell complementary goods or services that are compatible with the focal firm's goods or services.[136] When a complementor's goods or services contribute to the functionality of a focal firm's goods or services, it in turn creates additional value for that firm. Complementors can be an important part of a business ecosystem. A **business ecosystem** is a complex network of interconnected organizations—suppliers, customers, government agencies, technology suppliers, financiers, and other stakeholders—whose competitive and cooperative efforts are associated with the satisfaction of a particular value proposition (e.g., product or service).[137]

Complementors are companies or networks of companies that sell complementary goods or services that are compatible with the focal firm's goods or services.

A **business ecosystem** is a complex network of interconnected organizations—suppliers, customers, government agencies, technology suppliers, financiers, and other stakeholders—whose competitive and cooperative efforts are associated with the satisfaction of a particular value proposition (e.g., product or service).

There are many examples of firms whose goods or services complement other companies' offerings. For example, the services of the airlines and hotels are complementary. In the Strategy in Focus, we learned that electric car manufacturers and suppliers of electric charging stations are complementors; however, this changes when an electric car company also supplies charging stations. Intel and Microsoft are perhaps the most widely recognized complementors. The two firms typically do not directly buy from or sell to each other, but their products are highly complementary.

Alliances among airline companies such as Oneworld and Star involve member companies sharing their route structures and customer loyalty programs as a means of complementing each other's operations. (Alliances and other cooperative strategies are described in Chapter 9.) In this example, each of the two alliances is a network of complementors. American Airlines, British Airways, Finnair, Japan Airlines, and Fiji Airways are among the airlines forming the Oneworld alliance. Air Canada, Air China, Air New Zealand, Lufthansa, and United Airlines are five of the members forming the Star alliance. Both alliances constantly adjust their members and services offered to better meet customers' needs.

As our discussion shows, complementors expand the set of competitors that firms must evaluate when completing a competitor analysis. In this sense, American Airlines and United Airlines examine each other both as direct competitors on multiple routes but also as complementors that are members of different alliances (Oneworld for American and Star for United). In all cases though, ethical commitments and actions should be the foundation on which competitor analyses are developed.

2-7a Ethical Considerations

Firms must follow relevant laws and regulations as well as carefully articulated ethical guidelines when gathering competitor intelligence. Industry associations often develop lists of these practices that firms can adopt. Practices considered both legal and ethical include:

1. Obtaining publicly available information (e.g., court records, competitors' help-wanted advertisements, annual reports, financial reports of publicly held corporations, and Uniform Commercial Code filings), and
2. Attending trade fairs and shows to obtain competitors' brochures, view their exhibits, and listen to discussions about their products.

In contrast, certain practices (including blackmail, trespassing, eavesdropping, and stealing drawings, samples, or documents) are widely viewed as unethical and often are illegal as well.

Some competitive intelligence practices may be legal, but a firm must decide whether they are also ethical, given the image it desires as a corporate citizen. Especially with electronic transmissions, the line between legal and ethical practices can be difficult to determine. For example, a firm may develop website addresses that are like those of its competitors and thus occasionally receive email transmissions that were intended for those competitors. The practice is an example of the challenges companies face in deciding how to gather intelligence about competitors while simultaneously determining how to prevent competitors from learning too much about them. To deal with these challenges, firms should establish principles and take actions that are consistent with them.

Professional associations are available to firms as sources of information regarding competitive intelligence practices. For example, while pursuing its mission to help firms make "better decisions through competitive intelligence," the Strategy and Competitive Intelligence Professionals association offers codes of professional practice and ethics to firms for their possible use when deciding how to gather competitive intelligence.[138]

Open discussions of intelligence-gathering techniques can help a firm ensure that employees, customers, suppliers, and even potential competitors understand its convictions to follow ethical practices when gathering intelligence about its competitors. An appropriate guideline for competitor intelligence practices is to respect the principles of common morality and the right of competitors not to reveal certain information about their products, operations, and intentions.

Information gathered through industry, competitor, and complementor analysis, as well as the information gathered through analyzing the general environment, should be well organized, evaluated and fed back to the managers that can use it to make good strategic decisions. The information technologies described in Chapter 1 are essential in making this happen.

Summary

- The firm's external environment is challenging and complex. Because of its effect on performance, firms must develop the skills required to identify opportunities and threats that are a part of their external environment.
- The external environment has three major parts:
  1. The general environment (segments and elements in the broader society that affect industries and the firms competing in them),
  2. The industry environment (factors that influence a firm, its competitive actions and responses, and the industry's profitability potential), and
  3. The competitor environment (in which the firm analyzes each major competitor's future objectives, current strategies, assumptions, and capabilities).
- Scanning, monitoring, forecasting, and assessing are the four parts of the external environmental analysis

process. Effectively using this process helps the firm in its efforts to identify opportunities and threats.

- The general environment has seven segments: demographic, economic, political/legal, sociocultural, technological, global, and sustainable physical. For each segment, firms have to determine the strategic relevance of environmental changes and trends.
- Compared with the general environment, the industry environment has a more direct effect on firms' competitive actions and responses. The five forces model of competition includes the threat of entry, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors. By studying these forces, a firm can identify a position in an industry where it can influence the forces in its favor or where it can buffer itself from the power of the forces in order to achieve strategic competitiveness and earn above-average returns.
- Industries are populated with different strategic groups. A strategic group is a collection of firms following similar strategies along similar dimensions. Competitive rivalry is greater within a strategic group than between strategic groups.
- Competitor analysis informs the firm about the future objectives, current strategies, assumptions, and capabilities of the companies with which it competes directly. A thorough competitor analysis examines complementors that support forming and implementing rivals' strategies.
- Different techniques are used to create competitor intelligence: the set of data, information, and knowledge that allow the firm to better understand its competitors and thereby predict their likely competitive actions and responses. Firms should use only legal and ethical practices to gather intelligence. The Internet enhances firms' ability to gather insights about competitors and their strategic intentions.

Key Terms

business ecosystem 52
competitor analysis 33
competitor intelligence 50
complementors 52
demographic segment 36
economic environment 38
general environment 33
global segment 41
industry 43
industry environment 33
opportunity 34
political/legal segment 39
sociocultural segment 39
strategic group 49
sustainable physical environment segment 42
threat 34
technological segment 40

Review Questions

1. Why is it important for a firm to study and understand the external environment?
2. What are the differences between the general environment and the industry environment? Why are these differences important?
3. What is the external environmental analysis process (four parts)? What does the firm want to learn when using this process?
4. What are the seven segments of the general environment? Explain the differences among them.
5. How do the five forces of competition in an industry affect its profitability potential? Explain.
6. What is a strategic group? Of what value is knowledge of the firm's strategic group in formulating that firm's strategy?
7. What is the importance of collecting and interpreting data and information about competitors? What practices should a firm use to gather competitor intelligence and why?

Mini-Case

Instacart Looks for New Ways to Succeed in a Rapidly Changing and Increasingly Competitive Environment

Founded by former Amazon employee Apporva Metha, Instacart was launched in 2012 as a pioneer in allowing customers to shop grocery store aisles from a smartphone screen. After Amazon acquired Whole Foods Market in 2017, Instacart's business expanded rapidly, as retailers were looking for ways to expand their online sales. The COVID-19 pandemic had the effect of increasing this growth, as both customers and retailers were more dependent on online services. Instacart's sales increased 330 percent from 2019 to 2020, with transactions volume quadrupling during the year. The company began delivering items other than groceries, and picked up customers like Best Buy and Dick's Sporting Goods. Before the pandemic, Instacart's online grocery delivery share was 20 percent. In 2020, the company enjoyed a 40 percent market share. With more than 750 retailers as customers, Instacart also raised $600 million from investors.

However, as is always the case in an industry with explosive growth, many new competitors entered the delivery market. In fact, online grocery and delivery apps were able to raise over $25 billion in venture capital in 2021. One new competitor, Gopuff, delivers goods through its own fulfillment centers. DoorDash introduced what it calls DashMarts, delivering both convenience and food items from its own stores. In one such location in New York City, DoorDash can deliver locally in 10 to 15 minutes. Other delivery services in New York alone include Fridge No More, Gorillas, Buyk, and JOKR. As a result of increasing competition and a cooldown in pandemic-related growth, Instacart's sales grew by only 15 percent in 2021.

In response to slowing sales growth and new competition, Instacart approached DoorDash to discuss a merger, but could not arrive at a deal. A deal with Uber was also sought, with no success. In addition to these attempts at a major deal, Instacart bought a company that makes automated shopping carts and another that provides catering software. In house, a new "Instacart Platform" was launched that includes warehouses, advertising, and in-store services. The company also announced that it was going to cut delivery times to 30 minutes for major retailers such as Kroger. In spite of these bold moves, the company still had to cut its valuation by about 38 percent in early 2022, citing difficulties associated with competing in the delivery market. Instacart also lost its CEO Carolyn Everson, a former Meta Platforms employee, only four months after replacing founder Apporva Metha in the position.

Meanwhile, Walmart is going to make it even tougher for delivery service companies like Instacart. "The retail giant is focused on adding new ways to offer shoppers home delivery and efficiently move online inventory as the pandemic-related-e-commerce surge shows signs of cooling." As of early 2022, third-party companies like DoorDash were making a lot of Walmart's home deliveries, and delivery service was available at more than 3,400 of its stores. Among other things, Walmart is experimenting with using its own workers to make home deliveries and expanding a service in which workers leave packages inside the homes of customers. Walmart is also exploring the use of autonomous delivery vehicles.

In addition, drone delivery is becoming a reality. In 2022, Wing (an Alphabet subsidiary) launched a drone delivery system in the Dallas–Fort Worth area. This one is different because Wing's largest customer, Walgreens Boots Alliance, is operating the system. Walgreens is giving customers 100 items to choose from, including popular over-the-counter medicines and a few household items. Wing also has a drone delivery service for other customers, including Blue Bell Creameries, in Frisco, Texas.

In the future, Instacart plans to expand its enterprise technology business by providing infrastructure and online tools for grocery store customers and developing "smart" shopping carts, as well as store checkouts and fulfillment centers. Will these strategic moves be enough to cope with changes in Instacart's environment and increasing competition?

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Mini-Case Questions

1. How hard is it to get into the home delivery business? What is needed? What are the primary deterrents to entering this market (entry barriers)?
2. Why do you suppose investors are continuing to pour money into the home delivery business? In other words, what are the major factors in the general environment that are driving growth in this industry?
3. What new technologies might be available in the future that will alter the way groceries and other goods are delivered?
4. How can delivery companies differentiate themselves from competitors?
5. Would you invest in Instacart right now? Why or why not?

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Chapter 3

The Internal Organization: Resources, Capabilities, Core Competencies, and Competitive Advantages

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

3-1 Explain why a firm needs to study and understand its internal organization.

3-2 Define value and discuss its importance.

3-3 Describe the differences between tangible and intangible resources.

3-4 Define capabilities and discuss their development.

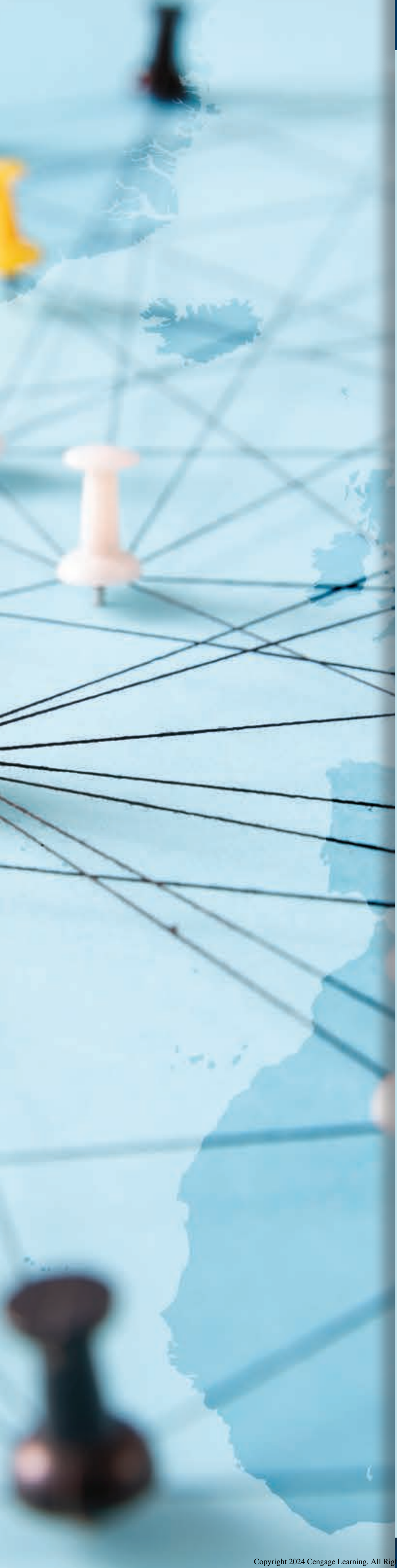
3-5 Describe four criteria used to determine if resources and capabilities are core competencies.

3-6 Explain how firms analyze value chains to determine where they are able to create value when using their resources, capabilities, and core competencies.

3-7 Define outsourcing and discuss reasons for its use.

3-8 Discuss the importance of identifying internal strengths and weaknesses.

How the COVID-19 Pandemic Demonstrated the Value of Achieving a Core Competence in Big Data Analytics in the Pharmaceutical Industry



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To date, and perhaps surprisingly, the idea of using data strategically remains somewhat novel in some organizations. However, as mentioned in Chapter 1, big data and big data analytics are becoming increasingly popular in business. In the current competitive landscape, most businesses must be innovative, and using big data analytics to interpret data retrieved from all stakeholder channels (mobile, Web, email, and physical stores) throughout the supply chain can help them become more innovative.

This is the situation for large pharmaceutical companies like Merck, Pfizer, Roche, and Johnson & Johnson. Prior to the global pandemic, many large pharmaceutical companies were struggling to be innovative, often putting more of an emphasis on marketing than the creation of new drugs. They were earning mediocre returns of about 3 percent return on investment (ROI), down from 10 percent a decade earlier. In fact, a Gallup poll found that consumers ranked the pharmaceuticals industry last among two dozen industries in favorability.

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Perhaps in response to slow sales and poor levels of innovation, many pharmaceutical companies had been working to develop a core competence in big data analytics even before the pandemic hit. In addition to lackluster innovation, they were and are ramping up their big data analytics competencies because of vast increases in the amounts of data that must be studied and interpreted to remain competitive, in part because of changes in the health-care delivery landscape and health-care reform.

The global pandemic demonstrated some of the many benefits that can accrue to pharmaceutical firms that develop big data analytics as a core competence. Developing vaccines to fight COVID-19 required analysis of huge amounts of data in a short amount of time, which some believe has fundamentally changed the way pharmaceutical firms will function in the future. For example, big data analytics help a firm quickly identify trial candidates and accelerate their recruitment, develop improved inclusion and exclusion criteria to use in clinical trials, and uncover unintended uses and indications for products. Also, some firms—Pfizer in particular—reaped both enormous sales gains and increased cash flows due to new vaccine sales that allowed them to step up their investments in information technologies that can lead to higher performance in the future.

In developing their big data analytics capabilities, many of the big pharma companies are also investing in artificial intelligence (AI). AI provides the capability to analyze many different sets of information. For example, AI can help analyze data on clinical trials, health records, genetic profiles, and preclinical studies. AI can analyze and integrate these data to identify patterns and suggest hypotheses about relationships. A new drug generally requires a decade of research and $2.6 billion of investment. And only about 5 percent of the drugs that enter experimental research make it to the market and are successful. Eventually, it is expected that the use of AI could reduce the early part of research development time from four to six years to one year, not only greatly reducing the time of development but also the costs.

As we discuss in this chapter, capabilities are the foundation for developing core competencies. There are several capabilities big pharma companies need for big data analysis to be a core competence. Supportive architecture, the proper mix of data scientists, and "technology that integrates and manages new types and sources of data flexibility and scalability while maintaining the highest standards of data governance, data quality, and data security" are examples of capabilities that pharmaceutical companies need if they wish to develop a core competence in this area.

Big data analytics capabilities are likely to be a necessity for pharmaceutical firms to succeed in the future, and firms that develop a genuine competence in this area will have an advantage over competitors. In fact, this very competitive industry is likely to become even more competitive on a global scale. Most Chinese pharmaceutical firms are medium-sized and sell generic drugs and therapeutic medicines, investing in research and development (R&D) at only about 25 percent of the amount invested by big pharma in developed countries. However, China has a plan to develop large, competitive pharmaceutical firms. China also has a goal to become the world leader in AI, which can facilitate the creation of these firms.

Thus, big pharma executives feel pressure, especially with the initial costs of developing big data analytics and AI. Hopefully, investments in these areas will lead to reduced costs and higher rates of success in the development of new drugs. Until then, however, analysts are predicting more mergers and acquisitions in the pharmaceutical industry, with big pharmaceutical companies acquiring successful medium-sized pharmaceuticals and biotechnology firms. For example, in December 2021, Pfizer agreed to acquire Arena Pharmaceuticals for $6.7 billion.

Sources: 2022, Pfizer forecasts $54 billion in 2022 sales from Covid vaccine, treatment, *Wall Street Journal*, www.WSJ.com, February 8; 2021, Pfizer to acquire Arena Pharmaceuticals in $6.7 billion deal, *Wall Street Journal*, www.wsj.com, December 13; 2021, Pfizer's boss thinks covid-19 is reshaping Big Pharma for the better, *The Economist*, www.economist.com, April 10; S. Mukherjee, 2018, How big pharma is using AI to make better drugs, *Fortune*, www.fortune.com, March 19; Z. Torrey, 2018, China prepares for big pharma, *The Diplomat,* www.thediplomat.com, March 14; E. Corbett, 2018, European mid-sized pharma companies—biotechs and big pharma? *The Pharmaletter*, www.thepharmaletter.com, March 9; M. Jewel, 2018, Signs that 2018 will be a record year for pharma M&A, *The Pharmaletter*, www.thepharmaletter.com, March1; B. Nelson, 2018, Why big pharma and biotech are betting big on AI, *NBC News*, www.nbc.news.com, March 1; Big data analytics: What it is & why it matters, 2015, *SAS*, www.sas.com, April 2; B. Atkins, 2015, Big data and the board, *Wall Street Journal Online*, www.wsj.com, April 16.

Learning Objective

3-1 Explain why a firm needs to study and understand its internal organization.

3-1 Understanding the Firm's Internal Environment

As discussed in the first two chapters, several factors in the global economy—including the rapid development of the Internet's capabilities and globalization in general—are making it difficult for firms to develop competitive advantages. Increasingly, innovation appears to be a vital path to efforts to develop competitive advantages, particularly sustainable ones.[1] This means that many firms seek to develop innovation as a core competence. In Chapter 1, we defined *core competencies* as capabilities that serve as a source of competitive advantage for a firm over its rivals. We discuss core competencies in this chapter and explain how firms use their resources and capabilities to form them. Organizations achieve strategic competitiveness and earn above-average returns by acquiring, bundling, and leveraging their resources for the purpose of taking advantage of opportunities in the external environment in ways that create value for customers.[2] As the Opening Case demonstrates, many pharmaceutical firms are attempting to use new technologies such as big data analytics and AI to better leverage their existing resources in order to achieve a competitive advantage.

Even if a firm develops and manages resources in ways that create core competencies and competitive advantages, competitors will eventually learn how to duplicate the benefits of the firm's value-creating strategy; thus, all competitive advantages have a limited life.[3] Because of this, the question of duplication of a competitive advantage is not *if* it will happen, but *when*. In general, a competitive advantage's sustainability is a function of three factors:

1. The rate of core competence obsolescence because of environmental changes,
2. The availability of substitutes for the core competence, and
3. The imitability of the core competence.[4]

The challenge, then, is to effectively manage current core competencies while simultaneously developing new ones. Only when firms are able to do this can they expect to achieve strategic competitiveness, earn above-average returns, and remain ahead of competitors over the long term. As well-known strategy scholar Clayton Christensen noted, "successful strategists need to cultivate a deep understanding of the processes of competition and progress and of the factors that undergird each advantage. Only thus will they be able to observe when old advantages are poised to disappear and how new advantages can be built in their stead."[5]

We studied the general, industry, and competitor environments in Chapter 2. Armed with knowledge about the realities and conditions of their external environment, firms have a better understanding of marketplace opportunities and the characteristics of the competitive environment in which those opportunities exist. In this chapter, we focus on the firm. By analyzing its internal organization, a firm determines what it can do. Matching what a firm *can do* (a function of its resources, capabilities, and core competencies in its internal organization) with what it *might do* (a function of opportunities and threats in the external environment) yields insights for the firm to select strategies from among those we discuss in Chapters 4 through 9.

We begin this chapter by briefly describing conditions associated with analyzing the firm's internal organization. We then discuss the roles of resources and capabilities in developing core competencies, which are the sources of the firm's competitive advantages. Included in this discussion are the techniques firms use to identify and evaluate resources and capabilities and the criteria for identifying core competencies from among them.

Resources alone typically do not provide competitive advantages. Instead, resources create value when the firm uses them to form capabilities, some of which become core competencies, and hopefully sources of competitive advantage. Because of the relationship among resources, capabilities, and core competencies, we also discuss the value chain and examine four criteria that firms use to determine if their capabilities are core competencies and, as such, sources of competitive advantage.[6] The chapter closes with comments about outsourcing as well as the need for firms to prevent their core competencies from becoming core rigidities. The existence of core rigidities indicates that the firm is too anchored to its past, a situation that prevents it from continuously developing new capabilities and core competencies.

3-1a Why Understand the Internal Organization

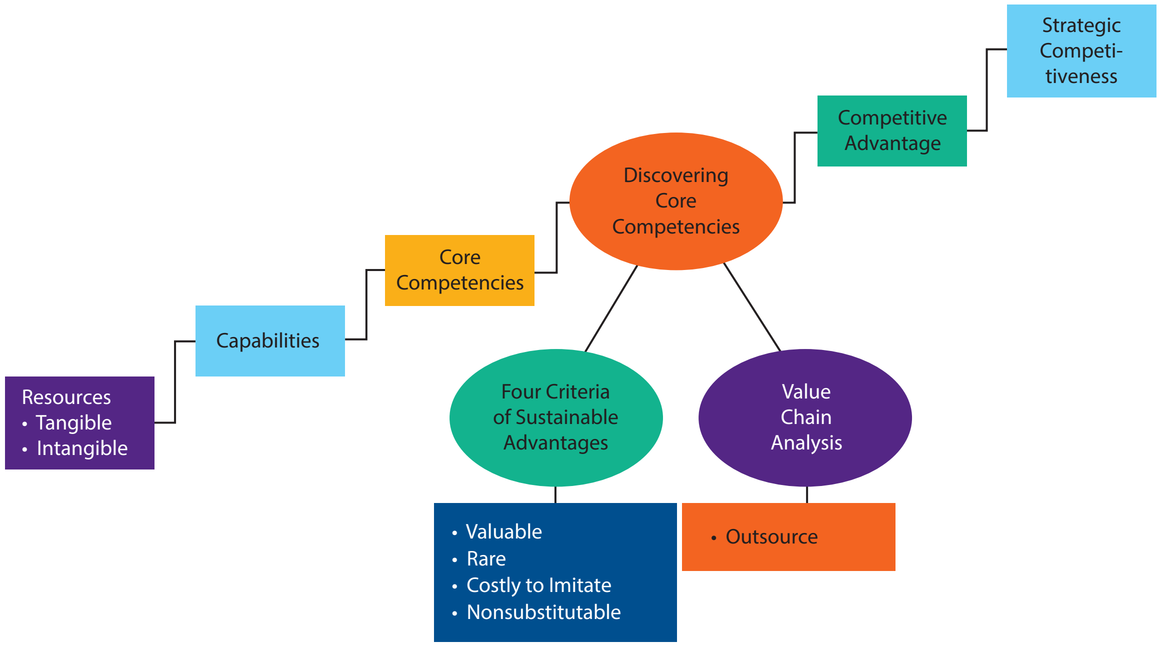
One of the conditions associated with analyzing a firm's internal organization is the reality that in today's global economy, some of the resources that were traditionally critical to firms' efforts to produce, sell, and distribute their goods or services—such as labor costs, access to financial resources and raw materials, and protected or regulated markets—although still important, are now less likely to be sources of competitive advantage.[7]

Given the increasing importance of the global economy, those analyzing their firm's internal organization should adopt a **global mind-set**, which is the ability to analyze, understand, and manage an internal organization in ways that are not dependent on the assumptions of a single country, culture, or context.[8] Because they are able to span artificial boundaries, those with a global mind-set recognize that their firms must possess resources and capabilities that allow understanding of and appropriate responses to competitive situations that are influenced by country-specific factors and unique cultures. Using a global mind-set to analyze the internal organization has the potential to significantly help the firm in its efforts to outperform rivals.[9]

A **global mind-set** is the ability to analyze, understand, and manage an internal organization in ways that are not dependent on the assumptions of a single country, culture, or context.

Finally, analyzing the firm's internal organization requires that evaluators examine the firm's entire portfolio of resources and capabilities. This perspective suggests that individual firms possess at least some resources and capabilities that other companies do not—at least not in the same combination. Resources are the source of capabilities, some of which lead to the development of core competencies; in turn, some core competencies may lead to a competitive advantage for the firm.[10] Understanding how to leverage the firm's unique bundle of resources and capabilities is a key outcome decision makers seek when analyzing the internal organization.[11] Figure 3.1 illustrates the relationships among resources, capabilities, core competencies, and competitive advantages, and shows how their integrated use can lead to strategic competitiveness. As we discuss next, firms use the resources in their internal organization to create value for customers.

Figure 3.1 Components of an Internal Analysis



Learning Objective

3-2 Define value and discuss its importance.

Value is measured by a product's performance characteristics and by its attributes for which customers are willing to pay.

3-2 Creating Value and Its Importance

Firms use their resources as the foundation for producing goods or services that will create value for customers.[12] **Value** is measured by a product's performance characteristics and by its attributes for which customers are willing to pay. Firms create value by innovatively bundling and leveraging their resources to form capabilities and core competencies.[13] Firms with a competitive advantage create more value for customers than do competitors. Walmart uses its "every day low price" approach to doing business (an approach that is grounded in the firm's core competencies, such as information technology and distribution channels) to create value for those seeking to buy products at a low price compared to competitors' prices for those products. The stronger these firms' core competencies, the greater the amount of value they're able to create for their customers.[14] Ultimately, creating more value for customers is the source of above-average returns for a firm.

Making decisions involving the firm's assets—identifying, developing, deploying, and protecting resources, capabilities, and core competencies—may appear to be relatively easy. However, the strategic decisions managers make about the internal organization are nonroutine, have ethical implications, and significantly influence the firm's ability to earn above-average returns.[15] These decisions involve choices about the resources the firm needs to collect and how to best manage and leverage them. Also, while making these decisions they must be simultaneously aware of changes in the firm's external environment.[16] Moreover, the task is increasingly internationalized.[17] Some believe that too much pressure on managers to make only decisions that help the firm meet anticipated quarterly earnings makes it difficult to accurately examine the firm's internal organization.[18]

The challenges of making effective decisions are implied by preliminary evidence suggesting that one-half of organizational decisions fail.[19] Sometimes, mistakes are made as the firm analyzes conditions in its internal organization.[20] Managers might, for example, think a capability is a core competence when it is not. That is, they may believe it has the capacity to lead to *long-term* competitiveness, but such is not the case. American automobile manufacturers, discussed in Chapter 2, believed that their competencies in building large, comfortable cars would sustain them over the long term; however, the market shifted to smaller, fuel efficient cars and U.S. manufacturers were slow to respond.

A firm can improve by studying its mistakes; in fact, the learning generated by making and correcting mistakes can be important in the creation of new capabilities and core competencies.[21] One capability that can be learned from failure is when to quit. For example, News Corp.'s Amplify unit (founded 2011) was created to change the way children are taught. As of mid-2015, the firm had invested over $1 billion in the unit, which makes tablets, sells online curricula, and offers testing services.

Figure 3.2 Conditions Affecting Managerial Decisions about Resources, Capabilities, and Core Competencies

Conditions	**Uncertainty**	**Uncertainty exists about the characteristics of the firm's general and industry environments and customers' needs.**
	Complexity	**Complexity results from the interrelationships among conditions shaping a firm.**
	Intraorganizational Conflicts	**Intraorganizational conflicts may exist among managers making decisions as well as among those affected by the decisions.**

In 2014, Amplify generated a $193 million loss, facing competition from well-established textbook publishers enhancing their own ability to sell similar digital products. In September 2015, News Corp. decided to sell Amplify to a team of managers and private investors, incurring a significant loss.[22] News Corp. could have saved a significant amount of money if they had dropped this operation many years previously.

Uncertainty, complexity, and intraorganizational conflict affect managers as they analyze the internal organization and make decisions about resources (refer to Figure 3.2). Environmental uncertainty increases the complexity and range of issues to examine when studying the internal environment.[23] Managers face uncertainty due to such things as new proprietary technologies, rapidly changing economic and political trends, transformations in societal values, and shifts in customers' demands.[24] Consider how uncertainty affects the ways resources are used at coal companies such as Peabody Energy Corp. and Murray Energy Corp. Coal. These companies have been suffering in the last decade or more with significant regulations and competition from cleaner forms of energy such as natural gas. They were aided some by the reduction of regulations by the Trump administration, but the Biden administration reversed a lot of what Trump did, and the competition from cleaner and cheaper forms of energy remains. Thus, their environment is both highly complex (many factors to consider) and uncertain. Biases regarding how to cope with complexity and uncertainty can affect decisions made about how to manage the firm's resources and capabilities to form core competencies.[25]

Additionally, intraorganizational conflict may surface when decisions are made about the core competencies a firm should develop and nurture. Conflict might surface in the energy companies mentioned above about the degree to which resources and capabilities should be used to form new core competencies to support newer "clean technologies."

In making decisions affected by these three conditions, judgment is required. *Judgment* is the capability of making successful decisions when no obviously correct model or rule is available or when relevant data are unreliable or incomplete. In such situations, decision makers must be aware of possible cognitive biases, such as overconfidence. Individuals who are too confident in the decisions they make about how to use the firm's resources may fail to fully evaluate contingencies that could affect those decisions.[26]

When exercising judgment, decision makers often take intelligent risks. In the current competitive landscape, executive judgment can become a valuable capability. Effective judgment demonstrated by decision makers allows a firm to build a strong reputation and retain the loyalty of stakeholders whose support is linked to above-average returns.[27] Discussed fully in Chapter 12, strategic leaders can be thought of as individuals with an ability to examine the firm's resources, capabilities, and core competencies and make effective choices about their use and development.

Next, we consider the relationships among a firm's resources, capabilities, and core competencies. While reading these sections, keep in mind that organizations have more resources than capabilities and more capabilities than core competencies.

3-3 Resources, Tangible and Intangible

Learning Objective

3-3 Describe the differences between tangible and intangible resources.

Resources, capabilities, and core competencies are the foundation of competitive advantage. Resources are bundled to create organizational capabilities. In turn, capabilities are the source of a firm's core competencies, which are the basis of establishing competitive advantages.[28] We introduced these relationships in Figure 3.1 and discuss them next.

Broad in scope, resources cover a spectrum of individual, social, and organizational phenomena. By themselves, resources do not allow firms to create value for customers as the foundation for earning above-average returns. Instead, resources are used and combined to form capabilities.[29] For example, Subway, the fast-food sandwich chain, links its fresh ingredients with several other resources, including the continuous training it provides to those running its restaurants, as the foundation for customer service as a capability—customer service is also a core competence for Subway.

The Internet is a resource for Amazon.com. The firm uses the Internet to sell goods at prices that typically are lower than those offered by competitors selling the same goods through more costly brick-and-mortar storefronts. By combining other resources (such as access to a wide product inventory and a fast delivery system), Amazon has developed a reputation for excellent customer service. Amazon's capability in terms of customer service is a core competence as well, in that the firm creates unique value for customers through the services it provides to them.

Tangible resources are assets that can be observed and quantified.

Intangible resources are assets that are rooted deeply in the firm's history, accumulate over time, and are relatively difficult for competitors to analyze and imitate.

Some of a firm's resources are tangible while others are intangible. **Tangible resources** are assets that can be observed and quantified. Production equipment, manufacturing facilities, distribution centers, and formal reporting structures are examples of tangible resources. For energy giant Kinder Morgan, its stock of oil and gas pipelines are a key tangible resource. **Intangible resources** are assets that are rooted deeply in the firm's history, accumulate over time, and are relatively difficult for competitors to analyze and imitate. Because they are embedded in unique patterns of routines, intangible resources are difficult for competitors to analyze and imitate. Knowledge, trust between managers and employees, managerial capabilities, organizational routines (the unique ways people work together), scientific capabilities, the capacity for innovation, brand name, the firm's reputation for its goods or services and how it interacts with stakeholders (such as employees, customers, and suppliers), and organizational culture are intangible resources.[30]

Intangible resources require nurturing to maintain their ability to help firms engage in competitive battles. For example, brand names have long been a valuable intangible resource for companies like Coca-Cola, Nike, and Disney. These companies are very protective of their brands, and they make sure that all of their products and advertising reflect the appropriate brand image. Similarly, research and development processes at companies like the big chip makers Intel and TSMC (Taiwan Semiconductor Manufacturing Company) are carefully nurtured. As the Strategic Focus demonstrates, Harley-Davidson (Harley) has a well-protected competence in its premium brand and also in its stakeholder relationships, especially with customers, that fortifies its brand image among motorcycle riders. However, the company is not as popular with the rising generation of riders, so the question is whether these competencies are enough to provide competitiveness for Harley in the future.

The Harley-Davidson example demonstrates that intangible resources such as a strong brand name or relationships with customers may be even more important in the development of core competencies than tangible resources. Internal analysis can help a firm determine which resources are important to future success. For each analysis, tangible and intangible resources are grouped into categories. The four primary categories of tangible resources are financial, organizational, physical, and technological (refer to Table 3.1). The three primary categories of intangible resources are human, innovation, and reputational (refer to Table 3.2).

Table 3.1 Tangible Resources

Financial Resources	• **The firm's capacity to borrow** • **The firm's ability to generate funds through internal operations**
Organizational Resources	• **Formal reporting structures**
Physical Resources	• **The sophistication of a firm's plant and equipment and the attractiveness of its location** • **Distribution facilities** • **Product inventory**
Technological Resources	• **Availability of technology-related resources such as copyrights, patents, trademarks, and trade secrets**

Sources: Adapted from J. B. Barney, 1991, Firm resources and sustained competitive advantage, *Journal of Management*, 17: 101; R. M. Grant, 1991, *Contemporary Strategy Analysis*, Cambridge: U.K.: Blackwell Business, 100–102.

Strategic **Focus**

Will Harley-Davidson's Core Competencies Continue to Provide Competitive Advantage?

Harley-Davidson is one of the most storied brands in the world. Founded in 1903 by William Sylvester Harley and three members of the Davidson family, the company is known worldwide for its big street bikes with a well-known "Harley" sound. Because Harley's motorcycles were used by the military in both the first and second world wars, their leadership position was solidified. However, new Japanese players entered the U.S. motorcycle industry in the 1960s, threatening this position. Harley asked the U.S. government to increase import tariffs for Japanese motorcycles, and the government complied. However, eventually these tariffs were removed.

Harley experienced ups and downs after that; however, the company developed a loyal cult following through developing close relationships with customers and associating the Harley brand with adventure and the thrill of riding. Both of these core competencies, brand identity and close relationships with customers, are exemplified in this statement by Harley management: "A chill sweeps through your body, created by a spontaneous outburst of pure, unadulterated joy. You are surrounded by people from all walks of life and every corner of the globe. They are complete strangers, but you know them like your own family. They were drawn to this place by the same passion—the same dream. And they came here on the same machine. This is one place you can truly be yourself. Because you don't just fit in. You belong."

Loyal customers and a strong brand name have sustained Harley though the tough times. Also, toward the end of the last century, Harley established a larger presence in Canada, Europe, the Middle East, Africa, Asia-Pacific, and Latin America. However, Harley's fortunes internationally have varied widely. For example, in 2019 Harley sold less than 2,500 motorcycles in India, causing the company to partner with the large Indian distributor Hero MotoCorp to help with marketing and sales in that country. Harley also diversified into electric motorcycles a few years ago; however, the price tag of almost $30,000 discouraged many potential consumers.

Looking ahead, one of the primary questions with regard to the future performance of Harley is whether the company can generate the same sort of loyalty in a new generation of riders that it has enjoyed for so many years with what is now an aging consumer base. Basically, is the Harley brand going to remain a core competence? This question remains unanswered, and Harley sales of motorcycles (in units) declined each year from 2017 to 2020.

As a result of the COVID-19 pandemic, Harley fared better in 2021 than in previous years, as people were anxious to get outside rather than being isolated. Retail motorcycle sales grew by 8 percent in North America, which is Harley's biggest market, although they declined in other regions of the world. Gina Goetter, chief financial officer, told *Barron's* that Harley's factories were running at full capacity, and the company was looking for ways to increase production.

Is the uptick in sales a sign of the future or is it a temporary bump? In an effort to increase its appeal to the new generation of riders and strengthen its international position, in 2020 Harley appointed Jochen Zeitz, a European environmental activist, as its CEO. Under his leadership, the company is making a huge new investment in electric motorcycles. To raise funds, Harley spun off its LiveWire electric motorcycle business into a separate publicly traded company late in 2021. The deal was estimated to raise more than $500 million, to be used for product development and to grow LiveWire's manufacturing and distribution capabilities. The deal left Harley with a 74 percent ownership stake in the new company. Harley CEO Jochen Zeitz said that the capital infusion and independence will allow LiveWire to act like a start-up. Can Harley gain the same sort of brand recognition and loyalty with a new generation that it has enjoyed with older riders for so many years?

Zety Akhzar/Shutterstock.com

Harley Davidson is so widely popular, that over the years the brand has created retail stores globally.

Sources: S. Escobar, 2022, Harley-Davidson stock surges on surprise fourth-quarter earnings, *Barron's*, www.barrons.com, February 8; M. Grossman, 2021, Harley-Davidson's electric-vehicle division to go public via SPAC merger, *Wall Street Journal*, www.wsj.com, December 13; M. Carlier, 2021, Harley-Davidson motorcycles sales by region 2017–2020, *Statista*, www.statista.com, February 24; A. Root, 2021, Harley stock is up because people want to get outside, *Barron's*, www.barrons.com, February 16; 2021, Harley-Davidson, Inc. Company Profile, *MarketLine*, www.marketline.com, April 6; J. E. Ellis, 2020, Harley-Davidson gets an unlikely rider, *Bloomberg Businessweek*, July 27: 8–10; 2020, Harley Davidson may exit India due to fall in sales: Report, *Automobile Snapshot*, August 25: 13–14; 2020, Harley-Davidson says working with partner Hero to ensure smooth transition for customers in India, *FRPT Automobile Snapshot*, November 24: 8–9; A. Agnihotri, 2013, Turnaround of Harley Davidson—Cult brand or strategic fit approach, *Journal of Strategic Marketing*, 21: 292–301.

Table 3.2 Intangible Resources

Human Resources	• Knowledge • Trust • Skills • Abilities to collaborate with others
Innovation Resources	• Ideas • Scientific capabilities • Capacity to innovate
Reputational Resources	• Brand name • Perceptions of product quality, durability, and reliability • Positive reputation with stakeholders such as suppliers and customers

Sources: Adapted from R. Hall, 1992, The strategic analysis of intangible resources, *Strategic Management Journal*, 13: 136–139: R. M. Grant, 1991, *Contemporary Strategy Analysis*, Cambridge: U.K.: Blackwell Business, 101–104.

Tangible Resources

As tangible resources, a firm's borrowing capacity and the status of its physical facilities are visible. The value of many tangible resources can be established through financial statements, but these statements do not account for the value of all of the firm's assets because they disregard some intangible resources.[31] The value of tangible resources is also constrained because they are hard to leverage—it is difficult to derive additional business or value from a tangible resource. For example, an airplane is a tangible resource, but "you can't use the same airplane on five different routes at the same time. You can't put the same crew on five different routes at the same time. And the same goes for the financial investment you've made in the airplane."[32]

Intangible Resources

Compared to tangible resources, intangible resources are a superior source of capabilities and, subsequently, core competencies.[33] In fact, in the global economy, a firm's intellectual capital often plays a more critical role in corporate success than do physical assets.[34] Because of this, being able to effectively manage intellectual capital is an increasingly important skill for today's leaders to develop.[35]

Because intangible resources are less visible and more difficult for competitors to understand, purchase, imitate, or substitute for, firms prefer to rely on them rather than on tangible resources as the foundation for their capabilities. In fact, the more unobservable (i.e., intangible) a resource is, the more valuable that resource is in the creation of capabilities.[36] Another benefit of intangible resources is that, unlike most tangible resources, their use can be leveraged. For instance, sharing knowledge among employees does not diminish its value for any one person. To the contrary, two people sharing their individualized knowledge sets often can be leveraged to create additional knowledge that, although new to each individual, contributes potentially to performance improvements for the firm.

iStock.com/Courtney Keating

Developing capabilities in specific functional areas can give companies a competitive edge. The effective use of social media to direct advertising to specific market segments has given some firms an advantage over their rivals.

Reputational resources (refer to Table 3.2), as demonstrated in the Harley-Davidson example, can be important sources of a firm's capabilities and core competencies.[37] Earned through the firm's actions as well as its words, a value-creating reputation is a product of years of superior marketplace competence as perceived by stakeholders.[38] A reputation indicates the level of awareness a firm has been able to develop among stakeholders and the degree to which they hold the firm in high esteem.[39]

Taking advantage of today's technologies, many firms are using social media as a means of influencing their reputations.[40] Recognizing that thousands of conversations occur daily throughout the world and that what is being said can affect its reputation, Coca-Cola Company encourages its employees to be a part of these social media-based discussions as a means of positively influencing the company's reputation. Driving the nature of these conversations is a set of social media principles that Coca-Cola employees use as a foundation for how they will engage with various social media. Being transparent and protecting consumers' privacy are examples of the commitments the firm has established.[41]

3-4 Capabilities and Core Competencies

Learning Objective

3-4 Define capabilities and discuss their development.

A firm combines individual tangible and intangible resources to create capabilities.[42] In turn, capabilities are used to complete the organizational tasks required to produce, distribute, and service the goods or services the firm provides to customers. As a foundation for building core competencies and hopefully competitive advantages, capabilities are often based on developing, carrying, and exchanging information and knowledge through the firm's human capital.[43] **Strategic human capital** allows a firm to develop capabilities through matching the knowledge, skills, and abilities of their employees to particular strategic objectives. Simply having highly skilled and knowledgeable people in the firm is not enough. For example, a firm may have employees who possess multicultural knowledge, skills, and abilities, but unless they are put in a position in which they can use those attributes in helping the firm with its international strategies and operations, they will not help a multinational firm achieve higher performance.[44]

Strategic human capital allows a firm to develop capabilities through matching the knowledge, skills, and abilities of their employees to particular strategic objectives.

As illustrated in Table 3.3, capabilities are often developed in specific functional areas (such as manufacturing, R&D, and marketing) or in a part of a functional area (e.g., advertising). Table 3.3 presents a grouping of organizational functions and the capabilities that some companies are thought to possess in terms of all or parts of those functions.

3-4a Core Competencies

Defined in Chapter 1, core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals. Core competencies distinguish a company competitively and reflect its personality. Core competencies emerge over time through an organizational process of accumulating and learning how to deploy different resources and capabilities.[45] As the capacity to take action, core competencies are the "crown jewels of a company," the activities the company performs

Table 3.3 Example of Firms' Capabilities

Functional Areas	Capabilities	Examples of Firms
Distribution	• Effective use of logistics management techniques	• Walmart
Human Resources	• Motivating, empowering, and retaining employees	• Microsoft
Management Information Systems	• Effective and efficient control of inventories through point-of-purchase data collection methods	• Walmart
Marketing	• Effective promotion of brand-name products • Effective customer service • Innovative merchandising	• Procter & Gamble • Ralph Lauren Corp. • McKinsey & Co. • Crate & Barrel
Management	• Ability to envision the future of clothing	• Hugo Boss • Zara
Manufacturing	• Design and production skills yielding reliable products • Product and design quality • Miniaturization of components and products	• Komatsu • Witt Gas Technology • Sony
Research & Development	• Innovative technology • Development of sophisticated elevator control solutions • Rapid transformation of technology into new products and processes • Digital technology	• Caterpillar • Otis Elevator Co. • Chaparral Steel • Thomson Consumer Electronics

especially well compared to competitors and through which the firm adds unique value to the goods or services it sells to customers.[46] Thus, if a big pharmaceutical company develops big data analytics as a core competence, one could conclude that the firm has formed capabilities through which it is able to analyze and effectively use huge amounts of data in a competitively superior manner.

Innovation is a core competence at Apple. As a capability, R&D activities are the source of this core competence. More specifically, the way Apple has combined some of its tangible (e.g., financial resources and research laboratories) and intangible (e.g., scientists and engineers and organizational routines) resources to complete research and development tasks creates a capability in R&D. By emphasizing its R&D capability, Apple can innovate in ways that create unique value for customers in the form of the products it sells.

Excellent customer service in its retail stores is another of Apple's core competencies. In this instance, unique and contemporary store designs (a tangible resource) are combined with knowledgeable and skilled employees (an intangible resource) to provide superior service to customers. A number of carefully developed training and development procedures are capabilities on which Apple's core competence of excellent customer service is based. The procedures that are capabilities include specification of how employees are to interact with customers, carefully written training manuals to describe on-site tech support that is to be provided to customers, and deep thinking about every aspect of the store's design, including music that is played. Apple has a special training program designed to build associates' knowledge of Apple products and how to sell them.[47]

3-4b Building Core Competencies

Two tools help firms identify their core competencies. The first consists of four specific criteria of sustainable competitive advantage that can be used to determine which capabilities are core competencies. Because the capabilities presented in Table 3.3 have satisfied these four criteria, they are core competencies. The second tool is value chain analysis. Firms use this tool to select the value-creating competencies that should be maintained, upgraded, or developed and those that should be outsourced.

Learning Objective

3-5 Describe four criteria used to determine if resources and capabilities are core competencies.

3-5 The Four Criteria of Sustainable Competitive Advantage

Capabilities that are valuable, rare, costly to imitate, and nonsubstitutable are core competencies (refer to Table 3.4). In turn, core competencies help firms to gain competitive advantages over their rivals. Capabilities failing to satisfy the four criteria are not core competencies, meaning that although every core competence is a capability, not every capability is a core competence. In slightly different words, for a capability to be a core competence, it must be valuable and unique from a customer's point of view. For a core competence to be a potential source of competitive advantage, it must be inimitable and nonsubstitutable by competitors.[48]

A sustainable competitive advantage exists only when competitors are unable to duplicate the benefits of a firm's strategy or when they lack the resources to attempt imitation.[49] For some period of time, the firm may have a core competence by using capabilities that are valuable and rare, but easy to imitate. For example, some firms are trying to develop a core competence and potentially a

Table 3.4 The Four Criteria of Sustainable Competitive Advantage

Valuable Capabilities	• Help a firm neutralize threats or exploit opportunities
Rare Capabilities	• Are not possessed by many others
Costly-to-Imitate Capabilities	• Historical: A unique and a valuable organizational culture or brand name • Ambiguous cause: The causes and uses of a competence are unclear • Social complexity: Interpersonal relationships, trust, and friendship among managers, suppliers, and customers
Nonsubstitutable Capabilities	• No strategic equivalent

Strategic **Focus**

Patagonia's Core Competence As a "Green" Company

Founded by Yvon Chouinard in 1973, Patagonia makes a variety of outdoor gear, focusing primarily on clothes for climbing, skiing, surfing, fishing, and running. The company was created as a result of the passion of the founder for the outdoors. Yvon got his start in climbing in 1953 in Southern California. He met and began climbing with some other young climbers who were members of the Sierra Club, an environmental group. In 1957, he taught himself to blacksmith and began making pitons, the spikes climbers use to scale sheer rock walls. Word of the pitons spread, and he eventually began selling them for $1.50 each from the back of his car. In 1965, Yvon formed Chouinard Equipment with a partner, Tom Frost. They redesigned almost every climbing tool to improve strength, weight, and functionality. By 1970, Chouinard Equipment was the largest supplier of climbing hardware in the United States. However, Yvon and Tom became concerned that their gear was defacing the rock, so they decided to minimize their piton business. They also introduced aluminum "chocks" that could be wedged into cracks by hand without hammering them into the rock. Demand for their chocks quickly outstripped supply.

In 1970, on a winter climbing trip to Scotland, Yvon bought a rugby shirt. The shirt performed very well for climbing because of its ruggedness. Back in the United States, Yvon's climbing friends wanted to know where to get one. This experience eventually led to the creation of a clothing line, which the company called Patagonia. The clothing featured specialized fabrics that performed much better than competing products. Also, at a time when most outdoor clothes were in dull colors, the company decided to drench its product with vivid colors such as teal, seafoam, and French red. The company grew rapidly—at one time listed on *Inc*. magazine's list of the fastest growing privately held companies. The culture at the company is laid back and friendly, with employees dressing any way they want, even barefooted. There are no private offices in the company, which can cause distractions but also stimulates open communication.

Patagonia was fairly small when they began to engage in efforts to save the environment from the perils of global climate change, deforestation, acid rain, polluted rivers, and the rapid loss of groundwater. In one of their first environmental efforts, they showed up at a city council meeting to protest a development that would damage a popular surfing area. At the meeting, they met a young biology student, and partnered with him to save a local river. Patagonia then began making donations to small groups working to protect the natural habitat. In 1986, the company began donating 10 percent of its profits to these types of groups. Later they committed to donating 1 percent of sales, regardless of whether they made a profit, and began encouraging others to do so through a group called 1% for the Planet.

Now headed by Jenna Johnson, an avid rock climber who was previously vice president of technical outdoor for the company, Patagonia, Inc., is on the cutting edge of environmentally friendly business practices. Many of their raw materials are grown organically or produced from recycled materials. The company also works tirelessly to reduce its carbon footprint. In fact, the company's mission statement is, "We're in business to save our home planet." Patagonia became a Certified B Corporation in 2012, a designation given to firms that have strong records in social and environmental performance. The company is also very politically active. For example, Hans Cole, Patagonia's director of environmental campaigns and advocacy, recently testified to the U.S. House Committee on Natural Parks, Forests, and Public Lands on the topic of global climate change. The company also recently launched a "Blue Heart of Europe" campaign to protect the Balkan region from the ill effects of thousands of proposed hydropower projects. In addition, Patagonia makes certain that the companies with which it does business are socially responsible. For example, the company set 2020 as the year by which its suppliers in Taiwan would have to ensure that none of the migrant workers they hire will ever have to pay for their jobs.

Patagonia's customers know that the company is "green," and since many of them are outdoor enthusiasts, this image is a core competency that fosters loyalty. Because Patagonia is so well known for its environmentally friendly practices, it would be difficult for most competitors to do enough to catch up to them in this area.

sylv1rob1/Shutterstock.com

Patagonia's stakeholders love the company's green focus

Sources: J. Gallagher, 2022, Why are all these people showering in their Arc'teryx jackets, *Wall Street Journal*, www.wsj.com, January 17; 2022, Yvon Chouinard, *Forbes*, www.forbes.com/profile/yvon-chouinard, February 17; 2022, Company History, *Patagonia*, www.patagonia.com, February 17; 2022, The 10 most environmentally friendly & sustainable companies, *Grow Ensemble*, www.growensemble.com, February 17; C. Ryan, 2021, For fashion brands, green is the hardest color to sell, *Wall Street Journal*, www.wsj.com, November 5; 2019, *Annual Benefit Corporation Report*, Ventura, CA, Patagonia, Inc.

competitive advantage by out-greening their competitors. Developing a "green" core competence can contribute to the firm's efforts to earn above-average returns while benefitting the broader society. Patagonia, featured in the Strategic Focus, is an example of a company that has a "green" core competence that has put them in a favorable position in the outdoor clothing market for many years.

The length of time a firm can expect to create value by using its core competencies is a function of how quickly competitors can successfully imitate a good, service, or process. Value-creating core competencies may last for a relatively long period of time only when all four of the criteria we discuss next are satisfied. Thus, Patagonia has a core competence that gives the company a sustainable competitive advantage because its green strategy and associated brand image satisfy all four of the criteria.

Valuable

Valuable capabilities allow the firm to exploit opportunities or neutralize threats in its external environment.

Valuable capabilities allow the firm to exploit opportunities or neutralize threats in its external environment. By effectively using capabilities to exploit opportunities or neutralize threats, a firm creates value for customers.[50] For example, Groupon created the "daily deal" marketing space that connected buyers to sellers through what amounts to deeply discounted online coupons for Groupon members. Because it was the first major offering in this space, the firm reached $1 billion in revenue faster than any other company in history. Restaurants, hair and nail salons, and hotels are examples of the types of companies making frequent use of Groupon's services. Young, urban professionals desiring to affordably experience the cities in which they live are the firm's target customers.[51]

While offering value to customers, the capabilities to offer its services can be imitated and Groupon's initial success invited rivals to enter the market. Competing daily-deal websites such as LivingSocial quickly surfaced and offered similar and often less expensive deals. In fact, many competitors entered the market, to include Yipit, Woot, RetailMeNot, Tanga, and Ebate, in addition to LivingSocial.[52] Groupon profits declined significantly from net income of $14 million in 2017 to a loss of $11 million in 2018. By 2020 the loss was $288 million. Revenues declined from $2.8 billion in 2017 to $1.4 billion in 2020.[53]

Rare

Rare capabilities are capabilities that few, if any, competitors possess.

Rare capabilities are capabilities that few, if any, competitors possess. A key question to be answered when evaluating this criterion is, "how many rival firms possess these valuable capabilities?" Capabilities possessed by many rivals are unlikely to become core competencies for any of the involved firms.[54] Instead, valuable but common (i.e., not rare) capabilities are sources of competitive parity.[55] Competitive advantage results only when firms develop and exploit valuable capabilities that become core competencies and that differ from those shared with competitors. The central problem for Groupon is that its capabilities to connect buyers and sellers through daily deals and discounts reached competitive parity quickly.

Costly to Imitate

Costly-to-imitate capabilities are capabilities that other firms cannot easily develop.

Costly-to-imitate capabilities are capabilities that other firms cannot easily develop. Capabilities that are costly to imitate are created because of one or a combination of three reasons (refer to Table 3.4). First, a firm sometimes is able to develop capabilities because of *unique historical conditions*. As firms evolve, they often acquire or develop capabilities that are unique to them.[56] For example, a firm with a unique and valuable *organizational culture* that emerged in the early stages of the company's history "may have an imperfectly imitable advantage over firms founded in another historical period."[57] Briefly discussed in Chapter 1, organizational culture is a set of values that are shared by members in the organization. An organizational culture is a source of advantage when employees are held together tightly by their belief in it and the leaders who helped to create it.[58] Firms like Disney, Google (Alphabet), and Patagonia developed strong cultures under the guidance of their founders and those cultures are still paying off today.

A second condition of being costly to imitate occurs when the link between the firm's core competencies and its competitive advantage is *causally ambiguous*.[59] In these instances, competitors can't clearly understand how a firm uses its capabilities as the foundation for competitive advantage. As a result, firms are uncertain about the capabilities they should develop to duplicate the benefits of a competitor's value-creating strategy. This condition is evident in the research and development processes of large companies on the cutting edge of their industries. Although competitors can imitate the products that emerge from these processes, it is hard to figure out precisely how the research and development process that created them combines the firm's capabilities. Causal ambiguity is a source of sustainable competitiveness in firms like Intel, Apple, and Google (Alphabet).

The Washington Post/Getty Images

Southwest Airlines crew hold puppies that became homeless after Hurricane Maria damaged the island of Puerto Rico. The flight, which was donated by Southwest Airlines, carried 14,000 pounds of supplies.

Social complexity is the third reason that capabilities can be costly to imitate. Social complexity means that at least some, and frequently many, of the firm's capabilities are the product of complex social phenomena.[60] Interpersonal relationships, trust, friendships among managers and between managers and employees, and a firm's reputation with suppliers and customers are examples of socially complex capabilities. Southwest Airlines is careful to hire people who fit with its culture. This complex interrelationship between the culture and human capital adds value in ways that other airlines cannot, such as jokes on flights by the flight attendants or a high level of cooperation between gate personnel and pilots.

Nonsubstitutable

Nonsubstitutable capabilities are capabilities that do not have strategic equivalents. This final criterion "is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable. Two valuable firm resources (or two bundles of firm resources) are strategically equivalent when they each can be separately exploited to implement the same strategies."[61] In general, the strategic value of capabilities increases as they become more difficult to substitute. The more intangible, and hence invisible, capabilities are, the more difficult it is for firms to find substitutes and the greater the challenge is to competitors trying to imitate a firm's value-creating strategy. Firm-specific knowledge and trust-based working relationships between managers and nonmanagerial personnel, such as has existed for years at firms like Cisco Systems, Salesforce, and Hilton, are examples of capabilities that are difficult to identify and for which finding a substitute is challenging.[62]

Nonsubstitutable capabilities are capabilities that do not have strategic equivalents.

In summary, sustainable competitive advantage is only available to firms using valuable, rare, costly-to-imitate, and nonsubstitutable capabilities. Table 3.5 presents the competitive consequences and performance implications resulting from combinations of the four criteria of sustainability. The analysis suggested by the table helps managers determine the strategic value of a firm's capabilities. The firm should not emphasize capabilities that fit the criteria described in the first row in the table (i.e., resources and capabilities that are neither valuable nor rare and that are imitable and for which strategic substitutes exist). Capabilities yielding

Table 3.5 Outcomes from Combinations of the Criteria for Sustainable Competitive Advantage

Is the Capability Valuable?	Is the Capability Rare?	Is the Capability Costly to Imitate?	Is the Capability Nonsubstitutable?	Competitive Consequences	Performance Implications
No	No	No	No	• Competitive disadvantage	• Below-average returns
Yes	No	No	Yes/no	• Competitive parity	• Average returns
Yes	Yes	No	Yes/no	• Temporary competitive advantage	• Average returns to above-average returns
Yes	Yes	Yes	Yes/no	• Sustainable competitive advantage	• Above-average returns

competitive parity and either temporary or sustainable competitive advantage, however, should be supported. Some competitors, such as Coca-Cola vs. PepsiCo or Boeing vs. Airbus, may have capabilities that result in competitive parity, where no firm has a significant advantage over the other in any particular capability (although in both cases the two firms have an advantage over other rivals in their industries). In such cases, the firms will nurture their existing capabilities while simultaneously trying to develop capabilities that can yield either a temporary or sustainable competitive advantage.[63]

Learning Objective

3-6 Explain how firms analyze value chains to determine where they are able to create value when using their resources, capabilities, and core competencies.

3-6 Value Chain Analysis

Value chain analysis allows the firm to understand the parts of its operations that create the most value for customers, and can potentially be sources of competitive advantage or even sustainable competitive advantage if those operations represent core competencies that cannot be easily imitated.[64] Understanding these issues is important because the firm earns above-average returns only when the value it creates is greater than the costs incurred to create that value.[65]

The value chain is a template that firms use to analyze their cost positions and to identify the multiple means that can be used to facilitate implementation of their chosen strategies.[66] Today's competitive landscape demands that firms examine their value chains in a global rather than a domestic-only context.[67] In particular, activities associated with supply chains should be studied within a global context.[68]

Value chain activities are activities or tasks the firm completes in order to produce products and then sell, distribute, and service those products in ways that create value for customers.

Support functions include the activities or tasks the firm completes in order to support the work being done to produce, sell, distribute, and service the products the firm is producing.

We present a model of the value chain in Figure 3.3. As depicted in the model, a firm's value chain is segmented into value chain activities and support functions. **Value chain activities** are activities or tasks the firm completes in order to produce products and then sell, distribute, and service those products in ways that create value for customers. **Support functions** include the activities or tasks the firm completes in order to support the work being done to produce, sell, distribute, and service the products the firm is producing. A firm can develop a capability and/or a core competence in any of the value chain activities or in any of the support functions. Firms establish one or more sources of competitive advantage when they use their unique core competencies to create unique value for customers in a way that competitors cannot duplicate.[69]

The activities associated with each part of the value chain are presented in Figure 3.4, while the activities that firms complete when dealing with support functions appear in Figure 3.5. All items in both figures should be evaluated relative to competitors' capabilities and core competencies. To become a core competence and a source of competitive advantage, a capability must allow the firm to either:

1. Perform an activity in a manner that provides value superior to that provided by competitors, or
2. Perform a value-creating activity that competitors cannot perform.

Figure 3.3 A Model of the Value Chain

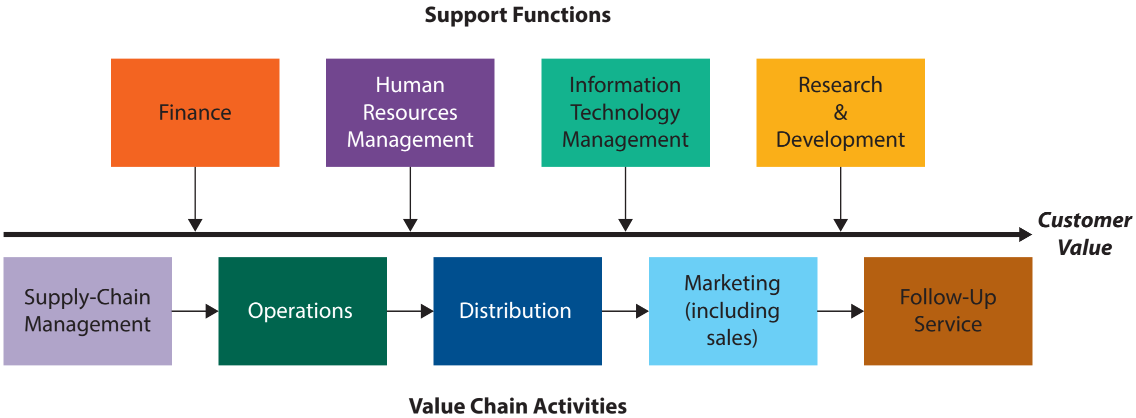
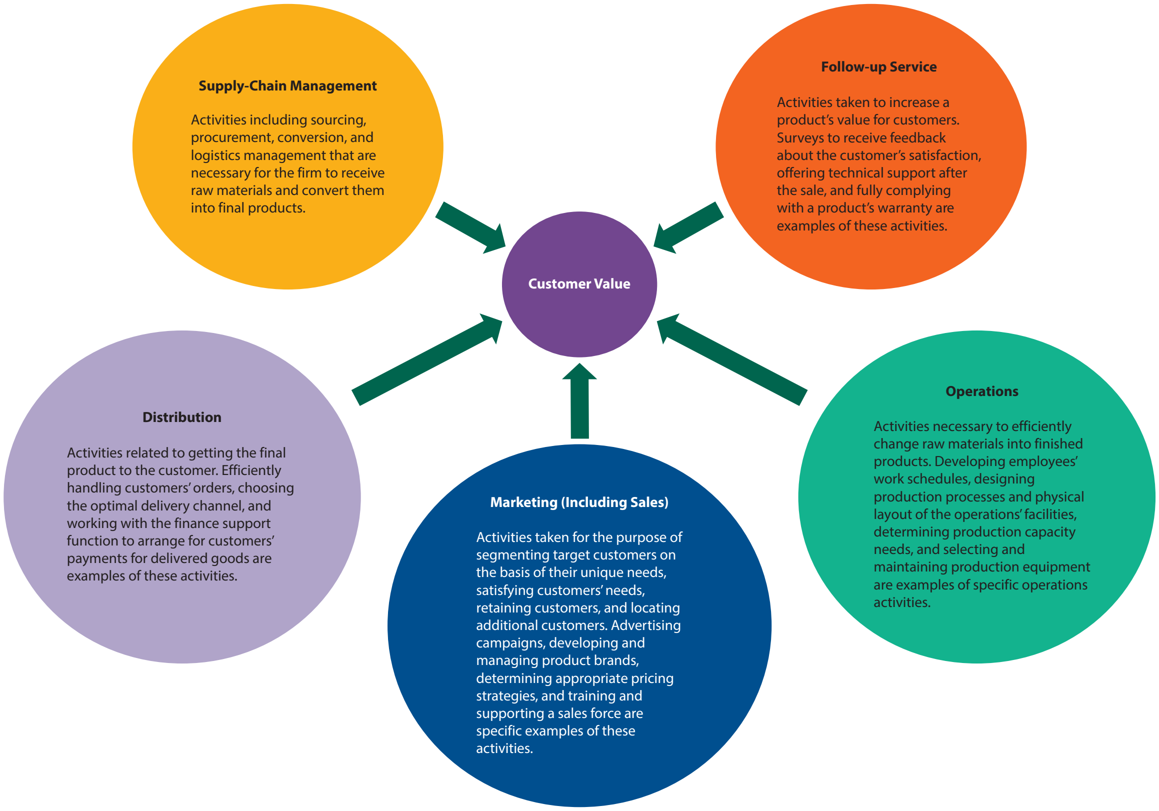


Figure 3.4 Creating Value through Value Chain Activities



If a firm doesn't have anything that it does better than competitors, value chain analysis can help managers determine which activities hold the most potential for the firm to develop such a competence. In the best case, managers may discover an activity in which the firm can develop a core competence because there are no other firms in the industry that have done so.

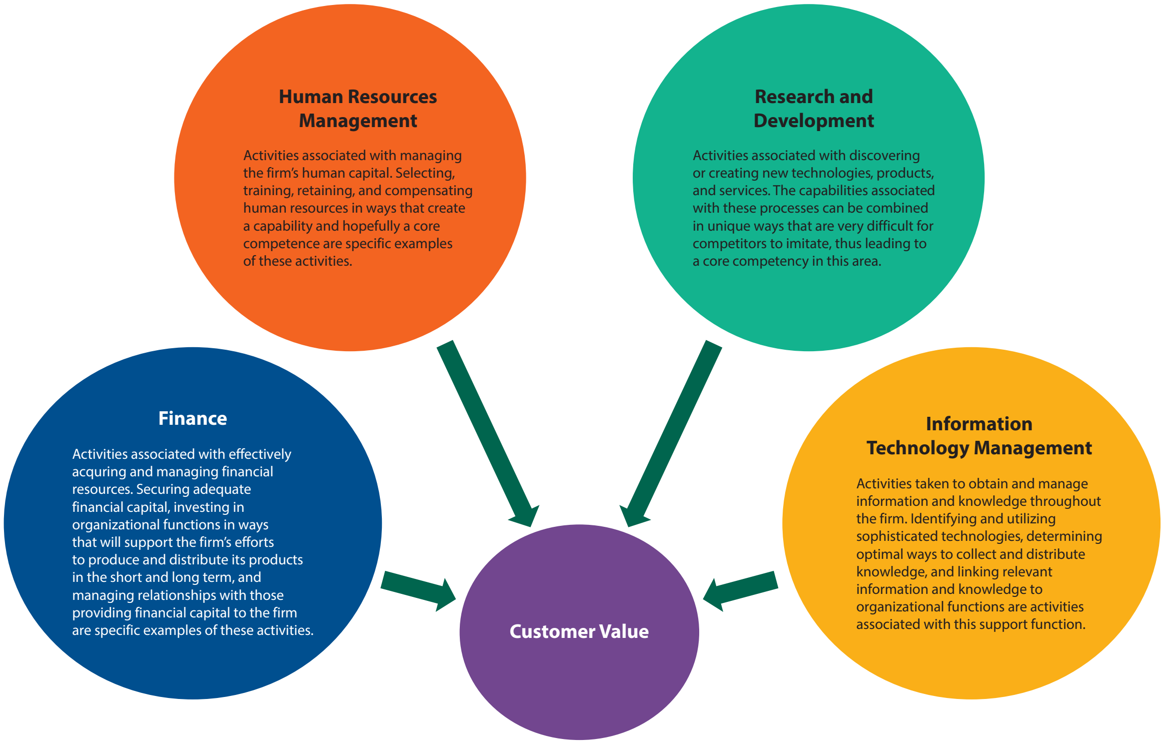
Thus far, the emphasis has been on using the value chain to identify activities in which the firm has a core competence or might develop one. However, value chain analysis can also be used to look for deficiencies in the organization that could be holding back the creation of value.[70] This part of the analysis rests on the assumption that a firm is a *value creation system*. In a **value creation system**, each part of a system depends on other parts of the system to create value.[71] If one part of the system is not functioning properly, it can hold back creation of value in the entire system.[72]

In a **value creation system**, each part of a system depends on other parts of the system to create value. If one part of the system is not functioning properly, it can hold back creation of value in the entire system.

Consider the following examples that demonstrate how a firm is a value creation system. If the finance function is not working well, essential investments in critical areas such as operations, research and development, or marketing might be curtailed. Similarly, if supply-chain management activities are weak, operations will not have what it needs to do its part well, and this can both hurt downstream activities such as distribution and marketing, as well as reducing the flow of funds to other critical areas because customer demand (and money spent) is reduced. This same pattern is evident in relationships among all the activities in the value chain and in the support functions. A weak area can hurt the performance of the entire system.

Creating value for customers by completing activities that are part of the value chain requires building strong and productive relationships with stakeholders, which include customers, suppliers, and alliance partners.[73] When firms have strong positive relationships with stakeholders, they are said to have *social capital*.[74] The relationships themselves have value because they lead to transfers of knowledge as well as access to resources that a firm may not hold internally.[75] Trust is required to build social capital, whereby resources such as knowledge are transferred across organizations. Indeed, partners must trust each other to allow their resources to be used in such a way that both parties will benefit over time while neither party will take advantage of the other.[76] If a relationship with a particular stakeholder is poor, this could be holding back the creation of more value for customers or other stakeholders.

Figure 3.5 Creating Value through Support Functions



Evaluating a firm's capability to execute its value chain activities and support functions is challenging. Earlier in the chapter, we noted that identifying and assessing the value of a firm's resources and capabilities requires judgment. Judgment is equally necessary when using value chain analysis, because no obviously correct model or rule is universally available to help in the process.

Learning Objective

3-7 Define outsourcing and discuss reasons for its use.

Outsourcing is the purchase of a value-creating activity or a support function activity from an external supplier.

3-7 Reasons for Outsourcing

When essential value chain activities or support functions are not competencies, a firm can consider outsourcing those activities. Concerned with how components, finished goods, or services will be obtained, **outsourcing** is the purchase of a value-creating activity or a support function activity from an external supplier. Not-for-profit, for-profit, and even government organizations actively engage in outsourcing.[77] Deciding to outsource to a foreign supplier is commonly called *offshoring*. Many financial institutions are outsourcing functions that support cashless transaction because their IT systems cannot handle these activities efficiently. Some governments are outsourcing services to increase the quality and efficiency with which the services are delivered (e.g., U.K. outsourcing some surgeries to French health-care providers). Outsourcing decisions must be made carefully, considering all of the options. However, when done effectively, outsourcing can provide access to needed capabilities without having to develop them internally.

Firms engaging in effective outsourcing increase their flexibility, mitigate risks, and reduce their capital investments.[78] Moreover, in some industries virtually all firms seek the value that can be captured through effective outsourcing. However, as is the case with other strategic management process decisions, careful analysis is required before a firm decides to outsource.[79] And firms must recognize that only activities where they cannot create value or where they are at a substantial disadvantage compared to competitors should be outsourced.[80] Experience suggests that virtually any activity associated with the value chain functions or the support functions may fall into this category.

Outsourcing can be effective because few, if any, organizations possess all the resources and capabilities required to achieve competitive superiority in each value chain activity and support function. For example, research suggests that few companies can afford to internally develop all the technologies that might lead to competitive advantage.[81] By nurturing a smaller number of capabilities, a firm increases the probability of developing core competencies and achieving a competitive advantage because it does not become overextended. In addition, by outsourcing activities in which it lacks competence, the firm can fully concentrate on those areas in which it has the potential to create value.

There are concerns associated with outsourcing.[82] Two significant ones are the potential loss in a firm's ability to innovate and the loss of jobs within the focal firm. When evaluating the possibility of outsourcing, firms should anticipate possible effects on their ability to innovate in the future as well as the impact of losing some of their human capital. On the other hand, firms are sometimes able to enhance their own innovation capabilities by studying how the companies to which they've outsourced complete those activities.[83]

3-8 Competencies, Strengths, Weaknesses, and Strategic Decisions

Learning Objective

3-8 Discuss the importance of identifying internal strengths and weaknesses.

By analyzing the internal organization, firms identify their strengths and weaknesses as reflected by their resources, capabilities, and core competencies. If a firm has weak capabilities or does not have core competencies in areas required to achieve a competitive advantage, it must acquire those resources and build the needed capabilities and competencies. Or, as noted in the previous section, some firms may decide to outsource a function or activity where it is weak in order to improve its ability to use its remaining resources to create value.

In considering the results of examining the firm's internal organization, managers should understand that having a significant quantity of resources and capabilities is not the same as having the "right" resources and capabilities. The "right" resources and capabilities are those with the potential to be formed into core competencies as the foundation for creating value for customers and developing competitive advantages because of doing so. Interestingly, decision makers sometimes become more focused and productive when seeking to find the right resources and capabilities when the firm's total set of resources and capabilities is constrained.[84]

Tools such as outsourcing help the firm focus on its core competencies as the source of its competitive advantages. However, evidence shows that the value-creating ability of core competencies should never be taken for granted. Moreover, the ability of a core competence to be a permanent competitive advantage can't be assumed. The reason for these cautions is that all core competencies have the potential to become *core rigidities*, which occur due to overdependence on a particular core competence even when situations change and the core competence is no longer generating a competitive advantage.[85] Events occurring in the firm's external environment can create conditions through which core competencies can become core rigidities, generate inertia (e.g., resistance to change), and stifle innovation.[86]

After studying its external environment to determine what it *might choose to do* (as explained in Chapter 2) and its internal organization to understand what it *can do* (as explained in this chapter), the firm has the information required to select a business-level strategy that it will use to compete against rivals. We describe various business-level strategies in the next chapter.

Summary

- In the current competitive landscape, the most effective organizations recognize that strategic competitiveness and above-average returns result only when core competencies (identified by studying the firm's internal organization) are matched with opportunities (determined by studying the firm's external environment).
- No competitive advantage lasts forever. Over time, rivals use their own unique resources, capabilities, and core competencies to form different value-creating propositions that duplicate the focal firm's ability to create value for customers. Because competitive advantages are not permanently sustainable, firms must exploit their current advantages while simultaneously using their resources and capabilities to form new advantages that can lead to future competitive success.

- Broad in scope, resources cover a spectrum of individual, social, and organizational phenomena. Resources are bundled to create organizational capabilities. Tangible resources are assets that can be observed and quantified. Production equipment, manufacturing facilities, distribution centers, and formal reporting structures are examples of tangible resources. Intangible resources are assets that are rooted deeply in the firm's history, accumulate over time, and are relatively difficult for competitors to analyze and imitate. Because intangible resources are less visible and more difficult for competitors to understand, purchase, imitate, or substitute for, firms prefer to rely on them rather than on tangible resources as the foundation for their capabilities. In fact, the more unobservable (i.e., intangible) a resource is, the more valuable that resource is in the creation of capabilities.
- A firm combines individual tangible and intangible resources to create capabilities. In turn, capabilities are used to complete the organizational tasks required to produce, distribute, and service the goods or services the firm provides to customers. Core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals. Competencies are activities the company performs especially well compared to competitors and through which the firm adds unique value to the goods or services. For example, strategic human capital allows a firm to develop capabilities through matching the knowledge, skills, and abilities of their employees to particular strategic objectives.
- Effectively managing core competencies requires careful analysis of the firm's resources (inputs to the production process) and capabilities (resources that have been purposely integrated to achieve a specific task or set of tasks). The knowledge the firm's human capital possesses is among the most significant of an organization's capabilities and ultimately provides the base for most competitive advantages. The firm must create an organizational culture that allows people to integrate their individual knowledge with that held by others so that, collectively, the firm has a significant amount of value-creating organizational knowledge.
- Capabilities are a more likely source of core competence and subsequently of competitive advantages than are individual resources. How a firm nurtures and supports its capabilities to become core competencies is less visible to rivals, making efforts to understand and imitate the focal firm's capabilities difficult.
- Only when a capability is valuable, rare, costly to imitate, and nonsubstitutable is it a core competence and a source of sustainable competitive advantage. Over time, core competencies must be supported, but they cannot be allowed to become core rigidities. Core competencies are a source of competitive advantage only when they allow the firm to create value by exploiting opportunities in its external environment. When this is no longer possible, the company shifts its attention to forming other capabilities that satisfy the four criteria of sustainable competitive advantage.
- Value chain analysis is used to identify and evaluate the competitive potential of resources and capabilities. By studying their skills relative to those associated with value chain activities and support functions, firms can understand their cost structure and identify the activities through which they are able to create value. Managers can also use value chain analysis to identify which activity area could be holding back the ability of the firm to create more value.
- When the firm cannot create value in either a value chain activity or a support function, outsourcing is considered. Used commonly in the global economy, outsourcing is the purchase of a value-creating activity from an external supplier. The firm should outsource only to companies possessing a competitive advantage in terms of the particular value chain activity or support function under consideration. In addition, the firm must continuously verify that it is not outsourcing activities through which it could create unique value.
- Examining the internal organization unveils if the firm has a significant quantity of the "right" resources and capabilities. The "right" resources and capabilities are those with the potential to be formed into core competencies. Decision makers then select strategies the firm can to do acquire or develop those resources and capabilities.

Key Terms

Review Questions

1. Why is it important for a firm to study and understand its internal organization?
2. What is value? Why is it critical for the firm to create value? How does it do so?
3. What are the differences between tangible and intangible resources? Why is it important for decision makers to understand these differences? Are tangible resources more valuable for creating capabilities than are intangible resources, or is the reverse true? Why?
4. What are capabilities? How do firms create capabilities?
5. What four criteria must capabilities satisfy for them to become core competencies? Why is it important for firms to use these criteria to evaluate their capabilities' value-creating potential?
6. What is value chain analysis? What does the firm gain by successfully using this tool?
7. How is a firm a value creation system? Give examples.
8. What is outsourcing? Why do firms outsource?
9. How do firms identify internal strengths and weaknesses? Why is it vital that managers have a clear understanding of their firm's strengths and weaknesses?
10. What are core rigidities? What does it mean to say that each core competence could become a core rigidity?

Mini-Case

How Publix Leverages Its Resources and Capabilities to Create a Sustainable Competitive Advantage

Headquartered in Lakeland, Florida, Publix Super Markets, Inc., operates supermarkets in Florida, Georgia, North Carolina, South Carolina, Virginia, Alabama, Wisconsin, and Tennessee. In addition to grocery products, dairy, deli, and health-care products, the company also has a pharmacy and sells floral products. Publix manages dairy and deli plants, and has a number of distribution centers and manufacturing facilities located within convenient range of most of its supermarkets. With revenue of nearly $45 billion, the company has 230,000 employees, and continues to grow.

Unlike other supermarket chains in the United States, Publix is employee owned. The company also treats its employees extraordinarily well. In fact, as of 2022, Publix has claimed a place on *Fortune* magazine's Best Companies to Work For list for 25 straight years. Only four companies have done that. Publix hires young people, identifies the ones with the most talent, and pours money into training employees so that they are genuine experts on products. Employees are not unionized, and they don't need to be, because they are already getting the same sort of compensation and benefits that they would get from a union contract. In one recent example, Publix began offering paid parental leave to employees starting in 2022.

One thing Publix offers that very few companies can offer is a career. People are promoted from within the company. Many top managers started as grocery baggers—90 percent of current managers started on the supermarket floor. After a year of employment, employees receive shares of stock in Publix that can only be traded within the company. "Just like a startup where workers are given equity, the model entices people to stay." This kind of employment pattern is rare in retail. Turnover is very high in other retail companies, and was especially a problem during the pandemic. "In December 2021 some 786,000 retail employees quit—a record in an industry already plagued by high turnover." In retail, having a well-trained workforce that stays is a huge advantage.

Customers tend to be very loyal to Publix, and might best be referred to as "fans" of the company. "Customers enjoy shopping at Publix in large part because employees seem to actually enjoy working there." Deli sandwiches are among the favorites of customers, and they line up for sub sandwiches around lunch time. If customers get anywhere near a Publix employee, they are guaranteed to be greeted cheerfully. If a product rings through the cash register at a price that is different from what it says on the shelf, the product is free. In 2020, Publix launched two initiatives for its customers—a personalized membership program called Club Publix and an Instacart Meals app that gives customers online ordering combined with delivery or pickup of made-to-order food. Publix pharmacies provide customers with free prescriptions for several oral antibiotics and maintenance medicines for diabetes and high blood pressure, having filled its 100 millionth free prescription in 2021. Even with the additional cost of all the extra service Publix provides to customers, its operating margins are higher than both Kroger and Walmart.

Publix is also a great corporate citizen. For example, in April 2020, Publix launched a new initiative to help farmers that were being hurt by the COVID-19 pandemic. The company bought produce and milk from farmers most affected, and then donated it to food banks to help people throughout its operating area who had likewise been hurt by the pandemic. In addition, Publix donated millions of dollars to the Feeding America foodbanks.

In spite of its long record of success, Publix refuses to become too comfortable. In 2018, in response to the trend toward healthier foods, Publix opened a concept store in Tallahassee, Florida, called GreenWise Markets, and announced its intention to open more throughout the southeastern United States. GreenWise specializes in organic and healthy foods. The Publix name is not seen on the signage outside the store or anywhere in the store. The product mix is unique—the only overlap is that some of the GreenWise products are also offered in Publix supermarkets (but no Publix brand products are offered in GreenWise). GreenWise Markets are complementary to Publix supermarkets rather than competitive, and are designed to appeal to a new target market.

Since the first opening, Publix has opened GreenWise Markets in Georgia, South Carolina, and more in Florida. "In the Fort Lauderdale location, customers will find a 'CUTS' section offering meat raised with no antibiotics or added hormones, as well as sustainably sourced seafood. Meanwhile, the 'EATS' area serves up made-to-order meals and grab-and-go foods such as gourmet sandwiches and fresh-baked pizza. More foodservice offerings are available in the 'POURS' section, which has locally roasted coffee, wine, beer on tap and other beverages that customers can drink in-store."

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Case Discussion Questions

1. Make a list of the key resources and capabilities Publix has.
2. From your experience with other grocery stores, which of these resources and capabilities are unique to Publix?
3. Which of the resources and capabilities would also be difficult or expensive for a competitor to imitate? In other words, which of them is likely to lead to a sustainable competitive advantage?
4. Using stakeholder theory explained in Chapter 1, explain how Publix can earn above average returns in spite of spending so much money on its employees, on customer service, and on giving back to the community.
5. If you were a close competitor of Publix, what would be your competitive strategy? That is, what could you do to be successful even with Publix in your market?

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Chapter 4

Business-Level Strategy

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

4-1 Explain what a business-level strategy is and its purpose.

4-2 Discuss the relationship between customers and business-level strategies in terms of *who*, *what*, and *how*.

4-3 Describe business models, including their relationship with business-level strategies.

4-4 Using the five forces model, explain cost leadership as a business-level strategy, including the associated risks.

4-5 Using the five forces model, explain differentiation as a business-level strategy, including the associated risks.

4-6 Explain focus strategies as a business-level strategy, including the associated risks.

4-7 Explain integrated cost leadership/differentiation as a business-level strategy, including the associated risks.

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Omnichannel Retailing in the Digital Age

"The pace of change is faster and more relentless, the level of uncertainty higher and the degree of complexity greater than it has even been." Digital technologies are driving a lot of that uncertainty and complexity because the world's competitive environments are increasingly information intensive and interconnected. This situation means that firms need to have a *digital strategy* to help implement all of their other strategies (in this chapter, we discuss business-level strategies). An effective digital strategy is based on digital principles—principles that redefine company imperatives around customers, growth, efficiency, and innovation.

The retailing industry has undergone some of the most drastic changes in the past few decades due to digital technology. It was not long ago that almost all goods were purchased from physical stores. As the Internet got faster and enjoyed more widespread use, digital platforms such as Amazon and eBay took an increasing share of retail purchases. Traditional brick-and-mortar retailers developed digital strategies to combat these advances, with varying degrees of success. The COVID-19 pandemic reinforced the popularity of digital purchases. Now, many traditional retailers are suffering from lost sales and, in some cases, even facing the reality that they may not survive much longer.

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Because of the march of digital technologies, a new mind-set is emerging in the retailing industry: *omnichannel*. It is reflected by a business model that provides a seamless experience to customers whether they are buying something online or from a physical store (business models are discussed in this chapter). Traditional brick-and-mortar retailers are continuing to enhance their online experiences by creating web-based stores and mobile apps and increasing "the number of customer touchpoints throughout the digital space." Also, online retailers like Amazon (e.g., Amazon Go) are moving into brick-and-mortar spaces, sometimes without cashiers. These efforts have blurred the line between digital and physical spaces.

The online Swedish clothing retailer ASKET found an innovative way to explore omnichannel retailing. Managers were concerned that customers could not experience the quality of ASKET products through their online store, so they tested different pop-up stores in various locations in Stockholm and abroad. These pop-up stores would last from a few days to a couple of months. After a customer visits a pop-up location, they receive an email with their own personalized size chart and instructions for placing an online order.

When implementing an omnichannel business model, firms need to train sales associates how to use in-store technologies and help customers smoothly interact with those technologies while they are in the store. Handheld devices that help locate products and allow customers to make immediate purchases are common. Firms should also leverage the mobile channel, allowing a high level of interaction with customers. In addition, data analytics strategies are important means through which omnichannel firms can analyze customer data to determine preferences. Collaborations with other businesses can also be important. For example, a firm may work with vendors to organize special events.

As with all strategies—whether purely digital, omnichannel, brick-and-mortar, or something else—committed leadership is essential. Working with others, leaders make choices about how a strategy is implemented, allocate resources essential to carrying it out, and predict the future with the type of clarity that allows the firm to recognize what could be a viable competitive position in the years to come.

Sources: L. Forman, 2021, Instacart needs to ring up grocers in store, *Wall Street Journal*, www.wsj.com, October 22; M. Jocevski, 2020, Blurring the lines between physical and digital spaces: Business model innovation in retailing, *California Management Review, 63:* 99–117; J. Ferguson & N. Anderson, 2018, How to build a digital strategy, *World Economic Forum*, www.weforum.org, January 10; K. Tama-Rutgliano, 2018, Mapping out your digital marketing strategy for 2018, *Forbes*, www.forbes.com, January 2; A. Bollard, E. Larrea, A. Singla, & R. Sood, 2017, The next-generation operating model for the digital world, *McKinsey & Company*, www.mckinsey.com, March.

Learning Objective

4-1 Explain what a business-level strategy is and its purpose.

4-1 Understanding Business-Level Strategies

Strategy is concerned with making choices among two or more alternatives.[1] Opportunities and threats in the external environment influence the company's choices (see Chapter 2), as do the nature and quality of the resources, capabilities, and core competencies in its internal organization (see Chapter 3).[2]

As discussed in the Opening Case, changing information technologies are among the most important external sources of both opportunities and threats facing business organizations. Information and the technologies available to gather and analyze it are at the core of a firm's effort to form a digital strategy. A **digital strategy** uses digital technology to help a firm understand its customers and their needs with greater clarity as a foundation for developing innovations that create more value for those customers.[3] A digital strategy is developed and implemented in combination with other firm strategies. In the case of retailing, firms are figuring out ways to enhance a traditional brick-and-mortar shopping experience through a digital strategy that makes the most out of both online and in-person experiences.

A **digital strategy** uses digital technology to help a firm understand its customers and their needs with greater clarity as a foundation for developing innovations that create more value for those customers.

This chapter is the first on strategy, which is the second part of the strategic-management process (as explained in Chapter 1). By selecting and implementing one or more strategies (see Figure 1.1), firms seek to gain strategic competitiveness and earn above-average returns.[4] Strategies are purposeful, engage rivals in marketplace competition, and demonstrate a shared understanding of the firm's vision and mission.[5] A strategy consistent with the conditions and realities of a firm's external and internal environments marshals, integrates, and allocates available resources, capabilities, and competencies to align them properly with opportunities in the external environment.

Business-level strategy, this chapter's focus, indicates the choices the firm has made about how it intends to compete in individual product markets.[6] A **business-level strategy** is an integrated and coordinated set of commitments and actions the firm uses to gain a competitive advantage by exploiting core competencies in a specific product market.[7] Given the complexity of competing successfully in the global economy, the choices about how the firm will compete are challenging.

A **business-level strategy** is an integrated and coordinated set of commitments and actions the firm uses to gain a competitive advantage by exploiting core competencies in a specific product market.

Every firm must develop and implement a business-level strategy. However, some firms may not use all of the other strategies discussed in Chapters 6 through 9 of this book—corporate-level, merger and acquisition, international, and cooperative. A firm competing in a single-product market in a single geographic location does not need a corporate-level strategy that defines its type and level of product diversification or an international strategy to deal with geographic diversity. Because every firm must develop and use at least one business-level strategy, it is the *core* strategy—the strategy that the firm forms to describe how it intends to compete against rivals on a day-to-day basis in its chosen product market.[8] The other types of strategy are built around the firm's core business-level strategy.

The purpose of a business-level strategy is to create differences between the firm's position and those of its competitors.[9] To position itself differently from competitors, a firm must decide if it intends to *perform activities differently* or if it will *perform different activities*.[10] Strategy defines the path that provides the direction of actions organizational leaders take to help their firms achieve success.[11] In today's complex competitive landscape, the successful use of a business-level strategy results from the firm learning how to integrate its activities in ways that create superior value for customers.

While firms devise their business-level strategies in the context of what is happening in its external environment, it is important to realize that they do not have to conform to all aspects of that environment. They can, through their strategies, influence the environment.[12] For example, early in the company's history, Walmart's CEO Sam Walton devised a strategy of building large discount department stores primarily in rural areas where consumers had no easy access to these types of retailers. At the time, the conventional wisdom was that such ventures would fail. In another example, Bank of America is working to counteract the disproportionate increase in rents in urban centers with a strategy that focuses on increasing affordable housing in those areas. Some tactics Bank of America is using to implement this strategy include forming nonprofit alliances and offering below-cost loans.[13]

We discuss several topics in our examination of business-level strategies. Customers are the foundation of success for all business-level strategies, and firms must continue creating value for their customers if they are to retain them.[14] Consequently, we begin with a discussion of how a customer focus influences business-level strategies. We then define business models and explain their relationship with business-level strategies. After our discussion of business models, we consider five *generic* business-level strategies. They are *generic* in nature in that any organization competing in any industry can use any of them.[15] Our analysis describes how effective use of each strategy allows the firm to position itself favorably relative to an industry's five competitive forces (see Chapter 2).

In addition, we use the value chain (see Chapter 3) to present examples of the primary and support activities necessary to implement specific business-level strategies. Because no strategy is risk-free, we describe the different risks the firm may encounter when using these strategies.[16] In Chapter 11, we explain the organizational structures and controls linked with the successful use of each business-level strategy.

4-2 Customers: Their Relationship with Business-Level Strategies

Learning Objective

4-2 Discuss the relationship between customers and business-level strategies in terms of who, what, and how.

Strategic competitiveness results only when the firm satisfies a group of customers by using its competitive advantages as the basis for competing in individual product markets.[17] Effective global competitors have become adept at identifying customers' needs in different cultures and geographic regions, as well as learning how to respond to changes in customer needs. They establish reach, richness, and affiliation with their customers.[18] The *reach* dimension of customer relationships revolves around the firm's access and connection to customers. In general, firms seek to extend their reach, adding customers in the process. *Richness* concerns the depth and detail of the two-way flow of information between the firm and customers. *Affiliation*, the third dimension, is concerned with encouraging ongoing customer interactions.[19] Viewing the world through the customer's eyes and constantly seeking ways to create more value for the customer have positive effects in terms of affiliation.

Firms strengthen their relationships with customers by delivering superior value to them. Strong interactive relationships with customers often provide the foundation for the firm to earn profits because of how well they serve customers' unique needs. Delivering superior value often results in increased customer satisfaction. In turn, customer satisfaction has a positive relationship with profitability because satisfied customers are more likely to be repeat customers and because they will spread the word to other potential customers.

Consequently, firms give a lot of weight to customers when they are devising a business-level strategy. In particular, managers must determine:

1. *who* will be served,
2. *what* needs those target customers have that it will satisfy, and
3. *how* those needs will be satisfied.

4-2a Who: Determining the Customers to Serve

It is important for a firm to decide *who* the target customer is that the firm intends to serve with its business-level strategy.[20] Companies divide customers into groups based on differences in customers' needs (needs are discussed further in the next section) to make this decision. **Market segmentation** is the process of dividing customers into groups based on their needs.[21] Market segmentation is a process used to cluster customers with similar needs into individual and identifiable

Market segmentation is the process of dividing customers into groups based on their needs.

groups. In the animal-food products business, for example, the food-product needs of owners of companion pets (e.g., dogs and cats) differ from the needs for food and health-related products of those owning production animals (e.g., livestock). Hill's Pet Nutrition, which is a subsidiary of Colgate-Palmolive Company, sells food products for pets.[22] Hill's categorizes its food products for cats as pets into three market segments: kitten, adult (one year-plus), and mature (seven years plus). The food products the firm produces and sells differ based on the veterinary-determined needs of each segment of pet cats.

Firms can use almost any identifiable human or organizational characteristic to subdivide a market into segments that differ from one another on a given characteristic. In Table 4.1, we show common characteristics on which customers' needs vary.

4-2b What: Determining Which Customer Needs to Satisfy

After the firm decides *who* it will serve, it must identify the targeted customer group's needs that its products can satisfy. Generally, *needs (what)* are related to a product's benefits and features. Successful firms learn how to deliver to customers what they want when they want it. Having close and frequent interactions with both current and potential customers helps them identify individuals and groups' current and future needs. For example, knowledge gained about the needs of its customers is driving Kroger, the largest grocery store chain in the United States, to enhance the speed of its grocery delivery services.[23] The company has been working with Instacart since 2017. Now, the partnership is working on a plan to deliver food and household products to customers in as little as 30 minutes.

From a strategic perspective, a basic need of all customers is to buy products that create value for them. The generalized forms of value that products provide are either low cost with acceptable features or highly differentiated features with acceptable cost. The most effective firms strive continuously to anticipate changes in customers' needs. The firm that fails to anticipate and certainly to recognize changes in its customers' needs may lose them to competitors whose products provide more value.

Successful firms also recognize that consumer needs change. For many years, Subway, which has more locations in the United States than any other restaurant chain, has offered a fairly standard menu, with only a limited number of new sandwich options for customers.[24] However, after a massive expansion drive, the firms have started to shrink, with a 20 percent drop in the number of domestic locations in the five years leading up to 2022. CEO John Chidsey realizes that what customers really want is food they crave. The company overhauled its menu, claiming that it is the biggest culinary change in its history. This overhaul was in addition to increasing its restaurant count globally.

Table 4.1 Basis for Customer Segmentation

Consumer Markets
1. Demographic factors (age, income, sex, etc.)
2. Socioeconomic factors (social class, stage in the family life cycle)
3. Geographic factors (cultural, regional, and national differences)
4. Psychological factors (lifestyle, personality traits)
5. Consumption patterns (heavy, moderate, and light users)
6. Perceptual factors (benefit segmentation, perceptual mapping)
Industrial Markets
1. End-use segments (identified by Standard Industrial Classification [SIC] code)
2. Product segments (based on technological differences or production economics)
3. Geographic segments (defined by boundaries between countries or by regional differences within them)
4. Common buying factor segments (cut across product market and geographic segments)
5. Customer size segments

Source: Based on information in S. C. Jain, 2009, *Marketing Planning and Strategy*, Mason, OH: South-Western Cengage Custom Publishing.

4-2c How: Determining Core Competencies Necessary to Satisfy Customer Needs

After deciding *who* the firm will serve and the specific *needs* those customers have, the firm is prepared to determine how to use its resources, capabilities, and competencies to develop products that can satisfy its target customers' needs. As explained in Chapters 1 and 3, *core competencies* are resources and capabilities that provide a competitive advantage for the firm over its rivals. Firms use core competencies to implement value-creating strategies, thereby satisfying customers' needs (*how*). Only those firms with a consistent ability to innovate and upgrade their competencies can meet and exceed customers' expectations across time.[25] By continuously upgrading their capabilities, firms can maintain an advantage over their rivals by providing customers with products that create value that exceeds the value created for them by competitors' offerings.[26]

Companies draw from a wide range of core competencies to produce products that satisfy customers' needs. In today's competitive high-tech environment, developing a core competence in the R&D function is critical. Tech firms like Apple, Amazon, Meta Platforms (Facebook), and Alphabet (Google) recognize this reality and invest significant resources to deal with it. Another core competence that is critical in many environments is firms' ability to effectively manage their human resources. *Strategic human resource management* means that the firm's human resource management practices reflect either best practice in their industry or best fit with what the environment needs (typically with a focus on customers).[27] In the hospitality industry, no firm is better at strategic human resource management than Hilton.[28] Year after year, the company is ranked as one of the best places to work, which is an even greater accomplishment when you consider how many of their employees clean rooms and work with (often grouchy) customers. This competency allows Hilton to hire the best workers, which translates into higher levels of guest satisfaction, loyalty, and ultimately higher profits.

Our discussion about customers shows that all organizations must use their capabilities and core competencies (the *how*) to satisfy the needs (the *what*) of the target customer group (the *who*) the firm has chosen to serve. We will now connect these ideas to business models.

4-3 Business Models and Their Relationship with Business-Level Strategies

Learning Objective

4-3 Describe business models, including their relationship with business-level strategies.

Business models are part of a comprehensive business-level strategy.[29] While business models inform the development and use of the other types of strategies a firm may choose to implement, their primary use is with business-level strategies. as noted previously in this chapter, a business-level strategy is the firm's core strategy—the one the firm forms to describe how it intends to compete against rivals on a day-to-day basis in its chosen product market. As part of a firm's business-level strategy, the business model influences strategy implementation, especially in terms of the interdependent processes the firm uses during implementation.[30] We use a discussion of business models and their relationship with strategy as a foundation for then describing five types of business-level strategies firms may choose to implement.

Multiple ways exist to define a business model.[31] The general consensus across these definitions is that a **business model** describes what a firm does to create, deliver, and capture value for its stakeholders.[32] As explained in Chapter 1, stakeholders value related yet different outcomes. For example, for shareholders, the firm captures and distributes value to them in the form of a return on their investment. For customers, the firm creates and delivers value in the form of a product featuring the combination of price and features for which they are willing to pay. For employees, the firm creates and delivers value through a job with compensation and benefits; employees also have opportunities to develop their skills by participating in continuous learning experiences.[33]

A **business model** describes what a firm does to create, deliver, and capture value for its stakeholders.

In a sense then, a business model is a *framework* for how the firm will create, deliver, and capture value. At the same time, a business-level strategy is the set of commitments and actions that yields the *path* a firm intends to follow to gain a competitive advantage by exploiting its core competencies in a specific product market. Understanding customers in terms of *who, what,* and *how* is foundational to successfully developing and using a business model and a business-level strategy.[34]

Business model innovation occurs when a firm determines that its current business model is outdated, and successfully replaces it with a newer one.

Regardless of the business model chosen, those leading a company should view that selection as one that will require adjustment in response to conditions that change from time to time in the firm's external environment (e.g., an opportunity to enter a new region surfaces) and its internal environment (e.g., new capabilities are developed).[35] **Business model innovation** occurs when a firm determines that its current business model is outdated and successfully replaces it with a newer one.[36] For example, Netflix and Blockbuster both used to deliver movies to customers by renting videodiscs (DVDs), with Netflix renting through the mail and Blockbuster through its stores. However, as broadband speeds improved, consumers started to prefer the convenience of streaming movies within their own homes. Netflix successfully changed its business model to one that focuses on in-home streaming. Blockbuster did not change its business model and eventually failed. Business-model innovation is difficult because of *inertia,* which is all forces that cause an organization to resist change.[37] If a business model has been highly successful over a long time, it is even more difficult to change to a different model.

Firms select from many different business models.[38] For example, some firms use a freemium model. They provide a basic product to customers for free and earn revenues and profits by selling a premium version of the service. Examples include Dropbox and Adobe PDF Reader. Firms that use an advertising model provide advertisers with high-quality access to their target customers for a fee. Traditional television networks and Pinterest are examples of firms using this business model. Also, firms can use a peer-to-peer model to match those wanting a particular service with those providing that service. Two examples are Task Rabbit and Airbnb. We will now highlight three other popular business models: the franchise model, the subscription model, and the digital platform model.

4-3a Franchise Business Model

A franchise business model finds a firm licensing its trademark—and the processes it follows to create and deliver a product—to franchisees.[39] In this instance, the firm franchising its trademark and processes captures value by receiving fees and royalty payments from its franchisees. The franchisor may also sell the franchisees many of the products used during the business operation, as is the case with many fast-food restaurants.

McDonald's and Panera Bread both use the franchise business model. However, McDonald's uses the model as part of its cost leadership strategy, while Panera Bread uses it to implement a differentiation strategy (both strategies are discussed in detail in the next major section). In this regard, McDonald's cost leadership strategy finds the company providing franchisees processes detailed in its franchise business model to deliver its customers consistent food items that are offered at a low price, but with acceptable taste and service quality, and in a clean setting.[40]

Panera Bread also uses a franchise business model, but its model differs from the McDonald's franchise business model. One difference is that a person can purchase a single McDonald's franchise, but Panera Bread doesn't sell single-unit franchises. Rather, they work with a franchisee to open several (about 15) bakery-cafes over 6 years.[41] Operating in the fast-causal part of the restaurant industry (McDonald's operates in the fast-food part of the industry), Panera implements a differentiation strategy to provide customers with tasty, very high-quality food at reasonable, but not low, prices. As the company states: "What is good eating? We believe it is food and an experience that leaves you feeling satisfied and nourished, without having to compromise between good and good for you."[42] Through this differentiation strategy, Panera uses a carefully designed set of processes to offer differentiated food items in a differentiated setting to provide customers with value for which they are willing to pay and at a cost that is acceptable to them. Thus, while McDonald's and Panera Bread use the same business model, the model itself is developed differently because the firms use the model to implement different business-level strategies.

4-3b Subscription Business Model

Firms that use a subscription business model offer a product to customers regularly, such as once per month, once per year, or upon demand.[43] Blue Apron uses a subscription business model. The firm is founded on the belief that the way food is grown and distributed is complicated, making it difficult for families to make "good" choices about what they eat. Blue Apron delivers food directly to consumers, eliminating intermediaries such as stores by doing so.

The firm partners with farmers who are committed to sustainable production processes and provide the highest-quality ingredients. Thus, Blue Apron uses a subscription model with a differentiation strategy to create, deliver, and capture value for the stakeholders (e.g., customers, suppliers, employees, and local communities) with whom the firm interacts while implementing its business-level strategy.[44]

Netflix is another firm that uses a subscription business model.[45] The company provides thousands of movies and other television shows to subscribers for a monthly fee. The company's first international expansion was to Canada in 2010. Less than a decade later, the company had subscribers in more than 190 countries, which is remarkable considering that each region has its own challenges, such as regulations and difficulties securing the rights to particular content. In addition, there were many competitors already established in other countries, such as Amazon Prime. Now, most revenues Netflix receives come from outside the United States.

Duplass/Shutterstock.com

Home-delivery food-subscription companies, such as Blue Apron, became widely used and saw a surge in business during the COVID-19 pandemic.

4-3c Digital Platform Business Model

Digital platforms facilitate exchanges among a variety of stakeholders.[46] A **digital platform** is an Internet-based location for exchanges of information, goods, or services to occur between producers, consumers, and other members of the platform community. They include social media platforms like Twitter or LinkedIn, media-sharing platforms like Spotify and YouTube, service-oriented platforms like Uber and Airbnb, and knowledge platforms like Yahoo! and Quora.[47] They are a way to manage *autonomous complementors*, stakeholders that work with, but typically are not in direct competition with, the platform provider.[48] Sometimes a firm that is a complementor in its use of a particular platform will develop a competing platform, but the need to establish legitimacy and not undermine the original platform can be a difficult process. For example, Cisco was able to create a new platform, Fog, while still working as a complementor within the Cloud platform through repositioning itself in the market and only partially competing with the Cloud.[49]

A **digital platform** is an Internet-based location for exchanges of information, goods, or services to occur between producers, consumers, and other members of the platform community.

Digital platforms have promoted innovation and increased efficiency in many economic sectors, including ecommerce, videogames, automobiles, payment systems, mobile phones, and many others.[50] They come in many forms, including online marketplaces (i.e., eBay), search engines (Google), social media (Twitter), professional networking and hiring (LinkedIn), and operating systems (Microsoft's Windows). There are two basic types: innovation platforms that facilitate the development of complementary products and services (i.e., Android, Google) and transaction platforms that facilitate buying and selling goods and services (i.e., eBay, Uber).[51] Some platforms, like Microsoft's Windows and Alphabet's Google, have achieved near-monopoly power in their respective markets, with more than 70 percent market share.[52] One of the biggest advantages of a digital-platform business model is that it can be scaled quickly with relatively lower costs than many other business models.[53] As the Strategic Focus demonstrates, digital platforms can also be a way to share excess resources among companies, thus enhancing efficiency in the economy.

Firms that provide digital platforms capture revenues in various ways. Microsoft directly charges for its Windows software, either directly or when a consumer purchases a hardware product (i.e., computer) that contains the software from another company. Alphabet collects fees from firms that advertise on its Google search engine. Uber collects part of the fees charged to passengers that use its services. Many of the most valuable companies in the world—Alibaba, Microsoft, Meta Platforms (Facebook), and Amazon—operate at least one prominent platform.[54]

A differentiation strategy is what has driven the popularity of most successful digital platforms. For example, Amazon provides high-quality service for the products it sells, but it also provides excellent service for the platform it has created that connects buyers and sellers directly. That is, many of the products sold on Amazon are shipped directly from sellers other than Amazon. If a customer has a problem with one of these products that cannot be resolved with the seller, Amazon steps in and, in some cases, even refunds the customer. Differentiation is one of several business-level strategies that will be discussed in the next section.

Strategic Focus

Piclo Flex, Hybrid Business Models, and the Sharing Economy

Hybrid business models simultaneously pursue both for-profit and for-purpose objectives. For example, a firm that is attempting to make money and protect the environment is pursuing a hybrid business model. Because of all its activities in protecting the environment, and its mission to "save our home planet," Patagonia (featured in the last chapter), the outdoor clothing company, is pursuing a hybrid business model. It is not enough to simply be a socially responsible company. Many firms are taking this approach. A hybrid business model requires that one of the company's primary objectives is to further a cause that society feels is important. In addition to protecting the environment, other causes that are being addressed through hybrid business models include the reduction of poverty, protection of children, education, and safety. A constant tension exists in organizations that are pursuing a hybrid business model because the for-profit and for-purpose objectives are often in conflict, and the firm has to be careful in allocating its limited resources across activities associated with each of the objectives.

One way a firm can make progress in addressing some of the grand societal challenges while reducing the amount of potential conflict in the firm's objectives is by designing a business model around what is known as the *sharing economy*, which is "a socio-economic ecosystem that commonly uses information technology [digital platforms] to connect different stakeholders…in order to make value by sharing their excess capacities for products and services." A sharing economy is good for the environment and the economy because it leads to more efficient use of resources. Also, it reduces the need for some firms to engage in producing a good or service themselves because they are readily available from other providers and easy to access through the digital platform. For both of these reasons, the sharing economy leads to an overall reduction in total resource consumption. The global sharing economy has grown from an estimated $15 billion in 2014 to a projected total of $335 billion by 2025. It spans multiple industries, including vehicle rides, accommodations, labor, expertise, food, and electricity.

Piclo Flex, based in the United Kingdom, bills itself as "The independent marketplace for trading energy flexibility online." The company creates "a single access point for various energy services, including system balancing, stability, and network capacity, with the aim of making it quicker and simpler for operating energy assets to provide these services." Basically, providers of services sign up and offer what they have to sell, and buyers bid for these services in what are called competitions. There are over 300 providers of these services across multiple countries.

Piclo Flex understands the importance of protecting the environment, and its digital platform is designed to maximize the efficient use of energy services. One of Piclo's investors is the Clean Growth Fund, established by the U.K. Department of Business, Energy and Industrial Strategy, and one of the U.K.'s largest charity-fund managers. The Clean Growth Fund invests in early stage, "clean growth" companies that are working to reduce carbon emissions. Another investor is Matt MacDonald Ventures, which is the corporate-venture division of a major consulting organization. These two investors demonstrate very well that Piclo Flex is successfully pursuing a hybrid strategy, where The Clean Growth Fund reflects a primary interest in the for-purpose objective and the Matt MacDonald investment is more closely associated with the for-profit objective.

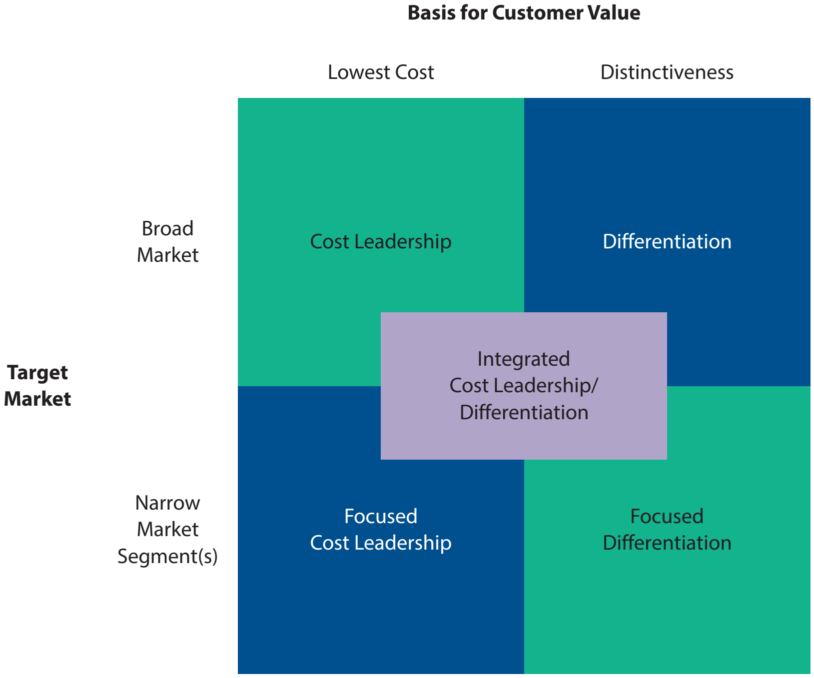
Sources: R. Garud, A. Kumaraswamy, A. Roberts, & L. Xu, 2022, Liminal movement by digital platform-based sharing economy ventures: The case of Uber Technologies, *Strategic Management Journal*, 43: 447–475; E. Reuter, 2022, Hybrid business models in the sharing economy: The role of business model design for managing the environmental paradox, *Business Strategy and the Environment*, 31: 603–618; 2022, *Piclo Flex Homepage*, www.picloflex.com, February 19; E. Mazareanu, 2019, Value of the global sharing economy, 2014–2015, *Statista*, www.statista.com, August 9; T. Laamanen, J. Pfeffer, K. Rong, & A. Van de Ven, 2016, Business models, ecosystems, and society in the sharing economy, *Academy of Management Discoveries*, 4(3): 213–219.

4-3d Types of Business-Level Strategies

Firms choose between five business-level strategies to establish and defend their desired strategic position against competitors: *cost leadership, differentiation, focused cost leadership, focused differentiation*, or *integrated cost leadership/differentiation* (see Figure 4.1). Each business-level strategy can help the firm establish and exploit a *competitive advantage* (either lowest cost or distinctiveness) as the basis for how it will create value for customers within a particular *competitive scope* (broad market or narrow market). How firms integrate the activities they complete within each business-level strategy demonstrates how they differ from one another.[55] For example, firms emphasize the integration of different types of activities and thus, what Southwest Airlines emphasizes differs from what competitors like JetBlue, United Airlines, or American Airlines emphasize. Superior integration of activities increases the likelihood a firm will develop an advantage relative to competitors as a path to earning above-average returns.

When selecting a business-level strategy, firms evaluate two types of potential competitive advantages: "lower cost than rivals or the ability to differentiate and command a premium price that exceeds the extra cost of doing so."[56] Lower costs result from the firm's ability to perform activities differently than rivals; being able to differentiate indicates the firm's capacity to perform different (and valuable) activities. Thus, based on the nature and quality of its internal resources, capabilities, and core competencies, a firm seeks to form either a cost-competitive advantage or a distinctiveness competitive advantage as the basis for implementing its business-level strategy.[57]

Figure 4.1 Five Business-Level Strategies



Source: Based on M. E. Porter, 1998, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York: The Free Press; D. G. Sirmon, M. A. Hitt, & R. D. Ireland, 2007, Managing firm resources in dynamic environments to create value: Looking inside the black box, *Academy of Management Review*, 32: 273–292; D. G. Sirmon, M. A. Hitt, R. D. Ireland, & B. A. Gilbert, 2011, Resource orchestration to create competitive advantage: Breadth, depth and life cycles effects, *Journal of Management*, 37: 1390–1412.

Target markets can be distinguished as broad or narrow (see Figure 4.1). Firms serving a broad market seek to use their capabilities to create value for customers on an industry-wide basis. A narrow market segment means that the firm intends to serve the needs of a narrow customer group. With focus strategies, the firm "selects a segment or group of segments in the industry and tailors its strategy to serving them to the exclusion of others."[58] Buyers with special needs and buyers located in specific geographic regions are examples of narrow customer groups. As shown in Figure 4.1, a firm could also strive to develop a combined low cost/distinctiveness value creation approach as the foundation for serving a target customer group that is larger than a narrow market segment but not as comprehensive as a broad (or industry-wide) customer group. In this instance, the firm uses the integrated cost leadership/differentiation strategy.

None of the five business-level strategies shown in Figure 4.1 is inherently or universally superior to the others. The effectiveness of each strategy is contingent on the opportunities and threats in a firm's external environment and the strengths and weaknesses derived from its resource portfolio. It is critical, therefore, for the firm to select a business-level strategy that represents an effective match between the opportunities and threats in its external environment and the strengths of its internal organization based on its core competencies.[59] After the firm chooses its strategy, it should consistently emphasize actions that are required to implement it successfully.

Learning Objective

4-4 Using the five forces model, explain cost leadership as a business-level strategy, including the associated risks.

4-4 Cost Leadership Strategy

The **cost leadership strategy** is an integrated set of actions taken to produce products with features that are acceptable to customers at the lowest cost, relative to that of competitors.[60] Firms using the cost leadership strategy commonly sell standardized goods or services, but with competitive levels of differentiation, to the industry's most typical customers. *Process innovations*, which are newly designed production and distribution methods and techniques that allow the firm to operate more efficiently, are critical to a firm's efforts to use the cost leadership strategy successfully. Commonly, firms using the cost leadership strategy also scour the world to find low-cost producers to which they outsource various functions (e.g., manufacturing goods) as a way to keep their costs low relative to competitors' costs.[61]

The **cost leadership strategy** is an integrated set of actions taken to produce products with features that are acceptable to customers at the lowest cost, relative to that of competitors.

Firms implementing the cost leadership strategy strive constantly to drive their costs lower and lower relative to competitors so they can sell their products and services to customers at a low and perhaps the lowest cost. U.S.-based Frontier Airlines, as well as EasyJet and Ryanair (based in Europe) and AirAsia (based in Asia), all pursue a cost leadership strategy.[62] These types of airlines offer "no frills" to their customers, which typically means no free drinks or snacks (except water). Customers also tend to pay for any luggage they bring, even carry-on luggage. In addition, they pay for features such as assigned seats or more legroom.

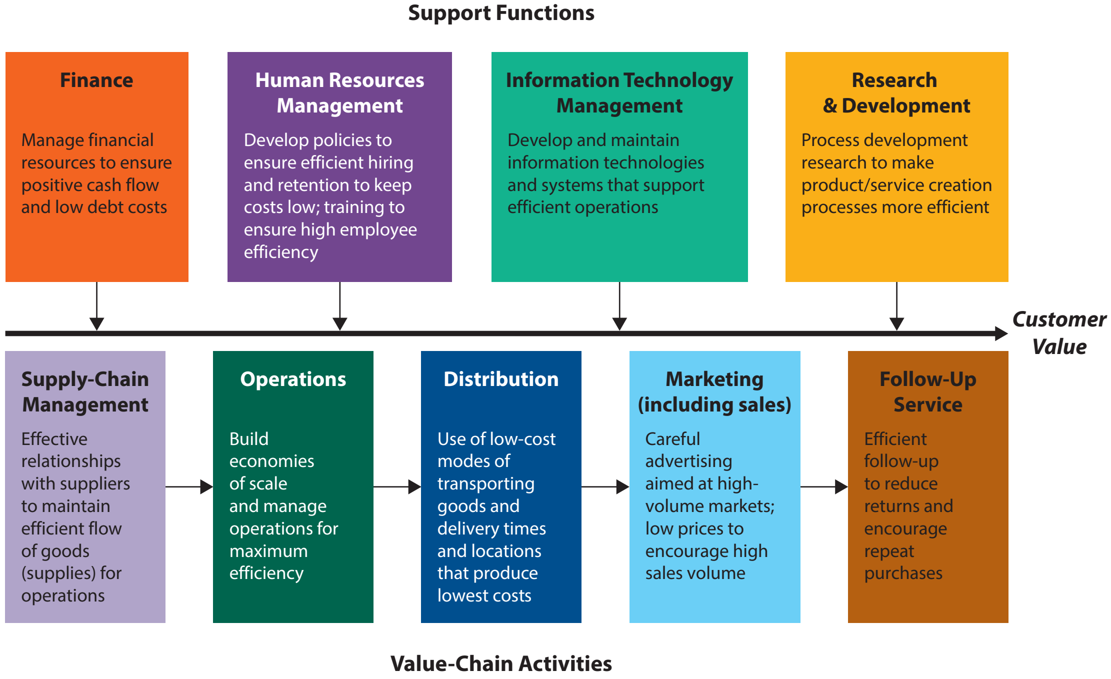
As described in Chapter 3, firms use value-chain analysis to identify the parts of the company's operations that create value and those that do not. Figure 4.2 demonstrates the value-chain activities and support functions that allow a firm to create value when implementing the cost leadership strategy. Companies lacking the ability to integrate the activities and functions shown in this figure typically lack the core competencies needed to use the cost leadership strategy successfully.

As primary activities, inbound logistics (e.g., materials handling, warehousing, and inventory control) and outbound logistics (e.g., collecting, storing, and distributing products to customers) often account for significant portions of the total cost to produce some products. Research suggests that a competitive advantage in logistics creates more value with a cost leadership strategy than with a differentiation strategy.[63] Thus, cost leaders seeking competitively valuable ways to reduce costs may want to concentrate on the primary activities of inbound logistics and outbound logistics. An example of this idea is the decision by several low-cost producers to outsource their manufacturing operations to low-cost firms with low-wage employees (e.g., China, Malaysia, Vietnam).[64]

Cost leaders also examine all support activities to find additional cost reductions. Developing new systems for finding the optimal combination of low cost and acceptable levels of differentiation in the raw materials required to produce the firm's products is an example of how the procurement support activity can help when implementing the cost leadership strategy.

Effective use of the cost leadership strategy allows a firm to earn above-average returns despite strong competitive forces (see Chapter 2). The next sections (one for each of the five forces) explain how firms seek to earn above-average returns by implementing the cost leadership strategy.

Figure 4.2 Examples of Value-Creating Activities Associated with the Cost Leadership Strategy



Sources: Based on M. E. Porter, 1998, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York, The Free Press; D. G. Sirmon, M. A. Hitt, & R. D. Ireland, 2007, Managing firm resources in dynamic environments to create value: Looking inside the black box, *Academy of Management Review*, 32: 273–292; D. G. Sirmon, M. A. Hitt, & B. A. Gilbert, 2011, Resource orchestration to create competitive advantage: Breadth, depth and life cycles effects, *Journal of Management*, 37, 1390–1412; J. S. Harrison, 2020, Sustaining High Performance in Business: Systems, Resources, and Relationships, New York, Business Expert Press.

Rivalry with Existing Competitors

Having a low-cost position is valuable when dealing with rivals. Because of the cost leader's advantageous position, rivals hesitate to compete on the price variable, especially before evaluating the potential outcomes of such competition.[65] Walmart and Family Dollar use the cost leadership strategy. Successfully executing their strategies causes competitors to avoid focusing on the price variable as a way to compete.

Several factors influence the degree of rivalry that firms encounter when implementing the cost leadership strategy. Examples of these factors include organizational size, resources possessed by rivals, a firm's dependence on a particular market, location, and prior competitive interactions between firms, and a firm's reach, richness, and affiliation with its customers.[66] The richness and affiliation Amazon has with its customers creates competitive challenges for competitors (even Walmart), as they ramp up efforts to challenge Amazon's superiority in online sales.

Those using the cost leadership strategy may also try to reduce the amount of rivalry they experience from competitors. For example, they may decide to form collaborations, such as joint ventures and strategic alliances (see Chapter 9), to reduce rivalry.[67] In other instances, cost leaders try to develop strong and mutually supportive relationships with stakeholders (e.g., important government officials, suppliers, and customers) to reduce rivalry and lower their costs as a result.[68] *Guanxi* is the name used to describe close relationships that Chinese firms develop with others to reduce rivalry.[69]

Bargaining Power of Buyers (Customers)

Powerful customers (e.g., those purchasing a significant amount of the focal firm's output) can force a cost leader to reduce its prices. However, competitive forces mean that prices typically will not be reduced below the level at which the cost leader's next-most-efficient industry competitor can earn average returns unless the low-cost leader is trying to push the next-most-efficient competitor out of the market. When customers can purchase only from a single firm operating in an industry (e.g., a monopoly), they pay more for products. In some cases, rather than forcing firms to reduce their prices, powerful customers may pressure firms to provide innovative products and services.

Bargaining Power of Suppliers

The cost leader generally operates with margins greater than the margins its competitors earn. This situation is especially true when its costs are relatively lower than competitors while its prices are approximately the same. Among other benefits, higher gross margins relative to those of competitors make it possible for the cost leader to absorb its suppliers' price increases. When an industry faces substantial increases in the cost of its supplies, only the cost leader may be able to pay the higher prices and continue to earn either average or above-average returns. Alternatively, a powerful cost leader may be able to force its suppliers to hold down their prices, which would reduce the suppliers' margins in the process.[70] For example, Walmart is large and powerful enough to successfully pressure suppliers to keep their prices down and margins low.

To reduce costs, some firms may outsource an entire function, such as manufacturing to a single or a small number of suppliers.[71] Outsourcing may take place in response to earnings' pressure as expressed by shareholders, particularly institutional investors.[72] In the face of earnings' pressure, a firm's decision makers may conclude that outsourcing will be less expensive, allowing it to reduce its products' prices as a result.

Potential Entrants

Through continuous efforts to reduce costs to levels that are lower than those against whom it competes, a cost leader becomes highly efficient. Increasing levels of efficiency (e.g., economies of scale) enhance profit margins. In turn, attractive profit margins create an entry barrier to potential competitors.[73] New entrants must be willing to accept less-than-average returns until they gain the experience required to approach the cost leader's efficiency. Also, to earn even average returns, new entrants must have the competencies required to match the cost levels of competitors other than the cost leader.

Product Substitutes

Compared with its industry rivals, the cost leader also holds an attractive position relative to product substitutes. A product substitute becomes a concern for the cost leader when its features and characteristics, in terms of cost and levels of differentiation that are acceptable to customers, are potentially attractive to the firm's customers. When faced with possible substitutes, the cost leader has more flexibility than do its competitors. To retain customers, it often can reduce its product's price. With still lower prices and competitive levels of differentiation, the cost leader increases the probability that customers will continue to prefer its product rather than a substitute.

Competitive Risks of the Cost Leadership Strategy

The cost leadership strategy is not risk free. One risk is that the processes used by the cost leader to produce and distribute its product could become obsolete because of competitors' innovations.[74] These innovations may allow rivals to produce products at costs lower than those of the original cost leader or to provide additional differentiated features without increasing the product's price to customers.

A second risk is that too much focus by the cost leader on cost reductions may occur at the expense of trying to understand customers' perceptions of competitive levels of differentiation. Some believe, for example, that Walmart often has too few salespeople available to help customers and too few individuals at checkout registers. These complaints suggest that there might be a discrepancy between how Walmart's customers define "minimal acceptable levels of service" and the firm's attempts to drive its costs increasingly lower.

Imitation is a final risk of the cost leadership strategy. Competitors sometimes learn how to imitate the cost leader's strategy using their core competencies. When imitation happens, the cost leader must increase the value its product provides to customers. Commonly, the cost leader increases the value it creates by selling the current product at an even lower price or by adding differentiated features that create value for customers while maintaining price.

Learning Objective

4-5 Using the five forces model, explain differentiation as a business-level strategy, including the associated risks.

4-5 Differentiation Strategy

The **differentiation strategy** is an integrated set of actions taken to produce products (at an acceptable cost) that customers perceive as being different in ways that are important to them.[75] While cost leaders serve a typical customer in an industry, differentiators target customers for whom the firm creates value because of how its products differ from those its competitors produce and market. Product innovation, in which a firm creates a new or modified product or service to satisfy a customer need, is critical to the successful use of the differentiation strategy.[76]

The **differentiation strategy** is an integrated set of actions taken to produce products (at an acceptable cost) that customers perceive as being different in ways that are important to them.

Firms must be able to provide customers with differentiated products at competitive costs to reduce upward pressure on the price they pay. That is, a customer must be willing to pay incrementally more for the differentiated features of a product or service than the incremental costs associated with producing them.[77] When a firm produces differentiated features for its products at noncompetitive costs, the price for the product may exceed what target customers are willing to pay. If firms have a thorough understanding of the value its target customers seek, the relative importance customers attach to the satisfaction of different needs and for what they are willing to pay a premium, the differentiation strategy can be effective in helping them earn above-average returns.

Through the differentiation strategy, the firm produces distinctive products for customers who value differentiated features more than low cost. For example, superior product reliability, durability, and high performance are among the differentiating features of high-end automobiles such as BMW or Toyota Motor Corporation's Lexus products. These product's unique attributes, rather than their purchase prices, provide the incremental value for which customers are willing to pay a higher price (compared to offerings from low-cost leaders).

To maintain success by implementing the differentiation strategy, the firm must consistently upgrade differentiated features that customers value and/or create new valuable features (i.e., innovate) without cost increases that require prices that are too high to be attractive to customers.[78] In other words, there is a careful balance between upgrading the features that continue to provide a high level of differentiation and the costs of producing them. Overall, a firm using the differentiation strategy seeks to distinguish itself from its competitors on as many dimensions as possible. The less similarity between a firm's goods or services and those of its competitors, the more buffered it is from rivals' actions. When firms are successful with this strategy, the ability to sell a product at a price that substantially exceeds the cost of creating its differentiated features allows the firm to outperform rivals and earn above-average returns.

Many dimensions are available to firms seeking to differentiate their products from competitors' offerings. Unusual features, responsive customer service, rapid product innovations, technological leadership, perceived prestige and status, different tastes, and engineering design and performance are examples of approaches to differentiation.[79] While the number of ways to reduce costs may be finite, virtually anything a firm can do to create real or perceived value in consumers' eyes can be a basis for differentiation.

Firms use the value chain to determine how to link the activities required to create value by using the differentiation strategy. In Figure 4.3, we show examples of value-chain activities and support functions that firms use commonly to differentiate a product. Companies without the skills needed to link these activities cannot expect to use the differentiation strategy successfully.

Next, we explain how firms using the differentiation strategy can successfully position themselves in terms of the five forces of competition (from Chapter 2) to earn above-average returns.

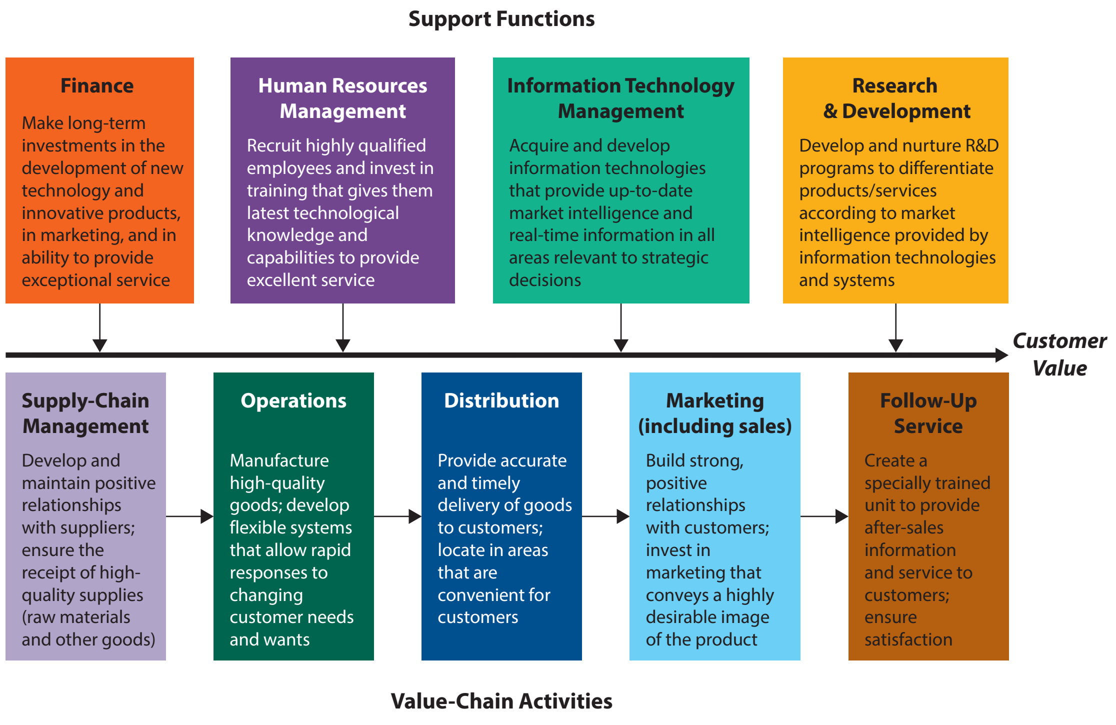
Rivalry with Existing Competitors

Customers tend to be loyal purchasers of products differentiated in ways that are meaningful to them. As their loyalty to a brand increases, customers become less sensitive to price increases. The relationship between brand loyalty and price sensitivity insulates a firm from competitive rivalry. Thus, positive reputations with customers sustain the competitive advantage of firms using a differentiation strategy.[80] Nonetheless, firms using a differentiation strategy must be aware of imitation efforts by rivals and aware of any resulting successes. This is the case between Samsung and Apple as Samsung seeks to improve on Apple's products, potentially creating value for customers when doing so. In the context of competitive rivalry (see Chapter 5), Apple must respond to imitation efforts to improve the value its products create for customers. Simultaneously, as a firm using the differentiation strategy, Apple must continue to develop new and novel products to maintain its reputation for producing and selling innovative and stylish products that target customers find valuable.[81]

Bargaining Power of Buyers (Customers)

The distinctiveness of differentiated products reduces customers' sensitivity to price increases. Customers typically accept a price increase when a product still satisfies their unique needs better than a competitor's offering. Thus, the golfer for whom the Ping G Stretch series of clubs or Piretti

Figure 4.3 Examples of Value-Creating Activities Associated with the Differentiation Strategy



Sources: Based on M. E. Porter, 1998, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York, The Free Press; D. G. Sirmon, M. A. Hitt, & R. D. Ireland, 2007, Managing firm resources in dynamic environments to create value: Looking inside the black box, *Academy of Management Review*, 32: 273–292; D. G. Sirmon, M. A. Hitt, & B. A. Gilbert, 2011, Resource orchestration to create competitive advantage: Breadth, depth and life cycles effects, *Journal of Management*, 37, 1390–1412; J. S. Harrison, 2020, *Sustaining High Performance in Business: Systems, Resources, and Relationships*, New York, Business Expert Press.

Strategic **Focus**

Peloton's Differentiation Strategy Is in Trouble

In 2012, Peloton was formed to bring "the community and excitement of boutique fitness into the home. The idea struck us after years of struggling to get to the workout classes we loved, while balancing our demanding jobs and busy families." The company uses the latest technologies to create immersive, challenging workouts within people's homes. The best instructors available are combined with music and images that make exercising an enjoyable experience. Some of its programs, like Leaderboard, are live. Consistent with a differentiation strategy, Peloton's exercise bikes and treadmills are priced significantly higher than most competitors in the industry, and the classes it offers add a monthly subscription fee. Owning a Peloton is considered by some as a status symbol, reinforcing its image as a highly differentiated product. Rounding out its product mix, the company also offers classes in strength training, yoga, and meditation.

During the height of the COVID-19 pandemic, Peloton experienced "unprecedented demand" as people looked for ways to exercise while being isolated at home. The stock price sextupled in about 18 months. In response to this success, the company made huge investments in new products and capacity increases. Peloton also took a big gamble and cut the prices on some of its products in an attempt to lure the middle class. However, supply-chain problems meant that the company was not able to deliver its products promptly, which frustrated a lot of customers.

The post-pandemic environment has not been kind to Peloton. As demand for its products declined, so did the company's financial fortunes. John Foley, Peloton co-founder and executive chair, introduced a restructuring plan in February 2022, "driving strategic initiatives across our global team that will help us focus on areas that are in need of adjustment, including implementing a comprehensive restructuring program. As part of this program, we've made the difficult decision to reduce the size of the Peloton team by approximately 2,800 positions globally." The company also decided not to pursue a new plant, opting instead for increased use of third-party manufacturers. In addition, Peloton reduced its number of warehouses. The company also raised its prices significantly through added fees for delivery and setup.

Right after Foley's announcement, Peloton appointed Barry McCarthy as the new CEO. Then, in March 2022, the company began testing a new pricing strategy in which customers rent an exercise bike that comes with a subscription for classes, all for one monthly price. According to McCarthy, "There is no value in sitting around negotiating what the outcome will be. Let's get in the market and let the customer tell us what works."

Competitors are also taking a toll on Peloton's business. Rivals are now offering very similar exercise equipment and experiences at lower prices. Myx, Echelon, and NordicTrack are among them. Apple also launched its own fitness platform. As Peloton's stock price dropped, an activist put pressure on the company to explore a sale. Amazon.com, among others, expressed interest.

Bloomberg/Getty Images

Founded in 2012, Peloton describes itself as the "best cardio machine on the planet."

Sources: S. Terlep, 2022, Peloton to test revamped pricing strategy, *Wall Street Journal*, March 11: B1, B2; C. Lombardo, M. Gottfried, & D. Cimilluca, 2022, Amazon and others look at potential Peloton deal, *The Wall Street Journal*, February 5: B1, B2; C. Furst, 2022, Peloton to raise price of bikes, treadmills as demand slows, *The Wall Street Journal*, January 19: B1, B4; 2022, The Peloton story, Peloton Homepage, www.onepeloton.com/company, February 26; A. Melin & J. Pitcher, 2021, Peloton wants to be more than a pandemic fad, *Bloomberg Businessweek*, January 25: 27–28; R. Hackett, 2021, Can Peloton keep up the pace? *Fortune*, February/March: 29–31; P. Anand, 2021, Peloton downscales in hunt for people making $50,000 a year, *Bloomberg*, www.bloomberg.com, August 27.

putters satisfies their needs will likely continue buying those products even when encountering price increases. Purchasers of brand-name food items (e.g., Heinz ketchup, Sir Kensington's ketchup, and Kleenex tissues) accept price increases in those products as long as they continue to perceive that the items satisfy their distinctive needs at an acceptable cost. In all of these cases, customers are relatively insensitive to price increases because they do not think an acceptable product alternative exists. As we see in the Strategic Focus, Peloton hopes this will be true as they significantly raise the prices of their exercise bikes and treadmills in response to slowing demand for their products.[82]

Bargaining Power of Suppliers

Because the firm using the differentiation strategy charges a premium price for its products, suppliers must provide high-quality components, driving up the differentiator's costs. However, the high margins the firm earns in these cases partially insulate it from suppliers' influence because high margins make it possible for the firm to absorb potentially higher costs from its suppliers.[83] On the other hand, because of buyers' relative insensitivity to price increases, the firm implementing a differentiation strategy might choose to pass the additional cost of supplies on to the customer by increasing the price of its unique product.

Potential Entrants

Customer loyalty and the need to overcome the uniqueness of a differentiated product create substantial barriers to potential entrants. Entering an industry under these conditions typically demands significant investments of resources and patience while seeking customers' loyalty. In these cases, some potential entrants decide to make smaller investments to see if they can gain a "foothold" (or a relatively secure position through which competitive progress is possible) in the market. In these cases, the firm's potential loss if it fails to develop a foothold is minimal while the gain from developing a foothold could be substantial.[84]

Product Substitutes

Firms selling brand-name products to loyal customers hold an attractive position relative to product substitutes. In contrast, companies without brand loyalty face a higher probability of customers switching either to products that offer differentiated features that serve the same function (particularly if the substitute has a lower price) or to products that offer more features and perform functions that create more value. In these instances, firms may be vulnerable to innovations from outside the industry that provide superior satisfaction in terms of customers' needs (e.g., Amazon's Alexa in the music industry).[85]

Competitive Risks of the Differentiation Strategy

One risk of the differentiation strategy is that customers may decide that the price differential between the differentiator's product and the cost leader's product is too large. In this instance, a firm may be offering differentiated features that exceed target customers' needs. The firm then becomes vulnerable to competitors that can offer customers a combination of features and price that is more consistent with their needs.

Another risk of the differentiation strategy is that a firm's means of differentiation may cease to provide value for which customers are willing to pay, or how the firm seeks to differentiate its offerings is unclear to target customers. A differentiated product becomes less valuable if competitors' imitation causes customers to perceive that competitors offer the same product but at a lower price. For example, does buying and using an iPhone create value that exceeds the costs and features of some competitors' offerings?

A third risk of the differentiation strategy is that experience can narrow customers' perceptions of the value of a product's differentiated features. For example, customers having positive experiences with generic tissues may decide that the differentiated features of the Kleenex product are not worth the extra cost. To counter this risk, firms must continue to differentiate their product (e.g., through innovation) for customers at a price they are willing to pay.[86]

Counterfeiting is the differentiation strategy's fourth risk. Counterfeits have a trademark or logo that is identical to or indistinguishable from a legal logo owned by another party, thus infringing the rights of the legal owner. When a consumer purchases such a product and discovers the deception, regret creates distrust of the branded product and reduces differentiation.[87] Because of this, firms take actions to prevent counterfeiters from imitating their products.

Failing to provide crisp and identifiable differentiation to customers through a firm's products (goods and services) is a fifth risk of the differentiation strategy. When this is the case, the firm does not meet customers' expectations through its efforts to implement the differentiation strategy. Another way of viewing this risk is to say that firms sometimes fail to create differentiation for which the customer is willing to pay when trying to implement the differentiation strategy. The Strategic Focus on Peloton demonstrates what can happen when a competitor's products seem similar enough to consumers that they are starting to doubt whether Pelaton's higher price tag is worth it.

Learning Objective

4-6 Explain focus strategies as a business-level strategy, including the associated risks.

The **focus strategy** is an integrated set of actions taken to produce products that serve the needs of a particular segment of customers.

4-6 Focus Strategies

The **focus strategy** is an integrated set of actions taken to produce products that serve the needs of a particular segment of customers. Thus, firms implementing a focus strategy use their core competencies to serve the needs of a particular industry segment or niche to the exclusion of others. Market segments firms may choose to serve by implementing a focus strategy that includes the following:

1. a particular buyer group (e.g., youth or senior citizens),
2. a certain segment of a product line (e.g., products for professional painters or the do-it-yourself group),
3. a particular geographic market (e.g., northern or southern Italy), or
4. a certain technology (e.g., artificial intelligence [AI] or robotics).[88]

With regard to the fourth type of focus strategy, firms develop a *technology strategy* in which their focus is on developing expertise with a particular technology instead of selling to a particular market. They then sell this technology to other firms, who use the technology to implement their own strategies. For example, Reliabotics provides product design and development services, as well as turnkey robotic and automation solutions for firms in the automotive, manufacturing, and pharmaceutical industries. Specific examples of applications of their robot automation and engineering services include surface preparation, laser-guided robots with programmable motion paths, and additive manufacturing.[89] Of course, a technology strategy can also be useful in a firm that is pursuing one of the other business-level strategies—the technology strategy is used as a way to implement the core business-level strategy. For example, Microsoft is using artificial intelligence, bots, and other technology to keep from hiring new workers in its finance division.[90]

Although the breadth of a target is clearly a matter of degree, the essence of the focus strategy "is the exploitation of a narrow target's differences from the balance of the industry."[91] Firms using the focus strategy intend to serve a particular customer segment of an industry more effectively than can industry-wide competitors. Entrepreneurial firms, and certainly entrepreneurial start-ups, commonly serve a specific market niche or segment, partly because they do not have the knowledge or resources to serve the broader market.[92] Firms implementing a focus strategy generally prefer to operate "below the radar" of larger and more resource-rich firms that serve the broader market. The focus strategy leads to success when the firm successfully serves a segment whose unique needs are so specialized that broad-based competitors choose not to serve that segment or when it creates value for a segment that exceeds the value created by industry-wide competitors.

Firms can create value for customers in specific and unique market segments using the focused cost leadership strategy or the focused differentiation strategy.

Focused Cost Leadership Strategy

Based in Sweden, IKEA, a global furniture retailer with 465 store locations in 63 markets and combined sales revenue of 41.9 billion euros in 2021, uses the focused cost leadership strategy.[93] Europe is IKEA's largest market, with 275 locations. Asia is second with 93 locations. North America is third, with 68 locations.

Demonstrating the low-cost part of the firm's strategy is its commitment to strive constantly to reduce costs without compromising quality. IKEA emphasizes several activities to keep its costs low. For example, instead of relying primarily on third-party manufacturers, the firm's engineers design low-cost, modular furniture that is ready for customers to assemble. To eliminate the need for sales associates or decorators, IKEA positions the products in its stores so that customers can view different living combinations (complete with sofas, chairs, tables, etc.) in a single room-like setting. The room-specific settings help customers imagine how furniture would look in their home.[94]

Highlighting the focus part of IKEA's focused cost leadership strategy is the firm's target market: young buyers desiring style at a low cost. Design is critical to the firm's ability to provide style at a low cost to these types of customers. Although it is a cost leader, IKEA offers some differentiated features that appeal to, or are acceptable to, its target customers. Unique furniture designs, in-store playrooms for children, wheelchairs for customer use, and extended hours are examples of the differentiated features IKEA customers like in addition to the low cost of the firm's products.

Focused Differentiation Strategy

Other firms implement the focused differentiation strategy. As noted earlier, firms can differentiate their products along many dimensions. For example, Goya Foods differentiates itself by providing a very wide assortment of high-quality foods while focusing on Hispanic consumers. Founded in 1936 by Don Prudencio Unanue and his wife, Carolina, Goya Foods, Inc. is the largest Hispanic-owned food company in the United States. Goya offers thousands of high-quality food products from Mexico, Spain, the Caribbean, Central America, and South America.[95] The firm is a leading authority on Hispanic food and seeks to be a premier source for those desiring to purchase authentic Latin cuisine. By successfully using a focus strategy, firms such as Goya gain a competitive advantage in specific market niches or segments, even though they do not possess an industry-wide competitive advantage.

With a focus strategy, firms must be able to complete various primary value-chain activities and support functions in a competitively superior manner to develop and sustain a competitive advantage and earn above-average returns. The activities required to use the focused cost leadership strategy are virtually identical to those of the industry-wide cost leadership strategy (see Figure 4.2); activities required to use the focused differentiation strategy are largely identical to those of the industry-wide differentiation strategy (see Figure 4.3). Similarly, the manner in which each of the two focus strategies allows a firm to deal successfully with the five competitive forces parallels those of the two broad strategies. The only difference is in the firm's choice of target market—that is, its competitive scope (see Figure 4.1). With a focus strategy, the firm chooses to focus on a narrow market segment. Thus, Figures 4.2 and 4.3, and the text describing the five competitive forces, also explain the relationship between each of the two focus strategies and competitive advantage.

Competitive Risks of Focus Strategies

With either focus strategy, the firm faces the same set of general risks a company faces using the cost leadership or the differentiation strategy on an industry-wide basis. However, focus strategies have three additional risks because of a narrow target market.

First, a competitor may be able to focus on a more narrowly defined competitive segment and thereby "out focus" the focuser. This could be a competitive challenge for IKEA if another firm found a way to offer IKEA's customers (young buyers interested in stylish furniture at a low cost) additional sources of differentiation while charging the same price or to provide the same service with the same sources of differentiation at a lower price. Harley Davidson's decision to sell electric motorcycles may challenge Zero Motorcycles, a much smaller company producing only electric motorcycles.[96] As mentioned in Chapter 3, Harley is ramping up this initiative with a huge investment made possible by taking the electric motorcycle business public, reducing Harley's percentage ownership in the business but making it a formidable contender for market share.[97]

A second risk is that a company competing on an industry-wide basis may decide that the market segment served by the firm using a focus strategy is attractive and worthy of competitive pursuit.[98] For example, while Peloton was the first major contender in the super-high-end exercise equipment market, now many other competitors have entered this segment.

The third risk associated with using a focus strategy is that customer needs within a narrow competitive segment may become more similar to those of industry-wide customers as a whole over time. When this happens, the firm implementing a focus strategy no longer provides unique value to its target customers. This may be what happened to RadioShack—the unique demand of do-it-yourself electronic dabblers that RadioShack traditionally focused on dissipated over time. Also, big-box-retailers such as Best Buy started carrying some of the "specialty" items RadioShack stocked. In response, RadioShack executives struggled to find the right focus and made too many strategic changes over time, which ultimately led to the firm's bankruptcy.[99]

Learning Objective

4-7 Explain integrated cost leadership/differentiation as a business-level strategy, including the associated risks.

The **integrated cost leadership/differentiation strategy** finds a firm engaging simultaneously in primary value-chain activities and support functions to achieve a low-cost position with some product differentiation.

4.7 Integrated Cost Leadership/Differentiation Strategy

Most consumers have high expectations when purchasing products. In general, it seems that most consumers want to pay a low price for products that possess somewhat highly differentiated features. Because of these expectations, many firms engage in primary value-chain activities and support functions that allow them to pursue low cost and differentiation simultaneously.

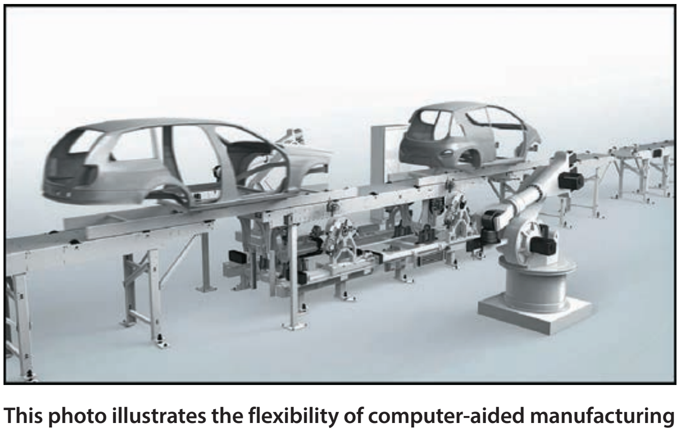
The **integrated cost leadership/differentiation strategy** finds a firm engaging simultaneously in primary value-chain activities and support functions to achieve a low cost position with some product differentiation. When using this strategy, firms seek to produce relatively low-cost products that have some differentiated features that their customers value. Efficient production is the source of maintaining low costs, while differentiation is the source of creating unique value. Firms that use the integrated cost leadership/differentiation strategy successfully usually adapt quickly to new technologies and rapid changes in their external environments. Concentrating jointly on developing two sources of competitive advantage (cost and differentiation) increases the number of primary value-chain activities and support functions in which the firm becomes competent. In these cases, firms often have strong networks with external parties that perform some of the value-chain activities and/or support functions.[100] In turn, having skills in several activities and functions increases a firm's flexibility and its adaptability.

Concentrating on the needs of its core customer group (e.g., higher-income, fashion-conscious discount shoppers), Target implements an integrated cost leadership/differentiation strategy. The firm informs customers of this strategy through its "Expect More. Pay Less." brand promise. The firm describes its strategy with the following statement: "We're here to help all families discover the joy of everyday life."[101] In addition to a relatively low price for its somewhat differentiated products (compared to Walmart), Target creates differentiation for customers by providing them with a quick check-out experience and a dedicated team providing more personalized service.

Flexibility is required for firms to complete primary value-chain activities and support functions in ways that allow them to use the integrated cost leadership/differentiation strategy successfully. A number of Chinese firms, including some in the automobile manufacturing sector, have developed a flexible architecture system through which they produce differentiated car designs at relatively low costs.[102] For firms seeking to balance cost reductions with sources of differentiation, flexible manufacturing systems, information networks, and total-quality management systems are three sources of flexibility that help them implement the integrated cost leadership/differentiation strategy successfully.

Flexible Manufacturing Systems

Using a flexible manufacturing system (FMS), firms integrate human, physical, and information resources to create somewhat differentiated products and to sell them to consumers at a relatively low price. A significant technological advance, an FMS is a computer-controlled process that firms use to produce a variety of products in moderate, flexible quantities with a minimum of manual intervention.[103] "A flexible manufacturing system (FMS) can improve efficiency and thus lower a company's production cost. Flexible manufacturing also can be a key component of a make-to-order strategy that allows customers to customize the products they want."[104]



FMS car system.PNG

This photo illustrates the flexibility of computer-aided manufacturing lines as two different vehicle bodies are pieced together on the same line.

Automobile manufacturing processes that take place in the Ford-Changan joint venture located in Chongqing, China, show the clear benefits of flexible production. This joint venture, with each firm owning 50 percent, manufacturers Ford brand passenger cars for the Chinese market.[105] Comments from Yuan Fleng Xin, the manufacturing engineering manager for the Ford-Changan partnership, highlight the benefits of using an FMS:

"We can introduce new models within hours, simply by configuring the line for production of the next model, while still being able to produce the existing models during the introduction of new models … This allows the phasing-in of new models, and the phasing-out of old models, directly driven by market demand and not by production capacity, lead time nor a need to wait for infrastructure build-up."[106]

The goal of an FMS is to eliminate the trade-off between low costs and product variety that is inherent in traditional manufacturing technologies. Firms use an FMS to change quickly and easily from making one product to making another, allowing a firm to increase effectiveness in responding to changes in its customers' needs, while retaining low-cost advantages and consistent product quality. Because an FMS also enables the firm to reduce the lot size needed to manufacture a product efficiently, the firm has a greater capacity to serve the unique needs of a narrow competitive scope.

Information Networks

By linking companies with their suppliers, distributors, and customers, information networks provide another source of flexibility. When used effectively, these networks help the firm satisfy customer expectations regarding product quality and delivery speed.[107]

Earlier, we discussed the importance of managing the firm's relationships with its customers to understand their needs. Customer-relationship management (CRM) is one form of an information-based network process firms use for this purpose.[108] An effective CRM system provides a 360-degree view of the company's relationship with customers, encompassing all contact points, business processes, and communication media and sales channels.

Salesforce.com is the world's largest provider of customer-relationship management services. The firm operates a CSM platform that helps firms integrate the efforts of their marketing, sales, and information technology teams. The company puts it this way: "Salesforce unites your marketing, sales, commerce, service, and IT teams from anywhere with Customer 360—one integrated CRM platform that powers our entire suite of connected apps. With Customer 360, you can focus your employees on what's important right now: stabilizing your business, reopening, and getting back to delivering exceptional customer experiences."[109] Firms use information about their customers to determine the trade-offs they are willing to make between differentiated features and low cost—an assessment that is vital for companies using the integrated cost leadership/differentiation strategy. Firms also use information networks to manage their supply chains.[110] Through these networks, firms use their supply chain to manage the flow of differentiated inputs as they proceed through the manufacturing process in a way that results in lower costs.

Total Quality Management Systems

Total quality management (TQM) "involves the implementation of appropriate tools/techniques to provide products and services to customers with best quality."[111] Firms develop and use TQM systems to:

1. increase customer satisfaction,
2. cut costs, and
3. reduce the amount of time required to introduce innovative products to the marketplace.[112]

Total quality management (TQM) involves the implementation of appropriate tools/techniques to provide products and services to customers with best quality.

It may seem counterintuitive that firms can reduce costs while increasing quality; however, this reduction is accomplished because when a product is produced well, it requires less rework and leads to fewer rejections during inspection, as well as fewer customer returns. Firms able to reduce costs while enhancing their ability to develop innovative products increase their flexibility, an outcome that is particularly helpful to companies implementing the integrated cost leadership/differentiation strategy. Exceeding customers' expectations regarding quality is a differentiating feature and eliminating process inefficiencies to cut costs allows the firm to offer that quality to customers at a relatively low price.[113]

Today, many firms have robust knowledge about establishing and using a TQM system effectively. It is typical for a firm's TQM system to yield competitive parity (see Chapter 3) rather than competitive advantage.[114] Nonetheless, because an effective TQM system helps firms increase product quality at a lower cost, it is particularly valuable for companies implementing the integrated cost leadership/differentiation strategy.

Competitive Risks of the Integrated Cost Leadership/Differentiation Strategy

The potential to earn above-average returns by using the integrated cost leadership/differentiation strategy successfully appeals to some leaders and their firms. However, it is a risky strategy in that firms find it difficult to perform primary value-chain activities and support functions in ways that allow them to produce relatively inexpensive products with levels of differentiation that create value for the target customer. Moreover, to use this strategy effectively across time, it is necessary for firms to reduce costs incurred to produce products (as required by the cost-leadership strategy) and to increase product differentiation (as required by the differentiation strategy) simultaneously.

Firms failing to perform the value-chain activities and support functions optimally when implementing the integrated cost leadership/differentiation strategy become "stuck in the middle."[115] Stuck in the middle means that a firm has a cost structure preventing it from pricing its products low enough to attract target customers and lacking sufficient differentiation to create value for those customers.

This appears to be what happened to J.C. Penney in recent years. A key decision made during Ron Johnson's tenure as the firm's CEO (from November 2011 until April 2013) was to replace the firm's historic pricing strategy with a new one. Instead of offering sales to customers, often through coupons, Johnson decided that the firm should engage in an "everyday low prices" pricing strategy that he used with Apple Stores when he was an executive with that firm. In addition to eliminating coupon-based sales, Johnson changed the firm's floor merchandise and added boutiques/streets within the stores.[116] Because of these actions, J.C. Penney became "stuck in the middle" in that its prices were no longer low enough to attract the firm's historic customers and its merchandise failed to create sufficient differentiation to attract new customers. Firms that are "stuck in the middle" fail to earn above-average returns and earn average returns only when the structure of the industry in which they compete is highly favorable.[117]

Despite the risks, the integrated cost leadership/differentiation strategy is becoming more common and perhaps necessary in many industries because of technological advances and global competition. This strategy often necessitates a long-term perspective to make it work effectively because it may require several years to generate positive returns.

Summary

- A business-level strategy is an integrated and coordinated set of commitments and actions the firm uses to gain a competitive advantage by exploiting core competencies in specific product markets. Five business-level strategies (cost leadership, differentiation, focused cost leadership, focused differentiation, and integrated cost leadership/differentiation) are discussed in the chapter.
- Customers are the foundation of successful business-level strategies. When considering customers, a firm simultaneously examines three issues: *who*, *what*, and *how*. These issues, respectively, refer to the customer groups the firm intends to serve, the needs those customers have that the firm seeks to satisfy, and the core competencies the firm will use to satisfy customers' needs. Increasing segmentation of markets throughout the global economy creates opportunities for firms to identify more distinctive customer needs that they can serve by implementing their chosen business-level strategy.
- A business model, which describes what a firm does to create, deliver, and capture value for stakeholders, is part of a firm's comprehensive business-level strategy. In essence, a business model is a framework for how the firm will use processes to create, deliver, and capture value. At the same time, a business-level strategy is a path the firm will follow to gain a competitive advantage by exploiting its core competencies in a specific product market. There are many types of business models, including the franchise, freemium, subscription, peer-to-peer, and digital platform models. Each type of business model can be paired with any one of the five generic business-level strategies as the firm seeks to compete successfully against rivals. Business model innovation occurs when firms determine that their current business model is outdated, and they replace it with a newer model. This is a hard process due to organizational inertia.
- Firms seeking competitive advantage through the cost leadership strategy produce no-frills, standardized products for an industry's typical customer. Firms must offer these low-cost products to customers with competitive levels of differentiation. Firms using this strategy earn above-average returns when they learn how to emphasize efficiency such that their costs are lower

than the costs of their competitors, while providing products to customers that have levels of differentiated features that are acceptable to them.

- Competitive risks associated with the cost leadership strategy include (1) a loss of competitive advantage to newer technologies, (2) a failure to detect changes in customers' needs, and (3) the ability of competitors to imitate the cost leader's competitive advantage through their own distinct strategic actions.
- Through the differentiation strategy, firms provide customers with products that have different (and valued) features. Customers pay a price for differentiated products that they believe is competitive relative to the product's features as compared to the cost/feature combinations available from competitors' goods. Because of their distinctiveness, differentiated products carry a premium price. Firms differentiate products on any dimension that some customer group values. Firms using this strategy seek to differentiate their products from competitors' products on as many dimensions as possible. The less similarity to competitors' offerings, the more buffered a firm is from competition with its rivals.
- Risks associated with the differentiation strategy include (1) a customer group's decision that the unique features provided by the differentiated product over the cost leader's product are no longer worth a premium price, (2) the inability of a differentiated product to create the type of value for which customers are willing to pay a premium price, (3) the ability of competitors to provide customers with products that have features similar to those of the differentiated product, but at a lower cost, (4) the threat of counterfeiting, whereby firms produce a cheap imitation of a differentiated product, and (5) failing to implement the differentiation strategy in ways that create value for which customers are willing to pay.
- Through the cost leadership and differentiated focus strategies, firms serve the needs of a narrow market segment (e.g., a buyer group, product segment, or geographic area). This strategy is successful when firms have the core competencies required to provide value to a specialized market segment that exceeds the value available from firms serving customers across the total market (industry).
- The competitive risks of focus strategies include (1) a competitor's ability to use its core competencies to out-focus the focuser by serving an even more narrowly defined market segment, (2) decisions by industry-wide competitors to focus on a customer group's specialized needs, and (3) a reduction in differences of the needs between customers in a narrow market segment and the industry-wide market.
- Firms using the integrated cost leadership/differentiation strategy strive to provide customers with relatively low-cost products that also have valued differentiated features. Flexibility is required for firms to learn how to use primary value-chain activities and support functions in ways that allow them to produce differentiated products at relatively low costs. Flexible manufacturing systems, improvements to them, and interconnected information systems within and between firms (buyers and suppliers) facilitate the flexibility that supports the use of the integrated strategy. Continuous improvements to a firm's work processes as brought about by a total quality management (TQM) system also facilitate the use of the integrated strategy. The primary risk of this strategy is that a firm might produce products that do not offer sufficient value in terms of either low cost or differentiation. In such cases, the company becomes "stuck in the middle." Firms stuck in the middle compete at a disadvantage and are unable to earn more-than-average returns.

Key Terms

business-level strategy 88
business model 91
business model innovation 92
cost leadership strategy 95
differentiation strategy 98
digital platform 93
digital strategy 88
focus strategy 102
integrated cost leadership/differentiation strategy 104
market segmentation 89
total quality management (TQM) 105

Review Questions

1. What is a business-level strategy?
2. What is the relationship between a firm's customers and its business-level strategy in terms of *who*, *what*, and *how*? Why is this relationship important?
3. What is a business model, and how do business models relate to business-level strategies?
4. What are the differences between the cost leadership, differentiation, focused cost leadership, focused differentiation, and integrated cost leadership/differentiation business-level strategies?
5. How can firms use the cost leadership or differentiation strategies to position themselves favorably relative to the five forces of competition?
6. What are the specific risks associated with using each business-level strategy?

Mini-Case

United Parcel Service (UPS): Serving the World with a Smile

Business-level strategy, this chapter's focus, describes actions a firm takes to compete successfully in a particular industry or industry segment by using its resources, capabilities, and core competencies to create a competitive advantage. United Parcel Service (UPS), the multinational shipping and supply chain management company, uses the integrated cost leadership/differentiation business-level strategy. "Strategy has never been taken lightly for UPS. Monthly meetings of teams specifically formed to envision the future and assess decisions have always played a large role in UPS's approach to low-cost management and differentiation through quality customer service."

UPS is led by CEO Carol B. Tomé. Prior to joining UPS, she was executive vice president and chief financial officer of the Home Depot. Her first position at UPS was as vice president and treasurer. From a business-level strategy perspective, Home Depot is very much like UPS–both companies emphasize keeping operating costs low and customer service high. Consequently, her skills and experience make her an excellent choice to lead UPS. She also has a clear vision for the company. According to Tomé, "UPS is a company with a proud past and an even brighter future. Our values define us. Our culture differentiates us. At UPS we are customer first, people led and innovation driven." The company's "Customer First" strategy is about providing the best digital experience to customers, making it simple to work with UPS, and removing any hindrances that interfere with an excellent customer experience. "People Led" means providing an outstanding employment experience and increasing the likelihood that an employee will recommend UPS as a great place to work. "Innovation Driven" pertains to implementing technology and productivity initiatives on an ongoing basis, and to providing high returns to shareholders.

Although UPS prices remain reasonable because of competition in the industry, the company doesn't focus on price. "We offer a relatively inexpensive service that can help customers ship packages practically anywhere. We promise great customer service and timely deliveries. Our prices have gone up in recent years in comparison to our closest rival FedEx, but our quality and service has not been diminished. With new technology we have been able to deliver products faster and more efficiently to your front door."

It is important to remember that the low-cost portion of an integrated cost leadership/differentiation business-level strategy does not mean the company will offer the lowest prices. Low-cost pertains to the cost of providing customers with a product or service and not the price charged. To keep operating costs low, UPS takes advantage of every technological innovation that can help the company reduce costs. It also does things that others might consider extreme with regard to its operations. For example, UPS delivery routes are mapped out before a driver leaves so that left-hand turns are avoided. This saves miles on the road, which also reduces the company's carbon footprint.

Despite its long history of success, UPS faces some challenges going forward. One of the greatest of these is the broad market shift to more residential deliveries. The pandemic led to a lot more online sales by individual consumers, and it appears that the increase in residential deliveries relative to business-to-business deliveries is going to remain. Business-to-consumer deliveries are lower in weight and require more stops. According to President of U.S. Operations George Willis, miles driven have increased by 10 percent and stops by 15 percent, while the average weight of packages declined. At the same time, competition is coming from unexpected places. For example, Amazon is growing its own cargo network, buying its own cargo planes, and using private entrepreneurial companies as partners to enhance its delivery volume through its Amazon Delivery Service Partner (DSP) business.

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Case Discussion Questions

1. We note in the Mini-Case that United Parcel Service (UPS) is implementing the integrated cost leadership/differentiation business-level strategy. Provide examples of the competitive dimensions on which this firm focuses while implementing this strategy.
2. What accounts for the higher level of business-to-consumer deliveries compared to business-to-business deliveries? Do you expect this trend to continue? Why or why not?
3. In years to come, should UPS try to grow primarily organically, through collaborative strategies such

as joint ventures and strategic alliances, or through mergers and acquisitions? Explain your answer. (Glance ahead to Chapter 7 to learn about mergers and acquisitions and to Chapter 9 to learn about joint ventures and strategic alliances.)

4. How can UPS deal effectively with the competitive threat from Amazon? Do you anticipate that other competitors will enter the industry? Why?

Notes

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Chapter 5

Competitive Rivalry and Competitive Dynamics

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

5-1 Define competitors, competitive rivalry, competitive behavior, and competitive dynamics.

5-2 Explain the types of competitive actions, competitive responses, and nonmarket strategies rival firms engage in as they compete with each other.

5-3 Describe market commonality and resource similarity as the building blocks of competitor analysis.

5-4 Explain awareness, motivation, and ability as drivers of competitive behavior.

5-5 Discuss factors affecting the likelihood a firm will take actions to attack its competitors.

5-6 Explain factors affecting the likelihood a firm will respond to actions its competitors take.

5-7 Describe competitive dynamics in slow-cycle, fast-cycle, and standard-cycle markets.

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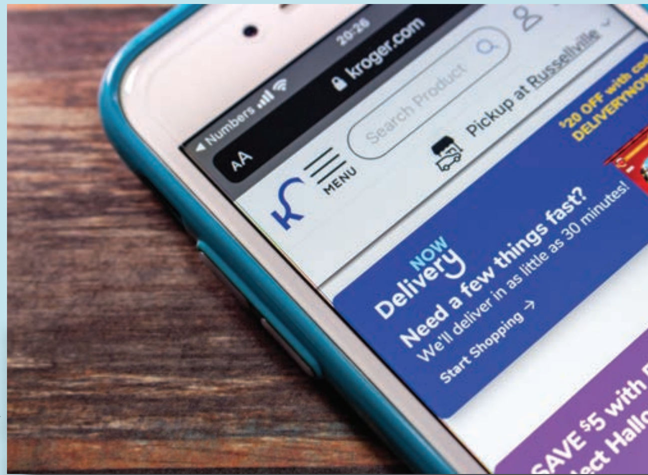
Kroger and Competitive Dynamics in the Grocery Industry

Serving nearly 11 million customers a day with nearly half a million employees, Kroger is the largest supermarket chain in the United States and one of the largest in the world. The firm has a well-known brand name, a historic ability to satisfy stakeholders through its performance, and a vision of "imagining a world with Zero hunger and Zero waste as we transform communities and improve health for millions of Americans." Because of these strengths, Kroger appears to have the potential required to achieve its objective of serving the "customer of tomorrow" effectively and efficiently. However, the grocery industry has experienced tremendous changes in recent years, with non-U.S.-based companies like the low-priced grocer ALDI (Germany) and the global giant Walmart—traditionally not engaged in the grocery industry—claiming large portions of the U.S. grocery market. In addition, domestic giants like Albertsons are formidable competitors.

Digital technologies are a major force driving rivalry in the industry. Saying that his firm is "incredibly focused on the customer of the future," Kroger Co.'s CEO, Rodney McMullen, noted that investments in online ordering and the ability to stock new products in its stores are vital to the firm's future success. However, in addition to traditional grocers beefing up their digital technologies and Walmart's huge investments to enhance the online grocery ordering experience and delivery options for customers, Kroger now faces additional competition from Amazon through Amazon's purchase of Whole Foods. Amazon paid approximately $13.7 billion to buy Whole Foods in 2017.

Amazon's purchase of Whole Foods is a *strategic action,* defined and discussed later in this chapter. Strategic actions find firms allocating substantial resources to support significant market-based actions with the potential to affect competition among industry rivals. Speaking about the acquisition of Whole Foods, some analysts suggest that "the impact of this in the grocery industry is going to be huge." Strategic actions, such as Amazon's purchase of Whole Foods, typically elicit *strategic responses*. As explored in this chapter, strategic responses, which also are resource-intensive, are actions competitors take to respond in the marketplace to a rival's strategic action(s).



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Grocers and their customers have embraced online ordering.

In contemplating the actions they will take in response to Amazon's purchase of Whole Foods, Kroger and other traditional grocery storefront operators, such as Albertsons, must recognize the significance of the challenge they face. Some believe, for example, that "the shift to e-commerce is not like the other marketplace ebbs and flows Kroger has weathered over the years. It is a dramatically different business model, with a new set of competitors, logistical hurdles and profitability impediments." Of course, COVID-19 accelerated the rate of change in the grocery store industry, as many shoppers are now comfortable with online ordering, delivery, and pickup.

Recognizing this reality, Kroger's CEO observed that "investments in online ordering were critical to Kroger's future and would take two or three years to build." Examples of the strategic response Kroger is taking relative to Amazon's strategic action—and those of other competitors as well—include the following: (1) building fewer physical stores as a means of generating financial capital to develop ecommerce options; (2) increasing the number of its storefront locations where customers can collect groceries they ordered online; (3) working with suppliers to reduce its freight costs, with generated savings going to ecommerce investments; (4) re-engineering its supply chain to become "more omnichannel, allowing (its) customers to order via desktop or mobile, in-store, or by phone"; (5) investing in technology and infrastructure to support its emerging ecommerce operations and (6) evaluating acquisitions and partnerships as a way of expanding its reach with U.S. customers and potentially to establish international operations as well.

Because of competitive rivalry and dynamics, competitors engage continuously in a series of actions and responses. Thus, while Kroger is responding to actions launched by rivals such as Amazon and Walmart, those firms will respond to Kroger's responses. For example, almost immediately after acquiring Whole Foods, Amazon assessed ways to offer Whole Foods' products to its Prime customers. This tactic is one example of Amazon's apparent intention of using Whole Foods' physical locations to expand its grocery delivery services. Over time, we can expect to see continuing efforts between Amazon and Kroger (and between these firms and other grocery industry competitors) to establish a favorable position in the marketplace.

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Learning Objective

5-1 Define competitors, competitive rivalry, competitive behavior, and competitive dynamics.

5-1 Defining and Understanding Competitors

Competitors are firms operating in the same market, offering similar products, and targeting similar customers.

Firms operating in the same market, offering similar products, and targeting similar customers are **competitors**.[1] Thus, Kroger and Amazon (through Whole Foods) engage in competitive behavior in the grocery business. Of course, Kroger and Whole Foods compete against many other rivals, including Albertsons, Costco, Walmart, Target, and Aldi.

Firms interact with competitors as part of the broad context within which they operate while attempting to earn above-average returns.[2] Another way to consider this idea is to note that firms do not compete in a vacuum. Each firm's actions are part of a mosaic of competitive actions and responses among a host of companies seeking the same objective—establishing a desirable position in the market as a means of superior performance relative to competitors. These firms participate in what is called a business ecosystem. Chapter 2 defined a business ecosystem as "a complex network of interconnected organizations—suppliers, customers, government agencies, technology suppliers, financiers, and other stakeholders—whose competitive and cooperative efforts are associated with the satisfaction of a particular value proposition (i.e., product or service)."[3]

Industries (comprised of firms producing products that are close substitutes) evolve through the competitive give and take of direct competitors as well as the actions of other firms within their ecosystems.[4] Innovation is essential in this process.[5] When a firm innovates, whether in its products and services (product innovation) or in the way they are produced and delivered (process innovation), other firms in the industry feel pressure to do likewise so they can remain competitive.[6]

In addition, other firms in the ecosystem (e.g., suppliers) provide the new supplies and components that the innovation requires. They compete with each other just as final product producers compete with each other.[7] For example, if the Chinese computer manufacturer Lenovo develops a significant new feature for its laptop computers, industry competitors HP, Dell, Apple, and Asus will feel pressure to match or surpass that feature to remain competitive. Within the broader computer ecosystem, suppliers will compete to provide Lenovo with what it needs to implement the new feature. Lenovo's customers (i.e., big box electronic stores, Amazon and other online retailers, discount department stores, etc.) will compete with each other for the most effective way to market and sell laptops with the new feature. Over time, these sorts of competitive actions define the industry and the larger ecosystem to which it belongs.[8]

Competitive rivalry describes competitive actions and responses among firms as they maneuver for an advantageous market position.

5-1a A Basic Understanding of Competitive Rivalry

Competitive rivalry describes competitive actions and competitive responses that occur among firms as they maneuver for an advantageous market position.[9] Evidence shows that the decisions firms make about their interactions with competitors affect their ability to earn above-average returns.[10] Especially in highly competitive industries, firms constantly jockey for advantage as they launch strategic actions and respond or react to rivals' moves.[11] Rivalry results from firms initiating their own competitive actions and then responding to actions competitors take.[12] Research indicates that firms are very likely to engage in a competitive action when a rival firm is experiencing temporary weakness because this makes them less able to respond.[13]

Competitive behavior is the set of competitive actions and responses a firm takes to build or defend its competitive advantages and improve its market position.[14] As explained in the Opening Case, it appears that a desire to expand the channels through which it can deliver groceries is one reason Amazon acquired Whole Foods. In this sense, Amazon's interest in Whole Foods as a distribution channel may exceed its interest in Whole Foods' physical storefronts.[15] In response to Amazon's competitive behavior, Kroger and other competitors are defending their current market positions (e.g., Kroger's storefront operations) while trying to enhance their competitive ability in related market positions (e.g., Kroger's actions to improve its ecommerce operations).

Competitive behavior is the set of competitive actions and responses a firm takes to build or defend its competitive advantages and improve its market position.

Increasingly, competitors engage in competitive actions and responses in more than one market.[16] United and Delta, and Alphabet (Google) and Apple are examples of this phenomenon. Firms competing against each other in several product or geographic markets engage in **multipoint competition**.[17] **Competitive dynamics** is the complete set of competitive actions and responses taken by all firms competing within a market.[18] We show the relationships among competitors, competitive rivalry, competitive behavior, and competitive dynamics in Figure 5.1.

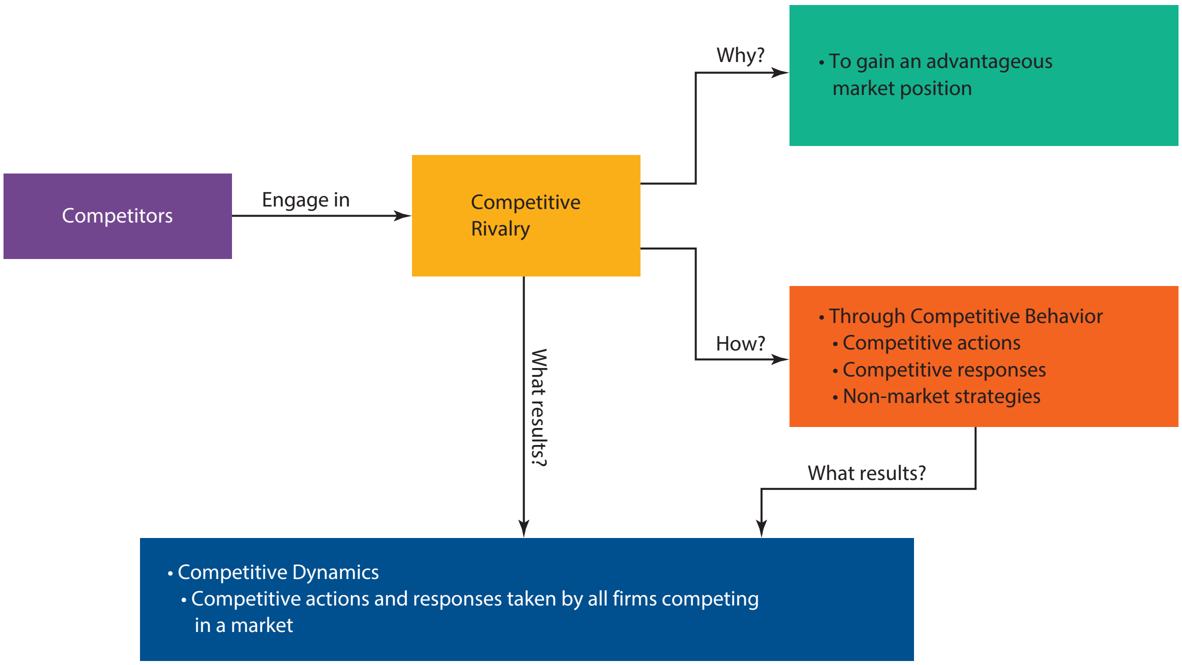
Multipoint competition occurs when firms compete against each other in several product or geographic markets.

Competitive dynamics is the complete set of competitive actions and responses taken by all firms competing within a market.

In this chapter, we focus on competitive rivalry and competitive dynamics. A firm's strategies are dynamic in that actions one firm takes elicit responses from competitors that typically result in responses from the firm taking the initial action.[19] Dynamism describes the competition among technology giants to gain a leadership position in voice recognition. In the early stages of the competition, Amazon's Alexa was the market leader. However, competition for the leadership position in voice recognition is intense as Amazon battles with Apple, Nuance Communications, Microsoft, IBM, and Alphabet (Google).[20]

Competitive rivalries such as this one in the voice recognition market affect a firm's strategies. This effect is because a strategy's success is a function of the firm's initial competitive actions (also called "attacks"), how well it anticipates competitors' responses to them, *and* how well the firm anticipates and responds to its competitors' initial actions.[21] Competitive rivalry affects all strategies (e.g., corporate-level, merger and acquisition, international, and cooperative). However, its dominant influence is on business-level strategy. Recall from Chapter 4 that business-level strategy

Figure 5.1 From Competition to Competitive Dynamics



Source: Adapted from M. J. Chen, 1996, Competitor analysis and interfirm rivalry: Toward a theoretical integration, Academy of Management Review, 21: 100–134.

is concerned with what the firm does to use its core competencies in specific product markets in ways that yield competitive success. Firms that develop and use effective business-level strategies tend to outperform competitors in individual product markets, even when experiencing intense competitive rivalry.[22]

Learning Objective

5-2 Explain the types of competitive actions, competitive responses, and non-market strategies rival firms engage in as they compete with each other.

5-2 Strategic and Tactical Actions and Responses

When engaging in competitive rivalry, firms use competitive actions and responses as well as strategic actions and responses.[23] A **competitive action** is a strategic or tactical action the firm takes to build or defend its competitive advantages or improve its market position. A **competitive response** is a strategic or tactical action the firm takes to counter the effects of a competitor's competitive action. A **strategic action** or a **strategic response** is a market-based move that involves a significant commitment of organizational resources and is difficult to implement and reverse. A **tactical action** or a **tactical response** is a market-based move that firms take to fine-tune a strategy; these actions and responses involve fewer resources and are relatively easy to implement and reverse. When engaging rivals in competition, firms must recognize the differences between strategic and tactical actions and responses and develop an effective balance between them.

A **competitive action** is a strategic or tactical action the firm takes to build or defend its competitive advantages or improve its market position.

A **competitive response** is a strategic or tactical action the firm takes to counter the effects of a competitor's competitive action.

A **strategic action** (or a **strategic response**) is a market-based move that involves a significant commitment of organizational resources and is difficult to implement and reverse.

A **tactical action** or a (**tactical response**) is a market-based move firms take to fine-tune a strategy; these actions and responses involve fewer resources and are relatively easy to implement and reverse.

In December 2018, Cigna Corp. successfully merged with Express Scripts Holding Company for $67B. This merger was a strategic response to a strategic action taken previously by other firms competing in the same market. For example, at roughly the same time, CVS acquired Aetna, Inc., in November 2018. Today, health insurers such as Cigna believe they must control additional parts of the value chain to earn above-average returns. The vertical integration within the value chain that results by combining health insurers such as Cigna and Aetna with pharmacy benefit managers such as CVS and Express Scripts increases the opportunities for the companies involved to operate more efficiently.[24]

Walmart prices aggressively as a means of increasing revenues and gaining market share at the expense of competitors. In this regard, the firm engages in a continuous stream of tactical actions to attack rivals by changing some of its products' prices and tactical responses to price changes taken by competitor Costco. Similarly, to compete against grocery retailers such as Kroger and online competitor Walmart, Amazon reduced prices for some of Whole Foods' products by as much as 43 percent almost immediately after completing the acquisition of the upscale grocery retailer.[25] Amazon is also making huge investments in robots to increase efficiency.[26] The Strategic Focus provides other examples of firms engaging in competitive and strategic actions and responses as they jockey for position in the videogame market.

5-2a Non-market Strategies

In addition to strategic and tactical actions and responses, firms use non-market strategies to influence the nature of competitive rivalry in an industry or a specific market within that industry.[27] **Non-market strategies** focus on altering a firm's institutional environment as part of its competitive strategy.[28] The institutional environment, as it pertains to non-market strategies, includes government influences such as regulations that establish the "rules of the game" as well as informal rules or norms that are predominant within a market or industry.[29] Basically, non-market strategies are used to attempt to change the industry architecture to make it more favorable from the perspective of one firm or, if firms combine their efforts, a group of firms. Research has found that non-market strategies can lead to competitive advantage.[30]

Non-market strategies focus on altering a firm's institutional environment as a part of its competitive strategy.

On the government side, a regulation a government enacts that pertains to a particular market or even a whole industry becomes a rule to which all companies in that market or industry must conform, or pay the consequences. Consequently, many firms use tactics such as lobbying, making donations to political candidates, and using media strategies that influence public opinion (i.e., social media, press releases, advertisements) to change the rules in their favor. For example, in Chapter 3, we mentioned that Hans Cole, Patagonia's director of environmental campaigns and advocacy, testified to a committee of the U.S. House of Representatives in an effort to influence legislators to enact more legislation to protect the environment. This action is consistent with Patagonia's strong strategic emphasis on environmental protection in all of its products and the way they are manufactured.[31]

Strategic **Focus**

Videogame Heavyweights Battle It Out—The Metaverse Is the Next Battleground

In the early 1970s, people of all ages were excited to play Pong. This simple videogame would hook up to any television. Two competitors would turn little dials to make a paddle move up and down on their side of the screen, simultaneously protecting their goal from an oncoming "ball" while trying to hit it into their opponent's goal. Pong, sold by Atari, was the first commercially successful at-home videogame, and it helped usher in a global obsession with videogames. However, it came out after the first home videogame console, the Magnavox Odyssey.

A lot has happened since the days of Pong and Odyssey. The market leaders in the gaming market are China's Tencent Holdings, LTD and Japan's Sony Group Corp. Tencent, China's largest tech conglomerate, is "both an internet and entertainment giant in China—the equivalent of Facebook or Google—but gamers are probably more familiar with Tencent's investments into a growing number of game developers and publishers." The company has over 300 of these investments in its portfolio, including sole ownership of Riot Games (League of Legends) and 40 percent ownership of Epic Games (Fortnite).

The purchase of Riot Games qualifies as a strategic action because it was a springboard for a lot of what Tencent Holdings has done in videogames. Several strategic tactics followed this strategic action to reinforce the firm's position in the market, including giving developers access to its platform so they can create games for it (e.g., Riot Forge) and holding a League of Legends World Championship with 12 leagues from around the world. Riot Games claims that League of Legends is the most-played PC game in the world. Tencent's $8.6 billion investment in the Finnish mobile game developer Supercell was also a strategic action that has paid off very well—60 percent of Tencent's $19 billion in gaming revenue in 2021 came from mobile gaming.

Like Tencent, Sony (Japan) is a huge and highly diversified international company engaged in the consumer electronics, music, pictures, imaging, gaming, and financial services markets. In the videogame market, Sony is known for its PlayStation console and the very popular *Grand Theft Auto* and *God of War* game series. The most interesting thing about these two huge companies is that their gaming divisions are a small part of their overall business portfolios. Their size gives them a lot of potential power to engage in strategic and competitive actions and reactions in the gaming market.

Another giant, Microsoft, stepped up its involvement in gaming with a $75 billion deal to buy Activision Blizzard (*Call of Duty, World of Warcraft, Candy Crush*) in 2022. Microsoft is already well known for its Xbox gaming system and its popular game titles *Minecraft* and *Doom*. Still, this strategic action will make Microsoft the third-largest gaming company in the world. This strategy is part of Microsoft CEO Satya Nadella's vision to make the business software giant into a videogame giant as well. The company hopes to lure even more gamers online and "turn its Game Pass subscription service into the Netflix of games." The market reaction to the announcement of this deal reinforces the competitive nature of this market. "Sony Group Corp.'s shares fell nearly 13% in Tokyo on Wednesday (January 19) on concerns about new competition for its videogame business from the combination of Microsoft Corp. and Activision Blizzard Inc."

agencies/Shutterstock.com

Virtual reality headsets are increasing in popularity in the videogame market.

In the midst of these battles for supremacy in the videogame market, here comes virtual reality. The best-selling virtual reality headset at present is the Meta Quest 2 (previously called Oculus Quest 2), but it is from Meta Platforms (Facebook) and not one of the big gaming companies. Meta reported $1 billion in spending for Quest content, and "sales of virtual reality and augmented-reality hardware more than doubled during the 2021 holiday season, versus the prior year." Some experts believe that Meta has at least 85 percent of the market, although its virtual reality unit is still losing money. Sony also has a headset, but it requires extra equipment and only appeals to the most ardent gamers. Apple and Microsoft have also expressed interest in the virtual reality market. It will be interesting to see this market evolve over the next few years, to see if Meta can hold on to its market leadership position in headsets, and what strategic and competitive actions and tactics competitors will take. To reinforce its position, Meta is pursuing the tactic of developing a higher-end headset.

Sources: A. Webb, 2022, It's an all-out brawl in the metaverse, *The Economist*, March 7: 72; K. Narioka & Y. Jie, 2022, Microsoft deal hits Sony's stock, *Wall Street Journal*, January 20: B4; C. Lombardo, K. Grind, & A. Tilley, 2022, Microsoft strikes Activision megadeal, *Wall Street Journal*, January 19: A1, A8; A. Tilley & S. E. Needleman, 2022, Microsoft pursues gamers to boost its cloud, *Wall Street Journal*, January 20: A1, A6; J. Stern, 2022, Make the Meta Quest 2 a better headset—and portal to the Metaverse, *Wall Street Journal*, www.wsj.com, February 23; 2022, *Sony Webpage*, www.sony.com, March 3; 2022, *Riot Games Homepage*, www.riotgames.com; S. Messner, 2020, Every game company that Tencent has invested in, *PC Gamer*, www.pcgamer.com, August 9.

Another part of a firm's institutional environment pertains to the informal rules or norms within a market or industry. For example, in the higher education industry, strong norms regarding retention policies (e.g., tenure) guide the actions of most research-oriented universities. Likewise, accounting firms are guided by strong norms regarding how they conduct their business—some of these are documented, but many are simply rules that industry members understand. One norm that is becoming widespread across many institutional environments is the norm that firms should be socially responsible. As a result, firms sometimes engage in activities that will raise their image as a responsible corporate citizen (i.e., charitable contributions, inclusion efforts, employee welfare initiatives) in an effort to gain legitimacy (and therefore power) in the eyes of other firms with whom they conduct business or compete.[32]

The two types of non-market strategies typically are complementary. For example, gaining legitimacy through socially responsible activities can improve a firm's ability to influence governmental policy, and a politically powerful firm can gain legitimacy and influence within its informal institutional environment. Consequently, "the coordinated management of corporate social responsibility and corporate political activities may lead to better firm performance. However, corporate social responsibility and corporate political activities should be aligned carefully to utilize this complementarity."[33]

5-2b A Model of Competitive Rivalry

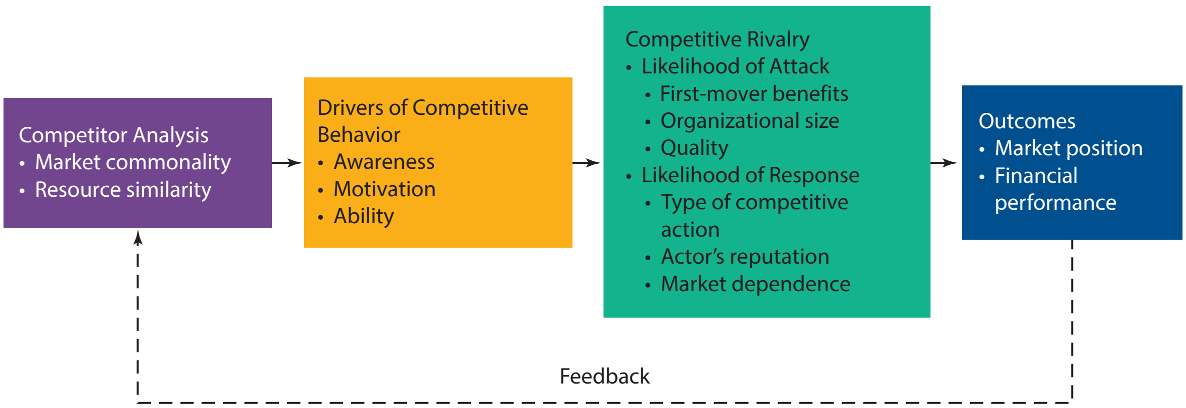
Competitive rivalry evolves from the pattern of actions and responses as one firm's competitive actions have noticeable effects on competitors, eliciting competitive responses from them.[34] The ongoing competitive action/response sequence between a firm and a competitor affects the performance of both companies.[35] This pattern suggests that firms are mutually interdependent, that competitors' actions and responses affect them, and that marketplace success is a function of both individual strategies and the consequences of their use.[36] Because of this, it is important for companies to carefully analyze and understand the competitive rivalry present in the markets in which they compete.[37]

Research shows that intensified rivalry within an industry results in decreased average profitability for the competing firms.[38] For example, at least in the short run, increased rivalry among Kroger, Amazon, ALDI, and Walmart is likely to reduce the profitability for all firms competing to sell and deliver grocery items.

Figure 5.2 presents a straightforward model of competitive rivalry at the firm level; this type of rivalry is usually dynamic and complex. The competitive actions and responses the firm takes are the foundation for successfully building and using its capabilities and core competencies to gain an advantageous market position.[39] Companies can use this model to understand how to predict a competitor's behavior and reduce the uncertainty associated with that behavior. Being able to predict competitors' actions and responses has a positive effect on the firm's market position and its subsequent financial performance.[40] Competitive dynamics describes the competitive behaviors associated with all of the individual rivalries that occur within a particular market.

The remainder of this chapter explains components of the model shown in Figure 5.2. We first describe market commonality and resource similarity as the building blocks of a competitor

Figure 5.2 A Model of Competitive Rivalry



Source: Adapted from M. J. Chen, 1996, Competitor analysis and interfirm rivalry: Toward a theoretical integration, Academy of Management Review, 21: 100–134.

analysis. We then discuss the effects of three organizational characteristics—awareness, motivation, and ability—on the firm's competitive behavior. This discussion is followed by an examination of competitive rivalry between firms (interfirm rivalry). We explain the factors that affect the likelihood a firm will take a competitive action and the factors that affect the likelihood a firm will respond to a competitor's action. In the chapter's final section, we turn our attention to competitive dynamics to describe how market characteristics affect competitive rivalry in slow-, fast-, and standard-cycle markets.

5-3 Competitor Analysis

Learning Objective

5-3 Describe market commonality and resource similarity as the building blocks of competitor analysis.

As noted previously, a competitor analysis is the first step the firm takes to predict the extent and nature of its rivalry with each competitor. Competitor analyses are also important when entering a foreign market because of the need to understand the local competition and foreign competitors operating in that market.[41] Without such analyses, firms entering the market are less likely to be successful.

Market commonality refers to the number of markets in which firms compete against each other, while resource similarity refers to the similarity in competing firms' resource portfolios (we discuss both terms fully later in the chapter). These two dimensions of competition determine the extent to which firms are competitors. Firms with high market commonality and highly similar resources are direct and mutually acknowledged competitors. The drivers of competitive behavior—as well as factors influencing the likelihood that a competitor will initiate competitive actions and respond to its competitors' actions—influence the intensity of rivalry.

In Chapter 2, we discussed competitor analysis as a technique firms use to understand their competitive environment. Together, the general, industry, and competitive environments comprise the firm's external environment. We also described how firms use competitor analysis to help them *understand* their competitors. This understanding results from studying competitors' future objectives, current strategies, assumptions, and capabilities (see Figure 2.3 in Chapter 2).

In this chapter, we extend the discussion of competitor analysis to describe what firms study to be able to *predict* competitors' behavior in the form of their competitive actions and responses. The discussions of competitor analysis in Chapter 2 and in this chapter are complementary in that firms must first *understand* competitors (Chapter 2) before their competitive actions and responses can be *predicted* (this chapter).

Being able to predict rivals' likely competitive actions and responses accurately helps a firm avoid situations in which it is unaware of competitors' objectives, strategies, assumptions, and capabilities. Lacking the information needed to predict these conditions for competitors creates *competitive blind spots*. Typically, competitive blind spots find a firm caught off guard by a competitor's actions, potentially resulting in negative outcomes.[42] Members of a firm's board of directors are a source of knowledge and expertise about other businesses and industry environments that can help a firm avoid competitive blind spots.

5-3a Market Commonality

Every industry is composed of various markets. For instance, the financial services industry has markets for insurance, brokerage services, banks, and so forth. To concentrate on the needs of different, unique customer groups, firms may further subdivide the markets they intend to serve. The insurance market could be broken into market segments (such as commercial and consumer), product segments (such as health insurance and life insurance), and geographic markets (such as Southeast Asia and Western Europe).

Particular characteristics distinguish the individual markets that form an industry. For instance, in the transportation industry, the commercial air travel market (i.e., United, Lufthansa, Singapore Airlines) differs fundamentally from the ground transportation market (FedEx, United Parcel Service, Con-Way) in the nature of the services provided to customers. Nonetheless, although differences exist, many of the markets within an industry share some similarities in terms of technologies used or core competencies needed to develop a competitive advantage. For example, all competitors in the transportation industry need information technologies to provide reliable and timely service. Commercial air carriers such as United, Lufthansa, and Singapore Airlines must therefore develop information technology and competencies to satisfy their passengers, while ground transport companies such as FedEx, United Parcel Service, or Con-Way must develop information technology and competencies to satisfy the needs of those using their services to ship goods.

Market commonality is concerned with the number of markets with which the firm and a competitor are jointly involved and the degree of importance of the individual markets to each.

Firms sometimes compete against each other in several markets, a condition called market commonality. More formally, **market commonality** is concerned with the number of markets with which the firm and a competitor are involved jointly and the degree of importance of the individual markets to each.[43] Firms competing against one another in several markets engage in multipoint competition, which was defined previously.[44] Coca-Cola and PepsiCo compete across a number of product markets (e.g., soft drinks, bottled water) as well as geographic markets (throughout North America and in many other countries throughout the world). Chemicals, pharmaceuticals, and consumer foods are examples of other industries with firms often competing against each other in multiple markets.

Firms competing in several of the same markets have the potential to respond to a competitor's actions within the market in which the competitor took an action and in other markets where they compete with the rival. This potential creates a complicated mosaic in which the firm may decide to initiate competitive actions or responses in one market with the desire to affect the outcome of its rivalry with a particular competitor in a second market.[45] These types of interrelationships complicate the rivalry between competitors. In fact, research suggests that a firm with greater multipoint contact is less likely to initiate an attack but more likely to respond aggressively when attacked. For instance, research in the computer industry found that "firms respond to competitive attacks by introducing new products but do not use price as a retaliatory weapon."[46] Thus, in general, multipoint competition reduces competitive rivalry, but some firms will still engage in attacks when the potential rewards (e.g., potential market share gain) are high.[47]

5-3b Resource Similarity

Resource similarity is the extent to which the firm's tangible and intangible resources compare favorably to a competitor's in terms of type and amount.

Resource similarity is the extent to which the firm's tangible and intangible resources compare favorably to a competitor's in terms of type and amount.[48] Firms with similar types and amounts of resources tend to have similar strengths and weaknesses and use similar strategies in light of their strengths to pursue what may be similar opportunities in the external environment. In other words, resource similarity increases competitive rivalry.

Resource similarity describes part of the competitive relationship between FedEx and UPS. For example, these firms have similar truck and airplane fleets, similar levels of financial capital, and rely on equally talented reservoirs of human capital along with sophisticated information technology systems (resources). Another big part of the relationship comes from the fact that the two firms share many markets in common in various countries and regions. Thus, the rivalry between FedEx and UPS is even more intense because of the additive effects from both resource similarity and market commonality.

Consequently, when performing a competitor analysis, a firm analyzes each of its competitors with respect to both market commonality and resource similarity. When two firms have high levels of both market commonality and resource similarity, they use their similar resource portfolios to compete against each other in many markets that are important to each. These firms are direct and mutually acknowledged competitors.

If a firm and its competitor have little similarity in their markets or resources, they are not direct and mutually acknowledged competitors. Thus, a small, local restaurant concentrating on selling "gourmet" hamburgers is not in direct competition with McDonald's. They have only one small market in common, and their resources are quite different. It is possible, then, for a small restaurant to thrive even in the shadow of a huge competitor like McDonald's. On the other hand, other small local restaurants would tend to have similar resources and, of course, they compete in the same market. The competitive rivalry between the two small local restaurants is likely to be strong.

The nature of the relationship competitors have with each other may change over time as well. Consider General Mills and The Kellogg Company (Kellogg's). For decades, they competed against each other directly and aggressively to sell their cereal products. However, the competition between these firms may become less direct in the future because of the actions these firms take. General Mills, for example, acquired pet food company Blue Buffalo Pet Products Inc. for $8 billion in 2018. One reason for this acquisition was that the pet food business is "one of the largest center-of-the-store categories in the U.S. food and beverage market."[49] Moving into pet foods finds General Mills competing more directly with another foods company, J.M. Smucker Co., in that Smucker paid $3 billion to buy Milk-Bone owner Big Heart. Similarly, Kellogg's, whose CEO noted that "cereal doesn't have to be the growth engine of Kellogg," is emphasizing other products such as Pringles chips, Cheez-It crackers, Pop-Tarts, and frozen Eggo waffles to stimulate firm growth.[50] Emphasizing snack products could find Kellogg's competing more directly with PepsiCo, the owner of snack-giant Frito Lay.

5-4 Drivers of Competitive Behavior

Learning Objective

5-4 Explain awareness, motivation, and ability as drivers of competitive behavior.

Market commonality and resource similarity influence the drivers of competitive behavior—awareness, motivation, and ability.[51] In turn, these drivers of competitive behavior influence the firm's actual competitive behavior, as revealed by the actions and responses it takes while engaged in competitive rivalry (see Figure 5.2).[52]

Awareness, which is a prerequisite to any competitive action or response a firm takes, refers to the extent to which competitors recognize the degree of their mutual interdependence that results from market commonality and resource similarity.[53] Awareness affects the extent to which the firm understands the consequences of its competitive actions and responses. A lack of awareness can lead to excessive competition, resulting in a negative effect on all competitors' performance.[54]

Awareness tends to be greatest when firms have highly similar resources (in terms of types and amounts) to use while competing against each other in multiple markets (e.g., multipoint competition). Coca-Cola and PepsiCo are certainly aware of each other as they compete in multiple markets to satisfy consumers' beverage tastes. Because of evolving tastes and the installation of taxes on sugary drinks some governmental agencies are levying, the companies are investing in healthier alternatives.[55] However, developing new soda products to meet consumers' interests is more critical for Coca-Cola compared to PepsiCo because PepsiCo's ownership of food products such as Frito-Lay means that it sells a number of items to consumers in addition to sodas.

Motivation, which concerns the firm's incentive to take action or to respond to a competitor's attack, relates to perceived gains and losses. Thus, a firm may be aware of competitors but may not be motivated to engage in rivalry with them if it perceives that its market position will neither improve nor suffer if it does not respond.[56] Nonresponse in this situations is called *strategic forbearance* and is often a result of firms taking a broader perspective on the situation, considering the influence of its possible actions on stakeholders and the longer-term implications on competitive rivalry.[57] A benefit of lacking the motivation to engage in rivalry at a point in time with a competitor is the ability to retain resources for other purposes, including competing against a different rival.

Market commonality affects the firm's perceptions and resulting motivation. For example, a firm is generally more likely to attack the rival with whom it has low market commonality than the one with whom it competes in multiple markets. The primary reason for this is the high stakes involved in trying to gain a more advantageous position over a rival with whom the firm shares many markets. As mentioned earlier, multipoint competition can result in a competitor responding to the firm's action in a market different from the one in which the initial action occurred. Actions and responses of this type can cause both firms to lose focus on core markets and to battle each other with resources they could be allocating for other purposes. Because of the high competitive stakes under the condition of market commonality, the probability is high that the attacked firm will feel motivated to respond to its competitor's action in an effort to protect its position in one or more markets.[58]

In some instances, the firm may be aware of the markets it shares with a competitor and be motivated to respond to an attack by that competitor, but lack the ability to do so. *Ability* relates to each firm's resources and the flexibility they provide.[59] Without available resources (such as financial capital and people), the firm is not able to attack a competitor or respond to its actions. For example, smaller and newer firms tend to be more innovative, but they generally have fewer resources to attack larger and established competitors. Local firms' social capital (relationships) with stakeholders including consumers, suppliers, and government officials create a disadvantage for foreign firms lacking the social capital of local companies.[60] However, possessing similar resources, such as is the case with Coca-Cola and PepsiCo, suggests similar abilities to attack and respond. When a firm faces a competitor with similar resources, carefully studying a possible attack before initiating it is essential because the similarly resourced competitor is likely to respond to that action.[61]

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Small competitors find it difficult to respond to the competitive threat that exists with Walmart. Yet, they must find a way to respond, perhaps by offering personalized services, so they can survive such a threat.

Resource *dissimilarity* also influences the competitive actions and responses firms choose to take. The reason is that the more significant is the difference between resources the acting firm owns and those against whom it has taken action, the longer is the delay by the firm with a resource disadvantage.[62] For example, Walmart initially used a focused cost leadership strategy to compete only in small communities (those with a population of 25,000 or less). Using sophisticated logistics systems and efficient purchasing practices, among other methods to gain competitive advantages, Walmart created a new type of value (primarily in the form of wide selections of products at the lowest competitive prices) for customers in small retail markets. Local competitors lacked the ability to marshal needed resources at the pace required to respond to Walmart's actions quickly and effectively.

However, even when facing competitors with greater resources (greater ability) or more attractive market positions, firms should eventually respond, no matter how daunting the task seems. Choosing not to respond can ultimately result in failure, as happened with at least some local retailers who did not respond to Walmart's competitive actions. Today, with Walmart as the world's largest retailer, it is indeed difficult for smaller competitors to have the resources required to respond effectively to its competitive actions or competitive responses.[63]

Learning Objective

5-5 Discuss factors affecting the likelihood a firm will take actions to attack its competitors.

5-5 Actions That Drive Competitive Rivalry

Previously, we discussed how market commonality, resource similarity, and the drivers of awareness, motivation, and ability affect the likelihood a firm will use strategic and tactical actions to attack its competitors. Next, we discuss three additional factors—first-mover benefits, organizational size, and quality. In this discussion, we consider first movers, second movers, and late movers.

5-5a First-Mover Benefits

A **first mover** is a firm that takes an initial competitive action to build or defend its competitive advantages or to improve its market position.

A **first mover** is a firm that takes an initial competitive action to build or defend its competitive advantages or to improve its market position.[64] Work by the famous economist Joseph Schumpeter is the basis for the first-mover concept. Schumpeter argued that firms achieve competitive advantage by taking innovative actions.[65] In general, first movers emphasize research and development (R&D) as a path to developing innovative products that customers will value.[66] Amazon was a first mover as an online bookstore, while eBay was the first major online auction site.[67]

First-mover benefits can be substantial.[68] This is especially true in fast-cycle markets (discussed later in the chapter) where changes occur rapidly and where it is virtually impossible to sustain a competitive advantage for any length of time. A first mover in a fast-cycle market can experience many times the revenue and valuation of a second mover.[69] This evidence suggests that although first-mover benefits are never absolute, they are often critical to a firm's success in industries experiencing rapid technological developments and with relatively short product life cycles.[70] In addition to earning above-average returns until its competitors respond to its successful competitive action, the first mover can gain

- the loyalty of customers who may become committed to the products of the firm that first made them available
- market share that can be difficult for competitors to take when engaging in competitive rivalry

The general evidence that first movers have greater survival rates than later market entrants is perhaps the culmination of first-mover benefits.[71]

The firm trying to predict its rivals' competitive actions might conclude that they will take aggressive strategic actions to gain first-movers benefits. However, even though a firm's competitors might be motivated to be first movers, they may lack the resources and capabilities to do so. First movers tend to be aggressive and willing to experiment with innovation and take higher yet reasonable levels of risk, and their long-term success depends on retaining the ability to do so.[72]

To be a first mover, the firm must have the readily available resources to invest significantly in R&D as well as to rapidly and successfully produce and market a stream of innovative products.[73] Organizational slack makes it possible for firms to have the ability (as measured by available resources) to be first movers. *Slack* is the buffer provided by actual or obtainable resources not in use currently and that exceed the minimum resources needed to produce a given level of organizational output.[74] As a liquid resource, slack is available to allocate quickly to support competitive actions, such as R&D investments and aggressive marketing campaigns that lead to first-mover advantages. This relationship between slack and the ability to be a first mover allows the firm to predict that a first-mover competitor with available slack will probably take aggressive competitive actions as a means of continuously introducing innovative products. Furthermore, the firm can predict that, as a first mover, a competitor will try to gain market share and customer loyalty rapidly to earn above-average returns until its competitors are able to respond effectively to its first move.

Firms evaluating their competitors should realize that being a first mover carries risk. For example, it is difficult to estimate accurately the returns that a firm might earn by introducing product innovations to the marketplace.[75] Additionally, the first mover's cost to develop a product innovation can be substantial, reducing the slack available to support further innovation. Also, a first mover into a new international market may actually experience more difficulty establishing itself in the new market than a second mover because it is seen as an outsider (i.e., a liability of foreignness).[76]

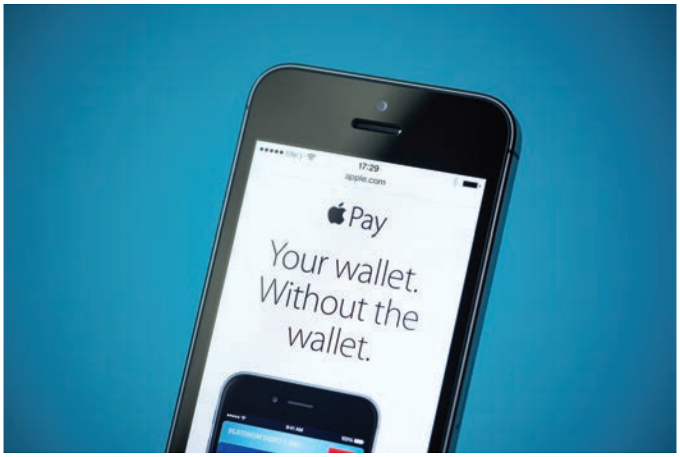
A **second mover** is a firm that responds to the first mover's competitive action, typically through imitation.[77] Although its successful iPhone changed consumers' and companies' perceptions about the potential of cell phones, Apple is a well-known second mover with many of its product introductions. In fact, "Apple has been second at most stuff. They're not a true innovator in the definition of the word. They weren't the first into object-oriented computing (the mouse), they weren't the first mp3 player, they weren't the first mobile phone."[78] What Apple does extremely well, though, is to study products as a means of determining how to improve them by making them more user friendly for consumers.

A **second mover** is a firm that responds to the first mover's competitive action, typically through imitation.

More cautious than the first mover, the second mover, such as Apple, studies customers' reactions to product innovations. In the course of doing so, the second mover also tries to find any mistakes the first mover made so that it can avoid them and the problems they created. Often, successful imitation of the first mover's innovations allows the second mover to avoid the mistakes and the major investments required of the pioneering first movers.[79]

Second movers have the time needed to develop processes and technologies that are more efficient than those the first mover used or that create additional value for consumers.[80] The most successful second movers rarely act too fast (so they can study the first mover's actions carefully) nor too slow (so they do not give the first mover time to correct its mistakes and "lock in" customer loyalty). Overall, the outcomes of the first mover's competitive actions may provide a blueprint for second and even late movers as they determine the nature and timing of their competitive responses.[81]

Determining whether a competitor is effective as a second mover (based on its actions in the past) allows a first-mover firm to predict when or if the competitor will respond quickly to successful, innovation-based market entries. The first mover can expect a successful second-mover competitor to study its market entries and to respond with a new entry into the market within a short time. As a second mover, the competitor will try to respond with a product that provides greater customer value than does the first mover's product. The most successful second movers are able to interpret market feedback with precision as a foundation for responding quickly yet successfully to the first mover's successful innovations.[82]



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Apple, a well-known second mover, studies customers' reactions to product innovations to avoid the mistakes of first movers.

A **late mover** is a firm that responds to a competitive action a significant amount of time after the first mover's action and the second mover's response.

A **late mover** is a firm that responds to a competitive action a significant amount of time after the first mover's action and the second mover's response.[83] General Motors introduced the Hummer late into the sport utility vehicle (SUV) market; the product failed to appeal strongly to a sufficient number of customers and was discontinued in 2010. The Hummer EV SUT was released in 2021. Although still available, the product struggles to find a target market of sufficient size to support GM's ambitions for it.

Typically, a late response is better than no response at all, although any success achieved from the late competitive response tends to be considerably less than that achieved by first and second movers. However, on occasion, late movers can be successful if they develop a unique way to enter the market and compete. For firms from emerging economies, this often means a niche strategy with lower-cost production and manufacturing. It can also mean that they need to learn from the competitors or others in the market so they can market products that allow them to compete.[84]

The firm competing against a late mover can predict that the competitor will likely enter a particular market only after both the first and second movers have achieved success in that market. Moreover, on a relative basis, the firm can predict that the late mover's competitive action will allow it to earn average returns only after the considerable time required for it to understand how to create at least as much customer value as that offered by the first and second movers' products.

5-5b Organizational Size

An organization's size affects the likelihood it will take competitive actions as well as the types and timing of those actions.[85] In general, small firms are more likely than large companies to launch competitive actions and tend to do so more quickly. Because of this tendency, smaller firms have the capacity to be nimble and flexible competitors. These firms rely on speed and surprise to defend their competitive advantages or to develop new ones while engaged in competitive rivalry, especially with large companies, to gain an advantageous market position.[86] Small firms' flexibility and nimbleness allow them to develop variety in their competitive actions; large firms tend to limit the types of competitive actions used.[87]

Large firms, however, are likely to initiate a larger total number of competitive actions and strategic actions during a given period because they have more resources to do so. Thus, when studying competitors in terms of organizational size, the firm should use a measurement such as total sales revenue or total number of employees to predict the number of competitive and strategic actions a competitor might take.

5-5c Quality

Quality has many definitions, including well-established ones relating it to making products with zero defects or as a cycle of continuous improvement.[88] From a strategic perspective, we consider quality to be the outcome of how a firm competes through its value chain activities and support functions (see Chapter 3). Thus, **quality** exists when the firm's products meet or exceed customers' expectations. Evidence suggests that quality is often among the most critical components in satisfying the firm's customers.[89]

Quality exists when the firm's products meet or exceed customers' expectations.

In the eyes of customers, quality is about doing the right things relative to performance measures that are important to them.[90] Customers may be interested in measuring the quality of a firm's products against a broad range of dimensions, which might include their durability, performance, aesthetics, features, or many other factors. Quality is possible only when top-level managers support it and when the organization validates its importance throughout its operations.[91] It is a universal theme in the global economy and is a necessary but insufficient condition for competitive success.[92] Without quality, a firm's products lack credibility, meaning that customers do not think of them as viable options. Indeed, customers will not consider buying a product or using a service until they believe that it can satisfy at least their base-level expectations in terms of quality dimensions that are important to them.[93]

Quality affects competitive rivalry. The firm evaluating a competitor whose products suffer from poor quality can predict declines in the competitor's sales revenue until the quality issues are resolved. Firms are more likely to attack a rival when it is weak, realizing that a rival with quality problems is unlikely to be aggressive in its competitive actions until it is able to correct those problems.[94] However, after correcting the problems, that competitor is likely to take aggressive competitive actions.

Strategic Focus

Competitive Rivalry Among Large-Scale Battery Manufacturers: Who Will Establish the Most Attractive Market Position?

The growth potential of the large-scale battery-storage market is substantial. Utility companies are one of the key customers for large-scale battery-storage products. They encounter the challenge of having sufficient capacity to meet peak demand for energy consumption. For example, mornings and evenings are the times when customers use the greatest amounts of electricity. At non-peak times, utilities have idle capacity. One way to resolve this problem is through pumped-storage hydro plants that "store and generate energy by moving water between two reservoirs at different elevations. During times of low electricity demand, such as at night or on weekends, excess energy is used to pump water to an upper reservoir. The turbine acts as a pump, moving water back uphill. During periods of high electricity demand, the stored water is released through turbines." However, not all utilities have the right environment or sufficient resources to participate in this type of energy storage.

Also, increasing levels of power generation from renewable energy sources such as wind and power require large-scale battery-storage units. The challenge with wind and solar is that they are intermittent energy sources. In this sense, power companies do not know exactly when the wind will blow (and for how long and at what velocity) and exactly when the sun will shine (and for how long and with what degree of intensity). Large-scale storage batteries address this issue by allowing the capture of wind- and solar-generated power when created and then storing it until needed to meet consumer demand.

The decreasing cost of lithium-ion batteries is also increasing the attractiveness of large-scale, battery-storage systems—small versions of lithium-ion batteries power our cell phones and a host of other products. In addition, many companies are moving into the production of solid-state lithium-ion batteries that do not require liquid electrolytes, charge faster, and are not combustible, which is a problem with many batteries.

Tesla, Siemens AG, and General Electric (GE) are primary competitors in large-scale battery storage, and the three companies are jockeying for position in this market. GE plans to invest $103 billion into energy-storage projects by 2030. As one of these projects in 2018, the company established a giant energy-storage platform called GE Reservoir. The platform is based on a modular, 20-foot-long, high-capacity reservoir storage unit that can be combined with other units. The platform allows storage of electricity generated by wind turbines and solar panels for later use. It also allows for power grid optimization. In addition, GE Reservoir offers energy consulting services, cost-benefit analysis, project planning, and service agreements.

Another of the big contenders, Tesla, in 2017 announced that in partnership with Neoen, a French renewable-energy provider, it would build, deliver, and install the world's largest lithium battery to a location north of Jamestown, South Australia, in 100 days. Tesla fulfilled this promise and delivered a battery-storage product that runs constantly, provides stability services for renewable-energy sources, and is available for emergency backup power in case of an energy shortfall.

To compete with Tesla and GE, Siemens and AES combined their efforts to form an energy-storage start-up called Fluence Energy. The partnership commenced operations in 2018 and immediately became the "supplier of AES' Alamitos power center energy storage project in Long Beach, California, serving Southern California Edison and the Western Los Angeles area. Fluence's battery-storage project was to be the largest in the world, exceeding the size of Tesla's project in Southern Australia." Then, in 2022, Fluence energy formed a partnership with QuantumScape "to introduce solid-state lithium-based rechargeable batteries into stationary power applications."

The attractiveness of the large-scale battery-storage market is drawing in a lot of new investment capital. For example, Rondo Energy Inc., a start-up based in the United States, raised $22 million in venture funding to try to figure out how to store and use surplus energy from wind and solar to power heavy industry. Also, Carlyle Group made a huge investment in a company called NineDot Energy in early 2022. NineDot is helping New York State achieve a goal of 100 percent clean energy by 2040. One of NineDot's projects involves buying land and working with local utilities to connect batteries on those sites to the power grid. These types of companies are likely to use existing battery-storage systems in the short term, but some of them will also influence the shape of this competitive market over time.

Sources: A. Root, 2022, QuantumScape is expanding beyond electric vehicles. It's a huge move, *Barron's*, www.barrons.com, January 13; M. Wirz, 2022, NineDot lands Carlyle investment for New York battery projects, *Wall Street Journal*, www.wsj.com, January 14; 2022, Reservoir solutions, *GE Power*, www.gegridsolutions.com, March 1; E. Ballard, 2022, Startup wants to store spare renewable electricity to power heavy industry, *Wall Street Journal*, www.wsj.com, February 8; S. Patterson, 2022, U.S. bets on faster-charging battery in race to catch energy rivals, *Wall Street Journal*, www.wsj.com, February 26; 2022, Pumped-storage hydro plants, *Duke Energy*, www.duke-energy.com, March 1; 2018, Siemens backs efficient digitalized large-scale production of batteries, *Siemens Homepage*, www.siemens.co, February 22; E. Ailworth, 2018, GE Power, in need of a lift, chases Tesla and Siemens in batteries, *Wall Street Journal*, www.wsj.com, March 7; J. Cropley, 2018, GE rolls out battery-based energy storage product, *Daily Gazette*, www.dailygazette.com, March 7; F. Lambert, 2018, AES and Siemens launch new energy storage startup to compete with Tesla Energy, will supply new world's biggest battery project, *Electrek*, www.electrek.com, January 11; B. Spaen, 2018, New 'Fluence Energy' builds world's biggest storage system in California, *GreenMatters*, www.greenmatters.com, January 12; B. Fung, 2017, Tesla's enormous battery in Australia, just weeks old, is already responding to outages in 'record' time, *Washington Post*, www.washingtonpost.com, December 26.

In the Strategic Focus, we discuss competitive rivalry that is emerging among firms seeking the most advantageous market position in the large-scale energy-storage battery market. Rivalry is becoming more intense in this market as firms seek to serve customers' needs to store large amounts of energy they can use later.

Learning Objective

5-6 Explain factors affecting the likelihood a firm will respond to actions its competitors take.

5-6 Likelihood of Response

The success of a firm's competitive action is a function of the likelihood that a competitor will respond to it as well as by the type of action (strategic or tactical) and the effectiveness of that response. As noted earlier, a competitive response is a strategic or tactical action the firm takes to counter the effects of a competitor's action. In the Strategic Focus, we saw Siemens and AES working together to form an energy-storage start-up in an effort to compete with Tesla and GE.

In general, a firm is likely to respond to a competitor's action when one of the following is evident:

- the action leads to better use of the competitor's capabilities to develop a stronger competitive advantage or an improvement in its market position,
- the action damages the firm's ability to use its core competencies to create or maintain an advantage, or
- the firm's market position becomes harder to defend.[95]

In addition to market commonality and resource similarity, and awareness, motivation, and ability, firms evaluate three other factors—type of competitive action, actor's reputation, and market dependence—to predict how a competitor is likely to respond to competitive actions (see Figure 5.2).

5-6a Type of Competitive Action

Competitive responses to strategic actions differ from responses to tactical actions. These differences allow the firm to predict a competitor's likely response to a competitive action that a firm took against it. Strategic actions commonly receive strategic responses, and tactical actions receive tactical responses. In general, strategic actions elicit fewer total competitive responses because strategic responses, such as market-based moves, involve a significant commitment of resources and are difficult to implement and reverse.[96]

Another reason that strategic actions elicit fewer responses than do tactical actions is that the time needed to implement a strategic action and to assess its effectiveness can delay the competitor's response to that action. In contrast, a competitor likely will respond quickly to a tactical action, such as when an airline company almost immediately matches a competitor's tactical action of reducing prices in certain markets. Either strategic actions or tactical actions that target a large number of a rival's customers are likely to elicit strong responses.[97] In fact, if the effects of a competitor's strategic action on the focal firm are significant (e.g., loss of market share, loss of major resources such as critical employees), a response is likely to be swift and strong.[98]

5-6b Actor's Reputation

In the context of competitive rivalry, an *actor* is the firm taking an action or a response, while *reputation* is "the positive or negative attribute ascribed by one rival to another based on past competitive behavior."[99] A positive reputation may be a source of above-average returns, especially for consumer goods producers.[100] Thus, a positive corporate reputation is of strategic value and affects competitive rivalry. To predict the likelihood of a competitor's response to a current or planned action, firms evaluate the responses that the competitor took previously when attacked. In this way, firms assume that past behavior predicts future behavior.[101]

Competitors are more likely to respond to strategic or tactical actions when market leaders take them.[102] In particular, evidence suggests that successful actions, especially strategic actions, are ones competitors will choose to imitate quickly. For example, although a second mover, IBM committed significant resources to enter the information service market. Competitors such as Hewlett-Packard (HP), Dell Inc., and others responded with strategic actions to enter this market also. As demonstrated in the Opening Case, Kroger and others responded quickly to market leader Amazon's acquisition of Whole Foods.

The IBM brand has had a very strong, positive reputation for many years.

In contrast to a firm with a strong reputation, competitors are less likely to respond to actions taken by a company with a reputation for risky, complex, and unpredictable competitive behavior. For example, the firm with a reputation as a price predator (an actor that frequently reduces prices to gain or maintain market share) generates few responses to its pricing tactical actions because price predators, which typically increase prices once they reach their desired market share, lack credibility with their competitors.[103]

5-6c Market Dependence

Market dependence denotes the extent to which a firm derives its revenues or profits from a particular market.[104] In general, competitors with high market dependence are likely to respond strongly to attacks threatening their market position.[105] Hardware and home improvement store giants Lowe's and Home Depot both rely on the same markets—do-it-yourselfers and contractors.[106] Consequently, they pay close attention to what the other firm is doing and respond quickly to attacks. Lowe's has been engaging in a number of competitive tactics recently to improve operations and increase efficiency, leading one analyst to declare that "Lowe's stole the edge away from Home Depot."[107] It is now up to Home Depot to respond.

In another battle, the Chinese Internet company ByteDance upended Meta Platforms (Facebook) with its TikTok app becoming the most downloaded app in 2021. The app also overtook Instagram (also owned by Meta Platforms) as the most popular app among young users, which is a key market for both companies. In response, Meta launched its short-video product Reels for all Facebook users around the world, and also introduced many new features that are attractive to advertisers. In addition, the company developed a number of new video-creation and monetization features. Meta reported that "video now accounts for more than half the time users spend on Facebook and Instagram."[108]

5-7 Competitive Dynamics in Different Types of Markets

Learning Objective

5-7 Describe competitive dynamics in slow-cycle, fast-cycle, and standard-cycle markets.

Whereas competitive rivalry concerns the ongoing actions and responses between a firm and its direct competitors for an advantageous market position, *competitive dynamics* concerns the ongoing actions and responses among *all* firms competing within a market for advantageous positions. Thus, United and Delta engage in competitive rivalry, while the competitive actions and responses taken by United, Delta, American, Southwest, British Airways, Lufthansa, and Emirates Airways (and many others) form the competitive dynamics of the airline passenger industry.

To explain competitive dynamics, we explore the effects of varying rates of competitive speed in different markets (called slow-cycle, fast-cycle, and standard-cycle markets) on the behavior (actions and responses) of all competitors within a given market. Competitive behaviors, as well as the reasons for taking them, are somewhat similar within each market type, but differ across types of markets. Thus, competitive dynamics differ in slow-, fast-, and standard-cycle markets.

As noted in Chapter 1, firms want to sustain their competitive advantages for as long as possible, although no advantage is permanently sustainable. However, as we discuss next, the sustainability of the firm's competitive advantages differs by market type. How quickly competitors can imitate a rival's competitive advantage and the cost to do so influences the sustainability of a focal firm's competitive advantage.

5-7a Slow-Cycle Markets

Slow-cycle markets are markets in which competitors lack the ability to imitate the focal firm's competitive advantages, often because of the costs of imitation, so these advantages typically last for long periods.[109] Thus, firms may be able to sustain a competitive advantage over longer periods in slow-cycle markets.[110] However, because no competitive advantage is permanently sustainable, even firms competing in slow-cycle markets can expect eventually to see a decline in the value their competitive advantage creates for target customers.

Slow-cycle markets are markets in which competitors lack the ability to imitate the focal firm's competitive advantages that commonly last for long periods, and where imitation would be costly.

This was the case for Swiss watchmakers for decades. Relying largely on the competitive advantage of exclusivity that was a function of extreme precision in the manufacture of watches, these companies lacked effective competitors for many years. However, technological innovations such as smartwatches and changes in consumers' interests (e.g., for "memorable experiences" rather than for valuable "things") have created serious competitive challenges for Swiss watchmakers. Their competitive advantage of exclusivity and the cachet of the term "Swiss Made" face challenges. In response, Swiss watchmakers are supporting efforts by Switzerland and the Federation of the Swiss Watch Industry group to fight counterfeiting of their products. Also, to attract younger customers, some Swiss watchmakers are using artists and athletes as product ambassadors.[111]

Building a unique and proprietary capability produces a competitive advantage and success in a slow-cycle market. This type of advantage is difficult for competitors to imitate. As discussed in Chapter 3, a difficult-to-understand and costly-to-imitate capability usually results from unique historical conditions, causal ambiguity, and/or social complexity. Patents developed from superior R&D processes—a huge source of competitive advantage in industries like pharmaceuticals—are examples of these types of capabilities.[112] After a firm develops a proprietary advantage by using its capabilities, the competitive actions and responses it takes in a slow-cycle market are oriented to protecting, maintaining, and extending that advantage. Major strategic actions in these markets, such as acquisitions, usually carry less risk than in faster-cycle markets.[113] Clearly, firms that gain an advantage can grow more and earn higher returns than those who simply track with the industry, especially in mature and declining industries.[114]

The Walt Disney Company continues to extend its proprietary characters, such as Mickey Mouse, Minnie Mouse, and Winnie the Pooh, to enhance the value its characters create for target customers. These characters have a unique historical development because of Walt and Roy Disney's creativity and vision for entertaining people. Products based on the characters seen in Disney's animated films are available to customers to buy through Disney's theme park shops, as well as freestanding retail outlets called Disney Stores and online. Because copyrights shield it, the proprietary nature of Disney's competitive advantage in terms of animated character trademarks continues to protect the firm from imitation by competitors.

Consistent with another attribute of competition in a slow-cycle market, Disney protects its exclusive rights to its characters and their use. As with all firms competing in slow-cycle markets, Disney's competitive actions (such as building theme parks in France, Japan, and China) and responses (such as lawsuits to protect its right to fully control use of its animated characters) maintain and extend its proprietary competitive advantage while also protecting it.

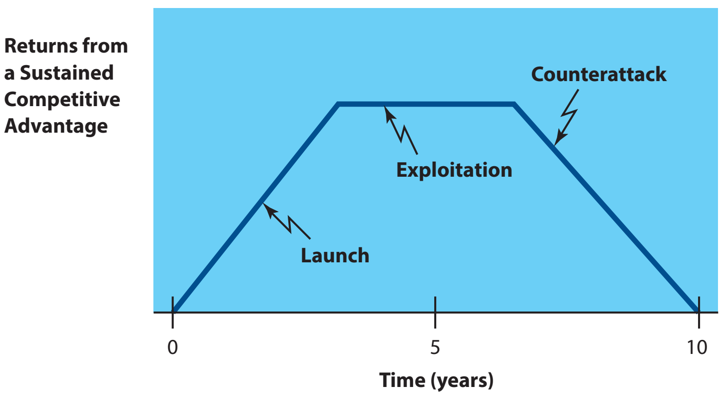
We show the competitive dynamics generated by firms competing in slow-cycle markets in Figure 5.3. In slow-cycle markets, the firm launches a product (e.g., a new drug) it developed through a proprietary advantage (e.g., superior R&D process) and then exploits that advantage for as long as possible while the product's uniqueness shields it from competition. Eventually, competitors respond to the action with a successful counterattack. In markets for drugs, this counterattack commonly occurs as patents expire or are broken through legal means, creating the need for another product launch by the firm seeking a protected market position.

5-7b Fast-Cycle Markets

Fast-cycle markets are markets in which competitors can imitate the focal firm's capabilities that contribute to its competitive advantages and where that imitation is often rapid and inexpensive.

Fast-cycle markets are markets in which competitors can imitate the focal firm's capabilities that contribute to its competitive advantages and where that imitation is often rapid and inexpensive.[115]

Figure 5.3 Gradual Erosion of a Sustained Competitive Advantage



Source: Adapted from I. C. MacMillan, 1988, Controlling competitive dynamics by taking strategic initiative, Academy of Management Executive, II(2): 111–118.

The velocity of change in fast-cycle markets places considerable pressure on top-level managers to help their firm make strategic decisions quickly that are effective. This is a challenging task for managers and the organizations they lead.

Reverse engineering and the rate of technology diffusion facilitate the rapid imitation that takes place in fast-cycle markets.[116] A competitor uses reverse engineering to gain quick access to the knowledge required to imitate or improve the firm's products. Also, technology diffuses rapidly, making it available to competitors in a short period. The technology firms competing in fast-cycle markets use often is not proprietary, nor is it protected by patents as is the technology used by firms competing in slow-cycle markets. For example, only a few hundred parts, which are readily available on the open market, are required to build a PC. Patents protect only a few of these parts, such as microprocessor chips. However, potential entrants may hesitate to enter even a fast-cycle market when they know that the success of one or more firms competing in the market is a function of the ability to develop valuable patents.[117]

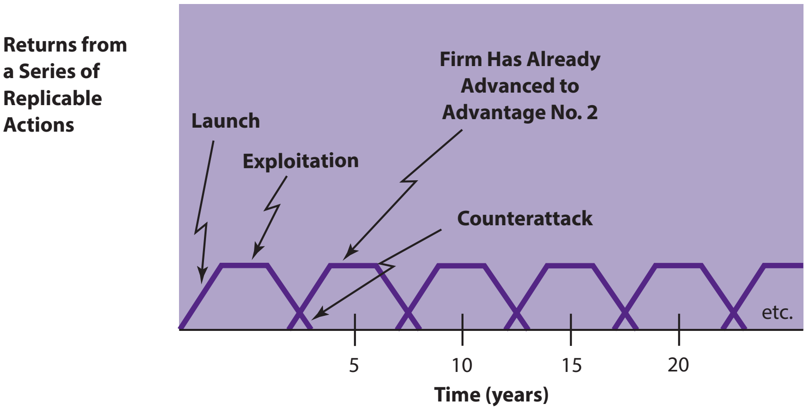
Fast-cycle markets are more volatile than slow- and standard-cycle markets. Indeed, the pace of competition in fast-cycle markets is almost frenzied as companies rely on innovations as growth engines. Because prices often decline quickly in these markets, companies need to profit rapidly from their product innovations.[118] Recognizing this reality, firms avoid "loyalty" to any of their existing products, preferring to cannibalize their own products before competitors learn how to do so through successful imitation. This emphasis creates competitive dynamics that differ substantially from those found in slow-cycle markets. Instead of concentrating on protecting, maintaining, and extending existing sources of competitive advantages, such as novel products, companies competing in fast-cycle markets focus on forming the capabilities and core competencies that will allow them to develop new competitive advantages continuously and rapidly.

In some industries, cooperative strategies such as strategic alliances and joint ventures (see Chapter 9) are a path to firms gaining access to new technologies that lead to introducing innovative products to the market.[119] In recent years, many of these alliances have been offshore (with partners in foreign countries); gaining access to a partner's capabilities at a lower cost is a key driver in such instances. However, finding the balance between sharing knowledge and skills with a foreign partner and preventing that partner from appropriating value from the focal firm's contributions to the alliance can be challenging.[120]

We show the competitive behavior of firms competing in fast-cycle markets in Figure 5.4. Competitive dynamics in this market type entail actions and responses firms take to introduce products rapidly and continuously into the market. Flowing from an ability to do this is a stream of ever-changing competitive advantages for the firm. In this sense, the firm launches a product to achieve a competitive advantage and then exploits the advantage for as long as possible. However, the firm also tries to develop another competitive advantage before competitors can respond to the first one. Thus, competitive dynamics in fast-cycle markets often result in rapid product upgrades as well as quick product innovations.[121]

Tech giants Alibaba Group Holding and Tencent Holdings compete against each other in a range of mobile Internet businesses. As competitors in this fast-cycle market, these direct competitors are aware of each other and have the motivation and ability to engage in aggressive competition. Some

Figure 5.4 Developing Temporary Advantages to Create Sustained Advantage



Source: Adapted from I. C. MacMillan, 1988, Controlling competitive dynamics by taking strategic initiative, Academy of Management Executive, II(2): 111–118.

analysts believe that the competition between these giants today "is likely to reshape the landscape of China's business world and affect the lives of Chinese and the destinies of smaller companies."[122] Initially, Alibaba and Tencent dominated separate Internet spheres: messaging and games for Tencent and ecommerce for Alibaba. Largely because of a reduction in the growth in online users, the rivalry between these firms is now more direct and intense as each firm seeks control over the convergence of online and offline services. While competing aggressively with each other, Alibaba and Tencent will try to find innovative ways to serve customers.

As our discussion suggests, innovation plays a critical role in the competitive dynamics in fast-cycle markets. For individual firms, innovation is a key source of competitive advantage. Through continuous and effective innovation, firms can cannibalize their own products through innovations before competitors successfully imitate them, which may help them maintain an advantage through next-generation products.

5-7c Standard-Cycle Markets

Standard-cycle markets are markets in which some competitors may be able to imitate the focal firm's competitive advantages and where that imitation is moderately costly.

Standard-cycle markets are markets in which some competitors may be able to imitate the focal firm's competitive advantages and where that imitation is moderately costly. Competitive advantages are partially sustainable in standard-cycle markets. However, this is the case only when a firm can upgrade the quality of its capabilities continuously as a foundation for being able to remain ahead of competitors. Firms initiate competitive actions and responses in standard-cycle markets to seek large market shares, to gain customer loyalty through brand names, and to control a firm's operations carefully. When successful with these efforts, a firm consistently provides the same positive experiences to customers.[123]

Companies competing in standard-cycle markets tend to serve many customers in what are typically highly competitive markets. Because the capabilities and core competencies on which firms competing in standard-cycle markets base their competitive advantages are less specialized, imitation is faster and less costly for standard-cycle firms than for those competing in slow-cycle markets. However, imitation is slower and more expensive in these markets than in fast-cycle markets. Thus, competitive dynamics in standard-cycle markets rest midway between the characteristics of dynamics in slow- and fast-cycle markets. Imitation comes less quickly and is more expensive for firms competing in a standard-cycle market when a competitor is able to develop economies of scale by combining coordinated and integrated design and manufacturing processes with a large sales volume for its products.

Because of large volumes, the size of mass markets, and the need to develop scale economies, the competition for market share is intense in standard-cycle markets. This form of competition is readily evident in the battles among consumer foods' producers, such as candy makers and major competitors Hershey Co., Nestlé, SA, Mondelēz International, Inc. (the name for the former Kraft Foods Inc.), and Mars. The dimensions on which these competitors compete as a means of increasing their share of the candy market include taste and the ingredients used to develop it, advertising campaigns, package designs, and product availability through different distribution channels.[124] Recent years found candy manufacturers contending with criticism from health professionals about the sugar, saturated fats, and calories their products provide. These criticisms revolve around the negative effects on individuals' health caused by the ingredients used to manufacture candy products.

Innovation can also drive competitive actions and responses in standard-cycle markets, especially when rivalry is intense. As explained in the Opening Case, we can anticipate innovation in distribution channels and in the use of data analytics to take place in the retail grocery industry as Amazon, Walmart, and others engage in competitive battles with traditional brick-and-mortar operators such as Kroger and Albertsons. Some innovations in standard-cycle markets are incremental rather than radical. (We discuss incremental and radical innovations in Chapter 13.) Both types of innovation, though, are critical to firms' efforts to achieve strategic competitiveness when competing in standard-cycle markets.

Overall, innovation has a substantial influence on competitive dynamics as it affects the actions and responses of all companies competing within a slow-, fast-, or standard-cycle market. In previous chapters, we emphasized the importance of innovation to the firm's strategic competitiveness. In our discussion of strategic entrepreneurship in Chapter 13, we again emphasize this relationship and its importance. These discussions highlight the critical role innovation plays for firms, regardless of the type of competitive rivalry and competitive dynamics they encounter.

Summary

- Competitors are firms competing in the same market, offering similar products, and targeting similar customers. Competitive rivalry is the ongoing set of competitive actions and responses occurring between competitors as they compete against each other for an advantageous market position. The outcomes of competitive rivalry influence the firm's ability to develop and then sustain its competitive advantages and the level (average, below average, or above average) of its financial returns.
- Competitive behavior is the set of competitive actions and responses an individual firm takes while engaged in competitive rivalry. Competitive dynamics is the set of actions and responses taken by all firms that are competitors within a particular market.
- Firms study competitive rivalry to predict the competitive actions and responses each of their competitors are likely to take. Competitive actions are either strategic, tactical, or non-market. Non-market strategies focus on altering a firm's institutional environment as a part of its competitive strategy. Government-focused non-market strategies are political and attempt to change the industry architecture, or the "rules of the game." The firm takes competitive actions to defend or build its competitive advantages or to improve its market position. Firms engage in competitive responses to counter the effects of a competitor's competitive actions.
- A strategic action or a strategic response requires a significant commitment of organizational resources, is difficult to implement successfully, and is difficult to reverse. In contrast, a tactical action or a tactical response requires fewer organizational resources and is easier to implement and reverse. For example, for an airline company, entering major new markets is an example of a strategic action or a strategic response; changing ticket prices in a particular market is an example of a tactical action or a tactical response.
- A competitor analysis is the first step the firm takes to be able to predict its competitors' actions and responses. In Chapter 2, we discussed what firms do to *understand* competitors. We extended this discussion in this chapter to describe what the firm does to *predict* competitors' market-based actions. Thus, understanding precedes prediction. Firms study market commonality (the number of markets with which competitors are involved jointly and their importance to each) and resource similarity (how comparable competitors' resources are in terms of type and amount) to complete a competitor analysis. In general, the greater the market commonality and resource similarity, the more firms intense is the competitive rivalry.
- Market commonality and resource similarity shape the firm's awareness (the degree to which it and its competitors understand their mutual interdependence), motivation (the firm's incentive to attack or respond), and ability (the quality of the resources available to the firm to attack and respond). Having knowledge of these characteristics of a competitor increases the quality of the firm's predictions about that competitor's actions and responses. A firm with greater multipoint contact is less likely to initiate an attack, but more likely to respond aggressively when attacked.
- In addition to market commonality, resource similarity, awareness, motivation, and ability, three more specific factors affect the likelihood a competitor will take competitive actions. The first of these is first-mover benefits. First movers, those taking an initial competitive action, often gain loyal customers and earn above-average returns until competitors can respond successfully to their action. Not all firms can be first movers because they may lack the awareness, motivation, or ability required to engage in this type of competitive behavior. Moreover, some firms prefer to be a second mover (the firm responding to the first mover's action). By evaluating the first mover's product, customers' reactions to it, and the responses of other competitors to the first mover, the second mover may be able to avoid the early entrant's mistakes and find ways to improve upon the value created for customers by the first mover's product. Late movers (those that respond a long time after the original action was taken) typically are less competitive.
- Organizational size tends to reduce the variety of competitive actions that large firms launch, while it increases the variety of actions smaller competitors undertake. However, because of the amount of resources it possesses, a large firm may initiate a larger number of actions when engaging in competitive rivalry. Another factor, quality, is a base denominator for competing successfully in the global economy and for achieving competitive parity, at a minimum. Quality refers to the quality of a firm's products as well as its management since the companies of weak CEOs are more likely to be attacked through competitive actions. Quality is a necessary but insufficient condition for establishing an advantage.
- To predict a competitor's response to its actions, a firm examines the type of action (strategic or tactical) it took, the competitor's reputation for the nature of its competitor behavior, and that competitor's dependence on the market in which the focal firm took action. Competitors respond more frequently to the actions taken by the firm with a reputation for predictable and understandable competitive behavior, especially if that firm is a market leader. In general, the firm can predict that when its competitor is highly dependent on its revenue and profitability in the market in which the firm took a competitive action, that competitor is likely to launch a strong response. However, firms with greater diversification across markets are less likely to respond to a particular action that affects only one of the markets in which they compete.

- In slow-cycle markets, firms generally can maintain competitive advantages for some amount of time. Competitive dynamics in slow-cycle markets often include actions and responses intended to protect, maintain, and extend the firm's proprietary advantages. In fast-cycle markets, competition is substantial as firms concentrate on developing a series of temporary competitive advantages. This emphasis is necessary because firms' advantages in fast-cycle markets are not proprietary; as such, they are subject to rapid and relatively inexpensive imitation. Standard-cycle markets have a level of competition between that in slow- and fast-cycle markets; firms often (but not always) have a moderate amount of protection from competition in standard-cycle markets as they use capabilities that produce competitive advantages with some sustainability. Competitors in standard-cycle markets serve mass markets and try to develop economies of scale to enhance their profitability. Innovation is vital to competitive success in each of the three types of markets. Companies should recognize that the set of competitive actions and responses taken by all firms differs by type of market.

Key Terms

competitive action 116
competitive behavior 115
competitive dynamics 115
competitive response 116
competitive rivalry 114
competitors 114
fast-cycle markets 128
first mover 122
late mover 124
market commonality 120
multipoint competition 115
non-market strategies 116
quality 124
resource similarity 120
second mover 123
slow-cycle markets 127
standard-cycle markets 130
strategic action or strategic response 116
tactical action or tactical response 116

Review Questions

1. Who are competitors? How are competitive rivalry, competitive behavior, and competitive dynamics defined in the chapter?
2. What is market commonality? What is resource similarity? In what way are these concepts the building blocks for a competitor analysis?
3. How do awareness, motivation, and ability affect the firm's competitive behavior?
4. What factors affect the likelihood a firm will take a competitive action?
5. What factors affect the likelihood a firm will initiate a competitive response to a competitor's action(s)?
6. What competitive dynamics can firms expect to experience when competing in slow-cycle markets? In fast-cycle markets? In standard-cycle markets?

Mini-Case

Different Responses of Incumbent Hotels to the Threat from Airbnb

The hotel industry was one of the most affected by the COVID-19 pandemic. The American Hotel & Lodging Association estimates that the U.S. hotel industry lost over $118 billion in room revenue as a result of the pandemic. In 2021, the industry began to re-emerge, "fueled by national vaccine distribution and consumer optimism." For example, in the United States, 2022 room revenues were projected to be approximately $168 billion, which is almost the same as room revenues in 2019. Occupancy rates in 2022 were expected to be about 63.4 percent, compared to 66.0 percent in 2019.

Nonetheless, new variants of COVID-19 continue to provide a high level of uncertainty. Also, staffing shortages are plaguing the industry. In addition, high levels of inflation mean that although a nominal recovery may occur, it is likely to take many years for the industry to fully recover. The industry is also experiencing an increase in what industry experts call "bileisure travel" that blends business and leisure travel. "Consumers' motivations, behaviors, and expectations all shifted during the pandemic—profoundly changing how hotels operate to satisfy their guests, who are increasingly likely to be leisure or bileisure travelers or digital nomads.

As a result, technology will be even more critical in a property's success."

Add to these problems the fact that the hotel industry is already extremely competitive. Globally, Marriott International is the largest hotel company, with $13.9 billion in revenues in 2021. Hilton is next, followed by InterContinental Hotels Group PLC and Hyatt Hotels Corp. Each of these companies has multiple hotel brands that vary from elite to discount. For example, Marriott has its brand name hotels in addition to Sheraton, Westin, The Ritz-Carlton, Renaissance Hotel, Fairfield, and others. These large hotel companies manage, franchise, and license hotels as well as residential and timeshare properties. Consequently, they engage in a high level of multipoint competition.

In addition to a high level of rivalry among the biggest competitors, and difficulties in dealing with COVID-19 uncertainties, the embattled hotel industry has lost demand due to an increasingly popular online alternative to traditional hotels. "One emerging issue in the lodging industry is the rise of online room sharing business models. Airbnb, the most successful room sharing platform, allows people to rent out their residences for short-term tourist purposes and has disrupted the hotel industry." One study found that for each 1,000 Airbnb listings, the occupancy rates for hotels declined by an average 3.9 percent. The decline was much greater in low-quality hotels than high-quality hotels.

A study was conducted to determine how incumbent hotels responded to the entry of Airbnb in their markets. They responded differently, depending on their business-level strategies. Low-quality hotels (low-cost leaders) responded by reducing their room prices and investments in service quality, whereas high-quality hotels (differentiators) increased their prices and service quality "to reposition themselves in the higher end of the lodging market." These differential responses reflect a tendency for firms to amplify their strategies when they are under attack. One thing is certain—in the highly volatile and competitive hotel industry, sustaining strategic competitiveness is difficult.

Sources: H.-H. Chang & D. D. Sokol, 2022, How incumbents respond to competition from innovative disruptors in the sharing economy—the impact of Airbnb on hotel performance, *Strategic Management Journal*, 43: 425-446; 2022, *The Year of the "New" Traveler*, Washington, D.C., American Hotel & Lodging Association & Accenture; M. Johnston, 2021, 10 biggest hotel companies and REITs, *Investopedia*, www.investopedia.com, September 10; 2021, *Marriott International 2021 Annual Report*, Bethesda, Maryland, Marriott International, Inc.

Case Discussion Questions

1. What is the state of competitive rivalry in the hotel industry? What are some factors firms use as a basis for competition?
2. How can new technologies such as artificial intelligence or virtual reality be used competitively by the large, traditional hotel companies in this industry?
3. What competitive advantages do traditional hotel companies have relative to room sharing platforms like Airbnb? Are these advantages sustainable?
4. In a competitive rivalry sense, explain what additional actions (strategic and/or tactical) you believe Marriott or one of the other large hotel companies might take in response to the rise of room-sharing platforms like Airbnb.

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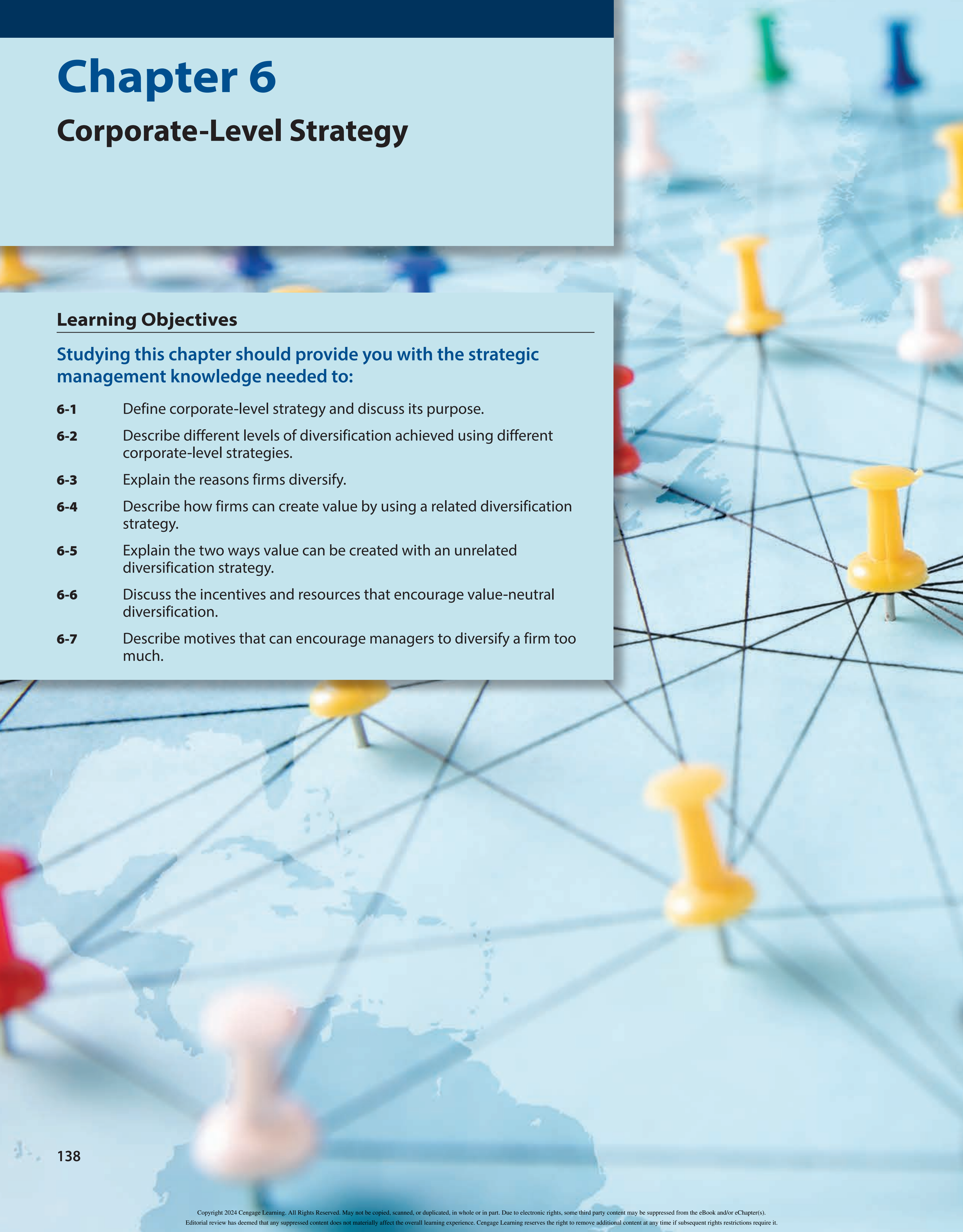

Chapter 6

Corporate-Level Strategy

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

6-1 Define corporate-level strategy and discuss its purpose.

6-2 Describe different levels of diversification achieved using different corporate-level strategies.

6-3 Explain the reasons firms diversify.

6-4 Describe how firms can create value by using a related diversification strategy.

6-5 Explain the two ways value can be created with an unrelated diversification strategy.

6-6 Discuss the incentives and resources that encourage value-neutral diversification.

6-7 Describe motives that can encourage managers to diversify a firm too much.

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Tata Group's Corporate-Level Strategy

In 1868, at 29 years of age, Jamsetji Tata established a trading firm in India. Over a century and dozens of acquisitions later, the 30 operating companies of the Tata Group are now leaders in India in 10 different business areas. The combined market capitalization of Tata companies was equivalent to $242 billion in U.S. dollars in March 2021, and combined revenues were $103 billion in 2020–2021. Tata Group companies employ more than 800,000 people. Tata Sons Private Ltd. is a private entity that owns most of the shares in the Tata Group of companies; however, each of the public companies operates independently and has its own board of directors. The chairperson of Tata Sons is usually the chairperson of the Tata Group.

Among the most globally influential of the Tata Group of companies is Tata Consultancy Services (TCS), which provides information technology (IT) services and consulting to many of the world's largest businesses. Around the turn of the present century, TCS started offering low-cost data processing services to Western companies, which significantly impacted the increase in offshoring of information technology services to India. For example, a lot of customer service calls are now routed to India, where specially trained service representatives provide service to customers at very low cost.

Volodymyr Plysiuk/Shutterstock.com

Another huge part of the Tata Group is Tata Motors, a leading global automobile manufacturer that produces cars, buses, trucks, and defense vehicles. In addition to its own Tata brand of vehicles, Tata owns the prestigious Jaguar and Land Rover brands. In an entirely different type of industry, Tata Steel, with an annual steel production capacity of 33 million tons per year, is known for its success in digitalizing its business operations, as well as the flexibility and customer focus it exhibited through all of the other changes that have taken place in India over the past half century.

Tata Chemicals is also part of the group. Heavily engaged in scientific research, Tata Chemicals produces both basic and specialty chemical products. Another of the Tata companies is Titan, a leading manufacturer of watches, jewelry, and eyewear. Also, Tata Power is the largest integrated power company in India, involved in conventional and renewable energy and applications such as solar rooftop panels and electrical vehicle charging stations. In addition, Tata Consumer Products produces food and beverage products (i.e., noodles, ready-to-eat meals, tea, coffee, mineral water) and has a presence in 50 countries. The list of Tata companies goes on and on.

Despite the wide variety of businesses in the Tata Group portfolio, the conglomerate is not done diversifying yet. In January of 2022, Tata Sons completed their purchase of Air India for 180 billion rupees, the equivalent of $2.4 billion. The money-losing airline was previously owned and operated by the government. It is a part of India's push to privatize businesses. Airline industry analysts predict that the Indian travel market is set for expansion as COVID-19 restrictions loosen, so this could end up being a very profitable investment in the future. The Tata family intends to restore Air India to its previous glory as "one of the most prestigious airlines in the world." This acquisition is especially significant because Air India was previously owned by Tata, and then the Indian government took over the airline in 1953.

Sources: 2022, *Tata Group Homepage,* www.tata.com, March 4; P. Gupta, M. Steward, J. Narus, & D. V. R. Seshadri, 2021, Pursuing digital marketing and sales transformation in an emerging market: Lessons from India's Tata Steel, *Vikalpa: The Journal for Decision Makers,* 46(4): 197–208; S. Li, 2021, India's Tata Sons to buy Air India for $2.4 billion, *Wall Street Journal,* www.wsj.com, October 8; T. Varadarajan, "Tata" review: From homestead to hegemony, *Wall Street Journal,* www.wsj.com, July 13; 2021, Why does Tata Group want Air India back?, *The Economist*, www.economist.com, October 16.

Learning Objective

6-1 Define corporate-level strategy and discuss its purpose.

A **corporate-level strategy** specifies actions a firm takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets.

6-1 Corporate Level Strategy and Its Purpose

Our discussions of business-level strategies (Chapter 4) and the competitive rivalry and competitive dynamics associated with them (Chapter 5) have concentrated on firms competing in a single industry or product market. In this chapter, we introduce you to corporate-level strategies, which are strategies firms use to *diversify* their operations from a single business competing in a single market into several product markets and businesses. Thus, a **corporate-level strategy** specifies actions a firm takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets.[1] Corporate-level strategies help companies to select new strategic positions—positions that are expected to increase the firm's value.[2] As explained in the opening case, Tata Group competes in a number of unrelated industries—a strategy called unrelated diversification.

Before moving forward, it is important to explain that because a diversified firm operates in two or more different businesses, it devises two types of strategies: corporate-level (company-wide) and business-level (competitive).[3] Consistent with the definition provided previously, corporate-level strategy is concerned with two key issues: in what product markets and businesses the firm should compete and how corporate headquarters should manage those businesses.[4] For the diversified company, a business-level strategy (see Chapter 4) must be selected for each of the businesses in which the firm has decided to compete. This means that a firm can have more than one type of business-level strategy operating within its portfolio of businesses.

As is the case with a business-level strategy, a corporate-level strategy is expected to help the firm earn above-average returns by creating value for stakeholders.[5] Some suggest that few corporate-level strategies actually create additional value beyond what the various businesses would create if they were operating on their own.[6] In other words, a corporate-level strategy's value is ultimately determined by the degree to which the businesses in the portfolio perform better under the management of the diversified company than they would if they operated independently, a phenomenon referred as a "corporate parenting advantage."[7] Thus, an effective corporate-level strategy creates, across all of a firm's businesses, aggregate returns that exceed what those returns would be without the strategy and contributes to the firm's strategic competitiveness and its ability to earn above-average returns.[8]

Product diversification, a primary form of corporate-level strategy, concerns the scope of the markets and industries in which the firm competes. Successful diversification is expected to reduce variability in the firm's profitability as earnings are generated from different businesses instead of relying on only one.[9] Diversification can also provide firms with the flexibility to shift their investments to markets where the greatest returns are possible rather than being dependent on only one or a few markets.[10] However, diversified firms incur additional costs because of the extra monitoring and management required. For example, a corporate-level strategy requires some amount of corporate-level management to allocate resources among the various markets and businesses, as well as to measure their performance and reward their managers.[11] The ideal portfolio of businesses balances diversification's costs and benefits.

We begin this chapter by examining different levels of diversification (from low to high). After describing the different reasons firms diversify their operations, we focus on two types of related diversification, which occurs when the businesses in a firm's portfolio have a common feature such as a similar customer, technology, or distribution channel. When properly used, these strategies help create value in the diversified firm, either through the sharing of resources (the related constrained strategy) or the transferring of core competencies across the firm's different businesses (the related linked strategy). We then examine unrelated diversification, which is the corporate-level strategy demonstrated in the opening case on Tata Group. Thereafter, the chapter shifts to incentives and resources that stimulate diversification. Some of the reasons for diversification can actually destroy some of the firm's value.

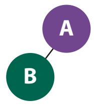
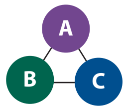
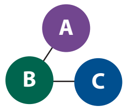
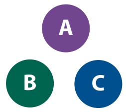
Learning Objective

6-2 Describe different levels of diversification achieved using different corporate-level strategies.

6-2 Levels of Diversification Through Corporate-Level Strategies

Diversified firms vary according to their levels of diversification and the connections between and among their businesses. Figure 6.1 lists and defines five categories of businesses according to increasing levels of diversification. The single- and dominant-business categories denote no or relatively low

Figure 6.1 Levels and Types of Diversification

Low Levels of Diversification		
Single business:	95% or more of revenue comes from a single business.	
Dominant business:	Between 70% and 95% of revenue comes from a single business.	
Moderate to High Levels of Diversification		
Related constrained:	Less than 70% of revenue comes from the dominant business, and all businesses share product, technological, and distribution linkages.	
Related linked (mixed related and unrelated):	Less than 70% of revenue comes from the dominant business, and there are only limited links between businesses.	
Very High Levels of Diversification		
Unrelated:	Less than 70% of revenue comes from the dominant business, and there are no common links between businesses.	

Sources: Adapted from R. P. Rumelt, 1974, *Strategy, Structure and Economic Performance*, Boston: Harvard Business School.

levels of diversification; more fully diversified firms are classified into related and unrelated categories. A firm is related through its diversification when its businesses share several links. For example, two or more businesses in a firm's portfolio may share product markets (goods or services), technologies (know-how), or distribution channels. The more links among businesses, the more "constrained" is the level of diversification. "Unrelated" refers to the absence of direct links between businesses.

6-2a Low Levels of Diversification

A firm pursuing a low level of diversification uses either a single- or a dominant-business diversification strategy. A *single-business diversification strategy* is a corporate-level strategy wherein the firm generates 95 percent or more of its sales revenue from its core business area.[12] For example, McIlhenny Company, headquartered on Avery Island in Louisiana and producer of Tabasco brand, has maintained its focus on its family's hot sauce products for seven generations. Historically, McIlhenny has used a single-business strategy while operating with relatively few products and maintaining a very wide global market presence. Tabasco brand sauce is "Labeled in 36 languages and dialects, sold in over 195 countries and territories, added to soldiers' rations and put on restaurant tables around the globe."[13] Although the company has begun to partner with other firms—the Tabasco taste can be found in a variety of food products, such as Jelly Bean candies or crackers—it is still considered a single-business company.

With the *dominant-business diversification strategy,* the firm generates between 70 and 95 percent of its total revenue within a single business area. United Parcel Service (UPS), the largest package delivery company, uses this strategy. Recently, UPS generated 82 percent of its revenue from its package delivery business (United States and international) and 18 percent from its nonpackaged business.[14] One of its nonpackaged businesses, healthcare logistics, is an area in which UPS sees tremendous growth potential. Although this is a separate business for reporting purposes, UPS is not straying far from its main business and is still able to apply its core competency in transportation management.

Firms that focus on one or very few businesses can earn positive returns because they are able to develop capabilities useful for these markets and can therefore provide superior products and services to their customers. Additionally, there are fewer challenges in managing one or a very small set of businesses, allowing them to gain economies of scale and efficiently use their resources.[15] Family-owned and controlled businesses, such as McIlhenny Company's Tabasco sauce business, are commonly less diversified. They tend to prefer the narrower focus because the family's reputation is related closely to that of the business. They may also prefer to distribute earnings as dividends rather than invest them in new diversified businesses.[16]

Thus, the dominant-business diversification strategy reflects a small amount of diversification as opposed to the related constrained strategy, which is discussed next.

6-2b Moderate and High Levels of Diversification

A firm generating more than 30 percent of its revenue outside a dominant business and whose businesses are related to each other in some manner uses a related diversification corporate-level strategy. When the links between the diversified firm's businesses are rather direct—meaning they use similar sourcing, throughput, and outbound processes—it is a *related constrained diversification strategy.* Caterpillar, Proctor & Gamble, and Merck & Co. use a related constrained strategy. Campbell Soup, featured in the Strategic Focus, also uses this strategy. With a related constrained strategy, a firm shares resources and activities across its businesses.

Strategic **Focus**

Campbell Soup Company and Its Related Constrained Diversification Strategy

Campbell Soup Company operates in two business segments, neither of which accounts for 70 percent of sales. Because all of the firm's businesses share product technological and distribution linkages, Campbell's corporate-level strategy is classified as related constrained. The Meals and Beverages segment (54 percent of sales) includes "retail and foodservice businesses in the U.S. and Canada" and the Snacks segment (46 percent of sales) includes "cookies, crackers, fresh bakery and frozen products" in the U.S., Canada, Latin America and, until recently, Europe. Soup accounts for over half of the sales in the Meals and Beverages segment.

In Campbell's Annual Report for 2021, Mark Clouse, president and chief executive officer, described Campbell's business portfolio this way, "Campbell's brands play an important part of the meals and snacks enjoyed every day across North America. Breakfasts often start with Pepperidge Farm breads, and kids of all ages hope to find Goldfish crackers in their lunches. Grilled cheese sandwiches and Campbell's Tomato Soup are the classic lunch combo. Campbell's condensed cooking soups, Swanson and Pacific Foods broths are used to create memorable family dinners. Friends reach for Kettle Brand chips or Snyder's of Hanover pretzels while watching their favorite games. Kids snack on Lance crackers in the dugout during Little League, and of course moms enjoy a Milano moment. Clearly, we have a unique and differentiated portfolio filled with iconic, fabric-of-the-nation brands that consumers love."

Relatedness among these products provides ample opportunities for sharing of resources and capabilities. Marketing expertise gained in the Meals and Beverages segment can be used to help market products in the Snacks segment. Distribution knowledge and channels can be used across the segments. Campbell's core competency in pre-packaged food science is applicable in both units. Also, Campbell is a master at managing iconic brand names, which is another core competency that can be used in snacks or meals and beverages.

Campbell is actively adding to, and removing products from, its portfolio in an effort to increase growth and efficiency and to adjust for changes in the consumer foods market. For example, in 2018 Campbell acquired Pacific Foods of Oregon and Snyder's-Lance. Then, in 2019, the company sold its refrigerated soup business, its Garden Fresh Gourmet business, and Bolthouse Farms. To focus more on its core U.S. segment, Campbell also sold several businesses in Australia, Asia Pacific, and Europe. In 2021, the company sold its Plum baby food and snacks business.

Sheila Fitzgerald/Shutterstock.com

Campbell Soup Company is best known for its classic soups in the red-and-white cans.

To take even better advantage of the efficiencies from relatedness across the two business segments, Campbells sometimes transfers a product into the other division. For instance, starting in 2022, the foodservice and Canadian portion of the Snacks segment will be managed within the Meals and Beverages segment. The company is also making changes in response to customer preferences. Campbell is removing high fructose corn syrup from all of its condensed soups, promoting their affordability as consumers deal with inflation, and is committed to making all of its containers recyclable by 2030. High inflation, labor shortages, and supply-chain issues were depressing sales in 2022, but Campbell was optimistic because of what the company saw as an improving labor market, and also expected that price increases would help mitigate inflation.

Sources: F. Fontana, 2022, Campell Soup Co., *Wall Street Journal,* www.wsj.com, March 11; 2021, A. Back, Campbell is getting warmer, *Wall Street Journal,* www.wsj.com, December 14; 2021, *Campbell's 2021 Annual Report*; 2021, Company Profile: Campbell Soup Company, *Marketline,* November 12; S. Harvey, 2019, Campbell Soup completes fresh division disposal with Bolthouse Farms sale to Butterfly Equity, *Just Food,* www.just-food.com, April 15.

As noted in the Strategic Focus, there is a high level of relatedness among the businesses of the Campbell Soup Company. Similar inputs, distribution channels, technologies, and customers allow Campbell to enjoy operating efficiencies and high growth potential. A product proliferation strategy like the one Campbell uses represents a form of within-industry diversification that can lead to higher performance.[17]

A diversified company with a portfolio of businesses that have only a few links between them is pursuing a mix between a related and unrelated diversification strategy, a corporate-level strategy called the *related linked diversification strategy* (see Figure 6.1). General Electric (GE), famous for making everything from lightbulbs to jet engines, used a related-linked diversification strategy for many years. Compared with related constrained firms, related linked firms share fewer resources and assets between their businesses, concentrating instead on transferring knowledge and core competencies between the businesses. GE had four strategic business units, each composed of related businesses. There were few relationships across the strategic business units, but many among the subsidiaries or divisions within them.

In the past several years, General Electric (GE) experienced serious setbacks, including problems in its oil and gas services as well as its power equipment businesses. GE also suffered significant revenue declines in its financial services businesses and subsequently sold its assets in that area. Then, in late 2021, GE announced plans to split into three separate companies: healthcare, aviation, and power and renewables.[18] This division was possible because GE's related linked diversification strategy created what were already essentially three companies within one company.

A highly diversified firm that has no strategically relevant relationships between its businesses follows an *unrelated diversification strategy*. In addition to Tata Group, United Technologies Corporation, Textron, and Samsung are examples of firms using this type of corporate-level strategy. These types of firms are often called *conglomerates*.[19] Newell Brands Inc. has a number of consumer businesses that are not very related to each other. It has over 100 brands, including Rubbermaid household products, Coleman camping equipment, Yankee Candle, First Alert fire detectors, Elmer's glue, and Nuk pacifiers.[20] Successfully managing the unrelated diversification strategy can be difficult, and Newell has struggled in recent years to satisfy investors and gain respect from analysts.[21] However, after years of sluggish growth and disappointing earnings, the company has made some progress with a major turnaround strategy that is focusing on innovation. Newell was named to *Fortune's* 2022 World's Most Admired Companies list, sitting at number 224.[22]

Another form of unrelated diversification strategy is pursued by private equity firms such Carlyle Group, Blackstone (see Mini-Case at the end of the chapter), and KKR & Co.[23] These firms amass a large amount of investment capital from institutional investors (i.e., pension funds) and high-new-worth individuals and use it to acquire equity ownership of companies. Large, private equity firms like these often have a portfolio of firms that have little in common with each other.

6-3 Reasons for Diversification

Learning Objective

6-3 Explain the reasons firms diversify.

A firm uses a corporate-level diversification strategy for a variety of reasons (see Table 6.1). The broad objective of a diversification strategy is to increase the firm's value by improving its overall performance.[24] Value is created when the firm's corporate-level strategy helps the firm do better in implementing its business-level strategies, either by increasing revenues or reducing costs within those business units.[25] One way to do this is to pursue synergies through sharing tangible (i.e., raw materials, distribution channels, plants) or intangible (i.e., knowledge, technologies, patents) resources across those business units. **Synergy** exists when the value created by business units working together exceeds the value that those same units create working independently.[26] This type of synergy comes from **economies of scope**, which are economic factors that lead to cost savings through successfully sharing resources and capabilities or transferring one or more corporate-level core competencies that were developed in one of a firm's businesses to another of its businesses.[27]

Synergy exists when the value created by business units working together exceeds the value that those same units create working independently.

Economies of scope are economic factors that lead to cost savings through successfully sharing resources and capabilities or transferring one or more corporate-level core competencies that were developed in one of a firm's businesses to another of its businesses.

A firm may use diversification to increase market power by reducing costs below the levels of close competitors or increasing the firm's ability to charge a price that is higher than competitors. Alternatively, a firm may increase its market power through producing inputs for its value creation system that were previously bought from other companies. This type of action is called backward vertical integration. A firm can also vertically integrate forward by becoming its own customer for some of its products or services.

Table 6.1 Reasons for Diversification

Value-Creating Diversification

• Economies of scope (related diversification)
  • Sharing activities
  • Transferring core competencies
• Market power (related diversification)
  • Blocking competitors through multipoint competition
  • Vertical integration
• Financial economies (unrelated diversification)
  • Efficient internal capital allocation
  • Business restructuring

Value-Neutral Diversification
• Antitrust regulation • Tax laws • Low performance • Uncertain future cash flows • Risk reduction for firm • Tangible resources • Intangible resources
Value-Reducing Diversification
• Diversifying managerial employment risk • Increasing managerial compensation

A firm can also increase value using a diversification strategy by allocating capital and other resources to business units that need them the most to stay competitive or to the highest-performing business units, thus providing a high return on those additional investments.[28] This type of efficiency through capital allocation falls into the category of financial economies. In addition, a firm may be able to create more value through restructuring its business portfolio by adding additional businesses or divesting those that are not high performing. As we saw in the Strategic Focus, Campbell Soup Company recently acquired Pacific Foods of Oregon and Snyder's-Lance, and then sold its refrigerated soup business, its Garden Fresh Gourmet business, and Bolthouse Farms in the next year.

Other reasons for using a diversification strategy may not be closely tied to increasing the firm's value. Rather, the firm may be adapting to changes in the external environment (i.e., antitrust legislation, tax law changes), responding to low performance, or trying to address uncertain cash flows. We will refer to these as value-neutral reasons for diversification. There are even reasons for diversification that can reduce firm value. Decisions to expand a firm's portfolio of businesses to reduce managerial employment risk can negatively affect the firm's value. The type of managerial risk we are discussing refers to employment risk—the risk of job loss.[29] Also, since the CEOs of larger firms tend to receive higher compensation, a CEO may promote higher levels of diversification to enhance their own welfare.

These value-creating, value-neutral, and value-reducing reasons for diversification will now be discussed in greater detail.

Learning Objective

6-4 Describe how firms can create value by using a related diversification strategy.

6-4 Value-Creating Diversification: Related Constrained and Related Linked Diversification

With a related diversification corporate-level strategy (related constrained or related linked), the firm builds upon or extends its resources and capabilities to build a competitive advantage by creating value for customers.[30] The company using a related diversification strategy wants to develop and exploit economies of scope between its businesses.[31] In fact, even nonprofit organizations have found that carefully planned and implemented related diversification can create value.[32]

Operational relatedness and corporate relatedness among the businesses of a diversified firm can both lead to the creation of value (see Figure 6.2).[33] The figure's vertical dimension depicts opportunities to share resources among the operational activities of the firm, called **operational relatedness**, while the horizontal dimension suggests opportunities for transferring corporate-level core competencies across businesses of the firm, called **corporate relatedness**. The firm with a strong capability in managing operational synergy, especially in sharing assets between its businesses, falls in the upper-left quadrant, which also represents vertical sharing of assets through vertical integration. The lower-right quadrant represents a highly developed corporate capability for transferring one or more core competencies across businesses. This capability is located primarily in the corporate headquarters office. Unrelated diversification is also illustrated in Figure 6.2 in the lower-left quadrant. Financial economies, rather than either operational or corporate relatedness, are the source of value creation for firms using the unrelated diversification strategy. This section focuses on operational and corporate relatedness. Financial economies will be discussed in the section on unrelated diversification.

Operational relatedness provides opportunities to share resources among the operational activities of the firm.

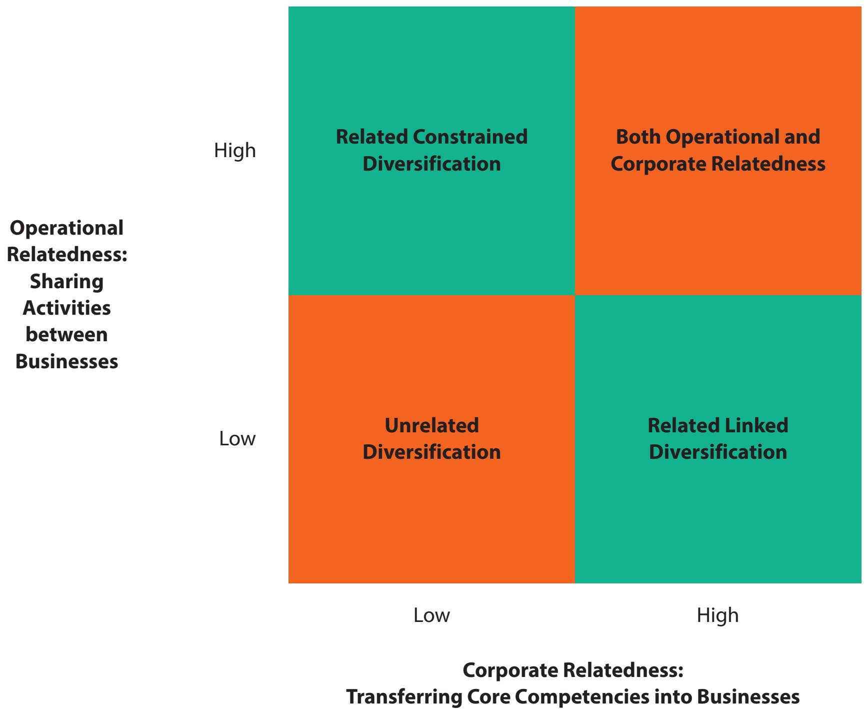
Corporate relatedness provides opportunities for transferring corporate-level competencies across businesses of the firm.

As illustrated in Figure 6.2, firms seek to create value from economies of scope through two basic kinds of operational economies: sharing activities (operational relatedness) and transferring corporate-level core competencies (corporate relatedness).[34] The difference between sharing activities and transferring competencies is based on how separate resources are jointly used to create economies of scope. To create economies of scope, tangible resources such as plants and equipment or other business-unit physical assets often must be shared. Less tangible resources, such as manufacturing know-how and technological capabilities, can also be shared. However, know-how transferred between separate activities with no physical or tangible resource involved is a transfer of a corporate-level core competence, not an operational sharing of activities.[35]

6-4a Operational Relatedness: Sharing Activities

Firms can create operational relatedness by sharing either a primary activity, such as an inventory delivery system, or a support activity, such as human resource management (see discussion of the value chain in Chapter 3). Firms using the related constrained diversification strategy share activities like these in an effort to create additional value for stakeholders. Proctor & Gamble, a consumer goods company, uses this corporate-level strategy across its personal care line of products such as its Gillette razors and Braun personal grooming products.[36] Caterpillar also shares activities. For example, most of Caterpillar's businesses share marketing activities because their equipment is sold to firms in the construction and mineral extraction industries.[37]

Figure 6.2 Value-Creating Diversification Strategies: Operational and Corporate Relatedness



Derick P. Hudson/Shutterstock.com

Dyson is more than just a vacuum company.

A firm must have the types and levels of resources and capabilities needed to successfully implement resource sharing.[38] Tangible resources can create resource interrelationships in production, marketing, procurement, and technology. One type of tangible resource is the plant and equipment necessary to produce a product; however, this type of tangible resource tends to be less flexible than other types because, typically, a plant and equipment can only be shared if the products are closely related, especially those requiring highly similar manufacturing technologies.

Excess capacity of other tangible resources, such as a sales force, can be used to diversify more easily. Excess sales force capacity is more effective with related diversification because it can be utilized to sell products in similar markets (e.g., same customers). In this case, the sales force is knowledgeable about related product characteristics, customers, and distribution channels.[39] Interestingly, Dyson, which is best known for vacuum cleaners, also sells high-end hair care devices. In fact, the company has developed a new hair care device, the Dyson Airwrap Multi-styler Complete, that dries, styles, and straightens hair at the same time, while using less heat than competing hair care products. In spite of a high price tag ($599), the product is regularly sold out.[40] Vacuum cleaners are often sold at the same retailers as these types of hair care products (i.e., Target, Walmart, traditional department stores), but there is also a knowledge base about customers that can help in marketing the product—consumers willing to pay more for an upscale vacuum are probably also more willing to pay more for a state-of-the-art hair styling device.

Activity sharing can be risky because ties among a firm's businesses create links between outcomes. For instance, if demand for one business's product is reduced, it may not generate sufficient revenues to cover the fixed costs required to operate the shared facilities. Also, if related businesses are tightly linked because they share a common market or market, and there is a downturn in that market, then the entire organization will suffer. These types of organizational difficulties can reduce activity-sharing success. Additionally, activity sharing requires careful coordination between the businesses involved (see Chapter 11 for further discussion).[41]

Although activity sharing across businesses is not risk-free, research shows that it can create value. For example, studies of acquisitions of firms in the same industry (horizontal acquisitions) found that sharing resources and activities and thereby creating economies of scope contributed to post-acquisition increases in performance.[42] Still other research discovered that firms with closely related businesses have lower risk.[43] These results suggest that gaining economies of scope by sharing activities across a firm's businesses may be important in reducing risk and in creating value through implementation of a corporate-level strategy. More attractive results are obtained through activity sharing when a strong corporate headquarters office facilitates it.[44]

6-4b Corporate Relatedness: Transferring of Core Competencies

Over time, the firm's intangible resources, such as its know-how, become the foundation of core competencies. **Corporate-level core competencies** are complex sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience, and expertise.[45] Intangible resources are more flexible than tangible physical assets in facilitating diversification. This approach to diversification is not unfamiliar to professional service firms such as Bain Strategy Consulting, which also started Bain Capital, a private equity fund, through the support of Bain partners (owners) in their consulting business.[46]

Corporate-level core competencies are complex sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience, and expertise.

In at least two ways, the related linked diversification strategy helps firms to create value. First, because the expense of developing a core competence has already been incurred in one of the firm's businesses, transferring this competence to a second business eliminates the need for that business to allocate resources to develop it. This transfer is a form of synergy, where cost savings occur because two related businesses are a part of the same firm. For example, research indicates that centralizing research and development activities at the corporate level can lead to more collaboration among inventors in the corporation and to innovations that use a wider range of technologies.[47]

Resource intangibility is a second source of value creation through corporate relatedness. Remember that, according to the resource-based view (see Chapters 1 and 3), because intangible resources are difficult for competitors to imitate, they can be effective sources of sustainable competitive advantage, leading to above-average returns.[48] Consequently, the unit receiving a transferred corporate-level competence can gain an immediate competitive advantage over its rivals.[49]

A number of firms have successfully transferred one or more corporate-level core competencies across their businesses. Virgin Group Ltd. transfers its marketing core competence and associated brand name across more than 40 companies in five business sectors across five continents. Businesses Virgin owns outright or has investments in include airlines, music, health clubs, hotels, entertainment, mobile phones, space travel, and a number of other businesses.[50] Honda has developed and transferred its competence in engine design and manufacturing among its businesses making products such as motorcycles, lawnmowers, aircraft, and cars and trucks. Honda is now making the transition to electric engines, with the goal of becoming carbon neutral by 2050.[51]

One way that managers facilitate the transfer of corporate-level core competencies is by moving key people into new management positions.[52] However, the manager of an older business may be reluctant to transfer key people who have accumulated knowledge and experience critical to the business's success. Thus, managers with the ability to facilitate the transfer of a core competence may come at a premium, or the key people involved may not want to transfer. In addition, the top-level managers from the transferring business may be resistant to transfer a competency to a new business.[53] Research suggests that an effective top management team can facilitate the knowledge and skill transfer process.[54]

6-4c Market Power

Firms using a related diversification strategy may gain market power when successfully using a related constrained or related linked strategy. **Market power** exists when a firm is able to sell its products above the existing competitive price level, reduce the costs of its primary and support activities below the cost levels of competitors, or both.[55] Heinz was bought by a private equity firm in Brazil called 3G Capital Partners LP, which subsequently combined Kraft Foods Group with Heinz to form Kraft-Heinz in 2015. These deals were supported by Warren Buffet's Berkshire Hathaway & Co., who teamed up with 3G to buy these food businesses. In a similar deal to build market power, 3G took private food restaurant Burger King Worldwide, Inc., and also bought Tim Hortons Inc. (a Canadian coffee and donut fast-food restaurant) for $12.5B in 2014 through its Burger King holdings. Warren Buffet also contributed $11 million to help finance the latter deal. These deals build market power for the combining firms in branded consumer foods and fast-food restaurants.[56] These companies can reduce costs through larger-scale operations and combined marketing.

Market power exists when a firm is able to sell its products above the existing competitive price level or to reduce the costs of its primary and support activities below the cost levels of competitors, or both.

In addition to efforts to gain scale as a means of increasing market power, firms can foster increased market power through multipoint competition. As described in Chapter 5, multipoint competition exists when two or more diversified firms simultaneously compete in the same product areas or geographical markets.[57] Through multipoint competition, rival firms often experience pressure to diversify because other firms in their dominant industry segment have made acquisitions to compete in a different market segment. The actions taken by UPS and FedEx in two markets, overnight delivery and ground shipping, illustrate multipoint competition. UPS moved into overnight delivery, FedEx's stronghold; in turn, FedEx bought trucking and ground shipping assets to move into ground shipping, UPS's stronghold.

Similarly, J.M. Smucker Company, a snack food producer, in 2015 bought Big Heart Pet Brands, which specializes in snacks such as Milk-Bone dog biscuits, treats, and chews and has over $2.2 billion in annual revenue. Smucker's competitor, Mars, had acquired a significant portion of Proctor & Gamble's dog and cat food division in 2014. Apparently, Smucker's was seeking to keep up its size and cross-industry positions relative to Mars by also diversifying into snacks for pets. In 2018, following these acquisitions, General Mills acquired Blue Buffalo Pet Products for $8 billion to obtain "a piece of the rapidly expanding natural pet-food market."[58]

6-4d Vertical Integration

Vertical integration exists when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration).

Some firms using a related diversification strategy engage in vertical integration to gain market power. **Vertical integration** exists when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration). For example, Apple now designs almost all of the computer chips used in its products, which has given Apple "more control and better

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When firms pursue vertical integration, more information is processed at headquarters, and thus, more knowledge processing is needed, as illustrated by these servers. External relations with suppliers are also supported by such information networks.

profit margins than it had when using other companies' designs."[59] In some instances, firms partially integrate their operations, producing and selling their products by using company-owned businesses as well as outside sources.[60]

Using a vertical integration strategy, market power is gained as the firm develops the ability to save on its operations, avoid sourcing and market costs, improve product quality, possibly protect its technology from imitation by rivals, and potentially exploit underlying capabilities in the marketplace.[61] Vertically integrated firms are better able to improve product quality and improve or create new technologies than specialized firms because they have access to more complementary information and knowledge.[62] Market power also is created when firms have strong ties between their productive assets for which no market prices exist. Establishing a market price would result in high search and transaction costs, so firms seek to vertically integrate rather than remain separate businesses.[63]

Vertical integration has its limitations. For example, an outside supplier may produce a raw material or supply at a lower cost, but the vertically integrated firm is obligated to using what is available inside the firm. As a result, internal transactions from vertical integration may be expensive and reduce profitability.[64] Also, bureaucratic costs can be present with vertical integration.[65] Because vertical integration can require substantial investments in specific technologies, it may reduce the firm's flexibility, especially when technology changes quickly.[66] Finally, changes in demand create capacity balance and coordination problems. If one business is building a part for another internal business but achieving economies of scale requires the first division to manufacture quantities that are beyond the capacity of the internal buyer to absorb, it would be necessary to sell the parts outside the firm as well as to the internal business. Thus, although vertical integration can create value, especially through market power over competitors, it is not without risks and costs.[67]

6-4e Simultaneous Operational Relatedness and Corporate Relatedness

As Figure 6.2 suggests, some firms simultaneously seek operational and corporate relatedness to create economies of scope. The ability to simultaneously create economies of scope by sharing activities (operational relatedness) and transferring core competencies (corporate relatedness) is difficult for competitors to understand and learn how to imitate. However, if the costs of management associated with realizing both types of relatedness are not offset by the benefits created, pursuing this type of strategy leads to lower performance.[68]

Amazon uses a related diversification strategy to simultaneously create economies of scope through operational and corporate relatedness. This relatedness is illustrated in how its deep customer knowledge is integrated in the various retail and media businesses along with the cloud service and shipping businesses. Amazon has pursued a related business strategy primarily through its online retail portal. For example, Amazon is deriving value through its economies of scale in cloud computing and warehouse and delivery logistics expertise. Through its purchase of Whole Foods Market, it now has other brick-and-morter locations to pursue its online expertise in the grocery business.[69]

Disney also applies this strategy. The company has separate but related businesses in media networks, parks and resorts, studio entertainment, consumer products, and interactive media. Within the firm's studio entertainment business, for example, Disney can gain economies of scope by sharing activities among its different movie distribution companies, such as Marvel, Touchstone Pictures, Hollywood Pictures, and Dimension Films. Disney relies on broad and deep knowledge about its customers to sustain its corporate-level core competencies in advertising and marketing. With these competencies, Disney is able to create economies of scope through corporate relatedness as it cross-sells products highlighted in its movies through the distribution channels that are part of its parks and resorts and consumer products businesses. Thus, characters created in movies become figures that are marketed through Disney's retail stores (which are part of the consumer products business). In addition, themes established in movies become the source of new rides in the firm's theme parks, which are part of the parks and resorts business, and provide themes for clothing and other retail business products.

To further take advantage of its core competencies, Disney announced that it is going to develop residential communities across the United States. One of these communities, called Cotino, will be located in Rancho Mirage, California. It will feature a 24-acre lagoon, recreational water activities, and Disney programming throughout the year. Cotino will also have a beachfront hotel, shopping, and dining.[70]

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Disney sells many products related to its movies in its own stores as well as broadly through other retail outlets.

Although The Walt Disney Company has been able to successfully use related diversification as a corporate -level strategy through which it creates economies of scope by sharing some activities and transferring core competencies, it may be difficult for investors to identify the value created by a firm as it shares activities and transfers core competencies. For this reason, the value of the assets of a firm using a diversification strategy to create economies of scope is often discounted by investors.[71] One notable exception to this idea is Fanatics, featured in the Strategic Focus. Fanatics has been able to attract major investors as it has continued to expand into related businesses.

6-5 Value Creation through Unrelated Diversification

Learning Objective

6-5 Explain the two ways value can be created with an unrelated diversification strategy.

Firms do not seek either operational relatedness or corporate relatedness when using the unrelated diversification corporate-level strategy. For instance, Tata Group, featured at the beginning of this chapter, operates like a holding company for a wide variety of unrelated businesses (i.e., automobiles, airlines, consulting, chemicals, hotels, communications).[72] An unrelated diversification strategy (see Figure 6.2) can create value through two types of financial economies. **Financial economies** are cost savings realized through improved allocations of financial resources based on investments inside or outside the firm.[73]

Financial economies are cost savings realized through improved allocations of financial resources based on investments inside or outside the firm.

Research has shown that efficient internal capital allocations can lead to financial economies.[74] Efficient internal capital allocations can reduce risk among the firm's businesses, for example, by leading to the development of a portfolio of businesses with different risk profiles. This may be one reason that firms facing a higher level of competitive intensity are more prone to engage in unrelated diversification than firms facing less competition.[75] The second type of financial economy concerns the restructuring of acquired assets. Here, the diversified firm buys another company, restructures that company's assets in ways that allow it to operate more profitably, and then sells the company for a profit in the external market.[76] Next, we discuss these two types of financial economies in greater detail.

6-5a Efficient Internal Capital Market Allocation

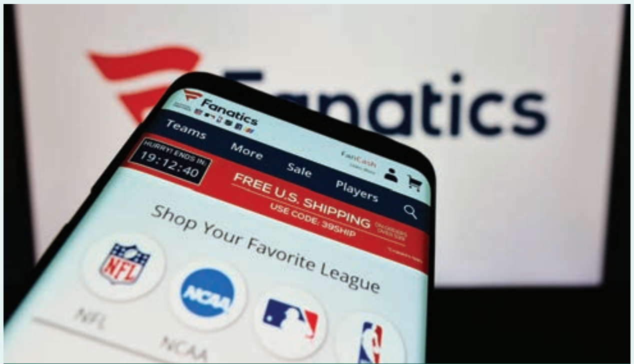
In a market economy, capital markets are believed to efficiently allocate capital. Efficiency results as investors take equity positions (ownership) with high expected future cash-flow values. Capital is also allocated through debt as shareholders and debt holders try to improve the value of their investments by taking stakes in businesses with high growth and profitability prospects.

In large, diversified firms, the corporate headquarters office distributes capital to its businesses instead of external markets. Managers in a firm's corporate headquarters generally have access to more detailed and more accurate information regarding the actual and potential future performance of each of the businesses in the company's portfolio than investors in the capital markets (i.e., stock market). Compared with corporate office personnel, external investors have relatively limited

Strategic **Focus**

Fanatics Builds a Portfolio of Related Businesses

Practically every sports fan in the United States has heard of Fanatics, Inc., and most have probably bought something from the company at some time. Beyond U.S. borders, the company also has partners across Europe, in Canada, and in Asia. The company defines itself as "the ultimate one-stop sports fan destination that ignites and harnesses the passion of fans and maximizes the presence and reach for more than 900 sports properties globally. Leveraging these long-standing relationships, a database of more than 80 million global consumers and a trusted, recognizable brand name, Fanatics is furthering its innovation across the sports landscape and creating a next-gen digital sports platform, complete with offerings including merchandise, NFTs, sports betting and gaming, trading cards and much more. Fanatics is a company that the sports world has never seen before—and we're just getting started."



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Fanatics caters to fans of a variety of sports.

"We're just getting started" seems pretty accurate. In August 2021, the company announced exclusive trading-card deals with unions that represent the players in the major U.S. leagues in baseball, football, and basketball, as well as the major baseball and basketball leagues themselves. This was a serious blow to Topps. Co., who had a long-standing relationship with these leagues. This didn't matter for long, though, because in January 2022, Fanatics reported that they were buying Topps for $500 million. Previously, the company bought a 75 percent stake in Mitchell & Ness, a sports apparel company that makes "street fashion" (throwback) apparel. Fanatics also launched a business that sells nonfungible tokens called Candy Digital. This part of the business likewise has deals with the professional sports leagues. Candy Digital was valued at $1.5 billion in October 2021. In addition, the company owns half of Lids Sports Group, which was acquired in 2019.

Notice that all of these businesses are closely related to each other. Fanatics can apply its core competency in selling sports merchandise to its new trading cards business. Existing relationships with the sports leagues and player unions are helpful across all Fanatics' businesses. The new apparel company fits nicely into the company's existing operations, but the company's emphasis on throwback apparel gives Fanatics entry into a new niche of the sports apparel market. Nonfungible tokens are a great fit with trading cards, and it is likely that some of the same people will buy both, which provides a marketing fit.

What's next? In 2021, Fanatics hired Matt King, the former CEO of FanDuel Group, a huge online betting platform. Fanatics wants him to help the company expand into the legal sports-betting industry. Because so much of online betting deals with sports contests, Fanatics can also use its considerable expertise with the sports industry to help launch this business. However, online betting is not as closely related as are most of the company's businesses, so it was a good move to bring in a seasoned executive with expertise in this industry.

In 2022, Fanatics raised $1.5 billion from investors, including Fidelity Management & Research Co., funds under the control of BlackRock Inc, and MSD Capital, controlled by Michael Dell's family. The money will be used by Fanatics to continue its diversification beyond its core sports merchandising business. Management has confirmed that an initial public offering (IPO) is likely in the future, but for now, the company is staying focused on building a strong portfolio of businesses.

Sources: M. Gottfried & A. Beaton, 2022, Fanatics attracts large investors, *Wall Street Journal,* March 3: B1, B2; A. Prang, 2022, Fanatics, investor group including Jay-Z, buy Mitchell & Ness for $250 million, *Wall Street Journal,* www.wsj.com, February 18; J. Diamond & A. Beaton, 2022, Fanatics pried baseball cards from Topps. Now Fanatics is buying Topps, *Wall Street Journal,* www.wsj.com, January 4; 2022, *Fanatics Homepage,* www.fanaticsinc.com, March 9; K. Sayre, 2021, FanDuel names Amy Howe as new chief executive, *Wall Street Journal,* www.wsj.com, October 4.

access to internal information and can only estimate the performances of individual businesses as well as their future prospects. Consequently, corporate portfolio managers can make better decisions about how to allocate capital to these businesses than would external investors if the firm's businesses were operated as separate entities with their own shareholders and bondholders. Capital can be allocated according to more specific criteria than is possible with external market allocations.[77] Research also suggests that during a financial downturn, diversification improves firm performance because external capital markets are costly and internal resource allocation becomes more important.[78]

One could argue that public companies are required to provide detailed information about their operations and strategies to regulators, banks, and insurance companies, and that much of this information is also provided to investors. Although businesses seeking capital must provide information to potential investors, firms with internal capital markets have at least two informational advantages. First, information provided to capital markets through annual reports and other sources emphasizes positive prospects and outcomes. Investors and financiers have a limited ability to understand the operational dynamics within large organizations. They are unlikely to receive complete disclosure.[79] Second, when an independent firm disseminates information, that information becomes simultaneously available to the firm's current and potential competitors. Competitors might attempt to duplicate a firm's value-creating strategy with insights gained by studying such information. Thus, the ability to keep more information private while efficiently allocating capital through an internal market helps the firm protect the competitive advantages it develops.

In addition to the information advantages associated with allocating capital across multiple business units of a diversified firm, corporate managers also have an advantage in correcting situations that are reducing the ability of a business unit to create value. That is, because the corporation owns the business, or at least a controlling interest in the business, it is relatively easy to replace managers or require changes to strategy within an underperforming business unit. It is much more difficult to orchestrate such changes from outside a firm. External parties can try to make changes by forcing the firm into bankruptcy or changing the top management team. Typically, these changes take place through the firm's board of directors, often because of an activist investor (an investor with a significant stake in the company). But this is much harder than, in the case of an internal capital market, the corporate headquarters fine-tuning its corrections, such as choosing to adjust business unit managerial incentives, encouraging strategic changes, or altering the amount of resources allocated to one of the firm's businesses.[80]

Despite the capital allocation advantages associated with an unrelated diversification strategy, there are some challenges. One of the biggest problems occurs when the corporate office tries to micromanage the business units in its portfolio.[81] If a corporation has many unrelated businesses in its portfolio, corporate-level managers cannot be expected to understand the nuances of each business. If the corporation tries to standardize practices or policies across multiple businesses, these actions are unlikely to result in more value creation because each business is subject to its own environmental and competitive influences and has its own unique customers and dominant technologies. Another problem with using the unrelated diversification strategy is that competitors can imitate financial economies more easily than they can replicate the value gained from the economies of scope developed through operational relatedness and corporate relatedness.

These challenges are particularly relevant in developed economies. However, the advantages of unrelated diversification outweigh these problems in emerging economies, in which some of the elements found in a developed economy are absent. These elements include effective financial intermediaries, sound regulations, and well-developed and enforced contract laws. In these situations, internal capital markets associated with an unrelated diversification strategy are an effective substitute for external markets. In fact, in emerging economies such as those in Taiwan, India, and Chile, research has shown that diversification increases the performance of firms affiliated within large, diversified business groups such as the Tata Group in India.[82]

6-5b Restructuring of Assets

Financial economies can also be created when firms learn how to create value by buying, restructuring, and often selling the restructured companies' assets in the external market.[83] As in the real estate business, buying assets at low prices, restructuring them, and selling them at a price that exceeds their cost generates a positive return on the firm's invested capital. This strategy has been taken up by private equity firms, who successfully buy, restructure, and then sell, often within a four- or five-year period.[84]

Unrelated diversified companies that pursue this strategy try to create financial economies by acquiring and restructuring other companies' assets. Some of these companies keep most of the assets they acquire indefinitely and use the restructuring gains to finance other acquisitions. For example, Danaher Corp.'s success requires a focus on mature manufacturing businesses because of the uncertainty of demand for high-technology products. It has acquired hundreds of businesses since 1984 and applied the Danaher Business System to reduce costs and create a lean organization by finding firms that provide opportunities for consolidation during restructuring.[85] Danaher has focused on high-technology businesses because resource allocation decisions are highly complex in these businesses, often creating information-processing overload on the small corporate headquarters, offices that are common in unrelated diversified firms. High-technology and service businesses are often human-resource dependent; these people can leave or demand higher pay and thus appropriate or deplete the value of an acquired firm.[86]

Buying and then restructuring service-based assets so they can be profitably sold in the external market is also difficult. Thus, for both high-technology firms and service-based companies, relatively few tangible assets can be restructured to create value and sell profitably. It is difficult to restructure intangible assets such as human capital and effective relationships that have evolved over time between buyers (customers) and sellers (firm personnel).

Sometimes unrelated diversified firms make large investments in companies so that they can influence their management, but they don't engage in any direct restructuring activities. Ideally, executives will follow a strategy of buying businesses when prices are lower, such as in the midst of a recession, and selling them at late stages during an expansion. Although Berkshire Hathaway owns several companies outright, it also owns large stakes in many others; the company used this approach with its investment in Wells Fargo. Berkshire increased its investment in Wells Fargo during a downturn and sold its position once the stock price improved significantly. However, this tactic also demonstrates the riskiness of such an approach. Although Berkshire likely made money on the sale of stock in 2020, Wells Fargo has since experienced very high performance, and its stock has soared. One analyst estimates that Berkshire "left about $15 billion on the table."[87] This is not a huge number when you consider that its CEO Warren Buffet has an outstanding record of success and Berkshire had a market capitalization of over $670 billion as of the end of 2022. Nonetheless, this example illustrates how hard it is to make money with this sort of strategy.

Learning Objective

6-6 Discuss the incentives and resources that encourage value-neutral diversification.

6-6 Incentives Driving Value-Neutral Diversification

The objectives firms seek when using related diversification and unrelated diversification strategies all have the potential to help the firm create value through the corporate-level strategy. However, these strategies, as well as single- and dominant-business diversification strategies, are sometimes used with value-neutral objectives. Basically, the quality and quantity of the firm's resources may permit only diversification that is value neutral rather than value creating. Incentives to diversify come from both the external environment and a firm's internal environment. External incentives include antitrust regulations and tax laws. Internal incentives include low performance, uncertain future cash flows, and reduction of risk for the firm.

6-6a Antitrust Regulation

Government antitrust policies and tax laws provided incentives for U.S. firms to diversify in the 1960s and 1970s.[88] Antitrust laws prohibiting mergers that created increased market power were stringently enforced during that period. Merger activity that produced conglomerate diversification was encouraged primarily by the Celler-Kefauver Antimerger Act (1950), which discouraged mergers between companies in the same markets, as well as mergers associated with vertical integration. As a result, many of the mergers during the 1960s and 1970s were "conglomerate," involving companies pursuing different lines of business. Between 1973 and 1977, 79.1 percent of all mergers were conglomerates.[89]

During the 1980s, antitrust enforcement lessened, resulting in more and larger mergers between firms in the same line of business, such as mergers between two oil companies.[90] In addition, investment bankers became more open to the kinds of mergers facilitated by regulation changes; as a consequence, takeovers increased to unprecedented numbers.[91] The conglomerates, or highly diversified firms, of the 1960s and 1970s became more "focused" in the 1980s and early 1990s as merger constraints were relaxed and restructuring became popular.[92] At the beginning of the twenty-first century, antitrust concerns emerged again with the large volume of mergers and acquisitions (see Chapter 7).[93] Mergers are now receiving even more scrutiny than they did at the start of this century.[94]

Thus, regulatory changes such as the ones we have described create incentives or disincentives for diversification. Interestingly, European antitrust laws have historically been stricter regarding mergers between companies in the same market than those in the United States, but they have become more similar over time.[95]

6-6b Tax Laws

The tax effects of diversification stem not only from corporate tax changes, but also from individual tax rates. To illustrate this point, we will examine the influence of individual and corporate tax laws in the United States, recognizing that similar forces are likely to influence diversification behavior in other parts of the world as well.

With regard to tax laws associated with individual taxes, we look at the decision companies make between distributing excess cash as dividends or reinvesting it. Some companies (especially mature ones) generate more cash from their operations than they can reinvest profitably. Some argue that these *free cash flows* (liquid financial assets for which investments in current businesses are no longer economically viable) should be redistributed to shareholders as dividends.[96] However, in the 1960s and 1970s, dividends were taxed more heavily than were capital gains (gains from price appreciation of a stock over time). As a result, before 1980, shareholders preferred that firms used free cash flows to buy and build companies in high-performance industries. If the firm's stock value appreciated over the long term, shareholders might receive a better return on those funds than if the funds had been redistributed as dividends because returns from stock sales would be taxed more lightly than would dividends.

Under the 1986 Tax Reform Act, however, the top individual ordinary income tax rate was reduced from 50 to 28 percent, and the special capital gains tax was changed to treat capital gains as ordinary income. These changes created an incentive for shareholders to stop encouraging firms to retain funds for diversification purposes. These tax law changes also influenced an increase in divestitures of unrelated business units after 1984. Thus, while individual tax rates for capital gains and dividends created a shareholder incentive to increase diversification before 1986, they encouraged lower diversification after 1986, unless the diversification was funded by tax-deductible debt. Yet, there have been changes in the maximum individual tax rates since the 1980s. The top individual tax rate has varied from 31 percent in 1992 to 39.6 percent in 2017. There have also been some changes in the capital gains tax rates.

Corporate tax laws also affect diversification. Acquisitions typically increase a firm's depreciable asset allowances. As a result, increased depreciation (a non-cash-flow expense) produces lower taxable income, thereby providing an additional incentive for acquisitions. At one time, acquisitions were an attractive means for securing tax benefits, but changes recommended by the Financial Accounting Standards Board (FASB) eliminated the "pooling of interests" method to account for the acquired firm's assets. It also eliminated the write-off for research and development in process, and thus reduced some of the incentives to make acquisitions, especially acquisitions in related high-technology industries (these changes are discussed further in Chapter 7).[97]

6-6c Low Performance

Some research shows that low returns are related to greater levels of diversification.[98] If high performance eliminates the need for greater diversification, then low performance may provide an incentive for diversification. GlaxoSmithKline PLC suffered from volatile earnings growth and poor stock price performance through the second decade of this century. The company's stock price was right around $50 at the end of 2014 and was hovering around $40 three years later, in 2017.[99] That is when newly appointed CEO Emma Walmsley embarked on a plan to turn around the company. As a part of that plan, Glaxo diversified into cancer drugs through the acquisition of oncology specialist Tesaro for $4.16 billion. Unfortunately, this acquisition did little to fix Glaxo's problems. In 2021, an activist investor described Glaxo as being too bureaucratic, and "failing to empower its scientists, spending less on research and development than its competitors, and having maintained a dividend that it couldn't afford."[100]

Although firms such as GlaxoSmithKline may have an incentive to diversify, there is a need to be careful because there are risks to moving into new areas where the company lacks expertise. There can be negative synergy (where potential synergy between acquiring and target firms is illusory), problems between leaders, and cultural fit difficulties that make value creation difficult.[101]

6-6d Uncertain Future Cash Flows and Reduced Risk of Failure

As a firm's product line matures or is threatened, diversification may be an important defensive strategy.[102] Diversifying into other product markets or businesses can reduce the uncertainty about a firm's future cash flows. For several years, Alcoa, the largest U.S. aluminum producer, pursued a "multi-material" diversification strategy driven by the highly competitive nature of its basic commodity business. Alcoa diversified into other metals besides aluminum while simultaneously moving into a variety of end-product industries. However, the company may have gone too far with its diversification strategy; in 2016, under pressure from an activist investor, it split into two separate companies: Alcoa Corporation (mining and manufacture of raw aluminum) and Arconic (processor of aluminum and other metals).[103]

The risk associated with uncertain cash flows is related to the risk that the firm might fail. Earlier in this chapter, we explained that closely related businesses might rely on the same markets, and if a common market experiences a downturn, it could hurt the performance of all the related businesses that depend on it. Also, similarly, diversified firms pursuing economies of scope often have investments that are too inflexible as they try to realize synergy among business units. For example, a factory might be designed to serve two or more related business units, but that also means that it would be difficult to repurpose it if one of the related business units no longer needs it. As mentioned previously, synergy exists when the value created by business units working together exceeds the value that those same units create working independently.[104] However, as a firm increases its relatedness among business units in pursuit of synergy, it also increases its risk of corporate failure because synergy produces joint interdependence among businesses that constrains the firm's flexibility to respond.[105]

A firm that is overexposed to risk of failure because of interdependencies among its related businesses or uncertain cash flows may decide to begin operating in different environments that are more certain. Expanding into environments that are more certain likely leads to diversification into industries with low growth potential.[106] Alternatively, the firm may constrain its level of activity sharing and forgo the potential benefits of synergy.

Neither diversifying to address uncertain cash flows or expanding into different environments is likely to create more value, which is why they are a part of this section on value-neutral diversification. Similarly, diversifying in response to antitrust legislation or tax law changes, or because the firm is low performing, is not likely to increase performance. However, none of these reasons will necessarily reduce performance either. GlaxoSmithKline's poor performance is not a result of its diversification into cancer drugs, but the acquisition of Tesaro did not solve its performance problems either. On the other hand, there are reasons for diversification that tend to reduce the value a firm produces for its stakeholders. These reasons will be explained in the next section.

Learning Objective

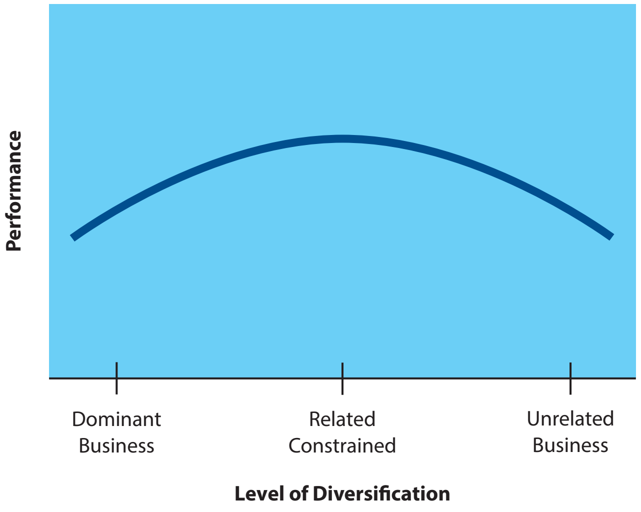
6-7 Describe motives that can encourage managers to diversify a firm too much.

6-7 Managerial Motives to Diversify

Research evidence and the experience of many firms suggest that an overall curvilinear relationship, as illustrated in Figure 6.3, may exist between diversification and performance.[107] Firms that are more broadly diversified compared to their competitors may have overall lower performance. One example of this phenomenon is the breakup of GE, discussed previously in this chapter. Prior to the breakup, GE was underperforming—the business units it was managing were losing their competitiveness. One of these underperforming business units, the appliance business, was sold to Qingdao, China–based Haier Group, in 2016. No longer under the management of GE, the appliance business is thriving, gaining market share in the United States every year from 2017 to 2021.[108] One reason for the lower performance of highly diversified firms may be that higher levels of diversification are often found to be associated with lower levels of innovation.[109] This notion holds true in the case of GE's cast-off appliance business, Haier Group, which focuses on home appliances and consumer electronics, has invested $1.5 billion in technology and new products in its appliance business.[110]

If higher levels of diversification often lead to lower performance, at least for firms in highly developed economies, why would top-level executives pursue such a strategy? Managerial motives to diversify can exist independent of value-neutral or value-creating reasons. The desire for reduced

Figure 6.3 The Curvilinear Relationship between Diversification and Performance



managerial risk and higher compensation are two motives for top-level executives to diversify their firms beyond the point at which the additional diversification is creating value for the firm and its stakeholders.[111]

Diversification provides additional benefits to top-level managers that shareholders do not enjoy. For example, decisions to expand a firm's portfolio of businesses to reduce managerial risk can negatively affect the firm's value. The type of managerial risk we are discussing refers to employment risk—the risk of job loss.[112] Greater amounts of diversification reduce managerial risk because if one of the businesses in a diversified firm performs poorly or fails, the top executive has a lower risk of job loss because some other business is (hopefully) doing well. Top-level executives may diversify a firm in order to spread their own employment risk, as long as profitability does not suffer excessively.[113] If profits take a big drop as a result of the additional diversification, they will still be at risk of being replaced by the board of directors. This sort of unprofitable diversification is often called *empire building.*

In addition, because diversification can increase a firm's size and thus managerial compensation, managers may have motives to diversify a firm to a level that reduces its value.[114] Research evidence shows that diversification and firm size are highly correlated, and as firm size increases, so does executive compensation and social status.[115] Because large firms are complex, difficult-to-manage organizations, top-level managers commonly receive substantial levels of compensation.[116] Greater levels of diversification can increase this complexity, resulting in still more compensation for executives as they lead an increasingly diversified organization. Governance mechanisms—such as the board of directors, monitoring by owners, executive compensation practices, and the threat of being taken over through an acquisition—can reduce tendencies to diversify beyond the point at which no new value is created.[117] These mechanisms are discussed in more detail in Chapter 10.

In some instances, though, a firm's governance mechanisms may not be strong, allowing executives to diversify the firm to the point that it fails to earn even average returns.[118] The loss of adequate internal governance may result in relatively poor performance, thereby triggering a threat of takeover. This result is referred to as a *capital market intervention* because it involves external capital market participants—investors who are attempting to gain high returns from their capital investments.

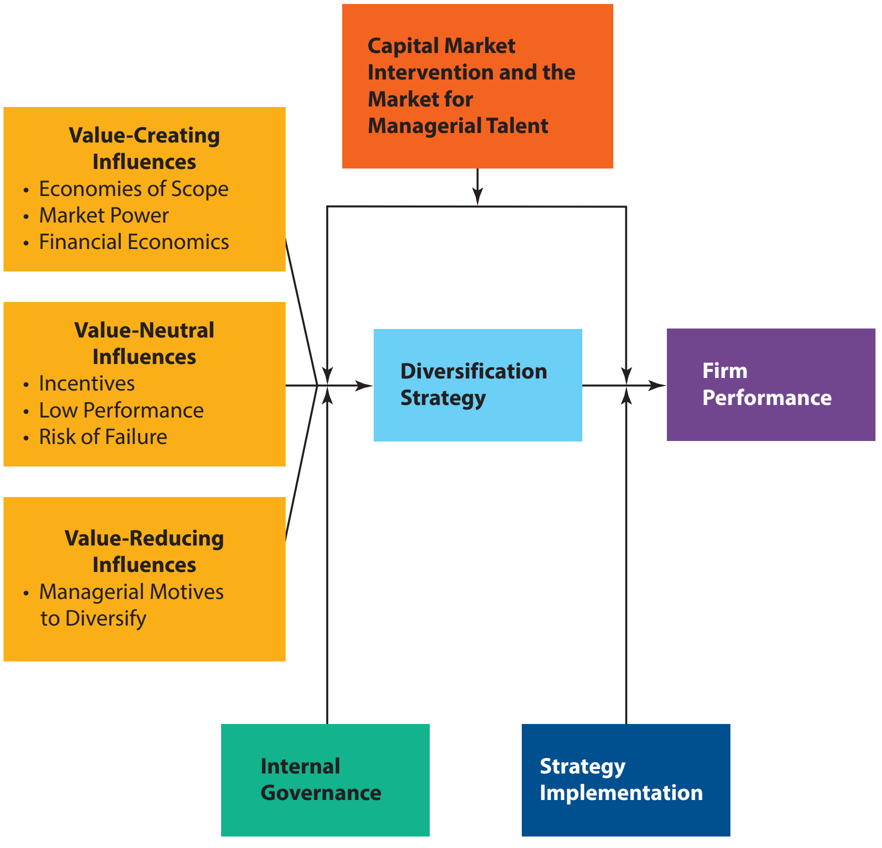
Although takeovers may improve firm performance by replacing ineffective managerial teams, managers may avoid takeovers through defensive tactics, such as "poison pills" that make the firm less attractive.[119] One example is a "golden parachute" agreement that gives top executives (especially the CEO) a huge payment if the firm is acquired and they no longer work for it.[120] For example, in the case of a takeover bid by Oracle of Cerner Corp., a computer and information technology company: "Four top executives, including former Cerner CEO Brent Shafer, have golden parachutes ranging from $10 million to almost $22 million if they are forced out in the Oracle acquisition, according to a filing with the SEC." Therefore, an external governance threat (e.g., a takeover), although it restrains managers, does not flawlessly control managerial motives for diversification.[121]

Highlighting this sort of behavior suggests that CEOs and other top executives are only concerned about their own welfare; however, most large publicly held firms are profitable because the managers leading them are positive stewards of firm resources, and many of their strategic actions, including those related to selecting a corporate-level diversification strategy, contribute to the firm's success.[122] As mentioned, governance mechanisms should be designed to deal with exceptions to the managerial norms of making decisions and taking actions that increase the firm's ability to earn above-average returns. Thus, it is overly pessimistic to assume that managers usually act in their own self-interest as opposed to their firm's interest.[123]

Top-level executives' diversification decisions may also be held in check by concerns for their reputation. If a positive reputation facilitates development and use of managerial power, a poor reputation can reduce it. Likewise, a strong external market for managerial talent may deter managers from pursuing inappropriate diversification.[124] In addition, a diversified firm may acquire other firms that are poorly managed in order to restructure its own asset base. Knowing that their firms could be acquired if they are not managed successfully encourages executives to use value-creating diversification strategies.

Figure 6.4 provides a model that combines many of the essential ideas found in this chapter. Diversification with the greatest potential for a positive effect on performance is a result of value-creating influences (economies of scope, market power, financial economies), promoted by effective internal governance (see Chapter 10 for a more detailed discussion). Value-neutral incentives, low performance, and the desire to reduce uncertainty of cash flows and risk of firm failure may promote diversification but are not expected to add much, if any, value for stakeholders. Managerial motives to diversify can also reduce value, but hopefully, internal governance and the threat of takeover will keep these motives in check. How a corporate-level diversification strategy is implemented also influences the amount of value created for stakeholders (i.e., firm performance).

Figure 6.4 Summary Model of the Relationship between Diversification and Firm Performance



Source: Adapted from R. E. Hoskisson & M. A. Hitt, 1990, Antecedents and performance outcomes of diversification: A review and critique of theoretical perspectives, *Journal of Management*, 16: 498.

We have described corporate-level strategies in this chapter. In the next chapter, we discuss mergers and acquisitions as prominent means for firms to diversify and grow. These trend toward more diversification through acquisitions, which have been partially reversed due to restructuring (see Chapter 7), are an indication that learning has taken place regarding corporate-level diversification strategies.[125] Accordingly, firms that diversify should do so cautiously, choosing to focus on relatively few, rather than many, businesses. In fact, research suggests that although unrelated diversification has decreased, related diversification has increased, possibly due to the restructuring that continued from the 1990s through the early twenty-first century. This sequence of diversification followed by restructuring has occurred in Europe and in countries such as Korea, following actions of firms in the United States and the United Kingdom.[126] Firms can improve their strategic competitiveness when they pursue a level and type of diversification that is appropriate for their resources and core competencies and the opportunities and threats in their country's institutional and competitive environments.[127]

Summary

- Firms use a corporate-level strategy to become more diversified in an effort to create more value for stakeholders. Using a single- or dominant-business corporate-level strategy may be preferable to seeking a more diversified strategy, unless a corporation can develop economies of scope or financial economies between businesses, or unless it can obtain market power through additional levels of diversification. Economies of scope and market power are the main sources of value creation when the firm uses a corporate-level strategy to achieve moderate to high levels of diversification.
- The related diversification corporate-level strategy helps the firm create value by sharing activities or transferring competencies between different businesses in the company's portfolio.
- Operational relatedness is associated with sharing tangible resources between businesses. Sharing activities are usually associated with the related constrained diversification strategy. Activity sharing is costly to implement and coordinate, may create unequal benefits for the divisions involved in the sharing, and can lead to fewer managerial risk-taking behaviors.
- Corporate relatedness is associated with transferring core competencies across business units or from the corporate headquarters office to a business unit. Transferring core competencies is often associated with related linked (or mixed related and unrelated) diversification, although firms pursuing both sharing activities and transferring core competencies can also use the related linked strategy.
- Efficiently allocating resources or restructuring a target firm's assets and placing them under rigorous financial controls are two ways to accomplish successful unrelated diversification. Firms using the unrelated diversification strategy focus on creating financial economies to generate value.
- Diversification is sometimes pursued for value-neutral reasons. Incentives from tax and antitrust government policies, low performance, or uncertainties about future cash flow are examples of value-neutral reasons that firms choose to become more diversified.
- Managerial motives to diversify (including to increase compensation or reduce risk of job loss) can lead to an unprofitably high level of diversification and a subsequent reduction in a firm's ability to create value for stakeholders. Evidence suggests, however, that many top-level executives seek to be good stewards of the firm's assets and avoid diversifying the firm in ways that destroy value.
- Managers need to consider their firm's internal organization and its external environment when making decisions about the optimum level of diversification for their company. Of course, internal resources are important determinants of the direction that diversification should take. However, conditions in the firm's external environment or unexpected threats from competitors may facilitate additional levels of diversification.

Key Terms

corporate-level core competencies 146
corporate-level strategy 140
corporate relatedness 145
economies of scope 143
financial economies 149
market power 147
operational relatedness 145
synergy 143
vertical integration 147

Review Questions

1. What is corporate-level strategy, and why is it important?
2. What are the different levels of diversification firms can pursue by using different corporate-level strategies?
3. What are three reasons firms choose to diversify their operations?
4. How do firms create value when using a related diversification strategy?
5. What are the two ways to obtain financial economies when using an unrelated diversification strategy?
6. What incentives and resources encourage diversification?
7. What motives might encourage managers to diversify their firms too much?

Mini-Case

BlackRock Inc. Corporate Strategy

BlackRock Inc. is the world's largest asset manager, with assets under management of $10 trillion at the end of 2021. Although most of its revenue comes from investment advisory and administrative fees, BlackRock also has businesses that provide technology systems, risk management services, and digital distribution tools to a variety of clients such as insurance companies, banks, and pension fund managers. In addition, the company provides consulting services to regulators, banks, and governments. These other businesses account for about 14 percent of BlackRock's revenues.

One noteworthy feature that sets BlackRock apart from other asset managers is its focus on sustainability, "As the world transitions to a low-carbon economy, our clients want to understand how to address climate risks in their portfolios. That's why we provide more sustainable investment options than anyone and make sustainability the standard for how we manage our clients' money."

BlackRock not only invests client money in sustainable companies but also actively engages in championing sustainability causes. For example, one of the biggest deterrents to effective socially responsible investing is that firms do not report on ESG (environment, society, governance) consistently. "Investment professionals in alternative asset classes have a growing need to access ESG data to help identify risk and opportunities. However, private market participants looking to incorporate ESG factors face complex decisions on which metrics are considered relevant due to the large array of frameworks in circulation and the evolving regulatory landscape." To address this problem, BlackRock announced in 2022 that it was working in a consortium of Limited Partners and Funds of Funds to help "streamline and standardize ESG reporting for private markets."

There has been some pushback with regard to the way BlackRock and other socially responsible fund managers do business. "BlackRock continues to receive criticism for its stance around climate-friendly policies. Last June [2021], Texas passed a bill requiring state entities like pensions to stop doing business with companies that boycott the fossil-fuel industry.… Lawmakers suggested that BlackRock is a likely candidate for the list—putting it at risk of losing millions of dollars of Texas pension business."

Another issue stems from the fact that big investment management companies typically vote their client's shares, which gives them tremendous influence over public companies. CEO Larry Fink insists that BlackRock's consideration of environmental, social, and governance risks is about long-term returns and not politics. He said climate change "has become a defining factor in companies' long-term prospects." There is pending legislation that would give passive investors the opportunity to vote when asset managers own more than 1 percent of a company's voting securities. BlackRock is already expanding proxy voting for its clients, and some institutional investors can now vote their shares.

BlackRock also makes investments in nontraditional assets when they have the potential to help clients meet their financial goals. For example, BlackRock and Warner Music invested $750 million in a fund with the objective of purchasing music-rights catalogs from diverse and female artists. "Unlike many recent blockbuster deals for decades-old music that can provide stable returns for passive investors collecting royalty payments, the new fund is focused on so-called modern evergreen music. It is investing in artists who are still writing music and looking to actively work—and maintain a stake in—their catalogs alongside their investors." The fund has already purchased 20 catalogs. Lylette Pizarro, founder and co-managing partner of Influence Media, is very optimistic about emerging and rising artists, stating that "data are showing the work of certain younger artists is resisting the decay in listenership that has been typical for music less than 10 years old."

Sources: A. Au-Yeung, 2022, BlackRock profit rises 20% on tech, fees, *Wall Street Journal,* April 14: B10; A. Steele, 2022, BlackRock, Warner Music invest $750 million in female and diverse artists, *Wall Street Journal,* www.wsj.com, February 24; J. Baer, 2022, BlackRock's climate stance is about profits, not politics, Larry Fink says, *Wall Street Journal,* www.wsj.com, January 17; A. Au-Yeung, 2022, Lawmakers seek to curb voting power of BlackRock, Vanguard and other big asset managers, *Wall Street Journal,* www.wsj.com, May 18; N. Reiff, 2022, How BlackRock makes money, *Investopedia,* www.investopedia.com, March 18; 2022, Where we stand, *BlackRock Home Page,* www.blackrock.com, May 18; 2022, BlackRock expands partnership with private market investors on universal solution for ESG reporting, *BlackRock Home Page,* www.blackrock.com, May 12.

Case Discussion Questions

1. What corporate diversification strategy is being pursued by BlackRock? What evidence do you have that supports your position?
2. Do you see the potential for synergies and economies of scope in BlackRock that keep its overall costs low?
3. What are the advantages and disadvantages of fostering a corporate-level core competence in socially responsible investing across all of BlackRock's businesses?
4. To what extent do you believe that investment management companies like BlackRock can make a difference in addressing social issues like sustainability? Is this something that these companies should be doing, or should they just seek the highest returns for their clients?

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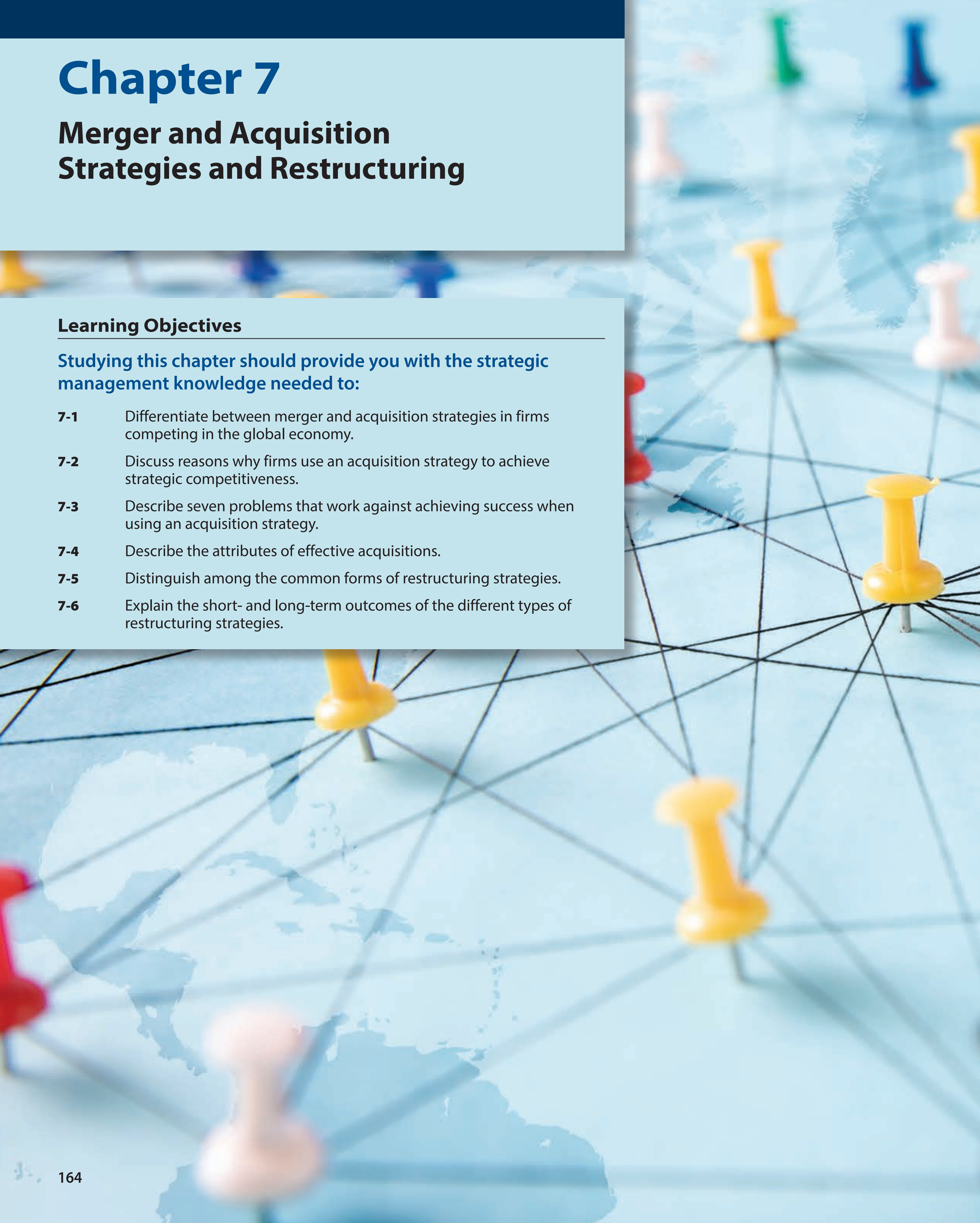
Chapter 7

Merger and Acquisition Strategies and Restructuring



Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

7-1 Differentiate between merger and acquisition strategies in firms competing in the global economy.

7-2 Discuss reasons why firms use an acquisition strategy to achieve strategic competitiveness.

7-3 Describe seven problems that work against achieving success when using an acquisition strategy.

7-4 Describe the attributes of effective acquisitions.

7-5 Distinguish among the common forms of restructuring strategies.

7-6 Explain the short- and long-term outcomes of the different types of restructuring strategies.

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Consolidation in the Financial Services Industry

The year 2021 was a record year for mergers and acquisitions in the financial services industry. The value of deals in the industry involving U.S.-based financial services companies rose from $558 billion in 2020 to $1.15 trillion in 2021. This volume of 8,307 deals indicates that a major consolidation trend has been occurring in the financial services industry for some time now. Industry consolidation means that firms in the same industry merge, reducing the number of industry competitors. All the airline mergers in the past decade indicate a consolidation in that industry also.

Several different reasons explain why firms in the same industry consolidate, but they all tend to reflect a desire to gain market power (see Chapter 6). Among the deals in 2021, Block (formerly called Square), a company involved in digital payments, agreed to pay $29 billion for Afterpay, an Australian company that engages in the buy-now-pay-later payments business. Afterpay pioneered the buy-now-pay-later business in Australia and then expanded into Europe and the United States. This closely related acquisition offers opportunities for synergy because both companies are heavily involved in digital technologies associated with payments processing. "Square aims to integrate Afterpay into its Cash and Seller apps, linking service for consumers and merchants."

In banking, M&T Bank, based in Buffalo, New York, announced an agreement to buy People's United Financial in Connecticut. The $7.6 billion deal created "the largest community-focused commercial bank in the northeast and mid-Atlantic." M&T was already the largest New York–based lender in its region and is one of the largest regional banks in the northeastern United States. In this case, M&T bank gained more market power through even greater economies of scale in the region. Explaining the deal, M&T Bank Chief Executive Rène Jones said, "The radius from the center of our franchise to the farthest branch is just under 300 miles, so we can actually be a really relevant financial institution to our customers in those regions." The combined company may also enjoy economies of scope as the two banks share resources (see Chapter 6). In addition, M&T Bank's core competence in serving local communities could be transferred to People's United.

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There were also some large deals in which financial services firms sold off part of their operations to improve their focus on what they do best, while the firm buying those operations could also enhance their market power. For example, Chubb LTD paid $6 billion to buy "Cigna's life, accident and supplemental health benefits in several countries." This acquisition expanded Chubb's presence in Asia.

One of the major trends driving the consolidation is the need for digital transformation (see Chapter 2). "Banks must heavily invest in digital transformation not simply to be in the game, but to be on the field at all." Another trend is that smaller regional financial institutions are merging to be competitive in the industry. The M&T Bank deal reflects this trend. In addition, many mergers are pursued to expand geographically or to pursue operational efficiencies. Industry experts expect the consolidation trend to continue in the financial services industry.

Sources: T. Johnson, 2022, Financial services M&A sets a new record in 2021. In *KPMG M&A Trends in Banking, Capital Markets, and Insurance,* New York, KPMG: 1–5; P. Vigna, 2021, Square changes name to block, days after CEO Jack Dorsey leaves Twitter, *Wall Street Journal,* www.wsj.com, December 1; D. Fonda, 2021, Square's deal for Afterpay is a hit. Why affirm could be next, *Barron's,* www.barrons.com, August 2; O. McCaffrey & C. Lombardo, 2021, M&T Bank to buy People's United for $7.6 billion, *Wall Street Journal,* www.wsj.com, February 22.

We examined corporate-level strategy in Chapter 6, focusing on types and levels of product diversification strategies firms use to create a competitive advantage and increases value for stakeholders. As noted in that chapter, diversification allows a firm to create value by productively using excess resources to exploit new opportunities.[1] In this chapter, we explore merger and acquisition strategies. Firms throughout the world use these strategies to grow and become more diversified.[2] Some firms, such as those in the financial services industry discussed in the Opening Case, get swept up in a major industry consolidation. Many of them combine with another firm that does the same thing, called a *horizontal acquisition* (i.e., bank merging with a bank), with the intent of increasing market power or geographic reach to remain competitive.

Many acquisitions fail to achieve the desired results, such as increased financial performance.[3] A key objective of this chapter is to explain how firms can successfully use merger and acquisition strategies to create stakeholder value and competitive advantages.[4] To reach this objective, we first discuss the continuing popularity of merger and acquisition strategies. As part of this explanation, we describe the differences between mergers, acquisitions, and takeovers. We next discuss specific reasons why firms choose to use merger and acquisition strategies and some of the problems organizations may encounter when doing so. We then describe the characteristics associated with effective acquisitions (we focus on acquisition strategies in the chapter) before closing the chapter with a discussion of different types of restructuring strategies. Restructuring strategies are commonly used to correct the results from unsuccessful mergers and acquisitions.

Learning Objective

7-1 Differentiate between merger and acquisition strategies in firms competing in the global economy.

7-1 Merger and Acquisition Strategies

Merger and acquisition (M&A) strategies have been popular among U.S. firms for many years. Some believe that these strategies played a central role in the restructuring of U.S. businesses during the 1980s and 1990s and that they continue generating these types of benefits in the twenty-first century. In fact, mergers and acquisitions also have a huge global impact. According to KPMG, "Global mergers and acquisition activity in 2021 easily surpassed the pre-pandemic level and nearly matched the peaks of 2015 and 2007."[5]

Although popular as a way of creating value and earning above-average returns, it is challenging to effectively implement merger and acquisition strategies. This is particularly true for the acquiring firms; some research results indicate that shareholders of the acquired firms often earn above-average returns from acquisitions, while shareholders of the acquiring firms typically earn returns that are close to zero.[6] Moreover, in approximately two-thirds of all acquisitions, the acquiring firm's stock price falls immediately after the intended transaction is announced. This negative response reflects investors' skepticism about the likelihood that the acquirer will be able to achieve the synergies required to justify the premium to purchase the target firm.[7]

Discussed more fully later in the chapter, paying excessive premiums to acquire firms can negatively influence the results a firm achieves through an acquisition strategy. Determining the worth of a target firm is difficult; this difficulty increases the likelihood a firm will pay a premium to acquire a target. Premiums are paid when those leading an acquiring firm conclude that the target firm would be worth more under its ownership than it would be as part of any other ownership arrangement or if it were to remain as an independent company. Recently, for example, Quidel Corp. (a U.S.-based global diagnostic healthcare provider) agreed to pay $24.68 per share for Ortho Clinical Diagnostics (a U.S.-based global provider of in vitro diagnostics), a 25 percent premium over Ortho's closing price on the previous day.[8] For this $6 billion to be considered a success, the combined company must generate what amounts to $1.5 billion in synergy through the combination. This goal may be possible, or it may not. That's why a lot of acquisitions are considered failures. Also, a 25 percent premium is not considered high. Consider how much harder it will be to justify an acquisition premium of 40 percent, which is what Liaoning Fangda (a Chinese industrial conglomerate) paid to acquire Hainan Airlines (also Chinese) in a $1.9 billion deal.[9] Similarly, Toronto-Dominion Bank (Canada) paid a 37 percent premium to acquire First Horizon (U.S.) in a $13.4 billion deal.[10]

7-1a Mergers, Acquisitions, and Takeovers: What Are the Differences?

Source: LinkedIn

Chord Energy was established in 2022, following the merger of Oasis Petroleum and Whiting Petroleum.

A **merger** is a strategy through which two firms agree to integrate their operations on a relatively coequal basis. For example, two oil shale drillers, Oasis Petroleum Inc. and Whiting Petroleum Co., merged in 2022, creating Chord Energy Corporation. Mark Viviano, from private-equity firm Kimmeridge Energy Management Co., which owns a stake in Oasis, said about the deal, "This merger of equals amongst offsetting operators will help the combined company gain operational scale, with synergies accruing to both sets of shareholders."[11] Two clues about whether the deal is a merger or an acquisition are whether the combined company will take on a new name and have a new ticker symbol. These are not requirements, but when they do occur, it is strong evidence that the deal is a merger rather than an acquisition. In the case of Oasis and Whiting, both conditions hold.

A **merger** is a strategy through which two firms agree to integrate their operations on a relatively coequal basis.

Evidence suggests that finalizing a proposal for firms to merge on an equal or a relatively equal basis is difficult. On a practical basis, deciding who will lead the merged firm, how to fuse what are often disparate corporate cultures, and how to reach an agreement about the value of each company prior to the merger are issues that commonly affect firms' efforts to merge on a coequal basis. For the Oasis and Whiting merger, Whiting's current president and CEO will assume the position as executive chairman of the board of directors of the new company. Oasis CEO Danny Brown will join the board and will serve as the combined company's CEO.[12]

An **acquisition** is a strategy through which a firm buys most or all a company's stock with the intent of making the acquired firm a subsidiary business within its portfolio.[13] After the acquisition is completed, the management of the acquired firm reports to the management of the acquiring firm.

An **acquisition** is a strategy through which one firm buys most or all a company's shares with the intent of making the acquired firm a subsidiary business within its portfolio.

A **takeover** is a special type of acquisition where the target firm does not solicit the acquiring firm's bid.

Although most mergers that are completed are friendly in nature, acquisitions can be friendly or unfriendly. A **takeover** is a special type of acquisition where the target firm does not solicit the acquiring firm's bid.[14] Thus, takeovers are unfriendly, sometimes called "hostile," acquisitions. As explained in Chapter 10, firms have developed defenses (mostly corporate governance devices) that can be used to prevent an unrequested and undesired takeover bid from being successful.[15]

When an unsolicited bid is received, the takeover target may try to determine the highest amount the acquiring firm is willing to pay, even while simultaneously using defense mechanisms to prevent a takeover attempt from succeeding. Multiple exchanges may take place between a potential acquirer and its target before a resolution of the unsolicited bid is reached, and these exchanges can become quite complicated. The exchanges between Broadcom and Qualcomm, two semiconductor producers, demonstrate this complexity. Broadcom made an offer for Qualcomm while Qualcomm's price was depressed due to regulator challenges over Qualcomm's dominance as a critical cell phone component supplier. At the same time, Qualcomm was seeking to close a deal for NPX, a semiconductor producer focused on automobiles and self-driving cars, which led to Broadcom lowering its offer price.[16] Ultimately, Broadcom withdrew its offer because it was disallowed by regulators due to government intellectual property and security concerns.[17] And Qualcomm walked away from the purchase of NPX due to lack of approval by Chinese regulators.

On a comparative basis, acquisitions are more common than mergers and takeovers. Accordingly, we focus most of the remainder of this chapter's discussion on acquisitions.

7-2 Reasons for Acquisitions

Learning Objective

7-2 Discuss reasons why firms use an acquisition strategy to achieve strategic competitiveness.

In this section, we discuss reasons why firms decide to acquire another company. As this discussion shows, there are many unique reasons that firms choose to use an acquisition strategy.[18]

7-2a Increased Market Power

Achieving greater market power is a primary reason for acquisitions.[19] Defined in Chapter 6, *market power* exists when a firm can sell its goods or services above competitive levels or when the costs of its primary or support activities are lower than those of its competitors. Market power

Strategic **Focus**

Intel's Acquisition Strategy

Intel is known around the world as one of the leading makers of computer chips—the brains that run computers and many other electronic devices. However, the company is also engaged in other closely related products, including servers, devices (i.e., laptops, workstations), wireless products, ethernet products, solid-state drives, and artificial intelligence. In fact, Intel's website lists over 60 product categories, with multiple products within each category. Intel has achieved this high level of related diversification primarily through 92 acquisitions, as of the end of 2021.

Intel's diversified portfolio has been helpful in weathering recent storms. In 2018, most of the Intel processors in current use were reported to be subject to security flaws. Fixing the flaws led to reductions in speed. Of course, Intel announced later in the year that it would redesign its central processing units to protect against these flaws, but other problems were found later in the year, as well as new flaws reported in 2019 and 2020. Perhaps at least in part because of these problems, in 2020, Apple announced that it would be switching from Intel chips to its own in-house design for the entire Mac line. This switch was a big blow for Intel, but the company still had other businesses that were doing well.

Although Intel's many acquisitions have increased its market power, Intel's performance relative to its competitors has been a disappointment to investors and analysts in recent years. To remedy the situation, Pat Gelsinger was chosen as CEO in early 2021 with the intention of orchestrating "the company's revival plan." True to the history of Intel as a highly acquisitive firm, Gelsinger said, "There will be consolidation in the industry. That trend will continue, and I expect that we're going to be a consolidator." Gelsinger was involved in about 100 acquisitions in his prior executive roles in EMC Corp. and VMware Inc. This experience makes him an excellent choice for an acquisition-based turnaround.

In 2021, Intel made several acquisitions. In June, the company acquired SiFive, a U.S. company involved in leading-edge semiconductor technology. In November, Intel acquired RemoteMyApp, a Polish company engaged in cloud-gaming solutions for businesses. In December, the company acquired Screenovate, an Israeli company that developed a technology that allows smartphone screens to be projected onto computers and TVs.

For more than a decade leading up to a major global chip shortage in 2021 and 2022, the major players in the market had been outsourcing production of their chips to specialist manufacturers. However, the shortage led to a rethinking of this strategy. Samsung made a bold move by announcing its intention to build a $17 billion chip factory in the United States, "part of the Korean company's bid to compete in the foundry business—making chips under contract for the companies that design them." Likewise, Intel made a major move to ramp up production of other companies' chips. In February of 2022, the company announced it would acquire Tower Semiconductor, an Israeli company that manufactures 2 million wafers a year for other chipmakers. Wafers are the building blocks from which integrated circuits (chips) are made. The $5.4 billion deal is the fourth largest in Intel's history, behind Altera, Mobileye, and McAffee.

Although Intel paid a 60 percent premium over-market value to buy Tower, analysts understand the logic behind the acquisition: "The rich price makes sense given the current realities of the chip manufacturing market and Intel's stated ambitions. It has long manufactured processors for PCs and servers that it designs itself. But booming demand for chips of all types plus a global shortage of production capabilities have created an opportunity for Intel to open its fabrication facilities to designs by others. This so-called foundry business model is a key part of the company's turnaround plan as it also seeks to recover its lead in the most advanced chipmaking processes now held by Taiwan Semiconductor Manufacturing, or TSMC."

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Tower Semiconductor was acquired in 2022 by Intel, making it Intel's fourth-largest acquisition deal.

Intel also sells businesses that no longer fit well within its business portfolio. In February 2022, Intel got approval from a Chinese regulator to sell its flash-memory chip business to South Korea's SK Hynix Inc. China's antitrust regulator "has broad reach to claim say over deals in which at least one party has a significant presence in the Chinese market." The $9 billion deal will help Intel pay for its acquisition of Tower.

Intel announced that it would be taking its Mobileye business unit public in mid-2022. Mobileye makes "chip-based camera systems that power automated driving features in cars." Intel believes Mobileye will achieve a market valuation of $50 billion, which is a nice return on an investment of a little over $15 billion it paid when it acquired Mobileye in 2017. The company will also include a recent acquisition of Moovit, an Israeli company that uses crowdsourced data to provide transit information even when there is no officially available data. Intel will retain a controlling interest in the company.

Sources: J. Yang, 2022, AMD's planned purchase of Xilinx clears last regulatory hurdle, *Wall Street Journal*, www.wsj.com, January 28; D. Gallagher, 2022, Intel pays up for foundry expertise; Premium offered for Tower Semiconductor makes sense given chip maker's stated ambitions, *Wall Street Journal*, www.wsj.com, February 15; C. Hetzner, 2022, Intel's $5.4 billion foundry acquisition hopes to catch its fabless chip rivals flat-footed, *Fortune*, www.fortune.com, February 16; 2022, Intel, *Tracxn*, www.tracxn.com, March 12; 2022, Products Home, *Intel Homepage*, www.intel.com, March 12; 2022, Acquisition, *Intel Newsroom*, www.newsroom.intel.com, March 12; D. Gallagher, 2021, Intel will race to cash in its car chips, *Wall Street Journal*, www.wsj.com, December 7; J. Sohn, 2021, Samsung to invest $205 billion in chip, biotech expansion, *Wall Street Journal*, www.wsj.com, August 24; A. Fitch & C. Lombardo, Intel CEO calls chip maker "willing buyer" as semiconductor industry consolidates, *Wall Street Journal*, www.wsj.com, August 19.

usually is derived from the size of the firm, the quality of the resources it uses to compete, and its share of the market(s) in which it competes.[20] Therefore, most acquisitions that are designed to achieve greater market power entail buying a competitor, a supplier, a distributor, or a business in a highly related industry so a core competence can be used to gain competitive advantage in the acquiring firm's primary market. As the Strategic Focus explains, the massive chipmaker Intel has a long history of acquiring companies to increase its market power.

Next, we discuss how firms use horizontal, vertical, and related types of acquisitions to increase their market power. Active acquirers simultaneously pursue two or all three types of acquisitions to do this. For example, Amazon has been expanding the scale and scope of its operations both horizontally (new international markets, new products) and vertically (moving into shipping).[21] These three types of acquisitions are subject to regulatory review by various governmental entities. Sometimes these reviews bring about the dissolution of proposed transactions, as illustrated in the Broadcom takeover attempt of Qualcomm discussed previously. Also, Amazon's bid to acquire a large stake in an Indian retailer called Future Retail is being scrutinized by India's antitrust body.[22] Future Retail operates more than 1,500 stores in the country.

Horizontal Acquisitions

The acquisition of a company competing in the same industry as the acquiring firm is a **horizontal acquisition**. Horizontal acquisitions increase a firm's market power by exploiting cost-based and revenue-based synergies.[23] Horizontal acquisitions occur frequently in the financial services industry, as illustrated in the Strategic Focus. Research suggests that horizontal acquisitions result in higher performance when the firms have similar characteristics, such as strategy, managerial styles, and resource allocation patterns.[24] Similarities in these characteristics, as well as previous experience in managing alliances between the two companies, support efforts to integrate the acquiring and the acquired firm. Horizontal acquisitions are often most effective when the acquiring firm effectively integrates the acquired firm's assets with its own, but only after evaluating and divesting excess capacity and assets that do not complement the newly combined firm's core competencies.[25]

A **horizontal acquisition** is an acquisition of a company competing in the same industry as the acquiring firm.

Because horizontal acquisitions involve companies that are competing in the same industry, they are highly subject to antitrust enforcement. Introduced in Chapter 2, antitrust legislation is found in most countries; the object is to protect consumers and other stakeholders against anticompetitive practices that occur when a company gets so large and powerful in a market that others have a hard time competing with it. With a great deal of market power, the firm can establish higher prices than it would be able to do if the market were competitive; it can then engage in other practices that are detrimental to consumers, competitors, suppliers, and government organizations. In Chapter 2, we mentioned that the FTC sued to block Lockheed Martin from buying Aerojet Rocketdyne Holdings.[26] In another example, "France's OVHcloud has filed a complaint that Microsoft is abusing its position to hurt competition in the cloud-computing market."[27]

Vertical Acquisitions

A **vertical acquisition** refers to a firm acquiring a supplier or distributor of one or more of its products. Through a vertical acquisition, the newly formed firm controls additional parts of the value chain (see Chapter 3), which is how vertical acquisitions lead to increased market power.[28]

A **vertical acquisition** refers to a firm acquiring a supplier or distributor of one or more of its products.

Through vertical integration, a firm has an opportunity to appropriate value being generated in a part of the value chain in which it does not currently compete, or to increase its participation in that part of the value chain, and to better control its own destiny in terms of costs and access. These motives led Amazon pursue an acquisition of movie studio MGM, which previously was a supplier of movies to Amazon. Although Amazon was already producing its own movies, MGM controls a huge volume of popular titles, including the James Bond series. It was Amazon's intention to use the acquisition to beef up its Prime Video streaming service to better compete with rivals like Netflix. In approving the deal, the European Commission's top regulator said, "the deal wouldn't significantly reduce competition in part because the companies don't significantly overlap in movie production."[29]

A firm can also enhance its production efficiency through vertical acquisitions, especially if there is some degree of relatedness between the industries of the acquiring and target firm.[30] In addition, research evidence suggests that firms that engage in a vertical acquisition experience an increase in their levels of innovation.[31]

A **related acquisition** occurs when a firm acquires another firm in a highly related industry.

Related Acquisitions

Acquiring a firm in a highly related industry is called a **related acquisition**. Through a related acquisition, firms seek to create value through the synergy that can be generated by integrating some of their resources and capabilities.[32]

Cisco Systems, a Silicon Valley (California) company, designs, manufacturers, and sells networking equipment. Over time, the firm has engaged in related acquisitions, primarily as a foundation for being able to compete aggressively in other product markets. For example, as software becomes a more integral aspect of all networking products, the firm is acquiring software companies that support and protect cloud computing, its newest emphasis. Cisco bought cloud software firm BroadSoft (U.S.) and AI monitoring manager AppDynamics (U.S.) in 2017, followed by cloud communications software firm IMImobile (U.K.), and cloud-native connectivity companies Banzai Cloud (Hungary) and Portshift (Israel) in 2020.[33] In 2022, Cisco made a bold move in offering \$20 billion for Splunk (U.S.), which makes software to monitor and analyze data.[34]

7-2b Overcoming Entry Barriers

Barriers to entry (introduced in Chapter 2) are factors associated with a market, or the firms currently operating in it, that increase the expense and difficulty new firms encounter when trying to enter a particular market.[35] For example, well-established competitors may have economies of scale in manufacturing or servicing their products. In addition, enduring relationships with customers often create loyalties and customer information that are difficult for new entrants to overcome.[36] When facing a market with highly differentiated products, new entrants typically must spend considerable resources to advertise their products and may find it necessary, at first, to sell below competitors' prices to entice new customers.

Facing the entry barriers that economies of scale and differentiated products create, a new entrant may find that acquiring an established company is more effective than entering the market as a competitor offering a product that is unfamiliar to current buyers. In fact, the higher the barriers to market entry, the greater the probability that a firm will acquire an existing firm to overcome them. Often entry barriers are highest for firms that desire to enter a foreign market.[37] Consequently, cross-border acquisitions are a common way to overcome them.

Cross-Border Acquisitions

Acquisitions made between companies with headquarters in different countries are called *cross-border acquisitions*.[38] Historically, North American and European companies were the most active acquirers of companies outside their domestic markets. However, today's global competitive landscape is one in which firms from economies throughout the world are engaging in cross-border acquisitions. In fact, in 2022, it is estimated that there will be approximately as many cross-border acquisitions in the Asia Pacific region as there will be in North America.[39]

Firms should recognize that cross-border acquisitions tend to have high risks and should be pursued with caution, even when a strong strategic rationale under-girds the completed transactions. One of the risks is associated with the high level of corruption that may exist in the country in which the target company is based.[40] Executives from firms that operate in developed economies may have difficulty in acquiring and managing a target firm in a country in which bribes and dishonesty are commonplace. There are also cultural differences across countries that can make managing a cross-border acquisition difficult.[41] In addition, deals can be delayed or canceled because customers, employees, media, or regulators in the target firm's country may be suspicious of the acquiring firm, thinking that perhaps the welfare of important stakeholders will be reduced or that the firm will act as a poor corporate citizen, neglecting its social responsibilities.[42]

China is a country that, because of its size and technological expertise, can be very attractive to potential acquirers from other countries. Political and legal obstacles associated with greenfield ventures can encourage foreign firms to use acquisitions to overcome barriers to entry when entering China, but they also increase the risk of doing so.[43] Being able to conduct an effective due-diligence process when acquiring a company in China can be difficult because the target firm's financial data and corporate governance practices may lack complete transparency.

However, difficulty goes both ways, because Chinese acquisitions of foreign firms have not had a stellar record. As a result, Chinese regulators hesitate to approve cross-border deals, especially if the acquiring firm has no expertise in managing the potential target business. For instance, Anbang

Insurance attempted to take over Starwood Hotels & Resorts of the United States for $14 billion, but the deal was blocked by Chinese authorities.[44] Thus, firms must carefully study the risks as well as the potential benefits when contemplating cross-border acquisitions.

7-2c Cost of New Product Development and Increased Speed to Market

Developing new products internally and successfully introducing them into the marketplace often requires significant investment of a firm's resources, including time, making it difficult to quickly earn a profitable return.[45] An acquisition strategy is another course of action a firm can take to gain access to new products and to current products that are new to it. Compared with internal product development processes, acquisitions provide more predictable costs, as well as faster market entry.

Celanese, a chemical-based materials firm, seeks to improve its engineered materials business in the United States through both acquisitions and internal innovation as it develops a portfolio of materials and resins to more fully meet its customers' emerging needs. It has found that in some changing areas it can more quickly gain access to products that are related to its own and that target the changing needs of historic customers. For example, the company was interested in entering into the emerging autonomous vehicle market. It purchased Nilit Plastics, a deal that increased the company's nylon compounding capability, so Celanese can now design and provide the plastics used to make the housings for the large number of sensors and cameras that autonomous vehicles use. Celanese also bought DuPont's mobility and materials business for $11 billion in its largest acquisition ever.[46]

7-2d Lower Risk Compared to Developing New Products

Because an estimated 88 percent of innovations fail to achieve adequate returns, concerns exist in firms about their ability to achieve adequate returns from the capital they invest to develop and commercialize new products. These types of outcomes may lead managers to perceive internal product development as a high-risk activity.[47]

The outcomes of an acquisition can be estimated more easily and accurately than the outcomes of an internal product development process; as such, managers may view acquisitions as less risky.[48] However, firms should be cautious: even though research suggests acquisition strategies are a common means of avoiding risky internal ventures (and therefore risky R&D investments), acquisitions may also become a substitute for internal innovation.[49]

Over time, being dependent on others for innovation leaves a firm vulnerable and less capable of mastering its own destiny when it comes to using innovation as a driver of wealth creation. Thus, a clear strategic rationale, should drive each acquisition a firm chooses to complete. If a firm is being acquired to gain access to a specific innovation or to a target's innovation-related capabilities, the acquiring firm should be able to specify how the innovation is or the innovation-based skills are to be integrated with its operations for strategic purposes.[50]

7-2e Increased Diversification

Acquisitions are also used to diversify firms. Based on experience and the insights resulting from it, firms typically find it easier to develop and introduce new products in markets they are currently serving. In contrast, it is difficult for companies to develop products that differ from their current lines for markets in which they lack experience. Thus, it is relatively uncommon for a firm to develop entirely new products internally to diversify its product lines.[51]

Acquisition strategies can be used to support the use of both related and unrelated diversification strategies. In an example of related diversification, Alphabet (Google) bought Mandiant, a cybersecurity company, for nearly $5.4 billion in 2022. Explaining the acquisition, Thomas Kurian, chief executive of Google Cloud, said, "Google wants to draw from Mandiant insights into how it applies security solutions to its products and that it intends to retain the Mandiant brand."[52] The acquisition will give Alphabet a much stronger position in cloud technology.

Samsung Group, a huge conglomerate, uses an unrelated diversification strategy to further diversify its operations. Headquartered in Suwon, South Korea, Samsung's portfolio recently included almost 70 companies competing in unrelated areas such as electronics, construction, life insurance, and fashion. It is South Korea's largest *chaebol*, or business conglomerate. Samsung Electronics, one of the firm's three core units, features three businesses that are well known to consumers throughout the world—mobile devices such as smartphones, consumer electronics (televisions and home appliances), and electronics components such as semiconductors and display panels. In 2017, Samsung bought Harman, focused on automotive and audio electronics. The move signaled an interest in expansion into automotive markets, industrial automation, and digital health. In 2020, Samsung bought network services provider TeleWorld to improve its end-to-end network support and help with the 5G rollout in the United States. Then, in late 2021, Samsung was in talks to acquire Biogen Inc., a pharmaceutical firm that had recently received approval of a new Alzheimer treatment in the United States.[53]

Firms using acquisition strategies should be aware that, in general, the more related the acquired firm is to the acquiring firm, the greater is the probability that the acquisition will be successful. Thus, horizontal acquisitions and related acquisitions tend to contribute more to the firm's strategic competitiveness than do acquisitions of companies operating in product markets that differ from those in which the acquiring firm competes. Nonetheless, the unrelated diversification strategy, such as the one Samsung is implementing, can also lead to success when used in ways that enhance firm value.

7-2f Reshaping the Firm's Competitive Scope

As discussed in Chapter 2, the intensity of competitive rivalry is an industry characteristic that affects a firm's profitability. To reduce the negative effect of an intense rivalry on financial performance, firms may use acquisitions to lessen their product and/or market dependencies.[54] Reducing a company's dependence on specific products or markets reshapes the firm's competitive scope. For example, in the highly competitive digital learning industry, Byju has made several acquisitions to increase the scope of its offerings. One of the more recent of these acquisitions was the 2021 purchase of the Austrian math-learning company GeoGebra. Byju expects that the acquisition will enable the creation of new products for its product portfolio, which will lessen the company's dependence on any one product.[55]

Another example is Carvana's acquisition of ADESA U.S. for $2.2 billion in 2022.[56] Carvana is known in the United States for its home delivery and car towers that stack dozens of used cars on top of each other. The used car market is incredibly competitive, with the powerhouse CarMax accompanied by AutoNation and a wide variety of other national, regional, and local dealers. ADESA is a public auction primarily for licensed car and specialty dealers. Adding auto auctions increases the scope of Carvana's operations. Note also that this is a form of vertical integration that can increase Carvana's market power. It is not unusual for a firm to make an acquisition for more than one of the reasons we have discussed in this section. Indeed, it is probably the norm rather than the exception.

7-2g Learning and Developing New Capabilities

Firms sometimes complete acquisitions to gain access to capabilities they lack. For example, firms often acquire technology-oriented companies to accelerate their innovation processes.[57] Research shows that firms can broaden their knowledge base and reduce inertia (e.g., resistance to change) through acquisitions and that they increase the potential of their capabilities when they acquire diverse talent through cross-border acquisitions.[58] Of course, firms are better able to learn these acquired capabilities if they share some similar properties with the firm's current capabilities.[59] Thus, firms should seek to acquire companies with different but related and complementary capabilities as a path to building their own knowledge base.[60]

As an example of an acquisition that led to new capabilities, Uniphore Software Systems acquired Emotion Research Lab to add video artificial intelligence (AI) capabilities to its software portfolio.[61] The result is impressive. The company's vision is to be "the defining conversational AI and automation platform to realize the value of every enterprise conversation."[62] They have combined voice AI, computer vision, and tonal emotion into what they call a conversational automation platform that allows accurate, personalized, and automated conversations, regardless of which language or dialect

Eric Glenn/Shutterstock.com

Carvana's 2022 acquisition of ADESA U.S. will allow them to operate in 56 ADESA U.S. locations.

is spoken, including emotion and intent. The company's dual headquarters are in India and the Silicon Valley in the United States, with additional offices in Spain, Japan, Singapore, and Israel.

In another example, in response to the highly competitive oil industry environment, and pressure from stakeholders to invest in "green" energy, Chevron paid over $3 billion to acquire Renewable Energy Group, a company that makes renewable fuels. Renewable Energy makes diesel and other fuels from sources such as cooking oil or corn. This acquisition gives Chevron a much-needed capability in an area that is only going to be even more important in the future. Chief Executive Mike Worth explained it this way: "We're creating a system here, not just buying a business to plug in. It is building capabilities to do things that are very analogous to what we've historically done, with a wide variety of feedstocks."[63]

7-3 Problems in Achieving Acquisition Success

Learning Objective

7-3 Describe seven problems that work against achieving success when using an acquisition strategy.

Effective and appropriate use of the acquisition strategies discussed in this chapter can facilitate firms' efforts to earn above-average returns. However, even when pursued for value-creating reasons, acquisition strategies are not problem-free. Reasons for the use of acquisition strategies and potential problems with such strategies are shown in Figure 7.1.

Figure 7.1 Reasons for Acquisitions and Problems in Achieving Success

Research suggests that perhaps 20 percent of mergers and acquisitions are successful, approximately 60 percent produce disappointing results, and the remaining 20 percent are clear failures; evidence suggests that technology acquisitions have even higher failure rates.[64] In general, though, companies appear to be increasing their ability to achieve success with acquisition strategies. Later, we will discuss several attributes that are associated with successful acquisitions (the attributes appear in Table 7.1). Despite this increasing success, firms using acquisition strategies should be aware of problems that tend to affect acquisition success so that they can avoid them, if possible. We show these problems in Figure 7.1 and discuss them next.

7-3a Integration Difficulties

The importance of a successful integration should not be underestimated.[65] Indeed, some believe that the integration process is the strongest determinant of whether an acquisition will be successful. This belief highlights the fact that post-acquisition integration is often a complex set of organizational processes that is difficult and challenging. The processes tend to generate uncertainty and often resistance because of cultural clashes and organizational politics.[66] How people are treated during the integration process relative to perceptions of fairness, openness of communications, and recognition of emotional needs is important when trying to integrate the acquiring and acquired firms.[67] Among the challenges associated with integration processes are the need to:

- meld two or more unique corporate cultures
- link different financial and information control systems
- build effective working relationships (particularly when management styles differ)
- determine the leadership structure and those who will fill it for the integrated firm.[68]

7-3b Inadequate Evaluation of Target

Due diligence is a process through which a potential acquirer evaluates a target firm for acquisition.

Due diligence is a process through which a potential acquirer evaluates a target firm for acquisition.[69] In an effective due-diligence process, hundreds of items are examined in areas as diverse as the financing for the intended transaction, differences in cultures between the acquiring and target firm, tax consequences of the transaction, pending legal suits, backgrounds of key managers, contracts, and actions that would be necessary to successfully meld the two workforces. It is also important to determine whether the target firm has any poison pills that will become effective if an acquisition takes place.[70] First mentioned in Chapter 6, poison pills are mechanisms put into place to discourage potential acquirers. The golden parachute was described in Chapter 6. Another type of poison pill allows investors to acquire additional shares in a company if a would-be acquirer takes a significant stake in the company's stock with the intention of taking it over.[71]

Due diligence is commonly performed with the assistance of investment bankers such as Deutsche Bank, Goldman Sachs, and Morgan Stanley, as well as accountants, lawyers, and management consultants specializing in that activity, although firms actively pursuing acquisitions may form their own internal due-diligence team. Even in instances when a company does its own due diligence, companies typically work with intermediaries such as large investment banks to facilitate their due-diligence efforts. Interestingly, research suggests that acquisition performance increases with the number of due-diligence–related transactions facilitated by an investment bank, but decreases when the relationship with a particular investment bank becomes exclusive.[72] Research also finds that when there is geographic overlap in the operational activities of the acquiring and target firms, informal due diligence between the deal firms is facilitated.[73] Because due diligence adds costs to an acquisition process, firms need to balance the need for more information during the due diligence process with the costs of acquiring that information.[74] Thus, the due diligence process is a complex matter requiring careful managerial attention.

Although a lot of the due diligence effort often focuses on evaluating the accuracy of the financial position and accounting standards used (a financial audit), due diligence also needs to examine the quality of the strategic fit and the ability of the acquiring firm to effectively integrate the target to realize the potential gains from the deal.[75] A comprehensive due-diligence process reduces the likelihood that an acquiring firm will have the experience Teva did as a result of acquiring Actavis Generics from Allergan for $40.5 billion. The deal saddled Teva with significant debt at the same time generic drugs were under a price squeeze due to increased competition from faster regulator generic drug approval.[76] Additionally, Teva acquired a smaller Mexican generic producer, Rimsa, which lost significant value after finding previously undiscovered "fraud" once the deal closed.[77] In both cases, effective due diligence could have prevented a lot of problems.

Much of the due diligence process occurs after a firm has announced its interest in acquiring a particular firm. However, before this occurs, the potential acquirer needs to estimate the size of premium over market value it is willing to pay for the target company. Firms are willing to pay a premium to acquire a company they believe will increase their ability to earn above-average returns. Determining the precise premium that is appropriate to pay is challenging.[78] While the acquirer can estimate the value of anticipated synergies, it is just that—an estimate. Only after working to integrate the firms and then engaging in competitive actions in the marketplace will the real value of synergies be known. When firms overestimate the value of synergies or the value of future growth potential associated with an acquisition, the premium they pay may prove to be too large.[79] The managerial challenge is to effectively examine each acquisition target in order to determine the amount of premium that is appropriate for the acquiring firm to pay.[80]

7-3c Large or Extraordinary Debt

To finance several the acquisitions completed during the 1980s and 1990s, some companies significantly increased their debt levels. Although firms today are more prudent about the amount of debt they are willing to accept to complete an acquisition, those evaluating the possibility of an acquisition need to be aware of the problem that taking on too much debt can create. In this sense, firms using an acquisition strategy want to verify that their purchases do not create a debt load that overpowers their ability to remain solvent and vibrant as a competitor.

A financial innovation called junk bonds supported firms' earlier efforts to take on large amounts of debt when completing acquisitions. *Junk bonds*, which are used less frequently today and are now more commonly called high-yield bonds, are a financing option through which risky acquisitions are financed with debt (bonds) that provides a large potential return to lenders (bondholders).[81] Because junk bonds are unsecured obligations that are not tied to specific assets for collateral, interest rates for these high-risk debt instruments sometimes reached between 18 and 20 percent during the 1980s.[82] Additionally, interest rates for these types of bonds tend to be quite volatile, a condition that potentially exposes companies to greater financial risk.[83]

Some financial economists view debt as a means to discipline managers, causing the managers to act in the shareholders' best interests.[84] The logic is that because the firm is heavily indebted, managers must exercise more care in making decisions or the firm will potentially fail. However, the perspective that debt disciplines managers is not as widely supported today as it was in the past.[85]

Bidding wars, through which an acquiring firm often overcommits to the decision to acquire a target, can result in large or extraordinary debt. While finance theory suggests that managers will make rational decisions when seeking to complete an acquisition, other research suggests that rationality may not always drive the acquisition decision. Managerial hubris (e.g., managers believe they can manage the target better than the last team), escalation of commitment to complete a particular transaction, and self-interest sometimes influence executives to pay a large premium, which, in turn, may result in taking on too much debt to acquire a target.[86] Excessive debt can make managers risk averse, which could reduce their willingness to invest in other risky activities that are essential to future performance, such as new research and development projects.

7-3d Inability to Achieve Synergy

Derived from *synergos*, a Greek word that means "working together," *synergy* exists when the value created by units working together exceeds the value that those units could create working independently (see Chapter 6).[87] That is, synergy exists when assets are worth more when used in conjunction with each other than when they are used separately. For shareholders, synergy generates gains in their wealth that they could not duplicate or exceed through their own portfolio diversification decisions.[88] Synergy is created by the efficiencies derived from economies of scale and economies of scope and by sharing resources (e.g., human capital and knowledge) across the businesses in the newly created firm's portfolio.[89]

A firm develops a competitive advantage through an acquisition strategy only when a transaction generates private synergy. *Private synergy* is created when combining and integrating the acquiring and acquired firms' assets yield capabilities and core competencies that could not be developed by combining and integrating either firm's assets with another company. Private synergy is possible when firms' assets are complementary in unique ways; that is, the unique type of asset complementarity is not always possible simply by combining two companies' sets of assets with each other.[90] Although difficult to create, the attractiveness of private synergy is that because of its uniqueness, it is difficult for competitors to understand and imitate, meaning that a competitive advantage results for the firms able to create it.

A firm's ability to account for costs that are necessary to create anticipated revenue and cost-based synergies affects its efforts to create private synergy. Firms experience several expenses when seeking to create synergy through acquisitions. Called transaction costs, these expenses are incurred when firms use acquisition strategies to create synergy.[91] Transaction costs may be direct or indirect. Direct costs include legal fees and charges from investment bankers who complete due diligence for the acquiring firm. Indirect costs include managerial time to evaluate target firms and then to complete negotiations, as well as the loss of top executives, managers and employees following an acquisition.[92] In 2019, French financial giant AXA SA acquired XL Group Ltd. to form the largest global property insurance company. Although Thomas Buberl, AXA CEO, justified the acquisition based on synergies on the "cost side and on the capital side," the market responded with skepticism. One analysis said, "From my calls with investors so far, they all point to three things: wrong asset, wrong timing and wrong price." At the time of the announcement, AXA was paying a 33 percent premium for the transaction.[93] Often firms tend to underestimate the sum of indirect costs when specifying the value of the synergy that may be created by integrating the acquired firm's assets with the acquiring firm's assets.

7-3e Too Much Diversification

As explained in Chapter 6, diversification strategies, when used effectively, can help a firm earn above-average returns. In general, firms using related diversification strategies outperform those employing unrelated diversification strategies. However, conglomerates formed by using an unrelated diversification strategy can also be successful.

At some point, however, firms can become overdiversified. The level at which this happens varies across companies because each firm has different capabilities to manage diversification. Recall from Chapter 6 that related diversification requires more information processing than does unrelated diversification. Because of this need to process additional amounts of information, related diversified firms become overdiversified with a smaller number of business units than do firms using an unrelated diversification strategy.[94] Regardless of the type of diversification strategy implemented, however, the firm that becomes overdiversified will experience a decline in its performance and likely a decision to divest some of its units.[95] Commonly, such divestments, which tend to reshape a firm's competitive scope, are part of a firm's restructuring strategy. (Restructuring is discussed in greater detail later in the chapter.)

Even when a firm is not overdiversified, a high level of diversification can have a negative effect on its long-term performance. For example, the scope created by additional amounts of diversification often causes managers to rely on financial rather than strategic controls to evaluate business units' performance (financial and strategic controls are discussed in Chapters 11 and 12). Top-level executives often rely on financial controls to assess the performance of business units when they do not have a rich understanding of business units' objectives and strategies. Using financial controls, such as return on investment (ROI), causes individual business-unit managers to focus on short-term outcomes at the expense of long-term investments. Reducing long-term investments to generate short-term profits can negatively affect a firm's overall performance ability.[96]

Another problem resulting from overdiversification, mentioned previously in this chapter, is the tendency for acquisitions to become substitutes for innovation.[97] Although managers may have no interest in acquisitions substituting for internal R&D efforts, a reinforcing cycle can evolve. Costs associated with acquisitions may result in fewer allocations to activities, such as R&D, that are linked to innovation. Without adequate support, a firm's innovation skills begin to atrophy. Without internal innovation skills, a key option available to a firm to gain access to innovation is to complete additional acquisitions. Evidence suggests that a firm using acquisitions as a substitute for internal innovations eventually encounters performance problems.[98]

7-3f Managers Overly Focused on Acquisitions

Typically, a considerable amount of managerial time and energy is required for acquisition strategies to be used successfully. Activities with which managers become involved include:

- searching for viable acquisition candidates
- completing effective due-diligence processes
- preparing for negotiations
- managing the integration process after completing the acquisition

Top-level executives do not personally gather all the information and data required to make acquisitions. However, they do make critical decisions regarding the targeted firms, the nature of the negotiations, and so forth.[99] In fact, research indicates that the knowledge and skills possessed by a CEO influence what kind of acquisitions the firm will seek (e.g., unrelated or related).[100] This evidence shows how much top executives are involved in the acquisition process. Company experiences show that participating in and overseeing the activities required for making acquisitions can divert managerial attention from other matters that are necessary for long-term competitive success, such as identifying and taking advantage of other opportunities and interacting with important external stakeholders.[101]

Both theory and research suggest that managers can become overly involved in the process of making acquisitions.[102] One observer suggested, "some executives can become preoccupied with making deals—and the thrill of selecting, chasing, and seizing a target."[103] The over-involvement can be surmounted by learning from mistakes and by not having too much agreement in the boardroom. Dissent is helpful to make sure that all sides of a question are considered.[104] For example, research suggests that CEOs who are not challenged substantially in their decision making, either by the CFO or the board, realize more value destructive acquisitions.[105] When failure does occur, leaders may be tempted to blame the failure on others and on unforeseen circumstances rather than on their excessive involvement in the acquisition process. Finding the appropriate degree of involvement with the firm's acquisition strategy is a challenging, yet important, task for top-level managers.

7-3g Too Large

Most acquisitions result in a larger firm, which should create or enhance economies of scale. In turn, scale economies can lead to more efficient operations—for example, two sales organizations can be integrated using fewer sales representatives because the combined sales force can sell the products of both firms (particularly if the products of the acquiring and target firms are highly related).[106] However, size can also increase the complexity of the managerial challenge and create diseconomies of scale—that is, not enough economic benefit to outweigh the costs of managing the more complex organization created through acquisitions.

Thus, while many firms seek increases in size because of the potential economies of scale and enhanced market power size creates, at some level, the additional costs required to manage the larger firm will exceed the benefits of the economies of scale and additional market power. The complexities generated by the larger size often lead managers to implement more bureaucratic controls to manage the combined firm's operations. *Bureaucratic controls* are formalized supervisory and behavioral rules and policies designed to ensure consistency of decisions and actions across a firm's units. However, across time, formalized controls often lead to relatively rigid and standardized managerial behavior which, at high levels, can hurt performance.[107]

Certainly, in the long run, the diminished flexibility that accompanies rigid and standardized managerial behavior can produce less innovation.[108] Because innovation is important to performance, the bureaucratic controls resulting from increased size due, in part, to an acquisition strategy, can negatively affect a firm's performance. Thus, although managers may decide their firm should complete acquisitions in the pursuit of increased size as a path to profitable growth, they should avoid allowing their firm to grow to a point where acquisitions are actually hurting performance.

7-4 Effective Acquisitions

Learning Objective

7-4 Describe the attributes of effective acquisitions.

As noted, many acquisition strategies do not lead to above-average returns for the acquiring firm's shareholders. Nonetheless, some companies can create value when using an acquisition strategy. Research evidence suggests that the probability of being able to create value through acquisitions increases when the nature of the acquisition and the processes used to complete it are consistent with the attributes of successful acquisitions shown in Table 7.1.[109] For example, when the target firm's assets are complementary to the acquired firm's assets, an acquisition is more successful. With complementary assets, the integration of two firms' operations has a higher probability of creating synergy. In fact, integrating two firms with complementary assets frequently produces unique capabilities and core competencies. With complementary assets, the acquiring firm can maintain its focus on core businesses and leverage the complementary assets and capabilities from the acquired firm.[110] In effective acquisitions, targets are often selected and "groomed" by establishing a working relationship prior to the acquisition.[111]

Research evidence also shows that friendly acquisitions facilitate integration of the acquiring and acquired firms. Of course, a target firm's positive reaction to a bid from the acquiring firm increases the likelihood that a friendly transaction will take place. After completing a friendly acquisition, firms collaborate to create synergy while integrating their operations with more speed than hostile acquisitions.[112] Friendly deals also allow for easier leadership and operational combinations and thus facilitate the ability to create synergy in the integration process.

Additionally, effective due-diligence processes involving the deliberate and careful selection of target firms and an evaluation of the relative health of those firms (financial health, cultural fit, and the value of human resources) contribute to successful acquisitions.[113] Financial slack in the form of debt equity or cash, in both the acquiring and acquired firms, also frequently contributes to acquisition success.[114] Even though financial slack provides access to financing for the acquisition, it is still important to maintain a low or moderate level of debt after the acquisition to keep debt costs low. When substantial debt is used to finance acquisitions, companies with successful acquisitions reduce the debt quickly, partly by selling off assets from the acquired firm, especially noncomplementary or poorly performing assets. For these firms, debt costs do not preclude long-term investments in areas such as R&D, and managerial discretion in the use of cash flow is relatively flexible.

Another attribute of successful acquisition strategies is an emphasis on innovation, as demonstrated by continuing investments in R&D activities.[115] One of the government concerns about the Broadcom acquisition of Qualcomm was that Broadcom has not had a strong tradition of R&D investment after its past acquisitions and Qualcomm, as a leader in 5G network implementation, would need strong innovation investment to maintain that leadership.[116]

Flexibility and adaptability are the final two attributes of successful acquisitions. When executives of both the acquiring and the target firms have experience in managing change and learning from acquisitions, they are more skilled at adapting their capabilities to new environments.[117] As

Table 7.1 Attributes of Successful Acquisitions

Attributes	Results
1. Acquired firm has assets or resources that are complementary to the acquiring firm's core business	1. High probability of synergy and competitive advantage by maintaining strengths
2. Faster and more effective integration and possibly lower premiums	2. Acquisition is friendly
3. Acquiring firm conducts effective due diligence to select target firms and evaluate the target firm's health (financial, cultural, and human resources)	3. Firms with strongest complementarities are acquired and overpayment is avoided
4. Financing (debt or equity) is easier and less costly to obtain	4. Acquiring firm has financial slack (cash or a favorable debt position)
5. Merged firm maintains low to moderate debt position	5. Lower financing cost, lower risk (e.g., of bankruptcy), and avoidance of trade-offs that are associated with high debt
6. Acquiring firm maintains long-term competitive advantage in markets	6. Acquiring firm has a sustained and consistent emphasis on R&D and innovation
7. Acquiring firm manages change well and is flexible and adaptable	7. Faster and more effective integration facilitates achievement of synergy

a result, they are more adept at integrating the two organizations, which is particularly important when firms have different organizational cultures.

As we have explained, firms using an acquisition strategy seek to create wealth and earn above-average returns. Sometimes, though, the results of an acquisition strategy fall short of expectations. When this happens, firms consider using restructuring strategies.

7-5 Restructuring

Learning Objective

7-5 Distinguish among the common forms of restructuring strategies.

Restructuring is a strategy through which a firm changes its set of businesses or its financial structure.

Restructuring is a strategy through which a firm changes its set of businesses or its financial structure.[118] Restructuring is a global phenomenon that is increasing in importance.[119] Historically, divesting businesses from company portfolios and downsizing (e.g., layoffs) have accounted for a large percentage of firms' restructuring strategies. Firms often focus on fewer products and markets following restructuring. In some cases, huge, highly diversified companies split into multiple smaller companies, as in the cases of General Electric and Toshiba—they both intend to divide into three separate companies.[120]

Although restructuring strategies are generally used to deal with acquisitions that are not reaching expectations, firms sometimes use restructuring strategies because of changes they have detected in their external environment. For example, Johnson & Johnson plans to split into two separate companies—consumer products, and pharmaceuticals and medical devices—believing that the two companies acting separately will be able to address the needs and challenges of their very different industry environments than would the combined company if it remains whole.[121] In a case like this one, restructuring may be appropriate to position the firm to create more value for stakeholders.[122]

Activist investors hold a significant, but not controlling, interest in the firm's stock. They use their positions to gain board seats and make shareholder proposals regarding what the firm can do to enhance shareholder returns.

Research shows that a lot of executives "hold onto businesses that, once critical to a portfolio, are now an unnecessary draw on resources and utilization of capital that could be better deployed elsewhere."[123] However, **activist investors** can put a lot of pressure on firms to either restructure or to put themselves up for sale. These are investors that hold a significant, but not controlling, interest in the firm's stock. They use their positions to gain board seats and make shareholder proposals regarding what the firm can do to enhance shareholder returns.[124] For example, activist investor Mill Road Capital Management, which owns a 5.1 percent stake in discount retailer Big Lots, is pressuring the company to put itself up for sale.[125] The Strategic Focus on Unilever's restructuring plans demonstrates a lot of the topic covered in this section, including the influence of an activist investor. Activist investors will be discussed in more depth in Chapter 10.

Firms typically engage in three types of restructuring strategies: downsizing, downscoping, and leveraged buyouts. The first two of these strategies, and often the third as well, involve divesting businesses. There are several common ways to divest a business. One is the complete *sell-off*, in which a firm sells a business (or several) directly to another firm. For example, Bayer AG sold its pest-control unit to a private-equity firm, Cinven, for $2.6 billion.[126] Another is the *spin-off*, in which the firm that owns the business that is being divested creates an independent company by either selling new shares of stock in the spun off business or giving shareholders stock in the spun off business proportional to the amount of stock they own in the parent company. AT&T spun off its WarnerMedia division so it can concentrate on building more fiber-optic lines.[127] Similarly, the Japanese conglomerate Toshiba decided to spin off its devices business, which includes semiconductors, in an effort to increase shareholder returns.[128] Divestitures such as these often lead to higher financial performance for the firm that engages in them.[129] In addition, researchers also found that they can enhance the firm's corporate social responsibility performance, perhaps by providing more liquid resources such as cash to allocate to these sorts of activities.[130] Also, firms that are more stakeholder-oriented are less likely to engage in divestitures.[131] This makes sense given that organizational changes associated with a divestiture can harm stakeholders, especially those of the divested business.

Another form of divestiture, albeit an incomplete form, is called a *carve-out*, in which the parent company sells only a partial interest in the company to investors, but keeps a large stake, or controlling interest, in the carved-out company. Discussed previously in this chapter, Intel's announcement that it would be taking its Mobileye business unit public is an example of a carve-out. Intel will retain control of the company. Research indicates that parents pursuing a sell-off perform better than the parents of carve-outs.[132]

Strategic Focus

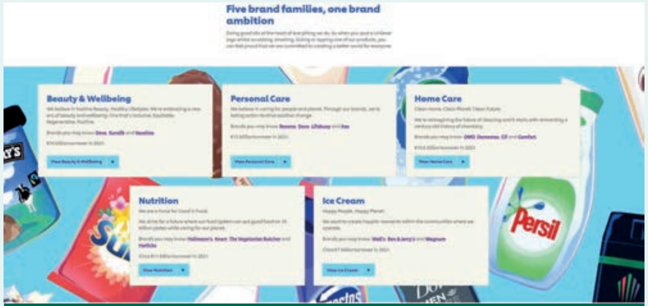
Unilever's Restructuring Accelerated Under Pressure by Activist Investor

Unilever, the huge consumer product company with headquarters in the United Kingdom, has its products available in around 190 countries. Over 400 brands include Ben & Jerry's ice cream, Dove soap, Hellman's mayonnaise, Suave shampoo, and Axe deodorant. The company has diversified its product offerings primarily through dozens of acquisitions. At the beginning of 2022, the company employed about 149,000 people around the world.

Recently, Unilever has been criticized for slow growth compared to its competitors, even during the pandemic when the company's packaged goods were in high demand. Analysts have also been critical of the company's resistance to divest slow-growth businesses and its lack of innovation for consumers. In a bold move to accelerate growth, Unilever surprised shareholders with an announcement of a \$68 billion bid for GlaxoSmithKline's consumer healthcare business in January 2022. Glaxo owns popular consumer brands like Aquafresh toothpaste and Advil analgesic. The bid was rejected as too low, and Unilever dropped its acquisition plans because of shareholder discontent and analyst criticism.

In January 2022, they announced a reorganization plan "aimed at improving its agility and increasing accountability for its different businesses." The plan included cutting thousands of jobs as well as both acquisitions and divestitures. A new organization structure effective in July created five stand-alone divisions, requiring a shuffling of executives around the company. The new structure was expected to reduce costs by 600 million euros over a period of two years and also improve sales growth. Alan Jope, CEO of Unilever, said about the restructuring: "Growth remains our top priority and these changes will underpin our pursuit of this."

Unilever intends to expand more into faster growing health, beauty and hygiene markets, while de-emphasizing food brands that are slower growing. However, inflation has made the turnaround even more difficult, with operating margins expected to drop up to 2.4 percent in 2022. In response to the dropping margins, Jope said that big acquisitions are no longer being considered as a part of the restructuring.



Source: Unilever.com

Unilever's 2022 reorganization plan created five new stand-alone divisions of the brand.

Nelson Peltz's Trian Fund Management acquired a stake in Unilever shortly after its failed bid for GlaxoSmithKline's consumer healthcare business. The activist investor immediately began putting pressure on Unilever's chief executive, Alan Jope. An analyst at Barclays, Warren Ackerman, said, "From Unilever's perspective, the status quo is not an option. It would seem that the stars are aligning with both Unilever management and an activist pushing for more urgency." Only time will tell if Unilever's reorganization is a success.

Sources: C. Ryan, 2022, Unilever's turnaround hopes clash with inflation, *Wall Street Journal*, www.wsj.com, February 10; S. Chaudhuri, 2022, Unilever to cut thousands of jobs, *Wall Street Journal*, January 25: B1, B2; S. Chaudhuri, 2022, Unilever looks to jump-start growth with sweeping overhaul, *Wall Street Journal*, www.wsj.com, January 25; S. Chaudhuri, 2022, Unilever walks away from Glaxo consumer-healthcare deal, *Wall Street Journal*, www.wsj.com, January 19.

7-5a Downsizing

Downsizing is a reduction in the number of a firm's employees and, sometimes, in the number of its operating units.

Downsizing is a reduction in the number of a firm's employees and, sometimes, in the number of its operating units; but the composition of businesses in the company's portfolio may not change through downsizing. Unilever's restructuring plan, discussed in the Strategic Focus, included downsizing through layoffs of thousands of employees. Thus, downsizing is an intentional managerial strategy that is used with the intention of improving firm performance. In contrast, organizational decline, which too often results in a reduction of a firm's resources—including the number of its employees and potentially in the number of its units—is an unintentional outcome of what turned out to be a firm's ineffective competitive actions.[133]

When downsizing, firms make intentional decisions about resources to retain and resources to eliminate. Organizational decline, on the other hand, finds firms losing access to an array of resources, many of which are critical to current and future performance. Thus, downsizing is a legitimate strategy to appropriately adjust firm size and is not necessarily a sign of organizational decline.[134] However, a downsizing firm still risks losing essential resources, such as skilled employees or productive assets, that are important to its ability to compete.[135]

Downsizing can be an appropriate strategy to use after completing an acquisition, particularly when there are significant operational and/or strategic relationships between the acquiring and the acquired firm. In these instances, the newly formed firm may have excess capacity in functional areas such as sales, manufacturing, distribution, human resource management, and so forth. In turn, excess capacity may prevent the combined firm from realizing anticipated synergies and the reduced costs associated with them.[136] Managers should remember that, as a strategy, downsizing will be far more effective when they consistently use human resource practices that ensure procedural justice and fairness in downsizing decisions.[137]

7-5b Downscoping

Downscoping refers to divestiture, spin-off, or some other means of eliminating businesses that are unrelated to a firm's core businesses. Downscoping has a more positive effect on firm performance than does downsizing because firms commonly find that downscoping causes them to refocus on their core business.[138] "Selling business units that no longer fit the company strategy—but that could be attractive additions to another company's portfolio—releases capital, which can then be deployed to strengthen the retained businesses or to acquire new businesses more aligned to a company's chosen direction."[139] Managerial effectiveness increases because the firm has become less diversified, allowing the top management team to better understand and manage the remaining businesses.[140] Also, research shows that the quality of innovation (e.g., probability of a major breakthrough) of pharmaceutical firms increases subsequent to divestiture, likely a result of being able to focus on what remains in a firm's technological portfolio.[141]

Downscoping refers to divestiture, spin-off, or some other means of eliminating businesses that are unrelated to a firm's core businesses.

Firms often use the downscoping and downsizing strategies simultaneously. As noted above, downsizing firms need to avoid losing key employees or other resources that are important to competitiveness. Instead, a firm that chooses simultaneously to engage in downscoping and downsizing should intentionally become smaller as a result of decisions made to reduce the diversity of businesses in its portfolio, allowing it to focus on its core areas.[142]

7-5c Leveraged Buyouts

A **leveraged buyout (LBO)** is a restructuring strategy whereby another company is purchased using a significant amount of debt to pay for the acquisition.[143] This is also called taking a company private because the company's stock is no longer publicly traded. At present, private equity firms are often the orchestrators of a leveraged buyout.[144] These firms get their capital from high-new-worth individuals and institutional investors who are trying to achieve higher returns than public equity markets provide.[145] LBOs can also be conducted by mangers (or even one manager) of the firm, or sometimes by a group of firm employees.

A **leveraged buyout (LBO)** is a restructuring strategy whereby another company is purchased using a significant amount of debt to pay for the acquisition.

Traditionally, leveraged buyouts were used as a restructuring strategy to correct for managerial mistakes or because the firm's managers were making decisions that primarily served their own interests rather than those of shareholders.[146] However, some firms complete leveraged buyouts for the purpose of building firm resources and expanding their operations rather than simply to restructure a distressed firm's assets.

To support debt repayments and to downscope the company so it can concentrate on its core businesses, the new owners may quickly sell several assets. It is not uncommon for those buying a firm through an LBO to restructure the firm to the point that it can be sold at a profit within a five- to eight-year period. Indeed, the point at which this happens is typically when the investors who orchestrated the LBO get their big payout.

Research shows that some LBOs lead to downscoping, increased strategic focus, and improved performance.[147] Research also shows that management buyouts can lead to greater entrepreneurial activity and growth.[148] As such, LBOs can represent a form of firm rebirth to facilitate entrepreneurial efforts and stimulate strategic growth and productivity.[149]

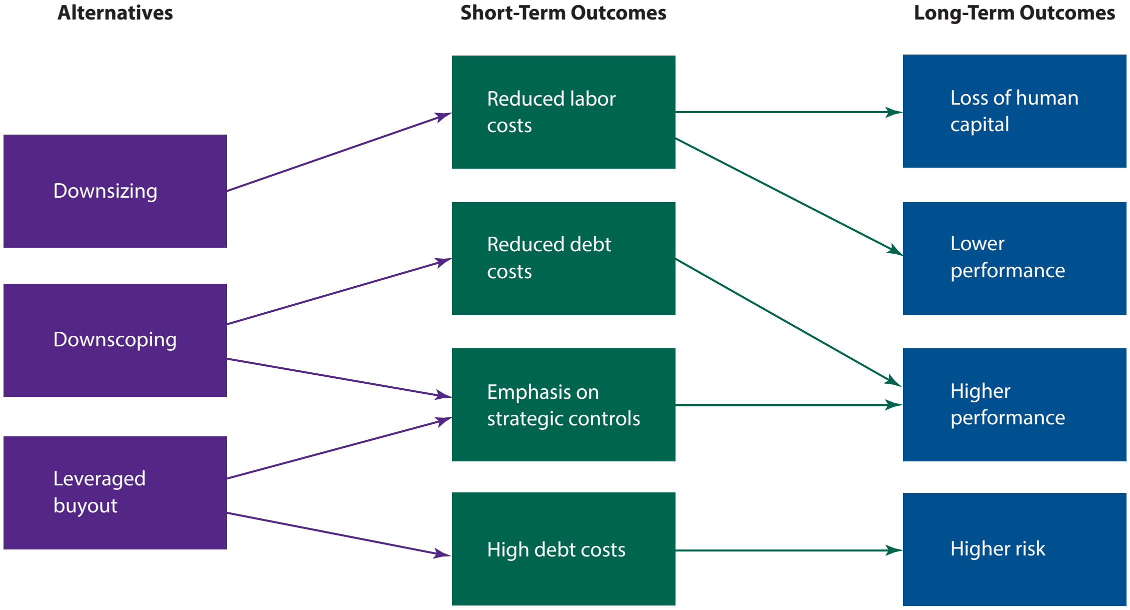
7-6 Restructuring Outcomes

Learning Objective

7-6 Explain the short- and long-term outcomes of the different types of restructuring strategies.

The short- and long-term outcomes that result from use of the three restructuring strategies are shown in Figure 7.2. As indicated, downsizing typically does not lead to higher firm performance.[150] In fact, some research results show that downsizing contributes to lower returns

Figure 7.2 Restructuring and Outcomes



for both U.S. and Japanese firms. The stock markets in the firms' respective nations evaluate downsizing negatively, believing that it has long-term negative effects on the firms' efforts to achieve strategic competitiveness. Investors also seem to conclude that downsizing occurs because of other problems in a company.[151] This assumption may be caused by a firm's diminished corporate reputation when a major downsizing is announced.[152]

The loss of human capital is another potential problem of downsizing (see Figure 7.2). Losing employees with many years of experience with the firm represents a major loss of knowledge. As noted in Chapter 3, knowledge is vital to competitive success in the global economy. Research also suggests that a loss of valuable human capital can spill over into dissatisfaction of customers.[153] Thus, in general, downsizing may be of more tactical (or short-term) value than strategic (or long-term) value, meaning that firms should exercise caution when restructuring through downsizing.

Compared to downsizing and leveraged buyouts, downscoping generally leads to more positive outcomes in both the short and long term. Downscoping's desirable long-term outcome of higher performance is a product of reduced debt costs and the emphasis on strategic controls derived from concentrating on the firm's core businesses. In so doing, the refocused firm should be able to increase its ability to compete.[154]

LBOs that involve taking over the whole firm have been hailed as a significant innovation in the financial restructuring of firms. However, this type of restructuring can be complicated, especially when cross-border transactions are involved.[155] Also, they can involve negative trade-offs.[156] First, the resulting large debt increases the firm's financial risk, as is evidenced by the number of companies that filed for bankruptcy in the 1990s after executing a whole-firm LBO. Sometimes, the intent of the owners to increase the efficiency of the acquired firm and then sell it within five to eight years creates a short-term and risk-averse managerial focus.[157] As a result, these firms may fail to invest adequately in R&D or take other major actions designed to maintain or improve the company's ability to compete successfully against rivals.[158] Because buyouts more often result in significant debt, most LBOs have been completed in mature industries where stable cash flows are the norm. Stable cash flows support the purchaser's efforts to service the debt obligations assumed as a result of taking a firm private.

Summary

- Mergers and acquisitions are popular for companies around the world. Through this strategy, firms seek to create value and outperform rivals.
- A merger is a strategy through which two firms agree to integrate their operations on a relatively coequal basis. An acquisition is a strategy through which a firm buys most or all of a company's stock with the intent of making the acquired firm a subsidiary business within its portfolio. A takeover is a special type of acquisition where the target firm does not solicit the acquiring firm's bid.
- A horizontal acquisition is an acquisition of a company competing in the same industry as the acquiring firm. A vertical acquisition refers to a firm acquiring a supplier or distributor of one or more of its products. A related acquisition occurs when a firm acquires another firm in a highly related industry.
- Firms use acquisition strategies to:
    - increase market power
    - overcome entry barriers to new markets or regions
    - avoid the costs of developing new products and increase the speed of new market entries
    - reduce the risk of entering a new business
    - become more diversified
    - reshape their competitive scope by developing a different portfolio of businesses
    - enhance their learning as the foundation for developing new capabilities
- Among the problems associated with using an acquisition strategy are:
    - the difficulty of effectively integrating the firms involved
    - incorrectly evaluating the target firm's value
    - creating debt loads that preclude adequate long-term investments (e.g., R&D)
    - overestimating the potential for synergy
    - creating a firm that is too diversified
    - creating an internal environment in which managers devote increasing amounts of their time and energy to analyzing and completing the acquisition
    - developing a combined firm that is too large, necessitating extensive use of bureaucratic, rather than strategic, controls
- Effective acquisitions have the following characteristics:
    - the acquiring and target firms have complementary resources that are the foundation for developing new capabilities
    - the acquisition is friendly, thereby facilitating integration of the firm's resources
    - the target firm is selected and purchased based on completing a thorough due-diligence process
    - the acquiring and target firms have considerable slack in the form of cash or debt capacity
    - the newly formed firm maintains a low or moderate level of debt by selling off portions of the acquired firm or some of the acquiring firm's poorly performing units
    - the acquiring and acquired firms have experience in terms of adapting to change
    - R&D and innovation are emphasized in the new firm
- Restructuring is used to improve a firm's performance by correcting for problems created by ineffective management. Restructuring by downsizing involves reducing the number of employees and hierarchical levels in the firm. Although it can lead to short-term cost reductions, the reductions may be realized at the expense of long-term success because of the loss of valuable human resources (and knowledge) and overall corporate reputation.
- The goal of restructuring through downscoping is to reduce the firm's level of diversification. Often, the firm divests unrelated businesses to achieve this goal. Eliminating unrelated businesses makes it easier for the firm and its top-level managers to refocus on the core businesses.
- Through a leveraged buyout (an LBO), a firm is purchased so that it can become a private entity. LBOs usually are financed largely through debt, although limited partners (institutional investors) are becoming more prominent. General partners have a variety of strategies, and some emphasize equity versus debt when minority partners have a longer time horizon. Management buyouts (MBOs), employee buyouts (EBOs), and whole-firm LBOs are the three types of LBOs. Because they provide clear managerial incentives, MBOs have been the most successful of the three. Often, the intent of a buyout is to improve efficiency and performance to the point where the firm can be sold successfully within five to eight years.
- Commonly, restructuring's primary goal is gaining or reestablishing effective strategic control of the firm. Of the three restructuring strategies, downscoping is aligned most closely with establishing and using strategic controls and usually improves performance more on a comparative basis.

Key Terms

activist investors 179
acquisition 167
downscoping 181
downsizing 180
due diligence 174
horizontal acquisition 169
leveraged buyout (LBO) 181
merger 167
related acquisition 170
restructuring 179
takeover 167
vertical acquisition 169

Review Questions

1. Why are merger and acquisition strategies popular in many firms competing in the global economy?
2. What reasons account for firms' decisions to use acquisition strategies as a means to achieving strategic competitiveness?
3. What are the seven primary problems that affect a firm's efforts to successfully use an acquisition strategy?
4. What are the attributes associated with a successful acquisition strategy?
5. What is a restructuring strategy, and what are its common forms?
6. What are the short- and long-term outcomes associated with the different restructuring strategies?

Mini-Case

Two Suitors Seek to Acquire Low-Budget Spirit Airlines

Two trends have predominated the airline industry over the past few decades. The first is industry consolidation. To name just a few of the larger mergers since 2010: United Airlines acquired Continental Airlines in 2010 and ExpressJet Airlines in 2019; Southwest Airlines acquired AirTran Airways in 2010; Alaska Airlines acquired Virgin America in 2016; American Airlines merged with US Airways in 2013; British Airways merged with Iberia in 2011 to form International Airlines Group (IAG); IAG was in the process of acquiring Air Europa in 2022, with the full acquisition expected to be completed in 2023. The most commonly cited reasons for these mergers and acquisitions are to enhance efficiency through economies of scale and to provide customers with more routes and destinations.

The other important trend is the increasing popularity of low-priced, "no frills" airlines. In 2022, the United States had Spirit Airlines, Frontier Airlines, and JetBlue Airlines, although JetBlue offers more extras for customers than the other two. Europe had Ryanair, EasyJet, and Wizz Air, among others. In Asia, Scoot Airlines and Indigo competed in a crowded field. Fastjet and FlySafair were among the many low-priced carriers in Africa. These types of airlines continue to proliferate. In 2017, IAG created a new airline called LEVEL, offering low-cost pricing on long flights.

These two trends came together in the merger of Spirit Airlines with, well, somebody. Frontier Airlines was the first suitor, with a deal valued at $2.9 billion. Spirit took the deal. Then JetBlue offered $3.6 billion to take over the company. Both companies viewed Spirit as important to growing and becoming more competitive with the major airlines. Either deal would make the merged airline the fifth largest in the U.S. market. "Both companies have accused the other of acting in bad faith."

Spirit's board turned down the offer from JetBlue: "Spirit's board said it believed there was too much risk that regulators would bar a merger with JetBlue, even after JetBlue pledged to shed assets to win regulatory approval and to pay a $200 million breakup fee if it was unable to complete the proposed acquisition for anti-trust reasons." Nonetheless, the board viewed the JetBlue offer as too risky for shareholders.

When Spirit turned the offer down in favor of maintaining its deal with Frontier, JetBlue launched a hostile takeover attempt. "JetBlue is appealing directly to shareholders by launching a tender offer for their shares, in hopes of pressuring Spirit's management to re-engage in negotiations." The offering price for the tender offer was $30 per share compared to its initial offer of $33 per share; however, JetBlue said it would be willing to negotiate if Spirit provided some information needed for due diligence. The lower price was because of what JetBlue said was a lack of cooperation from Spirit in providing necessary information. JetBlue CEO Robin Hayes said, "If the Spirit shareholders vote against the transaction with Frontier and compel the Spirit board to negotiate with us in good faith, we will work towards a consensual transaction at $33 per share, subject to receiving the information to support it."

JetBlue began meeting with Spirit shareholders to convince them that the JetBlue deal was in their best interests.

Although technically a large portion of shareholders must agree to tender their shares for a tender offer to be successful, in practice this often is not the case. If it appears that a deal is attractive to shareholders, reluctant boards will often change their positions and negotiate a deal. In this case, JetBlue won out in a deal valued at $3.8 billion.

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Case Discussion Questions

1. Of the reasons for acquisitions discussed in the chapter, which reasons are the primary drivers of the merger of Spirt Airlines with one of the two suitors? Beyond the two reasons mentioned in the case, are there others which would seem to apply to this situation?
2. If a company successfully completes a hostile takeover, is it more or less likely to be successful compared to a friendly merger? Why do you believe this is the case?
3. Is it ethical to entertain or even accept another deal when a board of directors already has an agreement with a previous company? Consider this question from the perspective of shareholders of the target company (e.g., Spirit), the shareholders of the suitor (JetBlue), and the shareholders of the firm with whom the firm already has an agreement (e.g., Frontier).
4. If you were a shareholder of Spirit Airlines as of the time of this case, what would you have wanted the board to do? Why?

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Chapter 8

International Strategy

Learning Objectives

Studying this chapter will provide you with the strategic management knowledge needed to:

8-1 Discuss global environmental trends and firm incentives affecting firms' decisions to pursue international strategies.

8-2 Explain the political, legal, and economic risks that discourage firms from pursuing international strategies.

8-3 Describe the common management problems multinational firms experience.

8-4 Explain what a firm should consider when deciding whether to enter an international market.

8-5 Describe the three international corporate-level strategies.

8-6 Identify and explain the five modes firms use to enter international markets.

8-7 Discuss the desired strategic competitiveness outcomes associated with an international diversification strategy.

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Tesla's Aggressive European Expansion

Tesla was founded in 2003 by a group of engineers "who wanted to prove that people didn't need to compromise to drive electric—that electric vehicles can be better, quicker and more fun to drive than gasoline cars." According to the company's website, "Tesla's mission is to accelerate the world's transition to sustainable energy." The company unveiled a state-of-the art, all-electric Roadster in 2008 and then began to design a premium sedan from the ground up. The Model S was revered by critics and customers alike as safe, comfortable, and very fast, with a record time of 2.28 seconds to accelerate from 0 to 60 miles per hour. The Model X, a sport utility vehicle, followed. Then, in 2016, the Model 3 was introduced as a lower-priced, high-volume electric vehicle. The company didn't quit there, but continued to design Tesla Semi, billed as "the most comfortable truck ever," a midsize sport utility vehicle called Model Y, and Cybertruck. True to its mission, Tesla also produces solar roofs and solar panels.

Tesla has factories in several places, but in 2021, most of its automobiles were manufactured California (U.S.) and Shanghai (China). Tesla was serving the European market primarily from Shanghai. That all changed in 2022 as Tesla began delivering cars from a new plant just outside Berlin in eastern Germany. Elon Musk, Tesla's CEO, said on the day the first cars were delivered to their new owners that "the factory would create a foundation for both electric vehicles and the batteries that could store energy from wind and the sun." He considers the opening of this plant a "big step in the fight against global warming." Musk also cited the huge cost savings associated with producing automobiles in the continent in which they are sold.

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Tesla's European plant is a direct threat to Volkswagen, currently the market leader in the European electric vehicle market. As of 2021, Tesla was in third place in Europe, barely behind second-place Stellantis (formed from the merger of Fiat Chrysler and the French PSA Group). However, Volkswagen announced that it was going to invest 2 billion euros in a new electric vehicle plant near its German headquarters. Construction begins in 2023, with the first cars rolling off the production line in 2026. Volkswagen says it wants to use technology in the new factory to reduce the number of hours it takes to make a car to 10 from its current 30 hours. Volkswagen is also considering making an electric truck in the United States.

Other competitors are also making bold moves to challenge Tesla's strong market position in electrical vehicles. General Motors is restarting production of its Chevy Bolt and is only shipping Hummer electric pickup trucks to dealers after customers order them online, a practice pioneered by Tesla for selling electric vehicles. Ford is now selling about as many of its all-electric Mustangs as its gas-powered versions; it is also considering a deliver-after-order system. Rivian Automotive, a California-based electric vehicle manufacturer (currently pickup trucks and sport utility vehicles), raised almost $12 billion in new capital as the company went public in late 2021, as investors felt confident that the company could rival Tesla.

The most limiting feature of electric vehicles is range, and Tesla is definitely getting some competition in this area. Tesla's longest range for the Model S is 405 miles. In 2021, Lucid Group released the 2022 Lucid Air, with an expected range of up to 520 miles. The secret is higher voltage. Run by former Tesla Executive Peter Rawlinson and majority owned by the Public Investment Fund of Saudi Arabia, Lucid is taking direct aim at Tesla's higher-end sedans. The sedan is a true luxury car with ample legroom, internal materials that include wool, wood, metal, and leather, and a lot of speed.

Sources: V. Walt, 2022, VW levels up on electric cars, *Fortune,* February/March: 55–59; W. Boston, 2022, Elon Musk open's Tesla's first European factory, *Wall Street Journal,* www.wsj.com, March 22; M. Colias, 2022, GM to restart Chevy Bolt production in April, *Wall Street Journal,* www.wsj.com, February 15; W. Boston, Volkswagen in advanced talks over Porsche IPO, *Wall Street Journal,* www.wsj.com, February 15; M. Colias, 2022, Tesla set the model for selling EVs: Ford, VW, and others want to follow, *Wall Street Journal,* www.wsj.com, March 11; W. Boston, 2022, Volkswagen considers making electric truck in U.S., *Wall Street Journal,* www.wsj.com, March 15; S. Wilmot, 2022, Tesla could take back Europe's EV market, *Wall Street Journal,* www.wsj.com, March 22; D. Neil, 2022, For Mustang Mach-E GT: The strong, silent type, *Wall Street Journal,* www.wsj.com, February 17; N. Exkert & M. Colias, 2022, EV startup Rivian walks back price increase, apologizes to customers, *Wall Street Journal,* www.wsj.com, February 15; 2022, About Tesla, *Tesla Homepage,* www.tesla.com, March 25; D. Neil, 2022 Lucid Air: At last, a worthy Tela opponent, *Wall Street Journal,* www.wsj.com, October 29.

Learning Objective

8-1 Discuss global environmental trends and firm incentives affecting firms' decisions to pursue international strategies.

8-1 Global Trends and International Strategies

Our description of Tesla's international expansion strategy in this chapter's Opening Case highlights the importance of international markets for this firm. Being able to effectively compete in countries and regions outside a firm's domestic market is increasingly important to firms of all types. One reason is that the effects of globalization continue to reduce the number of industrial and consumer markets in which only domestic firms can compete successfully. In place of what historically were relatively stable and predictable domestic markets, firms across the globe find they are now competing in globally oriented industries—industries in which firms must compete in all or most world markets where a consumer or commercial good or service is sold to be competitive.[1] However, unlike domestic markets, global markets are relatively unstable and much less predictable.[2]

An **international strategy** is a strategy through which a firm produces and/or sells its goods and/or services outside the country in which its headquarters office is located.

An **international strategy** is a strategy through which a firm produces and/or sells its goods and/or services outside the country in which its headquarters office is located. The market in which the headquarters office is located is referred to as the "home" market. A *multinational corporation (MNC)* can be defined as "a business entity with one or more foreign affiliates in which the parent company holds at least a 10 percent ownership stake."[3]

In some instances, firms using an international strategy become quite diversified geographically as they manufacture their products and compete in numerous countries or regions outside their domestic market.[4] In other cases, firms engage in no international diversification because they focus on their home market. Among the *Fortune* 500 firms, approximately 35 percent have no physical operations outside their home countries (although their products may still be exported), 25 percent operate in less than 25 locations in other countries, and about 5 percent have more than 500 international locations across a variety of countries.[5]

An **international diversification strategy** is a strategy through which a firm expands the production and/or sales of its goods and/or services across the borders of global regions and countries into a potentially large number of geographic locations or markets.

As a firm enters new markets outside its home country or increases the number of international markets in which it operates, it is pursuing international diversification; this is like the concept of diversification we discussed in Chapters 6 and 7, only with an international orientation. An **international diversification strategy** is a strategy through which a firm expands the production and/or sales of its goods and/or services across the borders of global regions and countries into a potentially large number of geographic locations or markets. In other words, an international diversification strategy describes the means through which a firm develops an international strategy. The resources a firm possesses provide limits to a firm's international diversification and provide a basis for achieving competitive advantage in the countries in which the firm expands.[6] As the firm grows internationally, both its organization and the resources it possesses change. Managers who are astute at managing this process can enhance firm performance and achieve above-average returns.[7]

The purpose of this chapter is to discuss how international strategies can be a source of strategic competitiveness for firms competing in global markets. To do this, we examine several topics. After reviewing some of the major trends that are either encouraging or discouraging international diversification, we describe factors firms should consider when selecting a country to enter. We then turn our attention to the international strategies available to firms. Specifically, we examine both international corporate-level and business-level strategies. The five modes of entry firms can use to enter international markets for implementing their international strategies are then examined, followed by a discussion of some of the outcomes firms seek when pursuing international diversification strategies.

8-1a Incentives Encouraging International Expansion

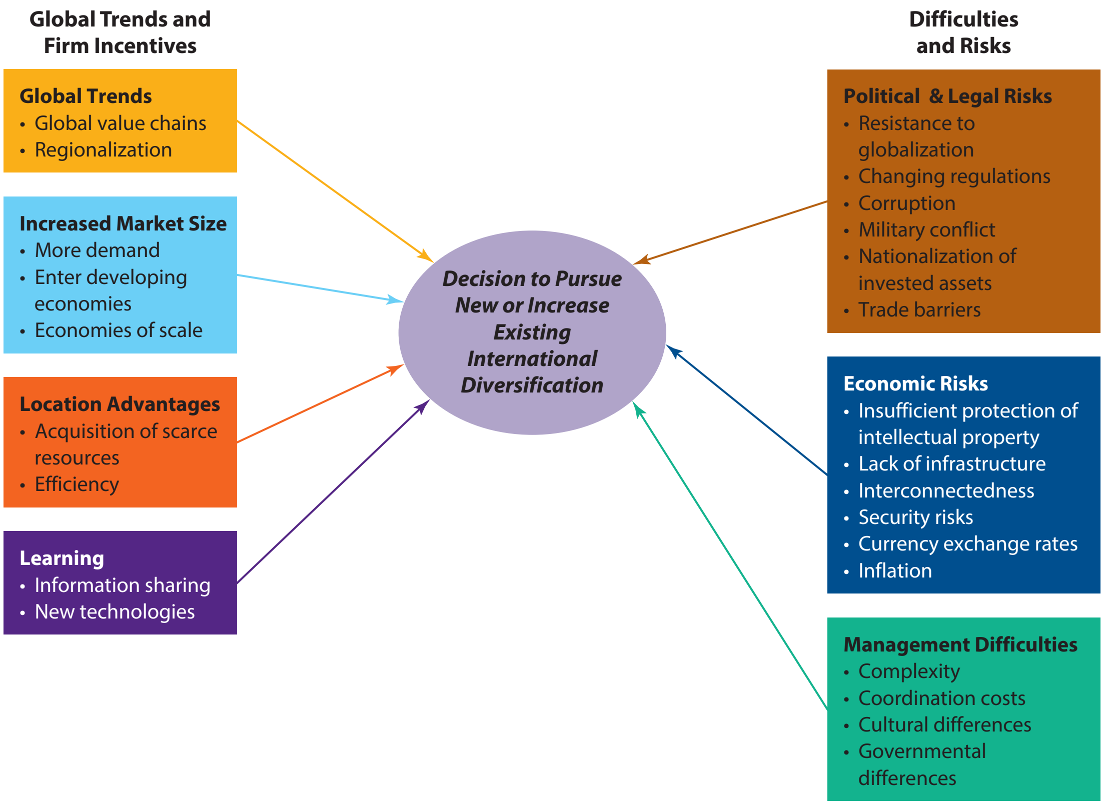
Raymond Vernon expressed the classic rationale for an international strategy.[8] He suggested that typically a firm discovers an innovation in its home-country market, especially in advanced economies such as those in Germany, France, Japan, Sweden, Canada, and the United States. Often demand for the product then develops in other countries, causing a firm to export products from its domestic operations to fulfil demand. Continuing increases in demand can subsequently justify a firm's decision to establish or expand operations outside of its home country, as illustrated in the Opening Case on Tesla.

In Chapter 1, we discussed the global economy and the increasing economic interdependence of countries and their organizations. We also introduced the idea of global supply chains that span multiple countries with the purpose of supplying goods and services.[9] In Chapter 2, we discussed several areas of the global segment of a firm's external environment to include in a strategic analysis. In this section and the one that follows, we will build on the information found in those chapters to explain why a firm may want to pursue or increase its level of international diversification and the risks and problems that often accompany such a decision (see Figure 8.1).

8-1b Global Trends

In Chapter 1, we explained that a *global value chain* is a process through which a firm receives raw materials and supplies from a firm that has the best products available (considering quality and price)—regardless of where in the world they are located—adds value through combining and altering these resources, and sells them to another firm or the ultimate consumer of the product, wherever they are located.[10] It is a set of interrelated activities that involve companies from

Figure 8.1 Forces Encouraging and Discouraging International Expansion



multiple countries, coordinated by a particular firm in search of a competitive advantage. Global value chains are becoming increasingly popular. As a natural extension of coordinating a global value chain, a firm may decide that it would be advantageous to acquire a supplier or a customer to achieve some of the advantages associated with vertical integration, such as having more control over the production process or more information from which to make better decisions.[11] Of course, increasing digitalization and the information systems it supports make coordination of a global value chain a lot more manageable.[12]

Related to increasing digitalization, many of the most important companies in the international economy operate digital platforms that enhance the ability to cross international borders.[13] In fact, researchers found that Chinese exporters that made use of the Alibaba.com business-to-business (B2B) platform had a greater ability to contact foreign buyers, which led to higher export performance.[14]

In addition to global value chains and digital platforms, *regionalization* is a global environmental trend influencing a firm's choice and use of international strategies. This trend is becoming prominent largely because *where* a firm chooses to compete can affect its strategic competitiveness.[15] As a result, the firm considering using international strategies must decide if it should enter individual country markets or if it would be better served by competing in one or more regional markets.

Regionalization makes pursuit of an international diversification reasonable for a larger number of firms. A regional international diversification strategy allows a firm to marshal its resources to compete effectively rather than spreading their limited resources across multiple country-specific international markets. In fact, there is research evidence to suggest that international firms that diversify quickly into countries within a region have higher performance than firms that diversify quickly across regions.[16]

Also, regionalization often helps a firm better understand the cultures, legal and social norms, and other factors that are important for effective competition in those markets. For example, a firm may focus on Asian markets only, rather than competing simultaneously in the Middle East, Europe, and Asia. Or a firm may choose a region of the world where markets share important similarities, making coordination and sharing of resources easier. Firms commonly focus much of their international market entries on countries adjacent to their home country, which might be referred to as their home region.[17]

Countries that develop trade agreements to increase the economic power of their regions may promote regional strategies. The European Union and South America's Organization of American States (OAS) are multi-country associations that developed trade agreements to promote the flow of trade across country boundaries within their respective regions.[18] Many European firms acquire and integrate their businesses in Europe to better coordinate pan-European brands as the European Union tries to create unity across the European markets. This process is likely to continue as new countries are added to the agreement.

The North American Free Trade Agreement (NAFTA), signed by the United States, Canada, and Mexico in 1993, facilitates free trade across country borders in North America. NAFTA loosens restrictions on international strategies within this region and provides greater opportunity for regional international strategies.[19] A revised agreement called the United States-Mexico-Canada Agreement (USMCA) in the United States and the Canada-United States-Mexico Agreement (CUSMA) in Canada, was approved by all three countries in 2020.[20] Many of the provisions are similar to NAFTA; however, the agreement provides more protection for intellectual property, removes barriers to storage of information in a country other than where it originated, and increases environmental and worker regulations.

Most firms enter regional markets sequentially, beginning in markets with which they are more familiar. They also introduce their largest and strongest lines of business into these markets first, followed by other product lines once the initial efforts are deemed successful. The additional product lines typically are introduced in the original investment location.[21] However, research also suggests that the size of the market and industry characteristics can influence this decision.[22]

Regionalization is important to most multinational firms, even those competing in multiple regions across the globe. For example, most large multinational firms have organizational structures that group operations within the same region (across countries) for managing and coordination purposes. Managing businesses by regions helps multinational enterprises deal with the complexities and challenges of operating in multiple international markets.

8-1c Increased Market Size

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Carrefour opened its first hypermarket in France in 1960 and is now the second-largest retailer in the world.

Firms can expand the size of their potential market—sometimes dramatically—by using an international strategy to establish stronger positions in markets outside their home market.[23] This is the case for French-based Carrefour S.A., the world's second-largest retailer (behind Walmart) and the largest retailer in Europe. Carrefour operates five main grocery store formats—hypermarkets, supermarkets, cash and carry, hypercash stores, and convenience stores. The firm also sells products online. Carrefour operates 12,225 stores in 30 countries.[24]

In addition to expanding into developed economies such as Europe or the United States, the potential for large increases in demand for goods and services from people in emerging markets such as China and India is another strong incentive for firms to use an international strategy.[25] According to data from the Bureau of Economic Analysis in the U.S., although about half of the sales from United States, foreign affiliates come from Europe, Asian sales are increasing, and currently account for about 30 percent of sales.[26]

Even though India differs from Western countries in many respects, such as culture, politics, and the precepts of its economic system, it offers a huge potential market, and the Indian government has become more supportive of foreign direct investment.[27] Differences among Chinese, Indian, and Western-style economies and cultures make the successful use of an international strategy challenging. As such, firms seeking to meet customer demands in emerging markets must learn how to manage an array of political and economic risks, which we discuss later in this chapter.[28]

By expanding the number of markets in which they compete, firms may be able to enjoy economies of scale, particularly in manufacturing operations. More broadly, firms able to make continual process improvements enhance their ability to reduce costs while, hopefully, increasing the value their products create for customers.[29] For example, rivals Airbus SE and Boeing have multiple manufacturing facilities and outsource some activities to firms located throughout the world, partly for developing economies of scale as a source of being able to create value for customers. Economies of scale are also a critical component of Costco's business model. Costco buys goods in large quantities at low costs (because of its economies of scale), thus allowing the firm to sell the goods to consumers at lower prices, passing on the savings provided by Costco's purchases.[30]

8-1d Location Advantages

Gaining access to needed and potentially scarce resources is another reason that firms use an international strategy. Key supplies of raw material—especially minerals and energy—are critical to firms' efforts in some industries to manufacture their products. Energy and mining companies have access to the raw materials, through their worldwide operations, which they in turn sell to manufacturers requiring those resources. Rio Tinto Group is a leading international mining corporation originally founded in Spain, but now with dual headquarters in London and Melbourne. Operating as a global organization, the firm has 49,000 employees and operates in 35 countries. Rio Tinto uses its capabilities of technology and innovation (see first incentive noted above), exploration, marketing, and operational processes to identify, extract, and market mineral resources throughout the world.[31]

In industries where labor costs account for a significant portion of a company's expenses, firms may choose to establish facilities in other countries to gain access to less expensive labor. Clothing and electronics manufacturers are examples of firms pursuing an international strategy for this reason.

Locating facilities outside their domestic market can also help firms reduce costs through increased operational efficiency. This benefit of an international strategy accrues to the firm when its facilities in international locations provide easier access to lower energy and other natural resources, in addition to labor. Other location advantages include access to critical supplies and to customers. Once positioned in an attractive location, firms must manage their facilities effectively to gain the full benefit of a location advantage.[32]

As we will discuss in the next section, the influences of cultural and formal country institutions (e.g., laws and regulations) may affect location advantages and disadvantages. International business transactions are easier for a firm to complete when there is a strong cultural match and similar country institutions with which the firm is involved while implementing its international strategy.[33]

8-1e Learning

Operating in multiple international markets also provides firms with new learning opportunities.[34] Knowledge can be transferred from the headquarters of a multinational firm to its international subsidiaries as well as across those subsidiaries and back to headquarters. The multinational firm's learning network expands through international diversification, and since each country provides a different set of environmental and competitive conditions, significant learning can take place.[35] In fact, a multinational firm has the opportunity to conduct "trial and error" experiments within various countries, and then apply what is learned in those countries across business operations in other countries and regions of the world.[36] Also, "unlearning" is important.[37] For example, a multinational firm may believe it has mastered a particular production process, but then discovers that one of its foreign subsidiaries does something even better, so it has to unlearn what it thought it knew so it can improve its own process.

Multinational firms can also pursue joint research and development (R&D) activities to both seek out new discoveries and exploit those discoveries. In fact, research indicates that a balanced program of discovery of new knowledge and exploitation (application) of that knowledge enhances performance in multinational firms.[38] Increasing the firm's R&D ability can contribute to its efforts to enhance innovation, which is critical to both short- and long-term success. However, research results suggest that to take advantage of international R&D investments, firms need to have a strong R&D system already in place to absorb knowledge resulting from effective R&D activities.[39] Also, a multinational firm produces more innovation if it has R&D activities in a moderate number of international regions as compared to many regions (which would be hard to manage) or a single region (which limits opportunities).[40]

Firms may also be able to exploit core competencies in international markets through resource and knowledge sharing between units and network partners across country borders.[41] By sharing resources and knowledge in this manner, firms can learn how to create synergy, which in turn can help each international business unit within the firm learn how to manufacture, sell, or deliver products or services more effectively. For example, research indicates that platform-based payment services (i.e., mobile wallets) are more popular in developing countries like China and India than in Western countries.[42] Consequently, firms that have business units in those countries can develop core competencies in these sorts of payment systems and transfer those competencies to business units in other countries.

The strength of the science base of the international markets in which a firm may compete is important to learning because scientific knowledge and human capital are needed to facilitate efforts to more effectively design, sell, or deliver products that create value for customers.[43] This is one of the reasons that Tesla decided to locate a new design center in Beijing.[44] China was not only Tesla's second-largest market in 2021 (after the United States), but there is significant technical expertise in China that the company can access to enhance the design of its automobiles.

Also, a firm that is engaged in knowledge activities with a high degree of overlap with industry rivals may internationalize their innovations in order to protect them.[45] For example, a firm may be concerned that if they do not introduce a product innovation into a particular country, a rival firm in that country may develop a similar product and beat them to market in that country, making it more difficult to enter the market at a later time.

8-2 Risks Discouraging International Expansion

Learning Objective

8-2 Explain the political, legal, and economic risks that discourage firms from pursuing international strategies.

The dramatic success of Japanese firms such as Toyota and Sony in the United States and other international markets in the 1980s was a powerful jolt to U.S. managers. This success awakened U.S. managers to the importance of international competition and the fact that many markets were rapidly becoming globalized. In the twenty-first century, Brazil, India, and China represent major international market opportunities for firms from many countries, including the United States, Canada, Japan, Korea, and members of the European Union. In addition, emerging economies such as Mexico, Indonesia, Lithuania, United Arab Emirates, and Malaysia have shown rapid growth, Internet penetration, and improving rule of law.[46] However, even if foreign markets seem attractive, there are legitimate concerns for firms considering entering these markets. Mentioned first in Chapter 1 is the *liability of foreignness*, a set of costs associated with various issues firms face when entering foreign markets, including unfamiliar operating environments; economic, administrative, and cultural differences from their home institutional environments; and the challenges of coordination over distances.[47]

Walt Disney Company's experience while opening theme parks in foreign countries demonstrates the liability of foreignness. For example, Disney suffered "lawsuits in France, at Disneyland Paris, because of the lack of fit between its transferred personnel policies and the French employees charged to enact them."[48] Disney executives learned from this experience and from building the firm's theme park in Hong Kong, and the company "went out of its way to tailor the park to local tastes."[49] The following sections explain in more depth many of the risks and problems firms face in their international expansions due to the liability of foreignness (see right side of Figure 8.1).

8-2a Political and Legal Risks

Political risks come from the probability that the operations of multinational firms will be disrupted by political forces or political events that occur within their home countries or in one or more of their host countries.[50] Closely related to political risks, *legal risks* stem from inadequate legal legislation or enforcement to protect a firms operations or assets.[51] For example, legal risks are higher when a country has inadequate legislation regarding contracts or if it is hard to enforce contracts when breaches occur.[52] Often a country that is less politically stable would also have a less well-established (and enforced) legal system.

A global movement against globalization, especially in advanced economies, has a large impact on the risk factors described in this section.[53] "There is mounting evidence of a widespread popular backlash against globalization in advanced economies, which can hurt multinational companies' (MNCs) interests."[54] Both growing ideological divisions and populism in societies are driving this trend, called *deglobalization*.[55] In fact, consumers sometimes hold lower perceptions of products produced in a country other than their own simply because they have hostile feelings about that country.[56] For example, in 2012, there was an anti-Japanese social movement in China that made it difficult for Japanese companies to sell products there.[57] Anti-globalization forces can also prevent the transfer of technological knowledge across international borders and restrict the free movement of engineers and scientists.[58] The risks of interconnectedness in global supply chains, discussed in Chapter 1, are also helping to drive the deglobalization movement.

Possible disruptions to a firm's operations when seeking to implement its international strategy create numerous problems, including uncertainty created by government regulation; the existence of many, possibly conflicting, legal authorities or corruption; and the potential nationalization of private assets (e.g., when a government takes control of those assets).[59] Firms investing in other countries, when implementing their international strategies, may have concerns about the stability of the national government and the effects of unrest and government instability on their investments or assets.[60] In fact, government stability and political risk have been found to be related to the amount of a foreign direct investment coming into a country.[61] Research also suggests that political risk in one country often spreads to others, as in the Arab Spring revolutions among many Middle Eastern countries.[62]

Russia provides a noteworthy example of a country with a high level of political and legal instability in the years following the collapse of the Iron Curtain. To regain more central control and reduce the decentralized chaos, Russian leaders have taken actions such as prosecuting powerful private firm executives, seeking to gain state control of firm assets, and not approving some foreign acquisitions of Russian businesses. The initial institutional instability, followed by the actions of the central government, caused some firms to delay or avoid significant foreign direct investment in Russia. The riskiness of the situation worsened when Russia took the Crimean Peninsula from Ukraine. These were all strong signals to firms considering international diversification into Russia; however, the enormity of the market and the thirst of the Russian people for Western products led many firms to make huge investments in the country.

When Russia invaded Ukraine, McDonalds, Volkswagen, Toyota, Goldman Sachs, Apple, and many other companies ceased their operations in Russia.[63] In response, Russian prosecutors issued warnings to Western companies with operations in Russia, "threatening to arrest corporate leaders there who criticize the government or to seize assets of companies that withdraw from the country, according to people familiar with the matter."[64] Shortly thereafter, "Moscow claimed that almost 800 commercial aircraft have already been re-registered from Bermuda and Ireland into its own aeronautical records—implying it has appropriated them—in response to the European Union requiring lessors to terminate contracts with Russian airlines by March 28."[65]

As a more subtle example of how political and legal risk can influence the success of international diversification, we can look at the potential effect of changing trade barriers (i.e., tariffs) on risk for an industry such as the global delivery business. This service industry has been booming in the last few years, primarily because of the significant increase in online sales. However, global delivery companies also face some unusual economic risks and uncertainties due to changes in tariffs and restrictions on international trade. For example, in 2018, the U.S. government implemented tariffs on specific goods imported from European countries, Canada, Mexico, and China. In response, the European Union, Canada, China, and Mexico all instituted tariffs on specific goods imported into their countries from the United States. If a major trade war breaks out, the gross domestic product (GDP) of each country is likely to decline.[66] In other words, no country is likely to come out of a trade war as a winner (based on the outcomes of past trade wars). If economies decline, the demand for delivery services will also decline.

To deal with these concerns, firms should conduct a political and legal risk analysis of the countries or regions they may enter. Through this sort of analysis, the firm examines potential sources and factors of noncommercial disruptions of their foreign investments and the operations flowing from them.[67]

8-2b Economic Risks

Economic risks include fundamental weaknesses in a country or region's economy with the potential to cause adverse effects on firms' efforts to successfully implement their international strategies.[68] As illustrated in the example of Russian instability, political risks and economic risks are interdependent. That is, a stable political system is needed to sustain a stable and healthy economic system.

Insufficient protection of intellectual property is a major economic challenge in countries that do not have and enforce such legislation. If firms cannot protect their intellectual property, they are highly unlikely to use a means of entering a foreign market that involves significant and direct investments. Therefore, countries need to create, sustain, and enforce strong intellectual property rights to attract foreign direct investment.[69] The revised version of NAFTA—the USMCA—is intended to address this issue. Again, we see the interconnectedness of political risk and economic risk—the USMCA is a politically derived document.

In emerging economies, another significant economic risk is the lack of availability of important infrastructure to allow companies to conduct their business efficiently. For example, miners need sufficient electrical power in national grids to meet their power usage requirements. Often, inefficient, state-owned electric power producers are forced to run intermittent blackouts, which is devastating for continuous process manufacturing and refining such as found in the mining industry. South Africa used to have a reliable electrical power grid. However, the state-owned electrical utility, Eskom Holdings Ltd., neglected to build new power plants and sufficiently maintain current operating generating plants. As such, intermittent power outages have occurred, lasting up to 12 hours, resulting in significant productivity decreases in the mining industry, which produces 60 percent of South Africa's exports. As this example suggests, infrastructure can be a significant economic risk in emerging or partially developed economies such as South Africa.[70]

The interconnectedness of operations across international borders can also cause significant problems for multinational firms.[71] Previously, we discussed global value chains as a benefit of internationalization; however, they also increase risk because something that happens in another country in which a firm operates can have a large impact on an entire value chain. For this reason, Volkswagen is rethinking globalization and changing its approach to manufacturing. The company is pursuing "strategies to shore up access to components and raw materials and shorted supply chains to make its regional businesses less dependent on far away suppliers, according to senior executives at the company."[72]

Another economic risk is the perceived security risk of a foreign firm acquiring companies that have rare natural resources or may be considered strategic regarding intellectual property. For instance, many Chinese firms have been buying natural resource firms in Australia and Latin America, as well as manufacturing assets in the United States. This has made the governments where the acquired firms are located concerned about such strategic assets falling under the control of state-owned Chinese firms.[73] Terrorism is also a security risk, and it can lead a company to resist entering a country. For example, terrorism has had a negative effect on foreign direct investment (FDI) into Pakistan.[74] In addition, digitalization, despite its benefits, has brought risks of its own. These risks come primarily from three sources: information security, digital interdependence, and regulatory complexity.[75]

As noted previously, the differences and fluctuations in the value of currencies is among the foremost economic risks of using an international strategy.[76] This is especially true as the level of the firm's geographic diversification increases to the point where the firm is trading in many currencies. The value of the dollar relative to other currencies can affect the value of the international assets and earnings of U.S. firms. For example, an increase in the value of the U.S. dollar can reduce the value of U.S. multinational firms' international assets and earnings in other countries.

Furthermore, the value of different currencies can, at times, dramatically affect a firm's competitiveness in global markets because of its effect on the prices of goods manufactured in different countries. An increase in the value of the dollar can harm U.S. firms' exports to international markets because of the price differential of the products. Currency value can be affected by the institution of tariffs and trade wars, as experienced recently in the United States and China. Also, the concerns about the tariffs implemented can affect the amount of foreign firm's investment even in developed economies (e.g., Western European countries).[77] Thus, government oversight and control of economic and financial capital, as well as corporate governance rules in a country, affect not only local economic activity, but also foreign investments in the country.[78]

8-3 Common Management Problems for Multinational Firms

Learning Objective

8-3 Describe the common management problems multinational firms experience.

Pursuing an international diversification strategy typically leads to growth in a firm's size and the complexity of its operations. In turn, larger size and greater operational complexity make a firm more difficult to manage.[79] In general, it becomes increasingly difficult to effectively implement, manage, and control a firm's international operations with increases in geographic diversity.[80] Consider the coordination costs associated with managing activities across a wide range of countries, as opposed to managing those same activities within a single country. Consequently, for an international diversification strategy to increase the performance of the multinational firm overall, the benefits discussed in the last section must outweigh the additional coordination costs.

Different cultures across countries in which a firm competes can also create management difficulties.[81] For example, researchers found that workplace flexibility is much more important to employees of multinationals who are working in the United States compared to those working in China.[82] Cultural factors can be strong barriers to the transfer of a firm's core competencies from one market to another.[83] Consequently, it is important for managers to work on integrating the social aspects of their business units across countries so that people will be willing to share knowledge.[84]

Differences in culture also relate to the importance of corporate social responsibility (CSR) and sustainability in different countries.[85] The citizens of some countries are very environmentally conscious, which results also in government legislation that is strict regarding things like carbon emissions and other types of pollution. There also tends to be a lot of variation across countries concerning factors associated with human rights (i.e., child labor, decent working conditions, freedom). These sorts of differences make management difficult. For example, firms are often held accountable not only for their own local operations, but for the business practices of foreign suppliers with whom they do business.[86] Such accountability means that managers in the home country must be aware of what their suppliers are doing, and aware of differences across countries concerning what is considered acceptable business practice.

The relationships between the firm using an international strategy and the governments in the countries in which the firm is competing can also create management difficulties because differences in host countries' governmental policies and practices can be substantial, creating a need for the focal firm to learn how to manage what can be a large set of different enforcement policies and practices.[87] Also, sometimes legislation is passed that regulates how a nation's firms must conduct business in host countries. For example, the Foreign Corrupt Practices Act, enacted by the U.S. Congress in 1977, prohibits bribery and requires companies to maintain accurate records of transactions when they are operating in other countries.[88] U.S. executives have often complained that this legislation puts U.S. companies at a competitive disadvantage when operating in a country in which bribery is the norm.

As a result of these management problems, multinationals often locate operations in friendly countries that are geographically close and have cultures and government systems more like what is found in their home country (e.g., regionalization). In that case, the firm is likely to encounter fewer trade barriers, the laws and customs are better understood, and the product is easier to adapt to local markets.[89] For example, U.S. firms may find it less difficult to expand their operations into Mexico, Canada, and Western European countries than into Asian countries. The next section goes into greater detail regarding how to select a country for international diversification.

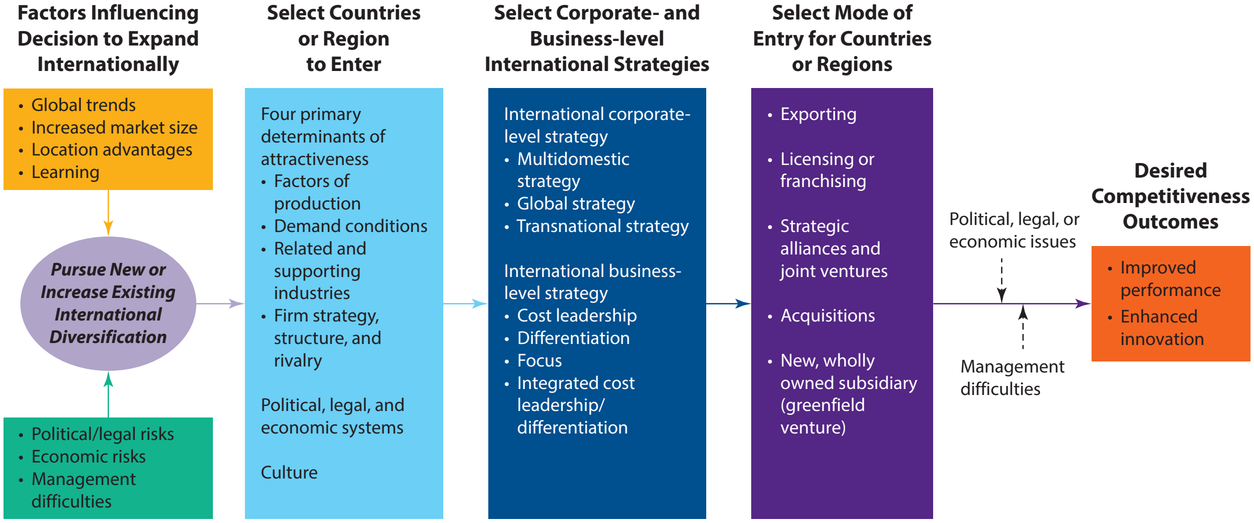
Learning Objective

8-4 Explain what a firm should consider when deciding whether to enter an international market.

8-4 Considerations for International Entry

Once a firm has decided to pursue an international diversification strategy or increase the geographic diversity of its current strategy through entering new countries, the next important decision is the selection of new countries to enter (see Figure 8.2). Variations in the political, legal, economic, social, and competitive environments make each country unique, so selecting the right countries for entry is a challenging task.[90] The Strategic Focus describes Israel as a potential country in which to do business. Israel is unique in that its lack of abundance of natural resources has been more than made up for by its culture and its highly trained and motivated workforce.

Figure 8.2 Opportunities and Outcomes of International Strategy



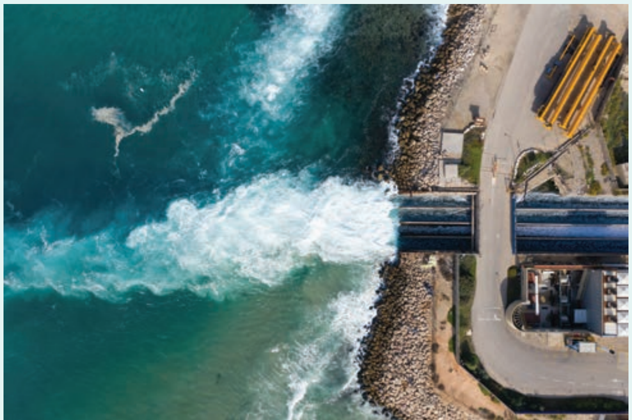
Strategic **Focus**

Israel's Extraordinary Business Success

Israel in its modern form is a relatively young nation. The General Assembly of the United Nations accepted Israel as a nation in 1947. However, due to internal conflict and resistance on the part of the British to withdraw from this occupied territory, it took another year for this nation to finally become a reality. After years of intense fighting to gain political independence, Israel had very few resources with which to build an economy. Unlike its close neighbors, Israel doesn't have vast reserves of oil. Only recently has Israel produced meaningful amounts of oil from wells dug into the ocean floor. Water is scarce. Most of the country is desert and the Sea of Galilee, the only noteworthy body of fresh water in Israel, eventually began to dry up.

Several times since its creation, the modern state of Israel has had to defend itself against hostile neighbors. One of the most noteworthy battles is known as the Six Day War, in which Israel foiled an attack by a coalition of Arab states including Jordan, Syria, and Egypt in just six days in 1967. This was not the last of Israel's military struggles. Its enemies, both foreign and domestic, frequently fire missiles at Israel from outside the country or engage in terrorism within the country. Israel is so used to these sorts of attacks that the country doesn't "shut down" when one occurs—people continue to go to work, children go to school, and businesses stay open.

Given all these hardships, and the lack of natural resources, Israel's business success is nothing short of miraculous. The country's scientists have made numerous important contributions to physics, chemistry, optics, medicine, economics, biotechnology, and computer science. One of the most important innovations, at least for Israel with its limited water, is drip irrigation. Israel has also planted millions of trees and gained competence with water desalinization to deal with its water shortage. Intel has a major research and development unit in Israel, as do many other high-tech firms. The Waze app was created there—so were cherry tomatoes and many other popular products.



Luciano Santandreu/Shutterstock.com

Ariel view of the world's largest water desalination facility in Hadera, Israel.

How has Israel been able to thrive under such hostile conditions? Perhaps most importantly, Israelis of all genders are required to serve in the military when they turn 18, and men are on reserve status with the military for many years after their active service. This service is voluntary for Arabs within the country, and some exceptions exist based on religious grounds. Everyone else serves. This service has produced competitive advantages for Israel. First, military training includes technical training, which means that Israelis are highly qualified to work in technical jobs when they are released from active service. Second, the social network that is created as people serve in the military lasts throughout their lifetimes. This social network makes it much easier to conduct business in Israel. In addition, Israel has made massive investments in education. Also, the country embraces a hard working, "can do," innovative culture that fosters an entrepreneurial spirit. From a very early age, children are taught that they can overcome obstacles and be successful in life and in business. The hardships Israel experiences have created a mind-set of finding creative solutions to overcome problems.

Despite all the military conflicts, the political system in Israel is democratic and stable. Because so many people have migrated to Israel from such a wide variety of countries and cultures, the population is diverse, which may also partially account for the high level of innovation in the country. Real Gross Domestic Product (GDP) contracted approximately 5 percent in 2020 due to restrictions related to COVID-19 but rebounded by over 5 percent in 2021. Israel's strong pharmaceuticals and information technology sectors, as well as the diversity of the nation's businesses, make Israel's economy very resilient to shocks like the pandemic.

Israel has continued to attract a lot of investment, especially in the tech sector. In 2021, Israeli tech companies raised $25.6 billion in private investments, a new record. This included 773 deals, with 77 of these deals attracting more than $100 million in funding. Several of the largest deals were orchestrated by SoftBank, a Japanese multinational conglomerate. There is no sign that the investment market is calming down. In early 2022, the *Wall Street Journal* reported that a United Arab Emirates sovereign-wealth fund had recently invested approximately $100 million in venture capital into Israel's technology sector. Also, Intel agreed to buy Israeli chip maker Tower Semiconductor for just under $6 billion as a part of its plan to make chips for other companies.

Sources: R. Jones & D. Lieber, 2022, U.A.E. just invested $100 million in Israel's tech sector as both countries get closer, *Wall Street Journal*, www.wsj.com, January 14; D. Cimilluca & C. Lombardo, 2022, Intel agrees to $6 billion deal to buy Tower Semiconductor, *Wall Street Journal*, www.wsj.com, February 15; R. Ben-David, 2022, Israeli tech companies raised $25.6 billion in 'extraordinary' 2021 report, *The Times of Israel*, www.timesofisrael.com, January 3; 2021, The Israel-Palestine conflict has claimed 14,000 lives since 1987, *The Economist*, www.economist.com, May 18, 2021, *Political Risk Yearbook: Israel Country Report*, Liverpool, NY, PRS Group; 2020, *Country/Territory Report*, London, IHS Markit Ltd.; S. Senor & S. Singer, 2009, *Start-up Nation: The Story of Israel's Economic Miracle*, New York, Hachette Book Group; L. Collins & D. Lapierre, 1972, *O Jerusalem: Day by Day and Minute by Minute the Historic Struggle for Jerusalem and the Birth of Israel*, New York, Simon & Schuster.

8-4a Four Primary Determinants of Attractiveness

Michael Porter conducted an analysis of why some nations are more competitive than other nations and why some industries within particular nations are more competitive relative to those industries in other nations. As Porter put it, "How can we explain why Germany is the home base for so many of the world's leading makers of printing presses, luxury cars, and chemicals? Why is Switzerland the home base for international leaders in pharmaceuticals, chocolate, and trading? Why are leaders in heavy trucks and mining equipment based in Sweden? Why has America produced the preeminent international competitors in personal computers, software, credit cards, and movies?"[91] Porter's findings fall into four broad categories: factors of production, demand conditions, related and supporting industries, and firm strategy, structure and rivalry. While global supply chains, advanced digital technologies and communications, international joint ventures, outsourcing, and global platforms have leveled the competitive playing field a lot across countries, the four determinants of national advantage are still highly relevant to help firms determine whether a country is a good candidate for entry.

Factors of production refer to the inputs necessary for a firm to compete in any industry.[92] Labor, land, natural resources, capital, and infrastructure (transportation, delivery, and communication systems) represent such inputs. There are basic factors (natural and labor resources) and advanced factors (digital communication systems and a highly educated workforce). Other factors of production are generalized (supply of capital available through the country's financial system and infrastructure items such as highway systems) and specialized (skilled personnel in a specific industry, such as the workers in a port that specialize in handling bulk chemicals). Before entering a country for the first time, a firm should assess the extent to which necessary resources are readily available.

The second factor, demand conditions, is characterized by the nature and size of customers' needs for the products the firm intends to produce. If a lot of customers are likely to purchase the product the entering firm creates, it will be able to develop scale-efficient facilities and enhance the capabilities, and perhaps core competencies, required to use those facilities.[93]

The third factor in Porter's model is related and supporting industries. For example, Italy is a leader in the production of high-quality shoes because a well-established leather-processing industry provides the leather needed to construct shoes and related products. Auto parts suppliers are a huge factor in the success of Japanese automakers, especially in Japan. Suppliers cluster around Toyota's factories, providing fast delivery times and an opportunity to work together with Toyota in ensuring the quality and attractiveness of its automobiles. A firm considering entering a country should carefully assess the strength of the industries from which it intends to acquire needed materials and technology.

Firm strategy, structure, and rivalry make up the final of the four factors. The types of strategy, structure, and rivalry among firms vary greatly from nation to nation. The excellent technical training system in Germany fosters a strong emphasis on continuous product and process improvements. In the United States, competition among computer manufacturers and software producers in the San Francisco area (e.g., Silicon Valley) contributes to further development of these industries.[94] In general, more rivalry leads to products that are attractive to customers, which enhances the competitiveness of firms in foreign markets. Nonetheless, if the rivalry in a particular industry within a country is particularly strong already, this could be a deterrent to entry because the entering company could have a hard time catching up to existing competitors. In this regard, Tesla's strategy in Germany is very interesting (see Opening Case). Tesla is entering an industry with very high rivalry among existing German auto manufacturers; however, Tesla is entering this market with a high-end product with which it already has a distinctive competency (e.g., electric vehicles).

Notice that the emphasis in this discussion is on manufacturing, which is consistent with Porter's original study. However, these four factors are still relevant for service industries—they can be adjusted so that they are useful to determining whether a country is an attractive place to offer services as well as products. Some of the factors of production are not as applicable, but the other factors can be just as important to providing services as they are to manufacturing.

8-4b Political, Legal, and Economic Systems

The success of all types of entries into new international markets, whether they are product or service oriented, are also subject to the strength and stability of a country's formal institutions, which include government regulatory bodies and the legal community. Policies of individual governments affect the nature of competition in a country; for example, they establish "the rules of the game." Some governments are especially hard on foreign firms entering their countries, making it difficult to compete. The legal community is also an important determinant of the attractiveness of a country for business. To what extent can a firm protect itself against unlawful actions or seek redress if another firm or individual does something harmful? Is contract law well defined and upheld in the courts?

As is evident from our discussion of political, legal and economic risks earlier in this chapter, firms should carefully examine these dimensions before entering a new country or region. Some countries have a very stable political system. Others are a lot less stable. In addition to Russia, there is also political instability in many countries in Central and South America, Asia, and Africa. These countries may offer huge market potential, but they also offer a level of risk that is not attractive for many firms. Research indicates that firms that diversify into countries that have regulatory environments similar to countries in which they have already expanded are much more likely to succeed.[95]

Beyond these formal institutions, perhaps the most obvious factor to consider is the strength of a country's economy. Firms should evaluate factors such as growth in gross national product (basic and per capita), the rate of inflation, the average income and distribution of income of citizens (to determine buying power), and movement in exchange rates between the home country's currency and the currency of the country under consideration. This latter subject is especially important if the firm intends to extract income from the country (as opposed to reinvesting it). According to a very broad-based survey of 20,000 citizens from four regions of the world, the most economically stable countries are Switzerland, Canada, Germany, Denmark, and Japan, in that order. Although it is the largest economy in the world, the United States ranked 15th.[96]

8-4c Culture

Previously, we discussed how variations in culture across countries makes management more difficult, and thus, increases the risk associated with international expansion. Here, we continue this discussion by considering culture, and in particular the cultural differences between the home country and the host country, as a factor to consider before entering a country. *Cultural distance* is the term used to describe differences in shared norms across cultures.[97] Included are dimensions such as the extent to which people avoid risk, whether they are more individualistic or collectivist in the way they think and act, and whether they are more short-term or long-term oriented. Beyond these more formal designations are differences in what behavior is considered acceptable, attitudes about diversity and inclusion, religious differences, language differences, differences in educational levels, and many other factors.

If two countries are culturally distant, it is harder to transfer managers and employees from the home country to the host country or the other way around. They may find it difficult to assimilate, and they may also experience differences in relating to, communicating with, or managing other people in the business or in the neighborhood in which they live. Similarly, there is a high likelihood that communications from the home office will be misunderstood, or that company-wide programs will be misapplied.[98] Also, it is often difficult to sell products when cultural barriers exist unless a high level of autonomy is given to the host country managers as to how the product will be tailored and marketed.[99] Research suggests that managers with a lot of international experience can help a firm overcome some of the negative effects from cultural distance.[100]

These are all issues to examine before deciding whether to enter a country. They can also help a firm decide how to enter a country—whether through building a manufacturing facility on its own, establishing a strategic alliance with a firm already doing business in the country, or in some other way. Entry methods will be explored in more depth later in this chapter.

8-5 International Corporate-Level Strategies

Learning Objective

8-5 Describe the three international corporate-level strategies.

Managers of a multinational firm must make decisions about the firm's corporate-level international strategy and its business-level international strategy (see Figure 8.2). At the corporate level, multidomestic, global, and transnational international strategies are considered. At the business level, firms select from among the generic strategies of cost leadership, differentiation, focused cost leadership, focused differentiation, and integrated cost leadership/differentiation. To contribute to the firm's efforts to achieve strategic competitiveness in the form of improved performance and enhanced innovation, international strategies should be based on one or more of the firm's core competencies.[101]

8-5a International Corporate-Level Strategies

A firm's international corporate-level strategy determines the amount of management independence business units in host countries are given. The headquarters unit guides strategy; however, country-level managers can have substantial strategic input depending on the type of international corporate-level strategy the firm uses. The three international corporate-level strategies are shown in Figure 8.3; they vary in terms of two dimensions—the need for global integration and the need for local responsiveness.[102]

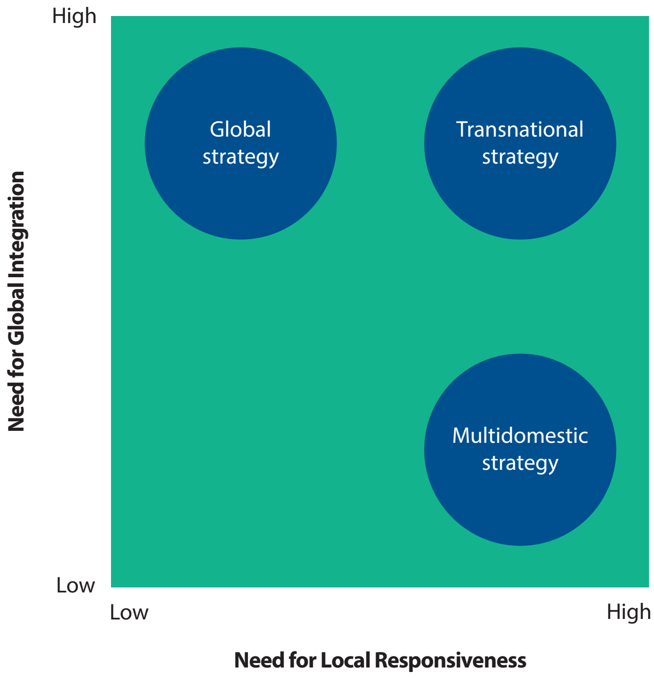
Multidomestic Strategy

A **multidomestic strategy** is an international strategy in which strategic and operating decisions are decentralized to the business units within individual countries or regions, allowing each unit the opportunity to tailor products to the local market.

A **multidomestic strategy** is an international strategy in which most strategic and operating decisions are decentralized to the business units within individual countries or regions, allowing each unit the opportunity to tailor products to the local market.[103] With this strategy, the firm's need for local responsiveness is high while its need for global integration is low. Influencing these needs is the firm's belief that consumer needs and desires, industry conditions (e.g., the number and type of competitors), political and legal structures, and social norms vary significantly by country. Thus, a multidomestic strategy focuses on competition within each country because market needs are thought to be segmented by country boundaries. To meet the specific needs and preferences of local customers, country or regional managers have the autonomy to customize the firm's products. Therefore, these strategies should maximize a firm's competitive response to the idiosyncratic requirements of each market.[104]

The use of multidomestic strategies can help a firm expand its local market share in host countries because the firm focuses its attention on the local clientele's needs. Nestlé, the Swiss food and beverage company, owns more than 2,000 brands. "They sell in over 186 countries, each with its selection of brands curated to match local preferences."[105] Because of this matching of brand portfolios to the needs and tastes of individual markets, Nestlé is pursuing a multidomestic strategy.

Figure 8.3 International Corporate-Level Strategies



Despite the benefits, using a multidomestic strategy results in less knowledge sharing for the corporation as a whole because of the differences across markets, decentralization, and the different international business-level strategies employed by local units.[106] Moreover, multidomestic strategies do not allow the development of economies of scale and thus can lead to higher costs.

Global Strategy

A **global strategy** is an international strategy in which a firm's home office determines the strategies that business units are to use in each country or region.[107] This strategy is most appropriate when a firm has a high need for global integration and a low need for local responsiveness. These needs indicate that, compared to a multidomestic strategy, a global strategy seeks greater levels of standardization of products across country markets.

A **global strategy** is an international strategy in which a firm's home office determines the strategies that business units are to use in each country or region.

The firm using a global strategy seeks to develop economies of scale as it produces the same, or largely the same, products for distribution to customers throughout the world. The assumption is that these customers have similar needs and tastes. Consequently, a global strategy is most effective when the differences between markets and the customers the firm is serving are insignificant. The global strategy offers greater opportunities to take innovations developed in one market and apply them in other markets.[108]

Efficient operations are required to successfully implement a global strategy. Increasing the efficiency of a firm's international operations mandates resource sharing and greater coordination and cooperation across market boundaries. Centralized decision making as designed by headquarters details how resources are to be shared and coordinated across markets. Research results suggest that the outcomes a firm achieves by using a global strategy become more desirable when the strategy is used in areas in which regional integration among countries is occurring.[109]

As illustrated in the Strategic Focus, IKEA has implemented the global strategy. IKEA uses a standardized set of products worldwide and has centralized several of its activities, including design and packaging. Accordingly, it integrates and centralizes some support functions from the firm's value chain (see Chapter 3). This integration and centralization foster economies of scale benefiting IKEA. Alternatively, IKEA is having to implement changes because of increasing digitalization and urbanization. As future growth may come largely from these types of sales, it has increased its online sales and continues to invest in the technology needed. It also has developed smaller and more specialized stores in the urban parts of cities, catering to new customers.

Because of increasing global competition and the need to simultaneously be cost efficient and produce differentiated products, the number of firms using a hybrid strategy—a transnational corporate-level strategy—is increasing.

Transnational Strategy

A **transnational strategy** is an international strategy through which a firm seeks to balance global efficiency and local responsiveness.[110] To overcome cultural barriers in the sale of products in the host country, a firm can use marketing and product features to increase the perception among consumers that their brand is local, or at least more local than global.[111] However, realizing the twin goals of global integration and local responsiveness is difficult because global integration requires close global coordination while local responsiveness requires local flexibility. "Flexible coordination"—building a shared vision and individual commitment through an integrated network—is required to implement the transnational strategy. Such integrated networks allow a firm to manage its connections with customers, suppliers, partners, and other parties efficiently.[112]

A **transnational strategy** is an international strategy through which the firm seeks to achieve both global efficiency and local responsiveness.

Transnational strategies are becoming increasingly necessary to successfully compete in international markets. Reasons for this include the continuing increases in the number of viable global competitors that challenge firms to reduce their costs. Simultaneously, the increasing sophistication of markets with greater information flows, made possible largely by the diffusion of the Internet and the desire for specialized products to meet consumers' unique needs, pressures firms to differentiate their products in local markets. Differences in culture and institutional environments also require firms to adapt their products and approaches to local environments.

Mondelēz International was created as a spin-off company from Kraft, which separated its domestic grocery products to focus on its high-growth snack foods business. Mondelēz had over $28 billion in revenue in 2021 and about 70,000 employees; it has power brands (brands that are globally known and respected) and local brands.[113] Because it globally integrates its operations to standardize and maintain its power brands while simultaneously developing and marketing

Strategic **Focus**

IKEA's International Strategy

Founded in Sweden, IKEA pursues a global strategy based on developing well-designed, inexpensive furniture displayed in vast, maze-like showrooms. Much of its furniture is assembled at home by customers. As with most companies pursuing a global strategy, IKEA emphasizes global efficiencies. The company continues to grow, with stores in 60 countries and counting.

One approach that IKEA has used to increase efficiency is to reduce shipping weight by efficient packaging. Standardization of the product offerings, efficient packaging, and the associated benefit of lower transportation costs are "at the heart of IKEA's ability to stay affordable." "Instead of changing products once they have hit shelves, IKEA is increasingly designing things with packaging and manufacturing in mind from the start." This also means that assembling IKEA products at home may be complicated; however, some behavioral economists believe this is actually a part of why IKEA is successful. Dubbed the IKEA Effect, "The basic idea is that after we devote effort to something, we have more positive feelings toward it; we become attached."

The number of visitors to IKEA stores is no longer increasing, so the firm is ramping up its focus on online shopping. IKEA is expanding this strategy by increasing its "click-and-collect merchandising approach where people order online and pick up the merchandise at a physical location." Also, because of increased urbanization, IKEA is developing smaller city-center stores with a lower range of products compared to its majority of suburban store locations. A store in Madrid offers only bedroom furnishings, while another one in Stockholm specializes in kitchen furniture and fixtures. IKEA is also experimenting with new store formats, "A renovation in China and new opening in Austria are designed to make customers want to linger, rather than pace toward the checkout." In Shanghai, IKEA has a store with a large space with comfortable seating where people can congregate, as well as a restaurant that features sustainable food practices and a workshop where people can repair old items or build new ones.

Although IKEA is focused on efficiency, it also invests a significant amount of time studying each new country it enters. It focuses on where a growing middle class is developing. Consequently, IKEA has entered China, India, and many South American countries. Even in these countries, IKEA is focusing on flat packing, efficient transportation, and customer assembly of its Swedish-styled furniture.

One of IKEA's latest strategies to improve its image is to develop a sounder approach to sustainability. Accordingly, its store roofs are outfitted with solar panels, and it operates wind turbines in many countries, with the goal of eventually becoming energy independent. With its multiple actions to enhance sustainability, IKEA expects to be perceived as a socially and environmentally responsible company. These costs have reduced its operating income in the short term, yet they should lower overall costs in the longer term.

Like most companies, the COVID-19 pandemic had a negative effect on IKEA's performance, which extended into 2021 because of global supply-chain difficulties. IKEA Group's fiscal year sales in 2021 were 25.6 billion euros, up slightly from 23.6 billion euros in fiscal year 2020; however, net income declined over 17 percent during the same period, and "the biggest cause was the steep increase in transport and raw material prices in the second half of the year." Although franchise fees and wholesale sales of IKEA products increased during the year, the global transportation crisis made it very difficult for the company to keep its IKEA stores well stocked.

Fishman64/Shutterstock.com

Interior shot of one of the many IKEA cafes throughout all the chain stores.

Sources: 2022, *Inter IKEA Group Financial Summary*, Delft, Netherlands, Inter IKEA Systems B.V.; T. Moss, 2021, IKEA struggles to stock shelves amid supply-chain woes, *Wall Street Journal*, www.wsj.com, October 14; K. Deighton, 2021, IKEA tests new store formats that free shoppers from the maze of aisles, *Wall Street Journal*, www.wsj.com, April 24; D. Ariely, 2021, The power of the "IKEA effect," *Wall Street Journal*, www.wsj.com, July 1; J. R. Hagerty, 2018, Ingvar Kamprad made IKEA a global retailer by keeping it simple, *Wall Street Journal*, https://www.wsj.com, February 2; R. Milne, 2018, What will Ikea build next? *Financial Times*, https://www.ft.com, January 31; C. Matlack, 2018, The tiny Ikea of the future, without meatballs of showroom mazes, *Bloomberg News*, https://www/Bloomberg.com, January 10; R. Milne, 2017, Ikea moves focus to center city stores, *Financial Times*, https://www.ft.com, November 28; T. Gillies, 2017, Ikea's strategy: Stick to the basics, and expand in the US, *CNBC*, www.cnbc.com, January 16; S. Chaudhury, 2015, IKEA's favorite design idea: Shrink the box, *Wall Street Journal*, June 18: B10; B. Kowitt, 2015, How IKEA took over the world, *Fortune*, www.fortune.com, March 13.

local brands that are specialized to meet the needs of local customers, Mondelēz pursues the transnational strategy. It is a global market leader in biscuits, chocolate, candy, and powdered beverages, and it is also strong in chewing gum and coffee. Almost half of its sales come from fast-growing, emerging markets and with the variety of brands offered, so it must adjust its strategy accordingly.

Some large multinational firms with diverse products use a multidomestic strategy with certain product lines and a global strategy with others. Many multinational firms may require this type of flexibility if they are to be strategically competitive, in part due to trends that change over time.

Mondalez International.PNG

Pictured above are many of the international brands that Mondelēz manages globally while implementing the transnational strategy.

8-5b International Business-Level Strategies

A firm's international business-level strategy is based, to some degree, on its international corporate-level strategy. Some international corporate-level strategies give individual country units the authority to develop their own business-level strategies, while others dictate the business-level strategies to standardize the firm's products and sharing of resources across countries.[114] The former situation typically goes along with a multidomestic corporate-level strategy, while the latter tends to occur when a multinational firm is pursuing a global corporate-level strategy. Consequently, it is possible for a multinational firm to have multiple different business-level strategies operating within various business units in particular countries. A multinational firm could have a business unit pursuing cost leadership in one country, differentiation in another, focus in another, and an integrated cost leadership/differentiation strategy in all the rest of the countries.

As we know from the discussion of competitive dynamics in Chapter 5, firms do not select and then use strategies in isolation of market realities. In the case of international strategies, conditions in a firm's domestic market affect the degree to which the firm can build on capabilities and core competencies it has established to create capabilities and core competencies in business units in international markets. Of course, conditions in the host country are just as critical in determining a business-level strategy. Firms need to carefully examine competition in a host country and determine not only what the generic business-level strategy will be, but also what its competitive tactics will be. The four primary determinants of country attractiveness—as well as the political, legal, economic, and cultural realities of the host country—help in determining which strategies and tactics to use.

8-6 Choice of Entry Mode for an International Market

Learning Objective

8-6 Identify and explain the five modes firms use to enter international markets.

Five modes of entry into international markets are available to firms.[115] We show these entry modes and their characteristics in Figure 8.4. Each means of market entry has its advantages and disadvantages, suggesting that the choice of entry mode can affect the degree of success the firm achieves by implementing an international strategy.[116] Many firms competing in multiple markets may use one or more or all five entry modes.[117]

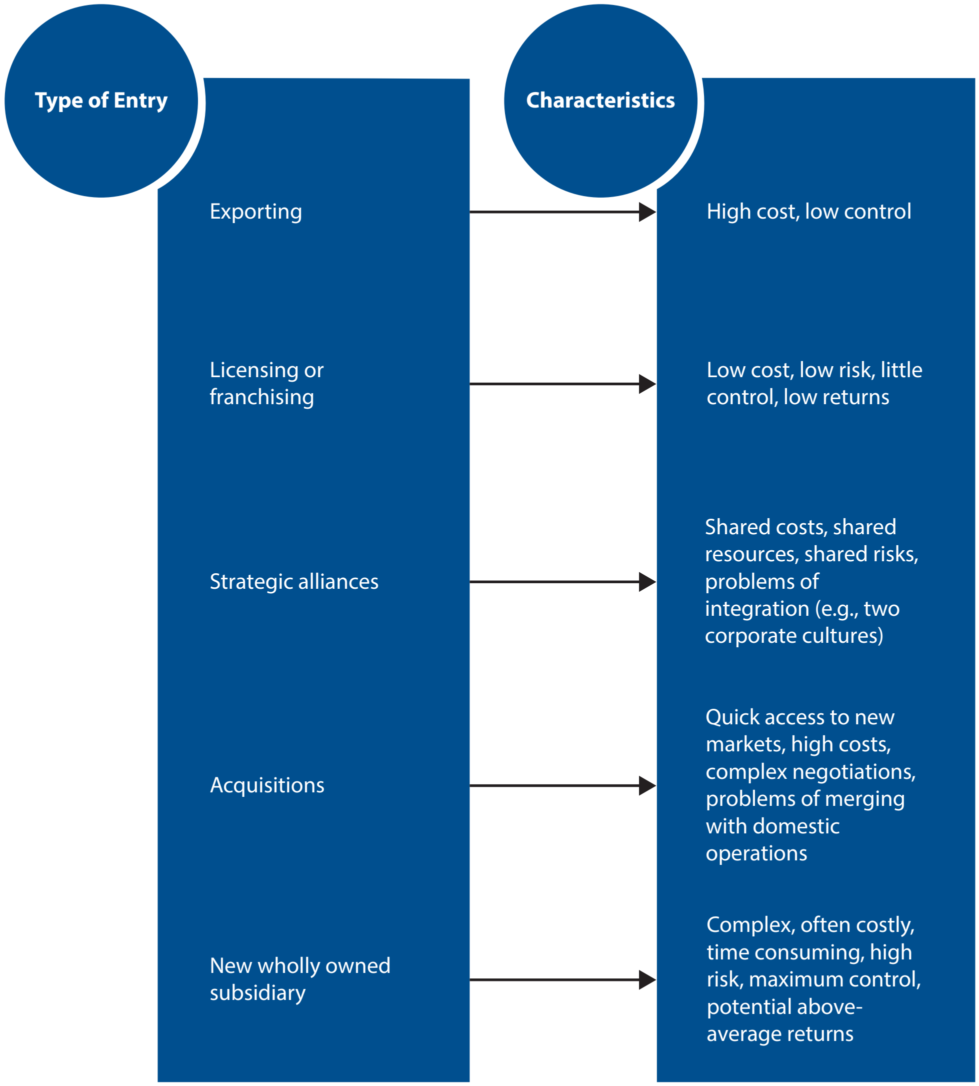
8-6a Exporting

For many firms, exporting is the initial mode of entry used.[118] *Exporting* is an entry mode through which the firm sends products it produces in its domestic market to international markets. Exporting is a popular entry mode choice for small businesses to initiate an international strategy.[119]

In Chapter 1, we defined a *global supply chain* as a network of firms that spans multiple countries with the purpose of supplying goods and services.[120] Participation in global supply chains is a primary source of exporting. For example, a firm in Malaysia may specialize in producing a special type of textile that is particularly useful in manufacturing outdoor sporting equipment (i.e., tents, sleeping bags). The textile is exported to five different sporting equipment manufacturers in five different countries. These firms export their finished sporting equipment to wholesalers and retailers around the world. Global supply chains like these develop over time, as companies search for the best and most economical materials regardless of where in the world they are located.

By exporting, firms avoid the expense of establishing operations in host countries in which they have chosen to compete. However, they must still establish some means of marketing and distributing their products. Usually, contracts are formed with host-country firms to handle these activities.

Figure 8.4 Modes of Entry and Their Characteristics



In addition to these contract costs, exporting costs include potentially high transportation costs to export products to international markets and the expense of tariffs placed on the firm's products because of host countries' policies. The exporting firm also loses some control over the way its products are marketed and distributed. Evidence suggests that, in general, using an international cost leadership strategy when exporting to developed countries has the most positive effect on firm performance, while using an international differentiation strategy with larger scale when exporting to emerging economies leads to the greatest success. In either case, younger firms with a strong management team and market orientation capabilities are more successful.[121]

Firms export mostly to countries that are closest to their facilities because usually transportation costs are lower and there is greater similarity between geographic neighbors. The Internet has also made exporting easier and more effective.[122] Firms of any size can use the Internet to access critical information about foreign markets, examine a target market, research the competition, and find lists of potential customers.

8-6b Licensing or Franchising

Licensing is an entry mode in which an agreement is formed that allows a foreign company to purchase the right to manufacture and sell a firm's products within a host country's market or a set of host countries' markets.[123] The licensor is normally paid a royalty on each unit produced and sold. The licensee takes the risks and makes the monetary investments in facilities for manufacturing, marketing, and distributing products. First mentioned in Chapter 4 as a type of business model, *franchising* is a form of licensing "that grants a franchisee access to a franchisor's proprietary business knowledge, processes, and trademarks, thus allowing the franchisee to sell a product or service under the franchisor's business name."[124] Again, the franchisee takes most of the risks. As a result, licensing and franchising are possibly the least costly forms of international diversification.

Alexander Pohl/Shutterstock.com

After learning the technology needed to create their own heavy-duty equipment from their licensors, Komatsu dropped their licensing agreements, leaving the licensors at a huge disadvantage.

Licensing and franchising also have disadvantages. For example, after the deal is set, the licensing or franchising firm typically has little control over selling and distribution. Developing agreements that protect the interests of both parties, while supporting the relationship embedded within an agreement, helps prevent this potential disadvantage.[125] In addition, licensing and franchising provide the least potential returns because profits are shared. Another disadvantage is that the international firm may learn the technology of the party with whom it formed an agreement and then produce and sell a similar competitive product after the licensing agreement expires. In a classic example, Komatsu first licensed much of its technology from International Harvester, Bucyrus-Erie, and Cummins Engine to compete against Caterpillar in the earthmoving equipment business. Komatsu then dropped these licenses and developed its own products using the technology it gained from the U.S. companies.[126] Because of potential disadvantages, the parties to a licensing arrangement should finalize an agreement only after they are convinced that both parties' best interests are protected.

8-6c Strategic Alliances

In a multinational context, a *strategic alliance* involves a firm collaborating with another company in a different setting to enter one or more international markets.[127] The nature of the collaboration can take many forms, including joint manufacturing, cooperative advertising and distribution, or a research collaboration. First mentioned in Chapter 1, a *joint venture* is a special type of strategic alliance in which two or more firms create a legally independent company to share resources. Strategic alliances and joint ventures will be more formally defined and described in Chapter 9.

Firms share the risks and the resources required to enter international markets when using strategic alliances.[128] Moreover, because partners bring their unique resources together for the purpose of working collaboratively, strategic alliances can facilitate developing new capabilities and possibly core competencies that may contribute to the firm's strategic competitiveness.[129] Indeed, developing and learning how to use new capabilities and/or competencies (particularly those related to technology) is often a key purpose for which firms use strategic alliances as an entry mode.[130]

French-based Groupe Limagrain is one of the largest seed companies in the world. Organized as an international cooperative group, Limagrain specializes in field seeds, vegetable seeds, and cereal products. Part of Limagrain's strategy calls for it to continue to enter and compete in additional international markets. Limagrain is using strategic alliances as one type of entry mode. In 2011, the firm formed a strategic alliance with the Brazilian seed company Sementes Guerra in Brazil, focused on corn. Limagrain also had an earlier, successful joint venture with KWS in the United States. This venture, called AgReliant Genetics, focused primarily on corn and soybeans, is the third-largest seed-company in the United States. More recently, in 2020, Limigrain created Seed Co West & Central Africa with its partner Seed Co (and African Seed Company) to distribute agricultural seed in Ghana.[131]

Not all alliances formed to enter international markets are successful.[132] International strategic alliances are especially difficult to manage. Incompatible partners, conflict between the partners, and a loss of trust are primary reasons for failure.[133] Efforts to build trust are affected by at least four fundamental issues: the initial condition of the relationship, the negotiation process to arrive at an agreement, partner interactions, and external events.[134] Trust is also influenced by the country cultures involved and the relationships between the countries' governments (e.g., degree of political differences) where the firms in the alliance are based.[135] Cultural and political differences can make it difficult to achieve the level of operational integration necessary for the alliance to be a success. If there is anticipation of a high level of conflict or lack of trust among partners in a strategic alliance, using acquisitions to enter international markets may be a better option.[136]

8-6d Acquisitions

When a firm acquires another company to enter an international market, it has completed a cross-border acquisition. Specifically, a *cross-border acquisition* is an entry mode through which a firm from one country acquires a stake in or purchases an entire firm located in another country.[137] As free trade expands in global markets, firms throughout the world are completing a larger number of cross-border acquisitions. The ability of cross-border acquisitions to provide rapid access to new markets is a key reason for their growth. In fact, of the five entry modes, acquisitions often are the quickest means for firms to enter international markets.[138] When the deal is done, they are immediately operating in the host country.

Although increasingly popular, acquisitions as an entry mode are not without costs, nor are they easy to successfully complete and operate. Cross-border acquisitions have some of the disadvantages of domestic acquisitions (see Chapter 7). For example, they often require a high level of debt financing to complete, which carries an extra cost and also increases leverage in the acquiring firm.

However, in many ways, cross-border acquisitions are even more difficult than domestic acquisitions. Negotiations for cross-border acquisitions can be exceedingly complex and are generally even more complicated than are the negotiations associated with domestic acquisitions.[139] Dealing with the legal and regulatory requirements in the target firm's country and obtaining appropriate information to negotiate an agreement are also frequent problems. Finally, the merging of the new firm into the acquiring firm is often more complex than is the case with domestic acquisitions. The firm completing the cross-border acquisition must deal not only with different corporate cultures, but also with potentially different social cultures and practices.[140] Research indicates that greater cultural distance between the countries in which the acquiring and acquired firms operate is associated with less long-term value creation.[141] Integrating the two firms after the acquisition is more challenging because it is difficult to capture the potential synergy when integration is slowed or stymied because of cultural differences.[142]

Therefore, while cross-border acquisitions are popular as an entry mode primarily because they provide rapid access to new markets, firms considering this option should be fully aware of the costs and risks associated with using it.

8-6e New Wholly Owned Subsidiary (Greenfield Venture)

A **greenfield venture** is an entry mode through which a firm invests directly in another country or market by establishing a new wholly owned subsidiary.

A **greenfield venture** is an entry mode through which a firm invests directly in another country or market by establishing a new wholly owned subsidiary. The process of creating a greenfield venture is often complex and potentially costly, but this entry mode affords maximum control to the firm and has the greatest amount of potential to contribute to the firm's strategic competitiveness as it implements international strategies. This potential is especially true for firms with strong intangible capabilities that might be leveraged through a greenfield venture.[143] Moreover, having additional control over its operations in a foreign market is especially advantageous when the firm has proprietary technology.

Research also suggests that "wholly owned subsidiaries and expatriate staff are preferred" in service industries where "close contacts with end customers" and "high levels of professional skills, specialized know-how, and customization" are required.[144] Other research suggests that, as investments, greenfield ventures are used more prominently when the firm's business relies significantly on the quality of its capital-intensive manufacturing facilities. In contrast, cross-border acquisitions are more likely to be used as an entry mode when a firm's operations are human-capital intensive—for example, if a strong local union and high cultural distance (between the countries involved) would cause difficulty in transferring knowledge to a host nation through a greenfield venture.[145]

The risks associated with greenfield ventures are significant in that the costs of establishing a new business operation in a new country or market can be substantial. To support the operations of a newly established operation in a foreign country, the firm may have to acquire knowledge and expertise about the new market by hiring either host-country nationals, possibly from competitors, or through consultants, which can be costly. This new knowledge and expertise often are necessary to facilitate the building of new facilities, establishing distribution networks, and learning how to implement marketing strategies that can lead to competitive success in the new market.[146] Importantly, while taking these actions, the firm seeks to maintain control over the technology, marketing, and distribution of its products. Research also suggests that when the country risk is high, firms prefer to enter with joint ventures instead of greenfield investments. However, if firms have previous experience in a country, they prefer to use a wholly owned greenfield venture rather than a joint venture.[147]

8-6f Dynamics of Mode of Entry

Several factors affect the firm's choice about how to enter international markets. As mentioned previously, market entry is often achieved initially through exporting, which requires no foreign manufacturing expertise and investment only in distribution. Licensing and franchising tend to be lower cost strategies for entering a foreign country; however, control is limited. Strategic alliances are a popular entry mode because they allow a firm to connect with an experienced partner already in the market. Partly because of this ability, geographically diversifying firms often use alliances in uncertain situations, such as an emerging economy where there is significant risk (e.g., Venezuela). However, if intellectual property rights in the emerging economy are not well protected, the number of firms in the industry is growing fast, and the need for global integration is high, other entry modes such as a joint venture or a wholly owned subsidiary are preferred.[148] In the final analysis though, all three modes—export, licensing/franchising, and strategic alliances—can be effective means of initially entering new markets and for developing a presence in those markets.

Researchers have found that multinational firms that use joint ventures to establish themselves in a foreign market often tend to abandon their local partners once they are established. As multinationals "gain a competitive advantage from leveraging resources across borders, they will initially benefit from sharing ownership with a local firm, to embed their foreign subsidiaries in the local environment and access local resources more effectively. Later, they will benefit from taking over the local partner's equity share, to better embed their subsidiaries in the parent organization and transfer locally accessed resources to the MNC's other locations."[149] Acquisitions and greenfield ventures can help firms establish a strong presence in an international market; however, both acquisitions and greenfield ventures are likely to come at later stages in the development of a firm's international diversification strategy.

Thus, to enter a global market, a firm selects the entry mode that is best suited to its situation. In some instances, the various options will be followed sequentially, beginning with exporting and eventually leading to greenfield ventures. In other cases, the firm may use several, but not all, of the different entry modes, each in different markets. The decision regarding which entry mode to use is primarily a result of the industry's competitive conditions; the country's situation and government policies; and the firm's unique set of resources, capabilities, and core competencies.

8-7 Desired Strategic Competitiveness Outcomes

Learning Objective

8-7 Discuss the desired strategic competitiveness outcomes associated with an international diversification strategy.

As this chapter has demonstrated, a firm's success in carrying out an international strategy depends on many factors, including success in identifying the best countries or regions to enter, selection and implementation of appropriate corporate-level and business-level international strategies, optimal selection of a mode (or modes) of entry. In addition, many factors are not under a firm's direct control—such as global conflicts, supply chain disruptions, trade wars, natural disasters, or new social movements—that can have a dramatic effect on the success of an international strategy. Firms should do what they can to mitigate anticipated risks through careful analysis of the business, political, and cultural environments in which they operate or desire to operate. In the best situations, and with skilled management, multinational firms can use an international strategy to achieve above-average returns and increase innovation.

8-7a International Diversification and Performance

Evidence suggests numerous reasons for firms to use an international diversification strategy, meaning that increases in international diversification should be related positively to a firm's performance as measured by the returns it earns on its investments.[150] About a quarter of the profits of U.S. multinational corporations come from abroad.[151] However, this is not really the important question. The question is whether higher levels of international diversification enhance a firm's performance.

Early research demonstrated that as international diversification increases, a firm's returns decrease initially but then increase quickly as it learns how to manage the increased geographic diversification it has created.[152] Then, at some point, the degree of geographic and possibly product diversification the firm's international strategies bring about causes the returns from using the strategies to level off and eventually become negative.[153] However, these early studies were replicated using a sample of 32,835 multinationals in 64 countries, and the researchers were unable to support previous findings. In fact, they found "no evidence of any within-firm effect of multinationality on performance."[154] Their results do not mean that international diversification is a bad idea. There was variation in their sample of firms, with some multinational firms enjoying high performance and others experiencing low performance. The significance of the study is that it points to the need to be careful in making decisions about where to expand and how to manage an internationally diversified portfolio of businesses. In general, it becomes increasingly difficult to effectively implement, manage, and control a firm's international operations with increases in geographic diversity.[155]

8-7b Enhanced Innovation

In Chapter 1, we indicated that developing new technology is at the heart of strategic competitiveness. A nation's competitiveness depends, in part, on the capacity of its industries to innovate.[156] Eventually, and inevitably, competitors outperform firms that fail to innovate. Therefore, the only way for individual nations and individual firms to sustain a competitive advantage is to upgrade it continually through innovation.[157]

An international diversification strategy creates the potential for firms to achieve greater returns on their innovations (through larger or more numerous markets) while reducing the often-substantial risks of R&D investments. Additionally, international diversification may be necessary to generate the resources required to sustain a large-scale R&D operation. An environment of rapid technological obsolescence makes it difficult to invest in new technology and the capital-intensive operations necessary to compete in such an environment. Firms operating solely in domestic markets may find such investments difficult because of the length of time required to recoup the original investment. However, diversifying into several international markets improves a firm's ability to appropriate additional returns from innovation before domestic competitors can overcome the initial competitive advantage created by the innovation.[158]

In addition, firms moving into international markets are exposed to new products and processes. If they learn about those products and processes and integrate this knowledge into their operations, further innovation can be developed.[159] To incorporate the learning into their own R&D processes, firms must manage processes effectively to absorb and use the new knowledge to create further innovations.[160] For several reasons, then, an international diversification strategy increases a firm's ability to innovate.

The relationship among international geographic diversification, innovation, and returns is complex. Some level of performance is necessary to provide the resources the firm needs to diversify geographically; in turn, geographic diversification provides incentives and resources to invest in R&D. Effective R&D should enhance the firm's returns, which then provide more resources for continued geographic diversification and investment in R&D.[161] Of course, the returns generated from these relationships increase through effective managerial practices. Evidence suggests that more culturally diverse top management teams often have a greater knowledge of international markets and their idiosyncrasies, but their orientation to expand internationally can be affected by the nature of their incentives.[162] Moreover, managing the business units of a geographically diverse multinational firm requires skill, not only in managing a decentralized set of businesses, but also coordinating diverse points of view emerging from businesses located in different countries and regions.[163] Firms able to do this increase the likelihood of outperforming their rivals.[164]

Summary

- An international strategy is a strategy through which a firm produces and/or sells its goods and/or services outside the country in which its headquarters office is located. An international diversification strategy is a strategy through which a firm expands the production and/or sales of its goods and/or services across the borders of global regions and countries into a potentially large number of geographic locations or markets. In other words, an international diversification strategy describes the means through which a firm develops an international strategy.
- Multiple factors and conditions are leading to increased international diversification, including:
  - the increasing use of global value chains in international business
  - digitalization and the use of global business platforms
  - regionalization, which occurs when firms engage in countries that are part of the same region instead of investing in countries that are part of multiple regions
  - the desire of many firms to increase their markets size beyond what is possible in their domestic markets
  - the ability to expand a firm's learning network across international boundaries
  - the existence of scarce or uniquely valuable resources in some countries or regions of the world
- Political risks, which come from the probability that the operations of multinational firms will be disrupted by political forces or political events, discourage international diversification. Legal risks, which are closely connected to political risks, can also discourage this sort of strategy.
- Economic risks include fundamental weaknesses in a country or region's economy with the potential to cause adverse effects on firms' efforts to successfully implement their international strategies. These sorts of risks make pursuit of an international strategy difficult.
- Firms that pursue international strategies also experience management difficulties associated with coordinating business operation, managing across different country cultures, and managing relations with various governments where their businesses are located.
- Firms that desire to pursue an international diversification strategy should carefully consider many factors when deciding on which countries to enter. They include: factors of production; demand conditions; related and supporting industries; firm strategy, structure, and rivalry; political, legal, and economic systems; and cultural distance, which describes differences in shared norms across cultures.
- There are three types of international corporate-level strategies. A multidomestic strategy focuses on competition within each country in which the firm competes. Firms using a multidomestic strategy decentralize strategic and operating decisions to the business units operating in each country, so that each unit can tailor its products to local conditions. A global strategy assumes more standardization of products across country boundaries; therefore, a competitive strategy is centralized and controlled by the home office. Commonly, large multinational firms, particularly those with multiple diverse products being sold in many different markets, use a multidomestic strategy with some product lines and a global strategy with others. A transnational strategy seeks to integrate characteristics of both multidomestic and global strategies to simultaneously emphasize local responsiveness and global integration.
- A firm's international business-level strategy is based, to some degree, on its international corporate-level strategy. Some international corporate-level strategies give individual country units the authority to develop their own business-level strategies, while others dictate the business-level strategies to standardize the firm's products and sharing of resources across countries. The former situation typically goes along with a multidomestic corporate-level strategy, while the latter tends to occur when a multinational firm is pursuing a global corporate-level strategy. A multinational firm could have a business unit pursuing cost leadership in one country, differentiation in another, focus in another, and an integrated cost leadership/differentiation strategy in all the rest of the countries.
- Firms can use one or more of five entry modes to enter international markets. Exporting, licensing/franchising, strategic alliances, acquisitions, and new wholly owned subsidiaries, often referred to as greenfield ventures, are the five entry modes. Most firms begin with exporting or licensing because of their lower costs and risks. Later they tend to use strategic alliances and acquisitions as well. The most expensive and risky means of entering a new international market is establishing a new wholly owned subsidiary (greenfield venture). On the other hand, such subsidiaries provide the advantages of maximum control by the firm and, if successful, the greatest returns. Large, geographically diversified firms often use most or all five entry modes across different markets when implementing international strategies.
- Successful use of an international diversification strategy can contribute to a firm's strategic competitiveness in

the form of improved performance. However, research has shown that, on average, international diversification doesn't increase performance. Consequently, managers of multinational firms need to be careful in making decisions about where to expand and how to manage their internationally diversified portfolio of businesses.

- International diversification facilitates innovation in a firm because it provides a larger market to gain greater and faster returns from investments in innovation. In addition, international diversification can help a firm generate the resources necessary to sustain a large-scale R&D program.

Key Terms

global strategy 205
greenfield venture 210
international diversification strategy 192
international strategy 192
multidomestic strategy 204
transnational strategy 205

Review Questions

1. What are the factors and conditions that are leading to increased international diversification?
2. Describe the major political risks firms experience when entering a country other than their home country.
3. Describe some of the economic risks firms experience when entering another country.
4. What are common management problems firms experience when they enter new countries as part of their international diversification strategy?
5. Explain the most important factors a multinational firm should consider when deciding whether to enter a particular country.
6. What are the three international corporate-level strategies? What are the advantages and disadvantages associated with these strategies?
7. What five entry modes do firms use to enter international markets? What is a common sequence in which firms use these entry modes?
8. What are the strategic competitiveness outcomes firms can achieve through an international diversification strategy?

Mini-Case

"Over The Top" (OTT) Platforms and Netflix in India

Modern "Over The Top" (OTT) platforms are what streaming services are called in India. India has some of the lowest mobile rates, which has fueled growth in the OTT market. Indian consumers have a voracious appetite for online video content. "As a result, an entire industry has cropped up to serve those needs, offering enough content—movies, TV series, documentaries, reality TV, and short-form—to last you till your deathbed, and beyond." By one report, a new OTT platform seems to emerge about every three months.

Although there are dozens of OTT platforms in India, a few stand out. Amazon Prime Video offers a wide selection of Hollywood movies and TV series, as well as Indian movies and TV shows. In 2021, Amazon Prime Video was the most popular streaming service in India. Another big contender, Disney + Hotstar is the third most popular streaming service in India. Disney + Hotstar is owned by Star India, which is a subsidiary of The Walt Disney Company India. It has two plans: "Premium" includes international movies and TV series and "Super" focuses on sports content and domestic programs in a wide variety of languages. The number four position belongs to JioTV, owned by Jio Platforms, which is a subsidiary of Reliance Industries LTD. It is the only one of the top four services that offers a dedicated app for live TV. JioTV doesn't offer any original programming, but it provides a very wide selection of entertainment options.

Indian companies offering OTT platforms also include Aha, owned by a joint venture between Geetha Arts and My Home Group. Aha only provides Telugu (Indian) content, without advertisements. Although one of the more recent additions to the OTT platform market, it already has 2.5 million users. Voot is another Indian OTT platform that provides content in Hindi, English, Tamil, Gujrati, Bengali, Marathi, and Kannada. All this competition from Indian and international companies has pushed pricing down to very low levels, only a fraction of what streaming services charge in most other countries.

What about Netflix? Although it ranked as the second most popular streaming service in India in 2021, according to one source, the company is not doing well by its own standards. When Netflix enters a new country, its strategy is to target wealthy, young consumers in big cities first. "Then, to reach progressively larger audiences, the company hires a local team to commission projects from the country's biggest producers, offering them creative freedom they wouldn't get elsewhere."

CEO Reed Hastings told investors that he expected Netflix to sign up 100 million customers in India. To date, Netflix hasn't come anywhere near that number. "Netflix underestimated the immense complexity and challenges India brings."

In India, pay TV costs a lot less than it does in the rest of the world, with prices in the U.S. dollar equivalent of $2 to $3 per month. Netflix entered India with a price of about $7.50 per month. A while later, the company realized its error, and began lowering the price. Initially, the lower prices were only available for mobile devices, but eventually, Netflix brought its pricing down to levels in line with the competition. Because Indian laws require customers to approve a payment each month, cancellation rates are much higher in India than other countries. Also, India is a diverse nation where over 20 languages are spoken, making programming difficult.

Netflix has deals with some of India's biggest production companies. It released a popular series in 2020 called Bad Boy Billionaires, an investigative docuseries that "explores the greed, fraud and corruption that built up—and ultimately brought down—India's most infamous tycoons." Mai: A Mother's Rage is about a grieving mother who transforms from meek to merciless as she tracks down her daughter's murderer. The Fame Game is a series about the search for India's most famous actress. Nonetheless, Netflix customers are still more interested in international content than Indian content. One problem is that the production companies with which Netflix is working are accustomed to making big movies and not series. Also, the pandemic slowed down production of original programs. Nonetheless, Netflix is plowing ahead, and many of the shows it planned to make in 2021 are going into production in 2022.

When asked about competition in India, Pratiksha Rao, Netflix India's director of films and licensing, said, "Competition is always great, it pushes us to do better. It also widens the market, widens the supply. It's great for the creative community." After listing several Netflix projects in a variety of languages, she said, "Our aim is always to be more reflective of the market that we're in. So while we are doing originals in those languages, we're also licensing a lot from those languages. Whether its Telugu, Tamil, Malayalam. In fact, it's very heartwarming when we premiere these films on digital after the theatrical release."

Sources: L. Shaw, 2022, Netflix's Indian drama, *Bloomberg Businessweek,* April 4: 16–18; N. Ramachandran, 2022, Netflix India's Pratiksha Rao welcomes competition in crowded streaming market, *Variety,* www.variety.com, April 29; T. Basuroy, 2022, Share of consumers who subscribed to selected video streaming services in India as of May 2021, *Statista,* www.statista.com, May 17; 2022, Bad Boy Billionaires: India, *Netflix,* www.netflix.com, May 19, P. Baboori, 2022, Best 10 OTT platforms in India 2022, *Indian Online Seller,* www.indianonlineseller.com, March 1; A. Arora, 2021, The best movie and television streaming service in India, *360 Guide,* www.gadgets360.com, January 13.

Case Discussion Questions

1. How are differences between India and other countries influencing the success of Netflix in that country?
2. While Netflix is spending a lot on production of new series and movies in India, it is also charging a lot less for its streaming services than it does in other countries. Doesn't this situation mean that Netflix is going to lose money in India? What could Netflix be thinking?
3. What business-level strategy does Netflix seem to be pursuing in India? How does that strategy compare to other companies described in the case?
4. How do you think Netflix should change its strategy in India? What can it do to increase competitiveness, or should Netflix just abandon the Indian market? Explain.

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Chapter 9

Cooperative Strategy

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

9-1 Define cooperative strategies and explain why firms use them.

9-2 Define and discuss the three major types of strategic alliances.

9-3 Name the business-level cooperative strategies and describe their use.

9-4 Discuss the use of corporate-level cooperative strategies.

9-5 Understand why firms use cross-border strategic alliances as an international cooperative strategy.

9-6 Discuss the use of network cooperative strategies.

9-7 Explain cooperative strategies' risks.

9-8 Describe two basic approaches used to manage cooperative strategies.

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Google's Diversified Alliance Portfolio

Firms that participate in cooperative strategies commit to sharing some of their unique resources to reach an objective that is important to all participants. Cooperative strategies are often used to give firms access to new markets. Alternatively, some partnerships are formed between similar firms who desire to develop scale economies to enhance their competitiveness. For years, automobile manufacturers have formed large numbers of partnerships for this reason. In other instances, firms competing in different industries combine their unique resources to pursue what they believe is a value-creating shared objective. For this reason, in 2015, Google, Intel, and TAG Heuer formed a partnership to design and produce a smartwatch.

In part, the decision Google, Intel, and TAG Heuer made to collaborate was a strategic action taken in response to Apple's introduction of the iWatch. The partnership produced a high-end smartwatch, with the most expensive version priced at about $17,000. They have also produced a lower-priced smartwatch named the Connected Modular 45 that starts at $1,650. Still, this watch serves a special luxury market niche, in keeping with the TAG Heuer market focus.

FABRICE COFFRINI/AFP/Getty Images

Guy Semon (Tag Heuer), Jean-Claude Biver (Tag Heuer), Michael Bell (Intel), and David Singleton (Google) pose with a block of Swiss cheese at the announcement of the new partnership between the watch brand and the two giants of Silicon Valley.

Google has parlayed the knowledge it gained in the alliance with Intel and TAG Heuer into another alliance with Fitbit. For example, Fitbit uses Google's "health data standards for apps," as well as Google's cloud data storage platform, which complies with the U.S. Health Standards and Accountability Act. This legislation regulates the use of medical records. The partnership allows Fitbit to avoid building its own system to comply with this law. Fitbit CEO James Park says that "working with Google gives us the opportunity to transform how we scale our business, allowing us to reach more people around the world faster, while also enhancing the experience we offer to our users and the healthcare system." Google is also working with Fitbit because its Android Wear software was unsuccessful in the market. After the Google alliance was announced, the price of Fitbit shares on the market increased by 8 percent.

Google has developed an increasingly diversified portfolio of strategic alliances. For example, Google has alliances with Carrefour, a large French retailer, and Repsol, a major energy firm in Spain. The alliance with Carrefour has moved to the second stage, helping the firm increase its ecommerce presence. Alternatively, the alliance with Repsol is using Google's machine-learning tool to deploy big data and artificial intelligence tools across Repsol's refineries. Google shut down its search engine activity in China in 2010, and rather than taking actions to re-enter the market, it started a research center in China and signed an agreement to form an alliance with Tencent, a large Chinese conglomerate.

Additionally, Google formed an alliance partnership with Information Resources, Inc. (IRI) to conduct marketing mix analyses. This work is part of Google's Google Measurement Partners program launched in 2018. The intent of this program (and its alliance with IRI) is to provide high quality and choice to its advertisers across multiple areas of specialization. IRI will help bolster Google's marketing efforts. In another partnership, Google formed a 10-year alliance with AES Corporation "to accelerate the expansion and adoption of clean energy by leveraging Google Cloud technology." Also, Google formed a different 10-year alliance with TELUS to pursue innovations in new services that help companies digitize their operations within the healthcare, agriculture, connected home, communications technology, and security industries.

These are just a few examples of the many alliances Google has undertaken to keep its competitive edge. Google also continues to invest heavily in R&D to develop new technologies and services (e.g., in artificial intelligence and many other areas). Thus, we can expect Google to be a dominant force in high technology for years to come.

Sources: 2022, How many partnerships does Google have? *ICSTD*, www.icstd.org, February 10; 2021, TELUS and Google form strategic alliance to bring digital transformation to key industries, including communications technology, healthcare, and agriculture, *Daily Energy Insider*, www.dailyenergyinsider.com, February 9; K. Randolph, 2019, AES, Google created strategic alliance to accelerate adoption of clean energy, *Daily Energy Insider*, www.dailyenergyinsider.com, November 7, 2019; S. Hughes, 2018, Google selects IRI to join new measurement partners program, *Odessa American*, https://www.oaoa.com, July 18: R. Zhong, 2018, Google, rebuilding its presence in China, invests in retailer, JD.com, *New York Times*, www.nytimes.com, June 18; T. Bradshaw, 2018, Fitbit shares jump on Google alliance, *Financial Times*, www.ft.com, April 30; A. Pressman, 2018, Fitbit strikes deal with Google that could lead to wearables collaboration, *Fortune*, www.fortune.com, April 30; 2017, Tag Heuer teams up with Google, Intel for new $1,650 Android smartwatch, *PYMNTS.com*, https://www.pymnts.com, March 15; D Pierce 2017, Tag Heuer's new $1,600 smartwatch (almost) worth it, *Wired*, www.wired.com, March 14; Chen, 2015, Google, Intel, TAG Heuer to collaborate on Swiss smartwatch, *Wall Street Journal*, www.wsj.com, March 19.

Learning Objective

9-1 Define cooperative strategies and explain why firms use them.

9-1 Cooperative Strategies and Their Uses

In this chapter's Opening Case, we describe the actions Google took with Intel and TAG Heuer to develop technological innovations to compete in the world of luxury fashion. Google has also developed alliances with Fitbit, Carrefour, Repsol, Tencent, IRI, AES, and TELUS; in each case, the firms and Google have complementary resources to use in the alliance. Thus, as is the case for all companies implementing cooperative strategies, Google and its alliance partners intend to use their resources in ways that will create the greatest amount of value for stakeholders.[1]

A **cooperative strategy** is a means by which firms collaborate to achieve a shared objective.

Forming a cooperative strategy like those that Google has formed, such as the one with Intel and TAG Heuer, has the potential to help companies reach an objective that is important to all the partners, such as firm growth. Specifically, a **cooperative strategy** is a means by which firms collaborate to achieve a shared objective.[2] Cooperating with others can help a firm create value for a customer that it likely could not create by itself. As noted in the Opening Case, this is the situation for Google, Intel, and TAG Heuer, in that none of these firms could have created the intended high-end smartwatch without the combination of the three companies' resources. (Throughout this chapter, the term "resources" is used comprehensively and refers to a firm's capabilities as well as its resources.)

Firms also try to create competitive advantages when using a cooperative strategy.[3] A competitive advantage developed through a cooperative strategy often is called a *collaborative* or *relational* advantage, indicating that the relationship that develops among collaborating partners is commonly the basis on which to build a competitive advantage.[4] Successfully using cooperative strategies can help a firm to outperform its rivals in terms of strategic competitiveness and earn above-average returns.[5]

A **strategic alliance** is a cooperative strategy in which firms combine some of their resources to create a competitive advantage.

We examine several topics in this chapter. First, we define and offer examples of different strategic alliances as primary types of cooperative strategies. We focus on strategic alliances because firms use them more frequently than other types of cooperative relationships. In succession, we describe business-level, corporate-level, international, and network cooperative strategies. This chapter closes with a discussion of the risks of using cooperative strategies and how effectively managing the strategies can reduce these risks.

Learning Objective

9-2 Define and discuss the three major types of strategic alliances.

9-2 Strategic Alliances as a Primary Type of Cooperative Strategy

A **strategic alliance** is a cooperative strategy in which firms combine some of their resources to create a competitive advantage.[6] Firms use strategic alliances to leverage their existing resources while working with partners to develop additional resources as the foundation for new competitive advantages. Alliances are a vital strategy that firms use to try to outperform rivals.[7]

Shanghai GM.PNG

Shanghai GM facility where the work of the firms' joint venture takes place.

9-2a Types of Major Strategic Alliances

Joint ventures, equity strategic alliances, and nonequity strategic alliances are the three major types of strategic alliances firms use. The ownership arrangement is a key difference among these alliances.

A **joint venture** is a strategic alliance in which two or more firms create a legally independent company to share some of their resources to create a competitive advantage.[8] Typically, partners in a joint venture own equal percentages and contribute equally to the venture's operations. In fact, research evidence exists that equal ownership is associated with higher performing joint ventures.[9] Often formed to improve a firm's ability to compete in uncertain competitive environments, joint ventures can be effective in establishing long-term relationships and in transferring knowledge between partners.[10]

A **joint venture** is a strategic alliance in which two or more firms create a legally independent company to share some of their resources to create a competitive advantage.

General Motors and China-based SAIC Motor Corp. Ltd., China's largest automobile manufacturer by sales volume, formed a joint venture to develop new cars that cater specifically to Chinese tastes. Called Shanghai General Motors Corporation Limited, each partner controls 50 percent of this cooperative enterprise. These companies have also partnered in other ways. For example, Shanghai OnStar, a joint venture between these two companies, is the leader in telematics for automobiles in China. Also, SAIC and GM agreed for SAIC to take over GM's Opel manufacturing plant in India, which allows SAIC to enter India's automobile market.[11] Demonstrating the complexities associated with being a successful competitor in today's business environment is the fact that SAIC also has a joint venture with Volkswagen. Among other products, the SAIC-VW joint venture manufactures the Tiguan sport-utility model, which is the number one foreign-brand SUV being sold in China.[12]

Because it can't be codified, tacit knowledge, which is increasingly critical to firms' efforts to develop competitive advantages, is learned through experiences such as those taking place when people from partner firms work together in a joint venture.[13] Overall, a joint venture may be the optimal type of cooperative arrangement when firms need to combine their resources to create a competitive advantage that is substantially different from any they possess individually, when knowledge sharing is important to success, and when the partners intend to compete in highly uncertain environments.

An **equity strategic alliance** is an alliance in which a firm purchases equity in another firm, which means that it is now a partial owner of that firm. "In exchange for the equity interest, the firm is required to join a partnership and contribute a lump sum of capital. These equity investments are typically made through a direct purchase of shares in the firm."[14] Equity strategic alliances can lead to competitive advantage because they can help firms refocus their efforts due to the addition of new resources. They are also helpful if there is an opportunity that is too expensive, complex, or risky to be pursued by one firm on its own. "Panasonic's $30 million investment in Tesla is a good example of an equity strategic alliance. Along with the purchase of Tesla stock, Panasonic also brought its cutting-edge battery cell technology to the partnership."[15]

An **equity strategic alliance** is an alliance in which a firm purchases equity in another firm, which means that it is now a partial owner of that firm.

A **nonequity strategic alliance** is an alliance in which two or more firms develop a contractual relationship to share some of their resources in pursuit of a mutually beneficial project.[16] In this type of alliance, firms do not establish a separate independent company, nor do they take equity positions in each other. For this reason, nonequity strategic alliances are less formal, demand fewer partner commitments than do joint ventures and equity strategic alliances, and often do not foster an intimate relationship between partners; nonetheless, research evidence indicates that they can create value for the involved firms.[17] The relative informality and lower commitment levels characterizing nonequity strategic alliances make them unsuitable for complex projects where success requires partners to effectively transfer tacit knowledge to each other.[18] Licensing agreements, distribution agreements, and supply contracts are examples of nonequity strategic alliances.

A **nonequity strategic alliance** is an alliance in which two or more firms develop a contractual relationship to share some of their resources in pursuit of a mutually beneficial project.

Foxconn manufacturer working to produce iPhones for Apple.

Commonly, outsourcing arrangements are organized in the form of a nonequity strategic alliance. (Discussed in Chapter 3, *outsourcing* is the purchase of a value-chain activity or a support-function activity from another firm.) Apple Inc. and most other companies involved with selling computers, tablets, and smartphones use nonequity strategic alliances to outsource most or all the activities required to manufacture their products. Apple, for example, outsources most of its manufacturing to Foxconn and Pegatron, both based in Taiwan (although most iPhones are assembled in China of parts made around the world).[19] Firms often choose to use nonequity strategic alliances to outsource manufacturing activities to emerging market companies because of the cost efficiencies those firms generate through scale economies.

9-2b Reasons Firms Develop Strategic Alliances

Cooperative strategies are an integral part of the competitive landscape and are important to many companies. In addition to partnerships among for-profit organizations, alliances are also formed between educational institutions and individual companies to commercialize ideas flowing from basic research projects that are completed at universities.[20] Moreover, in addition to dyadic partnerships where two firms form a collaborative relationship for competitive purposes, competition now occurs between large alliances in some industries. This pattern of competition exists in the global airline industry where individual airlines compete against each other but simultaneously join alliances (such as Star, Oneworld, and SkyTeam—the three largest Airline Alliances), which in turn compete against each other.[21] What the alliance means for customers is that booking a flight may include legs on various carriers in the alliance. What it means for the airlines is shared resources and increased utilization of current resources. The array of alliances with which firms are involved highlights the various options available to companies seeking to increase their competitiveness by cooperating with others.

Overall, firms choose to participate in strategic alliances for many reasons. We mention two key reasons here and discuss additional ones below by explaining how strategic alliances may help firms improve their competitiveness while competing in slow-, fast-, or standard-cycle markets.

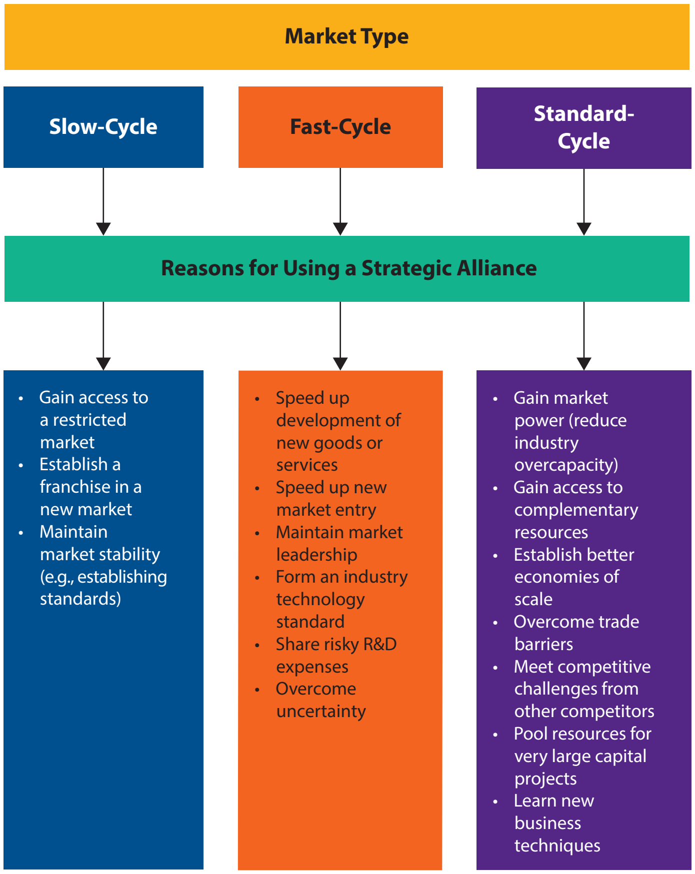
The first important reason firms form strategic alliances is to create value they couldn't generate by acting independently, which often includes entering markets more rapidly.[22] This is demonstrated in a joint venture SK Innovation of Korea formed with Ford Motor Company (Ford) to build two battery factories in North America. The factory is expected to produce enough batteries for 600,000 electric vehicles per year by 2025.[23] The joint venture gives SK Innovation access to a huge North American market that would have been difficult to achieve otherwise.

A second major reason firms form strategic alliances is that most (if not all) companies lack the full set of resources needed to pursue all attractive opportunities available to them as they pursue their objectives.[24] Given constrained resources, firms can collaborate for many purposes, including reaching new customers and broadening both the product offerings and the distribution of their products without adding significantly to their cost structures. Alternatively, firms with greater cash and other resources might form alliances to enter multiple markets, allowing them to compete more effectively with rivals across markets and/or to forestall rivals' entrance or certain competitive actions in certain markets.[25]

An alliance formed by Barnes & Noble and Starbucks illustrates how a partnership can allow a firm to reach new customers without a huge strain on resources. Having Starbucks coffee shops in Barnes & Noble bookstores allows customers to peruse new books while enjoying a fresh cup of coffee. Both firms profit from this partnership. Starbucks has also partnered with grocery store chains, and it is not unusual to be able to buy a cup of coffee from a Starbucks coffee shop while buying groceries.[26]

As we discussed in Chapter 5, when considering competitive rivalry and competitive dynamics, unique competitive conditions characterize slow-, fast-, and standard-cycle markets.[27] As Figure 9.1 shows, these unique market types create different reasons for firms to use strategic alliances.

Figure 9.1 Reasons for Strategic Alliances by Market Type



In short, *slow-cycle markets* are markets where the firm's competitive advantages are shielded from imitation for relatively long periods and where imitation is costly.[28] Railroads and, historically, telecommunications, utilities, and financial services are industries characterized as slow-cycle markets. In *fast-cycle markets*, the firm's competitive advantages are not shielded from imitation, preventing their long-term sustainability.[29] Competitive advantages are moderately shielded from imitation in *standard-cycle markets*, typically allowing them to be sustained for a longer period than in fast-cycle market situations but for a shorter period than in slow-cycle markets.

Slow-Cycle Markets

Firms in slow-cycle markets often use strategic alliances to enter restricted markets or to establish a franchise in a new market. For example, Carnival Corporation, owner and operator of Carnival Cruise Line, formed two joint ventures with state-owned China Merchants Group, which is a conglomerate with businesses in financial investments and property development as well as transportation. One venture between the two firms focuses on shipbuilding while the second concentrates on developing new ports and travel destinations in and around China. The launching of China's first domestic cruise brand that will target Chinese customers is one outcome associated with the collaborations between the two companies. Carnival's interest with these joint ventures is to compete in China, where the cruise industry is beginning to grow rapidly. The shipbuilding venture launched its first new cruise ship in December 2021.[30]

Slow-cycle markets are becoming rare in the twenty-first-century competitive landscape for several reasons, including the privatization of industries and economies, the rapid expansion of the Internet's capabilities for quick dissemination of information, and the speed with which advancing technologies make quickly imitating even complex products possible.[31] Firms competing in slow-cycle markets should recognize the likelihood that in the future, they will encounter situations in which their competitive advantages become partially sustainable (in the instance of a standard-cycle market) or unsustainable (in the case of a fast-cycle market).

Fast-Cycle Markets

Fast-cycle markets are unstable, unpredictable, and complex—in a word, hypercompetitive.[32] Combined, these conditions virtually preclude establishing sustainable competitive advantages, forcing firms to constantly seek sources of new competitive advantages while creating value by using current ones. Alliances between firms with current excess resources and those with promising resources help companies competing in fast-cycle markets effectively transition from the present to the future and gain rapid entry into new markets. Alliances can also help firms to gain legitimacy more quickly in new markets.[33]

High-technology industries are excellent examples of fast-cycle markets, and firms often create partnerships that help them remain competitive. For example, Ford and security specialist ADT jointly invested $105 million into a new venture called Canopy that provides high-tech security systems for vehicles to prevent burglary and theft. The venture will begin providing its new service for commercial vehicles in the United States and United Kingdom in 2023, but it intends to extend this service to other consumers in the future. Technology used in the venture will include sensors, human monitors, cameras, and artificial intelligence "that can distinguish a bird from a burglar."[34]

Standard-Cycle Markets

In standard-cycle markets, alliances are more likely to be made by partners that have complementary resources.[35] Participating in an alliance can enhance a firm's market power through strength in numbers. The alliances formed by airline companies, briefly mentioned earlier in this chapter, are an example of standard-cycle market alliances. Three major airline alliances are operating today: Star Alliance (27 airlines), SkyTeam Alliance (20 airlines), and Oneworld Alliance (14 airlines).[36]

When initially established, airline alliances were intended to allow firms to share their complementary resources to make it easier for passengers to fly between secondary cities in the United States and Europe. Today, airline alliances are mostly global and are formed primarily so members can gain marketing clout, have opportunities to reduce costs, and have access to additional international routes.[37] Of these reasons, international expansion by having access to more international routes is the most important because these routes are the path to increased revenues and potential profits. To support efforts to control costs, alliance members jointly purchase some items and share facilities, such as passenger gates, customer service centers, and airport passenger lounges, when possible. For passengers, airline alliances create benefits such as less complicated ticket buying processes, easier connections for international flights, and the earning of frequent flyer miles.

Learning Objective

9-3 Name the business-level cooperative strategies and describe their use.

9-3 Business-Level Cooperative Strategy

A **business-level cooperative strategy** is a strategy through which firms combine some of their resources to create a competitive advantage by competing in one or more product markets. As discussed in Chapter 4, business-level strategy details what the firm intends to do to gain a competitive advantage in specific product markets. Thus, the firm forms a business-level cooperative strategy when it believes that combining some of its resources with those of one or more partners will create competitive advantages that it can't create alone and lead to success in a specific product market. We present the four business-level cooperative strategies in Figure 9.2.

A **business-level cooperative strategy** is a strategy through which firms combine some of their resources to create a competitive advantage by competing in one or more product markets.

Complementary strategic alliances are business-level alliances in which firms share some of their resources in complementary ways to create a competitive advantage.

9-3a Complementary Strategic Alliances

Complementary strategic alliances are business-level alliances in which firms share some of their resources in complementary ways to create a competitive advantage.[38] Vertical and horizontal are the two dominant types of complementary strategic alliances (see Figure 9.2).

Vertical Complementary Strategic Alliance

In a *vertical complementary strategic alliance*, firms share some of their resources from different stages of the value chain to create a competitive advantage (see Figure 9.3).[39] Oftentimes, vertical complementary alliances are formed to adapt to environmental changes, and sometimes, the changes represent an opportunity for partnering firms to innovate while adapting.[40] For example, Honda teamed up with Sony to build electric vehicles. Honda is way behind competitors in the electric vehicle market. Sony was once a market leader in portable electronic devices but lost its position to Apple, Samsung, and others. Discussing the joint venture, "Sony CEO Kenichiro

Strategic **Focus**

Accenture's Rothco Unit Partners with Warner and Apple to Help Children with Speech Disorders

Accenture is one of the world's largest professional service firms. The company provides services in areas that include strategy and consulting, creativity and technology, and operations to practically every industry imaginable, including health, aerospace, chemical, life sciences, travel, utilities, insurance, capital markets, and the federal government. The company employs approximately 699,000 employees and has operations in more than 200 cities in 50 countries. Among other things, Accenture is "the largest independent technology services provider," and partners with many high-technology companies, including SAP, Oracle, Salesforce, and Microsoft.

Accenture Interactive is a unit within Accenture that specializes in digital services, especially for the advertising industry. In 2017, it acquired an Irish agency named Rothco. Shortly thereafter, Rothco won industry awards for its creation called "JFK: Unsilenced," in which artificial intelligence was used to create a version of a never-heard speech by John F. Kennedy, a U.S. president who was assassinated while in office. In 2019, Accenture Interactive was recognized by *Fast Company* as one of the most innovative advertising companies.

Julie Sweet, chair and CEO of Accenture, describes the ethical orientation of the company's employees in these words: "Across the globe, one thing is universally true of the people of Accenture: We care deeply about what we do and the impact we have with our clients and communities. It is personal to all of us." A recent alliance between Accenture Interactive's Rothco Unit, Warner Music, and Apple Music provides evidence to support this statement.

Source: www.saylists.com

Over 70 million songs were analyzed for Saylists to ensure that particular repetition patterns were found to help users with their speech while singing along.

The alliance can be described in these words, "For people with speech disorders, repetition is key to the treatment. But when it comes to kids, they find repetition boring. So, we wanted to see if there was a way to connect the world of speech therapy to the world where repetition is fun: music." Rothco partnered with Warner Music and Apple Music and analyzed over 70 million songs, looking for any songs in which problem sounds occur that can be helpful during speech therapy. The songs were then converted into "Saylists" that help make speech therapy fun for children. This alliance was listed as one of the most innovative in 2022 by *Fast Company.*

Sources: D. Lidsky, The 10 most innovative joint ventures of 2022, *Fast Company*, www.fastcompany.com, March 8; 2022, *Accenture Homepage*, www.accenture.com, April 9; 2022, *Accenture Newsroom*, www.newsroom.accenture.com, April 9; 2022, Most innovative companies: Accenture Interactive, *Fast Company*, www.fastcompany.com, April 9; 2022, Saylists, *Rothco: Part of Accenture Interactive*, www.rothco.ie, April 9.

Yoshida said his company wasn't going to miss out on what he called the next megatrend: Internet-connected electric cars. Sony hopes to leverage its prowess in videogames and video content, which have driven a revival in recent years."[41]

As described in the Strategic Focus, Accenture Interactive is another company that is cashing in on its digital expertise. One vertical alliance in particular, with Warner Music Group and Apple Music, is creating a special kind of value by helping children overcome speech disorders.

Figure 9.2 Business-Level Cooperative Strategies

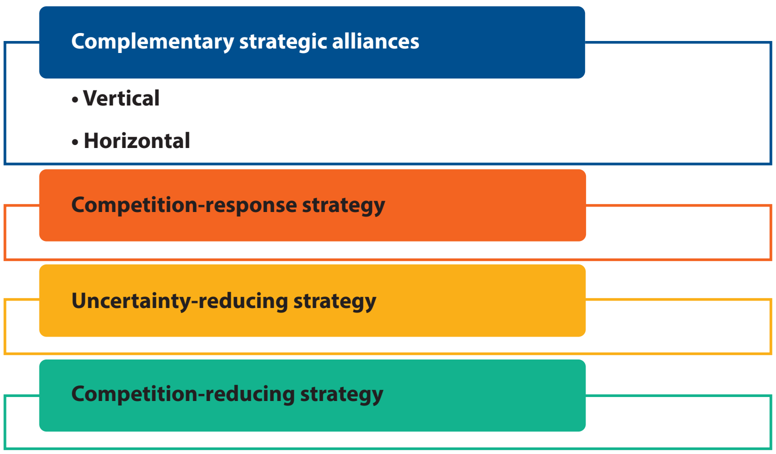
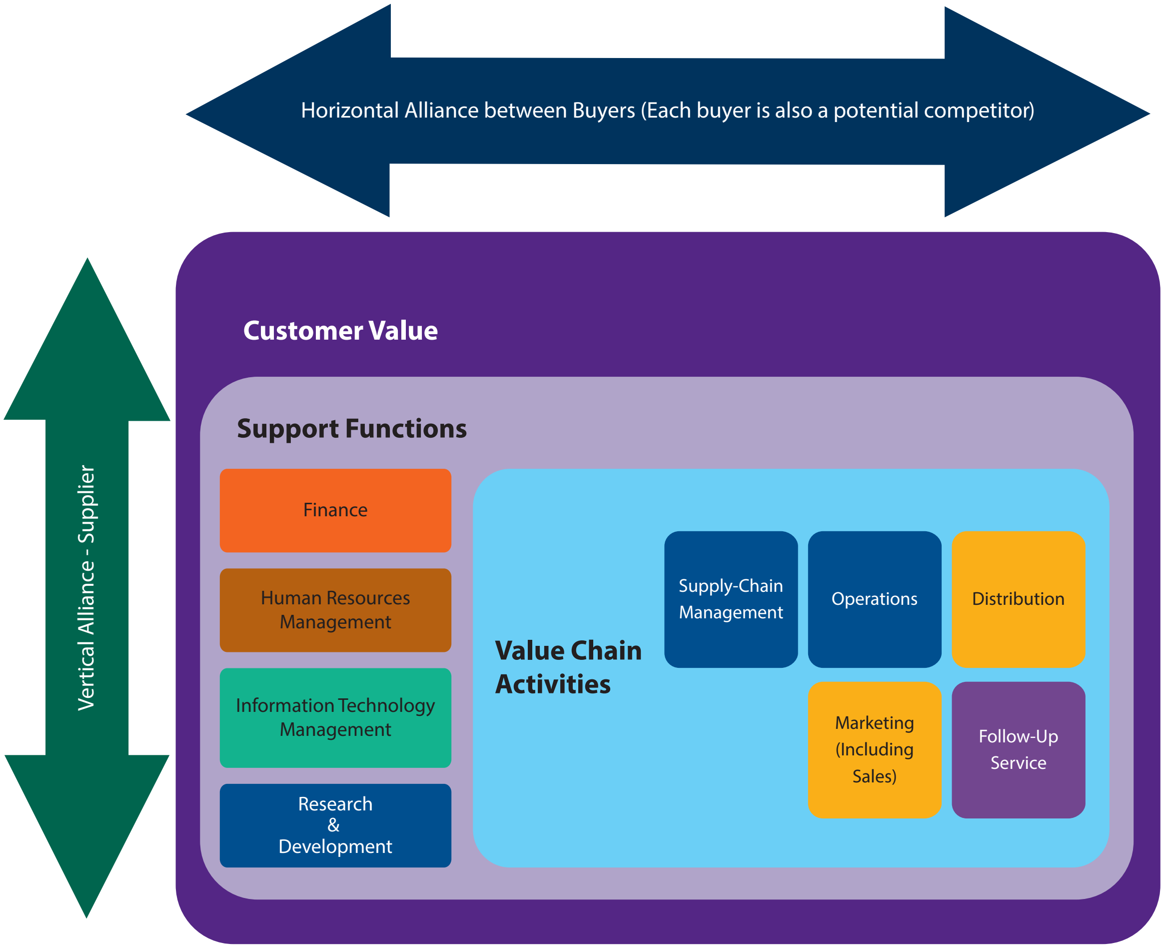


Figure 9.3 Vertical and Horizontal Complementary Strategic Alliances



Horizontal Complementary Strategic Alliance

A *horizontal complementary strategic alliance* is an alliance in which firms share some of their resources from the same stage (or stages) of the value chain for creating a competitive advantage. Pharmaceutical companies make frequent use of this type of alliance. Such alliances often help them to weather economic recessions and rivals' actions.[42] Some of the world's largest pharmaceutical firms, including Pfizer, Bristol-Myers Squibb, GlaxoSmithKline, and Eli Lilly, are sharing some of their proprietary assets through a collaboration organized by the U.S.-based National Institutes of Health; the objective is to more quickly develop drugs that cure and treat challenging and historically intractable diseases. Pharmaceutical company alliances played an important role in developing and producing a vaccine during the COVID-19 pandemic crisis.[43]

Coopetition involves simultaneous cooperation and competition among firms at the same stage of the value chain in the same industry.

One of the distinguishing features of most horizontal alliances is that firms that compete with each other for a share of the same markets also cooperate with each other. **Coopetition** is the term used to describe simultaneous cooperation and competition among firms at the same stage of the value chain in the same industry.[44] Research indicates a higher level of performance for firms that engage in coopetition.[45] Researchers also found a higher level of innovative performance in alliances when the environment is characterized by a high level of competition.[46] Perhaps this is because of the necessity to cooperate to remain competitive. Coopetition brought General Motors and Honda together in an alliance to develop affordable electric vehicles for the mass market.[47] The first of these vehicles is expected to cost less than $30,000 in the United States and be introduced to the market in 2027. Remember also that Honda is engaged in a vertical alliance with Sony to build electric vehicles. It will be interesting to see how Honda manages these two alliances with similar objectives.

While most horizontal alliances involve firms that compete directly with each other for the same customers (e.g., same product markets), an exception exists if firms in a horizontal alliance are at the same stage of the value chain but in different product markets. In an interesting study of 215 R&D alliances among pharmaceutical firms, researchers found that these types of alliances are more prone to joint value creation, whereas if firms in the alliance are in the same product markets, they are more likely to use the alliance to attempt to appropriate value for themselves.[48] This study suggests that innovation is stifled when firms that are too close as competitors (i.e., sell the same products to the same customers) engage in horizontal alliances.

Sometimes the desired outcomes of horizontal alliances are difficult to achieve. The parties to the alliance may not agree on how to combine their complementary resources, and the other alliances each partner has in its alliance portfolio can also affect the performance of the alliance over time.[49]

9-3b Competition Response Strategy

As discussed in Chapter 5, competitors initiate competitive actions (strategic and tactical) to attack rivals and launch competitive responses (strategic and tactical) to their competitors' actions. Strategic alliances can be used at the business level to respond to competitors' attacks. The alliance among Google, Intel, and TAG Heuer that is discussed in the Opening Case is a strategic response to Apple's strategic action of introducing the iWatch. Because strategic alliances can be difficult to reverse and expensive to operate, they are primarily formed to take strategic rather than tactical actions and to respond to competitors' actions in a like manner.

In October 2007, SABMiller and Molson Coors Brewing Company formed a partnership. At the time, these firms held the second and third largest shares of the U.S. brewing market. When formed, MillerCoors LLC commanded roughly 29 percent of the U.S. brewing market. However, Anheuser-Busch held 49 percent of the market. Indeed, the MillerCoors collaboration was a response to the size and scale of Anheuser-Busch's operations. (Anheuser-Busch itself was acquired by InBev in 2008, an acquisition that created the world's largest brewer.) Indicating that the collaboration would result in significant cost reductions and an ability to generate economies of scale through the firms' combined operations, a company official said that Miller and Coors would be stronger and more competitive together than either company would be on its own. However, the reduction in competition within the industry resulting from the MillerCoors joint venture led to price increases outsiders did not expect. In fact, a study economists conducted found that prices of beer products were 17–18 percent higher after the joint venture was consummated and as much as 8 percent higher than other factors explain. Thus, some alliances formed as competitive responses, particularly those that reduce overall competition, may have some unintended consequences.[50]

9-3c Uncertainty-Reducing Strategy

Firms sometimes use business-level strategic alliances to hedge against risk and uncertainty, especially in fast-cycle markets.[51] These strategies are also used where uncertainty exists, such as in entering new product markets, especially those within emerging economies. The development of new products to enter new markets and the entry into emerging markets often carry with them significant risks. Thus, to reduce or mollify these risks, firms often develop R&D alliances and alliances with emerging market firms, respectively.[52]

Another type of risk alliances address is being left behind the competition when applying new technologies. Electric vehicles are a technology with far-reaching implications for virtually every business on the planet. Ceres, a non-profit Boston-based sustainability group, launched the Corporate Electric Vehicle Alliance to help companies transition to electric vehicles. Members of the alliance include Amazon, IKEA, DHL (trucking), AT&T, Genentech, and Siemens, among others. Sue Reid, VP of Climate and Energy at Ceres, explained: "The climate crisis demands we decarbonize transportation—the highest-emitting sector in the U.S.—and electric vehicles are an essential component of this transition."[53] One of the goals of the alliance is to encourage the production of a wider array of electric vehicles. By participating in this alliance, member companies will be in a much better position to lead in the transition to electric vehicles rather than playing catch-up.

9-3d Competition-Reducing Strategy

Used to reduce competition, collusive strategies differ from strategic alliances in that collusive strategies are often an illegal cooperative strategy.[54] Explicit collusion and tacit collusion are the two types of collusive strategies.

Explicit collusion exists when two or more firms negotiate directly to jointly agree on how much to produce as well as how much to charge for what is produced.[55] Explicit collusion strategies are illegal in the United States and most developed economies (except in regulated industries). Accordingly, companies choosing to explicitly collude with other firms should recognize that competitors and regulatory bodies likely will challenge the acceptability of their competitive actions.

Tacit collusion exists when several firms in an industry indirectly coordinate their production and pricing decisions by observing each other's competitive actions and responses.[56] Tacit collusion tends to take place in industries dominated by a few large firms. It results in production output that is below fully competitive levels and above fully competitive prices. Researchers have found that strategic alliances among competitors reduce the likelihood that these firms will engage in competitive behavior that is damaging to the firms with which they are partnering (i.e., price wars).[57] In addition to the effects on competition within a particular market, research suggests that tacit collusion between two firms can lead to less competition in other markets in which both firms operate.[58]

As suggested above, tacit collusion tends to be used as a competition-reducing, business-level strategy in industries with a high degree of concentration, such as the airline and breakfast cereal industries. Research in the airline industry suggests that tacit collusion reduces service quality and on-time performance and leads to higher prices.[59] Firms in these industries recognize their interdependence, which means that their competitive actions and responses significantly affect competitors' behavior toward them. Understanding this interdependence and carefully observing competitors can lead to tacit collusion. It can occur in other industries as well. For example, we noted earlier that the MillerCoors joint venture led to a large price increase on the MillerCoors and Anheuser-Busch beers. When prices are above the competitive level in an industry, it is logical to assume that the dominant firms use a tacit collusion cooperative strategy.

Mutual forbearance is a form of tacit collusion in which firms do not take competitive actions against rivals they meet in multiple markets. Rivals learn a great deal about each other when engaging in multimarket competition, including how to deter the effects of their rivals' competitive attacks and responses. Given what they know about each other as competitors, firms choose not to engage in what could be destructive competition in multiple product markets.[60]

In general, governments in free-market economies seek to determine how rivals can form cooperative strategies to increase their competitiveness without violating established regulations about competition.[61] For example, "U.S. antitrust enforcers sued American Airlines Group Inc. and JetBlue Airways Corp. to unwind their agreement to coordinate flights in the U.S. Northeast, saying the pact violates antitrust laws by eliminating competition between them."[62] In an interesting twist, American and JetBlue ignored the lawsuit and expanded alliance benefits for their customers just three weeks later.[63]

Other actions can be taken to reduce competition other than collusion. For example, firms may engage in alliances to build their knowledge. In doing so, they can create capabilities that allow them to outmaneuver their competitors, perhaps even forestalling their entry into market niches or disallowing their access to market share.[64] Also, some firms may forestall competition through rapid actions that capture and hold customers. For example, some firms rapidly introduced greener technology strategies throughout their supply chains (including alliance partners), satisfying customers' desires for a cleaner environment.[65] In the final analysis, individual companies must analyze the effect of a competition-reducing strategy on their performance and competitiveness and decide if pursuing such a strategy facilitates or inhibits their competitive success.

9-3e Assessing Business-Level Cooperative Strategies

Firms use business-level cooperative strategies to develop competitive advantages that can contribute to successful positions in individual product markets. Evidence suggests that complementary business-level strategic alliances, especially vertical ones, have the greatest probability of creating a competitive advantage and possibly even a sustainable one.[66] Horizontal complementary alliances are sometimes difficult to maintain precisely because they are formed between firms that compete against each other at the same time they are cooperating.[67]

Airline companies, for example, want to compete aggressively against others serving their markets and customers. However, the need to develop scale economies and to share resources (such as scheduling systems) dictates that alliances be formed so the companies can compete by using cooperative actions and responses, while they simultaneously compete against one another through competitive actions and responses. The challenge in these instances is for each firm to find ways to create the greatest amount of value from their simultaneous competitive and cooperative actions.

Although strategic alliances designed to respond to competition and to reduce uncertainty can also create competitive advantages, these advantages often are more temporary than those developed through complementary (both vertical and horizontal) alliances. The primary reason for this is that complementary alliances have a stronger focus on creating value than do competition-reducing and uncertainty-reducing alliances.[68]

9-4 Corporate-Level Cooperative Strategy

Learning Objective

9-4 Discuss the use of corporate-level cooperative strategies.

A **corporate-level cooperative strategy** is a strategy through which a firm collaborates with one or more companies to expand its operations. Diversifying alliances, synergistic alliances, and franchising are the most commonly used corporate-level cooperative strategies (see Figure 9.4).

A **corporate-level cooperative strategy** is a strategy through which a firm collaborates with one or more companies to expand its operations.

When a firm seeks to diversify into markets in which the host nation's government makes acquisitions difficult, alliances become an especially appropriate option. Corporate-level strategic alliances are also attractive compared with alliances because they require fewer resource commitments and permit greater flexibility in terms of efforts to diversify partners' operations.[69] An alliance can be used to determine whether the partners might benefit from a future merger or acquisition between them.[70] This "testing" process often characterizes alliances formed to combine firms' unique technological resources and capabilities.

9-4a Diversifying Strategic Alliance

A **diversifying strategic alliance** is a strategy in which firms share some of their resources to engage in product and/or geographic diversification. Companies using this strategy typically seek to enter new markets (either domestic or outside of their home setting) with existing products or with newly developed products. For example, Fratelli Wines is an Indo-Italian alliance formed with the objective of applying Italian wine-making methods in India. The alliance has produced award-winning wines.[71]

A **diversifying strategic alliance** is a strategy in which firms share some of their resources to engage in product and/or geographic diversification.

Managing diversity gained through alliances has fewer financial costs compared to greenfield ventures (explained in Chapter 8) but often requires more managerial expertise. The need for expertise in managing diversity is heightened by the fact that the focal firm has less control over the partner. Managers must coordinate and build trust to coordinate alliance activities. Additionally, they must work at understanding their diverse partners and their capabilities to successfully coordinate within the alliance.[72]

9-4b Synergistic Strategic Alliance

A **synergistic strategic alliance** is a strategy in which firms share some of their resources to create economies of scope. Similar to the business-level horizontal complementary strategic alliance, synergistic strategic alliances create synergy across multiple functions or multiple businesses between partner firms.[73] A common example of a synergistic alliance is when firms partner across the value chain. When supply chain partners co-align, they often can create synergistic benefits enjoyed by both partners.[74] Synergy in sharing resources is more common

A **synergistic strategic alliance** is a strategy in which firms share some of their resources to create economies of scope.

Figure 9.4 Corporate-Level Cooperative Strategies

in alliances that provide resources to help firms become ambidextrous and thereby satisfy multiple needs (e.g., help them create multiple capabilities). In fact, some firms that have developed strong ambidexterity (perhaps through alliances) in turn are able to form alliances and search for their partner's special skills or resources (prospective resourcing).[75]

The partnership between French-based Renault SA and Japan-based Nissan Motor Company was formed in 1999 as a synergistic strategic alliance, That means, among other outcomes, that the firms seek to create economies of scope by sharing their resources to develop manufacturing platforms to produce cars that will carry either the Renault or the Nissan brand. Later, the firms added Mitsubishi to this alliance to become the largest automotive alliance in the world.[76]

9-4c Franchising

Franchising is a strategy in which a firm (the franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources with its partners (the franchisees).

Franchising was first mentioned in Chapter 4 as a type of business model and again in Chapter 8 as a technique for entering a country for the first time. **Franchising** is a strategy in which a firm (the franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources with its partners (the franchisees).[77] A *franchise* is a "form of business organization in which a firm that already has a successful product or service (the franchisor) licenses its trademark and method of doing business to other businesses (the franchisees) in exchange for an initial franchise fee and an ongoing royalty rate."[78] Often, the effectiveness of these strategic alliances is a product of how well the franchisor can replicate its success across multiple partners in a cost-effective way.[79] As with diversifying and synergistic strategic alliances, franchising is an alternative to pursuing growth through mergers and acquisitions. McDonald's, Choice Hotels International, Hilton International, Marriott International, Mrs. Fields Cookies, Subway, and Ace Hardware are well-known firms using the franchising corporate-level cooperative strategy.

Franchising is a particularly attractive strategy to use in fragmented industries, such as retailing, hotels and motels, and commercial printing. In fragmented industries, many small and medium-sized firms compete as rivals; however, no firm or small set of firms has a dominant share, making it possible for a company to gain a large market share by consolidating independent companies through the contractual relationships that are a part of a franchise agreement.

In the most successful franchising strategy, the partners (the franchisor and the franchisees) work closely together.[80] A primary responsibility of the franchisor is to develop programs to transfer to the franchisees the knowledge and skills that are needed to successfully compete at the local level.[81] In return, franchisees should provide feedback to the franchisor regarding how their units could become more effective and efficient.[82] Working cooperatively, the franchisor and its franchisees find ways to strengthen the core company's brand name, which is often the most important competitive advantage for franchisees operating in their local markets.[83]

9-4d Assessing Corporate-Level Cooperative Strategies

Costs are incurred to implement each type of cooperative strategy.[84] Compared with their business-level counterparts, corporate-level cooperative strategies commonly are broader in scope and more complex, making them relatively more challenging and costly to use.

Despite these costs, firms can create competitive advantages and customer value by effectively using corporate-level cooperative strategies.[85] Internalizing successful alliance experiences makes it more likely that the strategy will attain the desired advantages.[86] In other words, those involved with forming and using corporate-level cooperative strategies can also use them to develop useful knowledge about how to succeed in the future. To gain maximum value from this knowledge, firms should organize it and verify that it is always properly distributed to those involved with forming and using alliances.

We explained in Chapter 6 that firms answer two questions when dealing with corporate-level strategy: in which businesses and product markets will the firm choose to compete, and how will those businesses be managed? These questions are also answered as firms form corporate-level cooperative strategies. Thus, firms able to develop corporate-level cooperative strategies and manage them in ways that are valuable, rare, imperfectly imitable, and nonsubstitutable (see Chapter 3) develop a competitive advantage in addition to advantages gained through the implementation of business-level cooperative strategies.

9-5 International Cooperative Strategy

Learning Objective

9-5 Understand why firms use cross-border strategic alliances as an international cooperative strategy.

In the new competitive landscape, firms use various types of cross-border transactions for several purposes. In Chapter 7, we discussed cross-border acquisitions—actions through which a company located in one country acquires a firm located in a different country. In Chapter 8, we described how firms use cross-border strategic alliances and joint ventures as a way of entering international markets. Here in Chapter 9, we pick up on that discussion and examine cross-border strategic alliances as a type of international cooperative strategy. Thus, as the discussions in Chapters 7, 8, and 9 show, firms engage in cross-border activities to achieve several related and often complementary objectives.

A **cross-border strategic alliance** is a strategy in which firms with headquarters in different countries decide to combine some of their resources to create a competitive advantage.[87] These alliances are sometimes formed instead of mergers and acquisitions, which can be riskier. Even though cross-border alliances can themselves be complex and difficult to manage, they have the potential to help firms use some of their resources to create value in locations outside their home market. Through this collaboration, the partners often cooperate in one or more areas such as development, procurement, and production processes, partly with the intent to create value in markets throughout the world that neither firm could create operating independently.[88]

A **cross-border strategic alliance** is a strategy in which firms with headquarters in different countries decide to combine some of their resources to create a competitive advantage.

Limited domestic growth opportunities and foreign government economic policies are key reasons firms use cross-border alliances. As discussed in Chapter 8, local ownership is an important national policy objective in some nations. In India and China, for example, governmental policies reflect a strong preference to license local companies. In some cases, a firm may even be required (or find it highly advantageous) to partner with a political institution in the host country, which brings with it a new set of risks (including the risk that the political partner may expropriate the profits).[89] Thus, in some countries, the full range of entry-mode choices we described in Chapter 8 may not be available to firms seeking to geographically diversify. Indeed, investment by foreign firms in these instances may be allowed only through a partnership with a local firm, such as in a cross-border alliance.

In spite of these sorts of difficulties, strategic alliances with local partners can help firms overcome the liability of foreignness associated with moving into a foreign country, including problems related to a lack of knowledge of the local culture or institutional norms.[90] A cross-border strategic alliance can also help foreign partners from an operational perspective—the local partner has significantly more information about factors contributing to competitive success, such as local markets, sources of capital, legal procedures, and politics.[91] Interestingly, research results suggest that firms with foreign operations have longer survival rates than domestic-only firms, although this advantage is reduced if there are competition problems between foreign subsidiaries.[92]

In general, cross-border strategic alliances are more complex and riskier than domestic strategic alliances. For example, the level of corruption found in an alliance partner's home country is a source of risk.[93] Differences in the legal and institutional characteristics across countries can also increase complexity and risk.[94] As mentioned in Chapter 8, overcoming the liabilities associated with cross-border strategic alliances requires that the two partners develop trust, which is even more difficult to achieve than in domestic alliances.[95] Establishing trust requires highly effective managers who can build trusting relationships with partners.[96]

All the strategies described in this book can fail. Cross-border alliances are no exception. As described in the Strategic Focus, Ford and Mahindra formed a strategic alliance that was intended to allow the companies to combine their complementary capabilities in developing new vehicles for the Indian market. Ford would gain Mahindra's knowledge of designing and manufacturing cars for emerging markets, and Mahindra would gain access to Ford's technological capabilities. Unfortunately, things did not work out as planned, and the alliance is over.

Strategic Focus

The Cross-Border Alliance between Ford and Mahindra Runs into Trouble

Ford has been producing and selling automobiles in India for many years. In fact, in 2018, Ford sold its one millionth car in India. All told, Ford has invested almost $2 billion to build in India. In 2010, it began building two new manufacturing plants in India to accommodate growth in that market over time. However, Ford's sales in India were disappointing, so it began to export cars made in its new plants. Ford is not alone in failing to navigate the Indian automobile market effectively; Fiat Chrysler, General Motors, and Volkswagen have all experienced problems in the Indian market.

Nonetheless, Ford remains committed to the Indian market and decided to take a different approach. It developed an alliance with Mahindra and Mahindra Ltd. of India to cooperate in the development of specific vehicles for India and other emerging markets. They agreed to jointly develop a new SUV using an existing Mahindra platform, share powertrains including engines and transmissions, and co-develop a new compact SUV and a new electric vehicle. The new alliance was intended to provide Ford knowledge and expertise to better serve emerging markets, including India, and provide Mahindra access to Ford's technology. Mahindra would like to penetrate the U.S. vehicle markets. It is already third in the tractor market in the United States and is trying to break into the U.S. off-road vehicle and pickup truck markets as well.

Ford was extremely positive about the potential success of this alliance. It expected the Indian auto market to grow 8–10 percent annually for the near future. Nonetheless, industry analysts were skeptical partly because of the challenges involved in cross-border alliances. The two companies had to overcome different corporate cultures and different processes and find ways to coordinate and collaborate.

Deals such as this one must be approved by the Indian government. In early 2020, the Competition Commission of India approved formation of the joint venture between Ford and Mahindra, as well as the transfer of Ford's Indian automotive business into the new venture. Mahindra would own a 51 percent stake in the joint venture, while Ford would own 49 percent. This model means that Mahindra would have a controlling interest, and Ford would suspend all its independent operations in India. Around the same time, Mahindra announced that it was going to expand its engine capacity in a Ford plant in Chennai.

Given all the goodwill surrounding this venture, it was surprising that in early 2021, Ford and Mahindra announced that they had ended their joint activities on all their projects in India. Concerning what Ford would decide to do with Mahindra moving forward, a source said: "The options could include working out a new relationship with Mahindra or ending the relationship and related vehicles completely." Mahindra, for its part, decided to renew its efforts to produce sport-utility vehicles (SUVs) and electric vehicles. The particulars of why the deal fell apart were not reported to the press. All we know is that the breakup came as Ford was working on a new strategy for India.

Kyodo News/Getty Images

Mahindra's new version of their electric hatchback, the e20, was revealed at Auto Expo 2018.

Sources: 2021, Ford and Mahindra to end collaboration on all project in India, *FRPT Automobile Snapshot,* April 6: 9; 2021, Mahindra to focus on SUVs, electric after ending Ford JV, *FRPT Automobile Snapshot,* January 5: 23–24; 2021, Ford freezes projects with Mahindra amid strategy reassessment, *FRPT Automobile Snapshot,* February 23: 7–8; 2020, Competition Commission of India gives nod to Ford-Mahindra joint venture, *FRPT Automobile Snapshot,* February 18: 20–21; 2020, Mahindra to expand engine capacity in Ford plant, *FRPT Automobile Snapshot,* February 18: 22–23; P. Luthra, 2018, Ford India expects to grow faster than sector, working with Mahindra on electric vehicle, *CNBC*, www.cnbctv18.com, July 17; A. Tsang, 2018, As auto industry transforms, Ford and Volkswagen consider an alliance, *New York Times*, www.nytimes.com, June 20; S. S. Mohile, 2018, Mahindra, Ford Motor enter second phase for a potential alliance, *Business Standard*, www.business-standard.com, March 23; D. Kiley, 2018, Ford and Mahindra to build SUVs and EV together, *Forbes*, www.forbes.com, March 22; J. Rosevear, 2018, Why Ford and Mahindra are teaming up on SUVs and EVs for India, *The Motley Fool*, www.fool.com, March 22.

Learning Objective

9-6 Discuss the use of network cooperative strategies.

A **network cooperative strategy** is a strategy by which several firms agree to form multiple partnerships to achieve shared objectives.

9-6 Network Cooperative Strategy

In addition to forming their own alliances with individual companies, an increasing number of firms are collaborating in multiple alliances called networks.[97] A **network cooperative strategy** is a strategy by which several firms agree to form multiple partnerships to achieve shared objectives.

Through its Global Partner Network, Cisco has formed alliances with a host of companies, including IBM, Emerson, Hitachi, CA Technologies, Fujitsu, Intel, Nokia, and Wipro. Cisco uses alliances to drive its growth, differentiate itself from competitors, enter new businesses areas, and create competitive advantages. Recently, Cisco's annual revenues earned from its alliances exceeded

$5 billion. Sometimes, several of the firms with which Cisco has formed individual alliances partner together to form a network to achieve shared objectives.[98]

Demonstrating the complexity of network cooperative strategies is the fact that Cisco also competes against several firms with whom it has formed cooperative agreements, including network strategies. For example, Cisco and IBM compete against each other. However, Cisco and IBM also collaborate such that IBM security works with Cisco's security to deliver a more secure environment for their customers, better enabling operators and partner communities to reduce security threats.[99] Overall, coopetition between Cisco and IBM demonstrates how firms use network cooperative strategies as a way of creating value for customers by offering many goods and services in many geographic (domestic and international) markets.

A network cooperative strategy is particularly effective when it is formed by geographically clustered firms, as in California's Silicon Valley and Rome, Italy's aerospace cluster.[100] Fostering effective social relationships and interactions among partners while sharing their resources makes it more likely that a network cooperative strategy will be successful.[101] Also important is having a productive strategic center firm (we discuss strategic center firms in detail in Chapter 11). Firms involved in networks gain information and knowledge from multiple sources.[102] In fact, research has found that firms that are at the strategic center of a network are more likely to engage in international strategic alliances, which has the potential to expand the knowledge base found within the network.[103] Network firms can use these heterogeneous knowledge sets to produce more and better innovation. As a result, firms involved in networks of alliances tend to be more innovative.[104] Also, firms often imitate the level of exploratory research their partners exhibit, which could be another reason that they are more innovative.[105]

Nonetheless, there are disadvantages to participating in networks. A firm can be locked into its partnerships, which could preclude the development of alliances with other firms. In certain network configurations, such as a Japanese *keiretsu*, firms in a network are expected to help other firms in that network whenever support is required. Although research evidence suggests that being a member of some (but not all) *keiretsu* can enhance performance, it is also possible that the burdens associated with membership can become a burden and negatively affect the member firm's performance over time.[106]

9-6a Alliance Network Types

An important advantage of a network cooperative strategy is that firms gain access to their partners' other partners.[107] Having access to multiple collaborations increases the likelihood that additional competitive advantages will be formed as the set of shared resources expands.[108] In turn, being able to develop new resources further stimulates product innovations that are critical to strategic competitiveness in the global economy.

The set of strategic alliance partnerships that firms develop when using a network cooperative strategy is called an *alliance network*.[109] Companies' alliance networks vary by industry characteristics. A *stable alliance network* is formed in mature industries where demand is relatively constant and predictable. Through a stable alliance network, firms try to extend their competitive advantages to other settings while continuing to profit from operations in their core, relatively mature industry. Thus, stable networks are built primarily to *exploit* the economies (scale and/or scope) that exist between the partners, such as in the airline and automobile industries.[110]

Dynamic alliance networks are used in industries characterized by frequent product innovations and short product life cycles.[111] The industries in which Apple and IBM compete are examples of this situation. Apple and IBM each partner with a host of other firms to develop component parts that are critical to providing the products that are central to their success. Thus, a network of relationships among multiple companies is foundational to achieving the objectives Apple and IBM each seek.

In dynamic alliance networks, partners typically *explore* new ideas with the potential to lead to product innovations, entries to new markets, and the development of new markets. Research suggests that firms that help to broker relationships between companies remain important network participants as these networks change.[112] Often, large firms in industries such as software and pharmaceuticals create networks of relationships with smaller entrepreneurial start-up firms in their search for innovation-based outcomes. Alternatively, smaller firms with fewer resources or firms in developing economies often seek alliance participation to enhance their competitive positions.[113]

Similarly, small general practice law firms are partnering with larger firms to provide their clients with legal advice on intellectual property protection. In this way, the small firm better serves its client without having to add an expensive group of patent lawyers to its staff.[114] An important outcome for small firms successfully partnering with larger firms in an alliance network is the credibility they build by being associated with their larger collaborators.[115]

Learning Objective

9-7 Explain cooperative strategies' risks.

9-7 Competitive Risks with Cooperative Strategies

Stated simply, many cooperative strategies fail. In fact, evidence shows that two-thirds of cooperative strategies have serious problems in their first two years and as many as 50 percent of them fail. This failure rate suggests that even when the partnership has potential complementarities and synergies, alliance success is elusive.[116] Although failure is undesirable, it can be a valuable learning experience. Firms should carefully study a cooperative strategy's failure to gain insights about how to form and manage future cooperative arrangements.[117]

We show prominent cooperative strategy risks in Figure 9.5. One risk is that the contract governing the alliance is insufficient in addressing important issues as they arise. This risk can lead a firm to act opportunistically (e.g., take advantage of the other firm) or in a way that its partner thinks is opportunistic.[118] This sort of behavior leads to a breakdown of trust, which can damage the alliance's ability to achieve its objectives.[119] BP PLC and OAO Rosneft developed a joint venture to explore Russia's Arctic Ocean in search of oil. However, the investment value by minority partners of this joint venture was driven down at one point by 50 percent over concern that the Russian government, Rosneft's dominant owner, would expropriate value from the deal.[120]

While opportunistic behaviors can surface when formal contracts fail to prevent them, they can also occur when an alliance is based on a false perception of partner trustworthiness.[121] Typically, an opportunistic firm wants to acquire as much of its partner's tacit knowledge as it can.[122] Full awareness of what a partner wants in a cooperative strategy reduces the likelihood that a firm will suffer from another firm's opportunistic actions.[123]

Some cooperative strategies fail when it is discovered that a firm has misrepresented the resources it can bring to the partnership. This risk is more common when the partner's contribution is based on some of its intangible assets. Superior knowledge of local conditions is an example of an intangible asset that partners often fail to deliver. This type of risk suggests the importance of carefully selecting alliance partners. Some firms may guard against this risk by identifying other potential partners in case the original alliance is unsuccessful. Having "backup" suppliers available is a common approach used in supply chain alliances.[124]

The cooperative relationships in the form of nonequity strategic alliances that are being created between some large pharmaceutical companies and outsourcing firms is potentially an example of the "misrepresentation of available resources" risk. Pharmaceutical companies are outsourcing the monitoring of drug safety to firms claiming to have the requisite human capital skills needed to successfully complete various monitoring tasks. But critics of this approach argue that drug monitoring is difficult, requiring deep experience as well as knowledge of biochemistry and pharmacology.

Figure 9.5 Managing Competitive Risks in Cooperative Strategies

Also, these firms may not identify side effects, some of which might be very serious. Nonetheless, one study found that approximately 66 percent of the companies outsourced at least some portion of their drug safety activities.[125] Thus, pharmaceutical companies may need to carefully monitor the quality of the human capital resource their partners provide to complete what appears to be complicated monitoring work.

A firm's failure to make available to its partners the resources (such as the most sophisticated technologies) that it committed to the cooperative strategy is a third risk. This particular risk surfaces most commonly when firms form an international cooperative strategy, especially in emerging economies.[126] In these instances, different cultures and languages can cause misinterpretations of contractual terms or trust-based expectations.

A final risk is that one firm may make investments that are specific to the alliance while its partner does not. For example, the firm might commit resources to develop manufacturing equipment that can be used only to provide products associated with the alliance. If the partner isn't also making alliance-specific investments, the firm is at a relative disadvantage in terms of returns earned from the alliance compared with investments made to earn the returns.

9-8 Approaches for Managing Cooperative Strategies

Learning Objective

9-8 Describe two basic approaches used to manage cooperative strategies.

Although they are difficult to manage, cooperative strategies are an important means of growth and enhanced firm performance. Because the ability to effectively manage cooperative strategies is unevenly distributed across organizations in general, assigning managerial responsibility for a firm's cooperative strategies to a high-level executive or to a dedicated team improves the likelihood that the strategies will be well managed.[127] In turn, being able to successfully manage cooperative strategies can alone contribute significantly to a firm's competitive advantage.[128]

For all cooperative strategies, success is more likely when partners behave cooperatively, and cooperation requires the establishment of trusting relationships. Actively solving problems, being trustworthy, and consistently pursuing ways to combine partners' resources to create value are examples of cooperative behavior known to contribute to alliance success.[129] Those responsible for managing the firm's cooperative strategies should take the actions necessary to coordinate activities, categorize knowledge learned from previous experiences, and make certain that what the firm knows about how to effectively form and use cooperative strategies is in the hands of the right people at the right time.[130] Firms must also learn how to manage both the tangible and intangible assets (such as knowledge) that are involved with a cooperative arrangement. Too often, partners concentrate on managing tangible assets at the expense of taking action also to manage a cooperative relationship's intangible assets.[131]

Cost minimization and opportunity maximization are the two primary approaches firms use to manage cooperative strategies.[132] In the *cost-minimization* approach, the firm develops formal contracts with its partners. These contracts specify how the cooperative strategy is to be monitored and how partner behavior is to be controlled. The joint venture between GM China and SAIC Motor Corp. is being managed largely through formal contractual relationships. The goal of the cost-minimization approach is to minimize the cooperative strategy's cost and to prevent opportunistic behavior by a partner.

Maximizing a partnership's value-creating opportunities is the focus of the *opportunity-maximization* approach. In this case, partners are prepared to take advantage of unexpected opportunities to learn from each other and to explore additional marketplace possibilities. Less formal contracts, with fewer constraints on partners' behaviors, make it possible for partners to explore how their resources can be shared in multiple value-creating ways.

Firms can successfully use either approach to manage cooperative strategies. Ironically, contract creation and monitoring costs are greater with cost minimization because writing detailed contracts and using extensive monitoring mechanisms is expensive, even though the approach is intended to reduce alliance costs. As mentioned in the previous section, a detailed contract and monitoring system is one way to manage risks associated with cooperative strategies, but they also often preclude positive responses to new opportunities that surface to productively use each alliance partner's unique resources. Thus, formal contracts and extensive monitoring systems tend to stifle partners' efforts to gain maximum value from their participation in a cooperative strategy.[133]

The relative lack of detail and formality that is a part of the contract developed when using the opportunity-maximization approach means that firms need to trust that each party will act in the partnership's best interests. *Trust* in this context means that the mangers of the firms engaging in the cooperative behavior believe that the other firm will not do anything to exploit their firm's vulnerabilities, even if it has an opportunity to do so.[134] When partners trust each other, there is less need to write detailed formal contracts to specify each firm's alliance behaviors, and the cooperative relationship tends to be more stable.[135] On a relative basis, trust tends to be more difficult to establish in international cooperative strategies than in domestic ones. Differences in trade policies, cultures, laws, and politics that are part of cross-border alliances account for the increased difficulty.

Research showing that trust between partners increases the likelihood of success when using alliances highlights the benefits of the opportunity-maximization approach to managing cooperative strategies.[136] Trust may also be the most efficient way to influence alliance partners' behaviors. Thus, firms known to be trustworthy can have a competitive advantage in terms of how they develop and use cooperative strategies. Increasing the importance of trust in alliances is the fact that it is not possible to specify all operational details of a cooperative strategy in a formal contract. As such, being confident that its partner can be trusted reduces the firm's concern about its inability to contractually control all alliance details.[137]

Summary

- A cooperative strategy is one in which firms work together to achieve a shared objective. Strategic alliances, whereby firms combine some of their resources for the purpose of creating a competitive advantage, are the primary form of cooperative strategies. Joint ventures (whereby firms create a legally independent company that is jointly owned), equity strategic alliances (in which firms buy shares in their partner companies), and nonequity strategic alliances (whereby firms cooperate through a contractual relationship) are the three major types of strategic alliances. Outsourcing, discussed in Chapter 3, commonly occurs through nonequity strategic alliances.
- Two of the most important reasons firms form strategic alliances are to create value they couldn't generate by acting independently and to gain the full set of resources needed to pursue all identified opportunities to reach their objectives.
- The reasons firms use strategic alliances vary by slow-cycle, fast-cycle, and standard-cycle market conditions. To enter restricted markets (slow cycle), to move quickly from one competitive advantage to another (fast cycle), and to gain market power (standard cycle) are among the reasons firms decide to use strategic alliances.
- Four business-level cooperative strategies are used to help the firm improve its performance in individual product markets:
  - Through vertical and horizontal complementary alliances, companies combine some of their resources to create value in different parts (vertical) or the same parts (horizontal) of the value chain.
  - Competition response strategies are formed to respond to competitors' actions, especially strategic actions.
  - Uncertainty-reducing strategies are used to hedge against the risks created by the conditions of uncertain competitive environments (such as new product markets).
  - Competition-reducing strategies are used to avoid excessive competition while the firm marshals its resources to improve its strategic competitiveness. Explicit and implicit collusion are both competition-reducing strategies. Mutual forbearance is a form of tacit collusion in which firms do not take competitive actions against rivals they meet in multiple markets.

  Complementary alliances have the highest probability of helping a firm to create a competitive advantage; competition-reducing alliances have the lowest probability.
- Firms use corporate-level cooperative strategies to engage in product and/or geographic diversification. Through diversifying strategic alliances, firms agree to share some of their resources to enter new markets or provide new products. Synergistic alliances are ones in which firms share some of their resources to develop economies of scope. Synergistic alliances are like business-level horizontal complementary alliances whereby firms try to develop operational synergy, except that synergistic alliances are used to develop synergy at the corporate level. Franchising is a corporate-level cooperative strategy in which the franchisor uses a franchise as a contractual relationship to specify how resources will be shared with franchisees.
- As an international cooperative strategy, a cross-border strategic alliance is used for several reasons, including the performance superiority of firms competing in markets outside their domestic market and governmental restrictions on a firm's efforts to grow through mergers and acquisitions. Commonly, cross-border strategic

alliances are riskier than their domestic counterparts because of the differences in companies and their cultures and the frequent difficulty of building trust to share resources among the partners.

- In a network cooperative strategy, several firms agree to form multiple partnerships to achieve shared objectives. A firm's opportunity to gain access "to its partner's other partnerships" is a primary benefit of a network cooperative strategy. Network cooperative strategies are used to form either a stable alliance network or a dynamic alliance network. In mature industries, stable networks are used to extend competitive advantages into new areas. In rapidly changing environments where frequent product innovations occur, dynamic networks are used primarily as a tool of innovation.
- Cooperative strategies often carry risk. If a contract is not developed appropriately, or if a partner misrepresents its resources or fails to make them available, failure is likely. Furthermore, a firm may be held hostage through asset-specific investments made in conjunction with a partner, which may then be exploited.
- Trust is an increasingly important aspect of successful cooperative strategies. Firms place high value on opportunities to partner with companies known for their trustworthiness. When trust exists, a cooperative strategy is managed to maximize the pursuit of opportunities between partners. Without trust, formal contracts and extensive monitoring systems are used to manage cooperative strategies. In this case, the interest is "cost minimization" rather than "opportunity maximization."

Key Terms

business-level cooperative strategy 228
complementary strategic alliances 228
cooperative strategy 224
coopetition 230
corporate-level cooperative strategy 233
cross-border strategic alliance 235
diversifying strategic alliance 233
equity strategic alliance 225
franchising 234
joint venture 225
network cooperative strategy 236
nonequity strategic alliance 225
strategic alliance 224
synergistic strategic alliance 233

Review Questions

1. What is the definition of cooperative strategy, and why is this strategy important to firms competing in the current competitive landscape?
2. What is a strategic alliance? What are the three major types of strategic alliances that firms form to develop a competitive advantage?
3. What are the four business-level cooperative strategies? What are the key differences among them?
4. What are the three corporate-level cooperative strategies? How do firms use each of these strategies to create a competitive advantage?
5. Why do firms use cross-border strategic alliances?
6. What risks are firms likely to experience as they use cooperative strategies?
7. What are the differences between the cost-minimization approach and the opportunity-maximization approach to managing cooperative strategies?

Mini-Case

Avanade, Created Through a Joint Venture, Now Has More Than 50,000 Employees

Avanade was created in 2000 through a joint venture between Accenture and Microsoft. Earlier in this chapter, we discussed a much different type of partnership that included a unit of Accenture (Rothco), Warner Music, and Apple to help children with speech disorders. This venture with Microsoft was formed to combine strategy and technology to help clients improve their information technology (IT) capabilities, and thus improve their business performance. Avanade now has more than 50,000 employees around the world and thousands of clients, including many *Fortune* 500 companies.

In early 2019, Avanade, working with Accenture and Microsoft, launched the Accenture Microsoft Business Group. This new group expanded combined service capabilities on a global level to help clients overcome disruptions caused by digital technologies and assume positions of leadership in their industries. Specifically, the group is focused on using technology to transform businesses, helping clients innovate their use of digital technologies, and bringing together professionals to produce joint products and services built on the Microsoft cloud. "With proven methodologies, deep expertise and leading-edge technology, we can help you maximize cloud platforms, mobile applications, social media and big data securely to transform the way you do business."

The expansion continues. In 2022, Shawn Simmons, vice president of North America Engineering Hubs at Avanade, explained his company's decision to open an engineering hub in Tampa, Florida, as follows: "As our clients seek solutions for adapting to the accelerated pace of change in a new, hybrid world, it's imperative we continue to enhance our team with the best and brightest, forward-thinking talent. Watching Tampa emerge as one of the nation's hottest tech cities, we felt in made sense for us to plant our flag here and become an active part of this burgeoning community." Avanade expects to hire hundreds of employees in Tampa over the next three years.

Why has Avanade been so successful? For one thing, the company seamlessly integrates learning and development into its business strategy. Also, in 2021, the company was recognized by *Newsweek,* in collaboration with the Best Practice Institute, as a Most Loved Workplace. This list is made up of only 100 companies, so this recognition is indeed significant. Pamela Maynard, CEO of Avanade, wants to foster a culture at Avanade "where everyone is welcome to bring their authentic selves to work and where diverse perspectives, backgrounds and skills are value as critical differentiators in our ability to serve our clients." The word "love" is not used a lot in business, but Maynard has no problem using it: "When our people feel loved, when they feel a sense of purpose, when they feel they can be authentic and they belong, there's nothing—I truly believe there is nothing—that we can't accomplish as a business."

When asked how to create a Most Loved Workplace, Maynard cited three things. The first was: "Unite your organization around a common objective." Maynard said her employees wanted to know that they were having a positive impact on the world, so Avanade made this idea their purpose. Second was to "Create a culture of innovation." One thing Avanade does is run a global innovation contest for employees, companies, and research centers. Also, "geek allowances" are provided to employees so they can stay current on the latest technologies. The third is: "Diversity and inclusion." To achieve this objective, the company focuses on its hiring process. Avanade also hired a chief diversity and inclusion officer, who runs leadership and development programs.

Sources: L. Carter, 2022, How to be an employee-friendly company, *Newsweek Global,* April 22, 22–23; V. Brezina, 2022, Joint venture created by Microsoft and Accenture to open Tampa hub, *Catalyst,* www.stpetecatalyst.com, April 8; 2022, A proven partnership for the digital era, *Avanade Home Page,* www.avanade.com, May 19; 2022, Our purpose: To deliver on the promise of technology and human integrity, *Accenture Home Page,* www.accenture.com, May 19; 2022, Pamela Maynard, Chief Executive Officer, *Avanade Home Page,* www.avanade.com, May 19; 2019, New Accenture Microsoft Business Group will empower enterprises to thrive in the era of digital disruption, *Avanade Home Page,* www.avanade.com, February 4; T. Handler & D. Ratterman, 2018, Strategies for success, *Training,* 55(4), 50–53.

Case Discussion Questions

1. What are the resources each of the companies in this joint venture brought to the creation of Avanade? Were these resources complementary or redundant?

2. What have you learned in this chapter and previous chapters about what was taking place in the external environment (i.e., technological, social, global) that contributed to the success of this joint venture?

3. Why does the work environment and culture fostered in Avanade fit particularly well with the type of work the company does? Creating this sort of work environment is costly—do you suppose it would be worth it to invest so much into the internal work environment in all types of businesses? Why or why not?

4. Microsoft and Accenture presumably invested a lot of time, talent, money, and other resources into their venture over the years. What do you suppose Microsoft has received from these investments in addition to the profits the firm makes? What has Accenture received?

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Chapter 10

Corporate Governance

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

10-1 Define corporate governance and explain how it is used to monitor and control top-level managers' decisions.

10-2 Explain why ownership is largely separated from managerial control in organizations.

10-3 Define an agency relationship and managerial opportunism and describe their strategic implications.

10-4 Explain the use of three internal governance mechanisms to monitor and control managers' decisions.

10-5 Discuss the types of compensation top-level managers receive and their effects on managerial decisions.

10-6 Describe how the market for corporate control, regulators, and creditors restrain top-level managers' decisions.

10-7 Discuss the nature and use of corporate governance in international settings, especially in Germany, Japan, and China.

10-8 Describe how corporate governance can foster ethical decisions by a firm's top-level managers.

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Can Governance Changes Help Rescue Bed Bath & Beyond?

Bed Bath & Beyond, listed on the *Fortune* 500, operates a large chain of retail stores in the United States, Canada, and Mexico. With 55,000 employees, its more than 1,000 stores sell a variety of domestic merchandise, as well as health and beauty products, under the brand names that include Bed Bath & Beyond, Harmon Face Values, and buybuy Baby. In May 2021, the company announced a new venture called Simply Essential that would sell privately labeled brands at low prices.

When the company was launched in the early 1970s, "big-box" stores specializing in a particular type of merchandise were becoming increasingly popular. In the mid-1980s, Bed Bath & Beyond opened its first superstore. The company grew rapidly after that time. However, as has happened with a lot of traditional "brick-and-mortar" retailers, Bed Bath & Beyond began to suffer from increased competition from Walmart and Target, as well as a wide variety of Internet providers of domestic merchandise. The company has performed poorly on the Internet relative to competitors.

JHVEPhoto/Shutterstock.com

Bed Bath & Beyond's problems led to poor financial performance, including steady declines in sales and net income. Total revenue was $12.3 billion in the fiscal year ending March 3, 2018, with net income of $425 million. Since then, revenue has declined every year, all the way down to $7.9 billion in the fiscal year ending on February 26, 2022, according to a press release. This revenue was associated with a net loss of $559.6 million.

As a result of poor performance, activist investors have pushed for changes in governance at Bed Bath & Beyond. Shareholder activism refers to actions shareholders take to pressure top managers to amend corporate policies and practices that are more to their liking. In this case, activists have focused on changes in top management and in the board, as well as some new policies regarding governance in the firm. For example, in March 2019, three activist investment firms—Ancora Advisors, Marcellum Advisors, and Legion Partners—joined forces to oust CEO Steven Temares. They had an approximate 5 percent stake in the company at the time. Their pressure also led to the resignation of five directors and a smaller board. Later that year, Mark Tritton, who was previously chief merchandising officer at Target, was appointed CEO.

In 2020, Bed Bath & Beyond "announced a strategic restructuring program as part of the next phase of its work to rebuild the foundation of the business and create a sustainable, durable business model. The restructuring program includes a reorganization and simplification of its field operations, significant reduction in management positions across the business, and outsourcing of several functions." As a part of the reorganization, the company laid off approximately 500 employees. The program was intended to dramatically reduce operating expenses. The company also developed initiatives to improve the customer experience and increase sales.

Despite these efforts, as described above, financial performance continued to decline. Then, in early 2022, another activist investor made a bold move. Ryan Cohen's firm, RC Ventures, acquired almost a 10 percent stake in Bed Bath & Beyond.

Mr. Cohen then "sent a letter to the company criticizing the retailer's turnaround strategy and calling for a separation of the buybuy Baby chain or a sale of the entire company." Mr. Cohen also wanted the company to narrow its strategic focus. Bed Bath & Beyond agreed to add three new directors to the board, selected by RC Ventures. Two of these new directors—Marjorie Bowen and Ben Rosenzweig—would join "a four-member strategy committee to explore alternatives to unlock greater value from the buybuy Baby business, which sells, baby gear, furniture, clothes, and more." The other two members of the committee were existing independent (non-company affiliated) directors Sue Gove and Andrea Weiss. Both a spin-off and a sale of buybuy Baby were among the potential alternatives.

Mr. Cohen, the billionaire cofounder of Chewy Inc., an online pet products company, is also known for his investor activism at GameStop in 2020, picking up a board seat at the company and urging improvement in the company's ecommerce business and exploration of other technologically driven opportunities. Perhaps his influence will have a positive impact on turning the company around. Only time will tell us if this is the case; however, Wall Street investors seem fairly positive. Bed Bath & Beyond's share price increased by 34 percent on the day it was announced that RC Ventures had acquired a large stake in the company.

Sources: J. Lee, 2022, Bed Bath & Beyond goes to moon, *Wall Street Journal,* March 8: B10; C. McCabe, 2022, Activist sparks Bed Bath shares, *Wall Street Journal,* March 8: B1; W. Feuer, 2022, Bed Bath & Beyond adds new directors in deal with activist Ryan Cohen, *Wall Street Journal*, www.wsj.com, March 25; 2022, Bed Bath & Beyond, *Standard & Poor's Global NetAdvantage,* April 16; 2022, Fortune 500: Bed Bath & Beyond, *Fortune,* www.fortune.com, April 16; 2020, Bed Bath & Beyond Inc. announces strategic restructuring program to simplify operations and reset cost structure, *PR Newswire,* www.prnewswire.com, February 27; L. Fortado & K. Y. Pan, 2019, Activist funds seek to replace Bed Bath & Beyond board, *Financial Times,* www.financialtimes.com, March 26.

Learning Objective

10-1 Define corporate governance and explain how it is used to monitor and control top-level managers' decisions.

10-1 Corporate Governance and Top-Level Decisions

As the Opening Case suggests, corporate governance is a complex set of structures designed to provide firm oversight of major strategic issues. Because it is comprehensive in scope and complex in nature, corporate governance is a responsibility that challenges firms and their leaders. Evidence suggests that corporate governance is critical to firms' success, and dealing appropriately with this challenge is important. Because of this, governance is an increasingly important part of the strategic management process.[1]

Corporate governance is the set of mechanisms used to manage the relationships among stakeholders and to determine and control the strategic direction and performance of organizations.

Corporate governance is the set of mechanisms used to manage the relationships among stakeholders and to determine and control the strategic direction and performance of organizations.[2] At its core, corporate governance is concerned with identifying ways to ensure that decisions (especially strategic decisions) are made effectively and that they facilitate a firm's efforts to achieve strategic competitiveness.[3] Governance can also be thought of as a means to establish and maintain harmony between parties (the firm's owners and its top-level managers) whose interests may conflict.

In modern corporations—especially those in nations with "Westernized" infrastructures and business practices such as in the United States and the United Kingdom—ensuring that top-level managers' interests are aligned with other stakeholders' interests, particularly those of shareholders, is a primary objective of corporate governance. Processes used to elect members of the firm's board of directors, the general management of CEO pay and more focused supervision of director pay, and the corporation's overall strategic direction are examples of areas in which oversight is sought.[4] Because corporate governance is an ongoing process concerned with how a firm is to be managed, its nature evolves in light of the types of never-ending changes in a firm's external environment that we discussed in Chapter 2.

The recent global emphasis on corporate governance stems mainly from the apparent failure of corporate governance mechanisms to adequately monitor and control top-level managers' decisions (as exemplified by the growing focus on governance issues among activist investors, as discussed in the Opening Case). In turn, undesired or unacceptable consequences resulting from using corporate governance mechanisms cause changes such as electing new members to the board of directors with the hope of providing more effective governance. A second and more positive reason for this interest comes from evidence that a well-functioning corporate governance system can create a competitive advantage for an individual firm.[5]

In the chapter's first section, we describe the relationship on which the modern corporation is built—namely, the relationship between owners and managers. We use most of the chapter to explain various mechanisms owners use to govern managers and to ensure that they comply with their responsibility to satisfy stakeholders' needs, especially those of shareholders.

Three internal and three external governance mechanisms are most relevant to the modern corporation.[6] The three internal governance mechanisms described in this chapter are ownership concentration, represented by types of shareholders and their different incentives to monitor managers; the board of directors; and executive compensation. We then consider three external governance mechanisms: the market for corporate control, regulators, and creditors. The market for corporate control is essentially a set of potential owners seeking to acquire undervalued firms and earn above-average returns on their investments by replacing ineffective top-level management teams.[7]

The chapter's focus then shifts to the issue of international corporate governance. We briefly describe governance approaches used in several countries outside of the United States and United Kingdom. In part, this discussion suggests that the structures used to govern global companies competing in both developed and emerging economies are becoming more, rather than less, similar. Closing our analysis of corporate governance is a consideration of the need for these control mechanisms to encourage and support ethical and socially responsible behavior in organizations.

10-2 Separation of Ownership and Managerial Control

Learning Objective

10-2 Explain why ownership is largely separated from managerial control in organizations.

Historically, U.S. firms were managed by founder-owners and their descendants. In these cases, corporate ownership and control resided with the same group of people. As firms grew larger, "the managerial revolution led to a separation of ownership and control in most large corporations, where control of the firm shifted from entrepreneurs to professional managers while ownership became dispersed among thousands of unorganized stockholders who were removed from the day-to-day management of the firm."[8] These changes created the modern public corporation, which is based on the efficient separation of ownership and managerial control.

The separation of ownership and managerial control allows shareholders to purchase stock, which entitles them to income (residual returns) from the firm's operations after paying expenses. This right, however, requires that shareholders take a risk that the firm's expenses may exceed its revenues. To manage this investment risk, shareholders maintain a diversified portfolio by investing in several companies to reduce their overall risk.[9] The poor performance or failure of any one firm in which they invest has less overall effect on the value of the entire portfolio of investments. Thus, shareholders specialize in managing their investment risk.

Commonly, those managing small firms also own a significant percentage of the firm. In such instances, there is less separation between ownership and managerial control. Moreover, in numerous family-owned firms, ownership and managerial control are not separated to any significant extent. Research shows that family-owned firms perform better when a member of the family is the CEO rather than when the CEO is an outsider.[10] In fact, if an outsider serves as CEO and is then replaced by a family CEO, performance tends to increase dramatically, especially in stable industries.[11]

In many regions outside the United States, such as in Latin America, Asia, and some European countries, family-owned firms dominate the competitive landscape.[12] The primary purpose of most of these firms is to increase the family's wealth, which explains why a family CEO often is better than an outside CEO. Still, family ownership remains significant in U.S. companies as well—many of the largest U.S.-based companies have substantial family ownership.[13]

Family-controlled firms face at least two critical issues related to corporate governance. First, as they grow, they may not have access to all the skills needed to effectively manage the firm and maximize returns for the family. Thus, outsiders may be required to facilitate growth. Second, as they grow, they may need to seek outside capital and thus give up some of the ownership. In these cases, protecting the minority owners' rights becomes important.[14] To avoid these potential problems, when family firms grow and become more complex, their owner-managers may contract with managerial specialists. These managers make major decisions in the owners' firm and are compensated based on their decision-making skills. Research suggests that firms in which families own enough equity to have influence without major control tend to make the best strategic decisions.[15]

Without owner (shareholder) specialization in risk bearing and management specialization in decision making, a firm may be limited by its owners' abilities to simultaneously manage it and make effective strategic decisions relative to risk. Thus, the separation and specialization of ownership (risk bearing) and managerial control (decision making) should produce the highest returns for the firm's owners.

Learning Objective

10-3 Define an agency relationship and managerial opportunism and describe their strategic implications.

10-3 Agency Relationships and Agency Costs

An **agency relationship** exists when one or more persons (the principal or principals) hire another person or persons (the agent or agents) as decision-making specialists to perform a service.

The separation between owners and managers creates an agency relationship. An **agency relationship** exists when one or more persons (the principal or principals) hire another person or persons (the agent or agents) as decision-making specialists to perform a service.[16] Thus, an agency relationship means that one party delegates decision-making responsibility to a second party for compensation (see Figure 10.1). This sort of relationship exists between the shareholders (principals) and top-level managers (agents) of a public company.

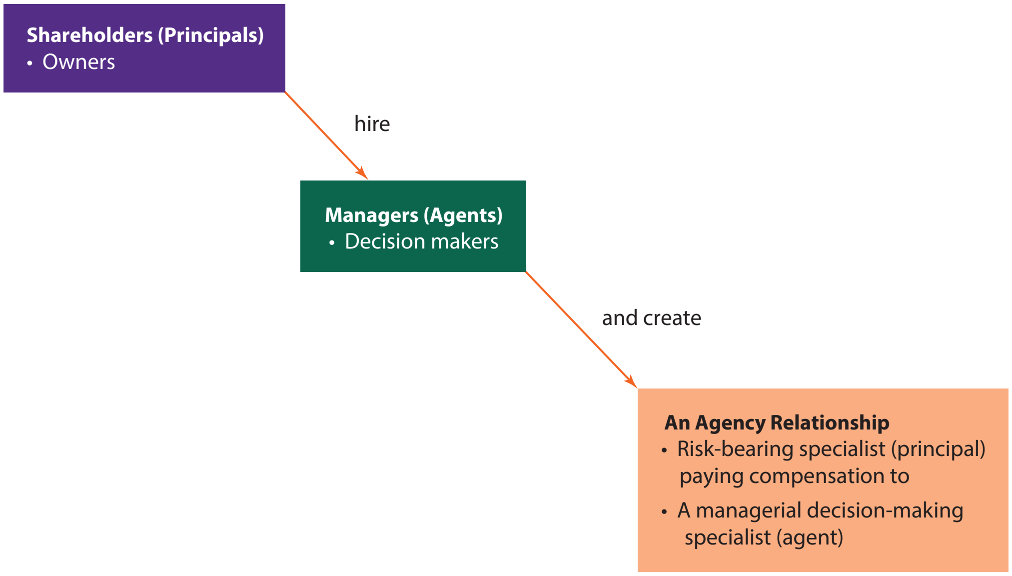
In addition to shareholders and top-level managers, other examples of agency relationships are top managers who hire subsidiary managers, client firms engaging consultants, and the insured contracting with an insurer. Moreover, an agency relationship exists between managers and their employees, as well as other stakeholders.[17] However, in this chapter, we focus on the agency relationship between the firm's owners (i.e., shareholders) and top-level managers because these managers are responsible for formulating and implementing the firm's strategies, which have major effects on firm performance.[18]

The separation between ownership and managerial control can be problematic. Research evidence documents a variety of agency problems in the modern corporation.[19] Problems can surface because the principal and the agent have different interests and goals or because shareholders lack direct control of large publicly traded corporations. Problems also surface when an agent makes decisions that result in pursuing goals that conflict with those of the principals. Thus, the separation of ownership and control potentially allows divergent interests (between principals and agents) to occur, which can lead to managerial opportunism.

Managerial opportunism is the seeking of self-interest with guile (i.e., cunning or deceit).

Managerial opportunism is the seeking of self-interest with guile (i.e., cunning or deceit).[20] Opportunism is both an attitude (i.e., an inclination) and a set of behaviors (i.e., specific acts of self-interest).[21] Principals do not know beforehand which agents will or will not act opportunistically. A top-level manager's reputation is an imperfect predictor; moreover, opportunistic behavior

Figure 10.1 An Agency Relationship



Strategic **Focus**

Product Diversification as an Example of an Agency Problem

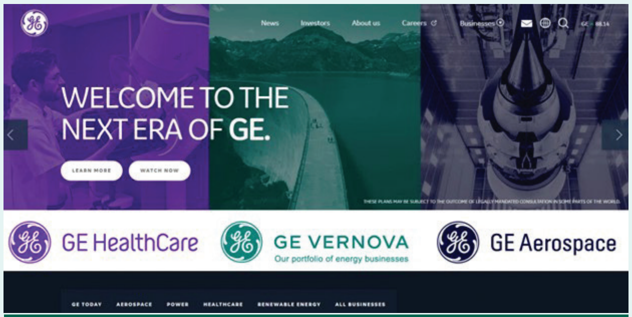
As explained in Chapter 6, a corporate-level strategy to diversify the firm's product lines can enhance a firm's strategic competitiveness and increase its returns, both of which serve the interests of all stakeholders and certainly shareholders and top-level managers. However, product diversification can create two benefits for top-level managers that shareholders do not enjoy, meaning that they may prefer product diversification more than shareholders do.

One reason managers prefer more diversification compared to shareholders is the fact that it usually increases the size of a firm and size is positively related to executive compensation. Diversification also increases the complexity of managing a firm and its network of businesses, possibly requiring additional managerial pay because of this complexity. Thus, increased product diversification provides an opportunity for top-level managers to increase their compensation.

The second potential benefit is that product diversification and the resulting diversification of the firm's portfolio of businesses can reduce top-level managers' employment risk. As discussed in Chapter 6, managerial employment risk is the risk of job loss, loss of compensation, and loss of managerial reputation. These risks are reduced with increased diversification because a firm and its upper-level managers are less vulnerable to the reduction in demand associated with a single or limited number of product lines or businesses.

Free cash flow can further incentivize top-level managers to engage in more diversification. Calculated as operating cash flow minus capital expenditures, free cash flow represents the cash remaining after the firm has invested in all projects that have positive net present value within its current businesses. Top-level managers may decide to diversify by investing free cash flow in products that are not associated with the firm's current lines of business.

Whenever managers use free cash flow to diversify the firm in ways that do not have a strong possibility of creating additional value for shareholders, the firm can become overdiversified, which reduces value for the shareholders and other stakeholders. Overdiversification is an example of self-serving and opportunistic managerial behavior. General Electric is one example of a firm that became overdiversified. As mentioned in Chapter 6, in late 2021, General Electric announced plans to split into three separate companies.



Source: General Electric Company (GE)

General Electric split into three company branches: GE HealthCare, GE VERONA, and GE Aerospace.

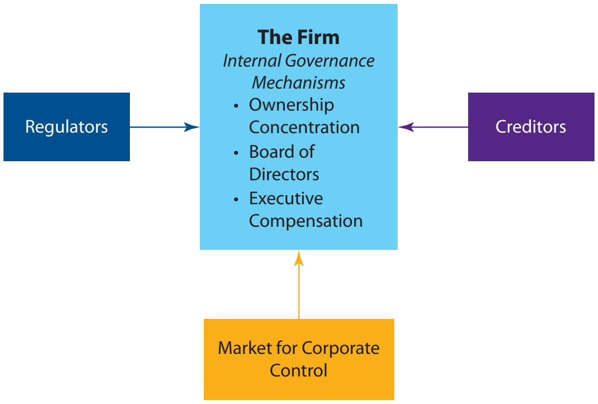
Sources: T. Gryta, 2021, The end of the GE era, *Wall Street Journal*, www.wsj.com, November 15; L. Ornitz & D. Song, 2021, Why conglomerates split up, *Wall Street Journal*, www.wsj.com, November 18; C. Stadler, M. J. Mayer, J. Hautz, & K. Matzler, 2018, International and product diversification: Which strategy suits family managers?, *Global Strategy Journal*, 8: 184–207; T.-E. Bakke, & T. Gu, 2017. Diversification and cash dynamics, *Journal of Financial Economics*, 123: 580–601; T. Nguyen, C. Cai, & P. McColgan, 2017, How firms manage their cash flows: An examination of diversification's effect, *Review of Quantitative Finance & Accounting*, 48: 701–724; Z. Chen, W. Hung, D. Li, & L. Xing, 2017, The impact of bank merger growth on CEO compensation, *Journal of Business Finance & Accounting*, 44(9/10): 1398–1442; T. B. Mackey, J. B. Barney, & J. P. Dotson, 2017. Corporate diversification and the value of individual firms: A Bayesian approach. *Strategic Management Journal*, 38: 322–341; S. Chang, B. Kogut, & J. Yang, 2016, Global diversification discount and its discontents: A bit of self-selection makes a world of difference. *Strategic Management Journal*, 37: 2254–2274; T. B. Mackey & J. B. Barney, 2013, Incorporating opportunity costs in strategic management research: The value of diversification and payout as opportunities forgone when reinvesting in the firm. *Strategic Organization*, 11: 347–363; M. S. Jensen, 1986, Agency costs of free cash flow, corporate finance, and takeovers, *American Economic Review*, 76: 323–329.

cannot be observed until it has occurred. Thus, principals establish governance and control mechanisms to prevent agents from acting opportunistically, even though only a few are likely to do so. Interestingly, research suggests that when CEOs feel constrained by governance mechanisms, they are more likely to seek external advice that, in turn, helps them make better strategic decisions.[22]

The agency relationship suggests that any time principals delegate decision-making responsibilities to agents, the opportunity for conflicts of interest exists.[23] Top-level managers, for example, may make strategic decisions that maximize their personal welfare and minimize their personal risk.[24] Decisions such as these prevent maximizing shareholder wealth. As discussed in the Strategic Focus, decisions regarding product diversification demonstrate this situation.

In general, shareholders prefer riskier strategies that are likely to bring higher returns as well as more focused diversification. Shareholders can then reduce their risk by holding a diversified portfolio of investments. Alternatively, managers cannot balance their employment risk by working for a diverse portfolio of firms; therefore, as mentioned in the strategic focus, managers may prefer a level of diversification that maximizes firm size and their compensation while also reducing their employment risk. Finding the appropriate level of diversification is difficult for managers. Research has shown that too much diversification can have negative effects on the firm's ability to create

Figure 10.2 Primary Corporate Governance Mechanisms



innovation (managers' unwillingness to take on higher risks). Alternatively, diversification that strategically fits the firm's capabilities can enhance its innovation output.[25] Product diversification, therefore, can create a potential agency problem.

The potential conflict between shareholders and top-level managers, coupled with the fact that principals cannot easily predict which managers might act opportunistically, demonstrates why principals establish governance mechanisms. However, the firm incurs costs when it uses one or more governance mechanisms. **Agency costs** are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent. Because monitoring activities within a firm is difficult, the principals' agency costs are larger in diversified firms given the additional complexity of diversification.[26]

Agency costs are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent.

In general, managerial interests may prevail when governance mechanisms are weak and therefore ineffective, such as in situations where managers have a significant amount of autonomy to make strategic decisions. If, however, the board of directors controls managerial autonomy, or if other strong governance mechanisms are used, the firm's strategies should better reflect stakeholders and certainly shareholders' interests.[27]

Next, we explain the effects of the three internal governance mechanisms on managerial decisions regarding the firm's strategies: ownership concentration, the board of directors, and executive compensation. This will be followed by a discussion of the three external governance mechanisms: the market for corporate control, regulators, and creditors. The six primary governance mechanisms are illustrated in Figure 10.2. Of course, in addition to these primary mechanisms, other stakeholders such as customers, communities, the media, alliance partners, and NGOs, among others, can also influence the way a firm is governed, although the influence is not as direct.[28]

Learning Objective

10-4 Explain the use of three internal governance mechanisms to monitor and control managers' decisions.

10-4 Ownership Concentration

Ownership concentration is defined by the number of large-block shareholders and the total percentage of the firm's shares they own.[29] **Large-block shareholders** typically own at least 5 percent of a company's issued shares. Ownership concentration as a governance mechanism has received considerable interest because large-block shareholders are increasingly active in their demands that firms adopt effective governance mechanisms to control managerial decisions so that they will best represent owners' interests.[30] In recent years, the number of individuals who are large-block shareholders has declined. Institutional owners have become more prevalent than individuals as large-block shareholders.

Ownership concentration is defined by the number of large-block shareholders and the total percentage of the firm's shares they own.

Large-block shareholders typically own at least 5 percent of a company's issued shares.

In general, diffuse ownership (numerous shareholders with small holdings and few, if any, large-block shareholders) produces weak monitoring of managers' decisions. One reason for this weak monitoring is that diffuse ownership makes it difficult for owners to effectively coordinate their actions. Ownership concentration influences decisions made about the strategies a firm will use.[31] Higher levels of monitoring by large-block shareholders can encourage managers to avoid strategic decisions that harm shareholder value, such as too much product diversification.[32] Research evidence suggests that ownership concentration is associated with lower levels of diversification. In general, ownership concentration's influence on strategies and firm performance is positive.[33]

There is, however, another side to high levels of ownership concentration. When large-block shareholders have a high degree of wealth, they have power relative to minority shareholders to appropriate the firm's wealth; this is particularly the case when they are in managerial positions. Excessive appropriation at the expense of minority shareholders is fairly common in emerging economy countries, where minority shareholder rights often are not as protected as they are in the United States. In fact, in some of these countries, state ownership of an equity stake (even minority ownership) can be used to control these potential problems.[34]

The importance of boards of directors to prevent excessive appropriation of minority shareholder value has been found in firms with strong family ownership, where family members have incentives to appropriate shareholder wealth, especially in the second generation after the founder has departed.[35] Nonetheless, family-controlled businesses still tend to outperform nonfamily-controlled businesses, especially smaller and private firms, because of the importance of enhancing the family's wealth and maintaining the family legacy.[36]

10-4a The Increasing Influence of Institutional Owners and Activist Investors

A classic work published in the 1930s argued that a separation of ownership and control had come to characterize the "modern" corporation.[37] This change occurred primarily because growth prevented founders–owners from maintaining their dual positions in what were increasingly complex companies. More recently, another shift has occurred: Ownership of many modern corporations is now concentrated in the hands of institutional investors rather than individual shareholders. In fact, institutional owners now account for approximately 80 percent of the equity market in the United States.[38]

Institutional owners are financial institutions, such as mutual funds and pension funds, that control large-block shareholder positions. Because of their prominent ownership positions, institutional owners, as large-block shareholders, have the potential to be a powerful governance mechanism. Estimates of the amount of equity in U.S. firms held by institutional owners range from 60 to 75 percent. In particular, pension funds are critical drivers of growth and economic activity in the United States because they are one of the most significant sources of long-term, patient capital.[39] *Patient capital* comes from investors who are willing to invest over the long term rather than seeking immediate returns.[40]

Institutional owners are financial institutions, such as mutual funds and pension funds, that control large-block shareholder positions.

As investors, institutional owners have both the size and the incentive to discipline ineffective top-level managers and that they can significantly influence a firm's choice of strategies and strategic decisions.[41] As the Opening Case indicates, institutional and other large-block shareholders are becoming more active in their efforts to influence a corporation's strategic decisions. "**Shareholder activism** refers to actions shareholders take with the intent of influencing corporate policy and practice."[42] Private activism occurs as powerful shareholders such as institutional investors or other types of large-block shareholders reach out to top managers through phone calls, meetings, letters, and dialogue to get them to change a policy or practice. If they own enough shares, they probably hold seats on the board of directors, which gives them easy access to top managers and other board members. If private activism fails, shareholder activists often engage in a variety of public activities such as media campaigns or publication of letters to force managers to comply with their wishes.[43]

Shareholder activism refers to actions shareholders take with the intent of influencing corporate policy and practice.

Initially, shareholder activists and institutional investors concentrated on the performance and accountability of CEOs and contributed to the dismissal of several them. More recently, activists have targeted the actions of boards more directly via proxy vote proposals that are intended to give shareholders more decision rights because they believe board processes have been ineffective.[44] A rule approved by the SEC allowing large shareholders (owning 1 to 5 percent of a company's stock) to nominate up to 25 percent of a company's board of directors enhances shareholders' decision rights.[45]

Sometimes activist investors join forces in what are called *wolf packs*.[46] They are led by one of the activists, often a hedge fund, with other activist investors engaging in peripheral activities. One interesting aspect of a wolf pack is that they tend to be uncoordinated; that is, they do not create a formal coalition.[47] Rather, individual activists ostensibly hear that a wolf pack is forming through word-of-mouth or some sort of announcement by the lead activist, and then they engage in the fray. However, some evidence suggests that a certain amount of undisclosed coordination is taking place.[48] "Wolf packs increase the probability of activists successfully securing board representation and golden leash compensation structures help to facilitate a market for activist board members, where well-reputed directors are recruited to suitable board positions, improving the overall quality of activist strategy and potentially lengthening the time horizon of activist investments."[49] Golden leash compensation structures "incentivize activist appointed directors to increase the share price of target companies."[50]

To date, research suggests that institutional activism may not have a strong direct effect on firm performance, but it may indirectly influence a targeted firm's strategic decisions, including those concerned with social issues. In addition, activism can influence the behavior of firms that are not even direct targets of an institutional investor when that investor also owns stock in their company—the mere recognition that the institutional investor is going after a different company in its portfolio is enough to encourage them into making strategic changes.[51] Thus, to some degree at least, institutional activism has the potential to discipline managers and to enhance the likelihood of a firm taking future actions that are not only in shareholders' best interests but also those of all stakeholders, including society at large.[52]

10-4b Board of Directors

The **board of directors** is a group of elected individuals who oversee managers to ensure that the corporation operates in ways that will best serve stakeholders' interests.

Shareholders elect the members of a firm's board of directors. The **board of directors** is a group of elected individuals who oversee managers to ensure that the corporation operates in ways that will best serve stakeholders' interests.[53] The board plays a "foundational role in strategic management" and can influence every aspect of the strategic planning process, "from setting strategic goals, to identifying strategic alternatives, to communicating and legitimating the strategy with organizational stakeholders, to monitoring and evaluating its success."[54] Helping board members reach their expected objectives are their powers to direct the affairs of the organization and reward and discipline top-level managers.

Unfortunately, evidence suggests that some boards have not been particularly effective in monitoring and controlling top-level managers' decisions and subsequent actions.[55] Because of their relatively ineffective performance, boards are experiencing increasing pressure from shareholders, lawmakers, and regulators to become more forceful in their oversight role to prevent top-level managers from acting in their own best interests. Moreover, in addition to their monitoring role, board members increasingly are expected to provide resources to the firms they serve.[56] These resources include their personal knowledge and expertise and their relationships with a wide variety of organizations.[57] Research has shown that it is especially important to have board members with expertise in areas that are most relevant to the types of risks the firm faces when making strategic decisions.[58]

10-4c Shareholders versus Stakeholders

For decades, a debate has been raging among scholars and business executives regarding whether top managers and boards should give the shareholders of an organization a higher priority than other stakeholders (i.e., customers, employees) when making strategic decisions.[59] In fact, many top executives believe it is a legal responsibility to put shareholders first, although there is evidence that this is not the case.[60] Whether giving shareholders top priority is a legal requirement or not, doing so is a strong norm among top executives that is unlikely to disappear for a long time; however, there is definite movement in the direction of giving non-shareholder stakeholders more importance in strategic decisions.[61] After all, value is created through working with stakeholders, so neglecting them is likely to reduce the value created, even for the shareholders.[62]

Societal trends are among the most important forces that are moving top managers and boards in the direction of a more balanced view of the stakeholder-oriented responsibilities. The CSR movement discussed in Chapters 1 and 2 means that investors, regulators, the press and social media, other stakeholders, and society at large are much more sensitive to how a firm treats its stakeholders. Also, "short-termism" associated with trying to maximize returns for shareholders has led to a loss of firm value over the longer term.[63] "The single-minded pursuit of a short-term value maximization 'mantra' by top managers often results in long-term value destruction for shareholders."[64] For example, cutting an R&D program could increase short-term profits, but

R&D is the lifeblood of many companies. There is irony in this situation because as executives pursue short-term profits and share prices increase, they probably feel as though they are serving shareholder interests well. Boards are responsible for ensuring that decisions are made that allow the firm to prosper not just in the short term, but also in the long term. A broader stakeholder orientation is more likely to lead to this sort of sustainable performance than an obsession with shareholder returns.[65]

Evidence exists that top executives have adopted a more stakeholder-oriented approach. As mentioned in Chapter 1, nearly 200 CEOs from the largest corporations in the United States released a signed statement in 2019 through an association called the *Business Roundtable* declaring that the purpose of the corporation is to serve the interests of employees, customers, suppliers, communities, and shareholders.[66] Two features of this statement are particularly important. First, there is no prioritization of stakeholders in this list. Second, this same group released a statement in 1997 stating that the most important duty of top managers and boards is to shareholders.

Other evidence that the tides of opinion are changing is found in the increasing popularity of benefit corporations. A *benefit corporation* (sometimes known as a public-benefit corporation) is very much like a traditional corporation regarding its legal and tax status; however, its approved corporate bylaws state that it is a benefit corporation and that its top managers and directors must consider other public benefits besides profits.[67] Examples include Patagonia, King Arthur Flour, and Kickstarter. Benefit corporations also have a much higher level of transparency than other corporations and publish benefit reports that outline their social and environmental performance. Most U.S. states have authorized benefit corporations, and there are now over 3,000 benefit corporations in the United States alone.[68] In addition, organizations can seek B-Corp certification from a third party such as B Lab. There are now over 5,000 companies in 80 countries and 154 industries that are certified as B-Corps.[69] Patagonia is both a benefit corporation and is B-Corp certified. Other examples of companies with this certification include the French fashion house Chloé and the Polish company Netguru.[70]

10-4d Types of Board Members

Generally, board members (often called directors) are classified into one of three groups (see Table 10.1). *Insiders* are active top-level managers in the company who are elected to the board because they are a source of information about the firm's day-to-day operations.[71] *Related outsiders* have some relationship with the firm, contractual or otherwise, that may create questions about their independence, but these individuals are not involved with the corporation's day-to-day activities. *Outsiders* provide independent counsel to the firm and may hold top-level managerial positions in other companies or may have been elected to the board prior to the beginning of the current CEO's tenure.[72] Historically, inside managers dominated a firm's board of directors; however, this situation has changed to the point that outsiders now comprise the majority of board members, at least in the United States.[73]

A widely accepted view is that a board with a significant percentage of its membership from the firm's top-level managers provides relatively weak monitoring and control of managerial decisions.[74] With weak board monitoring, managers sometimes use their power to select and compensate directors and exploit their personal ties with them. In response to the SEC's proposal, in 1984 the New York Stock Exchange (NYSE) implemented a rule requiring outside directors to

Table 10.1 Classification of Board of Directors' Members

Insiders
• **The firm's CEO and other top-level managers**
Related outsiders
• **Individuals not involved with the firm's day-to-day operations, but who have a relationship with the company**
Outsiders
• **Individuals who are independent of the firm in terms of day-to-day operations and other relationships**

head the audit committee. Subsequently, after the U.S. government pass legislation called the Sarbanes-Oxley Act (to be discussed later in this chapter), other new rules required that independent outsider directors lead important committees such as the audit, compensation, and nomination committees.[75] Policies of the NYSE now require companies to maintain boards of directors that are composed of a majority of outside independent directors and to maintain full independent audit committees. Thus, additional scrutiny of corporate governance practices is resulting in a significant amount of attention being devoted to finding ways to recruit quality independent directors and to encourage boards to take actions that fully represent shareholders' best interests.[76]

Having outside directors is not always enough to resolve agency problems because a powerful CEO can strongly influence a board's decisions.[77] One proposal to reduce the power of the CEO is to separate the chair's role and the CEO's role on the board so that the same person does not hold both positions.[78] A situation in which an individual holds both the CEO and chair of the board title is called *CEO duality*.[79] A CEO who also chairs the board is going to have even more power than a CEO who does not. Normally, this would be considered contrary to the interests of shareholders. However, in one interesting study, researchers found that CEO duality was associated with higher firm performance during a time of high economic policy uncertainty, perhaps because the unification of the two roles of CEO and chairperson provided for more decisive leadership.[80]

Although having numerous outside board members typically is seen as a good thing, it can also create some problems. For example, because outsiders typically do not have contact with the firm's day-to-day operations and do not have ready access to detailed information about managers and their skills, they lack the insights required to fully and effectively evaluate their decisions and initiatives, especially when they are busy serving on multiple boards.[81] Because they work with and lead the firm daily, insiders have access to information that facilitates forming and implementing appropriate strategies. Accordingly, some evidence suggests that boards with a critical mass of insiders typically are better informed about intended strategic initiatives, the reasons for the initiatives, and the outcomes expected from pursuing them.[82] Outsiders can at least partly overcome this information problem through frequent interactions with inside board members and through discussions during board meetings to enhance their understanding of the firm's managers and their decisions.

10-4e Enhancing the Effectiveness of the Board of Directors

Having a board that actively monitors top-level managers' decisions and actions does not ensure high performance. Because of the importance of boards of directors in corporate governance, and because of increased scrutiny from shareholders—in particular, large institutional investors—the performance of individual board members and of entire boards is being evaluated more formally and with greater intensity.[83] The demand for greater accountability and improved performance is stimulating many boards to voluntarily make changes. Among these changes are:

1. increases in the diversity of the backgrounds of board members (e.g., a greater number of directors from public service, academic, and scientific settings; a greater percentage of ethnic minorities and women; and members from different countries on boards of U.S. firms);
2. the strengthening of internal management and accounting control systems;
3. increased attention to issues of corporate social responsibility, especially sustainability and global warming;
4. establishing and consistently using formal processes to evaluate board members' performance;
5. modifying the compensation of directors, especially reducing or eliminating stock options as a part of their package; and
6. creating the "lead director" role that has strong powers regarding the board agenda and oversight of non-management board member activities.[84]

Diversity—in particular diversity among board members in terms of functional backgrounds, education, and experience—increases the quality of board involvement in decision making within the firm.[85] Recently, however, the focus has been more on including more women and minorities on boards.[86] Women hold only 19 percent of board seats and all minorities combined account for just over 10 percent, with African Americans accounting for the largest portion of minorities on boards.[87] In response, some U.S. states are requiring minority representation on public boards.[88] We still don't have sufficient research regarding the effect of this sort of diversity on strategy and performance, but we do know that female and racial minority board members have a more difficult time being heard, and there is also some evidence that minority members are more likely to be dismissed from the boards on which they serve.[89] Consequently, there is much room for improvement in the area of diversity. Especially when a firm is underperforming, diverse opinions and perspectives are most needed.

An increase in the board's involvement with a firm's strategic decision-making processes creates the need for effective collaboration between board members and top-level managers.[90] Board effectiveness depends on improving processes used by boards to make decisions, provide counsel to managers, monitor managers, and assess firm outcomes. It is also important to pay attention to board structure, such as the size of the board and the formation of committees to handle various tasks (i.e., compensation, auditing).[91] For example, research has shown that more experienced boards have the potential to help high-tech ventures take advantage of opportunities; however, they are less likely to do so if the board is too large.[92]

Increasingly, outside directors are being required to own significant equity stakes as a prerequisite to holding a board seat. In fact, some research suggests that firms perform better if outside directors have such a stake—one study found that director stock ownership leads to better firm acquisition outcomes.[93] However, other research suggests that too much ownership can lead to lower independence for board members.[94] Although questions remain about whether more independent and diverse boards enhance board effectiveness, the trends for greater independence and increasing diversity among board members are likely to continue.

10-5 Executive Compensation

Learning Objective

10-5 Discuss the types of compensation top-level managers receive and their effects on managerial decisions.

Executive compensation is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses, and long-term incentives such as stock awards and options. The compensation of top-level managers, and especially of CEOs, generates a great deal of interest and strongly held opinions.[95] Some believe that top-management team members, and certainly CEOs, have a great deal of responsibility for a firm's performance and that they should be rewarded accordingly.[96] CEO compensation can be used as a commitment device, based on their talent and experience, so that they do not leave the firm.[97] Also, a common argument, based on the economic forces of supply and demand, is that they should be paid comparably to their peer CEOs.[98] On the other side of the argument, others conclude that top executives (and again, especially CEOs) are greatly overpaid, that nobody deserves that much compensation, and that their compensation is not as strongly related to firm performance as should be the case.[99]

Executive compensation is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses, and long-term incentives such as stock awards and options.

From 2020 to 2021, the median compensation for U.S. CEOs increased 19 percent to $14.2 million for executives of companies listed on the S&P 500. "At roughly $247 million, Discovery Inc.'s David Zaslav had the highest salary disclosed so far, followed closely by Amazon's Andy Jassy at nearly $213 million. Compensation figures for CEOs consist of salary, stock rewards and cash bonuses, the latter two of which were responsible for the bulk of CEOs' pay increases, according to a *Fortune* analysis of 2021 executive pay, conducted by Compensation Advisory Partners (CAP)."[100] To put things in perspective, Zaslav's pay was nearly 3,000 times the median salary for other employees at Discovery and Jassy's salary was about 6,500 times the median salary at Amazon.[101]

REUTERS/Alamy Stock Photo

David Zaslav's salary skyrocketed in 2021 after signing an extended contract with Discovery as CEO through 2027.

Because of oversized compensation packages, the 2010 Dodd-Frank Act requires that public companies disclose their CEO-to-median-employee pay ratio in their annual proxy statement. There are huge differences in this ratio even among companies in the same industry. Along with Dodd-Frank, the

Security and Exchange Commission has given shareholders the opportunity to vote on the compensation the CEO receives—the so-called "Say on Pay" regulation. One of the business units within the advisory firm Institutional Shareholder Services provides analyses of company performance and CEO compensation to help shareholders decide how to vote their shares at annual meetings.[102] This kind of scrutiny makes board members more accountable to shareholders. As such, board members can be disciplined and even lose board seats if the compensation plan receives a negative vote from shareholders. Also, shareholders can sometimes have a direct influence on CEO pay, as in the case when General Electric CEO Larry Culp agreed to take a $10 million cut after shareholder protested his compensation, arguing that GE's performance was poor compared to the company's peers.[103]

As an internal governance mechanism, executive compensation is complicated, for several reasons. First, the strategic decisions top-level managers make are complex and nonroutine, meaning that direct supervision (even by the firm's board of directors) is likely to be ineffective as a means of judging the quality of their decisions. The result is a tendency to link top-level managers' compensation to outcomes the board can easily evaluate, such as the firm's financial performance. This leads to a second issue in that, typically, the effects of top-level managers' decisions are stronger on the firm's long-term performance than its short-term performance. This reality makes it difficult to regularly assess the effects of top managers' decisions (e.g., annually). Third, several other factors affect a firm's performance besides top-level managerial decisions and behavior. Unpredictable changes in segments (economic, demographic, political/legal, etc.) in the firm's general environment (see Chapter 2) make it difficult to separate the effects of top-level managers' decisions and the effects (both positive and negative) of changes in the firm's external environment on the firm's performance.

Long-term incentive plans (typically involving stock options and stock awards) are an important part of compensation packages for top-level managers, especially those leading U.S. firms. Theoretically, using long-term incentives facilitates the firm's efforts (through the board of directors' pay-related decisions) to avoid potential agency problems by linking managerial compensation to the wealth of common shareholders.[104] There is evidence that poor corporate governance can lead to the CEO taking a disproportionate share of the total managerial pay in an organization.[105] However, shareholders typically assume that top-level managers' pay and the firm's performance are more properly aligned when outsiders are the dominant block of a board's membership.[106]

Effectively using executive compensation as a governance mechanism is particularly challenging for firms implementing international strategies. For example, the interests of the owners of multinational corporations may be best served by less uniformity in the firm's foreign subsidiaries' compensation plans.[107] Developing an array of unique compensation plans requires additional monitoring, potentially increasing the firm's agency costs. Importantly, pay levels vary by regions of the world. For example, managerial pay is highest in the United States and much lower in Asia. Historically, compensation for top-level managers has been lower in India partly because many of the largest firms have strong family ownership and control.[108]

Learning Objective

10-6 Describe how the market for corporate control, regulators, and creditors restrain top-level managers' decisions.

10-6 External Governance Mechanisms

In addition to the three internal governance mechanisms discussed previously, there are also three external governance mechanisms. These are forces outside the firm that have a strong influence on top-level management decisions and actions. These mechanisms consist of what is called the market for corporate control as well as two powerful stakeholders—regulators and creditors.

10-6a The Market for Corporate Control

The **market for corporate control** is an external governance mechanism that is active when a firm's internal governance mechanisms fail.

The **market for corporate control** is an external governance mechanism that is active when a firm's internal governance mechanisms fail.[109] The market for corporate control is composed of individuals and firms that buy large-block shareholder positions in or purchase all of what they consider undervalued corporations, with the intention of making changes to enhance their value. Mentioned previously in Chapter 6, *private equity firms,* which amass large amounts of investment capital from high-net-worth individuals and institutional investors (i.e., Blackstone, KKR & Co., Carlyle Group), are very active in this market.[110] Because top-level managers are assumed to be

Strategic **Focus**

Elon Musk Threatens a Hostile Takeover of Twitter

Billionaire Elon Musk, who changed his title at Tesla to Technoking, and also heads SpaceX, wrote a letter to Twitter Chairman Bret Taylor on April 13, 2022, offering to buy the social media company for $54.20 per share ($43 billion). This was a 51 percent premium over the monthly average price for Twitter stock compared to its price before Mr. Musk expressed interest in buying the company earlier in the month. At the time of the letter, Musk owned over 9 percent of the stock. He had recently been very critical of management of Twitter, "especially its approach to content moderation, which he believes impedes free speech." He described Twitter as the "de facto town square," and said that it is very important that there be "an inclusive arena for free speech." In an ironic twist, he used his Twitter account, with 82 million followers, to share his criticisms.

The letter followed a month of what might be called "dancing" with Twitter. The company offered Mr. Musk a board seat, which was "contingent on a background check and formal acceptance." Twitter CEO Parag Agrawal announced that Musk would be joining the board, stating that he understood the risks of bringing Musk onto the board but thought it was the "best path forward" for the company. Then Musk turned down the invitation and signaled his intention to acquire the company instead. His intentions were complicated by defensive actions taken by the board. They launched what is known as a "poison pill" that allows other shareholders to buy discounted stock in Tesla if Musk's ownership exceeds 15 percent of the stock.

A regulatory filing on April 14 included Mr. Musk's letter to the Twitter chairman and said that the offer was nonbinding and dependent on his ability to raise the needed financing. By the end of April, the financing was arranged, including $25 billion in loans from a group of banks that included Bank of American, Morgan Stanley, and Barclays, with one-third of his stake in Tesla as collateral for the loans. Musk would commit $21 billion of his own equity to the deal. In the new filing, he also said he was willing to take the offer directly to the shareholders through a tender offer, which would bypass the board. In a tender offer, the potential buyer offers to buy stock directly from the shareholders. If they can acquire more than half the stock, then they control the company.

With financing arranged, and the threat of a tender offer, Twitter executives decided to enter negotiations with Mr. Musk, and met with him on April 24. Within two days an agreement was reached, with a $44 billion price tag. Jack Dorsey, Twitter's founder and former CEO, approved the purchase: "Elon is the singular solution I trust. I trust his mission to extend the light of consciousness."

Mr. Musk's agenda for Twitter is bold. He wants to soften Twitter's stance on content moderation, using more caution before deciding to take down tweets or permanently ban users. He also wants the company to create an edit feature for tweets, make Twitter's algorithm "open source" so that people outside the company can recommend fixes and changes, try to put a stop to both spam and scam bots, rely less on advertising, and allow longer tweets. According to Musk, "Twitter has extraordinary potential. I will unlock it."

FellowNeko/Shutterstock.com

Elon Musk's controversial beliefs that Twitter should be a source for free speech and civil debate has led to many users deactivating their Twitter accounts.

Sources: C. Lombardo, M. Bobrowsky, & G. Wells, 2022, Musk strikes deal to buy Twitter, Wall Street Journal, April 26: A1, A6; M. Bobrowsky, 2022, What Elon Musk would do with Twitter, *Wall Street Journal*, www.wsj.com, April 25; 2022, The world in brief, *The Economist*, www.economist.com, April 26; C. Lombardo & D. Cimilluca, 2022, Twitter, Musk in talks to strike a deal, *Wall Street Journal*, April 25: A1, A4; L. Hoffman & C. Lombardo, 2022, Musk lines up funding to buy Twitter, *Wall Street Journal*, April 22: A1, A4; C. Lombardo & L. Hoffman, Elon Musk could make a tender offer for Twitter. What does that mean? *Wall Street Journal*, www.wsj.com, April 21; M. Bobrowsky, Musk has ideas on how to transform Twitter, *Wall Street Journal*, April 18: B1, B4; D. Jacob, 2022, Jack Dorsey has his title change to block head, *Wall Street Journal*, April 23–24: B11; D. Gallagher, 2022, Musk gives Twitter's board a pricey out, *Wall Street Journal*, April 15: B10; N. Gordon, 2022, Musk turns down a seat on Twitter's board, leaving the door open for him to pursue a hostile takeover, *Fortune*, www.fortune.com, April 11.

responsible for the undervalued firm's poor performance, they are often replaced. An effective market for corporate control helps ensure that ineffective and/or opportunistic top-level managers are disciplined.[111]

Between the 1940s and the 1980s, large-block activist shareholders, labeled "corporate raiders," were the most influential players in the market for corporate control.[112] They would buy companies and often seek to increase the debt load, sell off business units, and downsize by laying off workers. If a target firm did not respond as the raider required, they would compel the company to pay a premium by buying back the shares they bought, often called "greenmail."[113]

Since 1985, after "the founding of Institutional Shareholders Services and the Council of Institutional Investors, institutional investors have become primary players in shareholder activism."[114] Public pension funds, mutual funds, and hedge funds are all participants. However, because of defensive tactics (to be discussed in the next section), actual takeovers are not as common as they used to be.[115] More often, activist investors use their stakes in companies as leverage to assume board seats and influence management to make changes that conform to what they would like to see done. Nonetheless, as we see in the Strategic Focus, takeovers (or threats of takeovers) are still a meaningful part of external governance. In fact, activist investors often use their influence to compel entrenched incumbent managers to sell.[116]

Because of the disciplinary power of the market for corporate control, target firm managers and board members are sensitive about takeover bids, since being a target suggests that they have been ineffective in fulfilling their responsibilities. For top-level managers, a board's decision to accept an acquiring firm's offer typically finds them losing their jobs because the acquirer usually wants different people to lead the firm. At the same time, rejection of an offer also increases the risk of job loss for top-level managers because the pressure from the board and shareholders for them to improve the firm's performance becomes substantial. As the Strategic Focus demonstrates, activist investors with significant funding from institutional investors are often the head of the spear when it comes to the market for corporate control.

In general, activist pension funds (as institutional investors and as an internal governance mechanism) are reactive in nature, taking actions when they conclude that a firm is underperforming. In contrast, activist hedge funds (as part of the market for corporate control) are proactive; they identify firms whose performance could be improved and then invest in them.[117]

Another possibility is suggested by research results—namely, that as a governance mechanism, investors sometimes use the market for corporate control to take an ownership position in firms that are performing well.[118] A study of active corporate raiders in the 1980s showed that takeover attempts often were focused on above-average-performance firms in an industry.[119] This work and other recent research suggest that the market for corporate control is an imperfect governance mechanism.[120] Actually, mergers and acquisitions are highly complex strategic actions with many purposes and potential outcomes. As discussed in Chapter 7, some are successful, and many are not—even when they have potential to do well—because implementation challenges when integrating two diverse firms can limit their ability to realize their potential.[121]

In summary, the market for corporate control is a blunt instrument for corporate governance; nonetheless, this governance mechanism does have the potential to represent shareholders' best interests. Accordingly, top-level managers want to lead their firms in ways that make disciplining by activists outside the company unnecessary and/or inappropriate. Top-level managers can use several defense tactics to fend off a takeover attempt. Managers leading a target firm that is performing well are almost certain to try to thwart the takeover attempt. Even in instances when the target firm is underperforming its peers, managers might use defense tactics to protect their own interests.

10-6b Managerial Defense Tactics

In most cases, hostile takeovers are the principal means by which the market for corporate control is activated. A *hostile takeover* is an acquisition of a target company that is unwanted by the company's top executives and board of directors.[122] Firms targeted for a hostile takeover may use multiple defense tactics to fend off the takeover attempt. Increased use of the market for corporate control has enhanced the sophistication and variety of managerial defense tactics that are used in takeovers.[123]

Because the market for corporate control tends to increase risk for managers, one defensive tactic, called a golden parachute, results in a huge payment to the CEO and sometimes other top executives if the firm is taken over. Golden parachutes, similar to most other defense tactics, are controversial in that they are often seen as harming shareholder interests; they are an agency problem. Another takeover defense strategy is traditionally known as a "poison pill," which was highlighted in the Strategic Focus. This strategy usually allows shareholders (other than the acquirer) to convert "shareholders' rights" into numerous common shares at a huge discount if an individual or company acquires more than a set amount of the target firm's stock (typically 10 to 20 percent).

Increasing the total number of outstanding shares dilutes the potential acquirer's existing stake. This means that, to maintain or expand its ownership position, the potential acquirer must buy additional shares at premium prices, increasing the potential acquirer's costs. Some firms amend the corporate charter so board member elections are staggered, resulting in only one third of members being up for reelection each year. Research shows that this results in reduced vulnerability to hostile takeovers but also provides for better long-term investments.[124] Additional takeover defense strategies are presented in Table 10.2.

Most institutional investors oppose the use of defensive tactics because such defenses are generally seen as a way to entrench top managers in their positions.[125] Many institutional investors also oppose severance packages (golden parachutes), and the opposition is increasing significantly in Europe as well.[126] However, an advantage to severance packages is that they may encourage top-level managers to accept takeover bids with the potential to best serve shareholders' interest.[127] Alternatively, research results show that using takeover defenses reduces the amount of pressure managers feel to seek short-term performance gains, resulting in them concentrating on developing strategies with a longer time horizon and a high probability of serving stakeholders' interests. Such firms are more likely to invest in and develop innovation; when they do so, the firm's market value increases, thereby rewarding shareholders.[128]

An awareness on the part of top-level managers about the existence of external investors in the form of individuals (e.g., Elon Musk, Carl Icahn) and groups (e.g., hedge funds) often positively influences them to align their interests with those of the firm's stakeholders, especially the

Table 10.2 Hostile Takeover Defense Strategies

Defense strategy	Success as a strategy	Effects on shareholder wealth
Capital structure change: Dilution of the target firm's stock, making it more costly for an acquiring firm to continue purchasing the target's shares. Employee stock option plans (ESOPs), recapitalization, issuance of additional debt, and share buybacks are actions associated with this strategy.	Medium	Inconclusive
Corporate charter amendment: An amendment to the target firm's charter for the purpose of staggering the elections of members to its board of directors so that all are not elected during the same year. This change to the firm's charter prevents a potential acquirer from installing a completely new board in a single year.	Very low	Negative to Negligible
Golden parachute: A lump-sum payment of cash that is given to one or more top-level managers when the firm is acquired in a takeover bid.	Low	Negligible
Greenmail: The repurchase of the target firm's shares of stock that were obtained by the acquiring firm at a premium in exchange for an agreement that the acquirer will no longer target the company for takeover.	Medium	Negative
Litigation: Lawsuits that help the target firm stall hostile takeover attempts. Antitrust charges and inadequate disclosure are examples of the grounds on which the target firm could file.	Low	Positive
Poison pill: An action the target firm takes to make its stock less attractive to a potential acquirer.	High	Positive
Standstill agreement: A contract between the target firm and the potential acquirer specifying that the acquirer will not purchase additional shares of the target firm for a specified period of time in exchange for a fee paid by the target firm.	Low	Negative

Sources: I. Obaydin, R. Zurbruegg, P. Brockman, & G. Richardson, 2021, The relative number of anti-takeover provisions and the market for corporate control, *Journal of Financial Research*, 44, 279–298; Y. Amihud & S. Stoyanov, 2017, Do staggered boards harm shareholders? *Journal of Financial Economics*, 123: 432–439; S. Bhojraj, P. Sengupta, & S. Zhang, 2017, Takeover defenses: Entrenchment and efficiency, *Journal of Accounting & Economics*, 63: 142–160; J. M. Karpoff, R. J. Schonlau, & E. W. Wehrly, 2017, Do takeover defense indices measure takeover deterrence? *Review of Financial Studies*, 30(7): 2359–2412; M. Straska & G. Waller, 2014, Antitakeover provisions and shareholder wealth: A survey of the literature, *Journal of Financial & Quantitative Analysis*, 49: 1–32; M. Ryngaert & R. Scholten, 2010, Have changing takeover defense rules and strategies entrenched management and damaged shareholders? The case of defeated takeover bids, *Journal of Corporate Finance*, 16: 16–37; N. Ruiz-Mallorqui & D. J. Santana-Martin, 2009, Ultimate institutional owner and takeover defenses in the controlling versus minority shareholders context, *Corporate Governance: An International Review*, 17: 238–254; J. A. Pearce II & R. B. Robinson, Jr., 2004, Hostile takeover defenses that maximize shareholder wealth, *Business Horizons*, 47(5): 15–24.

shareholders. Moreover, when active as an external governance mechanism, the market for corporate control has brought about significant changes in many firms' strategies and, when used appropriately, has served shareholders' interests.[129] Of course, the goal is to have the managers develop the psychological ownership of principals.[130] However, such sense of ownership can be taken too far such that narcissistic (i.e., egotistical) top executives can feel that they are personally central to the identity of the firm.[131]

10-6c Regulators

In the recent past, observers of firms' governance practices have been concerned about more egregious behavior beyond mere ineffective corporate strategies, such as that discovered at Enron, WorldCom, and Volkswagen, and major financial institutions. Partly in response to these behaviors, the U.S. Congress enacted the Sarbanes-Oxley Act (SOX) in 2002 and passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in mid-2010.

Because of these two acts, corporate governance mechanisms have received greater scrutiny.[132] While the implementation of SOX has been controversial to some, most believe that its use has led to generally positive outcomes in terms of protecting stakeholders and certainly shareholders' interests. For example, Section 404 of SOX, which prescribes significant transparency improvement on internal controls associated with accounting and auditing, has arguably improved the internal auditing scrutiny (and thereby trust) in firms' financial reporting. Moreover, research suggests that internal controls associated with Section 404 increase shareholder value.[133] Nonetheless, some argue that the Act, especially Section 404, creates excessive costs for firms.[134] In addition, a decrease in foreign firms listing on U.S. stock exchanges occurred at the same time as listing on foreign exchanges increased. In part, this shift may be because of the costs SOX generates for firms seeking to list on U.S. exchanges.

Dodd-Frank is recognized as the most sweeping set of financial regulatory reforms in the United States since the Great Depression.[135] The Act is intended to align financial institutions' actions with society's interests. Dodd-Frank includes provisions related to the categories of consumer protection, systemic risk oversight, executive compensation, and capital requirements for banks. The Act creates a Financial Stability Oversight Council headed by the Treasury secretary, establishes a new system for liquidation of certain financial companies, provides for a new framework to regulate derivatives, establishes new corporate governance requirements, and regulates credit rating agencies and securitizations. However, Congress has been seeking to pass relief for regional banks by lowering the capital requirements and requiring less obligations for big stress tests.[136]

More intensive application of governance mechanisms as mandated by legislation such as SOX and Dodd-Frank affects firms' choice of strategies. For example, more intense governance might find firms choosing to pursue fewer risky projects, possibly decreasing shareholder wealth as a result, although some research suggests that tighter governance associated with SOX regulation increases innovation, especially for firms with previously weaker governance.[137] Determining governance practices that strike an appropriate balance between protecting stakeholders' interests and allowing firms to implement strategies with some degree of risk is difficult.

Of course, the United States is not the only country that has seen changes in regulations regarding corporate governance. In 2015, Japan adopted a new governance code that strongly emphasized the importance of firms to elect many more independent outside directors.[138] Also, the Chinese government has taken steps to encourage more domestic institutional investment (but not foreign institutional investment).[139] Governance in Japan, China, and Germany will be discussed later in this chapter.

10-6d Creditors

Firms use more debt than equity to finance their operations.[140] Creditors have an influence over corporate governance in several ways. The one that usually comes to mind is the power creditors hold when a firm is in default on a loan, which means the firm is not able to make the required payments. Creditors, using legal institutions and negotiations tactics, can have a profound influence on the decisions the firm makes when a firm is in default.

However, actual defaults are not that common. Much more prevalent is when a firm violates financial covenants associated with a loan.[141] Covenants regard things like the amount of leverage a firm is allowed to have, its ability to cover its interest costs, or its total fixed charges. "Because a violation of a financial covenant can be considered a default event, the lender has the right to call for immediate payment of, or expedite, the entire loan balance. But lenders rarely expedite the loan and often use the acceleration right to usher in a renegotiation of the credit agreement. Through these renegotiations, the lending firms shape the governance and decisions of borrowers. . . ."[142]

Also, it is not uncommon for a board seat to be held by a representative of a large creditor. Research has shown that *bank-appointed directors* can serve a certification role, in that their presence increases the confidence of other creditors that their interests are being represented. This can increase the number of debt sources available to the firm, which can be especially important for firms in developing economies.[143] Because creditors like banks are such an important source of capital in countries in which equity markets are unstable or not well developed, the influence of creditors on governance may be even stronger than it is in economically developed countries.

In addition, firms with better governance characteristics (i.e., more independent directors) can often obtain lower interest rates on their debt.[144] In this way, creditors are indirectly influencing a firm's governance characteristics.

10-7 International Corporate Governance

Learning Objective

10-7 Discuss the nature and use of corporate governance in international settings, especially in Germany, Japan, and China.

Corporate governance is an increasingly important issue in economies around the world, including emerging economies. Globalization in trade, investments, and equity markets increases the potential value of firms throughout the world using similar mechanisms to govern corporate activities. Moreover, because of globalization, major companies want to attract foreign investment. For this to happen, foreign investors must be confident that adequate corporate governance mechanisms are in place to protect their investments.

One of the most important trends pertaining to governance in the international environment is the increasing influence of owners across borders.[145] Many firms cross-list their shares so that they can be traded on exchanges outside their home countries. However, this situation also creates tension because norms regarding governance vary from country to country. Sovereign wealth funds (SWFs), which are investments funds controlled by a national government, can also exert their influence on the governance of a firm.[146] For example, the China Investment Corporation, the Abu Dhabi Investment Authority, and the Pension Fund of Norway collectively have investments worth more than $2 trillion, and a lot of those investments are in countries other than their home countries.[147] Cross-border ownership influences are likely to increase similarity in governance across countries over time.

Although globalization is stimulating an increase in the intensity of efforts to improve corporate governance and potentially to reduce the variation in regions' and nations' governance systems, the reality remains that different nations do have different governance systems in place.[148] Research shows that firms seek to invest in nations with national governance standards that are acceptable to them.[149] Recognizing and understanding differences in various countries' governance systems, as well as changes taking place within those systems, improves the likelihood a firm will be able to compete successfully in the international markets it chooses to enter. Next, to highlight the general issues of differences and changes taking place in governance systems, we discuss corporate governance practices in two developed economies (Germany and Japan) and in the emerging economy of China.

10-7a Corporate Governance in Germany

In many private German firms, the owner and manager may be the same individual. In these instances, agency problems are not very prevalent.[150] Even in publicly traded German corporations, a single shareholder is often dominant, although this is changing. Thus, the concentration of ownership is an important means of corporate governance in Germany, as it is in the United States.[151]

Historically, banks have been considered to play a prominent role in the German corporate governance system.[152] This is the case in other European countries as well, such as Italy and France. As lenders, banks become major shareholders when companies they financed seek funding on the stock market or default on loans. The banks monitor and control managers, both as lenders and as shareholders, by electing representatives to supervisory boards. This is not the case in the United States because of the Glass Steagel Act banning bank ownership of common stocks.

German firms with more than 2,000 employees are required to have a two-tiered board structure that places the responsibility for monitoring and controlling managerial (or supervisory) decisions and actions in the hands of a separate group.[153] All the functions of strategy and management are the responsibility of the management board (the Vorstand); however, appointment to the Vorstand is the responsibility of the supervisory tier (the Aufsichtsrat). Employees, union members, and shareholders appoint members to the Aufsichtsrat.

Proponents of the German structure suggest that it helps prevent corporate wrongdoing and rash decisions by "dictatorial CEOs." However, critics maintain that it slows decision making and often ties a CEO's hands. The corporate governance practices in Germany make it difficult to restructure companies as quickly as can be done in the United States. Because of the role of local government (through the board structure) and the power of banks in Germany's corporate governance structure, private shareholders rarely have major ownership positions in German firms. Additionally, a significant number of cross-shareholdings among firms make takeovers more difficult.[154] However, large institutional investors, such as pension funds (outside of banks and insurance companies), are also relatively insignificant owners of corporate stock. Thus, at least historically, German executives generally have not been dedicated to maximizing shareholder wealth to the degree that is the case for top-level managers in the United States and United Kingdom.[155]

However, corporate governance practices used in Germany have been changing in recent years. A manifestation of these changes is that many German firms are gravitating toward U.S. governance mechanisms. Recent research suggests that the traditional system in Germany produced some agency costs because of a lack of external ownership power. Interestingly, German firms with listings on U.S. stock exchanges have increasingly adopted executive stock option compensation as a long-term incentive pay policy.[156]

10-7b Corporate Governance in Japan

The concepts of obligation, family, and consensus affect attitudes toward corporate governance in Japan. As part of a company family, individuals are members of a unit that envelops their lives; families command the attention and allegiance of parties throughout corporations. In addition, because Japan has a collectivist orientation, Japanese firms are concerned with a broader set of stakeholders than are firms in the United States, including employees, suppliers, and customers.[157] Consensus, another important influence in Japanese corporate governance, calls for the expenditure of significant amounts of energy to win the hearts and minds of people whenever possible, as opposed to top-level managers issuing edicts. Consensus is highly valued, even when it results in a slow and cumbersome decision-making process.

Moreover, a *keiretsu* (a group of firms tied together by cross-shareholdings) is more than an economic concept—it, too, is a family.[158] The extensive cross-shareholdings impede the type of structural change that is needed to improve the nation's corporate governance practices. However, recent changes in the governance code in Japan have been fostering better opportunities from improved corporate governance, fostered also by an increase in hedge fund activism.[159] Also, the *keiretsu* system itself has weakened considerably. While approximately 50 percent of shares of listed companies in Japan were tied up in *keiretsu*-style cross-shareholdings in 1989, this figure fell to about 4 percent in 2019.[160] A big part of this change is due to an increase of non-Japanese investment in Japanese listed companies.

As in Germany, banks in Japan have an important role in financing and monitoring large public firms.[161] Because the main bank in the *keiretsu* owns a large share position and holds a large amount of corporate debt, it has the closest relationship with a firm's top-level managers. The main bank provides financial advice to the firm and also closely monitors managers, although they have become less salient in fostering corporate restructuring.[162] Thus, although it is changing, Japan has traditionally had a bank-based financial and corporate governance structure, whereas the United States has a market-based financial and governance structure. Remember that, as mentioned previously, commercial banks in the United States are not allowed to own shares of publicly traded firms.

Japan's corporate governance practices have been changing in recent years. For example, because of Japanese banks' continuing development as economic organizations, their role in the monitoring and control of managerial behavior and firm outcomes is less significant than in the past.[163] Deregulation facilitated additional activity in Japan's market for corporate control, which was nonexistent in past years. In fact, research has found that bank-firm relationships increase the likelihood of a merger or acquisition, and that banks have facilitated both restructuring and international expansion.[164]

Most Japanese firms have boards that are largely composed of internal management, so they reflect the upper echelon of management. However, independent, the number of nonexecutive board members are increasing in Japanese firms.[165] Also, long-term executive compensation (e.g., stock options) is increasingly important to foster improved performance.[166]

10-7c Corporate Governance in China

China has a unique and large economy, mixed with both socialist and market-oriented traits.[167] China's listed companies have a two-tiered board system. A supervisory board has the responsibility of monitoring the board of directors.[168] The role of independent directors is to both monitor and advise directors. This system has elements of the two-tiered system found in Germany combined with features of boards in other countries such as the United States or the United Kingdom.

Over time, the Chinese government has done much to improve the corporate governance of listed companies, particularly considering the increasing privatization of businesses and the development of equity markets. However, the stock markets in China remain young and are continuing to develop. In their early years, these markets were weak because of significant insider trading, but with stronger governance these markets have improved.[169]

Although there has been a gradual decline in China in the equity held in state-owned enterprises, the Chinese Communist Party (CCP) is still China's largest controlling shareholder, and still directs how Chinese companies are governed.[170] Even private firms try to develop political ties with the government because of their role in providing access to resources and to the economy.[171] In terms of long-term success, these conditions may affect firms' performance. Research shows that firms with higher state ownership tend to have lower market value and more risk of default, perhaps because of agency conflicts within the firms and because executives must, at times, emphasize satisfying government-mandated social goals above maximizing shareholder returns.[172] Such a model sets up potential conflict between the principals, particularly the state owner and the private equity owners of such enterprises.[173]

Some evidence suggests that corporate governance in China may be tilting toward the Western model. Changing a nation's governance systems is a complicated task that will inevitably encounter setbacks. Still, corporate governance in Chinese companies continues to evolve and likely will do so for some time to come as parties (e.g., the Chinese government and those seeking further movement toward free-market economies) interact to form governance mechanisms that are best for their nation, business firms, and citizens. However, along with changes in the governance systems of specific countries, multinational companies' boards and managers are also evolving. For example, firms that have entered more international markets are likely to have more top executives with greater international experience and to have a larger proportion of foreign owners and foreign directors on their boards.[174]

10-8 Governance Mechanisms and Responsible Behavior

Learning Objective

10-8 Describe how corporate governance can foster ethical decisions by a firm's top-level managers.

The three internal and three external governance mechanisms are designed to ensure that the agents of the firm's owners—the corporation's top-level managers—make strategic decisions that best serve the interests of all stakeholders. Increasingly, top-level managers are expected to lead their firms in ways that will serve not only the shareholders, but the needs of other stakeholders, and society as a whole.[175] Therefore, the firm's actions and the outcomes flowing from them should result in, at least, minimal satisfaction of the interests of important stakeholders; otherwise, a firm risks seeing its dissatisfied stakeholders withdraw their support from the firm and provide it to another. For example, customers may purchase products from another firm, employees could leave the firm, suppliers could cancel their relationship with the firm, or communities could no longer allow permits needed to expand operations.[176]

Scandals at companies such as Enron, WorldCom, HealthSouth, Volkswagen, and Satyam (a large information technology company based in India), among others, emphasized the negative effects of poor ethical behavior on a firm's efforts to satisfy stakeholders. Consequently, stakeholder governance of ethical behavior by top-level managers is being taken seriously in countries throughout the world.[177] For example, the Stewardship Code was introduced in the United Kingdom "to enhance the engagement of institutional investors with shareholdings in UK listed companies."[178] Although institutional investors have often been conceptualized as owners, the stewardship concept combines the ownership role with broader responsibilities to stakeholders.

Internal corporate governance mechanisms designed and used by ethically responsible leaders and companies increase the ability of the firm to serve the interests of a broad stakeholder group.[179] As discussed in a Strategic Focus in Chapter 1, often this ability is measured in terms of a firm's corporate social responsibility (CSR). For example, research has demonstrated that multinational firms with higher levels of board gender diversity are likely to engage in more CSR disclosure.[180] In the same study, researchers found that higher levels of tenure diversity among board members were associated with more social disclosure. In an additional study, board independence was found to be associated with CSR, as was the presence of an independent audit committee.[181]

Another interesting study found that firms that had poor CSR performance were likely to have more directors with backgrounds in not-for-profit, private organizations (NGOs). These directors were most likely appointed to help guide the firm towards a higher level of CSR performance. Although there was no immediate influence on improvement in the CSR performance of those firms, there was a positive effect after 3 years.[182] Finally, in a large-scale evaluation of over 100 studies in over 20 countries, researchers concluded that board independence is generally associated with lower levels of corporate misconduct, although the relationship can vary depending on how independence is defined.[183]

Activist investors can also have an impact on a firm's CSR. In one study, researchers found that shareholder activists, and especially institutional activists, can influence greater disclosure of climate change risks. Investors responded well to the increased disclosure by giving these companies a higher valuation.[184] Well-known activist Carl Icahn, who owns a McDonald's stake worth about $50,000, is concerned about how the company treats pregnant pigs. As part of his strategy to get the company to change its treatment of these animals, he nominated two directors to McDonald's board. He also urged "BlackRock Inc. and other big index fund managers focused on socially conscious investing to support his proxy fight at McDonald's Corp. for better treatment of pregnant pigs."[185]

The decisions and actions of the board of directors can be an effective deterrent to unethical behaviors by top-level managers. Indeed, evidence suggests that the most effective boards set boundaries for their firms' business ethics and values.[186] After the boundaries for ethical behavior are determined, and likely formalized in a code of ethics, the board's ethics-based expectations must be clearly communicated to the firm's top-level managers and to other stakeholders (e.g., customers and suppliers) with whom interactions are necessary for the firm to produce and sell its products. Moreover, as agents of the firm's owners, top-level managers must understand that the board, acting as an internal governance mechanism, will hold them fully accountable for developing and supporting an organizational culture in which only ethical behaviors are permitted. As explained in Chapter 12, CEOs can be positive role models for improved ethical behavior.[187]

Through effective governance that results from well-designed governance mechanisms and the appropriate country institutions, top-level managers, working with others, can select and use strategies that result in strategic competitiveness and earning above-average returns. Such governance also provides long-term shareholder wealth and improved stakeholder cooperation.

Summary

- Corporate governance is the set of mechanisms used to manage the relationships among stakeholders and to determine and control the strategic direction and performance of organizations. How firms monitor and control top-level managers' decisions and actions affects the implementation of strategies. Effective governance that aligns managers' decisions with shareholders' interests can help produce a competitive advantage for the firm.
- Three internal governance mechanisms are used in the modern corporation: ownership concentration, the board of directors, and executive compensation. In addition, three external governance mechanisms are also important: the market for corporate control, regulators, and creditors.
- Ownership is separated from control in the modern corporation. Owners (principals) hire managers (agents) to make decisions that maximize the firm's value. As risk-bearing specialists, owners diversify their risk by investing in multiple corporations with different risk profiles. Owners expect their agents (the firm's top-level managers, who are decision-making specialists) to

make decisions that will help to maximize the value of their firm. Thus, modern corporations are characterized by an agency relationship that is created when one party (the firm's owners) hires and pays another party (top-level managers) to use its decision-making skills.

- Separation of ownership and control creates an agency problem when an agent pursues goals that conflict with the principals' goals. Principals establish and use governance mechanisms to control this problem.
- Ownership concentration is based on the number of large-block shareholders and the percentage of shares they own. With significant ownership percentages, such as those held by large mutual funds and pension funds, institutional investors often can influence top-level managers' strategic decisions and actions. Thus, unlike diffuse ownership, which tends to result in relatively weak monitoring and control of managerial decisions, concentrated ownership produces more active and effective monitoring.
- Institutional investors are a powerful force in corporate America, and they actively use their positions of concentrated ownership to force managers and boards of directors to make decisions that best serve shareholders' interests. Shareholder activism refers to actions shareholders take to influence corporate policy and practice. Sometimes activist investors join forces in what are called wolf packs.
- For decades, a debate has been raging regarding whether top managers and boards should give the firm's shareholders higher priority than other stakeholders. The pendulum is now swinging more in favor of serving a broader group of stakeholder interests.
- In the United States and the United Kingdom, a firm's board of directors, composed of insiders, related outsiders, and outsiders, is a governance mechanism expected to represent shareholders' interests. The percentage of outside directors on many boards now exceeds the percentage of inside directors.
- Boards are becoming increasingly diverse and independent, with stronger internal controls, formalized processes for evaluating board member performance, modifications to the way directors are compensated, and the creation of the role of lead director. Boards are also paying a lot more attention to corporate social responsibility.
- Executive compensation is a highly visible and often criticized governance mechanism. Salary, bonuses, and long-term incentives are used for the purpose of aligning managers' and shareholders' interests. A firm's board of directors is responsible for determining the effectiveness of the firm's executive compensation system. An effective system results in managerial decisions that are in shareholders' best interests.
- In general, evidence suggests that shareholders and boards of directors have become more vigilant in controlling managerial decisions. Nonetheless, these mechanisms are imperfect and sometimes insufficient.
- When the internal mechanisms fail, the market for corporate control—as an external governance mechanism—becomes relevant. Regulators also play an important role in influencing corporate governance from outside the organization. Through implementation of the SOX Act, outsiders are expected to be more independent of a firm's top-level managers compared with directors selected from inside the firm. Relatively recent rules formulated and implemented by the SEC to allow owners with large stakes to propose new directors are beginning to change the balance even more in favor of outside and independent directors. Additional governance-related regulations have resulted from the Dodd-Frank Act. In addition, creditors serve as an external governance mechanism.
- Corporate governance structures used in Germany, Japan, and China differ from each other and from the structure used in the United States. Historically, the U.S. governance structure focused on maximizing shareholder value. In Germany, employees, as a stakeholder group, take a more prominent role in governance. By contrast, until recently, Japanese shareholders played virtually no role in monitoring and controlling top-level managers. However, Japanese firms are now being challenged by "activist" shareholders. In China, the central government still plays a major role in corporate governance practices. Internationally, all these systems are becoming increasingly similar.
- Top-level managers are expected to lead their firms in ways that will serve not only the shareholders, but the needs of other stakeholders, and especially those that have the most impact on the value the firm creates (e.g., customers, suppliers, employees, and host communities). Internal corporate governance mechanisms designed and used by ethically responsible leaders and companies increase the ability of the firm to serve the interests of a broad stakeholder group. In addition, external governance mechanisms can serve to monitor the firm and encourage responsible behavior.

Key Terms

agency costs 254
agency relationship 252
board of directors 256
corporate governance 250
executive compensation 259
institutional owners 255
large-block shareholders 254
managerial opportunism 252
market for corporate control 260
ownership concentration 254
shareholder activism 255

Review Questions

1. What is corporate governance? What factors account for the considerable amount of attention corporate governance receives from several parties, including shareholder activists, business press writers, and academic scholars? Why is governance necessary to control managers' decisions?
2. What is meant by the statement that ownership is separated from managerial control in the corporation? Why does this separation exist?
3. What is an agency relationship? What is managerial opportunism? What assumptions do owners of corporations make about managers as agents?
4. How is each of the three internal governance mechanisms—ownership concentration, boards of directors, and executive compensation—used to align the interests of managerial agents with those of the firm's owners?
5. What trends exist regarding executive compensation? What is the effect of the increased use of long-term incentives on top-level managers' strategic decisions?
6. What is the market for corporate control? What conditions generally cause this external governance mechanism to become active? How does this mechanism constrain top-level managers' decisions and actions?
7. How do regulators and creditors function as governance mechanisms?
8. What is the nature of corporate governance in Germany, Japan, and China?
9. How can corporate governance foster ethical decisions and behaviors on the part of managers as agents?

Mini-Case

Toshiba Shareholders Reject Restructuring Plan—What's Next?

Toshiba Corp., the industrial conglomerate based in Japan, went through some tough times. In 2015, Toshiba was caught up in an accounting scandal, and then in 2017, its U.S. nuclear-energy business went bankrupt. Shareholders from outside Japan injected a lot of capital into the company in 2017 to shore up its finances, which gave them about 50 percent control. Toshiba had already sold off a lot of its most recognized businesses, including those making personal computers and televisions.

Toshiba shareholders were on the offensive since a report released in June 2021 indicated that the company and government officials had been collaborating to silence shareholder voices prior to a shareholder's meeting in July 2020. In early 2022, Satoshi Tsunukawa stepped down as CEO under pressure from shareholders. He was replaced by Satoshi Shimada, who came to Toshiba in 2018 after working for a Japanese unit of Siemens AG (based in Germany). This change in leadership came soon after the company announced its intention to split into two businesses—one focusing on devices and the other on energy and infrastructure. "The management shake-up is intended to lay the groundwork for the split. Toshiba said Mr. Shimada would lead the energy and infrastructure company after the spinoff, while another newly promoted executive, Hiroyuki Sato, would head the device company."

Foreign-based shareholders expressed dissatisfaction with the split, and also objected to an earlier plan to divide the company into three units. Singapore-based 3D Investment Partners asked the strategic-review committee at Toshiba to consider other options—one of them would involve selling to entire company to a private investor. Mr. Shimada was unconvinced, "We are going to go ahead with the separation plan as scheduled. To make that happen, we need to build a strong relationship of trust with our stakeholders as quickly as we can."

In mid-March, shareholders rejected the plan for a two-way split. Foreign shareholders led the rejection effort and suggested that it would be better to sell the whole company to a private-equity firm; however, nearly 60 percent of shareholders voted against the plan. Later in the month, Bain Capital revealed that it was considering a bid for Toshiba. "Bain, a U.S.-based private-equity firm, said it wanted to hold 'careful and sincere' discussions with Toshiba's management, the Japanese government, and banks over the possible deal."

Finally, toward the end of April 2022, the embattled company gave up: "Toshiba Corp. on Thursday put itself up for auction after pressure from foreign shareholders and said it would solicit bids from investors including those who want to take the company private." The company intended to move quickly, seeking proposals from potential suitors before its shareholder meeting in June of that year.

This drama was historically significant for Japan, "for the simple reason that a vigorous and unforgiving market for corporate control is normal in the U.S. Toshiba's travails represent a relatively new phenomenon in Japan." Also, Toshiba is not just any Japanese company. It is one of Japan's oldest conglomerates. The Japanese business system served to protect management until recently. "The most obvious manifestation was the *keiretsu* system by which banks would organize around themselves a constellation of client-companies who all integrated each other into their supply chains and even owned one another's shares. But there were other factors, such as the government's internal resistance to any regulatory shake-up, or law firms' discomfort with advising activist investors for fear of alienating corporate clients." However, as noted in this chapter, the *keiretsu* system has weakened, and the Japanese government has taken regulatory actions to bring Japanese governance systems more in line with other industrialized nations. Also, non-Japanese investors have dramatically increased their shareholdings in Japanese companies. The fact that Toshiba's shareholders have had such a dramatic influence on the direction of the company is tangible evidence that Japan's governance system is modernizing.

Sources: M. Fujikawa, 2022, Embattled Toshiba puts self up for sale, *Wall Street Journal*, www.wsj.com, April 22; J. Wong, 2022, Toshiba vote is a vote on Japan Inc.'s future, too, *Wall Street Journal*, www.wsj.com, February 15; J. Wong, 2022, Toshiba's boss battle will go on, *Wall Street Journal*, www.wsj.com, March 24; M. Fujikawa, 2022, Toshiba shareholders reject plan to break into two parts, *Wall Street Journal*, www.wsj.com, March 23; M. Fujikawa, 2022, Toshiba replaces CEO again but sticks with two-way split plan, *Wall Street Journal*, www.wsj.com, March 1; M. Fujikawa, 2022, Bain Capital looks at possible takeover bid for Toshiba, *Wall Street Journal*, www.wsj.com, March 31; J. C. Sternberg, 2021, The Toshiba split: A farewell to poor Japanese management? *Wall Street Journal*, www.wsj.com, November 18.

Case Discussion Questions

1. Why are countries like Japan adopting "Western-style" governance systems similar to those found in the United States and the United Kingdom that are more shareholder friendly?
2. Several large companies (i.e., Johnson & Johnson, General Electric) have decided to split into multiple companies. Why do you think shareholders (especially foreign shareholders) rejected the plan to split Toshiba into two companies?
3. Given all its problems, why would a private investment firm like Bain want to buy Toshiba?
4. What role should government play in regulating governance systems in a country?

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Chapter 11

Organizational Structure and Controls

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

11-1 Define organizational structure and controls, and describe the organizational control cycle.

11-2 Discuss the difference between strategic and financial controls.

11-3 Describe the relationship between strategy and structure.

11-4 Describe the major types of organizational structures used to implement strategies.

11-5 Explain how the functional structure is used to implement the business-level strategies.

11-6 Explain the use of three versions of the multidivisional structure to implement different diversification strategies.

11-7 Discuss the organizational structures used to implement three international strategies.

11-8 Explain strategic networks and digital platform structures, and how strategic center firms implement such structures at the business and corporate levels.

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Ford Splits into Two Divisions to Put More Emphasis on Electric Vehicles

Ford Motor Company (Ford) has a storied history that spans more than a century, all the way back to Henry Ford, who is largely responsible for perfecting the mass production of cars to make them affordable for more of the population. The company's purpose is lofty: "To help build a better world, where every person is free to move and pursue their dreams." According to current CEO Jim Farley, "What makes this company different is that Ford has a higher purpose. We serve others and improve lives." In 2021, Ford sold approximately 3.9 million vehicles worldwide, with about half of those sales in North America. This sales record represents a decline from approximately 4.2 million in 2020 and 5.4 million in 2019. Although the company has one of the most respected brand names in the automobile industry, something must be done to put Ford on an upward trajectory again.

In a Strategic Focus in Chapter 2, we discussed the evolution of the global automobile industry from the 1950s, when big flashy cars were popular, up to the recent trend toward electric vehicles. Consistent with this trend, the Opening Case for Chapter 8 described Tesla's aggressive expansion in Europe. Ford has also moved strongly in this direction—the company has projected electric vehicles will account for about one-third of global sales by 2026 and half of global sales by 2030. As mentioned previously, the company is now selling about as many all-electric Mustangs as gas-powered versions and is engaged in a joint venture with a Korean company to build two battery factories in North America. Ford also announced an all-electric version of its popular F-150 pickup truck, to be called The Lightning.

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In April 2022, the launch of the new all-electric Ford F-150 Lightning truck was celebrated at the New York Stock Exchange.

It can be difficult to give a new business area like electric vehicles enough attention when it is confined within an existing organizational structure. Indeed, this was the case for Ford. Chief executive Jim Farley "has repeatedly said the business of developing and selling electric vehicles is vastly different from its conventional gas-engine operations, requiring new technical expertise and a distinct sale strategy." In 2022, the company announced that it would be reorganizing its operations into two independent divisions. The company "plans to keep both operations in-house with separate names and their own leadership structures and profit-and-loss statements." The electric division will be called Ford Model e and the traditional division Ford Blue. Mr. Farley says the new structure will reduce complexity and help cut costs from the gas-engine part of the business. This goal will be accomplished through a greater focus on reducing quality problems and reducing how many models Ford sells.

There are still some details to work out. For instance, where will the two types of vehicles be manufactured? At present, it appears that the electric vehicles currently will be manufactured in the same plants as the gas vehicles, although facilities built in the future for electric vehicles will sit within the Model e division. Joint manufacturing could make creating separate income statements difficult, not to mention creating problems in determining which managers would be supervising these operations. In time, these issues will all be worked out. "For now, the value of this split is in the radical clarity it brings to Ford's transition to EVs... For what is on the surface just a company reorganization, this could be the start of a life-changing journey for Ford."

Sources: S. Wilmot, 2022, Ford tries to create an inner Tesla, *Wall Street Journal,* www.wsj.com, March 2; M. Colias, 2022, Ford separates gas-engine, EV units in major overhaul, *Wall Street Journal,* March 3: A1–A6; M. Carlier, 2022, Wholesale vehicle sales of the Ford Motor Company 2009–2021, *Statista,* www.statista.com, February 10; M. Colias, 2022, Tesla set the model for selling EVs: Ford, VW, and others want to follow, *Wall Street Journal,* www.wsj.com, March 11; 2022, Our purpose, *Ford Homepage,* www.ford.com, May 2; W. Boston, 2022, Elon Musk open's Tesla's first European factory, *Wall Street Journal,* www.wsj.com, March 22; 2021, Ford commits to manufacturing batteries, to form new joint venture with SK Innovation to scale NA battery deliveries, *Ford Media Center,* www.media.ford.com, May 20.

Learning Objective

11-1 Define organizational structure and controls, and describe the organizational control cycle.

11-1 Organizational Structure and Controls

Organizational structure and controls, this chapter's topic, provide the framework within which strategies are implemented and used in both for-profit organizations and not-for-profit agencies.[1] However, as we see in the Opening Case on Ford, separate structures and controls may be required to successfully implement different strategies. In all organizations, top-level managers have the final responsibility for ensuring that the firm has matched each of its strategies with the appropriate organizational structure for carrying them out and that both change when necessary. The match or degree of fit between strategy and structure influences the firm's attempts to earn above-average returns.[2] Thus, the ability to select an appropriate strategy and match it with the appropriate structure is an important characteristic of effective strategic leadership.[3]

This chapter opens with an introduction to organizational structure and controls. We then provide more details about the need for the firm's strategy and structure to be properly matched. The influence of strategy and structure on each other affects firms' efforts to match individual strategies with their appropriate structure.[4] As we discuss, strategy has a more important influence on structure, although once in place, structure influences strategy.[5] Next, we describe the relationship between growth and structural change successful firms experience. We then discuss the different organizational structures firms use to implement separate business-level, corporate-level, international, and cooperative strategies. We present a series of figures to highlight the different structures firms match with different strategies. Across time and based on their experiences, organizations, especially large and complex ones, customize these general structures to meet their unique needs.[6] Typically, firms try to form a structure that is complex enough to facilitate implementation of their strategies but simple enough for all parties to understand and use.[7]

Research shows that organizational structure and the controls that are a part of the structure affect firm performance.[8] In particular, evidence suggests that performance declines when the firm's strategy is not matched with the most appropriate structure and controls.[9] Even though mismatches between strategy and structure do occur, research indicates that managers try to act rationally when forming or changing their firm's structure.[10]

In the Opening Case, we talked about the decline in Ford sales, and how the company is trying to cope effectively with changes in the external environment that are moving the automobile industry toward electric vehicles. As we noted then, the firm is changing to better meet strong competitors like Tesla in that market. Specifically, changes are being made to the organizational structure at Ford with the expectation that doing so will lead to enhanced firm performance. The leadership at Ford believes that changes being made to the firm's structure will increase its efficiency (that is, cost reductions) and its effectiveness (that is, it will better serve customers' needs).

11-1a Organizational Structure

Organizational structure specifies the firm's formal reporting relationships, procedures, controls, and authority and decision-making processes.

Organizational structure specifies the firm's formal reporting relationships, procedures, controls, and authority and decision-making processes.[11] A firm's structure determines and specifies the decisions that are to be made and the work that is to be completed by everyone within an organization as a result of those decisions.[12] Organizational routines serve as processes that are used to complete the work required by individual strategies.[13]

Developing an organizational structure that effectively supports the firm's strategy is difficult, especially because of the uncertainty (or unpredictable variation) about cause-effect relationships in the global economy's rapidly changing competitive environments.[14] When a structure's elements (e.g., reporting relationships, procedures, etc.) are properly aligned with one another, the structure increases the likelihood that the firm will operate in ways that allow it to better understand the challenging cause/effect relationships it encounters when competing against its rivals. Thus, helping the firm effectively cope with environmental uncertainty is an important contribution organizational structure makes to a firm as it seeks to successfully implement its strategy or strategies as a means of outperforming competitors.[15]

Appropriately designed organizational structures provide the stability a firm needs to successfully implement its strategies and maintain its current competitive advantages while simultaneously providing the flexibility to develop advantages it will need in the future.[16] More specifically, *structural stability* provides the capacity the firm requires to consistently and predictably manage its daily work routines, while *structural flexibility* makes it possible for the firm to identify opportunities and then allocate resources to pursue them as a way of being prepared to succeed in the future.[17] Thus, an effectively flexible organizational structure allows the firm to *exploit* current competitive advantages while *developing* new advantages that can be used in the future. Alternatively, an ineffective structure that is inflexible may drive productive employees away because of frustration while completing their work.[18] Losing productive employees can result in a loss of knowledge within a firm.[19] This is an especially damaging outcome when a departing employee, who may accept employment with a competitor, possesses a significant amount of tacit knowledge.[20]

Modifications to the firm's current strategy or selection of a new strategy may call for changes to its organizational structure. However, research shows that once in place, organizational inertia often inhibits efforts to change structure, even when the firm's performance suggests that it is time to do so.[21] In his pioneering work, Alfred Chandler found that organizations change their structures when inefficiencies force them to do so.[22] Chandler's contributions to our understanding of organizational structure and its relationship to strategies and performance are significant. Indeed, some believe that Chandler's emphasis on "organizational structure so transformed the field of business history that some call the period before Chandler's work was published 'B.C.,' meaning 'before Chandler.'"[23]

Organizational controls guide the use of strategy, indicate how to compare actual results with expected results, and suggest corrective actions to take when the difference is unacceptable.

Firms seem to prefer the structural status quo and its familiar working relationships until their performance declines to the point where change is absolutely necessary.[24] Moreover, top-level managers often hesitate to conclude that the firm's structure or its strategy are the problem because doing so suggests that their previous choices were not the best ones.[25] Because of these inertial tendencies, structural change is often induced instead by actions from stakeholders (e.g., those from the capital market and customers) who are no longer willing to tolerate the firm's performance. Evidence shows that appropriate timing of structural change happens when top-level managers recognize that a current organizational structure no longer provides the coordination and direction needed for the firm to successfully implement its strategies.[26] Interestingly, many organizational changes take place in economic downturns because poor performance reveals organizational weaknesses.[27] As we discuss next, effective organizational controls help managers recognize when it is time to adjust the firm's structure.

Nytimes

Pictured here is Alfred Chandler, a scholar whose work enhanced our understanding of organizational structure and strategy.

11-1b Organizational Controls

Organizational controls are an important aspect of structure.[28] **Organizational controls** guide the use of strategy, indicate how to compare actual results with expected results, and suggest corrective actions to take when the difference is unacceptable. It is difficult for a firm to successfully exploit its competitive advantages without effective organizational controls.

A typical organizational control cycle is illustrated in Figure 11.1. Controls are a function of the strategic planning process. As described in Chapters 2 through 9, firms formulate strategies based on internal analysis, external analysis, and their missions, visions, and values. In doing so, they develop a sense of what these strategies should accomplish for the organization. These desired outcomes are translated into objectives. It is important also that once objectives are established, an individual or group (i.e., department, division) within the organization is given responsibility for their accomplishment. This individual or group then develops a detailed implementation plan, including a budget and a time frame for accomplishment. Resources are allocated to support the plan. At various points during the implementation process, those responsible for implementation return and report to higher level management. At this point, objectives are compared to actual performance and an assessment is done to determine whether the plan is on track or, if not, what is holding it back. Adjustments are made as needed. These regular assessments become information that is useful to the next round of the control cycle. Such information is useful to strategy formulation, objective setting, and creating updated or new implementation plans.[29]

Learning Objective

11-2 Discuss the difference between strategic and financial controls.

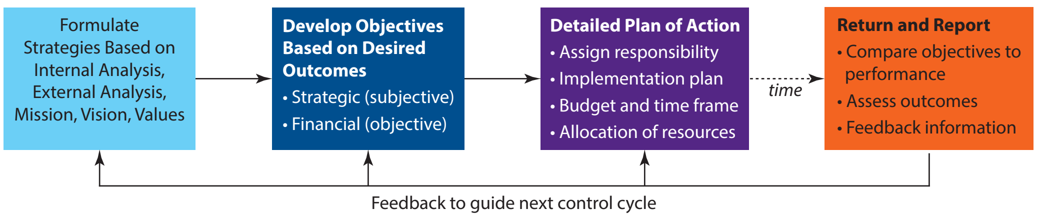
11-2 Strategic and Financial Controls

Properly designed organizational controls provide clear insights about behaviors that enhance firm performance.[30] Firms use both strategic controls and financial controls to support implementation of their strategies. **Strategic controls** are largely subjective criteria intended to verify that the firm is using appropriate strategies for external conditions and the company's competitive advantages. Thus, strategic controls are for examining the fit between what the firm *might do* (according to the opportunities in its external environment) and what it *can do* (according to its internal organization through its resources, capabilities, and core competencies). Effective strategic controls help the firm understand what it takes to be successful, especially where significant strategic change is needed.[31] Strategic controls demand rich communications between managers who use them to judge the firm's performance and those who implement the firm's strategies (such as middle- and first-level managers). These frequent exchanges between managers are both formal and informal.[32]

Strategic controls are largely subjective criteria intended to verify that the firm is using appropriate strategies for the conditions in the external environment and the company's competitive advantages.

Strategic controls are also used to evaluate the degree to which the firm focuses on the requirements to implement its strategies. For a business-level strategy, for example, the strategic controls are used to study value-chain activities and support functions (see Figures 3.3, 3.4, and 3.5 in Chapter 3) to verify that the critical activities and functions are being emphasized and properly executed. When implementing related diversification strategies at the corporate level, strategic controls are used to verify the sharing of activities (for the related-constrained strategy) or the transferring of core competencies (for the related-linked strategy) across businesses. To effectively use strategic controls when evaluating either of these related diversification strategies, headquarter executives must have a deep understanding of the business-level strategies being implemented within individual strategic business units.[33]

Figure 11.1 A Typical Organizational Control Cycle



Financial controls are largely objective criteria used to measure the firm's performance against previously established quantitative standards. When using financial controls, firms evaluate their current performance against previous outcomes and competitors' performance and industry averages.[34] Accounting-based measures, such as return on investment (ROI) and return on assets (ROA), as well as market-based measures, such as shareholder returns, are examples of financial controls. Partly because strategic controls are difficult to use with extensive diversification (e.g., top executives are not deeply familiar with each of the businesses), financial controls are emphasized to evaluate the firm's performance using an unrelated diversification strategy.[35] The unrelated diversification strategy's focus on financial outcomes (see Chapter 6) requires using standardized financial controls to compare performances between business units and those responsible for leading them.[36]

Financial controls are largely objective criteria used to measure the firm's performance against previously established quantitative standards.

Both strategic and financial controls are important aspects of a firm's structure; as noted previously, any structure's effectiveness is determined using a "balanced" combination of strategic and financial controls. But, determining the most appropriate balance to have in place between strategic and financial controls at specific times is challenging, partly because the relative use of controls varies by type of strategy. For example, companies and business units of large diversified firms using the cost leadership strategy emphasize financial controls (such as quantitative cost goals), while companies and business units using the differentiation strategy emphasize strategic controls (such as subjective measures of the effectiveness of product development teams).[37] As previously explained, a corporation-wide emphasis on sharing among business units (as called for by related diversification strategies) results in an emphasis on strategic controls, while financial controls are emphasized for strategies in which activities or capabilities are not shared (e.g., in an unrelated diversification strategy). Those determining how strategies are to be implemented must keep these relative degrees of balance between controls by type of strategy in mind when making implementation-related decisions.

11-3 Relationship between Strategy and Structure

Learning Objective

11-3 Describe the relationship between strategy and structure.

Strategy and structure have a reciprocal relationship and, if aligned properly, performance improves.[38] This relationship highlights the interconnectedness between strategy formulation (Chapters 4, 6–9) and strategy implementation (Chapters 10–13). In general, this reciprocal relationship finds structure flowing from or following selection of the firm's strategy. Once in place, though, structure can influence current strategic actions and choices about future strategies.[39] The new structure Ford is building, that we mentioned earlier, has the potential to influence implementation of strategies that are, in part, aimed to better identify and satisfy customers' demand for high-quality electric vehicles at lower prices than other auto manufacturers.[40] Overall, those involved with a firm's strategic management process should understand that the general nature of the strategy/structure relationship means that changes to the firm's strategy create the need to change how the organization completes its work.

Moreover, because structure can influence strategy by constraining the potential alternatives considered, firms must be vigilant in their efforts to verify how their structure not only affects implementation of chosen strategies, but also the limits the structure placed on possible future strategies. Overall, the effect of strategy on structure is stronger than is the effect of structure on strategy.

Regardless of the strength of the reciprocal relationships between strategy and structure, those choosing the firm's strategy and structure should be committed to matching each strategy with a structure that provides the stability needed to use current competitive advantages and the flexibility required to develop future advantages.[41] Therefore, when changing strategies, the firm should simultaneously consider the structure that will be needed to support use of the new strategy—properly matching strategy and structure can create a competitive advantage.

Learning Objective

11-4 Describe the major types of organizational structures used to implement strategies.

11-4 Evolutionary Patterns of Strategy and Organizational Structure

Research suggests that most firms experience a certain pattern of relationships between strategy and structure. Chandler found that firms tend to grow in somewhat predictable patterns: "first by volume, then by geography, then integration (vertical, horizontal), and finally through product/business diversification"[42] (see Figure 11.2). Chandler interpreted his findings as an indication that firms' growth patterns determine their structural form.

As shown in Figure 11.2, sales growth creates coordination and control problems the existing organizational structure cannot efficiently handle. Some of the most common symptoms of structural deficiency include communications problems, poor customer satisfaction, administrative inefficiencies, and employee frustration.[43] Organizational growth creates the opportunity for the firm to change its strategy to try to become even more successful. However, the existing structure's formal reporting relationships, procedures, controls, and authority and decision-making processes lack the sophistication required to support using the new strategy, meaning that a modified organizational structure is needed.[44]

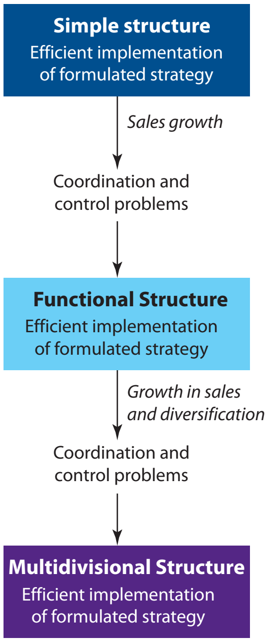
Firms choose from among three major types of organizational structures—simple, functional, and multidivisional—to implement strategies. Across time, successful firms move from the simple, to the functional, and to the multidivisional structure to support changes in their growth strategies.

11-4a Simple Structure

The **simple structure** is an organizational form in which the owner-manager makes all major decisions and monitors all activities, while the staff serves as an extension of the manager's supervisory authority.

The **simple structure** is an organizational form in which the owner-manager makes all major decisions and monitors all activities, while the staff serves as an extension of the manager's supervisory authority.[45] Typically, the owner-manager actively works in the business daily. Informal relationships, few rules, limited task specialization, and unsophisticated information systems characterize this structure. Frequent and informal communications between the owner-manager and employees make coordinating the work to be completed relatively easy. The simple structure is matched with focus strategies and business-level strategies in which a firm offers a single product line in a single geographic market. Local restaurants, repair businesses, and other specialized enterprises are examples of firms using the simple structure.

Figure 11.2 Strategy and Structure Growth Pattern



As the small firm grows larger and becomes more complex, managerial and structural challenges emerge.[46] For example, the amount of competitively relevant information requiring analysis substantially increases, placing significant pressure on the owner–manager. Additional growth and success may cause the firm to change its strategy. Even if the strategy remains the same, the firm's larger size dictates the need for more sophisticated workflows and integrating mechanisms.[47] At this evolutionary point, firms tend to move from the simple structure to a functional organizational structure.[48]

11-4b Functional Structure

The **functional structure** consists of a chief executive officer and a limited corporate staff, with functional line managers in dominant organizational areas such as production, accounting, marketing, R&D, engineering, and human resources.[49] The structure allows for functional specialization, thereby facilitating active sharing of knowledge within each functional area.[50] Knowledge sharing facilitates career paths as well as professional development of functional specialists. However, a functional orientation can negatively affect communication and coordination among those representing different organizational functions. For this reason, the CEO must verify that the decisions and actions of individual business functions promote the entire firm rather than a single function. As demonstrated in the Strategic Focus, Apple has overcome communication and coordination problems, and has mastered the art of using a functional structure.

The **functional structure** consists of a chief executive officer and a limited corporate staff, with functional line managers in dominant organizational areas such as production, accounting, marketing, R&D, engineering, and human resources.

Although Apple is an exception to the general rule, the functional structure typically is used to support implementing business-level strategies and some corporate-level strategies (e.g., single or dominant business) with low levels of diversification. However, when changing from a simple to a functional structure, firms want to avoid introducing value-destroying bureaucratic procedures since such procedures typically have the potential to damage individuals' efforts to innovate as a means of supporting strategy implementation activities.[51]

11-4c Multidivisional Structure

With continuing growth and success, firms often consider greater levels of diversification. Successfully using a diversification strategy requires analyzing substantially greater amounts of data and information when the firm offers the same products in different markets (market or geographic diversification) or offers different products in several markets (product diversification). In addition, trying to manage high levels of diversification through functional structures creates serious coordination and control problems, which often leads to a new structural form.[52]

The **multidivisional structure** consists of a corporate office and operating divisions, each operating division representing a separate business or profit center in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers. Each division represents a distinct, self-contained business with its own functional hierarchy.[53] As initially designed, the multidivisional structure was thought to have three major benefits: "(1) it enabled corporate officers to more accurately monitor the performance of each business, which simplified the problem of control; (2) it facilitated comparisons between divisions, which improved the resource allocation process; and (3) it stimulated managers of poorly performing divisions to look for ways of improving performance."[54] Active monitoring of performance through the multidivisional structure increases the likelihood that decisions made by managers heading individual units will be in stakeholders' best interests. Because diversification is a dominant corporate-level strategy used in the global economy, the multidivisional is a widely adopted organizational structure.[55]

The **multidivisional structure** consists of a corporate office and operating divisions, each operating division representing a separate business or profit center in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers.

Used to support implementation of related and unrelated diversification strategies, the multidivisional structure helps firms successfully manage diversification's many demands.[56] Chandler viewed the multidivisional structure as an innovative response to coordination and control problems that surfaced during the 1920s in the functional structures then used by large firms such as DuPont and General Motors.[57] Research shows that the multidivisional structure is appropriate when the firm grows through diversification.[58] Partly because of its value to diversified corporations, some consider the multidivisional structure to be one of the twentieth century's most significant organizational innovations.[59]

Strategic Focus

Apple's Astonishing Success with Its Functional Structure

Apple Inc. was founded in 1976 by Steve Jobs, Steve Wozniak, and Ronald Wayne. The first commercially available personal computer offered by Apple, the Apple I, was very basic and did not gain a lot of traction. However, its new computer, the Apple II, became a bestseller. In the mid-1980s, amid high product costs and strife among top executives, Jobs left Apple and founded NeXT with the objective of creating the next great computer.

After several years of poor performance, in 1997, Apple bought NeXT and brought Jobs back into the company, hoping he could help turn things around. He quickly restructured the company, dropping projects that were losing money and reorganizing the company into a functional structure. Jobs retained all control of the company and made all significant strategic decisions. This approach dramatically limited the autonomy of Apple's vice presidents. When Tim Cook took over in 2011, he left the functional structure in place, but gave the vice presidents a lot more decision-making authority to encourage innovation. "The expertise-focused hierarchy system that Apple has implemented within their organization means that they enjoy strong corporate control. The individual divisions all enjoy enough autonomy to enable them to perform at their very best, leading Apple to have created some truly market-leading products over the years."

Ringo Chiu/Shutterstock.com

Apple CEO Tim Cook and Deirdre O'Brien, Apple's senior vice president of Retail + People, open the doors of the new Apple Tower Theatre flagship retail store in downtown Los Angeles.

The functional structure means that managers have "deep expertise" in their functional areas, which is one of the strengths of this type of structure. Managers at all levels are also expected to be "immersed in the details of those functions." For example, Dierdre O'Brien, senior vice president of Retail + People, is an expert on everything to do with the retail environment. Sabih Kahn, senior vice president of operations, is the operations guru. Lisa Jackson, vice president for environment, policy, and social initiatives, is an expert on corporate social responsibility.

Having a functional structure doesn't mean that the various parts of the organization do not communicate or work with each other. "Apple Inc. maintains an intensive and effective collaboration between various groups and divisions of the company. Each product within Apple portfolio such as iPad, iPhone, iPad, Apple TV and iWatch is a result of collaboration of product-based groups." Decisions are made in a coordinated fashion by a group of people that has the best qualifications to make them. As described by Apple executives, "Apple is not a company where general managers oversee managers; rather, it is a company where experts lead experts." Manager bonuses depend on the whole company's success.

The rarity of the functional structure in a company like Apple is noteworthy. "Functional organizational structure is not common for behemoths like Apple, however, the tech giant benefits from the current patterns of its corporate structure. Specifically, unlike many other large companies there is no fight between heads of product divisions at Apple for resources. Moreover, functional organizational structure allows the tech giant to neglect short-term financial targets when developing new products that require considerable investments." Although the functional structure may not be practical or efficient in some huge, multiproduct companies, it has been working at Apple for over two decades.

Sources: 2022, Apple's organizational structure, *Organimi,* www.organimi.com, May 3; P. Meyer, Apple Inc.'s organizational structure & its characteristics (an analysis), *Panmore Institute,* www.panmore.com, January 18; 2022, Apple leadership, *Apple Homepage,* www.apple.com, May 3; J. Dodovkiy, 2021, Apple organizational structure: A brief overview, *Business Research Methodology,* www.research-methodology.net, February 3; J. M. Podolny & M. T. Hansen, 2020, How Apple is organized for innovation, *Harvard Business Review,* November-December: 87–95.

No single organizational structure (simple, functional, or multidivisional) is inherently superior to the others. Peter Drucker, a famous business writer, said the following about this matter, "There is no one right organization… Rather the task … is to select the organization for the particular task and mission at hand."[60] This statement suggests that the firm must select a structure that is "right" for successfully using the chosen strategy. This is certainly evident in the case of Apple, described in the Strategic Focus. Because no single structure is optimal in all instances, managers concentrate on developing proper matches between strategies and organizational structures rather than searching for an "optimal" structure. We now describe the strategy/structure matches that contribute positively to firm performance.

11-5 Matches between Business-Level Strategies and the Functional Structure

Learning Objective

11-5 Explain how the functional structure is used to implement the business-level strategies.

Firms use different forms of the functional organizational structure to support implementing the cost leadership, differentiation, and integrated cost leadership/differentiation strategies. The differences in these forms are accounted for primarily by different uses of three important structural characteristics: *specialization* (concerned with the type and number of jobs required to complete work), *centralization* (the degree to which decision-making authority is retained at higher managerial levels), and *formalization* (the degree to which formal rules and procedures govern work).[61]

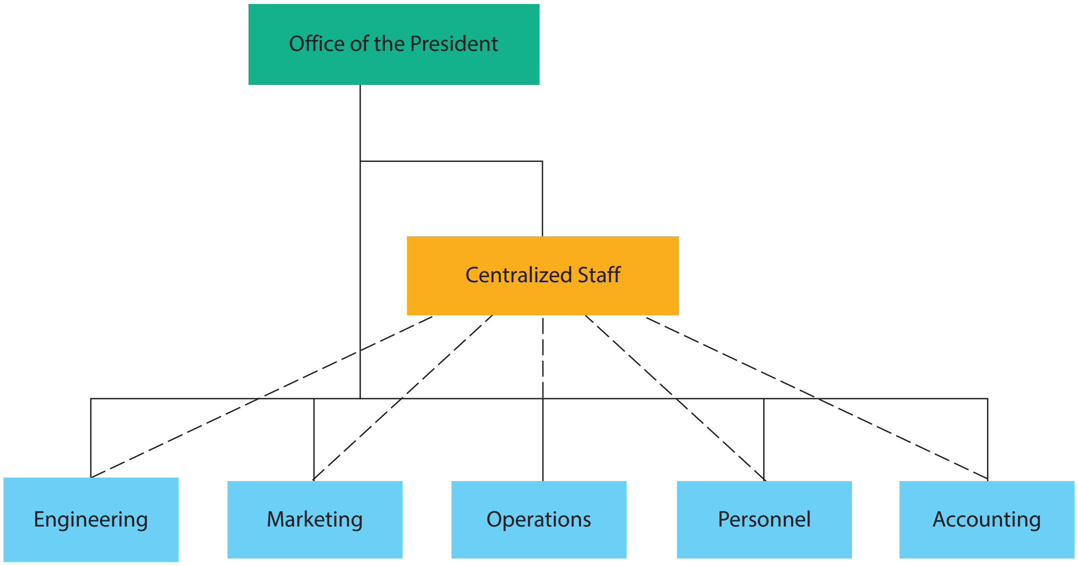
11-5a Using the Functional Structure to Implement the Cost Leadership Strategy

Firms using the cost leadership strategy sell large quantities of standardized products to an industry's typical customer. Firms using this strategy need a structure that allows them to achieve efficiencies and deliver their products at costs lower than those of competitors.[62] Simple reporting relationships, a few layers in the decision-making and authority structure, a centralized corporate staff, and a strong focus on process improvements through the manufacturing function (rather than the development of new products by emphasizing product R&D) help to achieve the needed efficiencies and thus characterize the cost leadership form of the functional structure (see Figure 11.3).[63] This structure contributes to the emergence of a low-cost culture—a culture in which employees constantly try to find ways to reduce the costs incurred to complete their work.[64] They can do this through the development of a product design that is simple and easy to manufacture, as well as through the development of efficient processes to produce the goods.[65]

In terms of centralization, decision-making authority is centralized in a staff function to maintain a cost-reducing emphasis within each organizational function (engineering, marketing, etc.). While encouraging continuous cost reductions, the centralized staff also verifies that further cuts in costs in one function won't adversely affect the productivity levels in other functions.[66]

Jobs are highly specialized in the cost leadership functional structure; work is divided into homogeneous subgroups. Organizational functions (i.e., marketing, operations, finance) are the most common subgroup, although work is sometimes batched based on products delivered or clients served. Specializing in their work allows employees to increase their efficiency,

Figure 11.3 Functional Structure for Implementing a Cost Leadership Strategy



Notes:
- Operations is the main function.
- Process engineering is emphasized rather than new product R&D.
- Relatively large centralized staff coordinates functions.
- Formalized procedures allow for emergence of a low-cost culture.
- Overall structure is mechanistic; job roles are highly structured.

resulting in reduced costs. Guiding individuals' work in this structure are highly formalized rules and procedures, which often emanate from the centralized staff.

Walmart Stores, Inc. uses the functional structure to implement cost leadership strategies in each of its three operating segments (Walmart U.S., Sam's Clubs, and Walmart International). In fact, researchers discovered that Walmart's emphasis on cost cutting has actually increased over the years.[67] Competitors' efforts to duplicate the success Walmart has achieved by implementing its cost leadership strategies have generally failed, partly because of the effective strategy/structure matches the firm has formed between the cost leadership strategy and the functional structure that is specific to the mandates of that strategy.

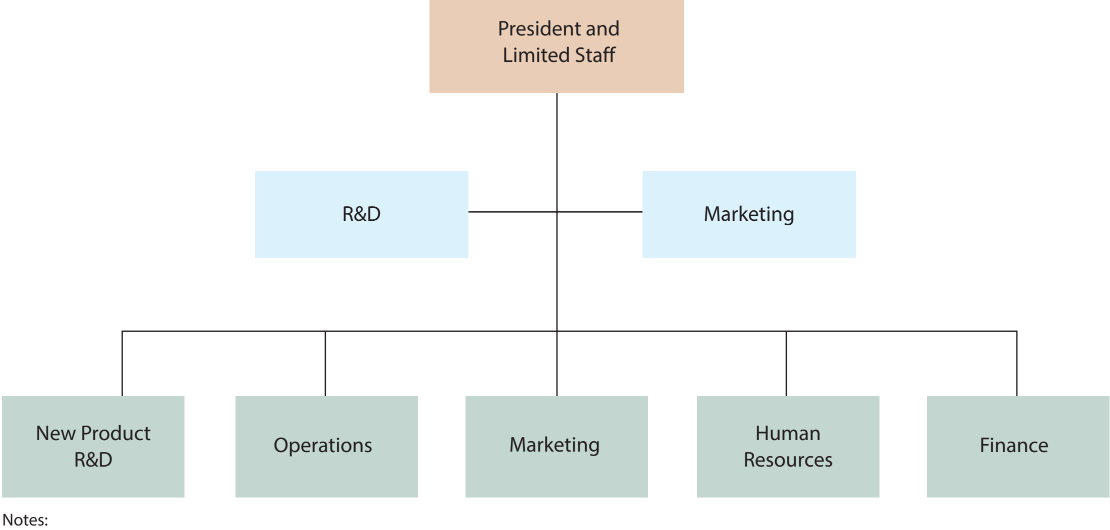
11-5b Using the Functional Structure to Implement the Differentiation Strategy

Firms using the differentiation strategy seek to deliver products that customers perceive as being different in ways that create value for them. Relatively complex and flexible reporting relationships, frequent use of cross-functional product development teams, and a strong focus on marketing and product R&D characterize the differentiation form of the functional structure (see Figure 11.4).[68] From this structure emerges a development-oriented culture in which employees try to find ways to further differentiate current products and to develop new, highly differentiated products.[69]

Continuous product innovation demands that people throughout the firm interpret and take action based on information that is often ambiguous, incomplete, and uncertain. Following a strong focus on the external environment to identify new opportunities, employees often gather this information from people outside the firm (e.g., customers and suppliers). Commonly, rapid responses to the possibilities indicated by the collected information are necessary, suggesting the need for decentralized decision-making responsibility and authority. This is consistent with what Apple's CEO Tim Cook did when he took over Apple, which uses a functional structure to implement its differentiation strategy (see Strategic Focus).[70] The structure helps Apple keep its technological capabilities strong and provides strategic flexibility necessary to compete against rivals. A strong technological capability and strategic flexibility enhance a firm's ability to take advantage of opportunities that changes in markets create.[71]

The level of specialization can be high or low in this structure when implementing a differentiation strategy. In the case of Apple, specialization is high, as indicated by the number of "experts" in the organization. However, many firms implementing a differentiation strategy through a functional structure have low specialization, which means that employees need a broad understanding

Figure 11.4 Functional Structure for Implementing a Differentiation Strategy



Notes:
- Marketing is the main function for keeping track of new product ideas.
- New product R&D is emphasized.
- Most functions are decentralized, but R&D and marketing may have centralized staffs that work closely with each other.
- Formalization is limited so that new product ideas can emerge easily and change is more readily accomplished.
- Overall structure is organic; job roles are less structured.

of many facets of the organization. Few formal rules and procedures characterize this structure. Low formalization and decentralization of decision-making authority and responsibility, create a structure in which people interact frequently to exchange ideas about how to further differentiate current products while developing ideas for new products that can be crisply differentiated at a point in the future. Again, this is consistent with Apple's structure.

11-5c Using the Functional Structure to Implement the Integrated Cost Leadership/Differentiation Strategy

Firms using the integrated cost leadership/differentiation strategy sell products that create value because of their relatively low cost and reasonable sources of differentiation. The cost of these products is low "relative" to the cost leader's prices, while their differentiation is "reasonable" when compared to the clearly unique features of the differentiator's products.

Although challenging to implement, the integrated cost leadership/differentiation strategy is used frequently in the global economy. The challenge of using this strategy is due largely to the fact that different value chain and support activities (see Chapter 3) are emphasized when using the cost leadership and differentiation strategies. To achieve the cost leadership position, production and process engineering need to be emphasized, with infrequent product changes. To achieve a differentiated position, marketing and new product R&D need to be emphasized while production and process engineering are not. Thus, effective use of the integrated strategy depends on the firm's successful combination of activities intended to reduce costs with activities intended to create differentiated features for a product. As a result, the integrated form of the functional structure must have decision-making patterns that are partially centralized and partially decentralized. Additionally, jobs are semi-specialized, and rules and procedures call for some formal and some informal job behavior. All of this requires a measure of flexibility to emphasize one or the other set of functions at any given time.[72]

11-6 Matches between Corporate-Level Strategies and the Multidivisional Structure

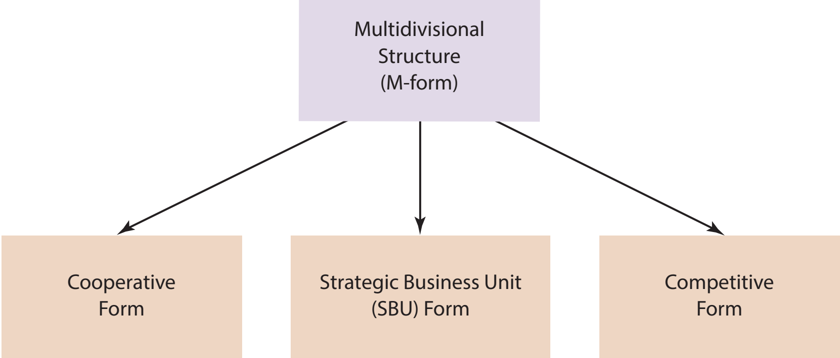
Learning Objective

11-6 Explain the use of three versions of the multidivisional structure to implement different diversification strategies.

As explained earlier, Chandler's research demonstrated that the firm's continuing success leads to product or market diversification or both.[73] The firm's level of diversification is a function of decisions about the number and type of businesses in which it will compete as well as how it will manage those businesses (see Chapter 6). Geared to managing individual organizational functions, increasing diversification eventually creates information processing, coordination, and control problems that the functional structure cannot handle. Thus, using a diversification strategy requires the firm to change from the functional structure to the multidivisional structure to form an appropriate strategy/structure match.

As defined in Figure 6.1, corporate-level strategies have different degrees of product and market diversification. The demands created by different levels of diversification highlight the need for a unique organizational structure to effectively implement each strategy (see Figure 11.5). We discuss the relationships between three diversification strategies and the unique organizational structure that should be matched with each one in the next three sections.

Figure 11.5 Three Variations of the Multidivisional Structure



11-6a Using the Cooperative Form of the Multidivisional Structure to Implement the Related Constrained Strategy

The **cooperative form** is a multidivisional structure in which horizontal integration is used to bring about interdivisional cooperation.

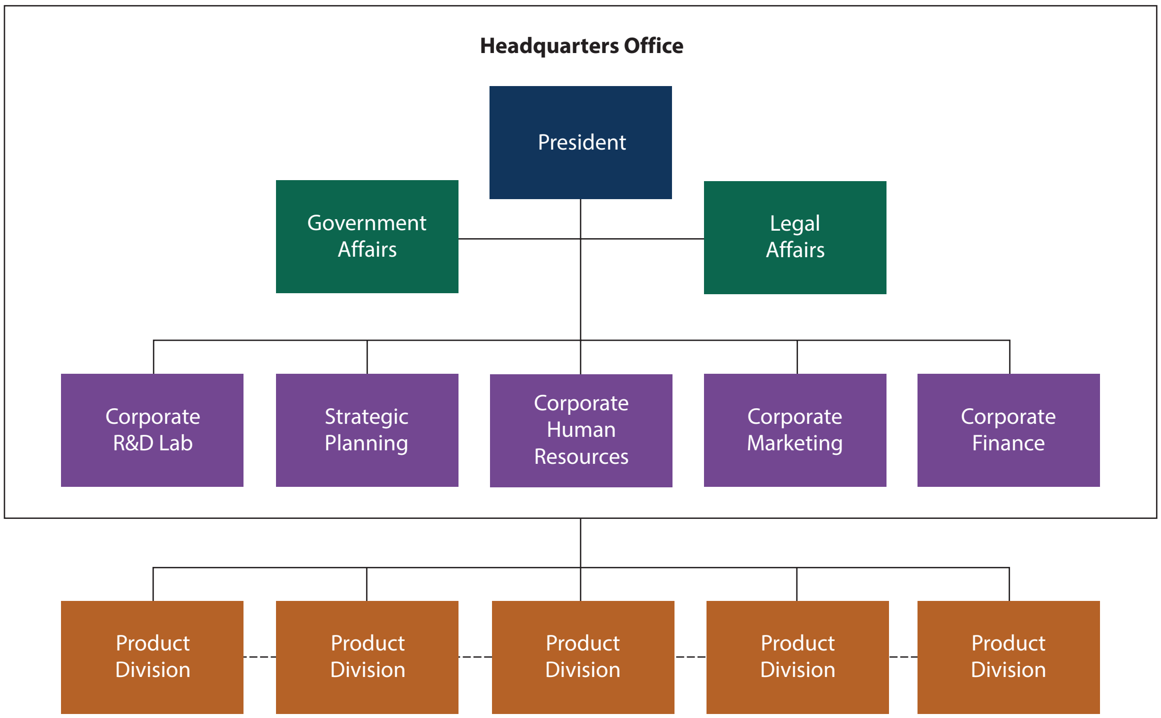
The **cooperative form** is a multidivisional structure in which horizontal integration is used to bring about interdivisional cooperation. Divisions in a firm using the related constrained diversification strategy commonly are formed around products, markets, or both. In Figure 11.6, we use product divisions as part of the representation of the cooperative form of the multidivisional structure, although market divisions could be used instead of, or in addition to, product divisions to develop the figure.

As explained in Chapter 6, the related constrained strategy finds a firm sharing resources and activities across its businesses. Sharing divisional competencies facilitates a firm's efforts to develop economies of scope (cost savings resulting from the sharing of competencies developed in one division with another division). Caterpillar uses a cooperative form of the multidivisional structure to implement its related constrained strategy. Rather than having decision-making authority vested in a management hierarchy, it is distributed throughout the organization in self-organizing teams.[74]

The cooperative structure uses different characteristics of structure (centralization, standardization, and formalization) as integrating mechanisms to facilitate interdivisional cooperation. Frequent, direct contact between division managers, another integrating mechanism, encourages and supports cooperation and the sharing of knowledge, capabilities, or other resources that could be used to create new advantages.[75] Sometimes liaison roles are established in each division to reduce the time division managers spend integrating and coordinating their unit's work with the work occurring in other divisions. Temporary teams or task forces may be formed around projects whose success depends on sharing resources that are embedded within several divisions. Formal integration departments might be established in firms frequently using inter-business unit teams or task forces.

The success of the cooperative multidivisional structure is significantly affected by how well divisions process information. However, because cooperation among divisions implies a loss of

Figure 11.6 Cooperative Form of the Multidivisional Structure for Implementing a Related Constrained Strategy



Notes:
- Structural integration devices create tight links among all divisions.
- Corporate office emphasizes centralized strategic planning, human resources, and marketing to foster cooperation between divisions.
- R&D is likely to be centralized.
- Rewards are subjective and tend to emphasize overall corporate performance in addition to divisional performance.
- Culture emphasizes cooperative sharing.

managerial autonomy, division managers may not readily commit themselves to the type of integrative information-processing activities that this structure demands. Moreover, coordination among divisions sometimes results in an unequal flow of positive outcomes to divisional managers. In other words, when managerial rewards are based at least in part on the performance of individual divisions, the manager of the division that can benefit the most by the sharing of corporate competencies might be viewed as receiving relative gains at others' expense. Strategic controls are important in these instances, as divisional managers' performance can be evaluated, at least partly, based on how well they have facilitated interdivisional cooperative efforts. In addition, using reward systems that emphasize overall company performance, besides outcomes achieved by individual divisions, helps overcome problems associated with the cooperative form. Still, the costs of coordination and inertia in organizations limit the amount of related diversification attempted (i.e., they constrain the economies of scope that can be created).[76]

Ultimately, a matrix organization may evolve in firms implementing the related constrained strategy. A *matrix organization* is an organizational structure in which a dual structure combines both business product or project specialization and functional specialization.[77] Although complicated, an effective matrix structure can lead to improved coordination among a firm's divisions.[78] We mentioned in Chapter 6 that Procter & Gamble (P&G) uses a related constrained strategy. For years, the company used the cooperative form of the multidivisional structure to implement this strategy, but recently, it changed to a matrix to enhance its ability to navigate its global markets. The company is now organized around five industry-based divisions: beauty; health care, grooming; fabric and home care; and baby, feminine, and family care. Each of these divisions has responsibility for its own sales, profit, cash flow, and value creation. In addition, P&G is also divided into focus markets, with market operations specialists. These specialists work across the industry-based division, providing market services, customer teams, warehousing, transportation, logistics, and public relations.[79]

11-6b Using the Strategic Business Unit Form of the Multidivisional Structure to Implement the Related Linked Strategy

Firms with fewer links or less constrained links among their divisions use the related linked diversification strategy. The strategic business unit form of the multidivisional structure supports implementation of this strategy. The **strategic business unit (SBU) form** is a multidivisional structure consisting of three levels: corporate headquarters, strategic business units (SBUs), and SBU divisions (see Figure 11.7). The SBU structure is used by large firms and can be complex, given associated organization size and product and market diversity.

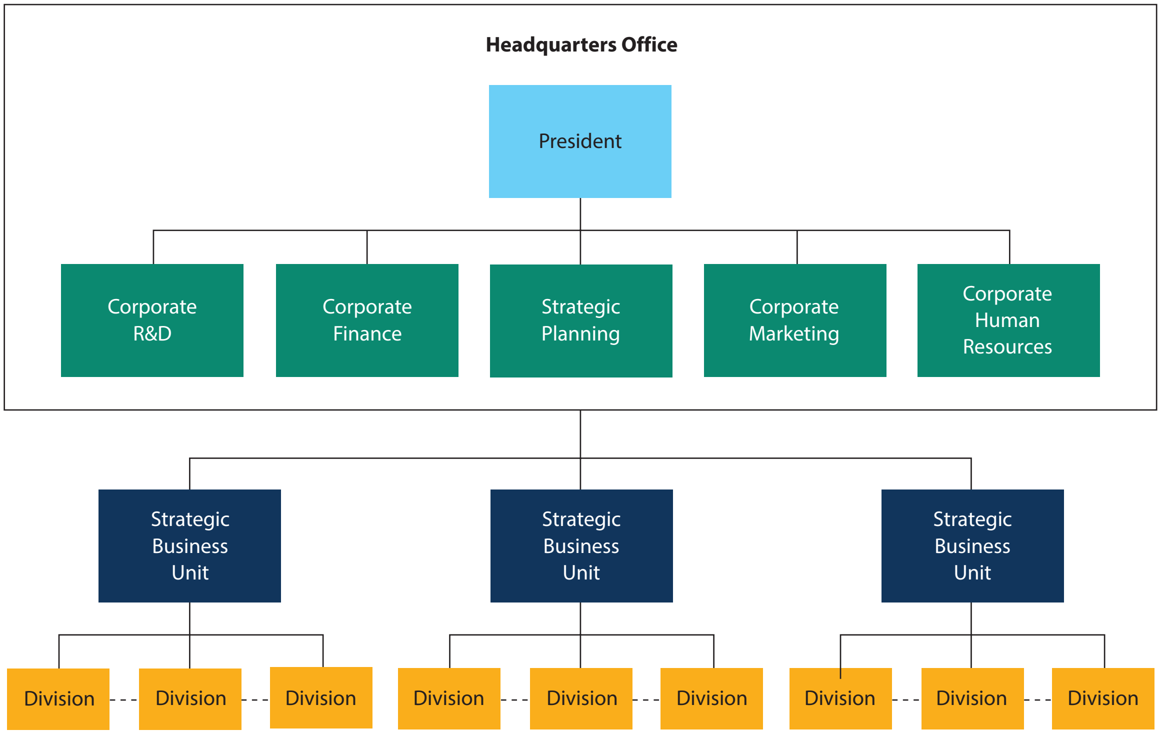
> The **strategic business unit (SBU) form** is a multidivisional structure consisting of three levels: corporate headquarters, strategic business units (SBUs), and SBU divisions.

The divisions within each SBU are related in terms of shared products or markets or both, but the divisions of one SBU have little in common with the divisions of the other SBUs. Divisions within each SBU share product or market competencies to develop economies of scope and possibly economies of scale. The integrating mechanisms discussed earlier can be used by the divisions within the individual strategic business units that are part of the SBU form of the multidivisional structure. In this structure, each SBU is a profit center that is controlled and evaluated by the headquarters office. Although both financial and strategic controls are important, on a relative basis, financial controls are vital to headquarters' evaluation of each SBU; strategic controls are critical when the heads of SBUs evaluate their divisions' performances. Strategic controls are also critical to the headquarters' efforts to evaluate the quality of the portfolio of businesses that has been formed and to determine if those businesses are being successfully managed. Sharing competencies among units within individual SBUs is an important characteristic of the SBU form of the multidivisional structure.

A disadvantage associated with the related linked diversification strategy is that, even when efforts to implement it are being properly supported by use of the SBU form of the multidivisional structure, firms using this strategy and structure combination find it challenging to effectively communicate the value of their operations to shareholders and to other investors due to its complexity.[80] Furthermore, if coordination between SBUs is required, problems can surface because the SBU structure, similar to the competitive form discussed next, does not readily foster cooperation across SBUs. Accordingly, those responsible for implementing the related linked strategy must focus on successfully creating and using the types of integrating mechanisms we discussed earlier.

For many years, Sony Corporation used the related constrained strategy and the cooperative form of the multidivisional structure to implement it. In recent years, and in response to declining

Figure 11.7 SBU Form of the Multidivisional Structure for Implementing a Related Linked Strategy



Notes:

- Structural integration among divisions within SBUs, but independence across SBUs.
- Strategic planning may be the most prominent function in headquarters for managing the strategic planning approval process of SBUs for the president.
- Each SBU may have its own budget for staff to foster integration.
- Corporate headquarters staff members serve as consultants to SBUs and divisions, rather than having direct input to product strategy, as in the cooperative form.

firm performance, Sony appears to be using the related linked strategy and the SBU form of the multidivisional structure to implement what is a new strategy for the firm. In particular, Sony (now called Sony Group Corporation) decentralized its operating and management structure, making each strategic business unit more independent, with its own leadership and staff functions.[81] Below the Sony Group Corporation are six SBUs: Game & Network Service; Music; Pictures; Electronic Products & Solutions; Imaging & Sensing Solutions; and Financial Services.[82] The new structure was devised, in part, to help overcome the primary weakness of the SBU structure (lack of cooperation across businesses). The group-level managers devote attention to "value creation through Group synergies and business incubation."[83]

11-6c Using the Competitive Form of the Multidivisional Structure to Implement the Unrelated Diversification Strategy

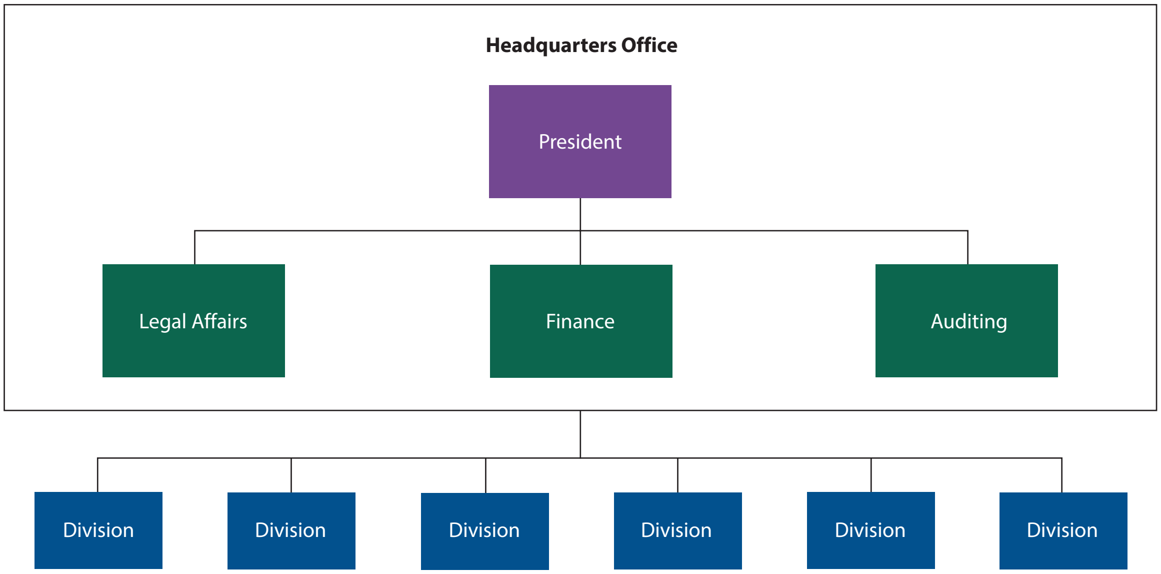
Firms using the unrelated diversification strategy want to create value through efficient internal capital allocations or by restructuring, buying, and selling businesses.[84] The competitive form of the multidivisional structure supports implementation of this strategy.

The **competitive form** is a multidivisional structure characterized by complete independence among the firm's divisions that compete for corporate resources.

The **competitive form** is a multidivisional structure characterized by complete independence among the firm's divisions that compete for corporate resources (see Figure 11.8). Unlike the divisions included in the cooperative structure, divisions that are part of the competitive structure do not share common corporate strengths. Accordingly, integrating mechanisms are not part of the competitive form of the multidivisional structure.

The efficient internal capital market that is the foundation for using the unrelated diversification strategy requires organizational arrangements emphasizing divisional competition rather than cooperation.[85] Three benefits are expected from the internal competition. First, internal competition creates flexibility (e.g., corporate headquarters can have divisions working on different technologies and projects to identify those with the greatest potential). Resources can then be allocated to the division appearing to have the most potential to drive the entire firm's success.[86] Second, internal competition challenges

Figure 11.8 Competitive Form of the Multidivisional Structure for Implementing an Unrelated Strategy



Notes:
- Corporate headquarters has a small staff.
- Finance and auditing are the most prominent functions in the headquarters office to manage cash flow and assure the accuracy of performance data coming from divisions.
- The legal affairs function becomes important when the firm acquires or divests assets.
- Divisions are independent and separate for financial evaluation purposes.
- Divisions retain strategic control, but cash is managed by the corporate office.
- Divisions compete for corporate resources.

the status quo and inertia because division heads know that future resource allocations are a product of excellent current performance as well as superior positioning in terms of future performance. Third, internal competition motivates effort in that the challenge of competing against internal peers can be as great as the challenge of competing against external rivals.[87] In this structure, organizational controls (primarily financial controls) are used to emphasize and support internal competition among separate divisions and as the basis for allocating corporate capital based on divisions' performances. However, this structure can be limited by too much emphasis on divisional rewards and can create disharmony due to social comparison about rewards based on personal effort.[88]

Textron Inc., a large "multi-industry" company, seeks to identify, research, select, acquire, and integrate companies and has developed a set of rigorous criteria to guide decision making. Textron continuously looks to enhance and reshape its portfolio by divesting noncore assets and acquiring branded businesses in attractive industries with substantial long-term growth potential. Textron operates several independent businesses, including Textron Aviation (Cessna, Beechcraft), Bell (helicopters), Textron Systems (national defense), Textron Industrial (Arctic Cat, Cushman), and Finance.[89] Leaders of these businesses are responsible for effectively guiding the day-to-day competitive actions of their units. Consistent with the mandates of the competitive form of the multidivisional structure, "Textron's Corporate Office provides oversight, direction, and assistance to its businesses."[90] The profit earned by individual business units within Textron is an important measure the firm uses to decide future capital allocations.

To emphasize competitiveness among divisions, the headquarters office maintains an arm's-length relationship with them, intervening in divisional affairs only to audit operations and discipline managers whose divisions perform poorly. In emphasizing competition between

mobil11/Shutterstock.com

Pictured here is a Bell Helicopter, a product manufactured by one of Textron's business units.

divisions, the headquarters office relies on strategic controls to set rate-of-return targets and financial controls to monitor divisional performance relative to those targets. The headquarters office then allocates cash flow on a competitive basis, rather than automatically returning cash to the division that produced it. Thus, the focus of the headquarters' work is on performance appraisal, resource allocation, and long-range planning to verify that the firm's portfolio of businesses will lead to financial success.

As is the case with the related linked diversification strategy, investors and shareholders find it challenging to understand the underlying value of the set of business units associated with a firm implementing the unrelated diversification strategy. Because of this challenge, upper-level managers must find effective ways of communicating their firm's underlying value to those investing capital in the firm.

The three major forms of the multidivisional structure should each be paired with a particular corporate-level strategy. Table 11.1 shows these structures' characteristics. Differences exist in the degree of centralization, the focus of the performance evaluation, the horizontal structures (integrating mechanisms), and the incentive compensation schemes. The most centralized and most costly structural form is the cooperative structure. The least centralized, with the lowest bureaucratic costs, is the competitive structure. The SBU structure requires partial centralization and involves some of the mechanisms necessary to implement the relatedness between divisions. Also, the divisional incentive compensation awards are allocated according to both SBUs and corporate performance.

Learning Objective

11-7 Discuss the organizational structures used to implement three international strategies.

11-7 Matches between International Strategies and Worldwide Structure

In Chapter 8, we explained that international strategies are increasingly important for companies' long-term competitive success in what is today virtually a borderless global economy.[91] Among other benefits, firms can search for new markets and then form the competencies necessary to serve them when implementing an international strategy.[92]

As with business-level and corporate-level strategies, unique organizational structures are necessary to successfully implement individual international strategies, given the different cultural, institutional, and legal environments around the world.[93] Forming proper matches between international strategies and organizational structures facilitates the firm's efforts to effectively coordinate and control its global operations. Research findings confirm the validity of the international strategy/structure matches we discuss here.[94]

11-7a Using the Worldwide Geographic Area Structure to Implement the Multidomestic Strategy

The *multidomestic strategy* decentralizes the firm's strategic and operating decisions to business units in each country so that product characteristics can be tailored to local preferences.[95] Firms using this strategy try to isolate themselves from global competitive forces by establishing protected

Table 11.1 Characteristics of the Structures Necessary to Implement the Related Constrained, Related Linked, and Unrelated Diversification Strategies

	Overall Structural Form		
Structural Characteristics	**Cooperative M-Form (Related Constrained Strategy)**	**SBU M-Form (Related Linked Strategy)**	**Competitive M-Form (Unrelated Diversification Strategy)**
Centralization of operations	Centralized at corporate office	Partially centralized (in SBUs)	Decentralized to divisions
Use of integration mechanisms	Extensive	Moderate	Nonexistent
Divisional performance evaluation	Emphasizes subjective (strategic) criteria	Uses a mixture of subjective (strategic) and objective (financial) criteria	Emphasizes objective (financial) criteria
Divisional incentive compensation	Linked to overall corporate performance	Mixed linkage to corporate, SBU, and divisional performance	Linked to divisional performance

market positions or competing in industry segments that are most affected by differences among local countries. The **worldwide geographic area structure** emphasizes national interests and facilitates the firm's efforts to satisfy local differences (see Figure 11.9). Consequently, it is well suited to implementing a multidomestic strategy. Using the multidomestic strategy requires little coordination between different country markets, meaning that formal integrating mechanisms among divisions around the world are not needed. Indeed, whatever coordination among units in a firm's worldwide geographic area structure does take place tends to be informal.

The **worldwide geographic area structure** emphasizes national interests and facilitates the firm's efforts to satisfy local differences.

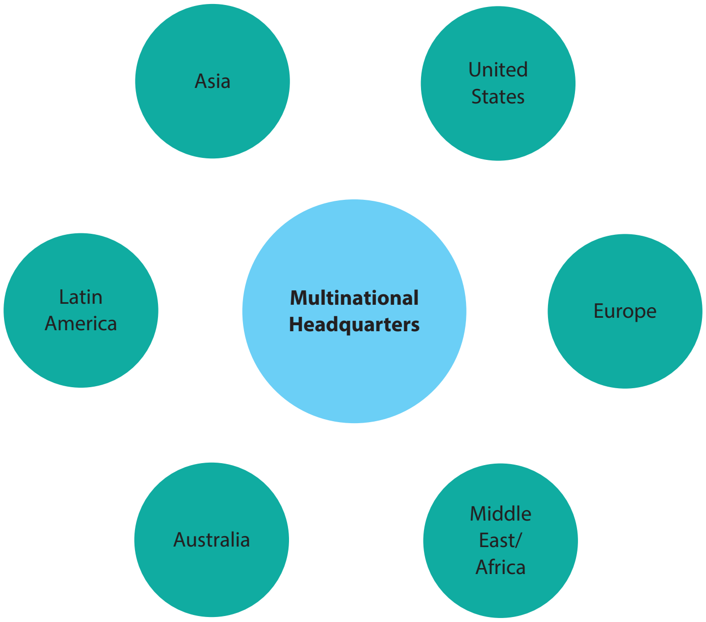
From a historical perspective, we note that the multidomestic strategy/worldwide geographic area structure match evolved as a natural outgrowth of the multicultural European marketplace. Friends and family members of the main business who were sent as expatriates to foreign countries to develop the independent country subsidiary often adopted the worldwide geographic area structure. The relationship to corporate headquarters by divisions took place through informal communication.

Founded in San Francisco, CA, in 2009, Uber Technologies, Inc. has pursued a multidomestic structure. As of 2022, Uber operates in more than 10,000 cities in 71 countries.[96] Although it has been countered by rival Lyft, especially in the United States, Uber remains the market leader. Uber pursued an aggressive strategy to grow rapidly outside its U.S. home market. However, it often flouted local country regulations in the process, leading to local rivals gaining strength. Although it targeted key markets in Asia, it ultimately had to cede its strategy to local rivals, ceding ownership in its Russian, Chinese, and Southeast Asian businesses as it sought to focus on its core markets. It is also under scrutiny for gender discrimination in the United States. Its aggressive tactics led to the replacement of its founding CEO, Travis Kalanick, with Dara Khosrowshahi.[97]

There is a key challenge associated with effectively using the multidomestic strategy/ worldwide geographic area structure match—namely, the inability to create global efficiencies. This inability is a product of companies' focus on serving unique customer needs particularly well. The inability to create global efficiencies in this match challenges firms to find ways to control costs while trying to serve local customers' unique needs.

It seems that creating global efficiencies has been a problem for Uber; it has been unable to deal with big differences in regulations around the globe as well as with local firms that were imitating Uber's strategy successfully. By the same token, if the firm can continue to identify and serve the unique needs of customers in different markets in ways that create value for them, being unable to develop scale economics will not be a fatal blow to Uber's efforts to succeed in international markets.

Figure 11.9 Worldwide Geographic Area Structure for Implementing a Multidomestic Strategy



Notes:
- The perimeter circles indicate decentralization of operations.
- Emphasis is on differentiation by local demand to fit an area or country culture.
- Corporate headquarters coordinates financial resources among independent subsidiaries.
- The organization is like a decentralized federation.

In other instances, the nature of products companies seek to sell in international markets and market conditions themselves demand that a firm be able to develop worldwide economies of scale. This need calls for firms to use the global strategy and its structural match, the worldwide product divisional structure.

11-7b Using the Worldwide Product Divisional Structure to Implement the Global Strategy

With the corporation's home office dictating competitive strategy, the *global strategy* is one through which the firm offers standardized products across country markets.[98] The firm's success depends principally on its ability to develop economies of scale while competing on a global basis and while serving customers without specific and unique needs relative to the firm's standardized product.

In the **worldwide product divisional structure**, decision-making authority is centralized in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units.

The worldwide product divisional structure supports use of the global strategy. In the **worldwide product divisional structure**, decision-making authority is centralized in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units (see Figure 11.10).

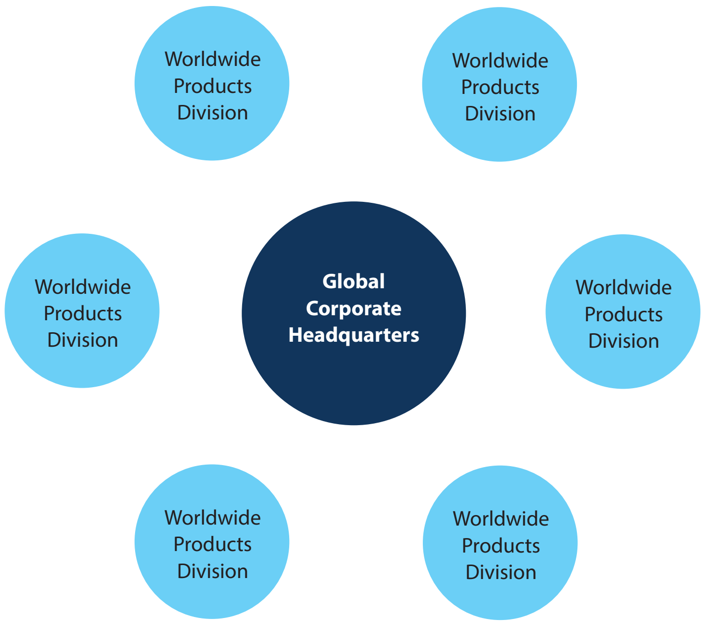
Integrating mechanisms are important to the effective use of the worldwide product divisional structure. Direct contact between managers, liaison roles between departments, and both temporary task forces and permanent teams are examples of these mechanisms. The disadvantages of the global strategy/worldwide structure combination are the difficulties involved with coordinating decisions and actions across country borders and the inability to quickly respond to local needs and preferences. To deal with these types of disadvantages, firms sometimes choose to try to somewhat simultaneously focus on geography and products. This simultaneous focus is like the combination structure that we discuss next.

11-7c Using the Combination Structure to Implement the Transnational Strategy

The *transnational strategy* calls for the firm to combine the multidomestic strategy's local responsiveness with the global strategy's efficiency. Firms using this strategy are trying to gain the advantages of both local responsiveness and global efficiency.[99] The combination structure is used to implement the transnational strategy. The **combination structure** is a structure drawing

The **combination structure** is a structure drawing characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure.

Figure 11.10 Worldwide Product Divisional Structure for Implementing a Global Strategy



Notes:
- The "headquarters" circle indicates centralization to coordinate information flow among worldwide products.
- Corporate headquarters uses many intercoordination devices to facilitate global economies of scale and scope.
- Corporate headquarters also allocates financial resources in a cooperative way.
- The organization is like a centralized federation.

characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure. The transnational strategy is often implemented through two possible combination structures: a global matrix structure and a hybrid global design.[100] Because of its flexibility, a hybrid design is particularly useful in an environment characterized by a high level of uncertainty.[101]

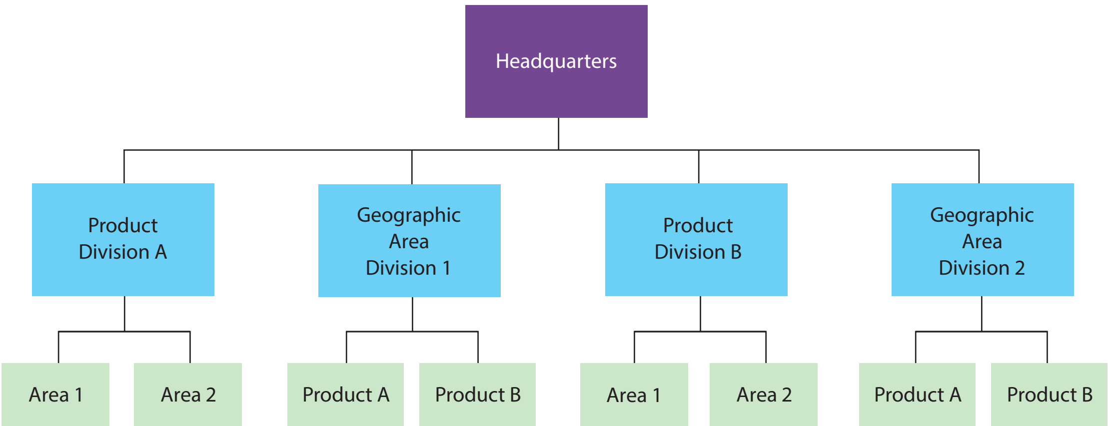
The global matrix design brings together both local market and product expertise into teams that develop and respond to the global marketplace. The global matrix design promotes flexibility in designing products in response to customer needs. However, it has severe limitations in that it places employees in a position of being accountable to more than one manager. At any given time, an employee may be a member of several functional or product group teams. Relationships that evolve from multiple memberships can make it difficult for employees to be simultaneously loyal to all of them. Although the matrix places authority in the hands of the managers who are most able to use it, it creates problems regarding corporate reporting relationships that are so complex and vague that it is difficult and time-consuming to receive approval for major decisions.

We illustrate the hybrid structure in Figure 11.11. In this design, some divisions are oriented toward products while others are oriented toward market areas. Thus, in cases when the geographic area is more important, the division managers are area oriented. In other divisions where worldwide product coordination and efficiencies are more important, the division manager is more product oriented.

The fit between the multidomestic strategy and the worldwide geographic area structure and between the global strategy and the worldwide product divisional structure is apparent. However, when a firm wants to implement the multidomestic and global strategies simultaneously through a combination structure, the appropriate integrating mechanisms are less obvious. The structure used to implement the transnational strategy must be simultaneously centralized and decentralized, integrated and nonintegrated, formalized and nonformalized. Sometimes the structure becomes extremely complex, a reality that challenges managers to remain vigilant in efforts to verify that the hybrid structure is effectively supporting use of their firm's transnational strategy.

FMC Subsea—a supplier to oil companies around the world that develop marine oil fields—was a division of FMC Technologies, a U.S. technology firm, which merged with the French engineering firm Technip in 2017. FMC Subsea was the largest division of FMC Technologies before the merger, representing about 66 percent of total revenues, and operated as an independent subsidiary. The primary purpose of a subsea "tree" is to control the flow of oil or gas out of a well on the seabed. FMC Subsea is the market leader and has the largest installed base of subsea trees (around 2,000) of all companies operating in this market. The initial challenge was to establish an organization that could serve international markets and adapt to local and regional customer requirements. As such, a multidomestic structure was chosen. However, the company experienced challenges in improving cost effectiveness—as noted above, often a problem with the multidomestic strategy. To overcome the problems, a combination strategy with a matrix structure was chosen with dual reporting for both geographic market and product units.[102]

Figure 11.11 Hybrid Form of the Combination Structure for Implementing a Transnational Strategy



Learning Objective

11-8 Explain strategic networks and digital platform structures, and how strategic center firms implement such structures at the business and corporate levels.

11-8 Matches between Cooperative Strategies and Network Structures

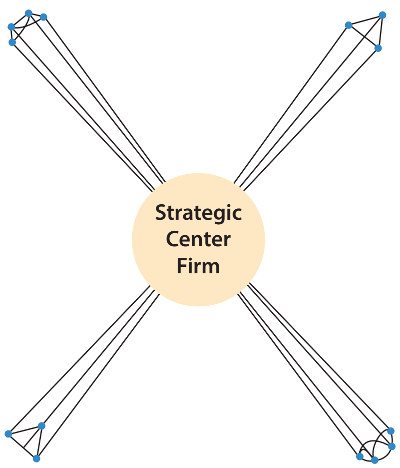
As discussed in Chapter 9, a network strategy cooperative strategy exists when partners form several alliances in order to improve the performance of the alliance network itself through cooperative endeavors.[103] The greater levels of environmental complexity and uncertainty facing companies in today's competitive environment are causing more firms to use cooperative strategies such as strategic alliances.[104] Firms can form cooperative relationships with many of their stakeholders, including customers, suppliers, and competitors. When a firm becomes involved with combinations of cooperative relationships, it is part of a strategic network, or what others call an alliance constellation or portfolio.[105]

A *strategic network* is a group of firms formed to create value by participating in multiple cooperative arrangements.[106] An effective strategic network facilitates discovering opportunities beyond those identified by individual network participants. A strategic network can be a source of competitive advantage for its members when its operations create value that is difficult for competitors to duplicate and that network members can't create by themselves. Strategic networks are used to implement business-level, corporate-level, and international cooperative strategies. Research has shown that the highest performing strategic networks are young and use a combination of governance based on both relationships (e.g., relational governance) and formal rules (e.g., formal governance). Larger and older networks have high levels of relational governance and low levels of formal governance; however, firms in these networks do not benefit as much as firms in younger networks.[107]

The typical strategic network is a loose federation of partners with flexible participation in the network's operations. At the core or center of the strategic network, the *strategic center firm* is the one around which the network's cooperative relationships revolve (see Figure 11.12).[108] Because of its central position, the strategic center firm is the foundation for the strategic network's structure and must ensure that incentives for participating in the network are aligned so that network firms have a reason to remain connected.[109] Concerned with various aspects of organizational structure, such as formal reporting relationships and procedures, the strategic center firm manages what are often complex, cooperative interactions among network partners. The strategic center firm is engaged in four primary tasks as it manages the strategic network and controls its operations.[110]

Strategic Outsourcing The strategic center firm outsources and partners with more firms than other network members. At the same time, the strategic center firm requires network partners to be more than contractors. Members are expected to find opportunities for the network to create value through its cooperative work.[111]

Figure 11.12 A Strategic Network



Competencies To increase network effectiveness, the strategic center firm seeks ways to support each member's efforts to develop core competencies with the potential of benefiting the network.

Technology The strategic center firm is responsible for managing the development and sharing of technology-based ideas among network members. The structural requirement that members submit formal reports detailing the technology-oriented outcomes of their efforts to the strategic center firm facilitates this activity.

Race to Learn The strategic center firm emphasizes that the principal dimensions of competition are between value chains and between networks of value chains. Because of these interconnections, an individual strategic network is only as strong as its weakest value-chain link. With its centralized decision-making authority and responsibility, the strategic center firm guides participants in efforts to form network-specific competitive advantages. The need for each participant to have capabilities that can be the foundation for the network's competitive advantages encourages friendly rivalry among participants seeking to develop the skills needed to quickly form new capabilities that create value for the network.[112]

Interestingly, strategic networks are being used more frequently, partly because strategic center firms can execute a strategy that effectively and efficiently links partner firms.[113] Improved information systems and communication capabilities (e.g., the Internet) facilitate effective organization and use of strategic networks. One of the best illustrations of a network is illustrated in the global airline alliances examples in the Strategic Focus.

11-8a Implementing Digital Platform Structures

Throughout this book, we have discussed the importance of digital technologies on business and the firm.[114] In Chapter 2, we highlighted the increasing importance of digital platforms as a part of the *sharing economy*, a socioeconomic system that uses information technology to link stakeholders with each other.[115] Chapter 4 discussed digital platforms as a potential business model. Here we discuss the implementation of a digital platform structure and how it fits within other organizational structures.

As defined in Chapter 4, a digital platform is an Internet-based location for exchanges of information, goods, or services to occur between producers, consumers, and other members of the platform community.[116] Firms that create and manage platforms can earn revenues through subscriptions, advertising, fee-per-use, charging a percentage of the value of goods traded (e.g., a commission), requesting donations (i.e., Wikipedia), or any number of other means. Unlike many of the other structures discussed in this chapter (i.e., simple structure, functional structure), there is no natural progression that leads to a platform structure. Some companies, like Uber and Amazon, began with a digital platform structure. Other companies, like Walmart, created a digital platform in response to competitive rivalry. Also note that a digital platform structure is often supplemental to the other structures discussed here. For example, a firm could have a functional structure with a traditional department organization (e.g., finance, R&D, operations, marketing) in support of its digital platform.

A digital platform is, in essence, a business ecosystem on its own.[117] Chapter 2 defined a business ecosystem as a complex network of interconnected organizations whose competitive and cooperative efforts are associated with satisfying a particular value proposition (i.e., product or service).[118] They have less formalization than a traditional organization, and decision making is almost entirely decentralized (e.g., in the hands of platform participants). However, participants are more closely tied to each other than would occur in a traditional market. "A distinctive feature of the platform architecture is its modular and interdependent system of core and complementary components bound together by design rules and an overarching value proposition."[119] In this sense, the digital platform structure is a lot like the network structure, with the platform creator playing a role similar to a strategic center firm.[120] The platform creator establishes and enforces the rules, and manages transactions among participants, and the effectiveness with which they perform this function has a dramatic effect on the platform's success.[121]

Because digital platforms are Internet-based, they are global by their very nature.[122] That is, people around the world could potentially have access to the platform, although the platform creator can restrict access through means such as passwords. The advantage of the global nature of a digital platform is that the upside market potential is huge. However, it also presents challenges associated with differences in language, culture, and government regulations. Even regional differences within the same country can make a difference.[123] Consequently, platform creators tend to focus on a specific market first, but then open their platforms later to achieve higher levels of sales growth.[124]

11-8b Implementing Business-Level Cooperative Strategies

As explained in Chapter 9, there are two types of business-level complementary alliances—vertical and horizontal. Firms with competencies in different stages of the value chain form a vertical alliance to cooperatively integrate their different, but complementary, skills.[125] Firms combining their competencies to create value in the same stage of the value chain are using a horizontal alliance.[126] Vertical complementary strategic alliances are formed more frequently than horizontal alliances.[127]

A strategic network of vertical relationships, such as the network in Japan between Toyota and its suppliers, often involves several implementation issues.[128] First, the strategic center firm encourages subcontractors to modernize their facilities and provides them with technical and financial assistance to do so, if necessary. Second, the strategic center firm reduces its transaction costs by promoting longer-term contracts with subcontractors so that supplier-partners increase their long-term productivity. This approach differs from that of continually negotiating short-term contracts based on unit pricing. Third, the strategic center firm enables engineers in upstream companies (suppliers) to have better communications with those companies with whom it has contracts for services. As a result, suppliers and the strategic center firm become more interdependent and less independent.

The lean production system (a vertical complementary strategic alliance) pioneered by Toyota and others has been diffused throughout many industries.[129] In vertical complementary strategic alliances, such as the one between Toyota and its suppliers, the strategic center firm is obvious, as is the structure that firm establishes. However, the same is not always true with horizontal complementary strategic alliances where firms try to create value in the same part of the value chain. For example, airline alliances are commonly formed to create value in the marketing and sales primary activity segment of the value chain. There are three major alliances—Star Alliance (26 members), SkyTeam (19 members), and Oneworld (14 members)—and each of them include multiple large airlines.[130] In this case, it is unclear who is the strategic center firm. In addition, in large alliances, it is often difficult to determine the contributions of each alliance partner.[131]

Also, if rivals band together in too many collaborative activities, one or more governments may suspect the possibility of explicit collusion among partnering firms (see Chapter 9). In fact, the airline alliances have been accused of fixing prices.[132] For these reasons, horizontal complementary alliances are used less often and less successfully than their vertical counterpart, although there are examples of success, such as some of the collaborations among automobile and aircraft manufacturers.

11-8c Implementing Corporate-Level Cooperative Strategies

Some corporate-level strategies are used to reduce costs. This was the objective with the collaboration that Walgreens and Swiss-based Alliance Boots, a pharmacy-led health and beauty group, initially formed. This partnership helped the firms negotiate lower prices with drug suppliers, reducing their overall costs as a result. Of course, the alliance eventually turned into a holding company that owns the Walgreens and Boots pharmacy chains, as well as an assortment of pharmaceutical companies. Walgreens Boots Alliance was ranked as number 16 on *Fortune*'s list of the 500 largest companies in 2021 and is now one of the companies making up the Dow Jones Industrial Average.[133]

Unilever is partnering with some firms to reach a different objective. Committed to decoupling its growth from negative environmental and social effects from its operations, Unilever formed an alliance with Jacobs Engineering Group Inc. in 2010 to reduce the company's carbon, water, and waste footprint across its manufacturing locations throughout the world.

Still other corporate-level cooperative strategies (such as franchising) are used to facilitate product and market diversification. As a cooperative strategy, franchising allows the firm to use its competencies to extend or diversify its product or market reach without completing a merger or acquisition.[134]

The potential to create synergy is a key reason corporate-level cooperative strategies, such as those involving Walgreens and Unilever are formed. McDonald's also seeks synergy through its franchise structure.[135] Historically, McDonald's approach to franchising as a corporate-level cooperative strategy found the firm emphasizing a limited value-priced menu. However, the firm's structure is being changed. One objective of these structural changes is to strip out significant firm costs. Overall, McDonald's headquarters serves as the strategic center firm for the network's franchisees. The headquarters office uses strategic and financial controls to verify that the franchisees' operations create the greatest value for the entire network.[136]

As the Strategic Focus demonstrates, corporate-level cooperative strategies are also formed to deal more effectively with emerging technologies. Major firms with a stake in wireless phone service joined forces to usher in 6G and future generations of technology.

Strategic **Focus**

Major Wireless Technology Players Form an Alliance to Develop 6G Technology

Fifth generation (5G) wireless technology wowed consumers with higher speeds, especially on large downloads. Even as 5G technology was being introduced, companies such as Samsung were starting to develop 6G technology. It takes about 10 years from the very beginning of research to full commercialization of a new generation of wireless technology. According to Sunghyun Choi, head of the Advanced Communications Research Center, "Going forward, we are committed to leading the standardization of 6G in collaboration with various stakeholders across industry, academia, and government fields." To make 6G viable, terahertz (THz) frequencies are likely to be necessary. These would require new antenna technologies, spectrum sharing, advanced duplex technologies, and artificial intelligence.

Source: ATIS Next G Alliance

Next G Alliance was launched by ATIS to advance North American mobile technology leadership in 6G.

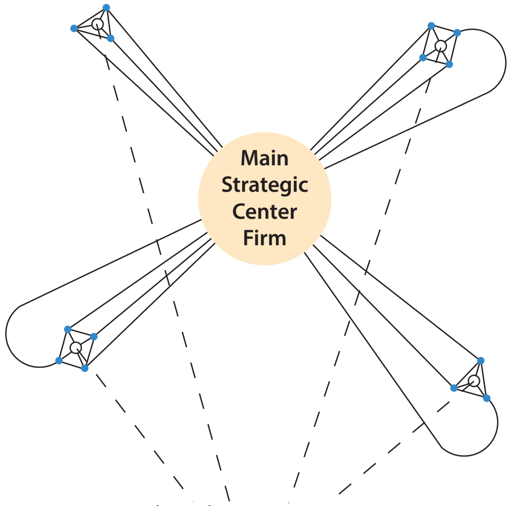
To develop 6G, collaboration took the form of a massive corporate-level cooperative strategy involving many companies. The "Next G Alliance" includes AT&T, Verizon, T-Mobile, Facebook, Microsoft, Bell Canada, Finland-based Nokia and Sweden-based Ericcson, South Korea's Samsung, and the U.S. Department of Defense, among many others. China's Huawei was not allowed to join as a founding member because the U.S. government had banned it from federal contracts. Lee Ki-dong, a senior researcher from LG Electronics, was selected to lead the alliance's applications working group.

Susan Miller, president and CEO of the Alliance for Telecommunications Industry Solutions (ATIS), the organization that facilitated creation of the Next G Alliance, said, "an important goal of the alliance is to influence the U.S. government's funding priorities and actions that can incentivize the communications technology industry. We think that's part of laying the groundwork for a very vibrant marketplace." The alliance also seeks to lay out a 6G roadmap to address the changing competitive landscape, establish priorities to steer leadership for 6G and future generations of technology, and identify early steps that will lead to rapid commercialization and encourage widescale adoption of the technology.

Some of the advanced multimedia services being discussed for 6G include "truly immersive extended reality (XR), mobile holograms, and digital replicas." To do this, transfer speeds will need to be increased from 20 Gbps (gigabits per second) associated with 5G to about 1,000 Gbps. In May 2022, the alliance, under the leadership of ATIS and Informa Tech, held a summit in Austin, Texas, to discuss advances in 6G technology. Says Miller, "The 6G Summit provides an opportunity to hear from leading Next G Alliance and other industry experts shaping the future of mobile technology."

Sources: M. Wolfe, 2022, ATIS' Next G alliance partners with Informa Tech on 6G summit, *ATIS Home Page,* www.atis.org, April 5; 2022, Building the foundation for North American leadership in 6G and beyond, *Next G Alliance Home Page,* www.nextgalliance.org, May 7; 2021, ATIS' Next G Alliance announces leadership; starts work on North American 6G roadmap, *Telecom Standards,* 31(3): 1–2; 2021, LG Electronics researcher to head alliance for 6G technology in US, *FRPT—Telecom Snapshot,* June 22: 12; B. Fletcher, 2020, AT&T, T-Mobile, Verizon and more form alliance for 6G leadership, *Fierce Wireless,* www.fiercewireless.com, October 13; M. Alleven, 2020, Samsung research tackles 6G, says use of THz 'inevitable,' *Fierce Wireless,* www.fiercewireless.com, July 14.

Figure 11.13 A Distributed Strategic Network



Strategic networks formed to implement international cooperative strategies result in firms competing in several countries.[137] Differences among countries' regulatory environments increase the challenge of managing international networks and verifying that, at a minimum, a network's operations comply with all legal requirements.[138]

Distributed strategic networks are the organizational structure used to manage international cooperative strategies. As Figure 11.13 shows, several regional strategic center firms are included in the distributed network to manage partner firms' multiple cooperative arrangements.[139] The structure used to implement the international cooperative strategy is complex and demands careful attention to be used successfully.[140]

Summary

- Organizational structure specifies the firm's formal reporting relationships, procedures, controls, and authority and decision-making processes. Essentially, organizational structure details the work to be done in a firm and how that work is to be accomplished. Organizational controls guide the use of strategy, indicate how to compare actual and expected results, and suggest actions to take to improve performance when it falls below expectations. A proper match between strategy and structure can lead to a competitive advantage.
- A typical organizational control cycle involves developing both strategic and financial objectives based on the strategies that were formulated, assigning responsibility, creating a detailed implementation plan (including budget and time frame), allocation of resources, comparing results with objectives, assessing outcomes, and feeding pertinent information back to decision makers to guide the next control cycle.
- Strategic controls (largely subjective criteria) and financial controls (largely objective criteria) are the two types of organizational controls used to support the implementation of a strategy. Both controls are critical, although their degree of emphasis varies based on individual matches between strategy and structure.
- Strategy and structure influence each other; overall, though, strategy has a stronger influence on structure. Firms tend to change structure when declining performance forces them to do so. Effective managers anticipate the need for structural change and quickly modify structure to better accommodate the firm's strategy.
- The functional structure is used to implement business-level strategies. The cost leadership strategy requires a centralized functional structure—one in which manufacturing efficiency and process engineering are emphasized. The differentiation strategy's functional structure decentralizes implementation-related

decisions, especially those concerned with marketing, to those involved with individual organizational functions. Focus strategies, often used in small firms, require a simple structure until such time that the firm diversifies in terms of products and/or markets.

- Unique combinations of different forms of the multidivisional structure are matched with different corporate-level diversification strategies to properly implement these strategies. The cooperative multidivisional form, used to implement the related constrained corporate-level strategy, has a centralized corporate office and extensive integrating mechanisms. Divisional incentives are linked to overall corporate performance to foster cooperation among divisions. The related linked SBU multidivisional structure establishes separate profit centers within the diversified firm. Each profit center or SBU may have divisions offering similar products, but the SBUs are often unrelated to each other. The competitive multidivisional structure, used to implement the unrelated diversification strategy, is highly decentralized, lacks integrating mechanisms, and utilizes objective financial criteria to evaluate each unit's performance.
- The multidomestic strategy, implemented through the worldwide geographic area structure, emphasizes decentralization and locates all functional activities in the host country or geographic area. The worldwide product divisional structure is used to implement the global strategy. This structure is centralized to coordinate and integrate different functions' activities to gain global economies of scope and economies of scale. Decision-making authority is centralized in the firm's worldwide division headquarters.
- The transnational strategy—a strategy through which the firm seeks the local responsiveness of the multidomestic strategy and the global efficiency of the global strategy—is implemented through the combination structure. Because it must be simultaneously centralized and decentralized, integrated and nonintegrated, and formalized and nonformalized, the combination structure is difficult to organize and successfully manage. Two structures can be used to implement the transnational strategy: the matrix and the hybrid structure with both geographic and product-oriented divisions.
- Increasingly important to competitive success, cooperative strategies are implemented through organizational structures framed around strategic networks. Strategic center firms play a critical role in managing strategic networks. Business-level strategies are often employed in vertical and horizontal alliance networks. Corporate-level cooperative strategies are used to pursue product and market diversification.

Key Terms

combination structure 296
competitive form 292
cooperative form 290
financial controls 283
functional structure 285
multidivisional structure 285
organizational controls 281
organizational structure 280
simple structure 284
strategic business unit (SBU) form 291
strategic controls 282
worldwide geographic area structure 295
worldwide product divisional structure 296

Review Questions

1. What is organizational structure and what are organizational controls? What are the differences between strategic controls and financial controls? What is the importance of these differences?
2. What are the steps in a typical organizational control cycle?
3. What does it mean to say that strategy and structure have a reciprocal relationship?
4. What are the characteristics of the different functional structures used to implement the cost leadership, differentiation, integrated cost leadership/differentiation, and focused business-level strategies?
5. What are the differences among the three versions of the multidivisional organizational structures that are used to implement the related constrained, the related linked, and the unrelated corporate-level diversification strategies?
6. What organizational structures are used to implement the multidomestic, global, and transnational international strategies?
7. What is a strategic network? What is a strategic center firm? How is a strategic center firm used in business-level, corporate-level, and international cooperative strategies?
8. What is a digital platform structure? What are the special challenges a firm faces when implementing a digital platform structure?

Mini-Case

ExxonMobil Implements New Structure to Cut Costs and Grow Value

On January 31, 2022, ExxonMobil announced that it would be moving its corporate headquarters to Houston from Irving, Texas, and streamlining its corporate structure by combining several businesses. The resulting company would be organized into three business lines—ExxonMobil Upstream Company (oil and gas production), ExxonMobil Product Solutions (chemicals and refining), and ExxonMobil Low Carbon Solutions. According to CEO Darren Woods, "Our transformed business structure enables us to more fully leverage the corporation's scale, integration, technology advantages, and the skills and capabilities of our talented workforce, to better serve our customers. Aligning our businesses along market-focused value chains and centralizing service delivery, provides the flexibility to ensure our most capable resources are applied to the highest corporate priorities and positions us to deliver greater shareholder returns." No layoffs are anticipated due to the restructuring.

The new ExxonMobil Product Solutions Company, to be headed by Karen McKee, is charged with engineering, manufacturing, and delivering new products. This business unit will play a big role in reducing carbon emissions and plastic waste through new products such as lower-emission fuels for commercial transportation (including aviation and marine), chemical performance products that help customers reduce emission, lubricants and plastics that improve automobile efficiency, and circular polymers that help with plastic recycling.

The ExxonMobil Low Carbon Solutions unit "is focused on lowering Exxon's carbon emissions and developing emerging technologies including carbon capture, hydrogen and biofuels." By putting its low carbon business on the same level in the organization as its other two businesses, ExxonMobil now has greater flexibility in allocating resources to efforts to help the company adjust to the transition to clean energy. This unit will focus on hard-to-decarbonize industrial sectors, including commercial transportation, power generation, and heavy industry. The company has received interest from 11 companies "to support large-scale carbon capture and storage hubs, with the first near Houston." ExxonMobil believes it may be possible to capture 100 million tons of carbon from chemical plants, power-generation facilities, and refineries around Houston by 2040. Also, ExxonMobil has a goal to achieve net-zero emissions from its operations by 2050, with specific plans to be developed by each of its operations.

The three business lines will be supported by a single technology organization called ExxonMobil Technology and Engineering, as well as other centralized groups that will provide particular services throughout the organization. This major restructuring was first envisioned around 2017, according to Senior Vice President Jack P. Williams, "It's an evolution. We have been working on it for a while now." One of the first steps was combining the fuel and lubricants division with supply and refining.

Previously implemented structural changes associated with centralization of the procurement function, right-sizing programs, and digitally transforming certain processes are on track to save the company $6 billion dollars by 2023, compared to 2019. This new structure is expected to save the company even more, but more importantly, the restructuring is intended to provide higher priority to important areas associated with sustainable business. "ExxonMobil's restructuring has put its clean energy operation on equal footing with its traditional oil and gas, refining and petrochemical operations."

Sources: C. M. Matthews, 2022, Exxon to move base to Houston, *Wall Street Journal,* February 1: B3; S. Valle, Exxon unveils sweeping restructuring in latest cost cutting move, *Reuters,* www.reuters.com, January 31; M. B. Powers, 2022, ExxonMobil restructure set to boost status of its low-carbon business, *Engineering News-Record,* www.enr.com, February 1; 2022, Exxon announces cost-cutting restructure, plans to move headquarters, *CNBC,* www.cnbc.com, January 31; B. Martin, 2022, ExxonMobil says relocation, restructuring will 'better serve our customers' and save billions, *Houston Daily,* www.houstondaily.com, February 3; 2022, ExxonMobil streamlines structure to enhance effectiveness, grow value, reduce costs, *ExxonMobil Home Page,* www.corporate.exxonmobil.com, January 31.

Case Discussion Questions

1. A company's business model requires it to perform certain value creating functions. Changing a structure is unlikely to eliminate any of those functions. So how can a restructuring like this one lead to lower costs?
2. How will ExxonMobil's new structure help the company to be competitive in 10 years?
3. At the time of this case, oil prices were skyrocketing, and ExxonMobil was flush with cash. Is this a good time for this sort of restructuring? Why or why not?
4. What are some of the emotions ExxonMobil employees likely felt when the company announced the restructuring? What can a company do to help employees overcome these feelings?

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Chapter 12

Strategic Leadership

Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

12-1 Define strategic leadership and describe top-level managers' importance.

12-2 Explain what top management teams are and how they affect firm performance.

12-3 Describe the managerial succession process using internal and external managerial labor markets.

12-4 Discuss the value of strategic leadership in determining the firm's strategic direction.

12-5 Describe the importance of strategic leaders in managing the firm's resources.

12-6 Explain what a firm does to sustain an effective culture.

12-7 Describe what strategic leaders can do to establish and emphasize the need for everyone to demonstrate ethical practices in their firms.

12-8 Discuss the importance of balanced organizational controls.

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Meg Whitman: A Pioneering Strategic Leader

Meg Whitman is the only female to serve as the CEO for two major U.S. corporations. The path Whitman traveled to become one of the most prominent women in American business and an experienced CEO in Silicon Valley is enlightening. Her path as a leader demonstrates increasing levels of responsibility and decision-making authority while moving from one opportunity to another.

A graduate of Princeton University and Harvard Business School, Whitman started her career in 1979 as a brand manager at Procter & Gamble. She later worked as a consultant in Bain & Company's San Francisco office, rising to a position as senior vice president in this firm. In 1989, she accepted a position as vice president for strategic planning at Walt Disney Corporation. She met Jeffrey Katzenberg while working for Disney. After two years, she joined Stride Rite Corporation before becoming president and CEO of Florists' Transworld Delivery in 1995. After another two years, she accepted the role of general manager for Hasbro's Playskool division, where she had responsibility for global management and marketing for two brands targeted to children—Playskool and Mr. Potato Head. From Hasbro, Whitman became CEO of eBay (the pioneering company that made it possible for strangers to exchange goods online) in March 1998. At the time, the firm had only 30 employees and annual revenue of approximately $4 million. Before resigning as eBay's CEO in November 2007, the firm's revenues had increased to $8 billion annually and the workforce numbered around 15,000.

Imaginechina Limited/Alamy Stock Photo

Meg Whitman, former CEO of Hewlett-Packard, led the turnaround plan to split HP into two companies: Hewlett Packard Enterprises (HPE) and Hewlett Packard Inc. (HPQ).

Whitman become CEO of Hewlett-Packard in September 2011. She remained in this role for a little over six years. During those years, "she led a turnaround plan that involved the largest split in corporate history, tens of thousands of layoffs, $18 billion in write-offs and a leadership shake-up." Deciding in 2015 to split Hewlett-Packard into Hewlett Packard Enterprise (HPE) and HP Inc. (HPQ) was the most prominent strategic action she took as Hewlett-Packard's CEO. HP Inc. took the printer and personal computer businesses, while HPE competes in various markets such as servers, storage, networking, consulting and support, and financial services. Whitman, her team, and Hewlett-Packard's board chose to split into two companies because of declining sales in what was a complicated organizational structure. The leaders believed that breaking the firm into two units would allow each to focus more on a smaller number of businesses as a way to unlock their full value.

As is the case for virtually all leaders serving as a CEO, Whitman's career is not without controversy. During her tenure at eBay, for example, the firm paid roughly $4.1 billion to acquire Skype in 2005. Later admitting that the premium she and her team agreed to pay for Skype was too large, eBay sold Skype to a group of investors for $2.75 billion.

Also, in Whitman's view, failing to recognize the market potential for eBay in Japan was a major error. Instead of investing in Japan, Whitman chose to invest in eBay's existing website. At the time, Japan was the world's second-largest Internet consumer market. In commenting about this matter, Whitman said that "I had a sense that the technology underpinning eBay was not going to help us scale where we needed to. That miss of eBay Japan is one of the big failures of my time at eBay."

Some also question a few decisions Whitman made during her tenure as HP's CEO: "Meg Whitman's tenure at Hewlett-Packard was marked by a series of splits and sales that reshaped the storied Silicon Valley company. Now, her successor Antonio Neri must take the remnants and reignite innovation." Others observed the continuing weakness in server sales at Hewlett Packard Enterprise as Whitman departed, suggesting that she was at least partly responsible for this situation.

After Whitman stepped down from her CEO position at Hewlett Packard Enterprise Co. in 2018, she said she was returning to what she considers her "start-up roots." She had decided to join with Hollywood executive and long-time friend Jeffrey Katzenberg to run a mobile-video company called WndrCo NewTV. This firm was part of Katzenberg's WndrCo LLC, a media and tech venture that plans to develop a portfolio of companies. The intention was to build "an online service, securing production partnerships and building a team at NewTV, which will target the 18- to 34-year-olds who have driven the rise in mobile-video viewing over the past several years." The resulting video platform, called Quibi, was shut down October 2020, only seven months after it launched.

Whitman currently holds seats on the boards of Procter & Gamble and Dropbox. She also invested in a Los Angeles e-sports company called Immortals LLC and sits on their board. Her vast executive experience can be of immense benefit to the managers and other board members in all those organizations.

Like virtually all high-profile business leaders, Whitman's career has seen ups and downs; however, many view Whitman as a leader who played a major role in commercializing the Internet industry. In doing so, she also amassed a personal fortune worth an estimated $3.2 billion. In December 2021, it was announced that Whitman was nominated by President Joe Biden to serve as ambassador to Kenya.

Sources: 2022, Meg Whitman, *Forbes,* www.forbes.com, May 10; B. Schwartz, 2021, Biden nominates megadonor and former Hewlett Packard CEO Meg Whitman to be ambassador to Kenya, *CNBC,* www.cnbc.com, December 8; D. Gallagher, 2018, New HPs give fresh life to old businesses, *Wall Street Journal*, www.wsj.com, February 23; E. Shwartzel, 2018, Meg Whitman to lead mobile-video startup NewTv, *Wall Street Journal*, www.wsj.com, January 24; D. Gallagher, 2017, Meg Whitman's latest turn signal, *Wall Street Journal*, www.wsj.com, November 22; R. King, 2017, Can Antonio Neri revive HP Enterprise after Meg Whitman? *Wall Street Journal*, www.wsj.com, November 30; R. King, 2017, Meg Whitman to step down as Hewlett Packard Enterprise CEO, *Wall Street Journal*, www.wsj.com, November 21; G. Hall, 2014, Hewlett Packard CEO talks biggest fails, *bizwomen*, www.bizjournals.com, May 2; M. Ames & Y. Levine, 2010, How Meg Whitman failed her way to the top at eBay, collecting billions while nearly destroying the company, *Alternet*, www.alternet.org, October 25.

Learning Objective

12-1 Define strategic leadership and describe top-level managers' importance.

12-1 The Importance of Strategic Leadership

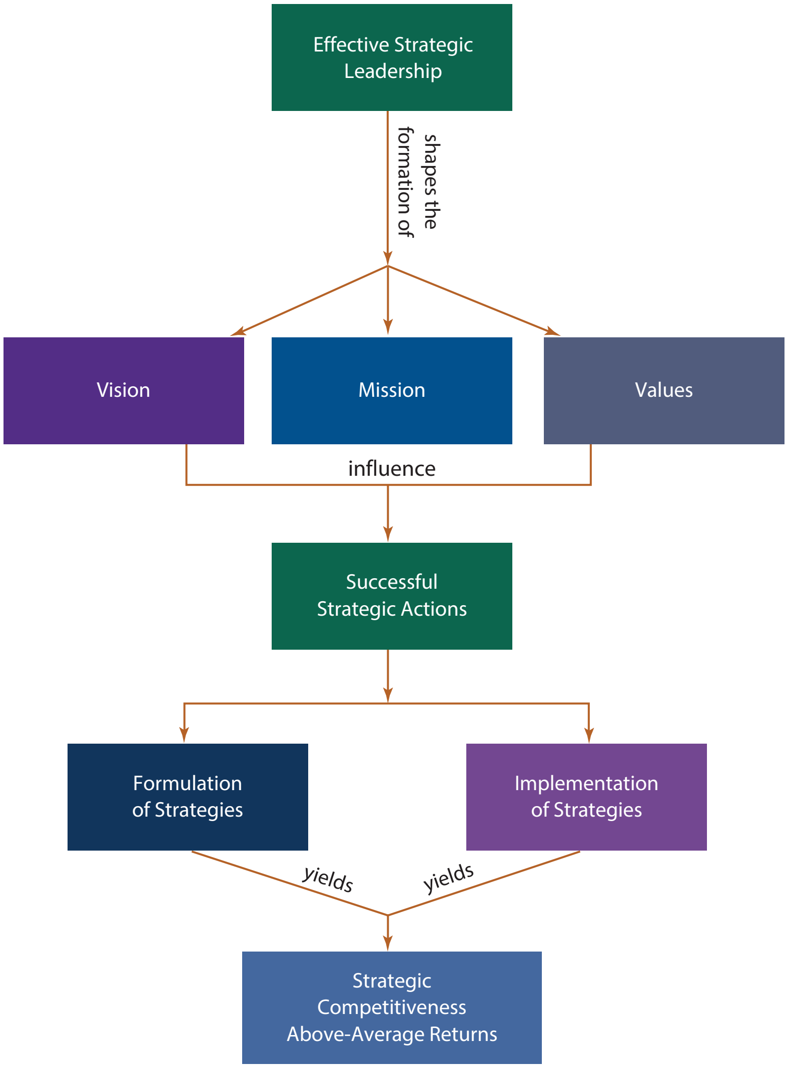
As the Opening Case suggests, strategic leaders' work is demanding, challenging, and requires the balancing of desired short- and long-term performance goals. Meg Whitman is a strategic leader who has taken strategic actions in each managerial position she held to deal with challenging situations in the pursuit of helping firms earn above-average returns. Sometimes, though, for many reasons, strategic leaders do not attain the level of success they desire. Even Whitman had her share of disappointments.

Regardless of the length of their tenure, strategic leaders' decisions and actions affect a firm's performance. Many—though not all—thought Steve Jobs was the primary catalyst in driving Apple to significant levels of success as the firm's CEO. There were questions about whether anyone could follow Jobs as CEO and come close to achieving his levels of success. Those questions dogged Tim Cook, who became Apple's CEO after Jobs passed away. Concerns about Cook may have been unnecessary. Since 2011, when Cook took over the CEO job, Apple's fiscal year revenues have grown from $108 billion to $366 billion. Net income for fiscal year 2021 was over $94 billion.[1]

As CEOs work with others to carry out strategic analysis leading to the development of effective strategies and their implementation, the firm is much more likely to achieve strategic competitiveness and above-average returns (e.g., the A-S-P model introduced in Chapter 1). We show how effective strategic leadership makes this possible in Figure 12.1.[2]

In this chapter, we first define strategic leadership and discuss its importance and the possibility of strategic leaders as a source of competitive advantage. These introductory comments include a brief consideration of different styles strategic leaders may use. We then examine the role of top-level managers and top management teams and their effects on innovation, strategic change, and

Figure 12.1 Strategic Leadership and the Strategic Management Process



firm performance. Following this discussion is an analysis of managerial succession, particularly in the context of the internal and external managerial labor markets from which firms select strategic leaders. Closing the chapter are descriptions of five key leadership actions that contribute to effective strategic leadership: determining strategic direction, effectively managing the firm's resource portfolio, sustaining an effective organizational culture, emphasizing ethical practices, and establishing balanced organizational controls.

12-1a Strategic Leadership and Strategic Change

Strategic leadership is the ability to anticipate, envision, maintain flexibility, and empower others to create strategic change as necessary.[3] **Strategic change** is change resulting from selecting and implementing a firm's strategies.[4] Strategic leaders promote strategic change by managing through others, managing an entire organization rather than a functional subunit, and coping with the rapid and intense changes associated with the global economy. Because of the global economy's complexity, strategic leaders must learn how to influence human behavior effectively, often in uncertain environments.[5] By word and by personal example, and through their ability to envision the future, effective strategic leaders meaningfully influence the behaviors, thoughts, and feelings of those with whom they work.[6]

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The Strategic Focus illustrates a lot of the points we have discussed thus far. The influence of Starbucks' founder Howard Schultz on the company is legendary, and he has returned as CEO twice to guide the company through significant challenges since he originally stepped down from the position.

Strategic **Focus**

Howard Schultz Steps in (Again) at Starbucks

Howard Schultz has had a profound impact on coffee shops in the United States. He bought out his local Starbucks in 1987 and began making changes to the company to improve its image and customer experience. He provided benefits to workers that were unusual in the restaurant industry, including health benefits for part-time workers. When the company went public in 1992, employees began receiving stock. Schultz also treated employees with great respect, holding town-hall style meetings with them and listening to their concerns. Starbucks has grown rapidly on a global scale since the company went public, achieving revenues of $29 billion in fiscal 2021. The company still has aggressive growth objectives, including opening 20,000 more cafes globally by 2030. This growth would mean a total of approximately 55,000 stores.

Schultz served as CEO from 1987 to 2000 and then returned to serve as CEO in 2008 to help guide Starbucks out of the Great Recession. Kevin Johnson became CEO in 2017. He could have had no idea what was brewing when he took over the top spot. Indeed, restaurants were one of the worst hit businesses during the COVID-19 pandemic.

One of the huge problems plaguing restaurant operators in the United States in 2021 was a shortage of workers. In fact, the whole hospitality industry was experiencing worker shortages and high turnover. This situation led to staffing shortages and more stress on the remaining employees. During this crisis, and possibly as a response to it, almost 140 stores in 26 states decided to hold elections regarding union organization. Another force causing the trend toward unionization was that the job of a barista had changed dramatically due to changes in the way consumers were buying coffee from Starbucks. Approximately 70 percent of all orders in the United States had become takeout orders, and the job of a barista was now complicated by drive-through windows and mobile orders. Although Starbucks announced an increase in barista pay, some shareholders were very upset about the way the company handled the unionization drive, and the stock suffered.

In November 2021, as employees were considering forming a union, Schultz traveled to Buffalo, New York, to deliver a message encouraging them to work with management and telling them that the company would best protect employees' interests. He said, "Our core purpose and reason for being is to build the kind of company that creates a fragile balance between profit and doing the right thing." However, they voted to organize anyway, claiming that union representation is needed to achieve higher pay, adequate staffing, and a stronger voice about how the company is managed. It is also significant that a Seattle store voted to unionize—this is Starbucks' hometown.

In 2021, Johnson that he would retire the next year. After Johnson announced his retirement, "Starbucks' board presumably had a year to find Johnson's successor, and they weren't able to find the right person," according to Pat Petitti, CEO of consulting firm Catalant. In addition to the unionization movement and a void in leadership at the top, Starbucks was facing rising prices and serious problems in some of its foreign markets (i.e., China due to pandemic-related lockdowns and Russia due to its invasion of Ukraine). During this crisis, Schultz, at 68 years old, agreed to return as CEO of Starbucks in April 2022, his third time in that office. The stock market responded positively to the announcement by bidding up the price of the stock by about 8 percent in less than a week. Schultz intends to establish a new tone with the company's 230,000 workers in its U.S. coffee houses. "We have to take a hard look at how we are doing as a company, and as a community of partners." He wants to "revamp" the company.

AP Images/Stephen Brashear

Incoming CEO Laxman Narasimhan (right) shadowed Interim CEO Howard Schultz for six months until he fully took over the CEO position in April 2023.

How much of a difference will Schultz make as the returning CEO? Starbucks Chairwoman Mellody Hobson expressed the sentiment that this appointment would be temporary and announced that a replacement would be announced by fall 2022. This timeline was difficult. "Schultz is widely credited with building Starbucks' reputation as a good place to work—a reputation that influences investors, customers, and potential employees. As executive chairman, he has been involved in the company's efforts to persuade workers not to unionize. But the billionaire exec seems to have retained a wide base of support in the rank and file—and whoever follows him may need the same." Meanwhile, all eyes are on Howard Schultz. "On his first day back as Starbucks Corp. chief executive, Howard Schultz suspended billions of dollars in share repurchases and said his immediate focus would be on cafes, customers and employees, rather than the stock market."

Sources: H. Haddon, 2022, Starbucks to prioritize cafes, not stock price, *Wall Street Journal*, www.wsj.com, April 5: A2, A4; H. Haddon, 2022, Starbucks' Schultz has tough to-do list, *Wall Street Journal*, April 4: B1, B4; H. Haddon, 2022, Seattle Starbucks votes to unionize, *Wall Street Journal*, March 23: B2; A. Kidwai, 2022, Can anybody else lead Starbucks? *Fortune*, April/May: 39; H. Haddon, 2022, Schultz returns as Starbucks CEO, saying chain needs to revamp, *Wall Street Journal*, www.wsj.com, March 17: B1, B4; H. Haddon, 2022, Schultz seeks a new start with baristas, *Wall Street Journal*, March 21: B5.

Effective strategic leaders create and then support the context or environment through which stakeholders (e.g., employees and suppliers) can perform at peak efficiency. This environment is what Schultz is trying to achieve as he reinvents Starbucks. The ability to attract and manage human capital and establish and nurture an appropriate context for that capital to flourish is critical to strategic leadership.[7] We also need to remember that the intellectual capital the firm possesses resides in the firm's human capital, so a firm's ability to produce innovations has much to do with the ability to retain (and manage) key employees, and this ultimately affects a strategic leader's success.[8]

The primary responsibility for effective strategic leadership rests at the top of the organization, and in particular with the CEO. Other strategic leaders include members of the board of directors, the top management team, and divisional general managers. In practice though, any individual with responsibility for the performance of human capital and/or a part of the firm (e.g., a production unit) is a strategic leader. Regardless of their title and organizational function, strategic leaders have substantial decision-making responsibilities they cannot delegate.[9] Strategic leadership is a complex but critical form of leadership. Without effective strategic leaders, firms fail in efforts to implement strategies in ways that lead to above-average returns.

12-1b Leadership Personality and Style

Strategy formulation and implementation are the result of human enterprise.[10] The top managers that guide these processes exhibit human characteristics, including interpretations, biases, fatigue, jealousies, and talents.[11] Consequently, researchers have investigated how the human characteristics of top managers influence their decisions.[12] For example, CEOs with a higher risk propensity are more likely to steer their firms toward higher levels of internationalization and riskier locations.[13]

Two areas of particular interest are personality traits and leadership style.[14] Researchers have found that the personality traits of CEOs have an influence on their style of leadership and, ultimately, on firm outcomes and value creation. For example, based on a study of the personality traits of nearly 3,000 CEOs, researchers found that levels of neuroticism (emotional instability), conscientiousness (thoughtfulness, goal-directed), and extraversion (energized around people, talkative) influence the perceived riskiness of a firm, as measure through the volatility of its stock.[15] One interesting outcome of this research is that the expected relationship between the risk and returns from a particular firm's stock may be either positive (riskier stocks provide higher returns) or negative (riskier stocks provide lower returns), depending on the personality of the CEO.

Also, researchers have discovered that the personality of the CEO can have a meaningful impact on strategic change.[16] They found higher levels of strategic change in firms in which the CEO has a personality associated with openness (imagination and insight), which is another of the most important personality characteristics. The bottom line in these studies is that personal characteristics of the CEO, such as personality and leadership style, matter in terms of the firm's ability to carry out its strategies and achieve high returns.

In addition to personality, a top manager's leadership style is influenced by their personal ideology and experience.[17] Consider Aziz Hasan, former CEO of Kickstarter, a funding platform. In a letter to shareholders, Hasan explained that the company has made commitments to support social causes. To support equality, the ratio of his pay to the median pay of a Kickstarter employee is 2.8 to 1 (compared with 320 to 1 at a typical company). In another example, Kickstarter has encouraged users to detail their own environmental commitments in their project pages, and about half have done so.[18] With regard to experience, consider Amy Howe, who in 2021 was appointed chief executive of Flutter Entertainment PLC, a global gambling operator. She has an aggressive management style, and experience in modernizing and growing businesses. "At Ticketmaster, as global chief operating officer, Ms. Howe led a modernization of the company's ticket platform and grew its mobile app customer base by 400% according to a statement from Flutter."[19] This experience and her leadership style make Amy an excellent choice for leading an expansion of Flutter Entertainment.

Given that both Aziz Hassan and Amy Howe have such a strong influence on culture and employee perspectives in their respective companies, they may be considered transformational leaders. Transformational leadership is one of the most effective strategic leadership styles. It entails motivating followers to exceed the expectations others have of them, to strengthen their capabilities through continuous training, and to place the interests of the organization above their own.[20] This is certainly manifest in the relatively low salary of Aziz Hassan at Kickstarter. Transformational leaders develop and communicate an organizational vision and work with others to formulate and execute a strategy to achieve it.

Transformational leaders also have emotional intelligence. Emotionally intelligent leaders understand themselves well, have strong motivation, empathize with others, and have effective interpersonal skills.[21] These characteristics contribute to transformational leaders' efforts to promote and nurture innovation in firms.[22]

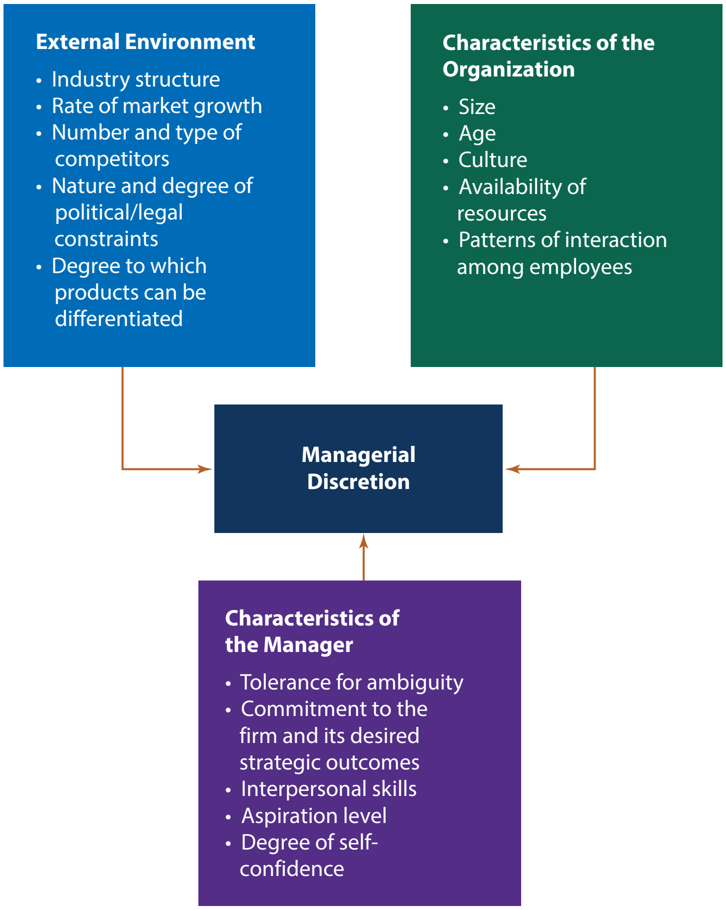
12-1c Top-Level Managers and Managerial Discretion

In their role, top-level managers make many decisions, such as the strategic actions and responses associated with their firm's competitive rivalries (see Chapter 5). When making decisions related to using the strategic management process, managers often use their discretion (or latitude for action).[23] "To understand the implications of strategic leadership for organizations and their stakeholders, it is necessary to first consider the extent to which corporate leaders can meaningfully influence firm strategy and, by extension, firm performance."[24]

Managerial discretion differs among managers leading firms in different industries. Because strategic leaders make decisions to help the firm outperform competitors, how they exercise discretion when making decisions is critical to the firm's success and influences its culture as well.[25] The primary factors that determine the amount of decision-making discretion a manager has (especially a top-level manager) are:

1. external environmental sources such as industry structure, the rate of market growth in the firm's primary industry, and the degree to which product differentiation is possible
2. organizational characteristics, including size, age, resources, governance, and culture
3. managerial characteristics, including commitment to the firm, tolerance for ambiguity, skills in working with different people, and aspiration levels (see Figure 12.2).

Figure 12.2 Factors Affecting Managerial Discretion



Source: Adapted from S. Finkelstein & D C. Hambrick, 1996, *Strategic Leadership: Top Executives and Their Effects on Organizations*, St. Paul, MN: West Publishing Company.

12-2 Top Management Teams and Performance

Learning Objective

12-2 Explain what top management teams are and how they affect firm performance.

Effectively guiding the firm through the strategic management process is both complex and challenging. Consequently, top management teams (TMTs), rather than a single top-level manager, are involved in this function.[26] "The interest in TMTs is due to the fact that it is not just the CEO, but also executives who report to the CEO who are responsible for the strategic and operational decisions that ultimately determine firm outcomes."[27] A **top management team (TMT)** is composed of the individuals responsible for making certain the firm uses the strategic management process, especially to select and implement strategies. Typically, the top management team includes the officers of the corporation, defined by the title of vice president and above or by service as a member of the board of directors. Among other outcomes, the quality of a top management team's decisions affects the firm's ability to innovate and change in ways that help its efforts to earn above-average returns.[28]

A **top management team (TMT)** is composed of the individuals responsible for making certain the firm uses the strategic management process, especially to select and implement strategies.

12-2a Power Dynamics at the Top of the Organization

Although the complex challenges facing most organizations require the exercise of strategic leadership by a team of executives rather than by a single individual, using a team to make decisions about how the firm will compete also helps to avoid another potential problem when CEOs make decisions in isolation: managerial hubris.[29] Research shows that when CEOs begin to believe glowing press accounts and to feel that they are unlikely to make errors, the quality of their decisions suffers.[30] Top-level managers should be self-confident, but they must not allow that to become arrogance, possibly leading to a false belief in their own invincibility.[31] An effective TMT can help guard against CEO hubris and the making of poor decisions. However, some TMTs do not function well. For example, they may not meet very often (or not at all) or they may be highly fragmented.[32] In this sense, they are not a team at all, but a group of disconnected high-level managers that perform specific functions within the firm.

Of course, the board of directors also performs an important function in limiting the discretion of the CEO and overcoming the potential for hubris. However, the power dynamic between CEOs and boards can be very different from one firm to another. Often the CEO has nominated several of the directors to the board, and they may be close friends or business partners. In other cases, an individual holds both the CEO position and chairs the board, a situation called *CEO duality*.[33] As mentioned in Chapter 10, a CEO who also chairs the board is going to have even more power than a CEO who does not. This situation can, but doesn't always, create agency problems.[34] A CEO who desires to be the best possible steward of the firm's assets gains efficiency through CEO duality.[35] In addition, because of this person's positive orientation and actions, extra governance and the coordination costs resulting from an independent board leadership structure become less necessary.[36]

In the optimal situation, the TMT and board of directors provide wise advice to the CEO that leads to good strategic decisions, and they also prevent the CEO from making unwise decisions that are likely to harm stakeholder value and lead to below-average returns. In suboptimal situations, the CEO has too much discretion regarding strategic decisions *and* exercises this discretion to the detriment of the firm and its stakeholders. The "and" is important here, because many (or perhaps most) CEOs act in the interests of shareholders and other stakeholders even when their base of power would allow them to do otherwise.[37]

12-2b Characteristics of Top Management Teams, Firm Performance, and Strategic Change

The job of top-level managers is complex and requires a broad knowledge of the firm's internal organization (see Chapter 3) as well as the three key parts of its external environment—the general, industry, and competitor environments (see Chapter 2). Therefore, firms try to form a top management team with the knowledge and expertise needed to operate the internal organization and deal with the firm's stakeholders as well as its competitors.[38] Organizing a team with different types of expertise and knowledge bases typically creates a heterogeneous top management team. More specifically, a **heterogeneous top management team** is composed of individuals with different functional backgrounds, experience, and education. Based on a large-scale study, McKinsey & Co. consultants "found that companies with diverse executive teams posted bigger profit margins than their rivals, compared with companies with relatively little diversity in their upper echelons."[39]

A **heterogeneous top management team** is composed of individuals with different functional backgrounds, experience, and education.

Increasingly, having international experience is a critical aspect of the heterogeneity that is desirable in top management teams, given the globalized nature of the markets in which most firms now compete.[40] If TMT members possess knowledge and experience regarding the local circumstances and social networks found in countries in which the firm operates, the firm then has an enhanced ability to allocate resources and develop high-performing strategies to compete in those markets. TMT international diversity can also lead to better firm-wide coordination and integration of knowledge. Research has demonstrated that international work experience is likely to bring these benefits to a multinational firm.[41]

Members of a heterogeneous TMT benefit from discussing their different perspectives. In many cases, these discussions, and the debates they engender, increase the quality of the team's decisions, especially when a synthesis emerges within the team after evaluating different perspectives. In effect, TMT members learn from each other and thereby develop better decisions.[42] In turn, higher-quality decisions lead to stronger firm performance.[43]

Interestingly though, the more heterogeneous and larger the TMT, the more difficult it is for the team to cohesively implement strategies.[44] Communication difficulties within larger top management teams account for some of this difficulty. Basically, the diversity of perspectives associated with making better decisions can actually hinder their execution. Overall, then, a group of top executives with diverse backgrounds could inhibit effective decision-making processes associated with implementation if the team lacks the ability to manage itself effectively. However, effective management of a TMT can help to overcome these issues. For example, a designated project manager can play a vital role as a communicator in helping the CEO and TMT resolve issues as a strategy is implemented.[45]

Having members with substantial expertise in the firm's core businesses is also important to a top management team's effectiveness.[46] In a high-technology industry, for example, it may be critical for top management team members to have R&D expertise, particularly when firms seek to grow. In the final analysis, the top management team's effect on decisions it makes depends on its expertise and how it manages the team as well as the context in which the team makes decisions (the governance structure, incentive compensation, etc.).[47]

The characteristics of TMT members, and even the personalities of the CEO and other team members, have a relationship with innovation and strategic change.[48] For example, decisions reached by more heterogeneous top management teams have a positive relationship with innovation and strategic change, perhaps in part because heterogeneity may influence the team, or at least some of its members, to think more creatively when making decisions and taking actions.[49] Supporting these expectations are results from a recent Boston Consulting Group study, where the researchers found that "increasing the diversity of leadership teams leads to more and better innovation and improved financial performance" in firms competing in both developed and emerging economies.[50] In another study, TMT heterogeneity and participative decision-making was found to be associated with a higher level of management innovation.[51]

Gender diversity in the TMT is also important to innovation and change. Researchers found that after female TMT appointments, firms became more change oriented. In particular, firms were less likely to engage in mergers and acquisitions, and they increased their research and development expenditures. This reflects more of a "building" rather than "buying" approach to strategic change.[52] Also, research has found that the presence of women on TMTs and in other top echelon positions is associated with "greater engagement in social and environmental projects. Their presence also positively influences the environmental and social performance and increases the level, quality, and transparency of sustainability disclosure. Furthermore, the presence of women in top echelon positions and the implementation of sustainable activities improve both the firm financial performance and value."[53]

Strategic change is also influenced by whether a CEO is selected from within or outside the firm and its industry. Specifically, evidence suggests that, compared to selecting a CEO from within the firm or from within the firm's industry, hiring a CEO from outside the firm and its industry increases the probability strategic change will take place.[54] On the other hand, although hiring a new CEO from outside the industry adds diversity to the top management team, such a change can affect the firm's relationships with important stakeholders, especially customers and employees.[55] Astute managers recognize any changes of this nature and deal with them in ways that demonstrate how additional heterogeneity among the team benefits stakeholders.

12-3 Managerial Succession

Learning Objective

12-3 Describe the managerial succession process using internal and external managerial labor markets.

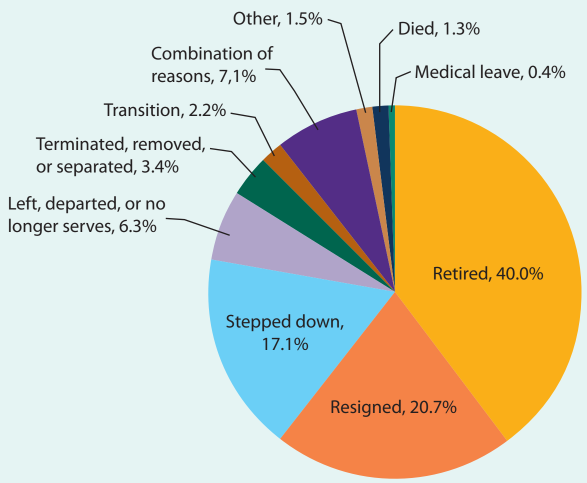
The choice of top-level managers—particularly CEOs—is a critical decision with important implications for the firm's performance.[56] "CEO succession, in which an incumbent chief executive officer (CEO) is replaced by a successor CEO, is perhaps one of the most crucial events in the life of a firm because of the substantive and symbolic importance of the CEO position."[57] Consequently, selecting the CEO has been and remains one of the most important responsibilities for a board of directors as it seeks to represent the firm's stakeholders.[58] As demonstrated in the Strategic Focus, boards also have the responsibility to dismiss a CEO when needed.

Strategic **Focus**

Voluntary and Involuntary CEO Turnover

Sometimes CEOs just don't work out, or even if they do for a while, their performance may falter over time as conditions in the environment or industry change. Research has confirmed that dismissal of the CEO is more likely when the firm is performing poorly or when analysts downgrade the value of the stock. CEO dismissal is also more common when a CEO has been involved in financial or some other type of misconduct. In addition, a CEO who seems to be overpaid or has received negative media attention is more likely to be terminated.

"Leadership transitions are the single most destabilizing moment in an organization's life, especially when they happen as a result of termination." Leadership transition periods are also a time when rivals can take advantage of the situation because they are fully functional and the company engaged in the transition is unlikely to react. For example, rivals may use the time to launch a new sales initiative or increase their merger and acquisition activity. Consequently, boards of directors use caution before making a decision as severe as terminating a CEO. Nonetheless, it does happen.



Stated Reason for CEO Departures

In one interesting case in 2022, the board of directors of Alaska's largest electric utility, Chugach Electric Association, fired a newly appointed CEO less than a month after appointing him. Hal Halpern, the new CEO, believes he was fired due to his age of 62, and his lawyer intends to sue the company based on age discrimination. However, the company denies this charge and calls it a "for cause" termination. This sort of termination would be for things like a failure to perform executive duties, failure to comply with directives from the board of directors, or "criminal, unethical or inappropriate behavior." Halpern's lawyer said, "They claimed that he embellished certain information in his background. It's not true at all."

In another case in 2022, Anthony Slonim, CEO of Renown Health, was also fired for cause. "Allegations range from sexual harassment, unethical behavior by top executives, financial mismanagement and an organizational culture rife with dysfunction and employee mistreatment." Employees were reported as saying that Slonim "was not a good guy to work with." Others spoke of his narcissism and lack of community values. They said the termination of Slonim by the board was "a strong move—because the issues at the hospital have been brewing for a long time under Slonim."

Of course, a high-performing CEO may leave voluntarily due to retirement or to take a different job. In addition, there are also situations when a low-performing CEO leaves voluntarily, such as when a founder CEO is no longer performing at a level that satisfies the board and stockholders. They may feel the need to leave the CEO job to someone else in in these situations, in the interest of the firm and its stakeholders. Researchers have discovered that a founder CEO is more likely to voluntarily leave the CEO position if they are only one of multiple cofounders or if they had prior entrepreneurial experience before founding the company in which they are serving. Alternatively, if the firm was private for a long time before its initial public offering, they are less likely to leave voluntarily because their own personal identity becomes inseparable with the firm they founded.

Sources: C. Grove, 2022, Alaska's biggest electric utility fires new CEO less than a month after hiring him, *Alaska Public Media*, www.alaskapublic.org, May 6; B. Conrad, 2022, Damning allegations emerge in the wake of renown CEO's firing, *This is Reno*, www.thisisreno.com, March 11; J. Garry, 2022, Our CEO was fired and the board has taken over, *Joan Garry Consulting*, www.blog.joangarry.com, May 11; C. H. Burchard, J. Proelss, U. Schäffer, & D. Schweizer, 2021, Bad news for announcers, good news for rivals: Are rivals fully seizing transition-period opportunities following announcers' top management turnovers? *Strategic Management Journal*, 42: 579–607; Y. Zhang, 2021, CEO succession, in I. M. Duhaime, M. A. Hitt, & M. A. Lyles (eds.), *Strategic Management: State of the Field and Its Future*, New York, Oxford University Press: 369; R. J. Gentry, J. S. Harrison, T. J. Quigley, & S. Boivie, 2021, A database of CEO turnover and dismissal in S&P 1500 firms, 2000–2018, *Strategic Management Journal*, 42: 968-991; J. M. Lee, D. Yoon, & S. Boivie, 2020, Founder CEO succession: The role of CEO organizational identification, *Academy of Management Journal*, 63: 224–245.

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Managers participating in a leadership training program.

In addition to the board, the current CEO also has a lot of responsibility in the succession process (assuming the CEO was not terminated involuntarily). Success in this process is dependent, in part, on the commitment of the current CEO "to developing the next generation of company leadership" and "the CEO's degree of need to control the succession process and outcomes."[59] These characteristics influence the nature of the succession—for example, where the successor comes from and how they are prepared to lead.

12-3a Internal and External Labor Markets

Organizations select leaders—including CEOs and other managers–from two types of managerial labor markets—internal and external.[60] An **internal managerial labor market** consists of a firm's opportunities for managerial positions and the qualified employees within it.[61] An **external managerial labor market** is the collection of managerial career opportunities and the qualified people who are external to the organization in which the opportunities exist.[62]

An **internal managerial labor market** consists of a firm's opportunities for managerial positions and the qualified employees within it.

An **external managerial labor market** is the collection of managerial career opportunities and the qualified people who are external to the organization in which the opportunities exist.

Employees commonly prefer that firms use the internal managerial labor market for selection purposes, particularly when choosing a CEO and top management team members. Evidence suggests that firms commonly follow these preferences—the vast majority of CEOs are selected from the internal labor market.[63] From the employee and lower-level manager perspectives, this policy gives them hope that, through diligent effort, they too can be promoted to high-level management positions, and possibly even become the CEO.

With respect to the CEO position, some believe that several benefits accrue to those using the internal labor market to select a new CEO, one of which is the continuing commitment to the firm's existing vision, mission, and strategies. In addition, because of their experience with the firm and the industry in which it competes, inside CEOs are familiar with company products, markets, technologies, and operating procedures. Another benefit is that choosing a new CEO from within usually results in lower turnover among existing personnel, many of whom possess valuable firm-specific knowledge and skills. In summary, CEOs selected from inside the firm tend to benefit from their:

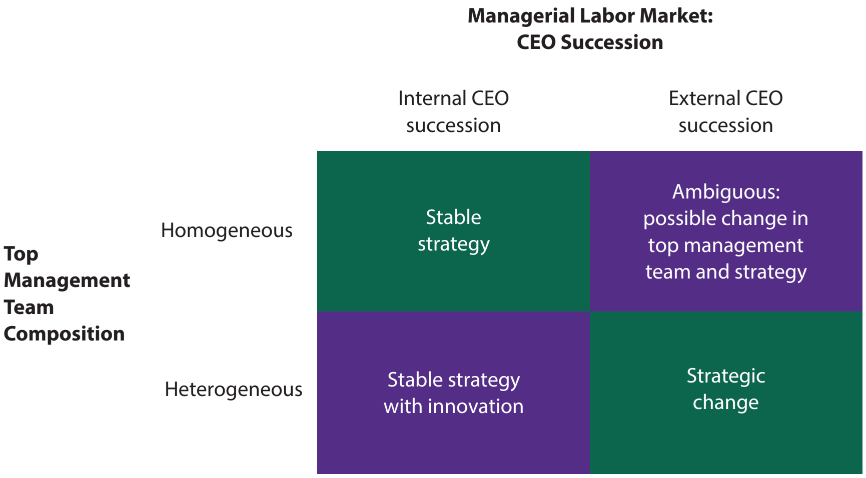
1. clear understanding of the firm's personnel and their capabilities
2. appreciation of the company's culture and its associated core values
3. deep knowledge of the firm's core competencies as well as abilities to develop new ones as appropriate
4. "feel" for what will and will not "work" in the firm.[64]

Despite the understandable and legitimate reasons to select CEOs from inside the firm, boards of directors sometimes prefer to choose a new CEO from the external managerial labor market. Broadly, conditions suggesting a potentially appropriate preference to hire from outside include:

1. the firm's need to enhance its ability to innovate
2. the firm's need to reverse its recent poor performance
3. the fact that the industry in which the firm competes is experiencing rapid growth
4. the need for strategic change.[65]

Overall, the decision to use either the internal or the external managerial labor market to select a firm's new CEO is one that should be based on expectations; in other words, what does the board of directors want the new CEO and top management team to accomplish? We address this issue in Figure 12.3 by showing how the composition of the top management team and the CEO succession source (managerial labor market) interact to affect strategy. For example, when the top management team is homogeneous (its members have similar functional experiences and educational backgrounds) and the new CEO comes from the internal managerial labor market, the firm's current strategy is unlikely to change. If the firm is performing well, absolutely and relative to peers, continuing to implement the current strategy may be precisely what the board of directors wants.

Figure 12.3 Effects of CEO Succession and Top Management Team Composition on Strategy



Alternatively, when a new CEO comes from outside the firm and the top management team is heterogeneous, the probability is high that strategy will change. This, of course, would be a board's preference when the firm's performance is declining, both in absolute terms and relative to rivals. When the new CEO is from inside the firm and a heterogeneous top management team is in place, the strategy may not change, but innovation is likely to continue. An external CEO succession with a homogeneous team creates a more ambiguous situation. Furthermore, outside CEOs who lead moderate change often achieve increases in performance, but high strategic change by outsiders frequently leads to performance declines.[66] In summary, a firm's board of directors should use the insights reflected in Figure 12.3 to inform its decision about which of the two managerial labor markets to use to select a new CEO.

12-3b Succession Management and Executive Training

Succession management is equally important in corporations, government agencies, and family-owned firms. Speaking to the issue of succession planning in governmental agencies, Deloitte consultants note that, based on their research, governmental agencies "with well-defined succession management practices realize significant employee engagement and retention gains, due to transparency in career paths and development opportunities, as well as more preparation time for leadership roles."[67]

In family firms, CEO succession requires discussion early in a family member's career, according to J. W. Marriott, chair of the Marriott International board of directors. Working with others, Marriott chose a strategic leader from the external managerial labor market (rather than selecting a family member from the internal managerial labor market) to succeed him as CEO of Marriott International. Marriott indicated that the choice of the firm's new CEO was in the company's best interests—the criterion that must, he believes, drive the successor decision.[68]

Many companies use leadership-screening systems to identify individuals with strategic leadership potential as well as to determine the criteria individuals should satisfy to be a candidate for the CEO position. The most effective of these screening systems assesses people within the firm and produces valuable information about the capabilities of other companies' strategic leaders.[69] Based on the results of these assessments, firms may place certain individuals into training and development programs as a means of shaping their potential as strategic leaders. Several firms have high-quality leadership programs in place, including Procter & Gamble (P&G), IBM, and Dow Chemical. Despite the value high-quality leadership training programs can create, many companies do not have training and succession plans in place for their top-level managers or for others holding key leadership positions (e.g., department heads, sections heads).[70]

In companies throughout the world, an interim CEO is commonly appointed when a firm lacks a succession plan or when an emergency occurs requiring an immediate appointment of a new CEO.[71] In most cases, interim CEOs come from inside the firm. Their familiarity with the company's operations supports their efforts to "maintain order" as the firm searches for a permanent CEO. Indeed, a primary advantage of appointing an interim CEO is that doing so can generate the amount of time the board of directors requires to conduct a thorough search to find the best candidate from the external and internal markets.

Next, we discuss key actions that effective strategic leaders demonstrate while helping their firm use the strategic management process.

Learning Objective

12-4 Discuss the value of strategic leadership in determining the firm's strategic direction.

12-4 Key Strategic Leadership Actions

Certain actions characterize effective strategic leadership; we present the most important ones in Figure 12.4. Many of the actions interact with each other. For example, managing the firm's resources effectively includes developing human capital and contributes to establishing a strategic direction, fostering an effective culture, exploiting core competencies, using effective and balanced organizational control systems, and establishing ethical practices. The most effective strategic leaders create viable options in making decisions regarding each of the key strategic leadership actions.[72]

12-4a Determining Strategic Direction

Determining strategic direction involves specifying the vision and the strategy to achieve the vision.

Determining strategic direction involves specifying the vision and the strategy to achieve the vision.[73] The opportunities and threats strategic leaders believe their firm will encounter while competing against rivals influence the framing of the strategic direction.[74] Increasingly, firms' strategic leaders are challenged to include societal contributions as part of the vision and strategy as a foundation for receiving financial investments from investors.[75]

The ideal long-term strategic direction has two parts: a core ideology and an envisioned future. The core ideology motivates employees through the company's heritage while the envisioned future encourages them to stretch beyond their expectations of accomplishment.[76] The envisioned future serves as a guide to many aspects of a firm's strategy implementation process, including motivation, leadership, employee empowerment, and organizational design. The strategic direction could include a host of actions such as entering new international markets and or developing a new orientation regarding artificial intelligence.[77] At Procter & Gamble, top executives envisioned a company that would shed its slow-paced, cautious approach to innovation in favor of a leaner, entrepreneurial model in which the company would be willing to take more risks in the hope of higher returns.[78]

Sometimes strategic leaders fail to select a strategy that helps a firm achieve its strategic direction. This outcome can happen when top management team members and the CEO are too committed to the status quo.[79] In this case, a firm's strategic direction remains relatively stable across time, even if changes in the environment would suggest that change is needed. An aversion to what decision makers perceive as risky actions creates an inability to adjust strategies as appropriate to deal with these changes. An aversion to risky actions tends to be common in firms that have performed well across time and firms with long-serving CEOs.[80]

Figure 12.4 Exercise of Effective Strategic Leadership

Research also suggests that some CEOs are erratic or even ambivalent when choosing their firm's strategic direction. This is particularly the case when a firm faces a turbulent competitive environment, making it difficult to identify the best strategy.[81] Of course, these erratic or ambivalent behaviors are unlikely to produce high performance and may lead to CEO turnover. Interestingly, research has found that incentive compensation in the form of stock options encourages talented executives to select strategies that contribute to strong firm performance. However, the same incentives used with less talented executives produce lower performance.[82]

Of course, not all CEOs are risk averse.[83] Indeed, there is evidence that risk takers become CEOs much faster than executives that are risk averse—an average of 14 years from first job to CEO for risk takers compared to 24 years for the risk averse.[84] This would suggest that there are more CEOs with a propensity to take risk than those who have an aversion to risk. Nonetheless, even when being guided by a risk-taking CEO, it is important for the firm not to lose sight of its strengths and weaknesses when making changes required by a new strategic direction.

Finally, being ambicultural can facilitate efforts to determine the firm's strategic direction and to choose and implement strategies to reach it. This means strategic leaders are committed to identifying the best organizational actions to take, particularly when implementing strategies, regardless of their cultural origin.[85] Ambicultural actions help the firm succeed in the short term as a foundation for reaching its vision in the longer term.

12-5 Effectively Managing the Firm's Resource Portfolio

Learning Objective

12-5 Describe the importance of strategic leaders in managing the firm's resources.

Effectively managing the firm's portfolio of resources is another critical strategic leadership action. In Chapter 3, we provided examples of some of a firm's tangible (i.e., financial, physical) and intangible (i.e., human, reputational) resources that influence competitiveness. Although a CEO or even a TMT cannot manage all the resources in a firm, they are still tasked with ensuring that the firm's resources are sufficient to sustain a competitive advantage and earn above-average returns. At the strategic leadership level, it is helpful to talk of these resources as a form of capital, in that they are assets owned by a company that can be utilized in the implementation of its strategies. The categories of capital that are most relevant to strategic leadership are financial capital, human capital, social capital, and organizational capital.

Effective management of these four types of capital leads to the development of core competencies. Examined in Chapters 1 and 3, core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals.[86] Typically, core competencies relate to skills within organizational functions, such as manufacturing, finance, marketing, and research and development.[87] Strategic leaders must verify that employees understand the firm's core competencies when selecting strategies and also ensure that the competencies are central to strategy implementation efforts. This suggests, for example, that with respect to their strategies, Apple emphasizes its design competence, while Netflix recognizes and concentrates on its competence of being able to deliver physical, digital, and original content.[88]

Firms develop core competencies over time as they learn from the results of the competitive actions and responses taken while competing against their rivals. Using what they have learned, firms continuously reshape their capabilities to verify that they are, indeed, the path through which core competencies are being developed and used to establish one or more competitive advantages.

Managing Financial Capital

Financial capital refers to all the financial assets a firm possesses. Clearly, financial capital is critical to organizational success; strategic leaders in both established and smaller entrepreneurial ventures understand this reality.[89] For example, research has demonstrated the importance of working capital management and having adequate working capital in generating high firm performance.[90] Ordinarily, oversight of working capital management in a firm would be the responsibility of a high-level executive with a title such as vice president of finance, under the direction of the CEO. However, ensuring that the firm has adequate capitalization to carry out its strategies and achieve its objectives is the responsibility of the CEO, the finance executive, and the board of directors. They should work cooperatively to determine targets for debt the

Financial capital refers to all the financial assets a firm possesses.

firm carries relative to its equity and assets, as well as its optimal level of liquidity (including the amount of cash and marketable securities the firm needs to keep available to cover its obligations even in the event of something unforeseen happening). If long-term financing is needed, this group determines whether it will be obtained through new debt (e.g., bank loans or a bond issue), a stock issue, or a sale of assets.

Although effective financial capital management is important, the most effective strategic leaders recognize the equivalent importance of managing each remaining type of capital (e.g., human, social, organizational), as well as managing the integration of resources (e.g., using financial capital to provide training opportunities for the firm's human capital). Most importantly, effective strategic leaders manage the firm's resource portfolio in ways that increase the likelihood of strong performance. To do this, they organize available resources into capabilities, structure the firm to facilitate using those capabilities, and choose strategies to leverage the capabilities to create value for customers.

Developing and Maintaining Human Capital

Human capital refers to the knowledge and skills of a firm's entire workforce.

Human capital refers to the knowledge and skills of a firm's entire workforce. From the perspective of human capital, firms should view employees as a capital resource requiring continuous investment.[91] In Chapter 3, we introduced the concept of *strategic human capital*, which allows a firm to develop capabilities through matching the knowledge, skills, and abilities of their employees to particular strategic objectives. Part of developing human capital also includes bringing talented human capital into the firm and then developing that capital to yield positive outcomes.

This reality suggests that people and the manner in which they are managed are highly significant sources of competitive advantage for firms, especially those competing in turbulent and fast-changing environments.[92] As a support function on which firms rely to create value, human resource management practices have the capacity to facilitate selecting and especially implementing the firm's strategies.[93] For example, high-performance work systems provide a foundation for developing organizational capabilities associated with innovation.[94]

Effective training and development programs increase the probability that some of the firm's human capital will become effective strategic leaders. Increasingly, the link between effective programs and firm success is becoming stronger because the knowledge gained by participating in these programs is integral to forming and then sustaining a firm's competitive advantage.[95] In addition to building human capital's knowledge and skills, these programs inculcate a common set of core values and present a systematic view of the organization, thus promoting its vision and helping form an effective organizational culture. Also, the programs help strategic leaders improve skills that are critical to completing other tasks associated with effective strategic leadership, such as determining the firm's strategic direction, exploiting, and maintaining the firm's core competencies, and developing an organizational culture that supports ethical practices. Thus, building human capital is vital to effective strategic leadership practices.

When facing challenging conditions, firms may decide to lay off some of their human capital, a decision that can result in a significant loss of knowledge and skill. Research shows that moderate-sized layoffs may improve firm performance primarily in the short run, but large layoffs result in stronger performance downturns in firm performance because of the loss of human capital.[96] Viewing employees as a resource to maximize rather than as a cost to minimize facilitates successful implementation of a firm's strategies, as does the strategic leader's ability to approach layoffs in a manner that employees believe is fair and equitable, especially compared to the treatment of their peers.[97]

Developing Social Capital

Social capital involves relationships inside and outside the firm that help in efforts to complete tasks that create value for stakeholders.

In Chapter 3, we said that when firms have strong positive relationships with stakeholders, they are said to have social capital.[98] **Social capital** involves relationships inside and outside the firm that help in efforts to complete tasks that create value for stakeholders.[99] The relationships themselves have value because they lead to transfers of knowledge as well as to access to resources that a firm may not hold internally.[100] Social capital is a critical asset given that employees must cooperate with one another and others outside the firm, such as suppliers and customers, to complete their work. In fact, research indicates that social capital has a positive effect on a firm's operating performance.[101] In multinational organizations, employees often must cooperate across country boundaries on activities such as R&D or marketing to achieve performance objectives.[102]

External social capital is increasingly critical to firm success in that few if any companies possess all the resources needed to compete successfully against their rivals. When using cooperative strategies, such as strategic alliances (see Chapter 9), firms may develop social capital by sharing complementary resources.[103] Transparency between firms regarding the specifics of how they will share resources creates trust and further encourages additional sharing of resources.[104] Social capital created this way yields many benefits. For example, firms with strong social capital can be more ambidextrous; that is, they can develop or have access to multiple capabilities, providing them with the flexibility to take advantage of opportunities and to respond to threats.[105]

Organizations' experiences and research evidence suggest that the success of many types of firms may partially depend on social capital. Large multinational firms, for example, often must establish alliances so they can enter new foreign markets, while entrepreneurial firms often must establish alliances to gain access to resources, venture capital, or other types of resources (e.g., special expertise that the entrepreneurial firm cannot afford to maintain in-house).[106]

Protecting Organizational Capital

Organizational capital refers to intangible resources the firm possesses that distinguish it from other firms and thus provide the potential to lead to a sustainable competitive advantage. Examples include the firm's reputation, name, trademarks, brands, patents, and culture. Sustaining an effective organizational culture is so important that it will be discussed as a separate category of a strategic leader's actions. This section will focus primarily on firm reputation, which is inseparably connected to the value of its name, brands, and trademarks.

Organizational capital refers to intangible resources the firm possesses that distinguish it from other firms and thus provide the potential to lead to a sustainable competitive advantage.

Firms gain strong reputations if they produce products and services that are perceived as a good value because they are of the highest quality and best features (e.g., differentiation), they provide a great value to customers relative to how much they cost (e.g., cost leadership), they combine these two approaches (e.g., integrated cost leadership/differentiation), or they are custom tailored to a specific customer group (e.g., focus). The key is not the type of strategy they are pursuing, but that they implement it especially well. Once established, a firm's reputation can be tarnished through a variety of different types of violations. For example, a firm may do something that violates stakeholder expectations, demonstrates inconsistency in its performance, demonstrates a lack of trustworthiness, or violates the law. How a firm responds to such violations can also have a large impact on its reputation.[107]

The CEO has a lot of responsibility for increasing the value of a firm's reputation as well as protecting that value.[108] Allocating resources to critical areas to protect the perceived quality of a brand, overseeing managers and ensuring that they act with integrity, ensuring that financial reporting is done properly, and communicating effectively with stakeholders are all important in this role. The perceived integrity of the CEO also has a big influence on the reputation of the firm.[109] CEOs can enhance and protect their reputations by being who they say they are, treating others with respect, balancing transparency with discretion, and building bridges that unify stakeholders.[110]

In Chapter 2, we discussed the increasing importance of corporate social responsibility (CSR) and sustainability (ESG). Reporting on social performance and initiatives has become important in determining a firm's reputation to stakeholders. As we mentioned in Chapter 10, activist shareholders often insist that firms increase their social performance. The TMT, and especially the CEO, have responsibility for making sure that the firm's policies, actions, and reporting present an image of the company as a responsible citizen.

Brand names are closely associated with a firm's reputation.[111] Indeed, the brand name of a company's products is often the same as the name of the company, which means that the reputation of the brand and the company are essentially the same in the minds of consumers. For example, Apple sells its products under the Apple brand name. According to an annual rating of the most valuable brands in the world, in 2022, the Apple brand was at the top, with an estimated value of $355 billion. Amazon and Google closely follow Apple. TikTok was deemed the fastest-growing brand. The United States and China hold two thirds of the brand value in the world, while the value of India's brand is growing.[112]

12-6 Sustaining an Effective Organizational Culture

Learning Objective

12-6 Explain what a firm does to sustain an effective culture.

In Chapter 1, we defined *organizational culture* as the complex set of ideologies, symbols, and core values that individuals and groups share throughout the firm and that influence how the firm conducts business. Because organizational culture influences how the firm conducts its business and helps to regulate and control employees' behavior, and because every organizational culture is unique, it can be a source of competitive advantage.[113] Bain & Company consultants suggest that "company culture is at the heart of competitive advantage, because it determines how things are done and how people behave."[114] Because it is hard (or maybe impossible) to imitate, it is also possible for a competitive advantage associated with an organizational culture to be sustainable.

Strategic leaders recognize the important relationship among organizational culture, employees' actions, and firm performance. They also know that the type of culture that leads to positive outcomes requires time and effort to build. Indeed, leaders must work diligently, consistently, and with patience to build an effective organizational culture. Research supports leaders' beliefs about culture's importance and its relationship with strategy.[115] Among other benefits, a strong culture informs employees how leaders want them to respond to situations that may develop, gives employees confidence that the responses they initiate will be the correct ones, and assures employees that they will be recognized and rewarded for acting in manners that demonstrate the firm's values as embedded in its culture. Thus, there is a strong link between leaders and the actions they take and the nature of a firm's culture.[116]

Building and supporting an effective culture yields multiple specific benefits for an organization. For example, culture can increase employee loyalty, help a firm attract talented individuals, reflect a firm's identity in that it demonstrates both how the company views itself and how it would like to be viewed by stakeholders, and create intrinsic motivation for employee behavior. Overall, developing and sustaining an effective organizational culture is indeed a key strategic leadership action.

Especially in large organizations, an organizational culture often encourages (or discourages) strategic leaders and those with whom they work to pursue (or not pursue) entrepreneurial opportunities. (We define and discuss entrepreneurial opportunities and an entrepreneurial mind-set in Chapter 13.) This is the case in both for-profit and not-for-profit organizations.[117] This issue is important because entrepreneurial opportunities are a vital source of growth and innovation.[118] Therefore, a key action for strategic leaders to take is to encourage and promote innovation by pursuing entrepreneurial opportunities.

Investing in opportunities as real options is one way of encouraging innovation. Investing in real options finds a firm investing in an opportunity now to provide the potential option of taking advantage of the opportunity at a point in the future.[119] For example, a firm might buy a piece of land to have the option to build on it at some time in the future should the company need more space and should that location increase in value to the company. Firms might enter strategic alliances for similar reasons. In this instance, a firm might form an alliance to have the option of acquiring the partner later or of building a stronger relationship with it (e.g., developing a new joint venture).[120]

Changing the Organizational Culture and Restructuring

Changing a firm's organizational culture is more difficult than maintaining it; however, effective strategic leaders recognize the need for cultural change. Commonly, firms make incremental changes to their culture when implementing strategies. More significant and sometimes even radical changes to organizational culture support selecting strategies that differ from those the firm has implemented historically. Regardless of the reasons for change, shaping and reinforcing a new culture requires effective problem solving and communication practices. In addition, selecting the right people (those who have the values the organization desires), engaging in effective performance appraisals (establishing goals that support the new core values and measuring individuals' progress toward reaching them), and using appropriate reward systems (rewarding the desired behaviors that reflect the new core values) also facilitate the forming and shaping of organizational culture.[121]

Evidence suggests that cultural changes succeed only when the firm's CEO, other key top management team members, and middle-level managers actively support them.[122] Some believe that middle-level managers "are essential in a change process" and that employees become more committed to supporting change when middle-level managers are involved actively with those changes.[123] For cultural change to occur, middle-level managers in particular need to be highly disciplined to energize the culture and foster alignment with the firm's vision and mission.[124] In addition, managers working at all organizational levels must be sensitive to the effects of other changes to the firm's culture. For example, downsizings can have a negative effect on organizational culture, especially if firms fail to implement them in accordance with the dominant organizational values.[125]

12-7 Emphasizing Ethical Practices

Learning Objective

12-7 Describe what strategic leaders can do to establish and emphasize the need for everyone to demonstrate ethical practices in their firms.

When based on ethical practices, the effectiveness of processes used to implement the firm's strategies increases. Ethical companies encourage and enable people at all levels to act ethically when taking actions to implement strategies. In turn, ethical practices and the judgment informing their development and use create social capital in organizations. Social capital increases the amount of goodwill that is available to organization individuals and groups. Alternatively, over time, if unethical practices begin to emerge in an organization, some managers may begin to accept them as normal business practices.[126] Once unethical practices become acceptable, individuals are more likely to engage in them to meet their goals when other efforts to meet them are insufficient.[127]

To influence employees' judgment and behavior properly, ethical practices must shape the firm's decision-making process and be an integral part of organizational culture. In fact, a values-based culture is the most effective means of ensuring that employees comply with the firm's ethical standards. In Chapter 1, we mentioned that a firm's values define what should matter most to managers and employees when they make and implement strategic decisions—they are a practical application of business ethics. Developing a values-based culture requires constant nurturing and support, rewards systems that are based on the firm's values, and behavior on the part of managers that is consistent with the values.[128] Also, strategic leaders, as well as others in the organization, are most likely to integrate ethical values into their decisions when the company has an explicit code of ethics, when extensive ethics training results in integration of the codes into how the firm conducts business, and when stakeholders expect ethical behavior.[129] Thus, establishing, communicating, and enforcing a meaningful code of ethics is an important way to encourage ethical decision making and actions when using the strategic management process.

Lockheed Martin is a global aerospace and security company with 114,000 employees worldwide.[130] Consistent with the requirements of its business environment (security and government contracting), the company has a strong ethical culture based on core values: "Lockheed Martin's success depends on our commitment to integrity. Our core values—Do What's Right, Respect Others and Perform with Excellence—are fundamental to who we are and what we do. At Lockheed Martin, we believe that doing what's right is more than just obeying laws and regulations. It's holding ourselves to a higher standard, even when the law may not require us to do so."[131] The company has a code of ethics and business conduct, ethics officers in every major location around the world, and holds regular ethics training sessions. These resources provide strong signals regarding the expected behavior of all Lockheed Martin employees, as well as the external stakeholders with whom the company does business.

12-8 Establishing Balanced Organizational Controls

Learning Objective

12-8 Discuss the importance of balanced organizational controls.

Organizational controls are an important part of the strategic management process—particularly the parts related to implementation (see Figure 1.1). As explained in Chapter 11, controls are necessary to help ensure that firms achieve their desired outcomes. They help strategic leaders build credibility, demonstrate the value of strategies to the firm's stakeholders, and promote and support strategic change. Most critically, controls provide the parameters for implementing strategies as well as letting strategic leaders know when implementation-related adjustments are required.

In this chapter, we focus on two organizational controls—strategic and financial—that we introduced in Chapter 11. Strategic leaders are responsible for helping the firm develop and properly use these two types of controls. As we explained in Chapter 11, financial control focuses on short-term financial outcomes while strategic control focuses on the *content* of strategic actions rather than their *outcomes*. Some strategic actions can be correct but still result in poor financial outcomes because of external conditions, such as an economic recession, unexpected domestic or foreign government actions, or natural disasters that a firm's leaders do not control directly. Because of this, emphasizing financial controls often produces more short-term and risk-averse decisions. Alternatively, strategic control encourages lower-level managers to make decisions that incorporate moderate and acceptable levels of risk because leaders and managers throughout the firm share the responsibility for the outcomes of those decisions and actions resulting from them.

The **balanced scorecard** is a tool firms use to determine if they are achieving an appropriate balance when using strategic and financial controls as a means of positively influencing performance.

The challenge for strategic leaders is to balance the use of strategic and financial controls to support efforts to improve the firm's performance. The **balanced scorecard** is a tool firms use to determine if they are achieving an appropriate balance when using strategic and financial controls as a means of positively influencing performance.[132] This tool is most appropriate when evaluating business-level strategies; however, it is also useful when assessing other strategies that firms implement (e.g., corporate, international, and cooperative).

The underlying premise of the balanced scorecard is that firms jeopardize their future performance when they emphasize financial controls at the expense of strategic controls.[133] This occurs because financial controls provide feedback about outcomes achieved from past actions but fail to communicate the drivers of future performance. Thus, an overemphasis on financial controls may promote behavior that sacrifices the firm's long-term, value-creating potential for short-term performance gains. In effect, managers can make self-serving decisions when they focus on the short term. Research shows that decisions balancing short-term goals with long-term goals generally leads to higher performance.[134]

The balanced scorecard is a product of integrating four perspectives:

- *financial* (concerned with growth, profitability, and risk from the shareholders' perspective)
- *customer* (concerned with the amount of value customers perceive the firm's products created for them)
- *internal business processes* (concerned with the priorities for various business processes that create customer and shareholder satisfaction)
- *learning and growth* (concerned with the firm's efforts to create a climate that supports change, innovation, and growth)

Thus, using the balanced scorecard finds the firm seeking to understand how it responds to shareholders (financial perspective), how customers view it (customer perspective), what processes to emphasize to successfully use its competitive advantage (internal perspective), and what it can do to improve its performance by innovating and growing (learning and growth perspective).[135]

The four perspectives upon which a traditional balanced scorecard is based are merely recommendations regarding what is most important to strategic competitiveness. In Chapter 1, we introduced the stakeholder model of above-average returns. We also introduced the idea that primary stakeholders—suppliers, customers, employees, shareholders (financiers), and the communities in which a firm operates—are directly involved in value creation with the firm.[136] This idea was reinforced by a signed statement through an association called the *Business Roundtable,* declaring that the purpose of the corporation is to serve these same five stakeholder groups.[137] Especially in a social environment that is demanding responsible business behavior, adopting a stakeholder perspective regarding organizational control makes good sense.[138] Such an approach is also strategically advantageous because it leads to behavior on the part of stakeholders that helps the firm create more value than might otherwise be created.[139]

Figure 12.5 contains an example of a possible stakeholder-oriented balanced scorecard. It is based on some of the indicators that are important to regarding each of the five primary stakeholder groups. Notice that the financial perspective found in the original balanced scorecard is not omitted. Financial measures such as stock returns, sales growth, and risk are very important to shareholders, so they are included in the example criteria for shareholders.

The example criteria include two types of information—what stakeholders are getting from the firm and what they are giving to the firm. For example, employee wages and benefits are associated with what employees get from a firm, whereas productivity measures are an indication of what they are giving to the firm (i.e., their levels of motivation, skill levels, etc.). Both types of information are useful, and frequently, they are related. For example, if firm productivity is low or declining, perhaps employees feel unhappy with their compensation. On the other hand, if productivity is low and wages are high (or comparable to what employees get in peer firms), then strategic leaders should investigate what else might be driving the low productivity. Both types of information can help a firm figure out what can be done to create more value in the organization's value-creating system, thus leading to strategic competitiveness and above-average returns.

Strategic leaders play an important role in determining a proper balance between strategic and financial controls, whether they are in single-business firms or large diversified firms. A proper balance between controls is important, in that "wealth creation for organizations where strategic

Figure 12.5 A Stakeholder-Based Balanced Scoreboard

Stakeholder	Example Criteria
Shareholders (financial)	• Shareholder stock returns • Risk associated with returns (beta, variance) • Price to earnings (P/E) ratio • Growth in sales
Employees	• Wages/benefits compared to peer firms • Productivity measures • Turnover • Surveys of employee satisfaction
Customers	• Surveys of customer satisfaction • Consumer reports on product quality/safety • Reputation rankings • Product return rates
Suppliers	• Longevity of suppliers relationships • Quality/timeliness of supplies • Existence or absence of supplier-leg legal actions • Days payable outstanding
Community	• Existence of community service programs • Percentage of income donated • Inclusion on list of socially responsible firms • Positive/negative social media posts

leadership is exercised is possible because these leaders make appropriate investments for future viability (through strategic control), while maintaining an appropriate level of financial stability in the present (through financial control)."[140] In fact, most firms use restructuring to refocus on their core businesses, thereby allowing top executives to re-establish strategic control in individual business units.[141]

As we have explained in this chapter, strategic leaders are critical to a firm's ability to use all parts of the strategic management process, including strategic entrepreneurship, successfully. Strategic entrepreneurship is the final topic included in the "strategic actions" part of this text's Analysis-Strategy-Performance model. We turn our attention to this topic in Chapter 13.

Summary

- Effective strategic leadership is a prerequisite to using the strategic management process successfully. Strategic leadership entails the ability to anticipate events, envision possibilities, maintain flexibility, and empower others to create strategic change.
- Strategic leaders promote strategic change by managing through others, managing an entire organization rather than a functional subunit, and coping with the rapid and intense changes associated with the global economy. Because of the global economy's complexity, strategic leaders must learn how to influence human behavior effectively, often in uncertain environments. By word and by personal example, and through their ability to envision the future, effective strategic leaders meaningfully influence the behaviors, thoughts, and feelings of those with whom they work.
- The personality traits of CEOs have an influence on their style of leadership and, ultimately, on firm performance, value creation, and strategic change. The amount of discretion CEOs have in making strategic decisions is influenced by external, organizational, and managerial characteristics.

- Key managers, who play a critical role in selecting and implementing the firm's strategies, form the top management team (TMT). Generally, these managers are officers of the corporation and may also serve on the board of directors.
- The TMT's characteristics, a firm's strategies, and the firm's performance are interrelated. For example, a top management team with significant marketing and research and development (R&D) knowledge positively contributes to the firm's ability to use a growth strategy. Overall, diversity (heterogeneity) increases the effectiveness of most top management teams.
- Typically, performance improves when the board of directors and the CEO are involved in shaping a firm's strategic direction. However, when the CEO has a great deal of power, the board may be less involved in decisions about strategy formulation and implementation. By nominating people for the board and simultaneously serving as CEO and chair of the board, CEOs have increased power.
- In managerial succession, the internal managerial labor market and the external managerial labor market are the sources for new CEOs. Because of their effect on firm performance, the selection of strategic leaders has implications for a firm's effectiveness. In most instances, firms use the internal market to select their CEO. Today, however, the number of instances in which new CEOs come from the external managerial labor market is increasing. Commonly, firms select outsiders as their new CEO because of the belief that they will initiate major changes in strategy. Firing a CEO is more likely when the firm is performing poorly or when analysts downgrade the stock. Dismissal is also more common when the CEO has been involved in some type of misconduct.
- Effective strategic leadership has five key leadership actions: determining the firm's strategic direction, effectively managing the firm's resource portfolio (including exploiting and maintaining core competencies and managing financial, human, social, and organizational capital), sustaining an effective organizational culture, emphasizing ethical practices, and establishing balanced organizational controls.
- The balanced scorecard is a tool that measures the effectiveness of the firm's strategic and financial controls. A stakeholder-oriented balanced scorecard leads to behavior on the part of stakeholders that helps the firm create more value than might otherwise be created. It is based on some of the indicators that are important to regarding each of the five primary stakeholder groups. The criteria include two types of information—what stakeholders are getting from the firm and what they are giving to the firm. Both types of information can help a firm figure out what can be done to create more value in the organization's value-creating system, thus leading to strategic competitiveness and above-average returns.

Key Terms

balanced scorecard 330
determining strategic direction 324
external managerial labor market 322
financial capital 325
heterogeneous top management team 319
human capital 326
internal managerial labor market 322
organizational capital 327
social capital 326
strategic change 315
strategic leadership 315
top management team (TMT) 319

Review Questions

1. What is strategic leadership? Why are top-level managers important resources for an organization?
2. What is a top management team, and how does it affect a firm's performance and its abilities to innovate and design and bring about effective strategic change?
3. Describe managerial succession. How important are the internal and external managerial labor markets to this process?
4. What is the effect of strategic leadership on determining the firm's strategic direction?
5. How do strategic leaders manage their firm's resource portfolio effectively to exploit its core competencies and leverage its financial, human, social, and organizational capital to achieve a competitive advantage?
6. What must strategic leaders do to develop and sustain an effective organizational culture?
7. As a strategic leader, what actions could you take to establish and emphasize ethical practices in your firm?
8. Why are strategic controls and financial controls important aspects of strategic leadership and the firm's strategic management process? What are the advantages of a stakeholder-based balanced scorecard?

Mini-Case

The Influence of Charismatic Leaders

Practically everyone has known a charismatic leader at some point in their lives. Charismatic leadership "is a form of professional guidance or management built on a foundation of strong communication skills, persuasiveness, and maybe even a little bit of charm to help them get the most out of everyone that works for them." Charismatic leaders can get people to perform at high levels that some might think impossible. Their own convictions about the work they are doing seems to be contagious.

Some of the characteristics charismatic leaders possess include a clear vision of the future, the ability to tap into people's abilities and emotions, openness to taking risks when warranted, sensitivity to the environment and people around them, the ability to stay calm under pressure, confidence, and strong engagement skills (e.g., the ability to connect with others). "Charismatic leaders, given their ability to connect with people on a deep level, are especially valuable within organizations that are facing a crisis or are struggling to move forward." Winston Churchill exhibited a high level of charismatic leadership in helping Great Britain survive World War II. Martin Luther King Jr. influenced a whole generation of Americans. In business, Oprah Winfrey has a charismatic leadership style that "draws people to her and keeps them captivated." Lee Iacocca's charismatic leadership helped him turn around Chrysler Corporation in the late 1970s.

Researchers have found evidence that charismatic leadership is associated with follower recruitment and development and, ultimately, to higher firm performance. Research also supports the idea that charismatic leaders can positively influence creativity and group performance. However, researchers also found that sometimes charismatic leadership can discourage people from expressing and working out conflicts in the organization. In addition, charismatic leaders are sometimes perceived as self-centered or phony. Perhaps even more important, those surrounding a charismatic leader may feel as though the leader wants to be blindly followed, which can stifle their willingness to provide alternative perspectives on important strategic issues.

Not surprisingly, there is debate about whether someone can learn to be a charismatic leader or must be born with those characteristics. In addition, charismatic leadership is important in some contexts than in others. There is also discussion about whether charismatic leadership is the same thing as transformational leadership. The consensus seems to be that they are very similar; however, transformational leadership typically is discussed in contexts in which large organizational changes are required.

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Case Discussion Questions

1. How does charismatic leadership relate to some of the topics found in this chapter? Be specific.
2. Can you think of a business situation or industry in which charismatic leadership might not make a difference?
3. Think back on your life and identify someone you believe was a charismatic leader. What qualities stand out in this person? What were they able to accomplish?
4. What can you do to become a more charismatic leader?

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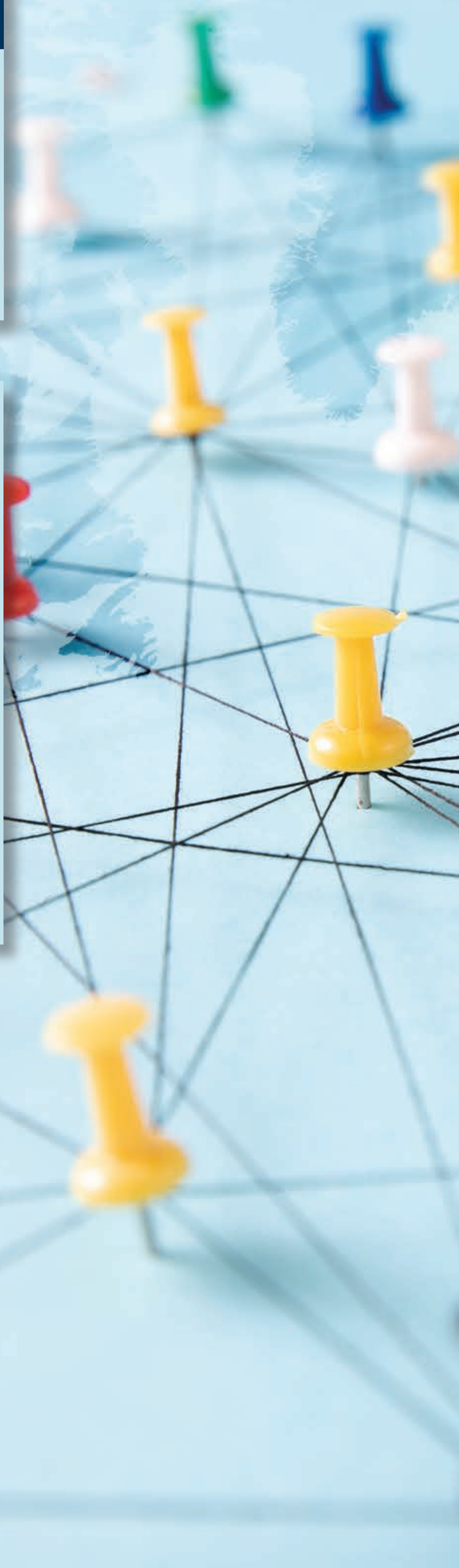
Chapter 13

Strategic Entrepreneurship



Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

13-1 Define strategic entrepreneurship and corporate entrepreneurship.

13-2 Explain nascent markets and how they evolve into established industries.

13-3 Define entrepreneurship and entrepreneurial opportunities and explain their importance.

13-4 Define invention, innovation, and imitation, and describe the relationships among them.

13-5 Describe entrepreneurs and the entrepreneurial mind-set.

13-6 Explain international entrepreneurship and its importance.

13-7 Describe how firms internally develop innovations.

13-8 Explain how firms use cooperative strategies to innovate.

13-9 Describe how firms use acquisitions as a means of innovation.

13-10 Explain how strategic entrepreneurship helps firms create value.

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Big Tech's Ambitious Investment Programs Will Change the World (Again)

A featured story in *The Economist* in early 2022 asked the question, "Is there any limit to the ambition and hubris of big tech firms?" The article went on to say, "In October Mark Zuckerberg renamed Facebook to Meta and described humankind's new future in virtual worlds. On January 18th Microsoft, worth more than $2 trillion, decided it wasn't big enough and bid $69 billion for Activision Blizzard, a videogame firm, in its biggest deal ever." The article went on to describe a surge in investment at five of the biggest tech firms—Meta, Amazon, Alphabet (Google), Microsoft, and Apple—which it playfully called MAAMA. These five firms invested $280 billion during 2021, which is equivalent to 9% of U.S. business investment, up from only 4% five years earlier. These investments were in everything from quantum computing to driverless cars, as they search for the "next big thing."

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In Chapter 1, we discussed how the COVID-19 pandemic increased demand for a lot of the products and services big tech offers. The industry turned their good fortunes into investments in the future. The metaverse seems like a good bet. We introduced the metaverse in Chapter 5 as the next battleground for videogames. However, it is much more than that. It has been described as a "3D-navigable, socially connected, conscience-curving, carefree virtual world." Imagine walking into a store and going down the rows of goods, picking up products and reading their labels—putting some of them in your cart and returning the others to the shelves. Only you are doing all of this from your bedroom. Within about an hour, a driverless vehicle delivers your products. This is the metaverse, and the technology is already here.

Meta's Horizon Worlds is described as a social virtual reality experience where people can "explore, play and create. Discover new places with friends, solve interactive puzzles or form teams to compete in action-packed games. Design worlds of your own or get to know other members of the community and be inspired by their creations." Even if Horizon Worlds fails to achieve a huge following, Meta's engineers are learning, and this learning will be incorporated into a lot of Meta's future products. Zuckerberg said, "Meta is testing new tools that allow creators to sell virtual assets and experiences within the worlds they build on Horizon." Other virtual worlds that sell everything from real estate to art include Decentraland and The SandBox. "Hip-hop star Snoop Dogg has purchased virtual land and a fan paid $450,000 in December to buy a plot next door to him on The Sandbox." Citi believes the metaverse economy could be worth over $8 trillion in less than 10 years.

Roblox is another high-tech metaverse contender. In 2004, David Baszucki founded the company after working with Erik Cassel, a software engineer, to build a new world. Baszucki realized that people wanted to create their own avatars and worlds, go into the worlds they were creating, and chat with friends. An early prototype was tested at a science fair. In March 2021, Roblox went public at a value of $41 billion. Although play is a key aspect of Roblox and other virtual world venues, they also have an important social dimension. "More established players have been known to throw virtual get-well-soon parties for young gamers who have fallen ill." A Lil Nas X concert attracted 36.9 million visits. According to Baszucki, "This is bigger than play. This gets into learning, and working." Ralph Lauren has a marketing venture on Roblox called "Winter Escape." Nike has a virtual showroom called "Nikeland." Gucci has "Gucci Garden," where a bidding war led to a sales price for a virtual handbag of $4,115. The real-life handbag sells for $3,400. Nonetheless, like many entrepreneurial ventures in their early stages, Roblox has yet to make a profit.

Space is another huge tech investment area. Amazon plans to launch over 3,000 low-Earth-orbit satellites through a venture called Kuiper. The satellites are intended to provide broadband internet access to "unserved and underserved communities around the world." Jeff Bezos said about investment, "Can I stand here and tell you that our $10 billion investment in Kuiper will generate returns on invested capital? I can't. I believe it will, and we're working hard to ensure that's the case. The only way to get above average returns is to take risks, and many of them will not pay off." Jeff Bezos also owns a rocket company called Blue Origin and was recently launched into space in the company's first peopled space flight. The Kuiper satellites will be in direct competition with Elon Musk's SpaceX (Space Exploration Technologies Corp.) satellites. Of course, SpaceX is better known as the company that provides transportation for astronauts to the International Space Station.

Sources: M. Maidenberg, 2022, Amazon bets billions on satellite fleet, *Wall Street Journal,* April 6: B1, B4; M. Maidenberg, SpaceX ferries private astronauts up to International Space Station, *Wall Street Journal,* April 9: B3; D. Gallagher, 2022, Amazon space race is a big "other bet," *Wall Street Journal,* April 5: B14; B. Warner, 2022, Why Wall Street loves the metaverse, *Fortune,* March: 44–50; S. Shead, 2022, Mark Zuckerberg says Meta will test selling virtual goods in the metaverse, *CNBC,* www.cnbc.com, April 12; Y. Jie, Microsoft's deal for Activision tests Sony's gaming strategy, *Wall Street Journal,* January 25: B4; B. X. Chen, 2022, What's all the hype about the metaverse, *The New York Times,* www.newyorktimes.com, January 19; 2022, Big tech's supersized ambitions, *The Economist,* www.economist.com, January 22; 2022, Horizon Worlds, *MetaQuest,* www.oculus.com, May 13; A. Kessler, 2021, The metaverse is already here, *Wall Street Journal,* www.wsj.com, December 26; P. Choudhury, C. Foroughi, & B. Larson, 2020, Work-from-anywhere: The productivity effects of geographic flexibility, *Strategic Management Journal*, 42: 655–683; A. Konrad, 2020, Zoom kaboom!, *Forbes*, May: 76–85; A. Tilley, 2020, Microsoft earnings grew last quarter with demand for cloud services, *Wall Street Journal,* www.wsj.com, January 25.

Learning Objective

13-1 Define strategic entrepreneurship and corporate entrepreneurship.

13-1 Strategic and Corporate Entrepreneurship

Strategic entrepreneurship involves taking entrepreneurial actions using a strategic perspective.

Nascent markets are often new markets but can also be existing markets that are experiencing significant technical, regulatory, or institutional shifts that fundamentally disrupt market order.

As explained in this chapter, firms engaging in strategic entrepreneurship concentrate on advantage-seeking and opportunity-seeking behaviors simultaneously. In essence, this concentration finds firms seeking entrepreneurial opportunities in their external environment that they can exploit through innovations and by successfully executing their chosen strategies. Focusing on advantage- and opportunity-seeking behaviors simultaneously is challenging in that by doing so, a firm concentrates on selling its current products while seeking to identify needs in the marketplace that it can serve by innovating. The Opening Case demonstrates this idea very well, as we see large, established big tech companies venturing into new areas while still seeking to maintain their competitiveness in their traditional business. The case also demonstrates just how risky entrepreneurial investments can be and how long they can take to pay off.

The focus of this chapter is on strategic entrepreneurship, which is a framework firms use to integrate effectively entrepreneurial and strategic actions.[1] More formally, **strategic entrepreneurship** involves taking entrepreneurial actions using a strategic perspective. In this process, the firm tries to find opportunities in its external environment that it can exploit through innovations. Identifying opportunities to exploit through innovations is the *entrepreneurship* dimension of strategic entrepreneurship; determining the best way to manage the firm's innovation efforts competitively is the *strategic* dimension.[2]

Learning Objective

13-2 Explain nascent markets and how they evolve into established industries.

13-2 The Evolution of Nascent Markets

Strategic entrepreneurship often takes place in **nascent markets**, which "are often new markets, but can also be existing markets that are experiencing significant technical, regulatory, or institutional shifts that fundamentally disrupt market order."[3] Institutions that establish norms about how business is conducted are yet to be widely acknowledged and established.[4] The market structure is in a fluid state, with a lack of clarity about what features the ultimate product will have or how it will be produced, competing technologies, and uncertain or rapidly growing demand. The electric vehicles market is currently a nascent market, as is the virtual reality (e.g., metaverse) market.[5]

Nascent markets evolve into established industries through three developmental stages.[6] During the incubation period, a technological discovery or identification of an unmet need leads to vibrant enterprising activity. It ends with the first commercialization of a new product. In the second stage, firms enter the new industry, slowly at first, followed by an increase in the number of competitors. During this stage, we see significant breakthroughs, although the product is still at such a rudimentary stage that consumer demand is low. The third stage sees even more firms entering the industry and a significant surge in sales. Because the entering firms have diverse information and capabilities, there is a lot of product innovation, and consumers start to see the industry as legitimate.[7] Over time, as product designs and manufacturing processes become more standardized and customer demand takes on more of a predictable pattern, the industry stabilizes. In terms of the rate of change, nascent markets are similar to the fast-cycle markets discussed in Chapter 5. However, unlike fast-cycle markets, it is not always true in nascent markets that products can be easily and quickly imitated.

We consider several topics to explain strategic entrepreneurship. First, we examine entrepreneurship and innovation in a strategic context. We present definitions of entrepreneurship, entrepreneurial opportunities, and entrepreneurs (those who engage in entrepreneurship to pursue entrepreneurial opportunities). We then describe international entrepreneurship, a process through which firms take entrepreneurial actions outside their home market. After this topic, the chapter shifts to descriptions of the three ways firms innovate—internally, through cooperative strategies, and by acquiring other companies.[8] We discuss these methods separately, although most large firms use all three methods to innovate. The chapter closes with summary comments about how firms use strategic entrepreneurship to create value.

Before turning to the chapter's topics, we should note that a major portion of the material in this chapter deals with entrepreneurship and innovation that takes place in ongoing firms. More formally, **corporate entrepreneurship** is the application of entrepreneurship within an established firm.[9] However, much of what we discuss in this chapter is important in start-up entrepreneurial ventures as well as established organizations.

Corporate entrepreneurship is the application of entrepreneurship within an established firm.

13-3 Entrepreneurship and Entrepreneurial Opportunities

Learning Objective

13-3 Define entrepreneurship and entrepreneurial opportunities and explain their importance.

Entrepreneurship is the process by which individuals, teams, or organizations identify and pursue entrepreneurial opportunities without being immediately constrained by the resources they currently control.[10] **Entrepreneurial opportunities** are conditions in which new goods or services can satisfy a need in the market. These opportunities exist because of competitive imperfections in markets and among the factors of production used to produce them, or because they were independently developed by entrepreneurs.[11] Entrepreneurial opportunities come in many forms, such as the chance to develop and sell a new product and the chance to sell an existing product in a new market.[12] Firms should be receptive to pursuing entrepreneurial opportunities whenever and wherever they may surface. For example, Campbell Soup Co. took advantage of a food trend that embraces "adventurous flavors" by launching a spicy chicken noodle soup.[13] The soup is infused with paprika, capsaicin, other spices, and vinegar. In response to an outcry against disposable straws, Cuisinart, best known for kitchen appliances, developed a set of stainless-steel straws, complete with a cleaning brush and a silicone holder.[14]

Entrepreneurship is the process by which individuals, teams, or organizations identify and pursue entrepreneurial opportunities without being immediately constrained by the resources they currently control.

Entrepreneurial opportunities are conditions in which new goods or services can satisfy a need in the market.

As the definitions of entrepreneurship and entrepreneurial opportunities suggest, the essence of entrepreneurship is to identify and exploit entrepreneurial opportunities—that is, opportunities others do not see or for which they do not recognize the commercial potential—and manage risks appropriately as they arise.[15] As a process, entrepreneurship results in the "creative destruction" of existing products (goods or services) or methods of producing them and replaces them with new products and production methods.[16] Cryptocurrencies such as Bitcoin or Ethereum may have the potential to replace long-established methods of financial transactions. However, in cryptocurrencies, we can also see the huge amount of risk associated with entrepreneurial ventures. In May of 2022, cryptocurrencies experienced huge declines in value and a lot of volatility. The effects were disastrous for many individuals, companies, and even a whole country. "The plunging value of bitcoin has hurt investors in cryptocurrency everywhere. The stakes are especially high in El Salvador, the indebted Central American country whose president has spent hundreds of millions of dollars in taxpayer money buying bitcoin and rolling it out as a national currency."[17] There are even fears that El Salvador will default on its debts.

Firms committed to entrepreneurship place high value on individual innovations, as well as the ability to innovate across time.[18] We study entrepreneurship at the level of the individual firm. However, evidence suggests that entrepreneurship is the economic engine driving many nations' economies in the global competitive landscape.[19] Thus, entrepreneurship and the innovation it spawns are important for companies competing in the global economy and for countries seeking to stimulate economic climates with the potential to enhance the living standard of their citizens.[20]

Andrey Gorgots/Shutterstock.com

The cryptocurrency market crashed in 2022, after hitting record highs in 2021.

Learning Objective

13-4 Define invention, innovation, and imitation, and describe the relationships among them.

Invention is the act of creating or developing a new product or process.

Innovation is a process used to create a commercial product from an invention.

Imitation is the adoption of a similar innovation by different firms.

13-4 Invention, Innovation, and Imitation

In his classic work, *The Theory of Economic Development*, Joseph Schumpeter argued that firms engage in three types of innovative activities.[21] **Invention** is the act of creating or developing a new product or process. **Innovation** is a process used to create a commercial product from an invention.[22] Thus, innovation follows invention in that invention brings something new into being while innovation brings something new into use. Accordingly, firms use technical criteria to determine the success of an invention whereas they use commercial criteria to determine the success of an innovation.[23] Finally, **imitation** is the adoption of a similar innovation by different firms.[24] Imitation usually leads to product standardization; commonly, imitative products have fewer features and a lower price for customers.[25] Entrepreneurship is critical to innovative activity because it acts as the linchpin between invention and innovation.[26]

For most companies, innovation is the most critical of the three types of innovative activities. The reason is that while many companies can create ideas that lead to inventions, commercializing those inventions sometimes proves to be difficult.[27] Patents are a strategic asset, and the ability to produce them regularly can be an important source of competitive advantage, especially when a firm intends to commercialize an invention and when a firm competes in a knowledge-intensive industry (e.g., pharmaceuticals).[28] In a competitive sense, patents create entry barriers for a firm's potential competitors.[29] However, in general, entry barriers provide less protection from competition for firms competing in the global economy. In the view of the chief information officer for Unilever, the giant consumer foods manufacturer, "basically there are no entry barriers" to prevent start-ups from entering the markets in which his firm competes.[30] Reasons for fewer entry barriers in Unilever's case include consumers' demands for natural ingredients in healthier products and the fact that costs associated with manufacturing consumer goods have declined. Thus, the challenge for today's firms is to understand the degree to which their innovations create entry barriers for potential and existing competitors.[31]

The famous business consultant, educator, and writer Peter Drucker argued that "innovation is the specific function of entrepreneurship, whether in an existing business, a public service institution, or a new venture started by a lone individual."[32] Moreover, Drucker suggested that innovation is "the means by which the entrepreneur either creates new wealth-producing resources or endows existing resources with enhanced potential for creating wealth."[33] Thus, entrepreneurship and the innovation resulting from it are critically important for all firms as they engage rivals in competitive battles.

The realities of global competition suggest that to be market leaders, companies must innovate regularly. This means that innovation should be an intrinsic part of virtually all a firm's activities.

Furthermore, managers have to work to synchronize (align) actions and resources within the firm, "including acquiring and developing resources, building capabilities, and ultimately designing and implementing a strategy to leverage those resources."[34] Moreover, firms should recognize the importance of their human capital's efforts to innovate.[35] Evidence suggests that particularly for radical innovation, workforce diversity increases human capital's ability to develop value-creating innovations.[36] Thus, as this discussion suggests, innovation is a key outcome firms seek through entrepreneurship, and it is often the source of competitive success, especially for companies competing in highly competitive and turbulent environments.[37]

13-5 Entrepreneurs and Their Mind-set

Learning Objective

13-5 Describe entrepreneurs and the entrepreneurial mind-set.

Entrepreneurs are individuals, acting independently or as part of an organization, who perceive an entrepreneurial opportunity and then take risks to develop an innovation and exploit it. Entrepreneurs exist throughout different parts of organizations—from top-level managers to those working to produce a firm's products.[38]

Entrepreneurs are individuals, acting independently or as part of an organization, who perceive an entrepreneurial opportunity and then take risks to develop an innovation and exploit it.

Entrepreneurs tend to demonstrate several characteristics: they are highly motivated, willing to take responsibility for their projects, self-confident, and often optimistic.[39] In addition, entrepreneurs tend to be passionate and emotional about the value and importance of their innovation-based ideas.[40] They are able to deal with uncertainty and are more alert to opportunities than are others.[41] To be successful, entrepreneurs often need to have good social skills and to plan exceptionally well (e.g., to obtain venture capital).[42]

Being committed to and engaging in entrepreneurship within organizations demands significant effort from entrepreneurs. On the other hand, pursuing entrepreneurial opportunities by working as an entrepreneur can be highly satisfying—particularly when entrepreneurs recognize and follow their passions. According to Jeff Bezos, Amazon.com's founder: "One of the huge mistakes people make is that they try to force an interest on themselves. You don't choose your passions; your passions choose you."[43]

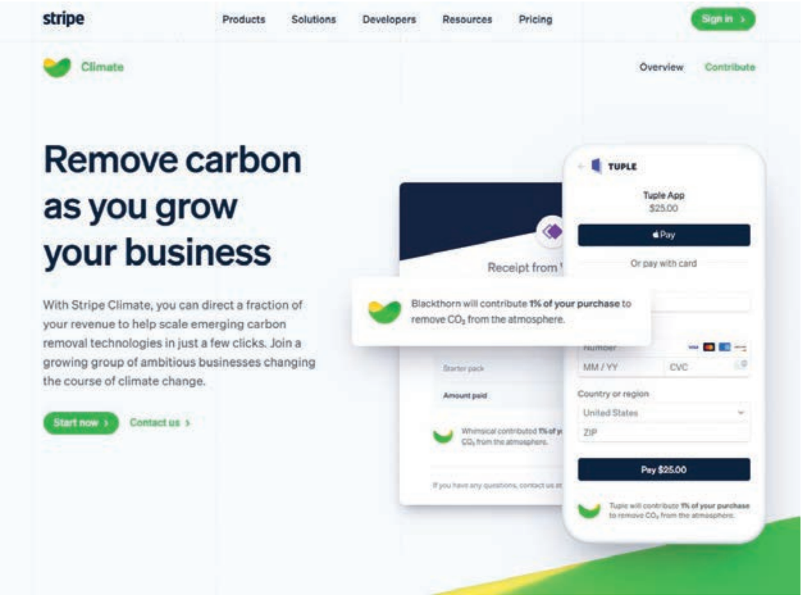
Evidence suggests that successful entrepreneurs have an entrepreneurial mindset. An individual with an **entrepreneurial mind-set** values uncertainty in markets and continuously seeks to identify opportunities in those markets to pursue through innovation.[44] In contrast, those without an entrepreneurial mind-set tend to view opportunities to innovate as threats. Importantly, an entrepreneurial mind-set also includes recognition of the importance of competing internationally, as well as domestically.[45]

An **entrepreneurial mind-set** values uncertainty in markets and continuously seeks to identify opportunities in those markets to pursue through innovation.

The notion of an entrepreneurial mind-set also applies to firms, where it becomes a part of their organizational culture (see Chapter 12). Five dimensions characterize a firm's entrepreneurial mind-set: autonomy, innovativeness, risk taking, proactiveness, and competitive aggressiveness.[46] In combination, these dimensions influence the actions a firm takes to be innovative when using the strategic management process.

Autonomy, the first of an entrepreneurial orientation's five dimensions, allows employees to take actions that are free of organizational constraints and encourages them to do so. The second dimension, *innovativeness*, "reflects a firm's tendency to engage in and support new ideas, novelty, experimentation, and creative processes that may result in new products, services, or technological processes."[47] Cultures with a tendency toward innovativeness encourage employees to think beyond existing knowledge, technologies, and parameters to find creative ways to add value. *Risk taking* reflects a willingness by employees and their firm to accept measured levels of risks when pursuing entrepreneurial opportunities. The fourth dimension of an entrepreneurial orientation, *proactiveness*, describes a firm's ability to be a market leader rather than a follower. Proactive organizational cultures constantly use processes to anticipate future market needs and to satisfy them before competitors learn how to do so. Finally, *competitive aggressiveness* is a firm's propensity to take actions through which it can outperform rivals consistently and substantially.[48]

Because it has the potential to lead to continuous innovations, an entrepreneurial mind-set can be a source of competitive advantage for a firm. An entrepreneurial mind-set is encouraged when individuals have easy access to new information. In fact, research shows that units within firms are



Source: Stripe, Inc

Stripe was named the most innovative company in the world in 2022 by *Fast Company*.

more innovative when people have access to new knowledge.[49] Transferring knowledge, however, can be difficult because the receiving party must have adequate absorptive capacity (or the ability) to understand the knowledge and to use it productively.[50] Learning requires a link between the new knowledge and the existing knowledge. Thus, managers need to develop the capabilities of their human capital to build on their current knowledge base while incrementally expanding it.

Some companies demonstrate a strong commitment to entrepreneurship, suggesting that they have an entrepreneurial mindset. In 2022, *Fast Company* identified Stripe as the most innovative company in the world. The huge online payments company started Stripe Climate, led by Nan Ransohoff, that allows customers "to fund ambitious carbon-removal technology by contributing a percentage of their digital sales that flow through Stripe's software."[51] Microsoft is in the top 10 for humanizing work processes based on what it discovered in a 30,000-person survey. SpaceX is, too, for designing rockets that make it more affordable to launch people into space.

Learning Objective

13-6 Explain international entrepreneurship and its importance.

International entrepreneurship is a process in which firms creatively discover and exploit opportunities that are outside their domestic markets.

13-6 International Entrepreneurship

Entrepreneurship is a process that many firms exercise at both the domestic and international levels. **International entrepreneurship** is a process in which firms creatively discover and exploit opportunities that are outside their domestic markets.[52] This is true for entrepreneurial ventures, as suggested by the fact that an increasing number of them move into international markets early in their life cycles. Large, established companies commonly have significant foreign operations and often start new ventures in international markets as well.[53]

Firms engage in international entrepreneurship to enhance their performance.[54] Nonetheless, those leading firms generally understand that taking entrepreneurial actions in markets outside the firm's home setting is challenging and not without risks, including risks of unstable foreign currencies, market inefficiencies, insufficient infrastructures to support businesses, and limitations on market size.[55] In addition, there is inadequate patent protection in some countries, especially in emerging markets.[56] Thus, the decision to engage in international entrepreneurship needs to be a product of careful analysis.

Even though entrepreneurship is a global phenomenon, its rate of use differs within individual countries. For example, according to the Global Innovation Index, the five most entrepreneurial countries in 2021 were, in the following order, Switzerland, Sweden, South Korea, the Netherlands, and Finland.[57] Switzerland's selection as the most innovative country is because of its knowledge-based economy (e.g., many top universities) and ability to convert innovative thinking into projects that yield value-creating products for customers. Sweden is another country that emphasizes education. Also, the country invests more than 3 percent of its GDP into research and development. Those compiling the rankings suggest that, in general, the most innovative countries engage students through creative teaching techniques, enforce progressive laws, conduct business through intellectually designed practices, and are home to individuals and companies that are willing to take risks.

A nation's culture is one reason for differential rates of entrepreneurship among countries worldwide. In Chapter 8, we discussed Israel's unique culture, which has allowed the country to achieve high levels of innovation and business success despite limited resources and an extremely turbulent environment. Country cultures like those found in Switzerland, Sweden, or Israel balance individual initiative and a spirit of cooperation and group ownership, which encourages innovation and entrepreneurial behaviors within organizations. This means that for firms to be entrepreneurial, they must provide appropriate autonomy and incentives for individual initiative to surface while simultaneously promoting cooperation and group ownership of an innovation as a foundation for successfully exploiting it. Thus, international entrepreneurship often requires teams of people with unique skills and resources.

The level of investment outside of the home country made by young ventures is also an important dimension of international entrepreneurship. In fact, with increasing globalization, a larger number of new ventures have been "born global."[58] One reason for this is that new ventures that enter international markets increase their learning of new technological knowledge and thereby enhance their performance.[59] They increase their knowledge through the external networks (e.g., suppliers, customers) that they establish in the new foreign markets, including strategic alliances in which they participate.[60]

The probability of entering and successfully competing in international markets increases when the firm's strategic leaders, and especially its top-level managers, have international experience. Because of the learning and economies of scale and scope afforded by operating in international markets, both young and established internationally diversified firms often are stronger competitors in their domestic market as well. Additionally, as research has shown, internationally diversified firms are generally more innovative.[61]

A firm's ability to develop and sustain a competitive advantage may be based partly or in large part on its ability to innovate. This is true for firms engaging in international entrepreneurship as well as those that have yet to do so. As we discuss next, firms can follow different paths to innovate internally. Internal innovation is the first of three approaches firms use to innovate, with cooperative strategies and acquisitions strategies being the other two.

13-7 Internal Innovation in Organizations

Learning Objective

13-7 Describe how firms internally develop innovations.

Efforts in firms' research and development (R&D) function are one primary source of internal innovations. Through effective R&D, firms can generate patentable processes and innovative products.[62] Increasingly, successful R&D results from integrating the skills available in the global workforce. Thus, the ability to have a competitive advantage based on innovation is more likely to accrue to firms capable of integrating the talent of human capital from countries around the world.[63]

R&D and the new products and processes it can spawn affect a firm's efforts to earn above-average returns while competing in today's global environment. Because of this ability, firms try to use their R&D labs to create disruptive technologies and products. Although critical to long-term competitive success, the outcomes of R&D investments are uncertain and often not achieved in the short term, meaning that patience is required as firms evaluate the outcomes of their R&D efforts.[64]

As noted earlier, successful R&D programs must have high-quality human capital—star scientists. Yet, not all ideas begin in the laboratory. For example, firms have learned that customers are often good sources for new products that will satisfy their needs.[65] Firms also use external networks such as other scientists, published research, and even alliance partners (discussed later in this chapter).[66] They may even be able to use public knowledge, such as that on a current technology, that can be combined to create an improved technology or perhaps even a new technology.[67] In addition, some of the most successful firms use trial-and-error processes, or what might be called "strategy-by-doing," in which they introduce a product and then make frequent design improvements to keep them attractive to customers.[68]

Companies use several methods to obtain employees' ideas for new products and other types of innovation. One technique is called innovation contests, in which a firm offers awards to employees who can provide the most innovative ideas for products or processes.[69] Also, some firms allow employees to allocate a certain amount of their time to innovative activities. At Google, employees have "20 percent time," which allows them to dedicate up to 20 percent of their working hours to projects they believe have the greatest potential to benefit the firm through innovation.[70] At Ericsson, employees are encouraged to participate in Idea Boxes. After employees submit an idea, they form a partnership with "idea-to-innovation" managers to develop it further and determine if it is feasible and valuable. Ericsson ONE is an internal venture-funding group that provides start-up capital to the best ideas.[71]

13-7a Incremental and Radical Innovation

Firms invest in R&D to produce two primary types of innovations—incremental and radical.[72] Most innovations are *incremental*—that is, they build on existing knowledge bases and provide small improvements in current products. Incremental innovations are evolutionary and linear in nature.[73] In general, firms introduce incremental innovations into established markets where customers understand and accept a product's characteristics. In essence, incremental innovations exploit an existing technology to provide an improvement over a current product.

Adding a different kind of whitening agent to a soap detergent is an example of an incremental innovation, as are minor improvements in the functionality in televisions (e.g., slightly better picture quality). Companies introduce to markets a larger number of incremental than radical innovations, largely because they are cheaper, easier to produce quickly, and involve less risk. Yet, firms normally cannot rely solely on incremental innovations. If they do so, they risk moving from being market leaders to market laggards.[74] Also, from the firm's perspective, incremental innovations tend to yield lower profit margins compared to those associated with the outcomes of radical innovations, largely because competition among firms offering products to customers that have incremental innovations is primarily on the price variable.[75]

In contrast to incremental innovations, *radical innovations* usually provide significant technological changes and create new knowledge.[76] Radical innovations, revolutionary and nonlinear, typically use new technologies to serve newly created markets. The development of the original smartphone is an example of such an innovation, as are driverless cars. Radical innovations are rare because of the difficulty and risk involved in their development. The value of the technology and the market opportunities associated with it are highly uncertain.[77] Consequently, although radical innovations have the potential to contribute more significantly to a firm's efforts to earn above-average returns, they also expose the firm to a higher level of risk.

Radical innovations can have a large impact on people's lives. Consider *agentic technologies*, which are technologies that become an active participant in the everyday lives of the consumers who use them.[78] Fitbit is one example of an agentic technology. It not only tracks the behavior of its users, but it also sends them reminders of things they should do to increase their health. In addition, Fitbit gives users positive feedback to reinforce their healthy behaviors. Because they deal with the technology/human interface, agentic technologies can shape the way people feel, think, believe, and act.[79]

Developing new processes is a critical part of producing radical innovations. Because radical innovation creates new knowledge and uses only some or little of a firm's current product or technological knowledge, creativity is required—creativity is as important to efforts to innovate in not-for-profit organizations as it is in for-profit firms.[80] Creativity is an outcome of using one's imagination. In the words of Jay Walker, founder of Priceline.com, "Imagination is the fuel. You're not going to get innovation if you don't have imagination." Imagination finds firms thinking about what customers will want in a changing world. For example, Walker says, those seeking to innovate within a firm could try to imagine "what the customer is going to want in a world where, for instance, their cellphone is in their glasses."[81] Imagination is more critical to radical than incremental innovations.

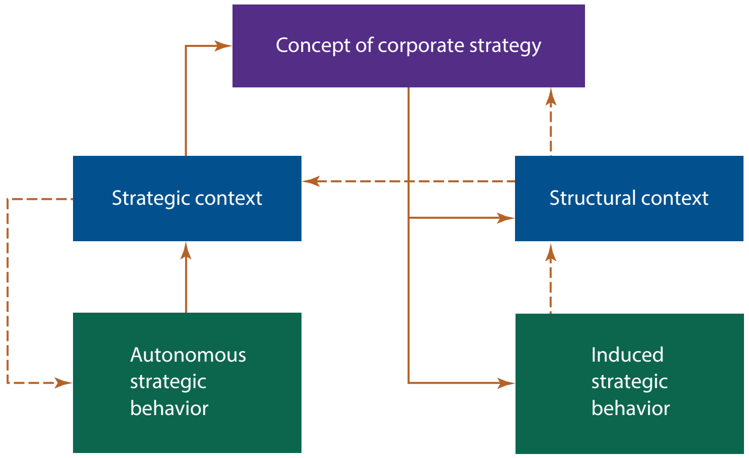
This discussion highlights the fact that internally developed incremental and radical innovations result from using a set of deliberate activities. *Internal corporate venturing* is the name used to capture this set of deliberate activities—activities that firms used to develop internal inventions and particularly internal innovations.[82] As shown in Figure 13.1, autonomous and induced strategic behaviors are the two types of internal corporate venturing. Each venturing type facilitates development of both incremental and radical innovations. However, a larger number of radical innovations spring from autonomous strategic behavior, while a larger number of incremental innovations come from induced strategic behavior.

In essence, autonomous strategic behavior results in influences to change aspects of the firm's strategy and the structure in place to support its implementation. In contrast, induced strategic behavior results from the influences of the strategy and structure the firm currently has in place to support efforts to innovate. We emphasize these points in the discussions below.

13-7b Autonomous Strategic Behavior

Autonomous strategic behavior is a bottom-up process in which a *product champion* pursues a new idea, often through a political process by means of which they develop and coordinate the actions

Figure 13.1 Model of Internal Corporate Venturing



Source: Adapted from R.A. Burgelman, 1983, A model of the interactions of strategic behavior, corporate context, and the concept of strategy, Academy of Management Review, 8–65.

required to convert an invention into an innovative product and to introduce that product into the market.[83] Product champions play critical roles in moving innovations forward.

The development of Post-it Notes is the classic example of an innovation that reached the market because of the tireless efforts of a product champion. 3M's Post-it Notes evolved from the work of Dr. Spencer Silver, a 3M scientist. In trying to develop a bigger, stronger, tougher adhesive, Dr. Silver actually discovered something called microspheres, which retain their stickiness while having a "removable" characteristic. This characteristic allows attached surfaces to peel apart easily (think of your Post-it Notes). It took years, and the forming of a partnership with Art Fry, another 3M scientist, for the company to see the innovation-related potential of Dr. Silver's invention. In describing how this result came about, Dr. Silver said that he become known as Mr. Persistent because he would not stop trying to sell his product inside 3M.[84] His persistence indicates that Dr. Silver indeed was a product champion. As this example shows, internal innovations springing from autonomous strategic behavior differ from the firm's current strategy and structure, taking it into new markets and perhaps new ways of creating value (see Figure 13.1).

As discussed in the Strategic Focus, government agencies sometimes seek innovation through autonomous strategic behavior. This is the case with the Public Investment Fund, which provides financial support to projects of strategic importance to the Kingdom of Saudi Arabia (KSA).[85] While reading about the Public Investment Fund's actions, notice that developing innovation throughout the Kingdom of Saudi Arabia is the force driving the fund's investment choices.

13-7c Induced Strategic Behavior

Induced strategic behavior, the second form of corporate venturing through which firms develop innovations internally, is a top-down process whereby the firm's current strategy and structure foster innovations that are associated closely with that strategy and structure.[86] In this form of venturing, the strategy in place filters through a matching structural hierarchy. It allows the firm and its managers to determine the type and amount of innovation desired.[87] For example, the firm could develop an intense innovation process to be the industry leader by introducing new products regularly, even if they cannibalize currently successful products. Intel is an example of a firm following this practice with the regular introduction of new microprocessors that make its current microprocessors much less attractive.

A firm that uses an induced approach to innovation needs to determine if it wishes to participate in *open innovation*, "where external ideas and technologies are brought into the firm's innovation process" and "un- and under-utilized ideas and technologies in the firm are allowed to go outside to be incorporated into others' innovation processes."[88] Open innovation, when managed well, can help firms appropriate value from technologies that can be used for a variety of different purposes, such as artificial intelligence.[89] The majority of innovation is closed innovation, although open innovation is becoming more common. Open innovation may be necessary to address what are sometimes called *wicked problems,* which are problems that are connected to so

Strategic Focus

Seeking Innovation through Autonomous Strategic Behavior at the Country Level

The Public Investment Fund (PIF) is a sovereign wealth fund established by the Kingdom of Saudi Arabia. Created to invest funds derived from a country's reserves in ways that benefit that country's economy and citizens, sovereign wealth funds are not uncommon. For example, Norway has a sovereign wealth fund with over $1 trillion in assets, China's is only slightly below $1 trillion, and Hong Kong's is a little over $500 billion.

Saudi Arabia's vision for its PIF is "to be a global investment powerhouse and the world's most impactful investor, enabling the creation of new sectors and opportunities that will shape the future global economy, while driving the economic transformation of Saudi Arabia." This economic transformation is important as Saudi Arabia seeks to reduce its dependence on oil income as the foundation for its economy. The structure of the PIF allows it to invest in companies with the potential to innovate because of their talent. The fund notes that, to date, it has "invested in some of the world's most innovative companies, forming partnerships that will ensure Saudi Arabia is at the forefront of emerging trends." The degree to which autonomous strategic behavior may emerge in a company as a means of developing innovations influences the PIF's decisions as it evaluates firms in which it may invest.

Noon is an e-commerce venture, with 50 percent of the investment coming from the PIF. In partnership with Dubai businessperson Mohamed Alabbar and other investors, Noon's permanent operational base is in Riyadh. One of the most expensive tech ventures in the Middle East, Noon is a competitive response to Amazon's strategic action of acquiring Dubai-based Souq.com as a means of boldly entering the Middle Eastern markets. Described by Mr. Alabbar as an Arabic-first ecommerce platform, Noon offers a range of clothing, home goods, grocery staples, and multiple other items. The PIF's managers believe that Noon will innovate in ways that will lead to commercial success in the online retail industry. In turn, Noon's commercial success would provide one avenue to reducing Saudi Arabia's dependence on oil revenue.

Noon uses a 3.5-million-square-foot fulfillment order center in Dubai to distribute its products. Mr. Alabbar is committed to "creating a different kind of infrastructure: a viable competitor to Amazon.com Inc. and other global e-commerce giants, which are moving into the Middle East to capitalize on an online shopping boom." To make Noon the only Arabic-first e-commerce platform competing in the Middle East, Mr. Alabbar and his colleagues seek to identify innovations to use as the foundation for outcompeting its rivals. With Amazon's Souq.com as a competitor, the battle to innovate as a means of capturing market share will be intense. In 2021, it was announced that Noon would be drawing fund financing in the amount of $2 billion from the PIF and other investors to upgrade infrastructure.

Adnan Ahmad Ali/Shutterstock.com

Noon has installed self-collect kiosks, such as this one inside metro station, in Dubai, as a way to distribute products.

Noon is one of several investments by the PIF. In 2021, the PIF announced that it would be investing in a venture called Cruise Saudi "which aims to establish and develop the cruise industry in Saudi Arabia." The intention is to "form a bridge between sea and land operations by developing cruise ports and terminals in several Saudi cities to provide an integrated experience with the wider tourism sector in the country."

Sources: A. Montambault Trudelle, 2022, the public investment fund and Salman's state: The political drivers of sovereign wealth management in Saudi Arabia, *Review of International Political Economy*, April: 1–25; 2022, Sovereign Wealth Fund—SWF, *Investopedia*, www.investopedia.com, May 17; 2022, About PIF, *Public Investment Fund Home Page*, www.pif.gov.sa, May 17; 2021, Amazon rival Noon to draw $2 billion from PIF, other backers, *FRPT—Economics Snapshot*, October 12, 8; 2021, Public investment fund of Saudi Arabia launches Cruise Saudi, *International Cruise & Ferry Review*, Spring/Summer: 23; O. Hasan, 2017, Gulf retailer Noon.com to ignite e-commerce race, *Phys.org Homepage*, www.phys.org, October 2; M. Kassem & N. Nanji, 2017, Noon launches in the UAE, tapping into regional e-commerce boom, *The National*, www.thenational.ae, October 1.

many interdependent factors that they seem impossible to solve.[90] Global climate change and racial inequality are examples of wicked problems.

13-7d Implementing Internal Innovations

An entrepreneurial mind-set is critical to firms' efforts to innovate internally, partly because it helps them deal with the environmental and market uncertainty associated with efforts taken to commercialize inventions.[91] When facing uncertainty, firms continuously try to identify the most attractive opportunities to pursue strategically. Thus, firms use an entrepreneurial mind-set to identify opportunities and then develop innovations and strategies to exploit them in the marketplace.[92] Often, firms provide incentives to individuals to be more entrepreneurial as a foundation for successfully developing internal innovations. One technique is called innovation contests, in which a firm offers awards to employees who can provide the most innovative ideas for products or processes.[93]

Often it is difficult to convince managers to fund new ventures because of the inherent risks involved.[94] Consequently, strong, supportive leadership is required for the type of creativity and imagination needed to develop radical innovations. A vision and mission are also important, with a strong innovation theme, an organizational culture that encourages risk taking, open communications within the firm, allocation of sufficient resources to promote innovative activities, and a compensation system that rewards entrepreneurial behavior.[95]

Additionally, firms sometimes encourage work teams to specify what they believe are the most appropriate incentives for the firm to use as a means of encouraging innovative behavior.[96] Collectively, employees use gathered knowledge to develop new, innovative products to introduce to new markets and to capture new customers—and gain access to new resources while doing so.

Having processes and structures in place through which a firm can exploit its innovations is critical. In the context of internal corporate ventures, managers must allocate resources, coordinate activities, communicate with many different parties in the organization, and make a series of decisions to convert the innovations resulting from either autonomous or induced strategic behaviors into successful market entries.[97] As we describe in Chapter 11, an organizational structure depicts the sets of formal relationships that support processes managers use to exploit the firm's innovations. Often, separate business units that start internal ventures produce the types of innovations that lead to these positive outcomes.

To implement the incremental and radical innovations resulting from internal corporate ventures, firms integrate the functions involved in internal innovation efforts—from engineering to manufacturing and distribution. Increasingly, firms use product development teams to achieve the desired integration across organizational functions.[98] Such integration involves coordinating and applying the knowledge and skills of different functional areas to maximize innovation and to create a culture of continuous improvement.[99] Teams must help make decisions about which projects to continue supporting and those to terminate. Emotional commitments sometimes increase the difficulty of deciding to terminate an innovation-based project.[100]

13-7e Cross-Functional Product Development Teams

Cross-functional product development teams facilitate efforts to integrate activities associated with different organizational functions, such as design, manufacturing, and marketing.[101] A number of individuals, representing a wide swath of the organization, are members of cross-functional new product development teams.[102] The reason for this is that, "in today's globally interconnected, fast-paced business environment, nearly every important initiative—whether it's revenue growth, cost reduction, or new product innovation—requires insights and actions from people working across an organization."[103] As team members, research scientists, for example, bring technological content knowledge to decisions made by product development teams. Those from marketing bring insights about products that appeal to millennials compared to members of the baby boomer generation. In addition to members from the organization, cross-functional product development teams may also include people from major suppliers because they have knowledge that can meaningfully inform a firm's innovation processes.[104] In addition, it is possible to complete new product development processes more quickly and to commercialize the products resulting from the processes more easily when cross-functional teams work collaboratively.[105] Using cross-functional teams, the firm batches product development stages into parallel processes so that it can tailor its product development efforts to its unique core competencies and to the market's needs.

Horizontal organizational structures support cross-functional teams in their efforts to integrate innovation-based activities across organizational functions.[106] These are structures that have few levels between the top and bottom of the organization.[107] Therefore, instead of using vertical hierarchical functions or departments as the design framework, core horizontal processes, which are relied on to produce and manage innovations, are the foundation for building the organization. Some of the horizontal processes that are critical to innovation efforts are documented as procedures and practices. More commonly, however, these important processes are informal and supported properly through horizontal organizational structures that find individuals communicating frequently on a face-to-face basis.

Although cross-functional teams are often used successfully to help develop innovative new products, they are not without potential weaknesses.[108] For example, team members' independent frames of reference and organizational politics are two barriers with the potential to prevent effective use of cross-functional teams.[109] Team members working within a distinct specialization (e.g., a particular organizational function) may have an independent frame of reference—one that common backgrounds and experiences influence. Such team members are likely to use the same decision criteria to evaluate issues, such as product development efforts, when making decisions within their functional units. This can impede collaborative functioning within a cross-functional team.

Additionally, individuals working in various organizational functions differ from one another in areas such as their goals, formality of the structure guiding their work, and the amount of time needed to complete their work. In turn, these differences influence how individuals working in an organization's functional departments view innovation-related activities. For example, a design engineer may consider the characteristics that make a product functional and workable to be the most important ones. Alternatively, a person from the marketing function may judge characteristics that satisfy customer needs to be most important. These different orientations can create barriers to effective communication across functions and may even generate intra-team conflict as different parts of the firm try to work together to innovate.[110]

Some organizations experience a considerable amount of political activity (i.e., organizational politics) when using cross-functional product development teams. Determining how to allocate resources to different functions is a key source of such activity. This means that inter-unit conflict may result from aggressive competition for resources among those representing different organizational functions. This type of conflict between functions creates a barrier to cross-functional integration efforts. Those trying to form effective cross-functional product development teams seek ways to mitigate the damaging effects of organizational politics. Emphasizing the critical role each function plays in the firm's overall efforts to innovate is a method firms use to help individuals appreciate the value of inter-unit collaborations.

13-7f Facilitating Integration and Innovation

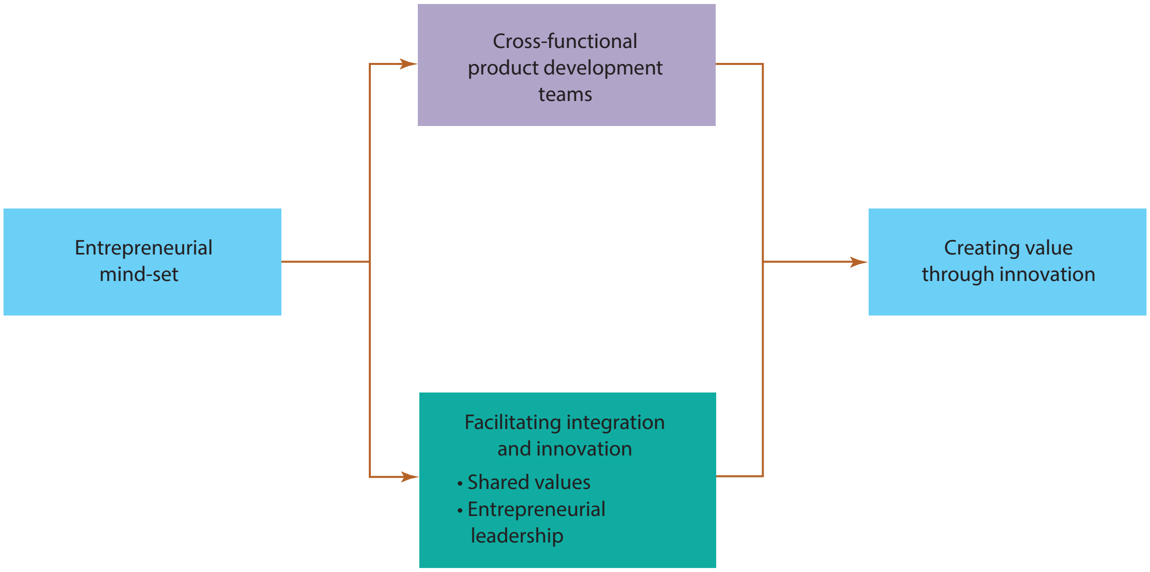
Shared values and effective leadership are important for achieving cross-functional integration and implementing internal innovations.[111] As part of culture, shared values are consistent with the firm's vision and mission and become the glue that promotes integration between functional units.

Strategic leadership is also important to efforts to achieve cross-functional integration and promote internal innovation. Working with others, leaders must set goals and allocate resources needed to achieve them. The goals include integrated development and commercialization of new products. Effective strategic leaders also ensure a high-quality communication system to facilitate cross-functional integration. A critical benefit of effective communication is the sharing of knowledge among team members, who in turn are then able to communicate an innovation's existence and importance to others in the organization. Shared values and leadership practices shape the communication routines that make it possible to share innovation-related knowledge throughout the firm.[112]

13-7g Creating Value from Internal Innovation

The model in Figure 13.2 shows how firms try to create value through internal innovation processes (autonomous strategic behavior and induced strategic behavior). As shown, an entrepreneurial mind-set is foundational to efforts to identify entrepreneurial opportunities the firm can pursue to create value through innovations.[113] As we have discussed, cross-functional teams are important for promoting integrated new product design ideas and gaining commitment to their subsequent implementation. Effective leadership and shared values promote integration and vision for innovation and commitment to it. However, competitive rivalry (see Chapter 5) affects the degree of success a firm achieves through innovation. Thus, firms must carefully study competitors' responses to their innovations to have the knowledge required to know how to adjust their innovation-based efforts, and even when to abandon those efforts if market conditions indicate the need to do so.[114]

Figure 13.2 Creating Value through Internal Innovation Processes



In the next two sections, we discuss the other approaches firms use to innovate—cooperative strategies and acquisitions.

13-8 Innovation through Cooperative Strategies

Learning Objective

13-8 Explain how firms use cooperative strategies to innovate.

Alliances with other firms can contribute to innovations in several ways. First, they provide information on new business opportunities and the innovations the firm might develop to exploit them.[115] In other instances, firms use cooperative strategies to align what they believe are complementary assets that have potential to lead to future innovations. Compared to other approaches to innovation, combining complementary assets through alliances has the potential to result more frequently in radical innovations.[116]

Rapidly changing technologies, globalization, and the need to innovate in ways that satisfy global standards influence firms' decisions to innovate by cooperating with other companies. Some believe that because of these conditions firms are becoming increasingly dependent on cooperative strategies as a path to innovation and, ultimately, to competitive success in the global economy.[117] Both entrepreneurial ventures and established firms use cooperative strategies to innovate. An entrepreneurial venture, for example, may seek investment capital as well as established firms' distribution capabilities to introduce successfully one of its innovative products to the market.[118] Alternatively, more-established companies may need new technological knowledge and can gain access to it by forming a cooperative strategy with entrepreneurial ventures. Large pharmaceutical firms and biotechnology companies form alliances to integrate their knowledge and resources to develop new products and bring them to market.[119]

An alliance formed between Inter IKEA Group, the parent company of the IKEA furniture brand, and Marriott International, Inc. is an example of large firms using a cooperative strategy to innovate. These firms formed an alliance to develop Moxy, a new hotel brand that is innovative in its design and the value it creates for customers.[120] In this alliance, IKEA provides novel and innovative construction techniques (such as its famed flat-pack technology through which it can quickly deliver and assemble furniture) to keep manufacturing costs down, while Marriott provides value in the form of unique design. The innovative foundation of the brand is combining value (IKEA's contribution) with style (Marriott's contribution). The hotel serves millennials with moderate prices and an open lobby/restaurant/bar with music at one end and space where guests can work on their devices at the other.

The first Moxy Hotel is innovative in both its design and the value it creates for customers.

However, alliances formed to foster innovation carry risk. In addition to conflict that is natural when firms try to collaborate to reach a mutual goal, alliance members also take a risk that a partner might appropriate their technology or knowledge and use it for its own benefit.[121] Carefully selecting partner firms mitigates this risk. The ideal partnership is one in which the firms have complementary skills as well as compatible strategic goals.[122] When this is the case, firms encounter fewer challenges and risks as they try to successfully manage their partnership. Companies also want to constrain the number of cooperative arrangements they form to innovate, in that becoming involved in too many alliances puts them at risk of losing the ability to manage each one successfully.[123]

Learning Objective

13-9 Describe how firms use acquisitions as a means of innovation.

13-9 Innovation through Acquisitions

Acquisitions are the final approach firms use to innovate. Evidence suggests that this approach is gaining in popularity as firms seek to enhance their technological capabilities on a continuous basis. The Boston Consulting Group offers the following commentary about this issue: "For an increasing number of organizations the answer is to buy rather than to build. Acquisitions of high-tech targets have become an instrument of choice for buyers in all sectors looking to boost innovation, streamline operations and processes, shape customer journeys, and personalize products, services, and experiences."[124] The Strategic Focus illustrates how Pfizer is enhancing its own innovative potential through acquisitions of firms that have state-of-the-art products and technologies.

One reason companies choose to acquire others as a means of innovating is that capital markets value growth, and acquisitions provide a rapid means to grow.[125] The truth is that sometimes the bureaucracies associated with large companies make internal innovation difficult. There are too many levels at which a new idea needs approval—too much of what is sometimes called "red tape." Consequently, a strategic rationale for an acquisition is often to gain ownership of an acquired company's innovations and access to its innovative capabilities.[126] Like Pfizer, several large technology-based companies have acquired firms largely for these purposes. Netflix acquired Millarworld to gain access to the firm's current stable of innovative products and to increase its ability to construct and tell innovative stories across time.[127]

Like internal corporate venturing and strategic alliances, acquisitions are not a risk-free approach to innovation. Beyond the very real risk that the alliance itself may not work out well (see Chapter 7), a risk associated with innovative activity is that a firm may substitute an ability to acquire innovations for an ability to develop them internally. Reducing allocations to R&D may result when a firm concentrates on financial controls to identify, evaluate, and then manage acquisitions. Of course, strategic controls are the ones through which a firm identifies a strategic rationale to acquire another company as a means of developing innovations. Thus, the likelihood a firm will achieve success through its efforts to innovate increases by developing an appropriate balance between financial and strategic controls. This is especially the case when strategic purposes drive the acquisitions and when the process to integrate the acquired firm into the focal firm proceeds without difficulty.[128]

Despite the risks, choosing to acquire companies with complementary capabilities and knowledge can support a firm's efforts to innovate successfully. For example, Vertellus, a firm that manufactures specialty materials, acquired Polyscope Polymers, a company that holds a global leadership position in specialty additives for coatings. Polyscope's complementary product portfolio, in addition to its highly advanced manufacturing capabilities, allows Vertellus to expand its European production and increase its reach into rapidly growing end markets.[129]

If sufficient financial capital is available, firms lacking success with internal innovation efforts are more likely to acquire companies possessing strong technological capabilities or that have new, potentially valuable innovations.[130] The ability to learn new capabilities that can facilitate

Strategic Focus

Pfizer's Acquisitions Enhance Innovation in the Company

In March 2022, Pfizer announced that its $6.7 billion acquisition of Arena Pharmaceuticals was complete. Arena is "a clinical stage company developing innovative potential therapies for the treatment of several immune-inflammatory diseases." Its portfolio of development-stage therapies includes many areas focused on dermatology, gastroenterology, and cardiology. These therapies have the potential to treat diseases such as ulcerative colitis, Crohn's disease, eosinophilic esophagitis, atopic dermatitis, and alopecia areata. Mike Gladstone, global president and general manager over Pfizer Inflammation and Immunology, said, "We are excited to add the impressive experience and pipeline of Arena Pharmaceuticals to Pfizer's Inflammation and Immunology therapeutic area, helping us further our purpose of developing breakthroughs to change the lives of those with immuno-inflammatory diseases. In particular, we're hopeful that we can accelerate clinical development of etrasimod successfully to have a positive impact on those living with these debilitating diseases."

Pfizer has a long record of buying companies to enhance its innovation portfolio. Medivation was purchased for $14 billion in 2016 to increase Pfizer's cancer drug capabilities, especially treatment of prostate cancer. Hospira, a $15.2 billion deal in 2015, added the largest manufacturer of generic injectable medicines. King Pharmaceuticals, a $3.6 billion acquisition in 2010, was acquired to expand Pfizer's pain relief products, but it also included the EpiPen and a line of animal health products. In the most expensive Pfizer deal to date, Warner-Lambert was acquired in 2000 at a cost of $90.2 billion. This acquisition greatly expanded Pfizer's worldwide presence and added a huge portfolio of products, including Listerine.

As a result of increased sales due to its COVID-19 vaccine and treatment, Pfizer continues searching for new deals to add to its pipeline of experimental products. Pfizer invested $25 billion in business development from 2019 to early 2022. "With a growing chest of cash, Pfizer says its deal-making strategy will focus on drugs in early- and late-stage development in areas the company is already focusing on, such as oncology, immunology and rare diseases."

In May 2022, Pfizer announced that it would buy all the stock it didn't already own in Biohaven Pharmaceutical Holding Co. for approximately $11.6 billion (a 79 percent premium over the previous day's closing price). This acquisition adds a new migraine drug to Pfizer's portfolio, which is a "potential blockbuster that analysts say could add billions of dollars in yearly sales to a big drugmaker facing several costly patent expirations in the coming years." Pfizer executives say they want to add an additional $25 billion in new revenue from deals by the end of the decade to offset sales lost due to expiring patents on aging products.

Sources: J. S. Hopkins & M. Grossman, 2022, A flush Pfizer is hunting for deals, *Wall Street Journal*, February 9: B1, B2; J. S. Hopkins & C. Kellaher, 2022, Pfizer to buy rest of Biohaven for $11.6 billion, *Wall Street Journal*, www.wsj.com, May 10; 2022, Pfizer completes acquisition of Arena Pharmaceuticals, *Pfizer Home Page*, www.pfizer.com, March 11; 2021, Pfizer to acquire Arena Pharmaceuticals, *Pfizer Home Page*, www.pfizer.com, December 13; S. Modi, 2020, Pfizer's most expensive acquisitions, *Business Chief*, www.businesschief.com, May 19; T. Staton, 2017, Pfizer's $14B Medivation deal's now a cautionary M&A tale, thanks to ASCO, *Fierce Pharma*, www.fiercepharma.com, June 5.

innovation-related activities from acquired companies is an important benefit for an acquiring firm. Thus, some firms produce innovations internally or use cooperative strategies to innovate, while others use external knowledge and external sources for innovations. Not surprisingly, large organizations tend to use all three approaches to innovate. However, the quality of actions used to implement each approach influences their success.[131]

13-10 Creating Value through Strategic Entrepreneurship

Learning Objective

13-10 Explain how strategic entrepreneurship helps firms create value.

Entrepreneurial ventures and younger firms are often more effective at recognizing opportunities than are larger, established companies.[132] For that reason, entrepreneurial ventures often produce more radical innovations than do larger, more established organizations. Entrepreneurial ventures' strategic flexibility and willingness to take risks account partially for their ability to produce radical innovations. Yet, because they tend to be novel, radical innovations are also risky. Thus, these innovations often fail, which frequently means that the new venture fails because such firms have little slack.[133]

Alternatively, larger, well-established firms often have more resources and capabilities to manage recognized opportunities strategically in the marketplace, but these efforts generally result in a larger number of incremental than radical innovations. Thus, younger, entrepreneurial ventures generally excel in the opportunity-seeking part of strategic entrepreneurship while larger, more established firms generally excel in the advantage-seeking part.

As we have discussed in this chapter, whether in a new entrepreneurial venture or as a part of an internal venture of an established firm, competitive success and superior performance relative to competitors accrues to firms capable of recognizing and exploiting opportunities. When able to exploit opportunities, firms establish a competitive advantage relative to their rivals.[134] On a relative basis then, newer entrepreneurial ventures should seek to enhance their strategic skills, while older, more established firms should try to become more entrepreneurial.

Firms trying to learn how to be more entrepreneurial and strategic simultaneously (that is, firms trying to use strategic entrepreneurship) understand that, after recognizing opportunities, leaders within entrepreneurial ventures and established organizations must help their firms develop capabilities that are valuable, rare, difficult to imitate, and nonsubstitutable (see Chapter 3). When capabilities satisfy these four criteria, the firm has the foundation in place through which strategic actions become the pathway to exploiting innovations in the marketplace and developing a competitive advantage.

As we explained in Chapter 1, without a competitive advantage, firm success is only temporary.[135] If grounded in a recognized and viable market opportunity, an innovation may be valuable and rare early in its life; but, by itself, an innovation does not result in a competitive advantage—strategic actions taken to introduce the new product to the market and protect its position against competitors are the source of competitive advantage. In combination, these actions (recognizing viable opportunities and using strategic actions to exploit them in the marketplace) constitute strategic entrepreneurship.

The essential responsibility of top-level managers focusing on emerging brands or innovation is to verify that their firm identifies entrepreneurial opportunities consistently. Additionally, they manage the firm's portfolio of innovation projects, selecting those for which further investment is appropriate while terminating unattractive projects.[136] These managers understand that some innovative projects fail; they try to learn from those failures to enhance the success of future projects.[137]

For projects that are to continue receiving support, chief innovation officers collaborate with others to integrate the innovation into the firm's strategy. In this sense, those responsible for identifying opportunities the firm might want to pursue. as well as those responsible for selecting and implementing the firm's strategies. share responsibility for verifying that the firm is taking entrepreneurial actions using a strategic perspective. Chief innovation officers and those working in their unit also help the firm select the innovations to use to pursue opportunities and decide whether those innovations should be developed internally through a cooperative strategy or by completing an acquisition. In the final analysis, the objective of these top-level managers is to help firms recognize entrepreneurial opportunities and then develop successful incremental and radical innovations and strategies to exploit them.

In this chapter, we focused on innovation's link to organizational success. Throughout the book, we have examined decisions and actions firms exercise when practicing strategic management. Both skills (the ability to innovate and the ability to be strategic in marketplace competitions) are vital for organizational success. Today's organizations must learn how to engage simultaneously in opportunity-seeking and advantage-seeking behaviors—strategic entrepreneurship combines these behaviors. Thus, companies that can simultaneously master these two types of behaviors are poised to achieve marketplace success at the expense of competitors that lack this ability.

Summary

- Strategic entrepreneurship involves taking entrepreneurial actions using a strategic perspective. Firms using strategic entrepreneurship simultaneously engage in opportunity-seeking and advantage-seeking behaviors. The purpose is to continuously find new opportunities and quickly develop and exploit innovations while simultaneously exploiting competitive advantages that are creating value through the products and services the firm currently sells.
- Nascent markets are often new markets but can also be existing markets that are experiencing significant

technical, regulatory, or institutional shifts that fundamentally disrupt market order. Nascent markets evolve into established industries through three developmental stages. During the incubation period, a technological discovery or identification of an unmet need leads to vibrant enterprising activity. It ends with the first commercialization of a new product. In the second stage, firms enter the new industry, slowly at first, followed by an increase in the number of competitors. The third stage sees even more firms entering the industry and a significant surge in sales.

- Entrepreneurship is a process used by individuals, teams, and organizations to identify entrepreneurial opportunities without being immediately constrained by the resources they control. Corporate entrepreneurship is the application of entrepreneurship (including the identification of entrepreneurial opportunities) within ongoing, established organizations. Entrepreneurial opportunities are conditions in which new goods or services can satisfy a market need. Entrepreneurship positively contributes to individual firms' performance and stimulates growth in countries' economies.
- Firms engage in three types of innovative activities:
    - invention, which is the act of creating a new good, process, or service
    - innovation, or the process of creating a commercial product from an invention
    - imitation, which is the adoption of similar innovations by different firms

  Invention brings something new into being, while innovation brings something new into use.
- Entrepreneurs see or envision entrepreneurial opportunities and then take actions to develop innovations and exploit them. The most successful entrepreneurs (whether they are establishing their own venture or are working in an established organization) have an entrepreneurial mindset, which is an orientation that values the potential associated with opportunities that are available because of marketplace uncertainties.
- International entrepreneurship, or the process of identifying and exploiting entrepreneurial opportunities outside the firm's domestic markets, is important to firms around the globe. Evidence suggests that firms capable of engaging effectively in international entrepreneurship generally outperform those competing only in their domestic markets.
- Firms use three basic approaches to produce innovation:
    - internal innovation, which involves R&D and forming internal corporate ventures
    - cooperative strategies such as strategic alliances
    - acquisitions
- Autonomous strategic behavior and induced strategic behavior are the two forms of internal corporate venturing. Autonomous strategic behavior is a bottom-up process through which a product champion facilitates the commercialization of an innovation. Induced strategic behavior is a top-down process in which a firm's current strategy and structure facilitate the development and implementation of innovations. Thus, the firm's current strategy and structure drives induced strategic behavior, while autonomous strategic behavior can result in a change to the firm's current strategy and structure.
- Firms create two types of innovations—incremental and radical—through internal innovation that takes place in the form of autonomous strategic behavior or induced strategic behavior. Overall, firms produce more incremental innovations, but radical innovations have a higher probability of significantly increasing sales revenue and profits. Cross-functional integration is often vital to a firm's efforts to develop and implement internal corporate venturing activities and to commercialize the resulting innovation.
- To gain access to the specialized knowledge required to innovate in the global economy, firms may form a cooperative relationship, such as a strategic alliance with other companies.
- Acquisitions are another method firms use to obtain innovation. Acquisitions can lead to direct access to an acquired firm's innovations, and/or firms can learn new capabilities from an acquisition, thereby enriching their internal innovation abilities.
- The practice of strategic entrepreneurship by all types of firms, large and small, new and more established, creates value for all stakeholders, especially for shareholders and customers. Strategic entrepreneurship also contributes to the economic development of countries.

Key Terms

corporate entrepreneurship 343
entrepreneurial mind-set 345
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entrepreneurship 343
imitation 344
innovation 344
international entrepreneurship 346
invention 344
nascent markets 342
strategic entrepreneurship 342

Review Questions

1. What is strategic entrepreneurship? What is corporate entrepreneurship?
2. What are nascent markets, and what are their stages as they evolve into established industries?
3. What is entrepreneurship, and what are entrepreneurial opportunities? Why are they important aspects of the strategic management process?
4. What are invention, innovation, and imitation? How are these concepts interrelated?
5. What is an entrepreneur, and what is an entrepreneurial mind-set?
6. What is international entrepreneurship? Why is it important?
7. How do firms develop innovations internally?
8. How do firms use cooperative strategies to innovate and to have access to innovative capabilities?
9. How does a firm acquire other companies to increase the number of innovations it produces and improve its capability to innovate?
10. How does strategic entrepreneurship help firms create value?

Mini-Case

Electric Aviation Is Coming Soon to an Airport Near You!

Concerns about global warming and sustainability are among the most important issues today. These concerns were a driving force in Shaw Industries' clean carpet manufacturing (Chapter 2), the increasing popularity of electric cars and trucks (Chapters 2, 8, and 11), Patagonia's green strategy (Chapter 3), and competition in the development of large-scale batteries (Chapter 5). It seems that electric technologies are going to continue to replace fossil fuel technologies throughout this century. But what about aviation? Is there any hope that electric engines will replace those massive jet engines that currently predominate commercial airlines?

Some of the major airlines are betting on electric aircraft. United Airlines announced that it is going to buy 100 small zero-emission electric airplanes from the start-up Heart Aerospace in Sweden. United will use them for short trips in the United States beginning in 2026. Finland's Finnair and the regional U.S. airline Mesa Airlines have also signed up to purchase Heart's aircraft. Europe's EasyJet has a partnership with an American start-up called Wright Electric to develop an "all-electric, 186-seat commercial passenger jet with an 800-mile range that's targeted to enter service around 2030." An earlier 100-seat version is due to be completed by Wright Electric in 2026.

Hawaiian Airlines invested in a company that is developing what are going to be called electric sea gliders. "The battery-powered sea gliders being developed by Regent, a Boston-based startup, are a hybrid of a boat and a plane. They would cruise 5 to 20 feet above the waves on average, flying on a cushion of air that keeps them aloft, known as the 'ground effect.'" Hawaiian Airlines would use the sea gliders for short hops between the Hawaiian Islands, which account for about a fifth of its revenue. The sea gliders will be able to travel 180 miles from port to port, at a speed of 180 miles per hour. Because the gliders won't need airport runways, Hawaiian hopes they will be able to use them to fly between harbors, filling a niche in island airline travel. "Digital flight control systems will react to gusts and keep the vessel above the notoriously rough seas between the islands."

Beyond these major ventures, scores of companies are entering the race to develop electric airplanes. Lilium, based in Germany, has developed a six-person capacity electric vertical take-off and landing jet. An Israeli company named Eviation has created a nine-seat electric commuter airplane it calls Alice. Eviation has received numerous awards for its innovations, including the Crystal Cabin Award (2021), the International Yacht & Aviation Award (2020), a Gold Edison Award (2020), and a European Technology Award (2019). The company was also recognized in *Time* magazine's Best Inventions for 2019. Fast Company gave Eviation a World Changing Ideas Award in 2018 and also listed the company in its World's Most Innovative Companies for the same year.

Large organizations such as Airbus, Boeing, NASA, and Toyota are backing the development of first-generation electric aircraft technology. Also, an accelerator in Germany called Sustainable Aero Lab is mentoring sustainable aviation startups. Their specific mission is to bring together founders, experienced entrepreneurs, researchers, industry professionals, and investors with the purpose of building a sustainable future for aviation. On their home page, we find: "Open innovation: We welcome anyone who can add value towards reducing the climate footprint of aviation."

In just a few years, electric aircraft will establish a foothold in the aviation industry. "Swiss bank UBS estimates that a full quarter of the civil aviation industry will be hybrid or fully electric by 2035." Venkat Viswanathan, a mechanical engineering professor at Carnegie Mellon University with a specialty in aviation batteries, says that electric battery power will be a good first step for addressing emissions in the aviation industry.

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Case Discussion Questions

1. The chapter describes three developmental stages of nascent markets as they evolve into established industries. In what stage is the electric aviation market? How do you know?
2. What are the most obvious risks associated with electric aviation?
3. If you were the CEO of a major airline not already mentioned in this case, what would you have your company do now to ensure that you are not left behind other airlines in electric aircraft and emissions-free airline travel? How would you "sell" these actions to shareholders and other stakeholders?
4. What can an airline do now to become more sustainable?

Notes

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Case Studies

Case Title	Manufac-turing	Service	Food/ Retail	High Tech	Internet/ Comm.	International Perspective	Social/ Ethical Issues	Industry Information	COVID-19
Airbus A380	X			X		X		X	
Air France-KLM		X				X		X	
Ant Group		X			X	X	X		
Aventiv Technologies		X			X		X		
Blue Apron		X	X					X	
Gap		X	X				X	X	X
Haier	X			X		X			
Hershey	X		X				X		
Hilton		X						X	X
JIO/Facebook		X			X	X			
Marriott		X			X			X	X
Meta		X		X	X	X	X		
Netflix		X				X			X
NIO vs. Tesla	X	X				X	X		
Pacari Chocolate	X		X				X	X	
Port of Antwerp		X					X	X	
Re:Build Manufacturing	X								
Uber		X			X	X	X		X
Washington Post		X			X				
Waymo		X		X			X	X	
Wellington Brewery	X		X					X	
We Work		X				X			

Case Title	Ch 1	Ch 2	Ch 3	Ch 4	Ch 5	Ch 6	Ch 7	Ch 8	Ch 9	Ch 10	Ch 11	Ch 12	Ch 13
Airbus A380					X			X					X
Air France-KLM					X		X	X					
Ant Group	X	X			X								X
Aventiv Technologies				X			X			X		X	
Blue Apron	X		X	X									
Gap	X	X	X	X								X	X
Haier								X	X		X		X
Hershey	X	X	X									X	
Hilton	X	X	X			X							
JIO/Facebook								X	X				
Marriott		X			X	X							X
Meta		X			X			X				X	X
Netflix		X		X	X			X					
NIO vs. Tesla		X			X			X					X
Pacari Chocolate	X	X	X	X				X					
Port of Antwerp		X	X										
Re:Build Manufacturing						X	X			X	X		
Uber		X	X	X	X			X					
Washington Post			X	X								X	X
Waymo		X	X		X						X		
Wellington Brewery	X	X							X				
We Work		X								X		X	

Preparing an Effective Case Analysis

What to Expect from InClass Case Discussions

As you will learn, classroom discussions of cases differ significantly from lectures. The case method calls for your instructor to guide the discussion and to solicit alternative views as a way of encouraging your active participation when analyzing a case. When alternative views are not forthcoming, your instructor might take a position just to challenge you and your peers to respond thoughtfully as a way of generating still additional alternatives. Often, instructors will evaluate your work in terms of both the quantity and the quality of your contributions to in-class case discussions. The in-class discussions are important in that you can derive significant benefit by having your ideas and recommendations examined against those of your peers and by responding to thoughtful challenges by other class members and/or the instructor.

During case discussions, your instructor will likely listen, question, and probe to extend the analysis of case issues. In the course of these actions, your peers and/ or your instructor may challenge an individual's views and the validity of alternative perspectives that have been expressed. These challenges are offered in a constructive manner; their intent is to help all parties involved with analyzing a case develop their analytical and communication skills. Developing these skills is important in that they will serve you well when working for all types of organizations. Commonly, instructors will encourage you and your peers to be innovative and original when developing and presenting ideas. Over the course of an individual discussion, you are likely to form a more complex view of the case as a result of listening to and thinking about the diverse inputs offered by your peers and instructor. Among other benefits, experience with multiple case discussions will increase your knowledge of the advantages and disadvantages of group decision-making processes.

Both your peers and instructor will value comments that contribute to identifying problems as well as solutions to them. To offer relevant contributions, you are encouraged to think independently and, through discussions with your peers outside of class, to refine your thinking. We also encourage you to avoid using "I think," "I believe," and "I feel" to discuss your inputs to a case analysis process. Instead, consider using a less emotion laden phrase, such as "My analysis shows…." This highlights the logical nature of the approach you have taken to analyze a case. When preparing for an in-class case discussion, you should plan to use the case data to explain your assessment of the situation. Assume that your peers and instructor are familiar with the basic facts included in the case. In addition, it is good practice to prepare notes regarding your analysis of case facts before class discussions and use them when explaining your perspectives. Effective notes signal to classmates and the instructor that you are prepared to engage in a thorough discussion of a case. Moreover, comprehensive and detailed notes eliminate the need for you to memorize the facts and figures needed to successfully discuss a case.

The case analysis process described above will help prepare you effectively to discuss a case during class meetings. Using this process results in consideration of the issues required to identify a focal firm's problems and to propose strategic actions through which the firm can increase the probability it will outperform its rivals. In some instances, your instructor may ask you to prepare either an oral or a written analysis of a particular case. Typically, such an assignment demands even more thorough study and analysis of the case contents. At your instructor's discretion, oral and written analyses may be completed by individuals or by groups of three or more people. The information and insights gained by completing the six steps shown in Table 1 often are of value when developing an oral or a written analysis. However, when preparing an oral or written presentation, you must consider the overall framework in which your information and inputs will be presented. Such a framework is the focus of the next section.

Preparing an Oral/Written Case Presentation

Experience shows that two types of thinking (analysis and synthesis) are necessary to develop an effective oral or written presentation (see Figure 1). In the analysis stage, you should first analyze the general external environmental issues affecting the firm. Next, your environmental analysis should focus on the particular industry (or industries, in the case of a diversified company) in which a firm operates. Finally, you should examine companies against which the focal firm competes. By studying the three levels of the external environment (general, industry, and competitor), you will be able to identify a firm's opportunities and threats. Following the external environmental analysis is the analysis of the firm's internal organization. This analysis provides the insights needed to identify the firm's strengths and weaknesses.

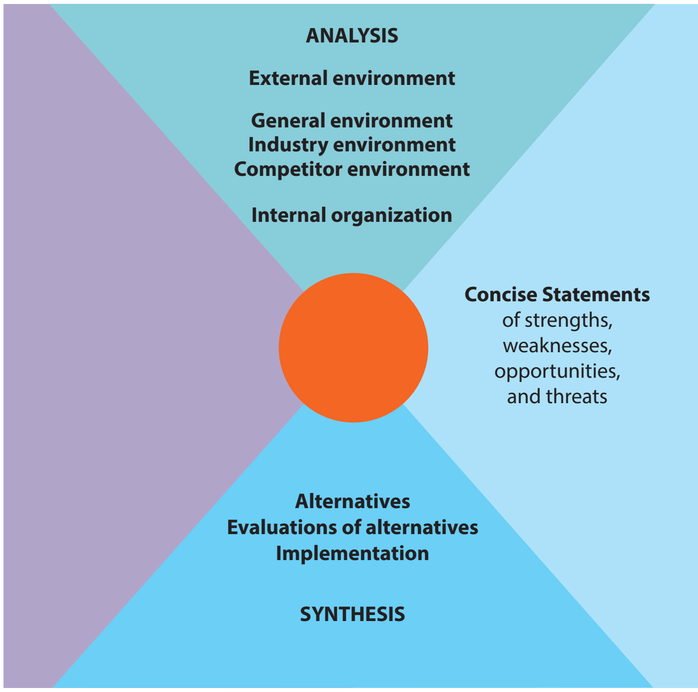
As noted in Figure 1, you must then change the focus from analysis to synthesis. Specifically, you must synthesize information gained from your analysis of the firm's external environment and internal organization. Synthesizing information allows you to generate alternatives that can resolve the significant problems or challenges facing the focal firm. Once you identify a best alternative, from an evaluation based on predetermined criteria and goals, you must explore implementation actions.

Table 1 An Effective Case Analysis Process

Step 1: Gaining Familiarity	a. In general—determine who, what, how, where, and when (the critical facts of the case). b. In detail—identify the places, persons, activities, and contexts of the situation. c. Recognize the degree of certainty/uncertainty of acquired information.
Step 2: Recognizing Symptoms	a. List all indicators (including stated "problems") that something is not as expected or as desired. b. Ensure that symptoms are not assumed to be the problem (symptoms should lead to identification of the problem).
Step 3: Identifying Goals	a. Identify critical statements by major parties (for example, people, groups, the work unit, and so on). b. List all goals of the major parties that exist or can be reasonably inferred.
Step 4: Conducting the Analysis	a. Decide which ideas, models, and theories seem useful. b. Apply these conceptual tools to the situation. c. As new information is revealed, cycle back to substeps a and b.
Step 5: Making the Diagnosis	a. Identify predicaments (goal inconsistencies). b. Identify problems (discrepancies between goals and performance). c. Prioritize predicaments/problems regarding timing, importance, and so on.
Step 6: Doing the Action Planning	a. Specify and prioritize the criteria used to choose action alternatives. b. Discover or invent feasible action alternatives. c. Examine the probable consequences of action alternatives. d. Select a course of action. e. Design an implementation plan/schedule. f. Create a plan for assessing the action to be implemented.

Sources: C. C. Lundberg and C. Enz, 1993, A framework for student case preparation, *Case Research Journal*, 13 (Summer): 144, NACRA, North American Case Research Association.

Figure 1 Types of Thinking in Case Preparation: Analysis and Synthesis



In Table 2, we outline the sections that should be included in either an oral or a written presentation: strategic profile and case analysis purpose, situation analysis, statements of strengths/weaknesses and opportunities/ threats, strategy formulation, and strategy implementation. These sections are described in the following discussion. Familiarity with the contents of your book's thirteen chapters is helpful because the general outline for an oral or a written presentation shown in Table 2 is based on an understanding of the strategic management process detailed in those chapters. We follow the discussions of the parts of Table 2 with a few comments about the "process" to use to present the results of your case analysis in either a written or oral format.

Strategic Profile and Case Analysis Purpose

You will use the strategic profile to briefly present the critical facts from the case that have affected the focal firm's historical strategic direction and performance. The case facts should not be restated in the profile; rather, these comments should show how the critical facts lead to a particular focus for your analysis. This primary focus should be emphasized in this section's conclusion. In addition, this section should state important assumptions about case facts on which your analyses are based.

Situation Analysis

As shown in Table 2, a general starting place for completing a situation analysis is the general environment.

General Environmental Analysis. Your analysis of the general environment should focus on trends in the seven segments of the general environment (see Table 3). Many of the segment issues shown in Table 3 for the seven segments are explained more fully in Chapter 2 of your book. The objective you should have in evaluating these trends is to be able to *predict* the segments that you expect to have the most significant influence on your focal firm over the next several years (say three to five years) and to explain your reasoning for your predictions.

Table 2 General Outline for an Oral or Written Presentation

- **I. Strategic Profile and Case Analysis Purpose**
- **II. Situation Analysis**
  - **A. General environmental analysis**
  - **B. Industry analysis**
  - **C. Competitor analysis**
  - **D. Internal analysis**
- **III. Identification of Environmental Opportunities and Threats and Firm Strengths and Weaknesses (SWOT Analysis)**
- **IV. Strategy Formulation**
  - **A. Strategic alternatives**
  - **B. Alternative evaluation**
  - **C. Alternative choice**
- **V. Strategic Alternative Implementation**
  - **A. Action items**
  - **B. Action plan**

Industry Analysis. Porter's five forces model is a useful tool for analyzing the industry (or industries) in which your firm competes. We explain how to use this tool in Chapter 2. In this part of your analysis, you want to determine the attractiveness of an industry (or a segment of an industry) in which your firm is competing. As attractiveness increases, so does the possibility your firm will be able to earn profits by using its chosen strategies. After evaluating the power of the five forces relative to your firm, you should make a judgment as to *how* attractive the industry is in which your firm is competing.

Competitor Analysis. Firms also need to *analyze* each of their primary competitors. This analysis should identify competitors' current strategies, strategic intent, strategic mission, capabilities, core competencies, and a competitive response profile (see Chapter 2). This information is useful to the focal firm in formulating an appropriate strategy and in predicting competitors' probable responses. Sources that can be used to gather information about an industry and companies with whom the focal firm competes are listed in Appendix I. Included in this list is a wide range of publications, such as periodicals, newspapers, bibliographies, directories of companies, industry ratios, forecasts, rankings/ratings, and other valuable statistics.

Internal Analysis. Assessing a firm's strengths and weaknesses through a value chain analysis facilitates moving from the external environment to the internal organization. Analysis of the value chain activities and the support functions of the value chain provides opportunities to understand how external environmental trends affect the specific activities of a firm. Such analysis helps highlight strengths and weaknesses (see Chapter 3 for an explanation and use of the value chain).

For purposes of preparing an oral or a written presentation, it is important to note that strengths are internal resources and capabilities that have the potential to be core competencies. Weaknesses, on the other hand, are internal resources and capabilities that have the potential to place a firm at a competitive disadvantage relative to its rivals. Thus, some of a firm's resources and capabilities are strengths; others are weaknesses.

When evaluating the internal characteristics of the firm, your analysis of the functional activities emphasized is critical. For instance, if the strategy of the firm is primarily technology driven, it is important to evaluate the firm's R&D activities. If the strategy is market driven, marketing functional activities are of paramount importance. If a firm has financial difficulties, critical financial ratios would require careful evaluation. In fact, because of the importance of financial health, most cases require financial analyses. Appendix II lists and operationally defines several common financial ratios. Included are tables describing profitability, liquidity, leverage, activity, and shareholders' return ratios. Leadership, organizational culture, structure, and control

Table 3 Sample General Environmental Categories

Technological Trends
- Information technology continues to become cheaper with more practical applications
- Big Data technology allows organization and analysis of vast amounts of information
- Telecommunications technology and networks increasingly provide fast transmission of all sources of data, including voice, written communications, and video information
- Artificial intelligence is leading to dramatic changes in all industries around the world.

Demographic Trends
- Regional changes in population due to migration
- Changing ethnic composition of the population
- Aging of the population
- Aging of the "baby boom" generation

Economic Trends
- Interest rates
- Inflation rates
- Savings rates
- Exchange rates
- Trade deficits
- Budget deficits

Political/Legal Trends
- Antitrust enforcement
- Tax policy changes
- Increasing animosity and aggression between countrie
- Extent of regulation/deregulation
- Privatizing state monopolies
- State-owned industries
- Importance of diversity and inclusion

Sociocultural Trends
- Awareness of health and fitness issues
- Concern with income inequality and poverty
- Importance of social media

Global Trends
- Currency exchange rates
- Free-trade agreements
- Trade deficits

Physical Environment Trends
- Environmental sustainability
- Corporate social responsibility
- Renewable energy
- Goals of zero waste
- Ecosystem impact of food and energy production

systems (see Chapters 11 and 12) are other characteristics of firms you should examine to fully understand the "internal" part of your firm.

Identification of Environmental Opportunities and Threats and Firm Strengths and Weaknesses (SWOT Analysis)

The outcome of the situation analysis is the identification of a firm's strengths and weaknesses and its environmental threats and opportunities. The next step requires that you *analyze* the strengths and weaknesses and the opportunities and threats for configurations that benefit or do not benefit your firm's efforts to perform well. Case analysts and organizational strategists as well seek to match a firm's strengths with its opportunities. In addition, strengths are chosen to prevent any serious environmental threat from negatively affecting the firm's performance. The key objective of conducting a SWOT analysis is to determine how to position the firm so it can take advantage of opportunities, while simultaneously avoiding or minimizing environmental threats. Results from a SWOT analysis yield valuable insights into the selection of a firm's strategies. The analysis of a case should not be overemphasized relative to the synthesis of results gained from your analytical efforts. There may be a temptation to spend most of your oral or written case analysis on results from the analysis. It is important, however, that you make an equal effort to develop and evaluate alternatives and to design implementation of the chosen strategy.

Strategy Formulation—Strategic Alternatives, Alternative Evaluation, and Alternative Choice

Developing alternatives is often one of the most difficult steps in preparing an oral or a written presentation. Developing three to four alternative strategies is common (see Chapter 4 for business-level strategy alternatives and Chapter 6 for corporate-level strategy alternatives). Each alternative should be feasible (i.e., it should match the firm's strengths, capabilities, and especially core competencies), and feasibility should be demonstrated. In addition, you should show how each alternative takes advantage of the environmental opportunity or avoids/ buffers against environmental threats. Developing carefully thought out alternatives requires synthesis of your analyses' results and creates greater credibility in oral and written case presentations.

Once you develop strong alternatives, you must evaluate the set to choose the best one. Your choice should be defensible and provide benefits over the other alternatives. Thus, it is important that both alternative development and the evaluation of alternatives be thorough. The choice of the best alternative should be explained and defended.

Strategic Alternative ImplementationAction Items and Action Plan

After selecting the most appropriate strategy (that is, the strategy with the highest probability of helping your firm in its efforts to earn profits), implementation issues require attention. Effective synthesis is important to ensure that you have considered and evaluated all critical implementation issues. Issues you might consider include the structural changes necessary to implement the new strategy. In addition, leadership changes and new controls or incentives may be necessary to implement strategic actions. The implementation actions you recommend should be explicit and thoroughly explained. Occasionally, careful evaluation of implementation actions may show the strategy to be less favorable than you thought originally. A strategy is only as good as the firm's ability to implement it.

Process Issues

You should ensure that your presentation (either oral or written) has logical consistency throughout. For example, if your presentation identifies one purpose, but your analysis focuses on issues that differ from the stated purpose, the logical inconsistency will be apparent. Likewise, your alternatives should flow from the configuration of strengths, weaknesses, opportunities, and threats you identified by analyzing your firm's external environment and internal organization.

Thoroughness and clarity also are critical to an effective presentation. Thoroughness is represented by the comprehensiveness of the analysis and alternative generation. Furthermore, clarity in the results of the analyses, selection of the best alternative strategy, and design of implementation actions are important. For example, your statement of the strengths and weaknesses should flow clearly and logically from your analysis of your firm's internal organization.

Presentations (oral or written) that show logical consistency, thoroughness, and clarity of purpose, effective analyses, and feasible recommendations (strategy and implementation) are more effective and are likely to be more positively received by your instructor and peers. Furthermore, developing the skills necessary to make such presentations will enhance your future job performance and career success.

Appendix I Sources for Industry and Competitor Analyses

Abstracts and Indexes	
Periodicals	ABI/*Inform* *Business Periodicals Index* *InfoTrac* Custom Journals *InfoTrac* Custom Newspapers *InfoTrac* OneFile EBSCO Business Source Premiere Lexis/Nexis Academic *Public Affairs Information Service Bulletin* (PAIS) *Reader's Guide to Periodical Literature*
Newspapers	*NewsBank—Foreign Broadcast Information* *NewsBank-Global NewsBank* *New York Times Index* *Wall Street Journal Index* *Wall Street Journal/Barron's Index* *Washington Post Index*
Bibliographies	*Encyclopedia of Business Information Sources*
Directories	
Companies—General	*America's Corporate Families and International Affiliates* *Hoover's Online: The Business Network* www.hoovers.com/free D&B Million Dollar Directory (databases: http://www.dnbmdd.com) *Standard & Poor's Corporation Records* *Standard & Poor's Register of Corporations, Directors, and Executives* (http://www .netadvantage.standardandpoors.com for all of *Standard & Poor's*) *Ward's Business Directory of Largest U.S. Companies*
Companies—International	*America's Corporate Families and International Affiliates* *Business Asia* *Business China* *Business Eastern Europe* *Business Europe* *Business International* *Business International Money Report* *Business Latin America* *Directory of American Firms Operating in Foreign Countries* *Directory of Foreign Firms Operating in the United States* *Hoover's Handbook of World Business* *International Directory of Company Histories* *Mergent's International Manual* Mergent Online (http://www.fisonline.com—for "Business and Financial Information Connection to the World") *Who Owns Whom*
Companies—Manufacturers	*Thomas Register of American Manufacturers* U.S. Office of Management and Budget, Executive Office of the President, *Standard Industrial Classification Manual* *U.S. Manufacturer's Directory, Manufacturing & Distribution, USA*
Companies—Private	*D&B Million Dollar Directory* *Ward's Business Directory of Largest U.S. Companies*
Companies—Public	Annual Reports and 10-K Reports *Disclosure* (corporate reports) *Q-File* Securities and Exchange Commission Filings & Forms (EDGAR) http://www.sec.gov/edgar.shtml *Mergent's Manuals:* ■ *Mergent's Bank and Finance Manual* ■ *Mergent's Industrial Manual* ■ *Mergent's International Manual* ■ *Mergent's Municipal and Government Manual* ■ *Mergent's OTC Industrial Manual* ■ *Mergent's OTC Unlisted Manual*

(*Continued*)

Appendix I Sources for Industry and Competitor Analyses (*Continued*)

Abstracts and Indexes	
	■ *Mergent's Public Utility Manual* ■ *Mergent's Transportation Manual* Standard & Poor's Corporation, *Standard Corporation Descriptions:* http://www.netadvantage.standardandpoors.com ■ *Standard & Poor's Analyst Handbook* ■ *Standard & Poor's Industry Surveys* ■ *Standard & Poor's Statistical Service*
Companies—Subsidiaries and Affiliates	*America's Corporate Families and International Affiliates* *Ward's Directory* *Who Owns Whom* *Mergent's Industry Review* *Standard & Poor's Analyst's Handbook* *Standard & Poor's Industry Surveys* (2 volumes) U.S. Department of Commerce, *U.S. Industrial Outlook*
Industry Ratios	Dun & Bradstreet, *Industry Norms and Key Business* *Ratios RMA's Annual Statement Studies* *Troy Almanac of Business and Industrial Financial Ratios*
Industry Forecasts	International Trade Administration, *U.S. Industry & Trade Outlook*
Rankings & Ratings	Annual Report on American Industry in *Forbes Business Rankings Annual* *Mergent's Industry Review* http://www.worldcatlibraries.org *Standard & Poor's Industry Report Service* http://www.netadvantage.standardandpoors.com *Value Line Investment Survey* *Ward's Business Directory of Largest U.S. Companies*
Statistics	*American Statistics Index (ASI)* Bureau of the Census, U.S. Department of Commerce, *Economic Census Publications* Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States* Bureau of Economic Analysis, U.S. Department of Commerce, *Survey of Current Business* Internal Revenue Service, U.S. Treasury Department, *Statistics of Income: Corporation Income Tax* *Returns* *Statistical Reference Index (SRI)*

Appendix II Financial Analysis in Case Studies

Table A-1 Profitability Ratios

Ratio	Formula	What It Shows
1. Return on total assets	$\frac{\text{Profits after taxes}}{\text{Total assets}}$ or $\frac{\text{Profits after taxes + Interest}}{\text{Total assets}}$	The net return on total investments of the firm or The return on both creditors' and shareholders' investments
2. Return on stockholders' equity (or return on net worth)	$\frac{\text{Profits after taxes}}{\text{Total stockholders' equity}}$	How profitably the company is utilizing shareholders' funds
3. Return on common equity	$\frac{\text{Profits after taxes} - \text{Preferred stock dividends}}{\text{Total stockholders' equity} - \text{Par value of preferred stock}}$	The net return to common stockholders
4. Operating profit margin (or return on sales)	$\frac{\text{Profits before taxes and before interest}}{\text{Sales}}$	The firm's profitability from regular operations
5. Net profit margin (or net return on sales)	$\frac{\text{Profits after taxes}}{\text{Sales}}$	The firm's net profit as a percentage of total sales

Table A-2 Liquidity Ratios

Ratio	Formula	What It Shows
1. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	The firm's ability to meet its current financial liabilities
2. Quick ratio (or acid-test ratio)	$\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$	The firm's ability to pay off short-term obligations without relying on sales of inventory
3. Inventory to net working capital	$\frac{\text{Inventory}}{\text{Current assets} - \text{Current liabilities}}$	The extent to which the firm's working capital is tied up in inventory

Table A-3 Leverage Ratios

Ratio	Formula	What It Shows
1. Debt-to-assets	$\frac{\text{Total debt}}{\text{Total assets}}$	Total borrowed funds as a percentage of total assets
2. Debt-to-equity	$\frac{\text{Total debt}}{\text{Total shareholders' equity}}$	Borrowed funds versus the funds provided by shareholders
3. Long-term debt-to-equity	$\frac{\text{Long-term debt}}{\text{Total shareholders' equity}}$	Leverage used by the firm
4. Times-interest-earned (or coverage ratio)	$\frac{\text{Profits before interest and taxes}}{\text{Total interest charges}}$	The firm's ability to meet all interest payments
5. Fixed charge coverage	$\frac{\text{Profits before taxes and interest} + \text{Lease obligations}}{\text{Total interest charges} + \text{Lease obligations}}$	The firm's ability to meet all fixed-charge obligations including lease payments

Table A-4 Activity Ratios

Ratio	Formula	What It Shows
1. Inventory turnover	$\frac{\text{Sales}}{\text{Inventory of finished goods}}$	The effectiveness of the firm in employing inventory
2. Fixed assets turnover	$\frac{\text{Sales}}{\text{Fixed assets}}$	The effectiveness of the firm in utilizing plant and equipment
3. Total assets turnover	$\frac{\text{Sales}}{\text{Total assets}}$	The effectiveness of the firm in utilizing total assets
4. Accounts receivable turnover	$\frac{\text{Annual credit sales}}{\text{Accounts receivable}}$	How many times the total receivables have been collected during the accounting period
5. Average collecting period	$\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	The average length of time the firm waits to collect payment after sales

Table A-5 Shareholders' Return Ratios

Ratio	Formula	What It Shows
1. Dividend yield on common stock	$\frac{\text{Annual dividend per share}}{\text{Current market price per share}}$	A measure of return to common stockholders in the form of dividends
2. Price-earnings ratio	$\frac{\text{Current market price per share}}{\text{After-tax earnings per share}}$	An indication of market perception of the firm; usually, the faster-growing or less risky firms tend to have higher PE ratios than the slower-growing or more risky firms
3. Dividend payout ratio	$\frac{\text{Annual dividends per share}}{\text{After-tax earnings per share}}$	An indication of dividends paid out as a percentage of profits
4. Cash flow per share	$\frac{\text{After-tax profits + Depreciation}}{\text{Number of common shares outstanding}}$	A measure of total cash per share available for use by the firm

Case 1

The Rise and Demise of Airbus A380

Landing at Singapore's Changi Airport on an unusually hot morning of July 2021, the Airbus A380 of the Singapore Airline (SIA) fleet had the forceful, unwavering presence of a giant predatory bird. With its enormous wings, spacious interior and broad domed crown, the aircraft was truly an engineering feat. However, sales of the A380 had failed to surge as the airline industry saw a decline in demand for very large aircrafts, and Airbus decided to halt the production of the A380 from 2021.[1] In a press address, Airbus CEO Tom Enders had sadly declared,

> *It's a painful decision. We have invested a lot of effort, a lot of resources and a lot of sweat into this aircraft. But, obviously, we need to be realistic. With the decision of Emirates to reduce orders, our order backlog is not sufficient to sustain production.*[2]

The A380 was developed as a strategic tactic by Airbus to compete with Boeing in the very large aircraft market space. The Boeing 747 (B747) was launched in 1965, and became a huge success as it was the only very large aircraft in the market.[3] The B747 enjoyed a monopoly for a few decades, and became Boeing's Cash Cow, helping catapult the company as the market leader in the commercial aircraft manufacturing industry.

The aircraft manufacturing industry was capital intensive and saw several waves of consolidations from 1960 to 1990. By the end of the 90s, it had mainly two large players - Airbus and Boeing, who competed head to head and accounted for more than 90% of the market share. Between 1990 and 2001, Airbus managed to launch several wide body and narrow body models, and eventually became the market leader in 2007. The A380 was officially launched in 2005; however, its first flight only happened in 2007, mainly due to several production delays of the aircraft. After the launch of the A380, the market for the very large aircraft was split between Boeing and Airbus.

The demand for very large aircrafts had emerged from a market trend in the aviation industry, where the hub-and-spoke model was predicted to become the main form of air travel by the late 1990s. Airlines had traditionally used the point-to-point travel mode. However, with economic growth, especially in Asia, many large cities had established themselves as mega airport hubs, and relied on the hub-and-spoke to connect flights with other cities across the globe. London's Heathrow Airport and Singapore's Changi Airport were examples of such mega hubs that had motivated airlines like British Airways, Emirates and SIA to rely on the hub-and-spoke model to reconfigure traditional air travel. Very large aircrafts supported the hub-and-spoke configuration by facilitating more seats per plane, higher fuel efficiency and lesser cost per seat for airlines using the model. The hub-and-spoke model also supported airport stopovers, and airport shopping by travellers, thereby creating a wine and cheese correlation of airlines and airports.

However, post the financial crisis in 2008, air travel had started to revert to the point-to-point mode, as airlines realised that it was more economical to maintain and fly medium sized airplanes given that running very large aircrafts profitably required a full aircraft for every flight. After the financial crisis, many new budget airlines started to emerge and became huge hits. Such airlines typically used medium to small sized aircrafts and the point-to-point mode to offer travellers a seat-only air travel experience for much cheaper ticket prices.

By 2010, the demand for very large aircrafts had started to slow down, and by 2018, many connoisseur airlines of hub-and-spoke travel started to reassess their strategies. Both A380 and B747 that catered to the hub-and-spoke model saw a dramatic decline in demand over the ensuing years. The A380 had been a hugely expensive project for Airbus in terms of R&D and development costs, which had far exceeded the original estimates by the time the aircraft was launched. Additionally, because of its size, it had required significant investments from the buyers (airlines) to accommodate the plane on their runaways. To remain attractive for its clients, the A380 had to be subsidised heavily for the airlines. By 2019, Airbus had incurred huge losses from the A380 (around US$ 219 million for the year alone)[4], and as it became clear that the aircraft could not become profitable in the near future, the company made the harsh decision of shutting down its pet project in June 2020.[5]

The demise of the A380 indicated the volatility of the commercial aircraft industry, and its frequent changing needs over time. What had caused the A380 to fail? Was it bad strategy? How could Airbus keep its competitiveness with changing times, and capture the potential of the developing air travel market in Asia? How could Airbus continue to maintain its leadership position in the market?

Aircraft Industry before the A380

The motivation for the A380 was rooted in Airbus's history, and its vision of competing with American aircraft manufacturers. After World War II, American aircraft companies

This case was written by Professor Geng Xuesong and Lipika Bhattacharya at the Singapore Management University. The case was prepared solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

like Boeing and McDonnell Douglas had become the leading providers of jet airliners in the world.[6] European airplane manufacturers, who had produced some of the world's best passenger aircraft and pioneered commercial jet travel, felt threatened, and were worried that they would end up as sub-contractors to American manufacturers. In July 1967, ministers from France, Germany and Britain agreed to form a joint consortium named Airbus to compete with the American manufacturers.

The consortium launched its first aircraft, Airbus A300, a short-to-medium range twin-engine aircraft for short-haul air travel, which started operating in 1972.[7] The market response to A300 was poor, and the European governments had to subsidise the consortium to keep it going. Despite the poor initial success, Airbus managed to sell 81 aircrafts by 1979, and launched the A320 in 1981. The A320 was hugely successful, with over 400 orders even before its first flight, catapulting Airbus into a major player in the industry.[8] While the A300 was a wide body aircraft, the A320 was a narrow body plane, and became popular in the point-to-point routes.[9]

Strategically, Airbus had started its journey building wide bodies, while Boeing had mainly focussed on building narrow bodies.[10] However, by the late 70's large airport hubs had started to emerge globally, motivating airliners to adopt the hub-and-spoke model increasingly.[11] Foreseeing this market trend, Boeing had launched the first very large commercial aircraft, B747, in 1970, to cater to the long-haul market, taking international air travel to a new level of excitement.12 The wide body B747 brought comfortable air travel at affordable prices to the forefront and saw humongous success as a passenger as well as a cargo aircraft.13 From 1970 to 1992, the B747 recorded a sale of 950 aircrafts and became the Cash Cow for the company.14

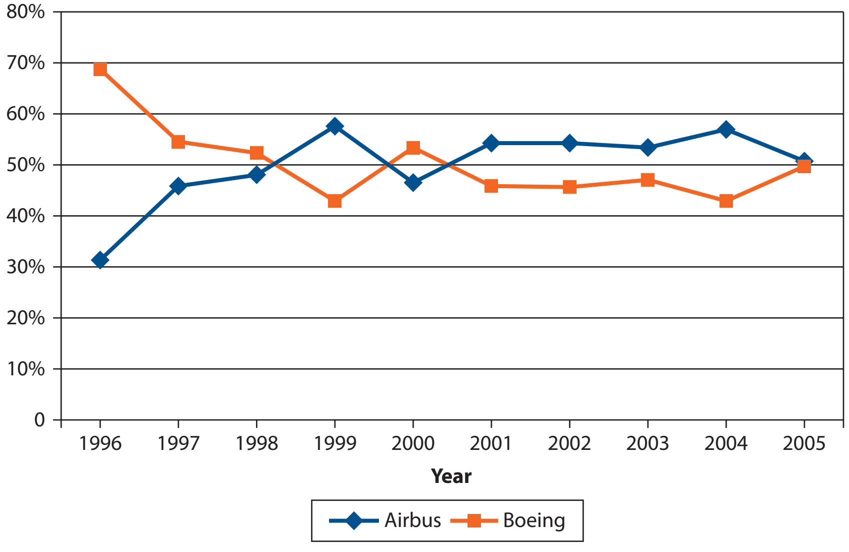
In 1992, the global aviation industry reached the US$100 billion mark and Boeing emerged as the clear market leader with 57% market share followed by McDonnell Douglas with 20% and Airbus with 16% of the market share.[15 16]

Duopoly: Airbus and Boeing

Between 1992 and 1997, the aircraft industry saw major consolidations, and smaller manufacturers were forced out of the market.[17] Airbus emerged as Boeing's biggest competitor and both firms continued to add new models, and became the two dominating players of the industry after 1997 (refer to **Exhibit 1** for Airbus and Boeing market share). Despite the progressing duopoly, growth in air travel was predicted to continue expanding and the consensus was that the commercial aircraft industry would become a US$1 trillion market over the next 20 years.[18]

In the competition between Boeing and Airbus, Boeing held the upper hand because of the B747, which became the most profitable airplane in the industry, allowing the company to reinvest those profits in other segments.[19] The B747 was the only aircraft at the time in the very large aircraft category, with more than 400 seats. Boeing had invested US$1.5 billion in the B747 and saw a growth of 39% in orders over the decade (total orders jumped from 935 in 1989 to 1303 in 1999, with an average of 37 planes per year).[20 21] The aircraft generated an operating profit of US$40 million per plane (on an average selling price of US$150 million per plane). Analysts had estimated that the B747 accounted for 70% of Boeing's operating profit during the 90s.[22]

Exhibit 1 Airbus and Boeing Market Share



Source: Ivan Png, Airbus vs Boeing, Managerial Economics, Cases, National University of Singapore, https://www.comp.nus.edu.sg/~ipng/mecon/cases/Airbus.pdf, accessed July 2021.

Both Airbus and Boeing depended on a huge ecosystem of suppliers globally for the manufacturing of the aircrafts. They purchased parts such as engines, wings, frames and flight instruments from many long-term suppliers who were heavily reliant on the manufacturer for revenues. Any changes in specifications, quality standards, or delivery dates could significantly and adversely affect the supply chain and the production timeline of the planes.[23]

Airbus and Boeing also had manufacturing sites spread across different locations. Boeing developed its aircrafts on the U.S. soil, and Airbus in Europe. Boeing manufactured its commercial aircrafts in the two principal facilities of Everett and Renton, in Washington, U.S. The company relied on other facilities for the production of sub-assemblies and machine parts from nine national (U.S.) sites and five international facilities. Airbus had 15 different facilities across four countries in Europe, where parts and assemblies were manufactured. The wings and various parts of the fuselage were manufactured at separate plants and sent to Toulouse, France, or Northern Germany for final assembly.[24]

Airlines

By 1998, the airline industry had consolidated into two distinct market segments. The first was the hub-and-spoke market dominated by established and powerful carriers, and the second, were peripheral markets serviced by point-to-point carriers, exemplified by Southwest Airlines.[25] The airline industry was also becoming increasingly global in orientation and scope. [26] The established airlines held a dominant position in their respective countries and were able to fend off penetration and competition by new entrants.[27] At the global level, none of the individual mega-carriers dominant in their respective regions were big enough to be a global player. All these airlines concentrated their hold on their home/niche market as a primary strategy, and had limited resources to expand on a global scale. Most carriers opted for choosing compatible partners to expand globally.[28]

Airlines would either purchase or lease a plane, and place orders with the manufacturer a few years in advance, as planes could take anywhere between one to two years to be produced and delivered. Aircraft purchase was a huge investment decision for airlines, and typically, most airlines chose to invest in models that were technologically similar to the ones they already owned so that cabin personnel benefited from familiarity of aspects on various aircraft types and required minimal additional training to operate. This enabled cross crew qualification – pilots trained to fly one aircraft could qualify to operate another with relatively little extra training and allowed airlines to better match capacity and demand. [29] Both Boeing and Airbus tried to build commonality in all their models to promote sales and decrease operating costs. Additionally, airlines also looked for attributes like fuel efficiency, operational costs per seat, number of seats, and range when deciding which aircrafts to purchase or lease.30

Decision to Launch the A380

The idea of the very large "super-jumbo" A3XX aircraft was presented in 1994. Following the announcement of the A3XX project, Airbus saw a swift growth in its market share and by 1998, clinched 52% of the market for new aircrafts and received 556 firm orders.[31]

In 2001, the aircraft design of the new A3XX was finalised, the model name A380 was revealed, and the production process of the aircraft was implemented. The number 380 was a break from the Airbus sequence, A300 to A340, and had two primary motivations. First, the number 8 resembled the double-deck interior cross section alignment of the model. Second, it was considered a lucky number in Asian countries, particularly China - the most promising growth market at the time.[32] For building the A380, Airbus consulted more than 20 leading airlines about what it wanted to see in the new double-decker, and refined its design based on feedback, targeting a 15–20% reduction in operating costs over the existing Boeing B747–400.[33]

The decision to launch the A380 was driven by several strategic considerations. Airbus felt that the very large aircraft market had potential, and the B747 was mainly successful because of its monopoly. In a company publication, Jean Roeder, a senior executive at Airbus, had noted,

> *If Airbus Industries was to become a real global player, the 747 monopoly would have to end. Airbus was making efforts at this time to get 30 percent of the market, and we thought that this just would not be possible in the long term if we did not get a complete set of aircraft in our program.*[34]

However, launching the A380 was a high stake decision, because the barriers to entry into the very large aircraft (super-jumbo) market was huge due to costs involved. Boeing estimated the development cost for a new super-jumbo model (from scratch) would be US$20 billion (note that the first B747-100s were sold at a list price of US$24 million and had estimated development cost of US$3.7 billion).[35] The process of developing a plane typically took 2 to 5 years and the total cost of development as a rule of thumb was estimated at US$20 million per seat of launch for a new plane.[36] Contrary to Boeing's opinion, Airbus had estimated the development cost for its new aircraft to be slightly over US$10 billion, totalling US$11.9 billion after adding operating costs.[37]

Airbus management strongly believed that airlines would continue to maximise existing hub- and-spoke systems and high capacity aircrafts would help accommodate the growing number of passengers and alleviate airport slot congestion. They surmised that new airlines like Emirates would find the suitability of the large planes for hub-and-spoke systems and long haul routes more attractive.[38]

For a while, Airbus and Boeing held discussions about building the new "super-jumbo" together. However, these talks fizzled out, as Boeing changed its perspective of the future. Boeing's interest had declined as it believed that such a product was unlikely to recover the projected US$11.9 billion development cost. However, Airbus foresaw a market for 1,200 super-jumbo passenger aircrafts by 2025, which represented a market value of approximately US$416 billion.[39] Boeing had a more conservative estimate of 530 very large aircrafts by 2025.[40] Boeing also believed that any new super-jumbo would need more than 600 seats while Airbus felt that the new super-jumbo would need 500 seats.[41]

There were a few other market factors, which influenced the A380 launch decision.[42] The first was related to the operation costs incurred by airlines for flying aircrafts. For every airplane maintained by an airline, there were fixed operation costs. Each seat on the plane represented a portion of the total flight cost, and hence revenue per seat and total revenue from an airplane was an important consideration.[43] A hub-and-spoke network strategy was preferred as higher revenues could be achieved through this mode with higher load in larger aircrafts, while maintaining the same amount of fixed ground facilities and personnel, leading to cost savings.

Another factor was the availability of slots at airports for airliners to load their airplanes. Due to limited available slots, airliners could maximise their revenue capacity by using larger airplanes. For example, the use of the A380 could enable nearly 10 million more passengers to fly to or from London Heathrow without increasing the number of flights. Moreover, the percentage of passengers that used at least one hub on their journey was surprisingly high and the volume of seats offered for hub-to-hub or hub-to-secondary city markets far outstripped the secondary-to- secondary city growth rates.[44]

For travellers, instead of travelling directly to the destination, they could depart from their origin and connect with another plane at the hub before reaching their final destination, which usually involved a longer travel time, but at a lower price.[45 46] In a survey conducted in 2004, 33% of respondents had chosen their particular flight based on airfare. Only 11% of respondents picked non-stop service as their prime motivation to choose a given flight.[47] The economics of long-range non-stop services between hub cities using smaller aircraft was less feasible for airlines to undertake as competitive low fares were almost impossible to achieve due to expenses of slots and other costs incurred at hubs.[48] Large airplanes also provided increased comfort standards to passengers, significantly lower fuel burn per passenger, lower costs per passenger mile and the ability for "slot poor" airlines to carry larger number of high yield passengers.[49]

Rise of A380

The early response to the A380 was promising. By 2001, the project had won 50 firm orders from six airlines - Air France, British Airways, Emirates Airlines, Qantas Airways, SIA and Virgin Atlantic. In addition, the same six customers had taken options to buy another 42 of the new jets. However, with its humungous costs of building, the company needed to book between 250 and 300 orders before the project could break even.50

The initial orders of the A380 not only increased the visibility of Airbus's commitment to the high capacity aircraft market, but also put the company in a position where it would be costly and embarrassing to back out.

The manufacturing of the aircraft commenced in 2002, with the production of the wing-box component, followed by subassembly in 2003 and final assembly in 2004. In January 2005, the first prototype was unveiled in Toulouse, and the first commercial flight was collaborated with SIA on 27 April 2005.[51] The full-length double deck aircraft had a typical seating capacity of 550 and was certified to carry up to 853 passengers. It was powered with four Rolls Royce turbofans and provided a range (distance it could travel between take-off and landing) of 8,000 nautical miles (14,800 kilometres).[52]

Airbus offered a suite of services for the A380, which were packaged and customised to meet customer needs.[53] Many airlines had been able to provide new solutions, consolidate frequencies and introduce new routes relying on the A380's offerings. For example, British Airways had used the A380 to consolidate frequencies and release valuable slots for new destinations. [54] Thai Airways had replaced 10 weekly flights between Bangkok and Paris with a daily A380 flight for the same route.[55] In 2008, SIA switched all three daily B747 frequencies to A380 on its London to Singapore route to capture the high levels of demand and carry more passengers.[56] Such switches and consolidations allowed airlines to reduce traffic in their runaways, optimise their network, focus on peak travel times and create some savings in the process.[57]

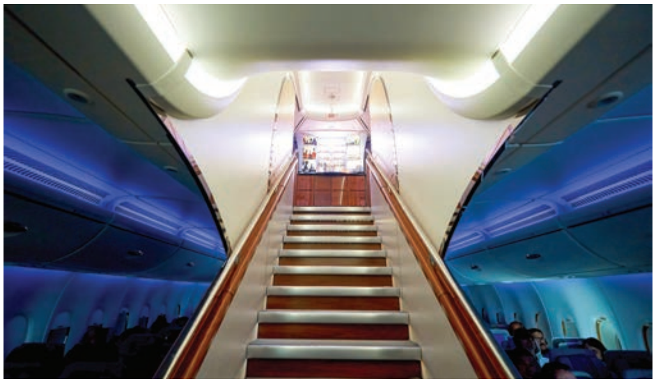
The seating capacity was believed to be the biggest advantage of the A380. More passengers in one flight reduced per passenger cost, translating to lower fares. This helped airlines attract travellers who would trade a stopover to pay a little less. The A380's unique size also allowed airlines to maximise their revenue potential through an optimised, segmented cabin design. Analysts had estimated the A380's operating margin to be between 14 to 19%.[58]

A380's interior design was flexible and allowed different class configurations depending on an airline's needs across short as well as long-haul flights providing solutions to maximise revenue and increase passenger traffic (refer to **Exhibit 2** for images of A380 – exterior and interior). The A380 cabin was considered the quietest and most spacious in the sky, and its service offerings ranged from a comfortable row of 11 seats in the economy section (each with a spacious 18-inch width), to a private three-room suite for a luxurious first-class experience.[59] On-board bars, lounges and even showers could be added because of its more than 500 square meters of usable floor space, which was 50% more than other large wide body models. Increased comfort of travel, flexible arrangement of seats to accommodate economy, business and luxury travellers, and ability to provide better airfares because of economies of scale contributed towards making the A380 one of the most popular jets amongst the passengers.[60]

Airports also benefited from the scale of the A380. Both Heathrow and Hong Kong airports had noticed that with

Exhibit 2 A380 Images

Ventura/Shutterstock



Sorbis/Shutterstock

M101Studio/Shutterstock

Leonard Zhukovsky/Shutterstock

Source: A380 Media Gallery, Airbus, https://www.airbus.com/search.image.html?tags=products-and- solutions%3Acommercial-aircraft%2Fa380-family&tagLogicChoice=OR, accessed July 2021.

extra passenger numbers, their retail and restaurant outlets had started to thrive. The two airports were so keen to have the A380 traffic, that they reduced the landing fees for the plane.[61] The A380 also had a dramatic effect on connecting traffic. Traffic figures had shown that the introduction of the A380 from San Francisco to Frankfurt had increased connecting traffic volume via Frankfurt by nearly 80%. Higher passenger volume also provided more revenue from regional and domestic feeder flights and competitive unit costs due to economies of scale.[62]

Increased tourism was also observed as a key benefit of the A380 in hub airports. For example, Emirates concentrated on long-haul traffic flows between Europe, Asia, India and Australia via its hub at Dubai, serving both primary and regional airports. Dubai's tourism benefited from this system, and it was reported that more passengers were stopping at Dubai for tourism, conference and business purposes.[63] Tourism in the regions and countries linked by Emirates had also benefited. For example, Emirates had invested heavily to promote Australia and Europe to the Middle East, which attracted a large number of tourists to Australia. Similarly, China Southern also benefited from increased tourism through its new flights between Australia and UK via Guangzhou using the A380. SIA also benefited with increased tourism in Singapore through the long-haul routes using the A380.[64]

Demise of the A380

By 2010, Airbus had seen some initial success for its A380 with 189 orders and 41 deliveries.65 The A380 had been well received by some of the key hub airlines in Asia like Emirates and SIA, and received positive responses from these clients in the initial years. However, despite the promising sales performance, some market trends had started to become increasingly unfavourable against larger aircrafts. While the A380 rose in popularity, the demand for the B747 remained bleak, and Boeing reduced its production capacity of the aircraft gradually (refer to Exhibit 3 for Airbus and Boeing aircraft orders).66 Airbus had anticipated that the economies of China and India would expand rapidly, and consequent passenger growth and volume demands between hubs in Asia would force airlines to consider using larger aircrafts. However, increased congestion of about 60% at hub airports in Asia had started to show up as early as in the late 90s, especially in Hong Kong, Taiwan, and Japan and many airlines had started to explore point-to- point routes with smaller aircrafts.67

Allegations

In addition to changing market conditions, the A380 faced other roadblocks over time. In 2004, the U.S. government lodged a case in the World Trade Organisation (WTO) against Airbus, for the funding support provided by the European Union (EU) for the A380 project. Allegedly, the project had garnered collective subsidies of approximately US$6.5 billion, causing significant loss of sales for the Boeing 747 aircraft. The EU retaliated to these allegations by filing a complaint on the US aid provided to Boeing, amounting to US$19 billion.[68] Over the years, the WTO ruled that both sides had unfairly subsidised their aircraft makers.[69]

Production Delays and Rising Costs

The A380 also experienced several production hiccups that delayed deliveries significantly. Due to the size of the aircraft, production imposed many challenges (such as the assembly

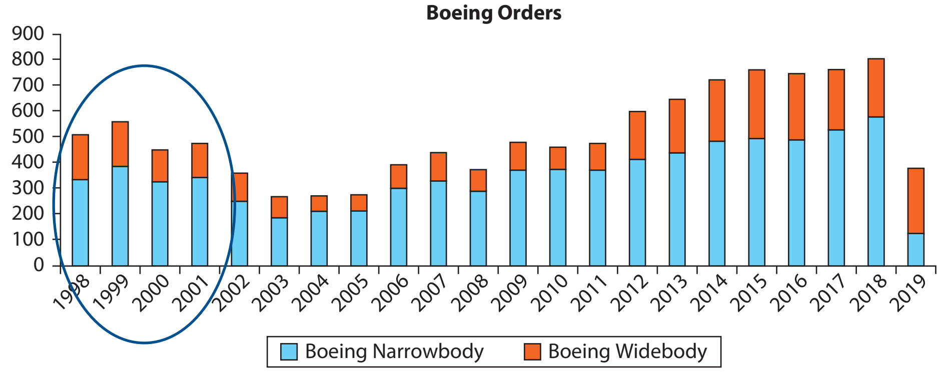
Exhibit 3 Airbus and Boeing Deliveries

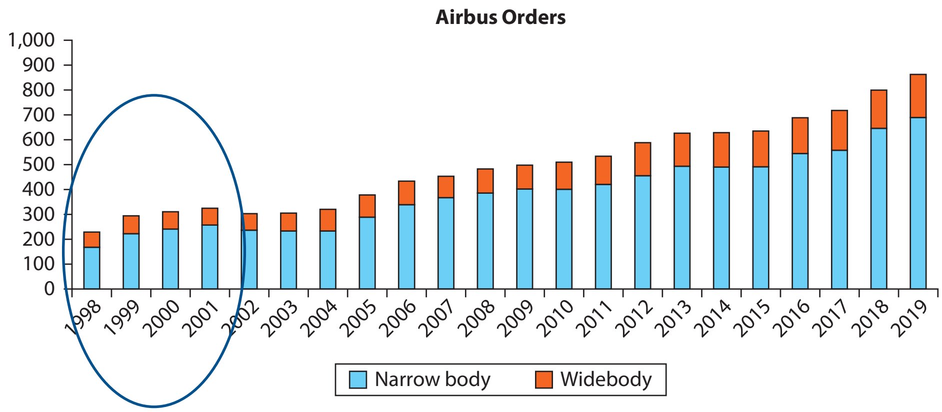
Airplane Type	Single aisle	Narrow body	Wide body	Narrow body	Wide body	Wide body	Wide body
Seats	100	130	242	243	245	350	525
Year	B717	B737	B787	B757	B767	B777	B747
1998		282		54	47	74	53
1999	12	320		67	44	83	47
2000	32	282		45	44	55	25
2001	49	299		45	40	61	31
2002	20	223		29	35	47	27
2003	12	173		14	24	39	19
2004	12	202		11	9	36	15
2005	13	212		2	10	40	13
2006	5	302			12	65	14
2007		330			12	83	16
2008		290			10	61	14
2009		372			13	88	8
2010		376			12	74	
2011		372	3		20	73	9
2012		415	46		26	83	31
2013		440	65		21	98	24
2014		485	114		6	99	19
2015		495	135		16	98	18
2016		490	137		13	99	9
2017		529	136		10	74	14
2018		580	145		27	48	6
2019		127	158		43	45	7

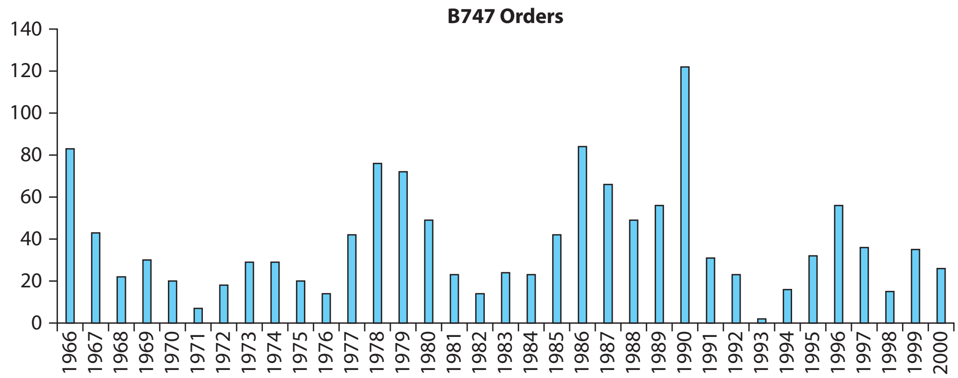
Exhibit 3 (cont.) Airbus and Boeing Deliveries

Airplane Type	Narrow body	Wide body	Wide body	Narrow body	Wide body	Wide body	Wide body	Wide body
Seats	133	247	240	186	250	270	300	550
Year	A220	A300	A310	A320	A330	A340	A350	A380
1998		13	1	168	23	24		
1999		8		222	44	20		
2000		8		241	43	19		
2001		11		257	35	22		
2002		9		236	42	16		
2003		8		233	31	33		
2004		12		233	47	28		
2005		9		289	56	24		
2006		9		339	62	24		
2007		6		367	68	11		1
2008				386	72	13		12
2009				402	76	10		10
2010				401	87	4		18
2011				421	87			26
2012				455	101	2		30
2013				493	108			25
2014				490	108		1	30
2015				491	103		14	27
2016				545	66		49	28
2017				558	67		78	15
2018	20			626	49		93	12
2019	48			642	53		112	8

Boeing Orders







of huge parts and revised testing processes to accommodate the size factor) and entailed building new production facilities from scratch. Not counting supplier facilities, around 16 Airbus sites scattered across Europe were involved in the construction of the major components. The logistics of transporting components from one site to another was also cumbersome, and huge parts were transported by land to assembly units.[70]

Production delays also increased due to the complexity and more time required than estimated for installing wiring in each aircraft, testing for weight related concerns, and building customised cabin interiors for each airline.[71] To add to these problems, the plane encountered a wing fracture issue during ground testing requiring elaborate fixes to the new wings, which extended the delay further.[72]

Due to production delays, complex fixes and re-tests, project costs for the A380 crept up significantly over the years, making it almost impossible for the company to recover the production costs from sales. At the official start of the project, the projected development cost was US$10.7 billion with an additional capital expenditure cost of US$1.2 billion putting the total development and launch cost at US$ 11.9 billion.[73]

Of this, 69% was earmarked for aircraft development and 31% for non-recurring investment.[74] However, by 2016, the development costs had more than doubled the initial estimation and risen to US$25 billion.[75]

Owing to the A380s size, it was estimated that approximately US$8 billion investment would be required by 2015 to prepare airport facilities for the widening of runaways, taxiways, and shoulders to accommodate the plane. Other modifications included reinforcement of pavements, installation of updated signals and lights, modification of blast pads and bridges and acquisition of necessary support infrastructure for expanding passenger and baggage handling systems.[76]

Boeing's Counter Strategy

To make matters worse, Airbus's competitor, Boeing responded to the market by coming up with a completely different strategy and product compared to the A380, which worked in its favour.

In response to the A380, Boeing had initially come up with the solution of a stretched version of the B747 (425 seats) in 2000, which would cost about US$4 billion to develop.[77] The company however, failed to secure any orders for the stretched B747 before announcing its decision to abandon the programme. But with the increasing popularity of the A380, Boeing announced in 2005 to develop the refined longer version of the B747, the B747-8 (or referred to as B747 Advanced), which would use fuel-efficient engines to carry 450 passengers. Boeing claimed that the B747-8 would be 10% lighter per seat and save airlines around 20% in trip-cost or a 6% reduction in the cost per seat-mile.[78]

However, soon Boeing's management changed its decision after observing the congestion at hub airports, and concluded that airlines would demand smaller and faster jetliners that would bypass hubs altogether. In 2003, Boeing started working on a new project called the B787 Dreamliner. The B787 was designed for long haul flights, with lightweight structure built from composite materials (reducing maintenance and replacement costs). The plane allowed airlines to offer direct flights between any pair of cities without layovers. With a capacity between 248 and 336 passengers and a range of up to 7530 nautical miles, the B787 was designed to use 20% less fuel compared to other similar sized airplanes, and provided a 10% lower cost per seat-mile compared to any other aircraft.[79]

By 2008, Boeing received orders from more than 50 airlines for 895 Dreamliner's. The overwhelming response to the Boeing 787 forced Airbus to rethink its strategy and quickly redesign its competitive mid-sized wide-bodied jet, the A350, to make it even wider, and re- release it as the A350XWB "extra wide body".[80] Analysts believed that Boeing's Dreamliner with a state-of-the-art and more recent engine technology was likely to be far more fuel efficient than the Airbus A380. Boeing's new model also provided a longer range for lower capacity, and therefore was more cost efficient. [81] The B787 was designed to bridge the gap between Boeing's 767 and 747, and was priced at US$442.2 million, which was cheaper than the A380 - priced at US$445.6 million.[82]

Boeing's counter prediction against Airbus's hub-and-spoke forecast also fared well. Boeing's projection was that passenger traffic would grow by 4.9 % year on year, the airlines industry would need a larger number of smaller aircrafts, and the single aisle airplanes would command the largest share of new deliveries.[83] The predicted change in demand pattern became clearer as Boeing planes designed for point-to-point systems started to become increasingly popular. The mid-size B777 (200-300 seaters) became the company's most lucrative model, and by 2008, orders for the second-generation B777 model approached 1098 aircrafts (refer to **Exhibit 4** for Airbus and Boeing models).[84 85]

Analysts attributed the dominance of point-to-point travel, despite the growth of airport hubs, to the Open Skies agreement, under which countries agreed to open up their airspace to market dynamics as opposed to being controlled by political allocations.[86] The EU nations, the U.S. and many other countries had signed the agreement, allowing more secondary cities to be able to offer international routes using point-to-point model. Under the agreement, airlines could respond to market demands and not be subject to political arrangements between countries on landings and take-offs.[87]

Fall in Demand

The demand for very large aircrafts in the market had started to fall by 2010.[88] Airlines that initially favoured big hubs such as Singapore and Dubai began to offer more direct flights from a significant number of middle-sized airports. Most importantly, the 2008 economic crisis had seriously cut into the growth in air traffic, and while some growth had returned a year later, the market was smaller than expected, making it harder to fill a 550 seat wide-body aircraft.

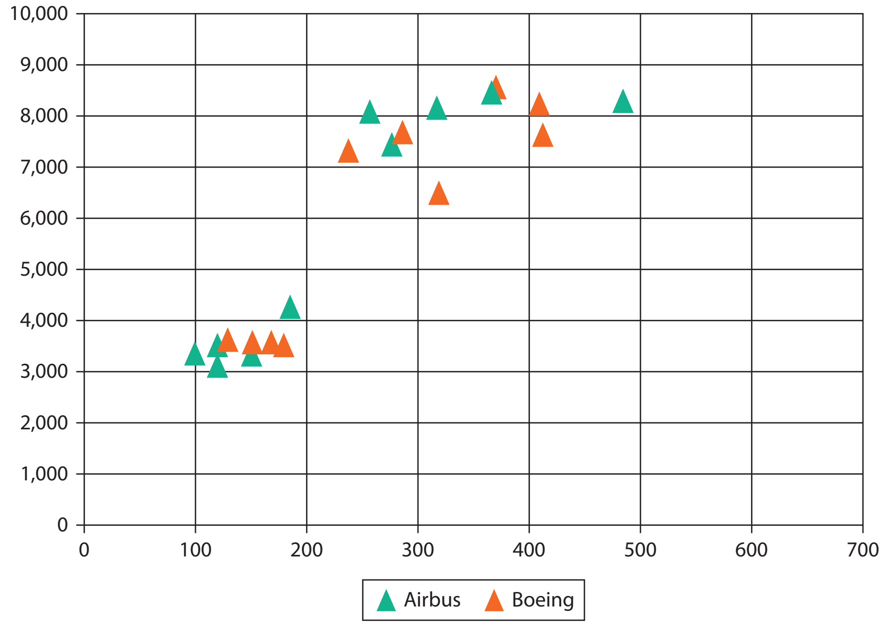
Surprisingly, although the airline industry made US$26 billion net profit in 2019, success remained unevenly distributed, with 65% of the total profit generated in North America.[89] In the face of its reputation for dynamic growth and demand, the Asia-Pacific region accounted for less than 20% of the global profitability.[90]

Besides, the rise of low-cost (budget) airlines had brought in influential new players in the airline market and weakened the long-time leaders that had seen big prospects for the A380. The 2010

Airbus Global Market Forecast had predicted that almost 26,000 new passenger and freight aircrafts worth US$3.2 trillion would be required over the next 20 years to satisfy demand.[91] However, these were mainly in the single-aisle segment, which was the workhorse of short-haul flights, especially for budget airlines.

Airlines had realised that compared to large aircrafts like the A380, smaller models were more feasible for meeting consumer demand and adapting to changing market conditions.

Exhibit 4 Airbus and Boeing Models



Source: Author's own, adapted from Orders and Deliveries, Airbus, Commercial Aircraft, https://www.airbus.com/aircraft/market/orders-deliveries.html, accessed July 2021; Orders and Deliveries, Boeing, Commercial, https://www.boeing.com/commercial/#/orders-deliveries, accessed July 2021.

Airlines had to sometimes balance between upgrading old planes and purchasing new planes and it became very costly to upgrade cabins for large aircrafts like the A380 when the planes aged. Smaller planes took small budgets and much shorter timeframe to upgrade. The estimated cost of upgrading a large aircraft could be over US$45 million - almost half of the list price of a smaller new plane like the A320. At the same time, new aircrafts with progressive technologies also helped airlines gain more fuel efficiency, which was a major competing criteria amongst airlines in a cut-throat competitive market.[92]

Due to high development costs, large aircrafts also faced a longer breakeven period. Airbus had estimated that the break-even for A380 could be achieved by 2015, after taking into account - delayed deliveries and overshooting development costs.[93] The program's total number of orders had only reached 234 by 2010.[94] Although the sales picked up in 2013, the A380 soon started losing its foothold.[95] It did not sell well in 2014 and 2015, with a grand total of 15 orders over the two-year period.[96] In 2015, Airbus delivered 55 A380s and in 2016, 28 A380s, rapidly depleting its order backlog. Due to the diminishing orders and shrinking backlog, Airbus decided to slash production of the A380 to 20 units in 2017 and then 12 annually beginning in 2018.[97] Notably, both the B747 and A380 saw dropping demand because of the changing market. The B747 had 92 deliveries in 1970 compared to seven in 2019, while Airbus had only eight deliveries in 2019, indicating a demand dip of almost 92% for very large aircrafts.[98]

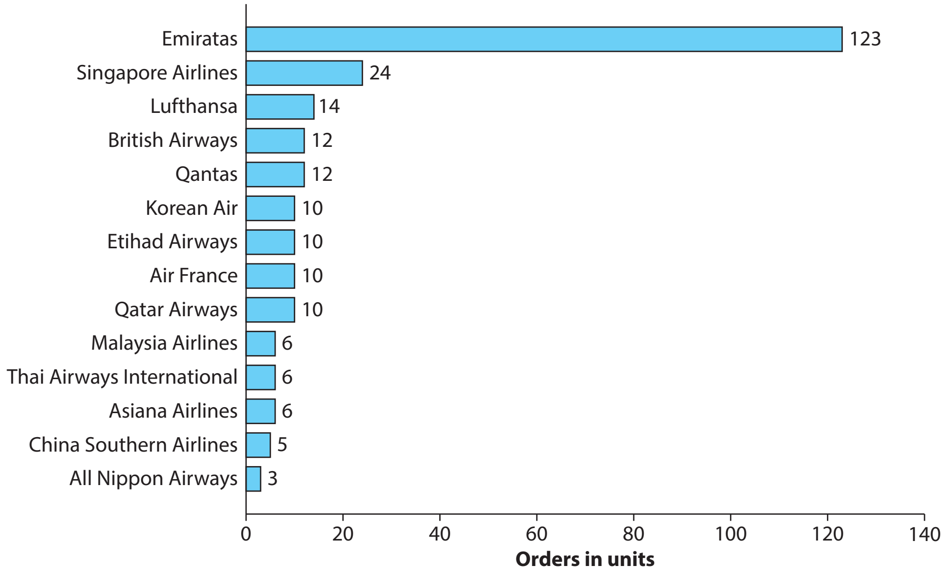
Losing Buyers

The connoisseurs of the A380 also started to back out on their support for the project (refer to **Exhibit 5** for key clients airlines of the A380). Emirates, A380's biggest and most ardent client, deferred six orders from 2017 to 2018 and another six orders from 2018 to 2019 due to engine problems. While Emirates had notable success with the hub-and-spoke model, like many airlines that had purchased the A380, it had started going the opposite direction by opening up new point-to-point routes. [99] Emirates also became more demanding asking for newer and customised models of A380 that could adapt to the market trends.[100]

SIA had supported the A380 project from the start, but the relationship started to turn sour when the first orders of the A380 got delayed by almost two years. In 2010, SIA experienced faulty engine issues in three of its 11 A380 super-jumbo jets.[101] In 2012, an A380 was turned back to Singapore after an engine problem three hours into a flight to Frankfurt. A380 planes were reported to be affected by a number of technical problems including minor cracks on part of its wings. While the A380 had been a very popular aircraft with passengers, SIA felt that it did not quite provide the economy and the profits that the airline had been expecting.[102]

The big size of the A380 proved to be a disadvantage in low peak periods when it became hard to fill every seat, negatively affecting the aircraft's yield. Airlines which used the A380 also faced several challenges on the ground, as only a few airports could accommodate the A380 because

Exhibit 5 Major Clients of The A380



Source: Author's own, adapted from Orders and Deliveries, Airbus, Commercial Aircraft, https://www.airbus.com/aircraft/market/orders-deliveries.html, accessed July 2021; Orders and Deliveries, Boeing, Commercial, https://www.boeing.com/commercial/#/orders-deliveries, accessed July 2021.

of its size - which limited the flexibility for the airlines to deploy the aircraft across routes. Additionally, the downtime (the time it took for the aircraft to manoeuvre in the airport and complete boarding) for the aircraft was also higher, which was a deterrent in 'slot-congested' large airports. The airlines which operated the A380 also suffered from lower fuel efficiency as lower load-factor (occupancy of flight) could dramatically reduce the aircraft's fuel efficiency because of its high fuel requirements.[103] Besides, the A380 was designed for passenger transport and its freight (cargo) version was halted due to its size, weight issues and lower initial demand.

Notably, the cargo market was a faster growing market than the passenger air travel market and aircrafts like B747 had minted on this opportunity due to their flexibility of being re-configured as a freight aircraft.[104]

Although the A380 had been developed with the ambition of luring airlines in China, the aircraft failed to attract the Chinese customers. Only one airline in China, China Southern, had procured five A380s from Airbus in 2011.[105] Several factors had affected this muted response from airlines in China. Firstly, very large aircrafts had a small demand in China, as the travel need was mainly domestic. Moreover, the A380 brought a risk of lower yields to Chinese airlines, and this was a key consideration as most Chinese airlines needed help with boosting yield and not volume.[106]

Other airlines also gradually lost interest in the A380 Virgin Atlantic had ordered six A380s in 2001 but never took delivery of the planes and later cancelled its order in 2018. In February 2019, Quantas cancelled its order of eight A380 airplanes, amidst doubts of the airplane's future. SIA had taken delivery of its original batch of 19 A380s and placed a top up order for an additional five aircrafts taking its total commitment to 24 – just one short of the number it had originally signed for in 2000. However, before these new aircrafts were delivered, SIA dropped a bombshell in 2016, when it decided not to extend its leases on its early batch of aircrafts, reducing its order total from 24 to 19 airplanes.[107] In February 2019, Emirates decided to cancel its order for 39 planes, opting to replace them with A350 and A330 Neos.108 Amidst such negative market sentiments, Airbus decided to close the production of the A380 by 2021, thereby ending its super-jumbo dream project.

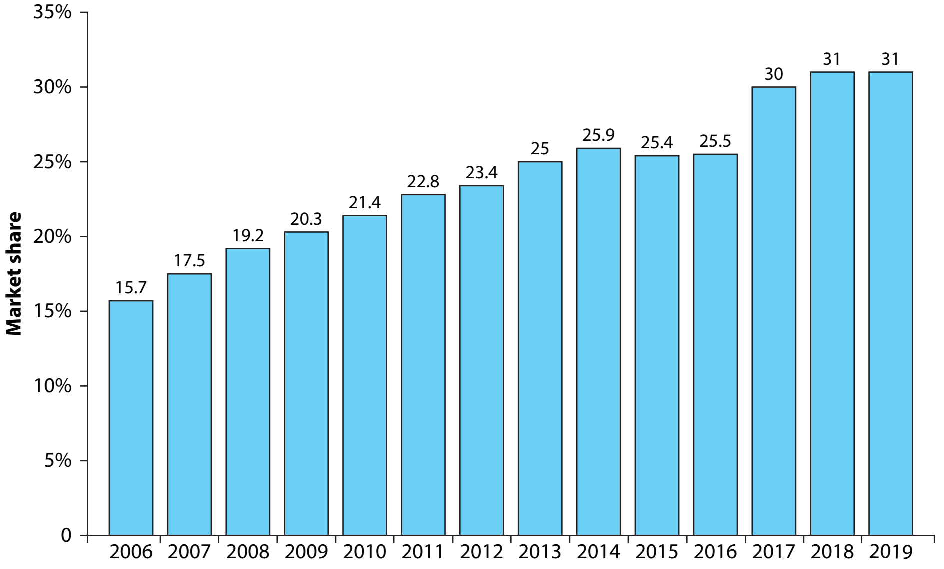
The Saga Continues

Despite the A380's much criticised journey, Airbus had continued to remain competitive in the market with its other airplanes (refer to **Exhibit 3** for Airbus and Boeing orders). Meanwhile, aviation technology had forged ahead with new airframes and engines, which promised lower fuel burn, less noise and more efficient flying.

Narrow-Bodies Market Trend

Narrow body aircrafts had gained popularity due to rise in point-to-point routes in the mid-size market segment, which was seen to carry huge potential.[109] The share of narrow bodies was expected to increase from 58% in 2019 to 66% by 2029.[110] The demand for narrow-body aircraft was attributed to the growth of the low-cost carrier (LCC) or the budget airlines business model (refer to **Exhibit 6** for the Growth of LCC from 2006 to 2019). Narrow bodies fitted the business model of the LCCs because of their extended ranges, fuel efficiency, and

Exhibit 6 Growth of Budget Airlines (LCC Growth)



Source: Low cost carriers' worldwide market share from 2007 to 2020, Aviation, Statista, https://www.statista.com/statistics/586677/global-low-cost-carrier-market-capacity-share/, accessed July 2021.

higher maximum take- off weight.[111] The goal was to accommodate more passengers with airplanes that were cheaper to operate than the larger, less flexible wide-body aircrafts that dominated long-haul flights. This transition also reflected a greater willingness by passengers to accept smaller cabins on long-haul flights than what was the norm just 10 years ago.[112]

The global wide-body fleet was forecast to remain at about 20% of the market share from 2019 to 2029 with minimal growth prospects.[113] On a separate note, worldwide passenger numbers were set to surpass 4.7 billion by 2020 and increase on average by 200 million every year. In a 2019 report, the mature markets of North America and Western Europe were forecasted to experience relatively modest growth while Asia was expected to see high levels of growth, with China, India, Middle East and Asia Pacific growing at annual rates of 7.9%, 9.9%, 4.7%, and 4.2 %.[114] However, almost all of the growth in these markets were expected to come from budget airlines, with little overall increase in premium traffic. Consequently, the new traffic flows were highly price sensitive, with passengers attracted to affordable seats provided by LCCs, which on a global basis was expected to account for over a third of the market.[115]

Growing China Market

Further market changes and trends were fuelled by the rising dominance of the Chinese economy. By 2020, China had emerged as the world's biggest market for aircrafts. Both Airbus and Boeing had sold heavily to China's multiple state airlines.[116] A total of 3,639 aircrafts were operating in China by the end of 2018 and Airbus accounted for half the market share by 2019.[117] China had announced a massive US$35 billion order for 300 Airbus planes in 2019, which was widely seen as a blow to Boeing, which faced risks in the China market due to escalating US-China trade wars.[118] In its yearly analysis, Boeing had this time, shared a similar view to Airbus' growth outlook; the estimate was that China would need 8,090 new planes by 2038 and generate nearly US$3 trillion worth of orders for the industry over the next two decades.

However, China had also started to manufacture its own planes with Shanghai-based aerospace manufacturer, Commercial Aircraft Corporation of China (COMAC), leading the way. [119] COMAC had forecasted a need of 9,205 planes by 2038 and had designed the C919, a narrow- body twinjet airliner, to compete with the Boeing 737 MAX families and Airbus 320 Neo families. COMAC had also started designing other planes in different market segments, and industry analysts felt that the company could soon potentially become a competitor to Airbus and Boeing.[120] After Boeing and Airbus struck deals to take over production of rival planes made by Embraer and Bombardier, China's COMAC was perceived as the third option in the market for planes with more than 100 seats.[121]

Airbus Market Lead

Despite the failure of the A380, and losses incurred from the project, Airbus had fared well in the market in terms of beating competition. In 2019, it had made 863 aircraft deliveries compared to 380 commercial aircrafts delivered by Boeing. Airbus had also secured 768 net orders, which included 476 A321neos, which accounted for well over 70% of all orders. Meanwhile, Boeing's order book had increased very modestly, with 246 gross orders offset by 192 contractual cancellations. Boeing's narrow body aircraft (B737 MAX) had been grounded by various governments, including China, after a report of two accidents in 2019. This in turn had impacted many of its suppliers around the world who were heavily reliant on their Boeing contracts and shared production costs with the company.[122] The demand for the B747 had also dwindled and it had ceased to be a Cash Cow for the company. In July 2020, Boeing had decided to end the production of the B747 due to the changing market conditions.[123]

Environmental Adaptations

In September 2020, Airbus had come up with three environment friendly commercial aircraft ideas that used hydrogen as their primary fuel source, with the ambition of making zero emissions a reality by 2035. This was in line with the air transport industry's long-standing goal of reducing its carbon footprint by 50% below 2005 levels by 2050.[124] Airbus's CEO had shared,

> *We think the laws of physics don't need to change to make hydrogen competitive on planes, it's just a lot of work on technologies, on demonstrators, on testing, on regulations, on certification to make it work, we believe it's feasible within the time frame that we have developed.*[125]

In contrast, Boeing had invested in the rollout of sustainable aviation fuels (SAF) for all its new aircrafts by 2030. The market observation was that Boeing's move towards SAF did not involve the expansive scope of exercise and testing like those required by Airbus for designing and certifying hydrogen-fuelled aircrafts.[126] Most analysts, however, agreed that the head-to-head battle between Airbus and Boeing was likely to continue in the near future.[127]

Uncertainties

While the A380 had been touted as a failure, Airbus had continued to protect its market share despite a turbulent two-year period between 2019 and 2021, when the Covid-19 pandemic had spread havoc across the world. Amidst uncertain times, both Airbus and Boeing were expecting the pandemic to take a toll on their businesses. While both the A380 and the B747 were slated to be written off soon, their experiences had surely left the two competing companies with several key takeaways. For Airbus, had the A380 been just a bad strategy? Alternatively, had it been a good strategy gone wrong in execution? What learning lessons had the A380 provided Airbus? How could Airbus stay competitive despite the demise of its magnificent A380 in the near future? Would environmentally friendly planes become the new battlefield for the two rivals - Airbus and Boeing?

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Case 2

Air France–KLM: A Strategy for the European Skies[1]

Benjamin Smith was appointed chief executive officer (CEO) of French air transport group Air France–KLM SA (Air France–KLM) in September 2018, after Jean-Marc Janaillac, the incumbent CEO, resigned. The group needed to end its losses, and in January 2019, work began to develop the firm's new vision, to be presented at the forthcoming board of director's meeting.[2]

Faced with several challenges, such as low profitability, falling prices, and increasing competition, Air France–KLM had gone from leading the European market in 2004 to fourth position, as local low-cost airlines and high-end emerging economy airlines joined the competition.[3] Air France–KLM had created several businesses to challenge the new competition but had yet to improve its financial results or increase its market share.[4] In this changing competitive context, what could Smith do to reassess the strategic role of the group's business units? What strategy could he propose to return the group to its leadership position?

The Air Transport Industry in Europe

Airline passengers were divided into two categories: leisure and business.[5] The former was typically price sensitive, while the latter valued flight schedules and service quality. Consumers sought cheap fares using Internet flight comparators such as Google Flights and Expedia. Through loyalty programs, airlines rewarded repeat business with benefits such as lounge access, upgrades, free flights, and reduced fares. Although business travellers represented only 12 per cent of the market, they accounted for up to 75 per cent of profits on certain routes.[6] By 2018, 802 million people travelled within the European Union (EU) annually.[7]

Core airline costs included fuel, aircraft, and wages (see Exhibit 1), with fuel costs varying substantially over time (e.g., fuel costs increased 54 per cent from 2017 to 2018).[8] Profitability in the wider airline industry varied, with airlines themselves being the least profitable.[9] In Europe, airlines earned an average of US$6.65 (€5.64)[10] per passenger, generating a margin of 3.37 per cent.[11]

Air transport was regulated by the EU. In 1997, the EU liberalized its air space,[12] giving carriers the right to fly anywhere and encouraging countries to negotiate bilateral agreements on the management of landing and take-off slots and airport capacity.[13] Deregulation had three consequences. First, legacy carriers[14] formed hub-and-spoke networks to increase the number of destinations they served, fill their planes, and reduce operating costs.[15] Second, the creation of airline alliances made it possible for individual

Exhibit 1 Main Costs of Airlines

Companies	Salary Costs (%)	Depreciation (%)	Maintenance (%)	Operating Costs * (%)	Roads and Charges (%)	Fuel (%)
Air France–KLM SA	30.0	11.1	9.3	23.0	7.3	19.2
Deutsche Lufthansa AG	24.9	6.2	5.2	33.8	12.6	17.2
International Airlines Group	22.7	10.1	8.6	23.3	10.3	24.9
Ryanair	14.7	9.6	2.9	25.3	11.2	36.3
easyJet plc	14.7	4.2	6.1	44.4	7.8	22.9

Note: *Operating costs included commercial charges, airport services, aeronautical services, and other unspecified expenses.

Sources: Air France–KLM, *Document de référence 2018* (n.p.: Air France KLM Group, 2019), https://www.airfranceklm.com/fr/system/files/document_de_reference_air_france-klm_2018_vf.pdf; Lufthansa Group, *Annual Report 2018* (Cologne: Deutsche Lufthansa AG, 2019), https://www.lufthansagroup.com/en/themes/annual-report-2018.html; International Airlines Group, *Annual Report 2018* (Harmondsworth, UK: International Airlines Group, 2019), https://www.iairgroup.com/~/media/Files/I/IAG/documents/annual-report-and-accounts-2018-interactive.pdf; Ryanair DAC, *Annual Report 2019* (Dublin: Ryanair, 2020), https://investor.ryanair.com/wp-content/uploads/2019/07/Ryanair-2019-Annual-Report.pdf; EasyJet Plc, *The Warmest Welcome in the Sky: Annual Report and Accounts 2018* (Bedfordshire, UK: EasyJet Plc, 2019), http://corporate.easyjet.com/~/media/Files/E/Easyjet/pdf/investors/results-centre/2018/2018-annual-report-and-accounts.pdf.

carriers to offer more destinations without increasing costs; by 2018, the three global alliances, Star Alliance, Oneworld, and SkyTeam, had captured 53.5 per cent of the total market share.[16] Third, low-cost airlines[17] competed with traditional airlines, capturing an increasing percentage of the market.[18]

Price wars became commonplace; for example, from 1992 to 2017, the cost of a round-trip Paris–Rome airfare decreased from €400 to €25.[19] European airports reacted to industry changes by moving toward privatization; by 2018, 59 per cent were public (down from 78 per cent in 2010[20]), 25 per cent were private–public partnerships, and 16 per cent were private. Consequently, airport charges at major European airports doubled.[21] By 2018, many European airports were on the verge of saturation; the EU estimated that there would be an overcapacity of 1.9 million flights by 2035 if congestion issues were not resolved.[22]

Other industry events also increased competition between air and other forms of travel. Given that planes were the most polluting mode of transport,[23] approximately one in five travellers claimed to have reduced their air travel out of concern for the environment.[24] The EU's 2009 Shift2Rail initiative, which aimed to increase rail travel significantly,[25] drove the development of Europe's high-speed rail network, leading to a fall in air ridership as train travel times decreased[26]—in some cases, by as much as 80 per cent.[27]

Within the EU, airline companies were exposed to tax systems, social systems, and regulations that varied between countries. The taxation of airline activities, for example, led to decreases in passenger demand, flights, and industry jobs.[28] In 2017 and 2018, the industry experienced a wave of low-cost carrier bankruptcies, while active carriers continued to experience significant financial difficulties.[29]

Exhibit 2 Market Share of the TOP 10 airlines in Europe (in seats)

Ranking	Companies	Share of Seats in Europe (%)
1	Deutsche Lufthansa AG	12.5
2	International Airlines Group	9.2
3	Ryanair	8.7
4	Air France–KLM SA	7.4
5	easyJet plc	6.3
6	Turkish Airlines Group	6.0
7	Aeroflot Group	4.5
8	Norwegian Group	3.1
9	SAS Group	2.8
10	Pegasus Airlines Group	2.2

Source: CAPA Centre for Aviation, "Europe Airline Outlook 2019: The Haves vs the Have-Nots," February 1, 2019, CAPA, https://centreforaviation.com/analysis/airline-leader/europe-airline-outlook-2019-the-haves-vs-the-have-nots-457915.

Competition

Deutsche Lufthansa

Founded in 1953 and based in Cologne, Germany, Deutsche Lufthansa AG (Lufthansa) had the largest number of seats in the European market, at 12.5 per cent at the start of 2019 (see Exhibit 2). It was also a member of the Star Alliance, which represented 21.7 per cent of the world's air traffic.[30] The firm owned six companies: Lufthansa, Swiss International Airlines AG, and Austrian Airlines AG made up the high-end network segment, while Brussels Airlines, Germanwings GmbH, and Eurowings GmbH (Eurowings) formed the low-cost (point-to-point) segment.[31] Lufthansa also operated three aeronautical service subsidiaries: Lufthansa Cargo AG, Lufthansa Technik AG, and the LSG Sky Chefs. In 2018, the turnover breakdown was as follows (see Exhibit 3): high-end business (63 per cent), low-cost segment (12 per cent), maintenance services (11 per cent), logistics services (7 per cent), LSG Sky Chefs (7 per cent), and other services (2 per cent).[32]

The company's goal was to remain the first choice for shareholders, customers, and employees, based on quality of service and strict cost control.[33] In 2012, Lufthansa introduced its "Synergy, Cost, Organization, Revenue, Execution" (SCORE) restructuring plan. As part of the plan, Lufthansa transferred all point-to-point flights from Lufthansa to Eurowings and renegotiated its employee contracts. It reduced hierarchical levels, promoted communication between subsidiaries, and reduced headcount. By 2014, it posted an additional revenue of €2.3 billion and focused on upgrading its high-end businesses.[34] From 2017 onward, Lufthansa was one of the few companies worldwide—and the only European firm—to be certified with five stars by the agency Skytrax.[35]

International Consolidated Airlines Group

International Consolidated Airlines Group SA (IAG) was based in Madrid, Spain, and was formed through the 2010 merger of British Airways (UK) and Iberia, Líneas Aéreas de España, SA Operadora, Sociedad Unipersonal (Iberia) (Spain). IAG accounted for 9.2 per cent of the European market (see Exhibit 2) and was part of the Oneworld alliance, which accounted for 15.6 per cent of world air traffic.[36] IAG subsidiaries included British Airways, Iberia, Aer Lingus, and two low-cost companies, Vueling Airlines SA and OpenSkies SASU (operating as LEVEL). IAG provided its subsidiaries with several commercial services, such as IAG GBS [global business services], which delivered digital and information technology (IT) services; the Avios loyalty program, which had 8.7 million members; IAG MRO [maintenance, repair, and overhaul] and Fleet, which provided maintenance services; and IAG Cargo, which transported goods. Its main

Exhibit 3 Financial Results of the Main Airline Competitors (in € millions)

Competitor	Results	2018	2017	2016	2015	2014
Lufthansa Group	Income	35,844	35,579	31,660	32,056	30,011
	Operating Revenue	2,800	3,140	2,190	1,555	1,171
	Operating Margin	7.8%	8.8%	6.9%	4.8%	3.9%
	Net Profit	2,163	2,340	1,776	1,698	55
International Airlines Group	Income	24,406	22,880	22,567	22,858	20,170
	Operating Revenue	3,230	2,950	2,535	2,335	1,390
	Operating Margin	13.4%	12.9%	11.2%	10.2%	6.9%
	Net Profit	2,481	2,231	1,990	1,539	1,003
Ryanair	Income	7,697	7,151	6,647	6,535	5,654
	Operating Revenue	1,016	1,667	1,543	1,460	1,042
	Operating Margin	13.1%	23.3%	23.2%	22.3%	18.4%
	Net Profit	885	1,450	1,315	1,559	867
easyJet	Income	6,542	5,598	5,178	5,197	5,021
	Operating Revenue	510	448	552	763	644
	Operating Margin	7.7%	8%	10.6%	14.7%	12.8%
	Net Profit	397	338	236	482	470

Sources: Lufthansa Group, *Annual Report 2018* (Cologne: Deutsche Lufthansa AG, 2019), https://www.lufthansagroup.com/en/themes/annual-report-2018.html; Lufthansa Group, *Annual Report 2016* (Cologne: Deutsche Lufthansa AG, 2017), https://investor-relations.lufthansagroup.com/fileadmin/downloads/en/financial-reports/annual-reports/LH-AR-2016-e.pdf; Lufthansa Group, *Annual Report 2014* (Cologne: Deutsche Lufthansa AG, 2015), https://investor-relations.lufthansagroup.com/fileadmin/downloads/en/financial-reports/annual-reports/LH-AR-2014-e.pdf; International Airlines Group, *Annual Report 2018* (Harmondsworth, UK: International Airlines Group, 2019), https://www.iairgroup.com/~/media/Files/I/IAG/documents/annual-report-and-accounts-2018-interactive.pdf; International Airlines Group, *Annual Report 2016* (Harmondsworth, UK: International Airlines Group, 2017), https://www.iairgroup.com/~/media/Files/I/IAG/annual-reports/iag-annual-reports/en/annual-report-and-accounts-2016-iag.pdf; International Airlines Group, *Report and Accounts* (Madrid: International Airlines Group, 2015), https://www.iairgroup.com/~/media/Files/I/IAG/annual-reports/iag-annual-reports/en/annual-report-and-accounts-2014-iag.pdf; Ryanair DAC, *Annual Report 2019* (Dublin: Ryanair, 2020), https://investor.ryanair.com/wp-content/uploads/2019/07/Ryanair-2019-Annual-Report.pdf; Ryanair DAC, *Annual Report 2016* (Dublin: Ryanair, 2017), https://investor.ryanair.com/wp-content/uploads/2016/07/Ryanair-Annual-Report-FY16.pdf; Ryanair DAC, *Annual Report 2014* (Dublin: Ryanair, 2015), https://investor.ryanair.com/wp-content/uploads/2015/04/2014-Annual-Reports-Annual-Report.pdf; EasyJet Plc, *The Warmest Welcome in the Sky: Annual Report and Accounts 2018* (Bedfordshire, UK: EasyJet Plc, 2019), http://corporate.easyjet.com/~/media/Files/E/Easyjet/pdf/investors/results-centre/2018/2018-annual-report-and-accounts.pdf; EasyJet Plc, *Investing in Our Strengths: Annual Report and Accounts 2016* (Bedfordshire, UK: EasyJet Plc, 2017), http://corporate.easyjet.com/~/media/Files/E/Easyjet/pdf/investors/result-center-investor/annual-report-2016.pdf; EasyJet Plc, *Making Travel Easy and Affordable: Annual Report and Accounts 2014* (Bedfordshire, UK: EasyJet Plc, 2015), http://corporate.easyjet.com/~/media/Files/E/Easyjet/pdf/investors/result-center-investor/annual-report-2014.pdf.

hubs were in London, Madrid, Rome, and Barcelona. The firm's key activities were passenger transport (88 per cent), commercial services (6.8 per cent), and freight transport (4.8 per cent).[37]

In 2018, IAG's objective was to become the top company in the world by maximizing the creation of value for its shareholders and customers (see Exhibit 3).[38] It sought to extend its dominant position in its main markets (London, Madrid, Barcelona, Dublin, and Rome) by offering new routes and establishing new markets with the launch of LEVEL long haul in Paris and LEVEL medium haul[39] in Vienna.[40]

After the merger, Iberia cut 3,800 jobs, reduced the size of its fleet, and renegotiated supplier contracts, allowing it to compete with low-cost airlines in Spain and capture market share in the premium long-haul segment.[41] British Airways renegotiated employment contracts, reduced its workforce, and froze wages for four years. It also continued to target higher-end segments with an investment of €7.4 billion.[42]

Ryanair

Ryanair DAC (Ryanair) was launched in 1984 in Dublin, Ireland, with the goal of creating the cheapest airline in Europe. Between 1997 and 2019, Ryanair operated 2,100 routes across Europe.[43] In 2018, the firm's average ticket price was €37 (down 6 per cent from 2017), and it accounted for 8.7 per cent of the European market.[44] It operated three low-cost subsidiaries: Buzz (Poland), Malta Air (Malta), and Lauda Luftfahrt GmbH (Austria).[45]

Like other low-cost airlines, initially Ryanair offered only one class of travel to all its passengers, with limited services (e.g., checked luggage cost extra). The company also stood out from its competitors by operating out of secondary airports[46] and regions that experienced lower air traffic, allowing passengers to disembark and board quickly and increasing overall capacity.[47]

However, although Ryanair claimed it was the most punctual airline in Europe and experienced the lowest percentage of lost baggage and flight cancellations,[48] in 2014 it was ranked the second-worst brand in the world.[49] In response, in 2014, the firm launched its "Always Getting Better" plan, which focused on additional services for business passengers, such as free checked luggage, priority boarding, flexible booking, and better seats.[50] The firm also allowed for a second piece of cabin baggage, reduced the price of printing a boarding pass at the airport, and enabled seat reservations.[51]

EasyJet

EasyJet PLC (easyJet) was founded in the United Kingdom in 1995 by Stelios Haji-Ioannou, a Greek-Cypriot businessperson, and represented 6.3 per cent of the European market (see Exhibit 2).[52] Unlike its rival Ryanair, easyJet operated from major airports in major cities and competed head on with traditional airlines.

In 2008, it launched its annual easyJet Plus subscription, which allowed members to board first and benefit from in-flight services.[53] In 2018, it introduced a plan to improve customer experience and retention by optimizing flight schedules for its business class passengers.[54] The company also focused on providing passengers with effortless trips and the "the warmest welcome in the sky."[55] It was the first low-cost airline to offer a loyalty program.[56]

Gulf-Based Companies

In the long-haul flight segment, Europe faced competition from Emirates, Qatar Airways Company QCSC, and Etihad Airways, Persian Gulf–based carriers that provided a luxury experience for the same price as flights with European-based companies. From 2004 to 2014, the number of routes between Europe and the Gulf countries increased from 23 to 69.[57] Between Europe and Asia, first-class travel on these three airlines grew 67 per cent, while business class travel grew 47 per cent.[58] In 2018, Qatar Airways was ranked the second-best airline in the world while Emirates was ranked fourth (see Exhibit 4). Lufthansa was the only European airline present in the top 10 (in seventh position).

Exhibit 4 Skytrax Ranking Of The 10 Best Airlines In The World

Companies	2018 Ranking	Ranking Change (from 2017)
Singapore Airlines	1	+1
Qatar Airways	2	−1
ANA All Nippon Airways	3	=
Emirates	4	=
EVA Air	5	+1
Cathay Pacific Airways	6	−1
Lufthansa	7	=
Hainan Airways	8	+1
Garuda Indonesia	9	+1
Thai Airways	10	+1

Source: "Airline of the Year Winners," Skytrax World Airline Awards, accessed June 11, 2021, https://www.worldairlineawards.com/airline-of-the-year-winners.

The Air France–Klm Merger

Prior to the Air France–KLM merger, Compagnie Nationale Air France (Air France) and Koninklijke Luchtvaart Maatschappij NV (KLM) operated as two independent organizations, targeting business and high-end leisure customers. Air France was launched as France's national airline in 1933 and privatized in 1999.[59] Throughout its long history, the company was considered a part of French heritage. From 1946 onward, the company offered luxurious in-flight services that included private cabins, meals cooked by top chefs, and champagne and claimed to be the ambassador of French gastronomy.[60] In 1995, the company restructured its hub networks at Paris's Charles de Gaulle (CDG) and Orly airports. In 2018, 51.4 million passengers travelled on its airlines, which included Air France, Air France Hop (HOP!), Joon SAS, and Transavia Airlines SAS (Transavia France).[61] Total operating revenue was €166 million with an operating margin of 1.7 per cent (see Exhibit 5).

KLM was launched as the Netherlands' national airline in 1919 and was the oldest airline to continue using its founding brand name.[62] KLM's main hub was located at Schiphol Airport in Amsterdam. It managed four subsidiaries: KLM CityHopper, for short- and medium-haul flights; Transavia Airlines CV (Transavia), in operation since 1966 for low-cost travel; and KLM Cargo and Martinair, for the transport of goods. KLM was the leading airline in the Netherlands, with Transavia in second place.[63] In 2018, KLM posted an operating revenue of €1,073 million and an operating margin of 9.8 per cent (see Exhibit 5).

In May 2004, Air France and KLM merged, creating a joint venture based in Tremblay-en-France.[64] The Air France–KLM Group held 100 per cent of KLM's economic rights but only 49 per cent of KLM's voting rights. The remaining 51 per cent of voting rights remained in the hands of two Dutch foundations (44.84 per cent), the State of the Netherlands (5.92 per cent), and other shareholders (0.30 per cent).[65] Air France–KLM was comprised of two divisions: Air France, with 51,707 employees, and KLM, with 29,818

Exhibit 5 Financial Results for Air France and Klm

Operating Costs (€ millions) and Margin (%)	2013	2014	2015	2016	2017	2018
Air France Division	−174 (−1.0%)	−314 (−2.0%)	426 (2.6%)	372 (2.4%)	588 (3.7%)	266 (1.7%)
KLM Division	301 (3.0%)	175 (1.8%)	384 (3.9%)	681 (6.9%)	910 (8.8%)	1,073 (9.8%)

Sources: Air France KLM Group, "Full Year 2018 Results," press release, Air France–KLM, February 20, 2019, https://www.airfranceklm.com/sites/default/files/q4_2018_press_release_en_vdef_0.pdf; Air France KLM Group, "Full Year 2016 Results," press release, Air France–KLM, February 16, 2017, https://www.airfranceklm.com/sites/default/files/communiques/fy_2016_press_release_en.pdf; Air France KLM Group, "Full Year 2014 Results," press release, Air France–KLM, February 19, 2015, https://www.airfranceklm.com/sites/default/files/communiques/2014-q4_press_release_en_def.pdf.

employees. In 2018, through its 548 aircraft (see Exhibit 6), the group earned 93 per cent of its revenue from air passenger and freight transport and 7 per cent from maintenance activities, with a total revenue of €26.5 billion (see Exhibit 7). The increase in the price of oil and strikes occurring in 2018 negatively impacted the group's revenue.[66]

Air France–KLM focused on three activities: passenger and freight transport, low-cost passenger transport, and aircraft maintenance. The group's head office managed several departments common to the two divisions, including finance, sales and alliances, commercial strategy, engineering and maintenance, cargo, IT, and the general secretariat. The group managed pricing, sales, and commercial alliances for all its airlines. It also managed the tiered loyalty program, Flying Blue, which had 15 million members.[67] The program allowed members travelling with the group to accumulate points, which were exchangeable for tickets, upgrades, or in-flight options. Platinum status benefits included priority boarding and access to private airport lounges.[68] In 2018, Air France–KLM carried 101.8 million passengers,[69] of which 60 per cent travelled for leisure and 40 per cent for business; 55 per cent were Flying Blue members.[70]

Air France was a founding member of the SkyTeam alliance, which accounted for 16.1 per cent of world air traffic,[71] allowing the group to increase its network to 1,150 destinations in 177 countries.[72] Air France–KLM alone had the largest long-haul network in Europe.[73] The alliance also allowed member airlines to co-coordinate flights, sales, ground operations, and loyalty programs.[74] The group also formed ventures with GOL Linhas Aéreas Inteligentes SA (GOL) (Brazil), Etihad (United Arab Emirates), and China Eastern Airlines Corporation Limited (China). Their largest joint ventures included Delta Air Lines Inc. (USA), Alitalia–Società Aerea Italiana SpA (Italy), and Virgin Atlantic Airlines Ltd. (UK), which dominated the transatlantic market.[75]

The Air France–KLM Group's ambition was to become the European aviation leader and one of the world's leading airlines through social and environmental responsibility.[76] The group was recognized for making its planes more energy efficient and for using biofuels. For 10 straight years, the group held the top spot in the Dow Jones Sustainability Index Airlines category.[77] Following the eurozone crisis (2009–2011), Air France–KLM experienced an intensification of competition, facing price pressure from both low-cost competitors and traditional competitors such as British Airways and Lufthansa. Emerging economy organizations (e.g., Turkish Airlines, Singapore Airlines, and the Gulf-based companies) also exerted pressure on long-haul flights through their premium services. In this increasingly complex market, new strategies were required for each of the group's subsidiaries.[78]

The Air France Division

Air France

Until 2013, Air France operated under one brand, targeting the business and high-end leisure traveller. It had the largest long-haul network in Europe. In response to the

Exhibit 6 Air France–KLM Fleet—number of Aircraft, 2018

Aircraft	Air France*	KLM	Transavia France	Transavia NL	Owned	Finance Lease	Operating Lease	Total
Long Haul	106	66	–	–	69	32	71	172
Medium Haul	115	50	34	40	77	28	134	239
Regional	82	49	–	–	60	33	38	131
Cargo	2	4	–	–	6	–	–	6
Total	305	169	34	40	212	93	243	548

Note: * Includes HOP! and Joon.

Source: Air France–KLM, *Registration Document 2018*, Air France KLM Group, 2019, https://www.airfranceklm.com/en/system/files/registration_document_air_france-klm_2018_va_def.pdf.

Exhibit 7 Consolidated Financial Results for Air France–Klm

(in € millions)	2018	2017	2016	2015	2014
Turnover	26,515	25,864	24,844	25,689	24,912
Other Activity Income	3	3	2	2	18
Product Activity Ordinary	26,515	25,867	24,846	25,691	24,930
External Charges	(15,224)	(14,188)	(14,243)	(15,768)	(15,791)
Staff Costs	(7,759)	(7,620)	(7,474)	(7,464)	(7,316)
Taxes and Duties	(166)	(158)	(164)	(155)	(169)
Other Income and Expenses	851	862	842	1,110	(65)
EBITDA*	4,217	4,763	3,787	3,414	1,589
Operational Rents (Aircraft)	–	–	(1,073)	(1,027)	–
EBITDA			2,714	2,387	
Depreciation, Impairment, and Provisions	(2,885)	(2,840)	(1,665)	(1,607)	(1,718)
Current Operating Results	1,332	1,923	1,049	780	(129)
Disposal of Aeronautical Equipment	4	18	21	(5)	–
Other Income and Expenses Non-Current	(16)	(1,925)	46	305	880
Results of Operational Activities	1,320	16	1,116	1,080	751
Cost of Gross Financial Debt	(465)	(570)	(309)	(372)	(446)
Cash Income and Cash Equivalents	39	34	49	62	76
Cost of Net Financial Debt	(426)	(536)	(260)	(310)	(370)
Other Financial Income and Expenses	(271)	649	(33)	(604)	(318)
Pre-Tax Profit of Integrated Companies	623	129	823	166	63
Taxes	(227)	21	(294)	(30)	(209)
Net Income from Discontinued Operations	–	(8)	270	26	(4)
Net Profit	411	163	792	127	(189)

Note: *EBITDA = earnings before interest, taxes, depreciation, and amortization.

Sources: Air France–KLM, *Document de référence 2018*, Air France KLM Group, 2019, https://www.airfranceklm.com/fr/system/files/document_de_reference_air_france-klm_2018_vf.pdf; Air France–KLM, *Reference Document 2016* [in French], Air France KLM Group, 2017, https://www.airfranceklm.com/sites/default/files/publications/afk_amf.pdf; and Air France–KLM, *Reference Document 2014* [in French], Air France KLM Group, 2015, https://www.airfranceklm.com/sites/default/files/publications/afklm_doc_de_reference_2014_fr.pdf.

changing industry landscape, Alexandre de Juniac, CEO of Air France from 2012 to 2016, launched two strategic plans: "Transform 2015" and "Perform 2020."[79] In 2014, Perform 2020 was launched to target a greater share of the business and premium economy markets by increasing the number of seats in business and premium economy classes, which were respectively 1.5 and 3.0 times more profitable than economy class. The intent of "Transform 2015" was to enable the group's companies, particularly Air France, to become competitive again in the European market. The group cut 2,800 Air France jobs and increased the subcontracting of operations in French airports, a practice usually done by low cost companies.[80] Air France regional flights were transferred to a new business, HOP! In 2014, Perform 2020 was launched to target a greater share of the business and premium economy markets by increasing the number of seats in the business and premium economy classes, respectively 1.5 and 3.0 times more profitable than economy class.[81]

In 2016, the "Trust Together" program was launched to enhance customer experience.[82] For example, Air France spent €250 million to modernize its long-haul planes by installing better entertainment systems and new seats and refining cabin design;[83] Air France employees underwent new customer service training; and gourmet chefs introduced new dishes for first- and business class travellers on main long-haul routes.[84]

In the first half of 2018, Air France employees launched a series of strikes, demanding wage increases. The strikes caused flight delays and trip cancellations, leading to a loss of €335 million. [85] The Air France–KLM CEO at the time, Janaillac, resigned.[86] By the end of 2018, Air France's Net Promoter Score[87] was 18 out of a possible 50 points and the airline was ranked 70th (of 87) on the list of most punctual airlines.[88] According to Skytrax, Air France was the 25th best company in the world, down 10 spots from 2015.[89] Despite 73 per cent of French citizens holding a positive opinion of the firm, 43 per cent felt that Air France's image had deteriorated and 83 per cent said that their fares were excessive.[90]

HOP!

In 2013, as part of Transform 2015, HOP! was created as a separately managed, single-class airline dedicated to regional flights. HOP! flew Air France passengers from regional airports into the CDG hub, enabling long-haul connections from across France. The airline also flew point to point between French cities,[91] focusing on the busier airports and adapting to the schedule needs of business customers.[92] HOP! also offered customers low prices, particularly with flexible price grids,[93] along with a self-service website. The logo included Air France in small print. All flights qualified for Flying Blue miles.[94]

In addition to HOP!'s offerings, Air France offered several short-haul options. For example, passengers could book both plane and train travel on the Air France website by choosing from 13 possible rail routes to and from CDG.[95] First-class and business travellers who were provided the equivalent rail travel class, could earn Flying Blue points, and were entitled to free taxi transfers between the airport and rail station.[96] Despite the desire to provide lower prices to its customers, HOP! was often criticized for its high prices.[97] In 2018, the short-haul network recorded losses of about €170 million.[98]

Joon

In 2017, as part of the Trust Together program, Air France–KLM created Joon, also independently managed within the Air France division, to operate 18 medium- and long-haul routes where Air France was experiencing losses.[99] Joon's crews were paid less than Air France crews, and operating costs were 13 per cent lower.[100] The airline targeted the 18- to 35-year-old segment, which was price sensitive but also in search of comfort.[101] It offered several travel classes and on-board services such as Wi-Fi and in-flight entertainment. It also offered a menu that included detox drinks, craft beer, organic products, and tapas.[102] When Joon was launched, Air France–KLM's CEO defined it as a "long-haul company with lower costs" that stood for "comfort, business class travel, flexibility, attractive offers, modern chic, relaxed, eco responsible, digital."[103] Business class passengers experienced the same level of service as on Air France, while economy class services came at an additional cost. Within a year of service, Joon flew at 90 per cent capacity.[104]

The Klm Division

As one of the oldest traditional airlines, KLM, like Air France, also targeted the business and high-end leisure traveller. In 2014, a veteran KLM employee of 21 years, Pieter Elbers, was appointed as chair of the KLM management board. The focus was on reducing costs, investing in the future, and transforming the organization with the intention of increasing profitability and flexibility while becoming more customer-centric.[105] KLM's chief operating officer, René de Groot (also a veteran employee of 24 years) stated, "We have determined that we will never be the cheapest or the most luxurious airline. We have the ambition to become the most focused European airline to customers, most innovative and most effective."[106] As part of the plan, the firm launched "KLM Compass," a program aimed at retaining employees and raising their awareness of the company's mission and values, employee responsibilities, client expectations, and the principles of leadership.[107] In an effort to increase productivity, in partnership with employees and with the support of new technologies, organizational hierarchy levels were reduced and employees were given more responsibility.[108]

In 2016, KLM launched "Digital Studio" to improve customer service and operational efficiency.[109] The firm used technology to track baggage locations, decrease losses, and enable faster baggage offloading in the event of a passenger's absence. In addition, to provide competitive customer service, 9,500 cabin crew and ground staff were given tablets and access to "Appy2Help," which provided access to customer profiles (e.g., birthday information). Appy2Help also provided information on connecting flights and allowed passengers to be checked in and assigned seats, compensated in the event of a broken-down plane, and rebooked in the case of a schedule disruption.[110] Other applications that focused on improving operational efficiency included Bax@Risk, which could predict which passengers were in danger of missing a flight, and PLUG, which optimized aircraft parking. Digital Studio apps reduced delays and maximized aircraft use.[111]

KLM was present on all social networking platforms, supported by the largest digital team in the industry (300 employees).[112] The platforms used artificial intelligence to provide customer service including packing instructions and information on checking luggage size in 10 languages.[113] KLM was also the first company to sell tickets on Facebook Messenger (2016) and the first non-Chinese company to authorize payments via WeChat (2018).[114] Through social media, customers could upgrade their seats or buy in-flight services. KLM also moved upmarket with "World Business Class," which provided more services and access to the Schiphol Airport lounge.[115] KLM was considered to be one of the best companies, globally, with a Net Promoter Score of 42.[116]

The Transavia Business

In service in the Netherlands since 1966, and in France since 2007, Transavia operated 225 lines in Europe and North Africa.[117] As the group's low-cost carrier, it maximized capacity while offering simplicity in service and pricing through a light management model and significant outsourcing of activities.[118] In 2014, Air France–KLM launched Transavia Europe to open new hubs in Portugal and Germany and attempted to renegotiate pilot and crew contracts to save on costs. In response, Air France pilots launched a strike, leading to €330 million in losses.[119] The group abandoned the project, deciding instead to further develop Transavia France. The unions supported a maximum increase of 40 aircraft on Air France routes.[120]

Transavia specialized in customer relations with its slogan "Make Low Cost Feel Good."[121] The firm had 1.2 million Facebook followers and managed customer service with the help of artificial intelligence. It was also the first airline to offer reservations through WhatsApp and Google Home. The firm managed over 500 conversations through the social networking platforms per day.[122] In 2018, it transported 15 million people, who could earn Flying Blue miles, to France and the Netherlands; was awarded for its reservation service; and was ranked first as the most punctual company in Europe. It was also recognized for its climate-related commitments, which included promising to ban plastic from its planes by 2020, and it had a customer satisfaction rate of 86 per cent.[123]

Next Steps

Smith was scheduled to present his strategy to the board on February 22, 2019. What should he propose to make Air France–KLM a leader, once again, in the European air transport industry?

Notes

1. This case has been written based on published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Air France–KLM SA or any of its employees.
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Case 3

Ant Group Backed Mybank: People, Planet, Profit in Rural China

For Ant Group, providing good service to millions of consumers and small businesses is how we contribute to society, and that is what we believe makes a good company.

—Ant Group CEO and Chairman Eric Jing[1]

It was April 2022, nearly two years after the initial peak of the COVID-19 outbreak in China, and MYbank, an online bank established in 2015 by Ant Group and a few other shareholders,[2] had just been enlisted as one of the two online banks to support the newly launched digital yuan app.[3] The other online bank recruited was its competitor, Tencent-backed WeBank. Since its establishment in 2014, WeBank had managed to service over 200 million users and targeted WeChat users to provide online banking services. MYbank on the other hand had largely focused on rural small, micro, and medium sized enterprises (SMEs) and farmers, and had serviced around 45 million SMEs and rural clients since its inception. There were also a few other private online banks operating in China, and competition was tough. The senior executives at MYbank had arranged brainstorming sessions to understand how the firm could tackle disruption, beat competition and incorporate a technology-led growth model while staying true to its vision.

Additionally, other business issues like the negative after effects of the pandemic and ongoing regulatory challenges required contemplation as well. During and after the pandemic, rural micro-lenders in China had faced adverse economic conditions, and MYbank had cut interest rates for its micro loans in 2020 and 2021 to help its customers cope, while using strategies like cost optimisation and economies of scale to offset the impact of interest cuts on profits. MYbank's President, Jin Xiaolong shared,

> In the past three years, the recurrence of epidemics and the danger of disasters caused by extreme weather have led to a slowdown in the growth of some consumer sectors, which has directly affected the business environment of small and micro groups… In this context, it is even more necessary for financial institutions to increase scientific and technological exploration and increase support for small and micro-operators. So, what is the next step in technological development for SME finance? In my opinion, it is necessary to continue to follow the original aspiration of providi ng financial credit services for every small and micro businesses operating with integrity.

Separately, the macro-economic trends of China had predicted slower growth in 2022, due to several factors including debt problems of major property developers, resurge of COVID-19 infections, contraction of onshore manufacturing activity and softened export demand. It was expected that the aggregate net profit of China's commercial banks would grow around 10% in 2022 compared to 12.6% in 2021.

However, despite the challenges, expectations were upbeat, as MYbank had reported a year-on-year growth of 31.6% for the first quarter of 2022. The loans and advances for the period from January to March 2022 had totalled a staggering US$30 billion (RMB189.1 billion[4]).[5] Even so, executives in the company knew that continued growth could only come through careful strategic planning.

Industrywide, sustainable banking services[6] had also become prevalent in other parts of the world to develop financial products and services, meet the needs of the people at the bottom of the pyramid (BoP) and safeguard the environment while generating profit. Many governments and firms were implementing the triple bottom line of People, Planet and Profit[7] to 'do good' using environment and social assessment guidelines for negative screening within the lending process. Yet, unlike MYbank, very few banks had adjusted interest rates based on their borrowers' business performance during downturns.

Traditionally, banking had always paid more attention to high-net-worth individuals (HNWI), focussed on fewer accounts, and one-on-one relationships. However, MYbank had focused on technology to enable quick transactions, a large volume of customers over a few customers of high financial standing, and lower operational costs to create a sustainable business model. The objective was to use automation, standardisation, and artificial intelligence (AI) to reach a very large number of small customers at the BoP.

Could MYbank adopt a low margin, high volume model like assembly line business models to target large swathes of the rural population and pull them up the BoP pyramid? Could MYbank become the McDonald's of rural, digital banking? Separately, could it beat competition to stay ahead in the cut-throat online banking business?

Rural China and Agricultural Finance

MYbank's home base, China, had over the past few decades risen in economic rankings and emerged as a global leader in world economics. However, China had also a large BoP population (239 million adults in 2015), making it the world's

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second biggest BoP market.[8] Around 38% of the country's population (about one-ninth of the world's population) lived in rural areas[9] and depended on agriculture and small businesses for their livelihood.[10] Despite that, the country did not produce enough food to meet domestic consumption and was the world's largest importer of food. Thus, rural development and food production was a huge concern and formed a key part of the country's policy.

To put it in perspective, China had 9% of the world's arable land to feed its people (20% of the world's population) in contrast to the US, which had 16.5% of the world's arable land to feed its people (4% of the world's population).[11] Geographically only 13% of the total land in China was arable, and that too faced constant pressure due to heavy industrialisation and urban encroachment. The Chinese government had introduced strict farmland protection measures and drawn "red lines" to protect the country's farmlands from industrial encroachment.[12]

Over the past decade, China had tried to ramp-up its own food production to reduce its dependency on imports by introducing higher-yield grains, improved farming techniques, and privatisation policies to incentivise farmers. However, the country still lagged in yield and food safety relative to developed countries with robust agriculture sectors. In addition, ageing rural demographics, environmental degradation, climate change, groundwater depletion, heavy metal pollution and a lack of technological adoption also posed challenges to its agricultural sector, which employed around 350 million people as of 2021.[13] In its annual central rural conference in Beijing in 2021, China had pledged concrete measures to consolidate the agriculture sector, advance rural vitalisation, and analyse existing issues related to agriculture, rural businesses, and farmers.[14]

Historically the country's agricultural policy had allowed even distribution of arable land amongst farmers to guarantee employment and livelihood. Farmers were given collective land ownership rights by the state, resulting in fragmented land plots that made large-scale agribusiness difficult to execute without land transfers.[15] As a result, over 98% of farmers in the country operated small-scale farms averaging less than 6 square km (in comparison, the average US farm size was about 1,800 square km).[16] Small farm holdings and lack of sufficient rural finance made investment in large-scale agriculture technology economically less viable. Moreover, varied soil quality, water, temperature, and climate in different regions made standardised and unified production processes harder to implement and scale up nationally.

Analysts had predicted China's demand for food to increase by 60% by 2050, but its agricultural system was already under pressure to satisfy current demand and the only way to increase food production beyond existing levels was to invest in sustainable technologies and climate-smart agriculture.[17] Yet financing the agricultural sector to help upgrade to sustainable technologies presented many challenges for financial institutions. These challenges encompassed high costs of reaching remote rural areas, weather risks, issues with scattered crop concentration, and price volatility, which in turn increased the credit risk for lenders like banks, reducing their appetite for the sector. Financing the agricultural sector required integral risk-management strategies and formed a key agenda of inclusive finance strategies implemented by the Chinese government.[18]

The Rise of Inclusive Finance

The term 'Inclusive Finance' had gained popularity since the early 2000s and was first discussed at length at a United Nations conference in 2005. The purpose of Inclusive Finance was to make financial services more accessible to low-income people while promoting sustainability and green rural development.[19] The concept had originally emerged from the analysis of challenges posed by the unequal distribution of wealth across the world, which was more or less in line with the 80/20 Pareto principle.[20] In China, the equation was similar, i.e., traditional banking institutions were focused on 20% of the customers (high-value clients) who controlled 80% of the country's wealth and resources.[21] The remaining 80% of the population (which included 45% of the country's population in rural areas) had marginalised income, and found it harder to get formal credit access.[22] This was partly due to the high overhead costs of branch banking which forced banks to focus only on market segments that offered the highest margins. Besides, only one third of the population in China had credit records while the rest were 'credit invisible' and loans in rural areas accounted for only 23% of the country's total loan balance.[23]

The rural credit statistics had motivated the government as well as international organisations like the World Bank (WB) to take action. WB had established an initiative in China in 2016, to extend loans to farmers and promote climate-smart, sustainable agriculture.[24] The initiative tried to implement mitigation and adaptation measures to address the impacts of climate change by providing incentives to producers to apply innovative, sustainable, solutions.[25] Prior to this, China Banking Regulatory Commission (CBRC) had introduced new regulations in 2014, to promote Inclusive Finance and allow privately-owned organisations like MYbank to operate in the banking sector to serve the rural population. This decision of the government was motivated by the rapid proliferation of the internet and smartphones in rural China.

Notably, as of 2015, 49% of the country's population were active internet users, internet penetration amongst the rural population was 30%, and promotion and sales of agricultural products on internet using e-commerce was commonplace.[26] Smartphone acquisition in rural China was also high and had risen further (from 32% in 2015 to 46%) by 2019.[27] Besides, the online retail market in China was the largest in the world (since 2013), with Alibaba at its forefront as the largest e-commerce player.[28]

The new banking regulations in China (introduced in 2014) had allowed private banks to operate in the country for the first time. Prior to this regulation, private investors were not allowed to be stakeholders of banking institutions. Five online-only banks were licensed under the new regulations—namely, Tencent backed WeBank, Ant Group backed MYbank, Baidu backed AiBank, Xiaomi backed XW bank, and Suning backed Suning Finance.[29] The policy intent was to allow the experimentation of new, completely online, banking models to improve available capital for small businesses and encourage economic growth in a way that state-owned banks were not set up to provide. Regulators were also eager to see if online banks could support economic growth in rural regions far from the main cities.[30]

MYbank

MYbank was established in 2015 by Ant Financial and its partners with the vision of empowering rural entrepreneurs through financial services. It was among the first batch of private commercial banks in China to use technologies like data analytics and AI to provide efficient services to its customers. The name MYbank was curated based on the company's 'do good' vision to provide financial inclusion and a sense of empowerment to its small business borrowers, and was based on the belief that banking services could be provided online to the rural population at a higher efficiency, lower cost and wider coverage as compared to branch banking. It aimed to create 'shared value' through a business model that could achieve social benefits without sacrificing corporate success and profits—using technology as its magic wand to fulfil this objective. The syllables 'MY' in MYbank were part of its brand design to attract rural SMEs and make them feel more attached to the bank.

Initially, MYbank was authorised to make loans only and not accept deposits, as regulators wanted to first evaluate the efficacy of private ownership modes and the implications of online banking services. Wang Jian, Chief Algorithm Expert for rural finance at MYbank recalled,

> Prior to MYbank, we had started a division known as Ali Microloans (阿里小贷), which focused on financial services for small and medium enterprises (SMEs). Then around 2015, we formally set up MYbank to serve SMEs. Our initial concept was akin to a system of fine capillaries, which could deeply penetrate rural China and deliver financial service to many SMEs across all provinces.

To deliver its services online, MYbank, focussed on hiring resources who mainly worked on high-tech development, user-centred design (USD), risk modelling, and operations.[31] It did not have client managers or branches, but instead used internet-based interactions with customers during the transaction process. Initially it catered to SMEs and sellers across the country engaging with the Alibaba e-commerce platforms (including Taobao and T-Mall). The duration of the loans, on average, was approximately up to 90 days and customers could flexibly borrow money and pay back the loans on a rolling basis. However, the majority of the loans approved were not made based on consumer credit history or collateral—which many small businesses, particularly those run by women, did not have. Instead, they were approved by an automated risk profiling algorithm using what MYbank called its '310' lending model, wherein it took only three minutes for a customer to apply for a loan, one second for the system to approve the loan, and the whole process involved zero human interaction (refer to Exhibit 1 for Key Metrics of MYbank's '310' model).

310 Lending Model

The '310' lending model included more than 100,000 risk profiling metrics and 100 credit risk models specifically suited to SME and individual lending which were developed over a period of time and subjected to iterative testing and refining. The platform assessed loan applications using built-in algorithms to weigh the risk parameters. The AI-based risk assessment helped to improve customer service, product delivery

Exhibit 1 Keymterics-Mybank's 310 Lending Model

3	Minutes to apply on mobile	1	Second to approve	0	Human intervention

80%	of MYbank's SME clients had never previously obtained a loan
89%	are in third or lower-tier cities in China
52%	have fewer than five employees and more than half of those are mom-and-pop shops
45%	of MYbank's loans are under RMB 50,000 (USD 7,000), with average loan size of RMB 11,000 (USD 1,600)

**According to a MYbank user survey as of February* 2019.

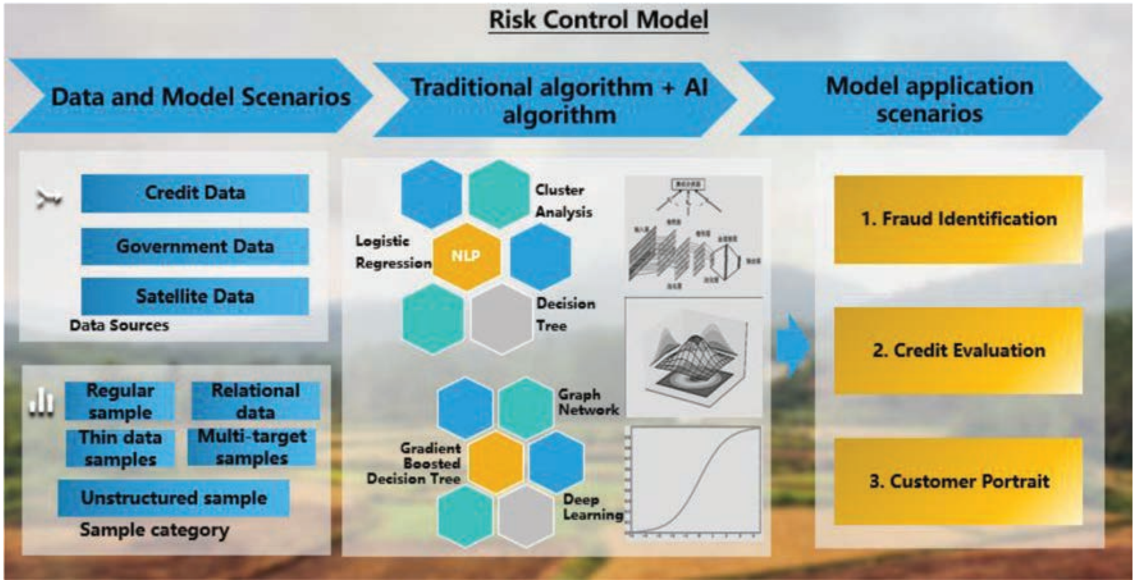
Source: Company Data

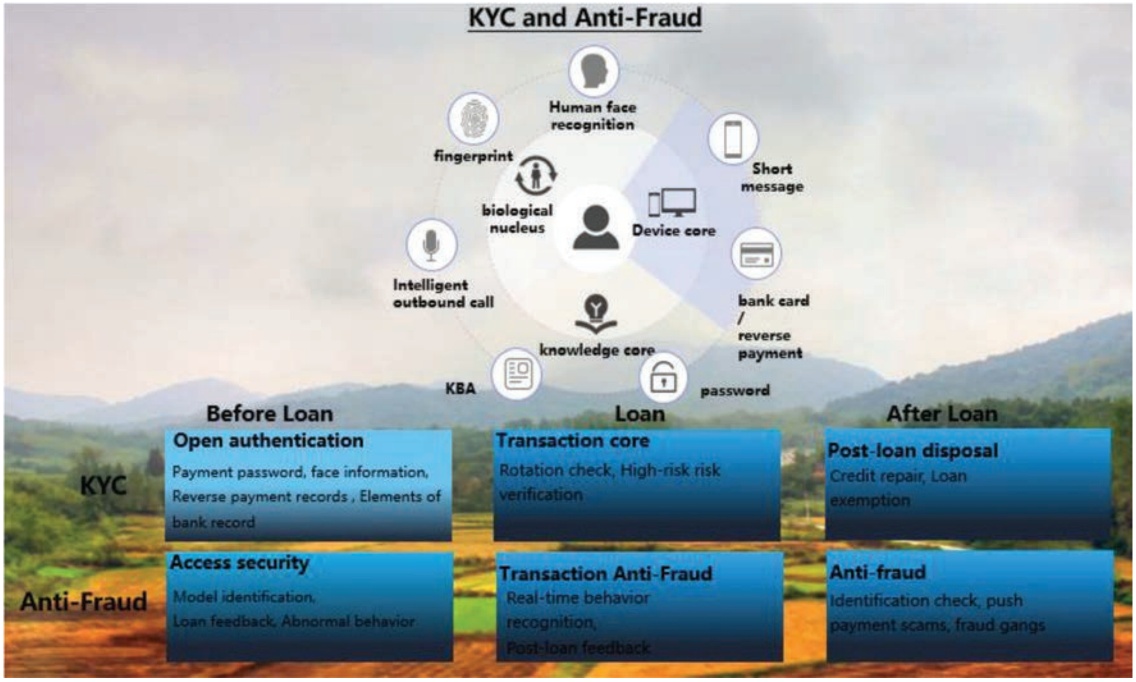
and operational costs. The algorithms used data of consumer repayment records from e-commerce platforms like Alibaba and Alipay, customer smartphone payment records, registered online customer profiles, e-commerce transactions, local government records and insurance records. However, by principle, they followed the rule of only using the minimum amount of personal information to make optimised risk-related lending decisions and adopted data privacy protection measures to protect consumer data. The algorithms could also assess monthly sales of small businesses and predict their repayment patterns in the future (refer to Exhibit 2 for a Snapshot of MYbank's Risk Controls).

The lending model helped stimulate loan approval rates, which quickly rose to four times of traditional lenders (who typically rejected 80% of SME loan requests and took at least 30 days to process the applications), and also helped control MYbank's average non-performing loan (NPL) ratio at around 1%.

The average loan amount granted to consumers was US$4,850 (RMB 34,000) and about 8.66% of the loan applications were submitted between 11 pm and 4 am, when traditional banks in China were closed for business, reflecting the need of anytime financial access by small entrepreneurs. MYbank also tried to support green business practises by

Exhibit2 Snapshot of Mybank's Risk Controls





Source: Company Data

implementing preferential interest rates for SMEs that implemented green initiatives, and such tracking of green business was also built into the automated loan approval process.

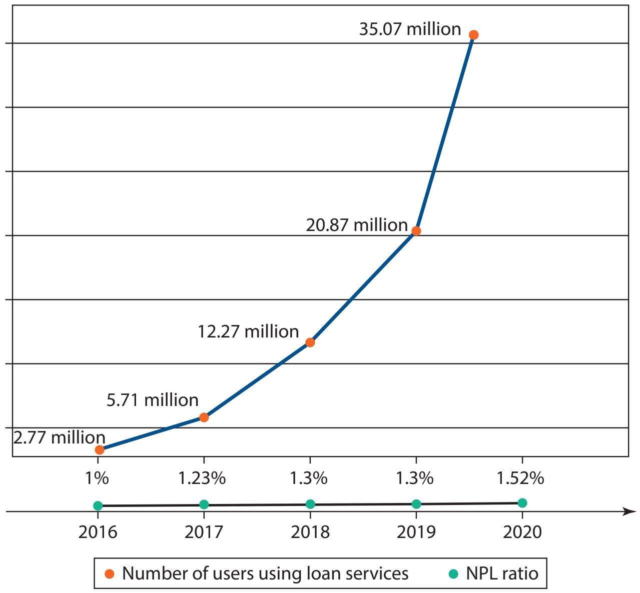
Despite the loans being extended without any collateral, the interest rates charged were competitive—ranging from 6% to 14%.[32] Yet the model was profitable, partly because of lower operational and delivery costs, generating net interest margins of 3% to 5%, which was considerably higher than some of China's biggest commercial banks.[33] For example, a traditional bank spent US$294 (RMB 2,000) to process a micro loan—in comparison to MYbank's average loan cost of around US$0.34 (RMB2.30).[34] Additionally, the bank's return on equity (ROE) was at 13.4%, which was slightly above the 13.1% average of traditional banks in China.[35]

Market Performance

In 2017, MYbank rolled out new savings and lending products, including a market-leader product called "Sell More, Borrow More", which provided loans to more than 50 million consumers offline, and used quick response (QR) merchant codes for executing deposit transactions.[36] Given that the bank did not have any physical branches to accept its clients' deposits, it had to rely on the interbank market, which was substantially more expensive to maintain compared to normal deposits. Notably, 60% of MYbank's total liabilities were due to interbank funding.[37]

In 2018, MYbank reported its first net profit of US$96 million (RMB 670 million), with a return on assets (ROA) of 0.8%. By 2019, the bank had gained a market share of close to half of all SMEs in China, and about 78% of these customers were first-time borrowers (refer to Exhibit 3 for MYbank Customer Growth). Female SME owners accounted for 40% of the customers served.[38] MYbank's innovation and success in the SME market became a strong motivation for other Chinese banks to boost their SME lending. Soon, government institutions like China Construction Bank, for example, increased their small business lending, while private

Exhibit 3 Mybank Customer Growth



According to the data of the China Banking and Insurance Regulatory Commission (CIRC), as of june 2020, the overall NPL rate of small and micro loans was 2.99%

Source: "MYbank Aims to Bring Inclusive Financial Services to 2,000 Rural Counties by 2025", Ant Group, Media Release, April 30, 2021, https://www.antgroup.com/en/news-media/press-releases/2021-04-30-16-54, accessed March 2022.

firms like Tencent Holdings and Ping An Insurance Group started to introduce similar services for SMEs.[39]

The MYbank Farmer Loan

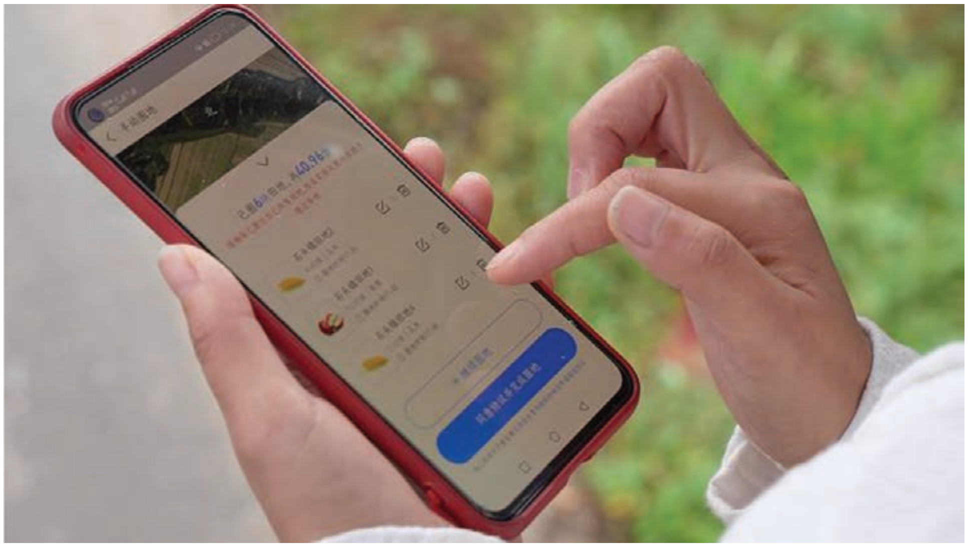
In addition to SMEs, MYbank also tried to service farmers, and offer them flexible loan products. The first farmer loan program was launched in mid-2015 to provide credit loans to rural farmers who planted crops, bred animals, or ran small agricultural businesses and featured streamlined application procedures and a speedy approval process. The farmer loans also followed the '310' lending model, and were delivered in collaboration with numerous financial institutions which served as sources of capital.[40] Users could borrow and repay at any time, and interest was calculated based on the duration of the loan. There were no penalty interest charges or fees for early repayment, and the credit limit amount was restored in real time for the customer, once the repayment was made (refer to Exhibit 4 for an example of a MYbank serviced farmer lender).

Rural Finance Division

MYbank also set up a rural finance division to provide customer support and assistance to its rural customers; the division's aim was to integrate the entire portfolio of micro-financial services including payment, wealth management, insurance, financing and credit, and work closely with Alibaba's rural Taobao programme and smart logistics network Cainiao.

Alibaba's Taobao programme had engaged rural entrepreneurs to open online shops on the Taobao Marketplace and had seen huge success. The rural Taobao program had expanded rapidly, from 212 villages in 12 counties in 2014 to more than 30,000 villages in 1,000 counties by 2018.[41] The

Exhibit 4 Mybank Farmer Loans



Farmer Kai can now easily circle his farmland on the mobile phone, authorize the produce data and apply for an agricultural loan from MYbank.

Source: Company Data

program was supported by Taobao rural centres which provided internet access and purchasing and delivery services to assist rural businesses to reach a wide base of consumers. Cainiao was the logistics arm of Alibaba and supported rural entrepreneurships by providing product delivery anywhere in China in 24 hours at low cost.

Initially MYbank's rural finance division was a five-member team which operated on a small scale. It did not do well in its first year, accumulating a bad debt of around US$8.95 million (RMB 60 million).[42] This was primarily because it relied on Alibaba's rural Taobao agents for credit risk assessment, which presented many risks like misjudgement by the human agent, non-payment due to failure of the lender's business and instances of fraud due to human involvement.

Additionally, there were a few biases within the division, like a general assumption that rural people were much poorer than city dwellers and did not have the willingness to repay. However, after several field visits, the team found that many of the rural farmers had a decent annual income and were supporting their children studying in cities and towns. They also found that the non-performing rate of farmer loans was actually lower than other loans, and that farmers were no less trustworthy than city dwellers. The real issue was the lack of customised solutions that could service them, and these were tricky to build as many farmers did not have any form of online credit history. Besides, many farmers felt humiliated to apply for loans, as they felt it reflected that they were not doing well financially or were facing a family problem/urgency.

On further research, the MYbank team found that there was secondary data available on farmers in existing documents (such as land rights, land contracts, crop seed subsidy distribution files, and farming machinery purchase invoices), which were public information and could be potentially used to assess a farmer's credit worthiness. The challenge was to assemble such information, and it was believed that this could be done through computing and algorithms.

Initially, MYbank experimented the usage of drones to help deliver farmer loans. However, the cost of using drones was relatively high and it was difficult to popularise the technology across the country.[43] Later, the bank adopted AI and satellite technology to service the loans.

By end 2016, the farmer loan service expanded to 1,000 villages and 65 counties across 28 provinces. The loans were unsecured and worth US$7,462 (RMB 50,000) each on average, involved flexible repayment terms of six, twelve, or twentyfour months (slightly longer than other MYbank loans), and accepted various repayment methods (including cash and electronic payments).

AI for Farmer Loans

To deliver the farmer loans, MYbank combined its '310' model with its in-house AI-based system called 'Tomtit', whose name was inspired by the rural songbirds. The technology was based on satellite remote sensing and image recognition. To apply for a loan, farmers would download the MYbank app on their mobile phone, authorise the application for information inquiry, identify their farmlands by selecting their farmland plot (also known as the act of 'circling' in Chinese), and then receive loans within a few minutes. As part of the risk control process, the Tomtit system checked for pre-existing records of the applicant on other platforms like Alibaba's Taobao and Alipay to create an accurate understanding of the customer's financial situation.

Using publicly available satellite images and the image of the farmers' self-authenticated crop field ('circled' farmland), data on climate, industry patterns, land registration data from government agencies and information about factors affecting price and expected crop growth, Tomtit could estimate the yield and output value of the selected land and accurately evaluate risk.

The unambiguous risk analysis method allowed Tomtit to assess and grant reasonable levels of credit and an appropriate repayment plan to the farmers based on the risk scores generated.

Satellite Technology

Following the loan disbursement, the farmlands were constantly monitored by Tomtit using satellite images to assess the growth/condition of the crops and predict any likely risks of loan default or additional capital requirements during the harvest season (Refer to Exhibit 5 for a Pictorial Demonstration of Satellite Technology for Farmer Loans).

A spectral recognition technology was applied to the satellite images to identify the type and growth status of the crops. The satellite images were updated frequently in real time in a cycle of five to seven days. The frequent monitoring of the croplands enabled the bank to make precise assessments, and proactively manage the risks on the loans. It also helped build trust between the bank and the farmers, as the accuracy of the deductions were high, and farmers knew that the loans were being approved based on the actual condition of their farms. While agricultural finance had been available to farmers through traditional banking earlier, it was not as convenient, and entailed monitoring of farmland through institutional visits to the fields, which were time-consuming, expensive to conduct and required a large number of trained employees. Frequent monitoring with satellites made the process faster, cheaper, more accurate and transparent.

MYbank mostly used low and medium-resolution satellite images from optical satellites, which were then processed by Tomtit AI recognition and deep learning algorithms, to eliminate cloud interference and identify the crops accurately. The lower resolution images were cheaper but had higher requirements in terms of obtaining training samples, training model parameters, and other AI and big data processing capabilities. After integrating the images with algorithm models from multiple data sources, the Tomtit platform was able to achieve more than 93% accuracy in crop species recognition.

There were two key challenges to using satellite imagery, however. One was the cost factor—high-resolution images were expensive, and low-resolution images required a lot of

Exhibit 5 Satellite Technology For Farmer Loans

Source: Company Data

processing to assess farmlands. The second challenge was to solve the problem of differentiating similar crops. China had a vast geography with varying agricultural conditions—for example, the reflected spectrum of corn grown in northern China could be similar to some weeds or rice grown in southern China, which challenged the remote sensing classification algorithms. To address such issues, MYbank used an agricultural knowledge map to optimise crop identification using common-sense information sources such as terrain, precipitation, accumulated temperature, commonly grown crops in the region and historical crop data.

Monitoring farmlands with satellite image processing not only helped minimise credit default risks of farmer loans, but also significantly eased the "analytics burden" of financial experts at MYbank, through access to close-to-real-time data from fields. In addition, there were several other benefits of such technology driven farmer loans that encompassed both environmental and social benefits, outside the equation of the business itself.

Benefits of Farmer Loans

Industry observers had opined that MYbank farmer loans could contribute significantly to China's agricultural development due to several reasons. [44] Firstly, they could help farmers improve crop yield by allowing them to invest in equipment, seeds, fertilisers and other crop-growing tools and implement sustainable farming practices.[45] Secondly, they could potentially bring rural small holding farmers out of the poverty cycle, and benefit the overall economy.[46] Thirdly, they could dissuade farmers from taking loans from loan sharks and rural moneylenders who would charge them exorbitant interest rates, often forcing them into a destructive cycle of more loans and repayments and abject poverty. Fourthly, they could allow the bank to collect useful information on farmer-consumers, who were hitherto outside the financial system due to their unique needs.[47] Finally, they allowed the government to promote inclusive finance and sustainable agricultural practices for farmers conveniently with minimal setup costs.[48]

MYbank tried to solve the big problem of access, and almost 80% of its users were first-time loan seekers. For the farming community, MYbank's interest rates were lower than other options available to them. However, executives in the bank had observed that the main concern of rural agricultural lenders was turnover, and not interest rate, as the demand for funds of such users was relatively urgent.

Also, because the borrowing cycle for the loans was short, the users were relatively less sensitive to interest rates and more concerned about quick access, convenience of getting the loan and repayment, and whether the loan amount granted was sufficient to meet their needs. Elaborating on the benefits, Wang explained,

> The traditional banks largely serve the top-tier customers in rural communities, who are rich farmers with large farmlands. According to industry estimates, in terms of person-hours and expenditure, it costs one or two thousand yuan (for a bank representative) to drive down to meet a user to initiate a transaction. Our customer base is focused on small scale farmers and agro businesses, where competition is not particularly intense yet.
>
> The rural consumer group itself is relatively complex, and its complexity is reflected in several dimensions. The first is the complexity of China's geographical environment: in some plain areas of the North for example, the fields are mainly grain producing. In some mountainous areas in the south, mostly fruit trees or highland vegetables are grown. In Shandong or Hebei (in north-east), for example, fruits such as pears and peaches are grown. Such variations lead to a relatively complex industrial structure. In addition, the structure of the agricultural production sector further stratifies the people in our target customer group.

In terms of the loan financing and execution, MYbank used its Tomtit platform and internal credit rating system for loan delivery, and partnerships with rural banks to finance the loans. An example was its partnership with Zhongmou Zhengyin rural bank in 2020, wherein it had extended loans to more than 50,000 individual households within two months, 90% of whom were new customers.

More Products

In October 2021, MYbank launched a loan scheme for SMEs to help with their supply chain financing. To support the loan scheme, MYbank launched a completely digital, supply chain financial system, called the "Goose System", which combined traditional supply chain finance processes with technologies such as large-scale graph computing, multimodal recognition, blockchain, and deep learning AI to service both upstream and downstream partners in the SME industry.

During the COVID-19 pandemic, SMEs were one of the worst hit due to their lower capacity to absorb shocks, and faced financing difficulties both on the supply and demand side. Within its first year of implementation, the Goose system was able to sign up over 500 suppliers, including big local brands like Haier, Mengniu and Want to help the SMEs.

MYbank referred to traditional supply chain models as the "1 + N" model, and its technological approach to solve the supply chain issue of SMEs as the $1 + N^2$ solution. The Goose system catered to loan demand and integrated fund management needs of SMEs across supply payments, procurement of orders, goods collection, franchising, and salary payments. In terms of execution, the supply chain financing scheme was straightforward. For example, if an SME wanted to procure equipment from suppliers but did not have the funds to do so, the Goose system would allow the SME to apply for a MYbank loan to pay off the equipment supplier after providing procurement details, and then repay that loan through monthly instalments.

The loan scheme helped both the SMEs and suppliers – while SMEs could now easily fund their business requirements and pay back in small easy instalments, suppliers could sell their products to new customers who could not afford their products earlier. Products eligible for such monthly payout included farming and agricultural equipment, livestock machinery, communications security equipment, commercial office equipment leasing, transport equipment, Internet of Things (IoT) equipment, irrigation machinery, solar equipment etc., and the plan was to continue extending the supplier base such that SMEs had access to borrowing from even more suppliers.

Responsible Business

ESG

MYbank's vision was to bring long term value to all its stakeholders using technology as its key driving force. The firm's short-term goal was to deal with the epidemic that had plagued SMEs and the long-term development goal was to enable a deeper understanding and grasp of the needs of the society. Its ESG strategy, focused on environmental, social, and governmental issues, formed the backbone of this vision, and emphasised on green finance management, with clearly set out goals for achieving environmental targets like 'carbon peak' and 'carbon neutrality'. A 'green evaluation system' was launched to identify environmentally-friendly SME lenders for green loan discounts based on how they operated their business. Such SMEs were also granted additional benefits like a zero balance savings account and preferential interest rates for vehicle procurement.

MYbank also implemented a digital governance system with personal data privacy protection measures, wherein all customer information were collected through secure technical methods using a multi-party trusted service and computing server. Using such technology-focused, ESG guided solutions, MYbank had serviced almost 70 million households by the end of 2021, which included 25 million SMEs, 35 million farmers and 10 million small and micro-operators with green ratings (highly-rated users).

CSR

Corporate social responsibility (CSR) and the triple bottom line of people, planet and profit fared high in MYbank's agenda, and included initiatives to promote women entrepreneurship, green lifestyle, inclusive finance, and digital enablement.[49] The strategic objective was to also help develop China's green financial system and green financial instruments, promote participation among consumers and investors in green finance, and guide small and micro enterprises to practice green finance as a means of delivering on China's broader green production and consumption goals.[50]

Beyond being part of country level strategic goals, MYbank also implemented a series of measures to help small and micro business owners overcome the economic impact of the pandemic, including waiving or lowering interest rates. It also partnered with 100 banks to launch an initiative to support SMEs as they resumed operations post pandemic. The initiative was able to serve over 10 million SMEs and extend loans totalling US$63 billion (RMB 400 billion) in 2020.[51]

A "zero-payment-day" service was launched in February 2020, which attracted around 6.5 million rural lenders in one month and was extended to another four months due to the expansive effect of the pandemic on the rural population.[52] Elaborating on some other CSR initiatives in 2022, Wang Jian, shared,

> This year, there were floods in Henan and Shaanxi; MYbank launched interest-free coupons and issued interest-free loans to help farmers cope with this difficult period. Through remote sensing and processing on the Tomtit platform, we can clearly know which customers and which farmers' fields are flooded and what state they are in. Then we can accurately issue interest-free coupons to these farmers and provide them with some discounts to help tide over difficult times.

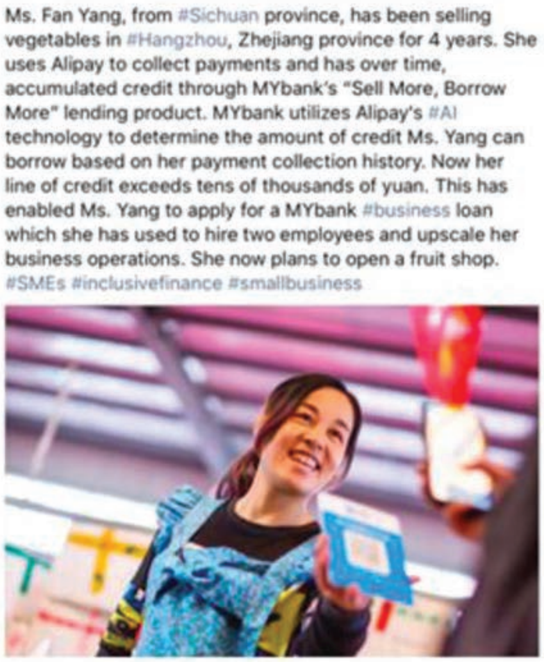
To help with the flood situation at a national level, MYbank also worked with China Agricultural University to assist the National Disaster Reduction Committee create a model to measure the flood situation—depicting what each area looked like and how to evaluate the economic loss. Despite taking up such philanthropic commitments on a regular basis, MYbank had managed to remain profitable in a market that formal financial institutions had always been apprehensive to enter due to its complexities, risks and lower margins. As of last quarter of 2021, MYbank had served more than 45 million SMEs and reported a surge in customer growth of almost 30% year-on-year. Statistically, around 90.8% of these SME lenders had paid back their loans on time, which had in turn helped increase their credit levels while continuing to maintain the non-performing loan ratio at low levels.[53,54]

MYbank had also launched social welfare programs to reduce economic parity. According to the International Finance Corporation (IFC), women entrepreneurs in emerging markets faced a daunting gender finance gap when it came to growing their start-ups, as they continued to face unequal access to capital in the traditional banking and investment environment. MYbank tried to bridge this gender bias by employing completely digital approval and delivery of loans which were known to be less biased. In addition, the bank tried to address the two key challenges faced by women entrepreneurs—accessing financing opportunities and lack of digital knowhow, through a '3D' approach—by enabling digital financing, providing digital skills training and building digital communities. The understanding was that the combination of these three key components could play a unique role in scaling up women entrepreneur's equitable and inclusive development.[55]

By 2020, over 50% of MYbank loan recipients were women entrepreneurs, and about 80% of them had received their first-ever loan from the bank. Between 2015 and 2020, MYbank was able to provide financing to more than 8.2 million women-operated SMEs in China, with an average loan amount of US$5,700. The default rate of MYbank loans across the board for all its products, was about 1.5%, which was 60% lower than the industry average, and almost half of the average ratio of 2.99% for SME loans in China.

MYbank also established a comprehensive digital communication community called the “business engine”, which was housed on the Alipay app. The community provided an open, safe and interactive place for about 40 million of its SMEs who had signed up, including 19 million women entrepreneurs to share learning experiences from their entrepreneurial journey. This initiative was further upgraded to form the “Mulan Community”, catering exclusively to women entrepreneurs.[56] The Mulan Community provided three services—a hotline for business advice, a virtual “Mulan University” that offered over a hundred financial and tech courses, and an online chatroom for women to exchange business ideas. Such a community environment provided a feeling of empowerment to the women entrepreneurs and helped them collaborate with career mentors, tech leaders and friends who shared a similar vision and challenges (refer to Exhibit 6 for further details on MYbank’s initiatives to support women entrepreneurship).[57]

Exhibit 6 Supporting Women Entrepreneurs



Women entrepreneurs in Dangshan County in eastern China’s Anhui Province were able to expand their fruit business with loans from MYbank.

Source: Ant Group Website

Technology Innovation for Greener Agriculture

MYbank's approach towards providing financial services for rural agriculture was two-pronged—first to grant accessible finance to farmers, and second, to help the agricultural industry embrace the development opportunities of the digital economy and accept innovative technology as the new way. The latter could improve the quality and safety of agricultural products, enhance the brand name of smaller farms, and increase operative benefits of agriculture and farming. Towards this end, partnerships were formed to bring new technologies to farmers.

For example, in 2020, MYbank's loan offerings were paired with Ant Group's rural vitalisation technology. Ant Group partnered with Agricultural Bank of China and the local government of Anhui Province's Dangshan County to create a rural vitalisation model called the 'Dangshan Model' to enable improved credit assessment. Each Dangshan-grown pear was verifiable with a unique ID generated by blockchain technology that could trace data on the source of the fruit, its planting history, distribution, and government supervision data, thereby establishing a fully credible and traceable agricultural production chain. The technology also allowed the tracking of the fruit's sales, delivery, and other related data in platforms like Taobao and Tmall, which in turn could be used by MYbank in its credit-assessment. Such solutions backed by technology created a robust foundation for the rural credit system and efficiently solved the dual problem of inclusive finance and sustainable agriculture.[58]

In another project in Inner Mongolia, MYbank's inclusive finance loan was paired with Ant's blockchain technology (AntChain) to create an efficient system for enabling green agriculture. This smart agricultural system used blockchain for traceability and authentication to determine and verify the value of a particular rice field and assign its produce a green digital ID, called the 'green-core' food safety code. The initiative was a pilot experiment to establish how technology could be used to standardise green produce, enable MYbank to assess credit needs and apply preferential credit rates for farmers based on such data, and promote green agriculture.

However, sustainable finance initiatives like the ones implemented above, were not new, had been tested unsuccessfully in many countries, and had their fair share of challenges.[59] For example, hundreds of dams and agricultural schemes set up across Africa by the World Bank had mostly failed to reach their intended goals due to problems associated with political and governmental management frameworks.[60]

The distributed inclusive finance solutions launched by MYbank on the other hand provided smallholding farmers with the capital and motivation required to implement more climate-sensitive farming practices, without the bureaucratic influence of political and management frameworks.[61] Analysts had forecasted that such technology solutions, usage of digital currencies, and increasing consumer interest in transparent carbon-offsets could establish an efficient pathway for new forms of liquidity pools[62] to counter financial risks from small-scale farmers exploring sustainable, eco-friendly agricultural techniques.[63]

Five Year Plan, Digital Yuan, and Moving Forward

In June 2020, MYbank had laid down its five-year plans for expansion; the objective was to reach more SMEs across China by working with partners across multiple sectors and embedding its services seamlessly into new use cases. To enable further growth, MYbank tried to establish new partnerships, using emerging technologies to build new, more efficient business solutions, and spread its user net wider.

Towards this end, the firm had collaborated with Chinese logistics platform Log56.com (with 70,000 registered corporate users), leveraging on Ant Group's blockchain technology, to extend micro loans to 200,000 truck drivers and micro logistics business owners. The blockchain technology aided credit risk assessment with reliable, tamper-proof logistics information such as order and execution numbers. In another project, MYbank teamed up with Chinese food manufacturing company Jinmailang Food to extend loans to over 5,000 distributors across its supply chain, which helped the distributors cope with the economic impact of the pandemic by using short-term loans to restock their supplies.

Fast forwarding to April 2022, as China's rural economy started to slowly recuperate after the pandemic, MYbank's role as an enabler of rural entrepreneurship became even more critical, amidst rising regulatory control to support stricter oversight on data sources and data use.[64] However, competition in the online banking market was increasing, and players like WeBank had also encroached into the SME market space, making it more difficult for MYbank to expand its profits based just on scale (refer to Exhibit 7 for comparison of MYbank and WeBank).

A separate consideration was regarding digital currencies. In January 2022, China had launched its pilot digital yuan, also referred to as the e-CNY, which had been highlighted by international and national institutions as a tool to promote an inclusive digital economy. Such currencies were predicted to promote financial inclusion and contribute to the countries' efforts towards creating a new financial system that centred around the needs of the people. As the financial ecosystem became increasingly digital, people who did not have bank accounts could be left further behind; and digital currencies could help avoid this gap by establishing a more inclusive digital payment ecosystem and creating financial data identities.[65]

MYbank had been selected as one of the distributors of e-CNY, which required residents in China to link their e-CNY services to a bank account. The e-CNY was expected to have a symbiotic relationship with payment platforms like Alipay and WeChat Pay and provide benefits to online payment platforms by creating more visibility and generating

Exhibit 7 Comparison of Mybank And Webank

Bank	Operational Model	Business Positioning	1st Biggest Shareholder	2nd Biggest Shareholder(s)
Webank	Purely Online Bank	Unsecured small loan through social app WeChat	Tencent (30%)	BaiYeYuan (20%) and Liye Group (20%)
MYbank	Purely Online Bank	Unsecured small loans to SMEs and farmers	Ant Group (30%)	Wanxiang Sannong Group
Sichuan Xinwang Bank	Purely Online Bank	Unsecured individual small loan, corporate bank	Xinxiwang (30%)	Sichuan Yinmi Technology (29.5%)
Tianjin Jincheng Bank	Online and Offline	Cash deposit, loan, bill discounting	Tianjin Huabei Group (20%)	Maigou Group (18%)
Wenzhou Minshang Bank	Online and Offline	Loans to micro and small companies in Wenzhou	Xzengtai Group (29%)	Huafeng Spandex (20%)
Shanghai HuaRui Bank	Online and Offline	Loans to companies or individuals; Corporate finance	Junyayo Group (30%)	Metersbonwe (15%)
Chongqing Fumin Bank	Online and Offline	Wealth management, unsecured loans	Hanhua Finance (30%)	Zongshen Industry Group (28%)

Online banks in China, business positioning comparisons.

Internet Bank	WeBank	MYbank
Total Assets	52 Billion RMB	61 Billion RMB
Loan Balance	30 Billion RMB	33 Billion RMB
Total Deposits	3.3 Billion RMB	23 Billion RMB
Net Profit	0.4 Billion RMB	0.3 Billion RMB
Non-Performing Loan Rate	0.32%	less than 1%
Capital Adequacy Rate	20.21%	11.07%

MYbank WeBank, Financial Comparison, FY2017

Note: WeBank and MYbank are not competitors, as both are in different businesses (i.e., serve different consumer segments and have different products). While MYbank serves SMEs and rural enterprises, WeBank mainly serves individual loan requirements across a range of consumers, mainly low-income groups like migrant workers in urban areas who have a lower default rate risk. The main intention of this Exhibit is to build a difference of the business models of the two companies for classroom discussion.

Source: "MYbank versus WeBank", China Channel, October 12, 2017, https://chinachannel.co/wp- contesnt/uploads/2017/10/nn.png, accessed March 2022. Leilei Wang, "China's Private Commercial Banks Like MYbank and WeBank Have a Ways to Go", Kapronasia, August 17, 2017, https://www.kapronasia.com/china-banking-research- category/china-s-private -commercial-banks-like-MYbank-and-webank-have-a-ways-to-go.html, accessed March 2022. Michael Chui, "Money, Technology and Banking: What Lessons Can China Teach the Rest of the World?", BIS Working Papers, No 947, June 7, 2021, https://www.bis.org/publ/work947.pdf, accessed March 2022. Wendy Weng, "Thirteen Most Profitable Digital Banks in Asia Pacific Upped Earnings by 49% in 2019", The Asian Banker, October 15, 2020, https://www.theasianbanker.com/updates-and-articles/thirteen-most-profitable-digital-banks-in-asia-pacific-upped - earnings-by-49-in-2019, accessed March 2022.

additional payment flows.[66] The challenge with the introduction of the e-CNY was its relevance to MYbank's target consumers, and how it would impact MYbank's existing business and solutions.

Despite the pressing uncertainties, the MYbank executives were hopeful. However, there were important dilemmas that they needed to address. How could MYbank continue to remain a sustainable business model under market pressures? How could it compete effectively in the cut-throat online banking market? How could it create a balance between its CSR/ESG goals and a high growth profitable business model? Could its CSR strategies provide the company with a competitive advantage in a banking industry that traditionally targeted high-net-worth customers?

Notes

1. "ANT Group Sustainability Report 2021", accessed March 2022.
2. According to Chinese regulation, a shareholder of a private bank should not own more than 30% of the bank's shares. Ant Group therefore owns 30% of MYbank's shares. The rest of the shares are held by other shareholders.
3. Digital Yuan, or Digital Currency Electronic Payment, is a central bank digital currency issued by China's central bank, the People's Bank of China. It is the first digital currency to be issued by a major economy, and entailed a smartphone app launched in early 2022, for payments and money transfers using the digital yuan.
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5. "Ant Group's MYBank Posts 31.6% Loan Growth in First Quarter", China Banking News, June 1, 2022, https://www.chinabankingnews.com/2022/06/01/ant-groups-mybank-posts-31-6-loan-growth-in-first-quarter/, accessed June 2022.
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20. 80% of the world's wealth belonged to 20% of the world's population.
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Case 4

Aventiv Technologies: Answering the Call for Change?

It was May 2021. Tom Gores, the billionaire founder of private-equity firm Platinum Equity (Platinum), was facing criticism from activists over one of the investments in the firm's $23 billion portfolio, Aventiv Technologies (Aventiv).[1] Like most private-equity firms, Platinum was used to buying companies, adding operational expertise to improve company performance, and then divesting the company in three to five years for a nice profit. The formula had worked very well in many industries Platinum invested in including chemicals, communications, logistics, health care, automotive, industrial products, and business services. But Aventiv, acquired for $1.5 billion in 2017, when the company was named Securus Technologies (Securus), was part of a multibillion-dollar industry that served the over two million inmates in the US prison system. As such, the company drew attention not only for its business performance but also for its business practices at the nexus of broad national debate about social justice, criminal justice, race, and mass incarceration in America. Early on, Platinum discovered that this made the Securus investment different. Gores said later, "I don't think we really had a good sense of the social issues underneath of it all."

The social issues around prison telecommunication centered primarily on the high rates charged to inmate consumers and their families and friends. For 20 years, the US prison industry had been in a growth market from which the telecom companies serving the industry had benefited greatly. Companies like Aventiv's subsidiary, Securus, contracted with the operators of federal, state, and local corrections facilities (the customer) for the right to offer telephone and other communications services to inmates and their friends and families (the consumer). Unlike traditional phone services people used every day on the outside, deploying telecommunications in a correctional environment had to account for a wide range of safety, security, legal, and operational considerations that added cost and complexity. Those services were paid for by the inmate and family consumers, not by the facility customers. In fact, in many cases, an additional charge was tacked onto the inmate consumers' bills and paid to the agency customers in the form of a "site commission" that was, in effect, a tax that generated revenue for the prison or jail operator. Those prison and jail operators valued not only the telecommunications platform and the service it provided to inmates and their families, but also the commissions they received—which helped fund their budgets. However, the consumers wanted the highest degree of access at the lowest possible price. That created a friction in balancing the demands of the agency customers and the inmate consumers. Securus Executive Randy Phillips said, "Because some of our consumer wants and the facility wants are sometimes diametrically opposed to each other, we're in the middle of it… you need to serve the facility customers in order to be able to serve the consumers…and that puts us in a very difficult spot at times to balance out all the parties' needs."

After Platinum bought the business, it pledged to make existing telecommunications products more affordable and accessible. And strategically, it planned to expand the business beyond telecommunications and into tablet and related technology that would offer education, entertainment, job training, and post-incarceration products and services that would benefit inmates on the inside and help reduce recidivism once they were released. A new corporate parent, Aventiv, was formed to drive this technology transformation. The transformation program represented a significant decision by Platinum to lean into the issues facing the company and the industry, rather than run away from them.

"We could sell and get out," said Gores, who owned the Detroit Pistons in addition to leading Platinum and its 50-plus operating companies. "But some other person may just get in and focus on the business aspects at the expense of the social aspects. They're not going to make the necessary change. Selling would have been a lot easier for us than taking the lumps that go along with really transforming a company and an industry, but I think this investment provides a really unique opportunity to do something that I think is revolutionary."

The first step was installing a new CEO, Dave Abel, with a mandate to launch broad and deep reforms. Then, in short succession, an outspoken advocacy group focused on broad corrections reform targeted Gores and Platinum for a pressure campaign, and then the COVID-19 pandemic hit. That only accelerated the company's rethinking of past industry practices. Gores knew that Aventiv and the industry were at a crossroads. The battering they were taking in the press only made change feel more urgent. And while it was only about 1% of Platinum's portfolio, Gores commented that, "It will be maybe one of the most important companies I ever buy." Change was coming. The question was, could Platinum and Aventiv lead it? And what exactly did change look like?

Mass Incarceration Drives Budgets

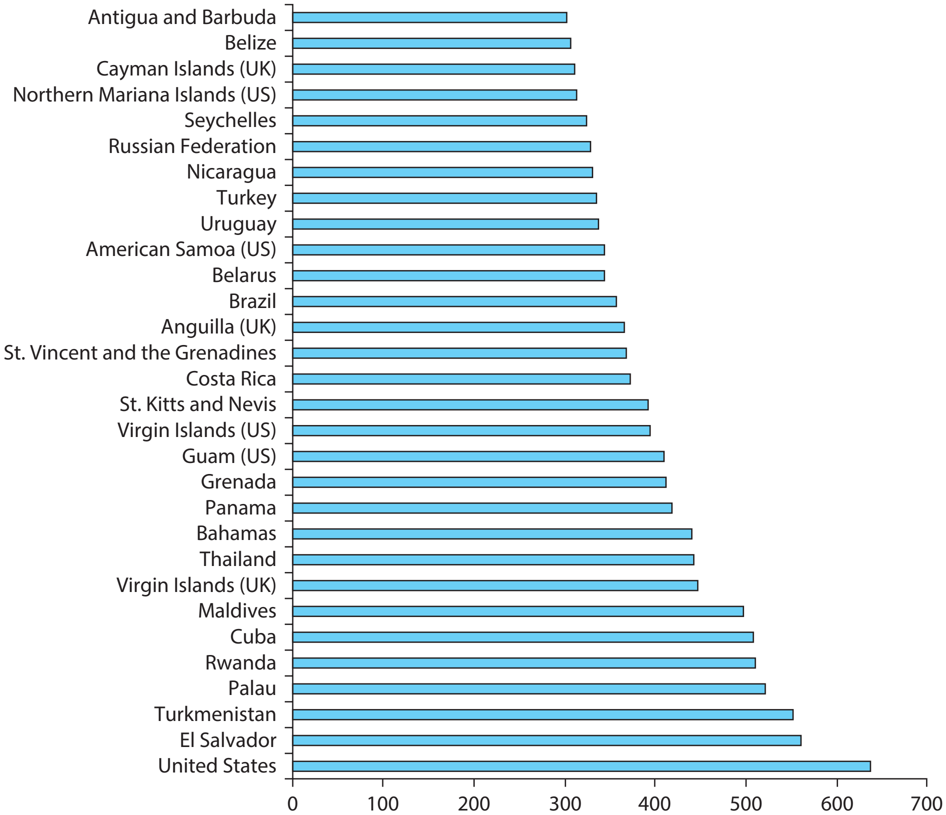
The prison communications industry had been shaped by two trends of the 25 years leading up to 2021: a rapid increase in US incarceration rates and the deregulation of the national telecommunications market. Stricter sentencing laws emanating from the Sentencing Reform Acts of 1984, along with later "tough on crime" legislation—like the 1994 "Three Strikes Law" in California, which required long mandatory sentences for repeat offenders, and the 1994 Violent Crime Control and Law Enforcement Act—led to a massive and sustained uptick in US incarcerations. In 1980, less than 320,000 people were serving time in state and federal prisons, a number which grew to 1.47 million by 2003.[2] By 2009, this number had peaked at 1.61 million.[3] By adding prisoners in local jails to the figure, the total number of people incarcerated rose to a high of 2.3 million in 2008, representing a peak incarceration rate per capita of about 1,000 inmates per 100,000 adults.[4] By 2021, the United States (with less than 5% of the world's population) imprisoned nearly 20% of the world's incarcerated,[5] yielding a higher rate per capita (639) than any other nation (Exhibit 1).

The incarceration rate disproportionately affected the African American community. By 2003, African American men were more than five times more likely than white men and three times more likely than Hispanic men to be serving time.[6] While this rate began to decline thereafter,[7] by 2019, African Americans were still more than three times more likely to be incarcerated than white people (Exhibit 2). As prison populations grew, spending surged to create new prisons, hire new corrections staff, and supply the prison ecosystem with myriad services. This effectively created an economic stimulus and jobs programs in many communities. Between 1980 and 2000, more than $7 billion per year was spent on the construction of new prisons.[8] State expenditures on corrections grew from an annual rate of $6.7 billion in 1985 to $60.9 billion by 2018 (Exhibit 3).

Deregulation Shapes the US Correctional Communications Market

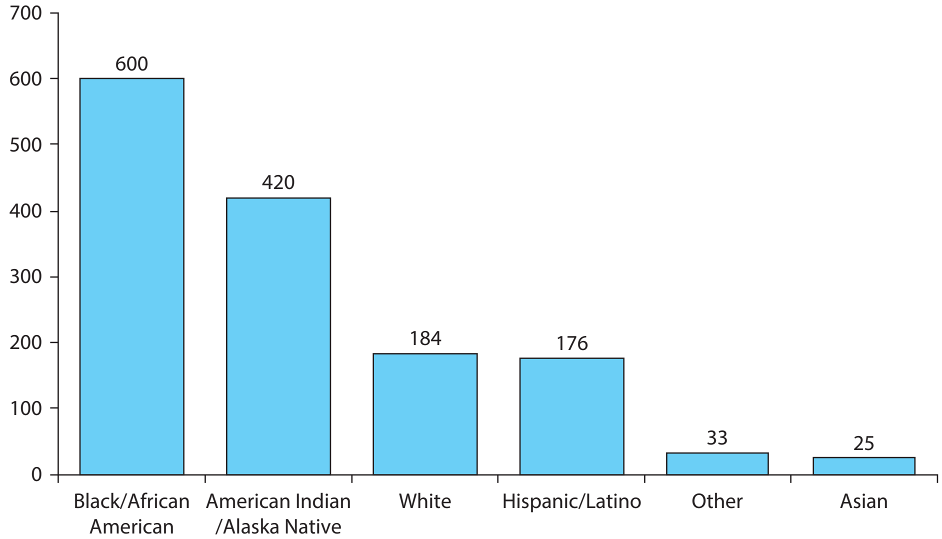
One of the critical services benefiting from this rise in prison-related spending was the telecommunications industry, which began to deregulate from AT&T's effective monopoly control in 1984. The breakup resulting from deregulation meant that AT&T would provide long-distance services while new independent "baby bell" regional operating companies would provide local telecom services. Until 1984, the inmate telephone market was controlled exclusively by

Exhibit I Countries with the Largest Number of Prisoners per 100,000 Residents as of May 2021



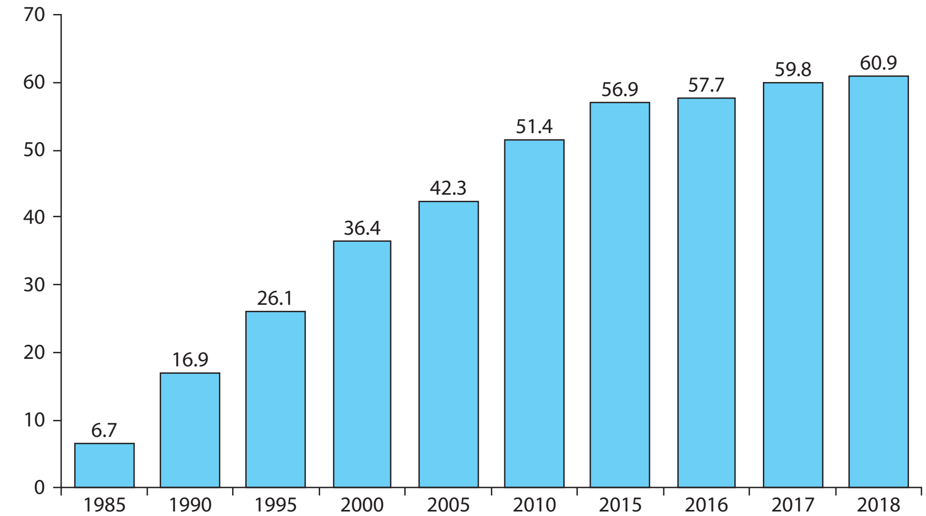
Data source: "Countries with the Largest Number of Prisoners per 100,000 of the National Population, as of May 2021," Statista, May 2021, https://www.statista.com/statistics/300986/incarceration-rates-in-oecd-countries/ (accessed Sept. 16, 2021).

Exhibit 2 2019 Jail Incarceration Rate of Confined Inmates in the United States by Race per 100,000 Residents



Data source: "Jail Incarceration Rate of Confined Inmates in the United States in 2019, by Race/Hispanic Origin (per 100,000 residents)," Statista, 2019, https://www.statista.com/statistics/816699/local-jail-inmates-in-the-united-states-by-race/ (accessed Sept. 16, 2021).

Exhibit 3 State Expenditures on Corrections in the United States from 1985–2018 (in billions of US dollars)



Data source: "Total State Expenditures on Corrections in the United States from 1985 to 2018 (in Billion U.S. Dollars)," Statista, 2019, https://www.statista.com/statistics/624443/state-expenditures-on-corrections-in-the-us/ (accessed Sept. 16, 2021).

AT&T. Thereafter, the service was offered by a mishmash of baby bells such as MCI, and new market entrants like Pay-Tel Communications and Global Tel*Link (GTL).

With a raft of communications firms now competing for lucrative contracts (usually between three and five years in length), county, state, and federal decision-makers began to monetize their position. At the time, pay phone providers rented space in high-traffic areas by paying a share of the revenue to the space's owner (for a pay phone in McDonald's, revenue would be split between franchisee and phone operator, or if a phone was on a city street corner, revenue would be shared with the city). As a result, the corrections customer began to require commissions (as a percentage of revenue) or "kickbacks" in order to sign deals. Some facilities started prioritizing these kickbacks over low rates or technology options when choosing a phone provider.[9] With budget demands rising, many sheriffs and jail officials welcomed the new source of revenue, which was passed along in higher per-minute costs to the inmate or their family and friends. Such commissions ranged from 10% to 55% of gross revenues and by 1995, were required by 90% of correctional systems nationwide.[10] Further deregulation in the Telecommunications Act of 1996 led to an acceleration of market entrants competing for communications contracts with correctional facilities.

Table 1 2021 communications RFP.

9.2 Proposals will be reviewed by an Evaluation Committee and scored on the following criteria:	
0–10 points Technical Specifications, System, Installation, & Operational Requirements	10
0–20 points Merits of the Proposal: clarity and directness of responses	20
0–20 points References, company background, qualifications, and stability	20
0–20 points Service and support capabilities	20
0–10 points Calling rates to be charged	10
0–20 points Commission and Call Accountability	20
	100

Source: Aventiv Technologies; used with permission.

Commissions were stated plainly as a scoring factor in the request for proposals (RFPs) that went out to the telecom companies competing for contracts. A recent 2021 RFP stated the following (Table 1).

A scoresheet was compiled, often with the help of consultants, rating each of the bidders in the various categories to select a winning bid (Exhibit 4).

To some, it made sense that the inmate (and their family and friends) should bear this additional expense rather than the taxpayer (who hadn't committed a crime), but the end rate paid by the inmate soon began to grow rapidly. By the mid-1990s, the price of a single 15-minute in-state call had topped $20 in some places, and out-of-state fees spiked as high as $2 per minute.[11] This stood out in contrast to the overall telecommunications industry, where consumer rates available outside of facilities plummeted due to deregulation and competition. Over time, the commissions grew with each new contract and encompassed third-party-services payments, signing bonuses, and equipment and technology grants. By 2000, the state of New York charged a national high of 60% and earned more than $20 million per year from prison phone revenue (a figure matched by California and the Federal Bureau of Prisons).[12]

Throughout the 1990s the market for inmate communications companies remained fragmented, but through a series of acquisitions, it came to be dominated by two carriers operating on lines leased from local exchange carriers: GTL and Securus. By 2021, GTL served 2,400 facilities in all 50 states; Washington, DC; and Puerto Rico (controlling 45% of the market), and Securus served about 2,000 facilities serving nearly one million incarcerated individuals (with 40% of the market). Typically, contracts ran for three years with two one-year renewals that could make the contract five years. Andrew Becker, a long-term employee responsible for financial analysis, estimated that the contract incumbent was about 20% more likely to retain the contract during the next bidding process, "because change is painful, right?" Fraudulent or criminal events originating from prison and jail phone calls along with technology innovations began to increase the need and ability for new technology that allowed corrections workers, police investigators, and prosecutors access to recordings on demand, which could be used by investigators across jurisdictions as a crime-solving tool.[13] By 2021, the prison telecom industry was worth $1.2 billion,[14] not including other revenues for participants like tablet applications and sales, money transfer, and monitoring.

Private Equity Discovers a Growth Industry

The growth in inmates and prison facilities meant that an increasing amount of dollars from state and federal budgets were devoted to the prison ecosystem. The cottage industry of companies servicing the telecommunications needs of this growth industry began to gain attention. Private-equity investors were quick to see value in companies like Securus that served the prison population. Securus had everything that private-equity investors valued—high margins, long-term recurring contracts, and growing cash flow. In 2011, investment firm Castle Harlan bought Securus from H.I.G. Capital, a private-equity firm based in Miami. At the time, Securus served 2,200 facilities across 44 states; Washington, DC; and Canada.[15] In 2013, Securus was acquired by ABRY Partners for $640 million (HarbourVest Partners and Mesirow Financial also participated).[16]

In 2017, Beverly Hills–based private-equity firm Platinum became interested in Securus. GTL and IC Solutions (ICS) were Securus's main competitors. GTL and Securus offered the two most robust offerings in the market, while ICS was more of a pure telephone company competing primarily in county and municipal markets. While GTL was bigger on the phone side, Securus had a lead in the tablet business and potentially more room to grow. Platinum's thesis was explained by one of the firm's partners, Mark Barnhill: "We look for broken companies. Undermanaged, underperforming. We buy them at a discount to market. We then fix what's

Exhibit 4 Example of Scoresheet for 2021 RFP

RFP Title: Inmate Phone Service
Due Date: 5/19/2021

	Company 1	Securus Technologies	Company 2
Evaluator 1	95	90	62
Evaluator 2	95	85	65
Evaluator 3	100	87	55
Total	290	262	182
Average	97	87	61

0–10 Tech	10	10	10
0–30 Merits	25	25	10
0–20 References	20	20	20
0–10 Service/Support	10	10	2
0–10 Calling Rates	10	5	5
0–20 Commission	20	20	15
Evaluator 1	95	90	62

0–10 Tech	10	10	10
0–30 Merits	25	25	10
0–20 References	20	10	20
0–10 Service/Support	10	10	5
0–10 Calling Rates	10	10	5
0–20 Commission	20	20	15
Evaluator 2	95	85	65

0–10 Tech	10	10	10
0–30 Merits	30	20	10
0–20 References	20	20	15
0–10 Service/Support	10	10	5
0–10 Calling Rates	10	7	5
0–20 Commission	20	20	10
Evaluator 3	100	87	55

Source: Aventiv Technologies; used with permission.

broken in them and turn them into market leaders, and then we sell them at a premium to market. The opportunity at Securus started with an operations transformation centered on moving from inmate telephony to a broader technology platform with more expansive products and services. But we also saw the importance of being change agents driving a larger industry transformation with respect to criminal justice and social-justice reform." Securus was acquired by Platinum through a $1.5 billion leveraged buyout in November 2017. Term loans worth over $1.1 billion along with a $150 million revolving credit line were provided by BNP Paribas, Jeffries Finance, Bank of America, Barclays, Citigroup, Credit Suisse, Goldman Sachs, Morgan Stanley, and Deutsche Bank.[17]

Becker pointed to the logical reason private equity liked the sector: "The only reason private equity would buy anybody is to make money, would they not? To have a long-term investment portfolio and grow the business somehow." Platinum's initial focus was on the operational transformation, but social-justice issues very quickly rose in prominence because much had changed in society. The global pandemic created both health concerns and isolation for inmates; social protests emanating from the death of George Floyd in 2020 magnified attention to racial, social, and economic justice issues in America; and the US election of the Biden administration brought a more progressive national legislative agenda. Tensions also flared between law enforcement and the communities it served. With respect to incarceration, the line was blurred between providing necessary products and services to prisons and jails and unnecessarily "profiteering" from that captive customer base. Aventiv, Securus, Platinum, and Gores all felt pressure to defend themselves as investors and change agents rather than profiteers, and Gores would later admit that he underestimated the "headline risk" and backlash from activists that his ownership of Securus would bring.[18] Critics were demanding lower phone prices for inmates, particularly at a time when the world was recovering from a pandemic. But because of the competitive nature of the industry, the multijurisdictional contracts with commissions, and Securus's cultural legacy, change was unlikely to be easy.

History: Tele-Matic Becomes Securus Becomes Aventiv Technologies[19]

The predecessor company to Securus, T-Netix, Inc. (T-Netix), was founded in 1986 under the name Tele-Matic Corporation. A series of business combinations through the 1990s culminated in the merger of two correctional industry giants in 2004: H.I.G. Capital–owned Evercom with T-Netix, forming Securus. Randy Phillips, who joined the company in 2008, explained that the implications of traditional collect calling offered to consumers of jail and prison phone calls and billed through local exchange carriers increased bad debt expense across many providers, threatening the financial health of the industry. At the time, the business worked like this: Inmates made collect calls home to family. The family would accept the charge, but not have to pay until later. Securus and other providers would bill telecom carriers for each completed call. Securus would then pay contractual commissions to the corrections facility. It would take several months to reconcile whether the family would pay for the collect calls to the telecom carrier, and an increasing number did not pay. This resulted in bad debt that was passed on to Securus (which was not paid, but still had to pay the corrections facility). "There were a number of competitors that failed to understand these operational complexities and would ultimately shut down," said Phillips.

In 2008, Rick Smith, a former telecom executive from Eschelon Telecom in Minnesota, joined the company as CEO, a position he would hold until the end of 2017. Phillips explained that Smith introduced a "disciplined financial, sales, and operational mindset," while at the same time the industry was changing, and society began to rapidly scale the use of cell phones. Unlike local exchange carrier billing, cell phone providers did not bill collect calls on behalf of jail or prison telecom providers. Phillips explained, "As society increased adoption of cell phones, it meant prison and jail telecom providers would need to migrate to a prepaid model. This meant friends and family members would need to open and fund a prepaid calling account before they could accept call charges from someone in jail or prison." Soon, though, another problem arose. Phillips explained, "Under previous/traditional collect calling methods, consumers accepting call charges were simply deferring payment until they received their home bill. Under evolving cell phone adoption, the prepaid function would add the complexity of informing consumers who was calling, and why and how to create and set up an account to accept calls."

To tackle these new consumer-facing issues, Securus began to test a number of "first call connect" strategies, such as 20-second free calls. The North Star of the company in those days was increasing call volume by reducing barriers to entry in order to maximize profitability. In order to facilitate efficient account creation and take online payments, Securus created a number of website capabilities—something historically not needed under traditional collect calling. That added an alternative to an 800 number or the option for friends and family to physically go to Western Union and pay the associated fees. Phillips explained that to improve call completions, "We had to be consumer friendly—we had to make our services easy to use." Around 2010, additional development enabled inmates access to their own telecom debit account. If they transferred money to these debit accounts, it allowed them to make and pay for calls to anyone (not just to friends and family that had prepaid) unless restricted by the facility. Costs continued to be high to the consumer, though, partly due to legacy telecom charges and dominant carrier rates, which were prevalent throughout the 1980s and 1990s, and partly due to an attempt to recover earlier bad debt losses from collect calls. In some cases, carriers in certain regions charged scaled-fee structures that Securus passed on in the form of $2.50 surcharges for calls, 35 cents for the first minute, and 10 cents for each additional minute. Interstate calls could be even higher, with some costing a $3.95 surcharge and 95 cents per minute. The company's hope was to decrease rates in time and make up for the revenue loss by increasing call volume.

Following the 2011 sale of Securus to Castle Harlan, the company went on a buying spree to consolidate its market position and build out its services for the changing market. In 2012, Securus bought DirectHit Systems (provider of a data-analysis tool for law enforcement and corrections clients) and bought Primonics (video provider to the corrections industry). In 2013, Securus bought Satellite Tracking of People, since renamed Securus Monitoring (which made GPS ankle monitors). In 2014, the company acquired JLG Technologies (provider of voice-biometric analysis and investigative tools) and bought Telerus, (an automated interactive voice-response system). In 2015, Securus tacked on four more acquisitions: CellBlox (a system to limit use of contraband wireless devices in prisons), JPay (which offered money transfer, a tablet program, and other financial services for inmates and family), Guarded Exchange (which provided forensic services for recovered digital devices), and Cara Clinicals (a service for electronic medical records and health cards). 2015 was also the year a security breach—a hack of call records—occurred in a company just before Securus acquired it.[20] Abel explained, "As early as my interview process with Platinum, I highlighted the need for every company to significantly upgrade cybersecurity protections, and especially a company with as much data under its care as Aventiv. Our consumers and customers must trust our stewardship of critical information, and the threats were clearly getting much worse across all industries. My very first hire upon arrival was a new chief information security officer (CISO). She has significantly improved our protection and faces an ever-evolving and maturing threat."

JPay was another price-inflation issue. The company primarily made money as a payment platform, facilitating the transfer of money from consumer to inmate by online payment, phone call, cash deposit at any MoneyGram agent location (including Walmart and CVS), or through a mobile app. The charges varied by state and facility, but in some instances, individuals could pay fees of more than 30% per transfer. Rates to send money to inmates in Virginia at the Appalachian Men's Detention Center, for example, cost $2.95 for the first $20 transferred, $5.95 for a transfer of between $20.01 and $100.00, $7.95 for a transfer of between $100.01 and $200.00, and $10.95 for a transfer of between $200.01 and $300.00. One inmate said, "The company charges us egregious fees to put money into our prepaid phone accounts: My brother refills mine for me, and gets charged several dollars for every $50 he puts in—the maximum he can transfer in a single transaction."[21]

By 2021, the company had regional offices in Carrollton, Texas; Houston, Texas; and Miramar, Florida; with additional teams in Massachusetts; Missouri; and Montreal, Canada; and employed approximately 1,800 people. The corporate culture during those years seemed largely focused on profit, growth, and serving the needs of the facilities customer, with less regard for the needs of the consumer, including inmates and their friends and family. Operations Manager Kelly Brooks, who joined Securus in 2016 in a customer-service role, explained, "In the old management, facility was the prime customer." Nicole Sullivan, who joined the company about six months before Platinum acquired it, commented that, "I get that it's business, I've been in business my entire life, but it felt a little predatory to me…We had a market that really couldn't go anywhere, with competitors who were running their business the same way we were. And so, we kind of put people in a position where they didn't have choices, and the choices they did have are probably not something you and I would be really excited about." That included high prices and quality that "wasn't as high as it should have been." Marci Thompson, a product leader, commented, "Historically, we've been about making our customer happy, which is the facilities, department of corrections, the sheriff. And so, when you're completely focused on that and only that, you make different decisions than when you are focused on both—our friends and family and our incarcerated versus our customer, which is the contract owner."

Following the 2017 acquisition of Securus by Platinum, the company attempted to acquire ICSolutions, the industry's third-largest company, in 2018. After reviewing the transaction, though, the Department of Justice's Antitrust Division and the Federal Communications Commission (FCC) signaled they would likely block the deal. In a press release,[22] FCC chair Ajit Pai wrote, "Based on a record of nearly 1 million documents comprised of 7.7 million pages of information submitted by the applicants, as well as arguments and evidence submitted by criminal justice advocates, consumer groups, and other commenters, FCC staff concluded that this deal posed significant competitive concerns and would not be in the public interest." The company decided to abandon the deal that would have further strengthened the duopoly with GTL.

Platinum's investment thesis envisioned moving Securus away from being a pure telecommunications services provider, and toward a more diversified technology offering based on tablet technology and a broader array of entertainment, education, job training, and post-incarceration products and services. In 2019, the company announced a corporate reorganization reflecting that vision and announcing a new corporate parent (Aventiv) focused on research, development, and innovation; and three underlying business lines (Securus, JPay, and AllPaid). Together, these businesses would focus on product-line expansions including next-generation tablets, new financial-management tools, and new government payment platforms.[23]

Platinum Equity Installs Abel as CEO

In 2019, Platinum unveiled a reorganization of Securus. The goal was to continue to transform the company from a telecommunications service provider for the corrections industry into more of a diversified company serving multiple sectors.[24] A new corporate structure was formed, featuring a new corporate parent called Aventiv with three principal divisions: (1) technology, media, and communications (Securus corrections business represented 80% of revenue); (2) consumer payment solutions (representing 15% of revenue), and (3) public-sector solutions (a monitoring business representing 5% of revenues). At the time, CEO Bob Pickens said, "We are working to ensure that our core communications services are more affordable, more responsive and attuned to the needs of all of our customers, including corrections agencies, incarcerated individuals, families, and friends. At the same time, we are developing innovative technology products and services that will better serve both customers and consumers and have broader application beyond the corrections marketplace."[25] Gores, however, was not happy with the pace of things under Pickens. Reflecting back, he noted, "Our old management team just wasn't listening."

In April 2019, Platinum recruited Abel to develop an accelerated business-transformation program for Securus. As an executive at IBM and a partner at PricewaterhouseCoopers, Abel was responsible for turning around and growing service and software businesses, gaining particular experience working with government contractors throughout his career. On January 13, 2020, Abel was named president and CEO of Aventiv. At the time, Bryan Kelln from Platinum commented, "Dave is an innovative leader who we recruited in April to develop and accelerate an ambitious business transformation program for Securus."[26] A key part of the transformation was becoming more consumer focused. When Abel was hired, he said, "We have the opportunity—and the responsibility—to address the financial and social needs of the communities we serve, making our services more affordable and accessible while continuing to innovate and help our government partners keep those communities safe and secure."[27]

One of the first surprising things Abel discovered when he became CEO was that Aventiv was facing a liquidity crisis. "We had such a high debt ratio and we had constrained cash flow and a lot of investments in infrastructure, technology, et cetera—and we were dangerously close to running out of cash, which means you're going to run out of blood in the body." The business had enjoyed steady growth until 2019, when profitability declined. Cash flow had been spent inefficiently, in Abel's opinion. Money was spent servicing existing contracts rather than in pursuit of new ones. There was also high turnover in call centers and the poor integration of several acquisitions. "The turn came really quickly. Part of that came from COVID," Abel said. There was less travel because people were locked down, so expenses decreased. Meanwhile, incarcerated individuals wanted to use more telecommunications to check on their loved ones, so volumes surged. Much of that increased demand was met by a program the company enacted that would ultimately provide 41.5 million free phone calls, totaling over 341.5 million free minutes.

When Abel took the helm, his top priority was around changing the company's culture. That required setting a new agenda and clarifying the mission. It also meant changing the leadership team. Within the first 18 months, Abel and Platinum had replaced 10 of the 14 people on the leadership team. Abel also pushed to decentralize the decision-making to be as close to customers and consumers as possible. "Creating a different purpose for the company is job number 1," said Abel. "The purpose of this company when I joined was to be bought and sold…but by itself that is not a purpose; it's an outcome or even a byproduct." Abel believed the number-one challenge for the company was to "balance out the creation of value in the organization equally, fairly among consumers, customers, shareholders, and employees." What about advocates, legislators, and regulators? Abel didn't think they were primary stakeholders in the traditional sense. He viewed them as key influencers worthy of engagement, but clearly noted that "we are not here to create value for them." Still, Abel believed that had the industry appropriately balanced value creation for its true stakeholders in the past, "you would not need lawmakers or regulators to step in and try to do the job."

Abel's second priority was "accessibility, affordability, and the quality of the products that we deliver." The phones and tablets had to be reliable, and the pricing had to come down so that the services were accessible. The third priority was research and development. "I fully expect tablets to replace phones." Innovation would continue to be important going forward to help connect people. That required research, innovation, and capital. In the press release around Abel's hiring, he previewed the main initiatives of the transformation: accessibility and affordability, transparency and education, re-entry and recidivism, listening and responsiveness, and technology and innovation (Exhibit 5).

Primary telecommunications (the traditional prison phones on walls) was the largest part of the company's business, though it was shrinking. With the average daily prison population unlikely to expand, and a resource-limited consumer, different approaches would be necessary to grow the business. In addition to the consumer base, margins were shrinking—mostly because of continued price pressures, but also because of cost-side inflation. The fastest-growing part of the company's business was media, messaging, and education—core tablet content. Abel explained that its growth rate was "60%, 70%, 80% quarter over quarter," showing the demand in the market for such services. Tablets were introduced to the prison market as early as 2010, initially as MP3 players. One corrections officer commented on the impact tablets had at his prison: "Suicide attempts and suicide ideations are down by at least 50%. If we can have a positive impact on recidivism rates and it makes it safer for the inmates and my officers, it's a win-win scenario."[28] The tablet business was improving, despite the fact that the overall prison population had declined since the start of the pandemic—due mostly to COVID-related early releases. This was because a larger percentage of inmates were using

Exhibit 5 Dave Abel's 2020 Plan for Aventiv Technologies

1. **Accessibility and Affordability**
   - **While Securus has reduced the average cost of calls by 30% over the past 3 years, not all consumers felt the same relief. The company pledges to work with all our institutional customers to broaden rate relief for more consumers by targeting the elimination of legacy outlier rates and reinvesting in the development innovations and tools to further reduce costs.**
   - **In 2019 Securus became the only service provider to announce full neutrality on the presence of site commissions and the provision of products regardless of the funding source and model determined by each locality. The organization will build on that in 2020 by working with all interested institutional customers on implementing these lower-cost-to-consumer alternatives.**
   - **Securus will reduce the application of third-party funding fees by investing in technology solutions where possible -- and negotiating lower rates where outside vendors are still required -- to provide savings to consumers of at least 35% on these fees by year end.**
2. **Transparency**
   - **Securus will provide a clear and simple recitation of call rates to both customers and consumers, ensuring that those call rates are always available online and at the time of each call before they are accepted.**
   - **The Company will commission an annual report of inmate calling costs, produced and published by an independent third party, including a breakdown of what is being charged beyond the specific cost of the call (for example, additional costs necessary for the provision of safety protocols and service).**
   - **Securus will publish by the middle of this year an industry-leading report detailing a terms-of-use policy for its products, and memorializing comprehensive data privacy standards.**
3. **Education, Reentry and Recidivism**
   - **Securus will immediately sign the Society for Human Resource Management Getting Talent Back to Work Pledge.**
   - **The Company will contribute at least $3 million in 2020 to efforts focused on reducing recidivism rates and improving reentry rates, including support for The Securus Foundation to connect justice agencies more closely to their communities utilizing technology.**
   - **The Company will create a post-incarceration scholarship program to facilitate the completion of post-secondary degrees begun under Securus' existing educational product and service opportunities.**
4. **Listening and Responsiveness**
   - **Mr. Abel and other company executives will meet each quarter with families and individuals personally impacted by incarceration to hear their recommendations and address their concerns about the company's products and services.**
   - **Company leaders will also meet with corrections facility customers, correctional trade associations and advocates of alternative incarceration approaches to hear their recommendations and hear their concerns.**
5. **Technology and Innovation**
   - **Securus pledges to invest at least $40 million this year in facility communication infrastructure for the advancement of public safety and community needs.**
   - **The Company will devote at least $30 million to fund innovations in the development of secure products to take on the ever-evolving challenges facing correctional agencies in the new decade.**

Source: Aventiv Technologies; used with permission.

the company's services to check on the health of loved ones (with whom they were not allowed to visit in person due to health risks) and also partly because of the increased liquidity and purchasing power for both inmates and their loved ones thanks to government stimulus checks. The company sought to balance the surge in demand by offering free credits for communications services such as e-messages, video chats, and phone calls.[29]

GTL and Aventiv were both exploring different models for getting the tablets to prisoners, who valued the ability to video-call friends and family on the outside. Charging inmates up front for the tablets didn't make economic sense for jails wherein individuals were held for only a month or two. For prisons, where stays were much longer, ownership of tablets could reduce the likelihood that tablets would be broken, which as of 2021 stood at 10% per year.

There was also the issue of the tablet programming. Aventiv, in an effort to sell music on tablets and media players, cut deals with publishing companies in the music, movie, video game, and educational industry to offer many options. Inmates seeking to better themselves would have access to college courses and other educational material. But they also had the ability to play video games and fill their time with more mindless entertainment options—for a cost, of course. Some figured the average prisoner would play games and music 8 to 10 hours a day, just like anyone in America, rather than work on programs that helped their rehabilitation.[30] Some were concerned about the possibility that tablets would replace in-person visits, which were thought to be better for lowering recidivism. Indeed, before Platinum bought the company, Securus had signed several contracts directly incentivizing prisons to restrict in-person visiting hours in order to drive more people to using the tablet product. "We've rooted that out of the system," said Barnhill. When the pandemic arrived, though, in-person meetings were not allowed, and inmates were thankful for the technology.

Abel was acutely aware of criticism in the industry and had plans to address it. "Our products are too expensive. The price of our products needs to be reduced. Period." (Exhibit 6.) Prices had come down by more than 30% under

Exhibit 6 History of Aventiv's Call Costs to Consumer, Including Commissions

Year	Cost per Minute	Avg Minutes per Call	Total Cost of a Call
2011	$0.271	12.44	$3.37
2012	$0.254	12.72	$3.23
2013	$0.259	12.90	$3.34
2014	$0.248	12.42	$3.08
2015	$0.223	11.88	$2.65
2016	$0.212	11.27	$2.39
2017	$0.208	10.63	$2.21
2018	$0.172	10.93	$1.88
2019	$0.142	11.06	$1.57
2020	$0.137	11.39	$1.56

Source: Aventiv Technologies; used with permission.

Platinum's ownership. The average price per minute of a Securus phone call dropped below $0.15, inclusive of all fees and commissions—or less than $2.25 for a 15-minute call. The company had committed to an additional 15% reduction over the next three years. It was working to further cut costs by renegotiating contracts with hundreds of customers and providing new options that could help those customers reduce or eliminate their commissions. Abel also pointed to a 2019 analysis the company had commissioned by consultant FTI,[31] which showed that "cost is driven almost entirely in our business outside of commission by size and location of facility." Smaller and more rural facilities were more expensive because there were fewer consumers and thus less volume. But there was no getting around commissions. "Our single highest cost in the business continues to be commissions," Abel said. How did the company manage that? First, Abel emphasized that it would not compete by acting as a "shield for obtaining commissions," as it had in the past. The second principle was to increase transparency. While some customers didn't care that their consumers were charged and that the public knew about it, others did. This could slowly bring change to the industry. Third, the company wanted to help facilitate a broader discussion with regulators and local decision-makers about who should bear the cost burden. The commission issue didn't seem to be going away, mostly because "constraints in the budgets are getting worse, not better."

Criminal-Justice Advocates Push Back

Since the late 1990s, advocates have pushed back against the high price of inmate communications. Inmate jobs in prisons only paid a few cents per hour, so much of the burden to pay for telecom services fell on families and friends. Advocates pointed out that low-income families often faced hard financial tradeoffs—telephone services often approached rent as the largest monthly bill.[32] Some reported foregoing medical operations or prescription drugs to meet payments on phone bills.[33] If instead, family and friends chose to cut off communications with the inmate to save money, many studies showed that a lack of connection to the community increased the likelihood that the criminal would reoffend when released.[34] Additional societal costs could be borne by the children of the incarcerated if communications were cut off.

Over time, excessive prison profiteering has been fought in the court of public opinion and through lawsuits.[35] The success of such efforts has been mixed. In 2002, California agreed to a reduction in state commissions to reduce inmate calling costs by as much as 25%. In 2013, the FCC put a cap of 21 cents per minute on interstate calls from both jails and prison. But for the 90% of calls that were in-state, costs remained too high—as much as $30 for a 15-minute call, in some states.[36] GTL had also been involved in multiple class-action lawsuits across the country, which include allegations of charging "unnecessary and unconscionable" rates to inmates and their families. In Mississippi, GTL settled a case—which alleged that the company bribed corrections officials—for $2.5 million, but admitted no wrongdoing in the settlement, and continued to provide phone service to inmates in the state.[37] In 2015, the FCC expanded the price caps to in-state calls, making them as low as 11 cents per minute, and lowered the cost of calls from jails to between 14 cents and 22 cents, depending on the size of the institution.[38] CenturyLink, GTL, Pay-Tel, Securus, and Telmate sued the FCC.[39] In 2017, the US Court of Appeals struck down the FCC's 2015 rate-cap ruling.[40]

In 2016, New Jersey capped calling rates at 11 cents per minute and prohibited kickbacks. A few months later, Securus sued the state in *Securus v. Christie* to declare that this new rate cap constituted an unconstitutional taking of private property. The American Civil Liberties Union (ACLU) of New Jersey and partner organizations argued that the state was within its rights to limit rates. In New Jersey, African Americans were incarcerated at 12 times the rate of white people, so high phone rates disproportionately affected people of color.[41] An ACLU representative commented, "It's wrong to exploit a literal captive market, which is exactly why New Jersey put limits on phone rates in prisons."[42] The state of New Jersey successfully dismissed Securus' suit and its later appeal.[43]

During the COVID-19 pandemic, many facilities and regions gave breaks for phone calls. Aventiv provided over 35 million free call credits during the first year of the pandemic.[44] But some thought free calls should be made permanent. Such advocates argued that free calls should be considered a cost of the institution, like plumbing and electricity, and thus be borne by the taxpayer.[45] In 2019, New York City became the first major city to make phone calls free from its city jails (previously, inmates were charged 50 cents for the first minute and 5 cents for each additional minute).[46] In August 2020, San Francisco began offering free calls and ending markups to items sold through the prison commissary.[47] In May 2021, the San Diego County Board of Supervisors voted to prohibit county-run jails and juvenile detention facilities from charging for phone calls (which had cost 21 cents per minute for interstate calls and 33 cents per minute for local and in-state calls).[48] Abel explained that Aventiv would provide service regardless of the decision of each community. "We will not restrict or deny service based on who pays the bills…Let's agree on a fair price for provision of the service and we will provide service."

While other states and facilities could follow suit, most corrections decision-makers continued to include requests for commissions in 2021 contract RFPs reviewed by Aventiv. Philosophies differed by state and county. A Securus representative explained: "Washington is very different than Georgia." Platinum called off Securus lobbying efforts in Connecticut in 2019, where lawmakers were considering a bill that would make the state the first in the nation to provide free phone calls to prisoners.[49] Abel explained that the new Aventiv approach was to not lobby for or against commissions. "That is a local community decision." Aventiv also found that, in the case of New York City at least, removing commissions lowered the price to the consumer and changed calling patterns. Abel explained, "What was interesting about it is, though, Securus' profitability went nearly unchanged actually, while consumer volume increased because calling patterns shifted dramatically once unconstrained by pricing."

A Change Is Gonna Come

On May 20, 2021, the FCC voted unanimously to cap the rates of interstate phone calls to 12 cents per minute, down from the previous 21-cent-per-minute cap.[50] Change, it seemed, was coming. In July, Securus announced it would change stance to fully embrace the FCC's Interim Order on Inmate Communications Services, supporting the rate caps and other new regulations, and take a public position calling for the elimination of site commissions. Abel said, "We believe it is long overdue for our industry to stop fighting with reform-minded regulators and legislators. Instead, we need to adopt a more collaborative approach that balances the needs of the incarcerated individuals and their families who use and pay for our services and the corrections agencies that contract for them."

On the issue of commissions, the company took its neutral position a step further. Abel said, "Securus wants to work with all stakeholders to eliminate commissions and we need to collectively find a way to honor affordability commitments and also raise funds for important programs. Securus will pass the savings from the elimination of calling commissions and reductions in taxes and fees directly through to the consumer." Securus also called on the FCC to make sure new regulations allowed for new approaches to contracting that would further reduce costs for consumers. The company noted that subscription calling plans, which allowed incarcerated callers to pay a monthly fee rather than pay per call, were found to increase call time by 27% and reduce costs by 50% in a Securus pilot program, but regulations prohibited subscription models in correctional institutions. Securus believed the FCC should update its regulations to allow for a subscription model, as advocates and justice-involved families had also been calling for, and hoped to file for an exemption that would allow the company to expand its existing subscription model.

Aventiv was already piloting a model in several different prisons that would effectively lower the price of calls to as low as 2 cents per minutes while making additional money on music and video streaming along with other add-on services from the tablet. Not everyone at the company thought that would work. "I don't think that model is sustainable," said Andrew Becker. That also assumed that commissions were not added on top of the base rate for phone calls. Still, Aventiv seemed insistent on trying different models to see what worked. Figuring out what would stick came down to "discussions and testing," according to Abel. The company was considering including several different pricing structures to offer in future RFPs.

Becker wondered if the scoring of the telecom contracts by consultants/agencies (which took about 9% of the commission the prison received) was a way to effect change. "Sometimes they'll say, 'Oh, it's all about the technology,' but when you get down to the scoring—they choose the person with the highest commissions," Becker said. "People looking at scoring from the outside might ask, 'Does this really align with social change?'" Becker also wondered why the FCC didn't just lower its own taxes charged to inmates in the form of interstate calls, where a 33.4% tax went to fund the Universal Service Fund (used to promote universal access to telecommunications in the United States).[51] "It's no different than commissions…If they wanted to lower rates, why wouldn't they eliminate those taxes on inmate calling?"

Changing the perception that telecom companies were prison profiteers wouldn't be easy, but Thompson thought part of the answer was bringing more sunlight to the pricing so that everyone understood the role played by commissions. "Our price points are high," she said, "because our customers require a high amount of commission, many just in order to operate safe facilities and provide rehabilitative programming. So, case in point, when I piloted this new pricing program, on our invoices, now it says 'Securus fee $19,' 'agency commission $43,' and then we total it out because everyone thinks that we are charging an arm and a leg, when in reality we have some customers that require 80% commission and more." On the one hand, the high prices from commissions branded Aventiv in a way that made it harder to achieve its mission; on the other hand, there weren't any revenues if the customers weren't happy. "It's a risky situation and we know it," Gores said. "We're playing with fire a little bit in that we're giving the commission system a little pushback. But who else is going to do it? I think if we can be leaders, eventually everyone is going to have to follow."

While much needed to change, Aventiv had already come a long way. Phillips explained, "Few people understand the realities for consumers 13 years ago to today. We have come a long way and we can continue to grow, because the society and technology continues to adapt and evolve. We have and will continue to find really innovative ways to operate in what is a really challenging environment." Kelly Brooks said, "I really like the direction the new executive team is going. So many new programs. More consumer focused. So many new initiatives." Abel acknowledged that the company had farther to go, though. "I want this company to lead the change."

Piloting new business models showed that Aventiv was reacting to the needs of its stakeholders, but it seemed to be an impossibility to try to sign deals with corrections facilities without offering commissions. A deal up for bid in May 2021 in Georgia required commissions. Becker summarized the risk of squeezing too hard: "You can't make change if you don't have any business." And Phillips added, "To reform the industry, you have to have contracts, and the competitors in this business make it difficult…That's why the industry has to be regulated." Radical change in the industry seemed hard unless the rules of the game changed. "The question is, are you going to be in front of that, helping lead those changes, or are you going to be behind that curve getting dragged toward change?" Mark Barnhill said. "We choose to try and lead."

Yusef Jackson, an attorney, activist, and entrepreneur hired as a senior executive at Aventiv and a senior adviser to Platinum in mid-2021, acknowledged that Aventiv "has been criticized for its high rates and fees, and, quite frankly, for being part of the problem. But over the last 18 months, the company has taken steps to become part of the solution by initiating a transformation of its culture and business practices, changing management, reducing its fee structure, and promoting policy that focuses on rehabilitation and reducing recidivism." Jackson continued, "To modernize these systems—replacing rudimentary wall phones with tablets enabled with SMS, email, apps, video calling, e-books, and so on—we must invest. To innovate, develop, and deliver technology that not only connects but also improves, empowers, and changes the lives of those who are incarcerated, we must invest. We envision a system that provides every inmate with a secure digital tablet so they can connect with loved ones *and* access educational offerings, faith-based programming, mental health resources, job training, employment resources, and second-chance programs that improve reentry outcomes. Of the 11 million Americans who churn through the prison industrial complex and the over 2 million incarcerated, up to 95% will be released. Imagine a society where people come out better prepared than when they entered. We have the opportunity to make this a reality."

While the vision sounded good, skeptics wondered whether the company could move fast enough and lead the type of significant change needed. "The work always has to speak for itself," said Gores, who was personally all in on changing the culture and direction of Aventiv and, ultimately, the industry. "You can't talk your way out of this situation. You need to execute. It takes what I've done my whole life but do in a bit of a different format. I know how to execute, pull people together, and now I just have to take all of those skills…and throw them into this."

Notes

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Case 5

Blue Apron: Has the Supply Chain Disrupter Been Disrupted?

Lydia Thomas, a third-year consultant in McKinsey and Co.'s (McKinsey's) Agriculture practice in Chicago, was working from home on Friday, March 4, 2022, when the phone rang. Her boss, Marco Ramos, the head of McKinsey's global Agriculture practice, was on the other line.

"Lydia, have you heard of Blue Apron?" Ramos asked. "The meal-kit service? They just called and want our help evaluating their business model and disruption threats."

"Of course I know Blue Apron. I'm actually a customer of theirs."

Thomas had been a customer of Blue Apron for the past three months, after receiving a $130 gift card for the service as a birthday present. She had decided to keep using Blue Apron when she found bi-weekly meal kits to be high quality, affordable, and convenient. The company's tagline was "A meal kit built for your busy lifestyle."[1] Thomas and her boyfriend, another McKinsey consultant from the Metals and Mining group, liked having Blue Apron meals handy in their condo. Neither had time to shop, but they liked to cook. Blue Apron meals had supplied special ingredients in just the right amounts to create yummy creations like Crispy Skin Salmon with Salsa Verde and Farro Salad or Cheesy Pork Chorizo Enchiladas with Bell Pepper and Rice. Thomas had always wanted to learn to cook better, but hadn't found the time. Blue Apron and a bottle of white wine had become her recipe for a cozy date night.

"Well, that's good. Actually, my family used Blue Apron for a year too—but then we dropped it," Ramos said. "I guess too many other customers have been dropping them as well, lately."

"They've got competition from meal-kit providers like HelloFresh, Plated, and Home Chef, right?" Thomas recalled analysis she had done for a previous pitch—it had showed that some of McKinsey's Agriculture clients were selling an increasing amount of product to Blue Apron's competitors.

"That's true," Ramos conceded, "but that's only part of the problem. Walmart and Amazon are threats—you never want them as competitors. But Blue Apron is also concerned with the more recent rise of Instacart and delivery platforms like Uber Eats. That's why they called."

"Shouldn't this mandate be handled by our Retail group?" Thomas asked.

"It's going to be a joint proposal, actually," Ramos said. "Blue Apron is a farm-to-table play, so they called us in. And while Instacart and Uber Eats aren't Agriculture clients, I said we'd give a first crack at a global strategy recommendation. So I thought you'd be the best to take a crack at breaking down the supply chain. Evaluate the threats."

"Okay. What's the deadline?"

"I've asked for one week. But I'd like your initial thoughts by Wednesday morning."

The Beginnings of Blue Apron

Thomas decided the place to start on her inquiry was with Blue Apron itself. She quickly pulled up the stock chart for APRN and saw the company had about a $160 million market cap.[2] "Not bad," she thought. But then she noticed that the company had been valued at $2 billion on the private market in 2015 before going public. Investors in that round were down 91%. Clearly the earth had been shifting underneath the company. What happened? Thomas figured she needed to understand the past before she could help advise on where things might be heading.

Blue Apron was founded in 2012, when 28-year-old Matt Salzberg, a Harvard MBA and an associate at Bessemer Venture Partners, partnered with Ilia Papas to create a business. They raised a friends-and-family round of money and tried a few start-up ideas before coming up with the Blue Apron concept: giving people an easy way to make dinner using trusted, chef-recommended recipes, including all the ingredients they'd need, precisely measured out.[3] Blue Apron hadn't pioneered the idea. Linas Matkasse, a Swedish subscription meal service launched in 2008, had grown to nearly $50 million in sales. Blue Apron's thought was to offer recipes to subscribers each week and build relationships with local farmers, creating menus based on seasonal ingredients.

With no food experience, Salzberg (who would become the CEO) and Papas (who was chief technical officer), turned to chef Matt Wadiak, who had been trained at the Culinary Institute of America. Wadiak was a wholesaler of truffles and avocados and catered dinners for Salzberg's mother-in-law. Soon, Wadiak joined Blue Apron's board, then became its COO. The food needed to be portioned correctly, then packaged and delivered quickly, within 24 hours, to assure that it was fresh. The pricing was set at $9.99 per person, later $8.74 per person for a two-to-four-person family.[4] The company's name came from the tradition of beginner cooks wearing a blue apron in cooking school. The product made cooking super easy, with all the ingredients supplied in the correct pre-measured quantities, complete with step-by-step instructions that usually included photos and sometimes even videos. Salzberg, Papas, and Wadiak packed and shipped the first 30 orders themselves from a commercial kitchen in Long Island City.

Early testers could order meals based on one main protein: fish, poultry, or a choice of beef or pork. Wadiak helped build the initial relationships with farms and food providers and a courier mailed the first orders across Manhattan. Beta testers loved the products and shared photos on social media of what they made. Demand took off instantly. "Pretty much from day one we've had steady exponential customer growth. I think the moment we did our first week of deliveries we sort of knew that we had a business that we thought would be really successful."[5] If the trio ran low on ingredients, they'd run to a local grocery store. The early demand helped the founders raise a $3 million Series A financing round at a $9 million valuation in February 2013. Six months later, they raised an additional $5 million Series B at a $30 million valuation.

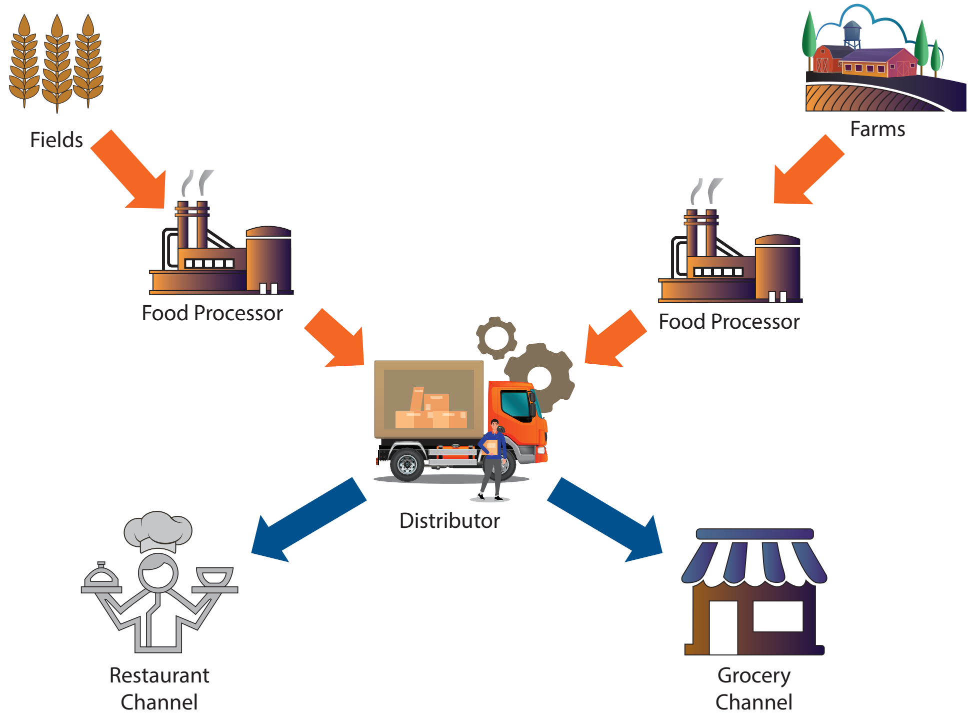
In time, the business proposition to customers centered on the notion of making food that was healthier than takeout, easier to produce than cooking from scratch, and cheaper than hiring a private chef or relying on meal delivery. Busy professionals and rural foodies would thus be able to order the ingredients for interesting dishes like crispy catfish with kale-farro salad and warm grape relish or shokichi squash ragù and Mafalda pasta with mushrooms with just a few clicks of their mouse or taps in a mobile app.[6] What seemed to excite investors most, however, was the chance to disintermediate the supply chain.

A Shortcut in the Food Supply Chain

While seasonally rotating unique recipes in meal kits delivered in sustainable packaging helped drive demand, Blue Apron believed a key value proposition was its ability to buy direct from the farm or food manufacturer and sell direct to end customers. Wadiak said, "I think that there is a great opportunity today to create, through technology, a leaner food system that cuts out the various steps between the consumer and supplier." (Exhibit 1.) Theoretically, this avoided intermediaries and allowed the company to pass savings on to the customer. The model echoed that of Warby Parker (founded in 2010), which had built a big business by successfully cutting out go-betweens in the eyewear supply chain to deliver designer frames to consumers at a value price. Wadiak worked to build hundreds of relationships with local farmers, ranchers, and pasta makers to provide fresh products. By November 2014, Blue Apron was shipping one million meals per month. In April 2014, the company raised $50 million and was valued at $500 million.

By 2015, the company was selling a reported three million meals per month at about $10 per meal and claiming

Exhibit 1 Food Supply Chain



Source: Created by authors.

it would someday "reach 99% of potential home cooks."[7] That same summer, Blue Apron was ordering three million pounds of produce from 11 family-run farms. One farmer with 800 acres in Oakley, California, met Wadiak at a sustainable agriculture conference a year after Blue Apron's founding, and two years later, he was selling entire acres of sweet corn and beans to the company. He was in talks to sell more obscure ingredients too, such as zucchini blossoms and purslane, an edible weed that grew next to his beans.[8] The more of the farmer's land that could be converted to organic crops, the more Blue Apron offered to purchase. Blue Apron's growth meant it had to execute precision logistics at enormous volume. Ingredients had to be measured, cut, prepped, bagged, packed, palletized, and shipped.[9] Healthy, appealing recipes had to be created with affordable ingredients procured from purveyors of produce, meat, cheese, bread, and spices, and hundreds of family-run farms. It was a massive undertaking.

In June 2015, the company raised $135 million at a $2 billion valuation. The money was earmarked to continue growing Blue Apron's 1,800 employee staff, adding to positions in fulfillment, marketing, technology, operations, and purchasing. The company was busy developing in-house software tools to manage purchasing, fulfillment operations, e-commerce, ordering, shipping, and customer service. Three fulfillment centers had been built in Jersey City, New Jersey; Arlington, Texas; and Richmond, California; and more were planned. In 2015, Salzberg said, "We source from farms locally to different regional fulfillment centers. So if you're in California you are generally getting produce from a California farm. We have a whole team of people whose job it is to go out, meet farmers, build those relationships. Today we are literally at the point in the company's life where we are planting items in the ground with farms just for us... What it allows us to do is work with the farmers to plan their production in a way that allows them to be more seasonal, more efficient and utilize their resources better which results in higher quality crops for us and for our customers at lower prices for them."[10]

Customers also seemed to like that ingredients were sustainably sourced and that the company supported local and family-owned businesses. Blue Apron even used some of the new funds to start a wine-subscription business in 2015, going directly to vineyards to create custom Blue Apron wines to uniquely pair with meals. Growth seemed limitless.

Vulnerabilities in the Value Proposition?

Blue Apron's founders believed that its core product was the experience it offered its customers. The company strived to build a "consumer lifestyle brand that symbolizes the emotional human connections that are formed through the cooking experiences we create."[11] Blue Apron's processes aimed to increase efficiencies, ultimately leading to increased profitability. By 2016, the company had 4,000 employees, selling eight million meal kits per month.

For a fast-growing company, some amount of growing pains were assumed. Thomas came across reports that a former team lead at Blue Apron had said, "There were plenty of times where the kitchen would say we had 2,000 celery, but we actually had zero…I would get sent to Whole Foods and buy things if we really needed an ingredient and we didn't have it in the building."[12]

Thomas could see the appeal of the service as a way to restore a family to the tradition of sitting at the dinner table together. Home-cooked meals were an important factor contributing to a family's health and general well-being. But did healthy eating require cooking? Thomas wasn't sure. Cooking required time, the lack of which was a primary reason people gave for not preparing food at home. Blue Apron tried to simplify this process and customers seemed to like the product, at least for a while. Forty-two percent of Blue Apron's customers in 2017 were acquired through their customer referral program. Thomas wondered, though, about customer retention. Blue Apron seemed like a smart, easy way to learn to cook, but once people had learned their way around the kitchen, wouldn't they want to shop from the grocery store themselves? It surely would be cheaper. Salzberg said, "People are interested in cooking things that they hadn't cooked before. They are interested in trying new ingredients. Part of the reason we can work with ingredients that a grocery store doesn't have is because we taught you how to work with them…We're generating demand for these kind of products in a way that grocery stores can't generate demand."[13] In June 2017, Blue Apron made its IPO at $10 per share, a price that valued Blue Apron at just under $2 billion—but the deal was priced 34% below the original range set by Wall Street bankers.

When Thomas pulled up Blue Apron's financials, she expected to see some evidence of the company's efficiencies of scale. (Exhibit 2.) While it had grown its revenues, so too had it grown its losses. Thomas understood the Silicon Valley ethos of spending excess marketing dollars to grow sales, but what about profits? Thomas wondered about the sustainability of the business model. Still, the market was enormous—the US grocery market was near $780 billion with just a 1.2% online penetration, and the US restaurant market was near $540 billion with a 2.2% online penetration. The global restaurant market was almost five times larger.[14] In 2017, the company's two-person plan represented 79% of meal orders. 21% were for the four-person family plan.[15] Blue Apron remained "committed to sourcing fresh, high-quality ingredients from farmers, ranchers, fishermen, and artisans year round."[16] The company stressed that its beef, poultry, and pork came from animals given exclusively vegetarian feed with no added hormones or antibiotics. It sourced only non-GMO ingredients and bought mostly from organic producers. "A lot of our farmers are medium- and small-sized farms instead of these larger commercial farms," explained Salzberg.[17]

Exhibit 2 Blue Apron Historical Financials

	Year Ended December 31,						
	2015	2016	2017	2018	2019	2020	2021
	(in thousands of US dollars)						
Net revenue	$ 340,803	$ 795,416	$ 881,191	$ 667,600	$ 454,868	$ 460,608	$ 470,377
Operating expenses: Cost of goods sold (COGS)	263,271	532,682	627,964	433,496	279,135	282,924	301,763
Marketing	51,362	144,141	154,529	117,455	48,133	49,934	72,086
Product, technology, general, and administrative	70,151	165,179	247,907	194,340	144,925	137,244	145,442
Depreciation and amortization	2,917	8,217	26,838	34,517	31,200	24,503	22,203
Other operating expense	–	–	12,713	2,170	3,571	4,567	0
Total operating expenses	387,701	850,219	1,069,951	781,978	506,964	499,172	541,494
Income (loss) from operations	(46,898)	(54,803)	(188,760)	(114,378)	(52,096)	(38,564)	(71,117)
Net income (loss)	$ (46,965)	$ (54,886)	$(210,143)	$(122,149)	$ (61,081)	$ (46,154)	$ (88,381)
EBITDA	(43,981)	(46,586)	(161,922)	(79,861)	(20,896)	(14,061)	(48,914)

Data source: "Blue Apron:Citron Research Joining the Party," Seeking Alpha, January 21, 2022, https://seekingalpha.com/article/4480745-blue-apron-stock-citron-research-peloton-acquisition (accessed Mar. 2, 2022).

In late 2017, however, customers began to leave the service. (Exhibit 3.) This occurred even though marketing expenses had risen to $154.5 million in 2017, up from $144.1 million in 2016. Soon, though, quality issues put a temporary halt to marketing. As a result, profitability sank, as expected. Analysts also pointed to extremely labor-intensive assembly processes where most costs of operations (including shipping and packaging) were not reflected in the company's pricing structure. Some thought the company should raise prices to achieve profitability, but that would just drive more customers away. The company began to retrench, focusing on margin improvements through improved productivity and expense control. Headcount was reduced and decision-making responsibilities were streamlined to ensure greater accountability. Construction of a Fairfield, California, fulfillment center was halted, given the reduced sales outlook. The Jersey City fulfillment center transitioned all its production volume to the company's new Linden, New Jersey, facility, which boasted state-of-the-art technology though its efficiencies and profitability lagged behind the other two facilities in Arlington and Richmond.

In November 2017, Salzberg stepped down as CEO but remained chairman, and Brad Dickerson took the CEO title. Between 2017 and 2019, Blue Apron cut marketing outlays further, resulting in more customers fleeing. In April 2019, Linda Findley Kozlowski replaced Dickerson as CEO. In the second quarter of 2020, Blue Apron closed its Arlington fulfillment facility.

Thomas checked Google trends to understand the search picture and general interest in the term "Blue Apron," and noticed that it seemed to have peaked in early 2017 (Exhibit 4). Customer retention had always been an issue in the industry—Blue Apron's churn was close to 25% for the first two years of a customer using the service. This translated into a $95 customer acquisition cost. An average customer spent about $1,000 per year in 2017 and produced 30% gross margins, but these numbers had increased in 2021 to about $1,250 per year, with a 33% gross margin.[18] There were many potential reasons for Blue Apron's faltering growth, but Thomas thought the biggest problem Blue Apron faced might be related to the rise of competitors and new disrupters in the industry.

Competition

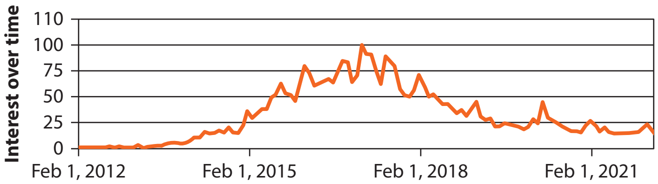
According to the Blue Apron annual reports that Thomas scrolled through, the company faced competition from six areas: other food and meal delivery companies, the supermarket industry, food retailers, casual dining and quick-service restaurants, wine retailers, and food manufacturers. The meal-kit industry was highly fragmented: companies competed heavily on price, the quality of the offering, and convenience. In the United States, the industry was estimated to be worth almost $7 billion in 2021 and was projected to grow to $10 billion by 2024.[19] Twenty-five percent of people living in cities had tried meal-kit services, compared to just

Exhibit 3 Blue Apron Operating Metrics

2015	31-Mar	30-Jun	30-Sep	31-Dec
Orders (*in thousands*)	841	1,247	1,763	1,970
Customers (*in thousands*)	213	303	414	429
Average order value	$ 57.77	$ 58.74	$ 58.01	$ 59.21
Orders per customer	3.9	4.1	4.3	4.6
Average revenue per customer	$ 228	$ 242	$ 247	$ 272
2016	**31-Mar**	**30-Jun**	**30-Sep**	**31-Dec**
Orders (*in thousands*)	2,903	3,399	3,597	3,674
Customers (*in thousands*)	649	766	907	879
Average order value	$ 59.28	$ 59.40	$ 57.12	$ 58.78
Orders per customer	4.5	4.4	4.0	4.2
Average revenue per customer	$ 265	$ 264	$ 227	$ 246
2017	**31-Mar**	**30-Jun**	**30-Sep**	**31-Dec**
Orders (*in thousands*)	4,273	4,033	3,605	3,196
Customers (*in thousands*)	1,038	943	856	746
Average order value	$ 57.23	$ 58.81	$ 58.16	$ 57.99
Orders per customer	4.1	4.3	4.2	4.3
Average revenue per customer	$ 236	$ 251	$ 245	$ 248
2018	**31-Mar**	**30-Jun**	**30-Sep**	**31-Dec**
Orders (*in thousands*)	3,474	3,122	2,647	2,418
Customers (*in thousands*)	786	717	646	557
Average order value	$ 56.58	$ 57.34	$ 56.79	$ 58.12
Orders per customer	4.4	4.4	4.1	4.3
Average revenue per customer	$ 250	$ 250	$ 233	$ 252
2019	**31-Mar**	**30-Jun**	**30-Sep**	**31-Dec**
Orders (*in thousands*)	2,482	2,048	1,726	1,622
Customers (*in thousands*)	550	449	386	351
Average order value	$ 57.15	$ 58.16	$ 57.60	$ 58.14
Orders per customer	4.5	4.6	4.5	4.6
Average revenue per customer	$ 258	$ 265	$ 258	$ 269
2020	**31-Mar**	**30-Jun**	**30-Sep**	**31-Dec**
Orders (*in thousands*)	1,763	2,152	1,917	1,879
Customers (*in thousands*)	376	396	357	353
Average order value	$ 57.68	$ 60.88	$ 58.56	$ 61.43
Orders per customer	4.7	5.4	5.4	5.3
Average revenue per customer	$ 271	$ 331	$ 314	$ 327
2021	**31-Mar**	**30-Jun**	**30-Sep**	**31-Dec**
Orders (*in thousands*)	2,104	1,977	1,760	1,678
Customers (*in thousands*)	391	375	350	336
Average order value	$ 61.63	$ 62.72	$ 62.30	$ 63.78
Orders per customer	5.0	5.3	5.0	5.0
Average revenue per customer	$ 331	$ 330	$ 313	$ 319

Data sources: Blue Apron SEC Form 10-K, 2017, https://otp.tools.investis.com/clients/us/blue_apron/SEC/sec-show.aspx?FilingId=12572692&Cik=0001701114&Type=PDF&hasPdf=1 (accessed Mar. 2, 2022).

Exhibit 4 Google Trends results for "Blue Apron"



Source: https://trends.google.com/trends/explore?date=2012-01-07%20 2022-02-07&geo=US&q=blue%20apron (accessed Mar. 2, 2022). Google and the Google logo are registered trademarks of Google Inc., used with permission.

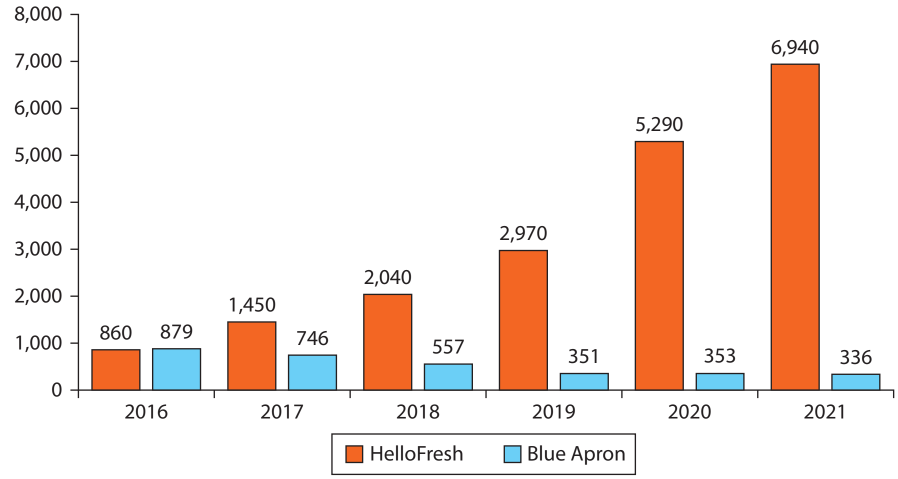
14% of people in rural areas.[20] While Blue Apron had pioneered the meal-kit industry, low barriers to entry and access to a mountain of venture capital money meant that by 2022, many competitors existed. In addition to Blue Apron, three publicly traded peers existed: HelloFresh, Marley Spoon, and Goodfood (which was only in Canada). There were also more than 100 other private competitors. Better-known global examples included Home Chef, EveryPlate, Sunbasket, Dinnerly, Plated, Purple Carrot (which was entirely plant based), Maria, Ooooby, Gousto, Nutrisystem, Diet-To-Go, Gobble, and My Food Bag.

Since 2016, the Germany-based HelloFresh had risen as Blue Apron's prime challenger in terms of active subscribers, based on its growth in the United States and internationally (Exhibit 5). It had taken the lead in the United States in 2018.[21] HelloFresh launched in 2012, and 40% of its sales came from outside the United States. HelloFresh had operations in Germany, Austria, Netherlands, Belgium, the United Kingdom, the United States, Australia, Switzerland, Canada, and Luxemburg. HelloFresh utilized a data-driven approach, which helped it to more efficiently spend its marketing dollars to optimize customer acquisition while executing on the logistics end. The minimum spend for HelloFresh was $54.95 per week, which paid for two two-serving meals at $11.49 per serving plus $8.99 shipping. By comparison, Blue Apron's minimum spend per week was $47.95. On the high end (eight four-serving meals) HelloFresh cost $245.67, including $5.99 shipping, while Blue Apron charged $239.68 for the same number, and offered free shipping.[22] HelloFresh and other competitors offered new customers as much as $30 off on orders and offered lapsed customers $25 off.

Pricing was competitive—the average meal price ranged from about $5.00 to $11.50 (Exhibit 6). Competition had already forced prominent closures from Chef'd in 2018 (after three years of service), Munchery in 2019 (after nine years of service) and PeachDish in 2019 (after five years in service). Sixty-three percent of potential customers in the United States cited price as the reason for not using meal kits.[23] There had also been some consolidation in the market (Exhibit 7.) Many supermarket chains like Kroger had started to sell their own meal kits and created hot bars and ready-to-go meal options to cater to customers seeking convenience and high-quality products at a reasonable price. Albertsons had even directly joined the meal-kit competition by acquiring Plated for $300 million in 2017. Eight months later, Kroger acquired Home Chef. Optimism for global growth in the industry continued to be strong despite setbacks. The size of the global meal-kit industry was expected to grow to $24 billion by 2027 (Exhibit 8). In early 2022, Gousto raised $100 million from SoftBank's Vision Fund, showing venture funds' continued interest in the space.

Amazon was also making its own push into the business. In 2017, Amazon launched AmazonFresh, a grocery-delivery service that allowed users to shop online, reserve times to pick up groceries, and have them loaded into their car. Soon, the company started selling meal kits ranging in price from $16 to $20. In 2019, Amazon began to offer one-to-two-hour delivery of meat, seafood, eggs, and produce in a test market, and in 2020, AmazonFresh started building a new chain of physical grocery stores while continuing to offer home delivery on the same or the next day for grocery items, including meal kits. Amazon also acquired Whole Foods for over $13 billion in 2017, operating it independently from

Exhibit 5 Number of Active Subscribers



Data source: Koen van Gelder, "Global Number of Active Subscribers of HelloFresh and Blue Apron 2016–2021," Statista, March 4, 2022, https://www.statista.com/statistics/947620 /meal-kit-companies-number-subscribers-worldwide/ (accessed Mar. 2, 2022). 2021 HelloFresh subscriber count is from Q3.

Exhibit 6 Average Meal Price in Meal-Kit Industry

Company	Avg. Meal Price	Shipping	Best For
Blue Apron	$9.74	$0.00	Wine lovers
HelloFresh	$8.99	$6.99	Dietary restrictions
EveryPlate	$4.99	$8.99	Easy recipes
Sunbasket	$8.99	$6.99	Organic
Nutrisystem	$8.57	$0.00	Weight loss
Diet-To-Go	$9.52	$19.98	Clean eating
Freshly	$8.00–$11.49	$12.00	Quick meals
Dinnerly	$4.80	$8.99	Families
Marley Spoon	$7.99	$8.99	Foodies
Purple Carrot	$9.99	$0.00	Vegans

Data source: John Schmoll, "Blue Apron Competitors: 9 Top Alternatives," Frugal Rules, April 21, 2021, https://www.frugalrules.com/blue-apron-competitors/ (accessed Mar. 2, 2022).

Exhibit 7 Acquisition Multiples in Subscription Food Business

Date	Target	Acquirer	Acquisition Price	Revenue	Acquisition Revenue Multiple
Nov-20	Factor 75	HelloFresh	$277	$100	2.8
Oct-20	Freshly	Nestle	$1,500	$430	3.5
May-18	Home Chef	Kroger	$700	$250	2.8
Sep-17	Plated	Albertsons	$300	$100	3.0

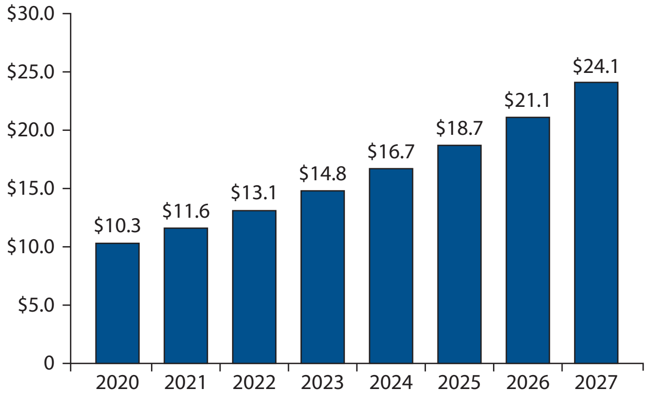
Data source: "Blue Apron: Citron Research Joining the Party," Seeking Alpha, January 21, 2022, https://seekingalpha.com/article/4480745-blue-apron-stock-citron-research-peloton-acquisition (accessed Mar. 2, 2022).

AmazonFresh. Whole Foods products could also be delivered in as little as two hours.[24]

In 2018, Walmart entered the fray with its own line of meal kits rolling out to more than 2,000 stores. The pre-packaged meals were made in-store daily and each two-person kit sold for $8 to $15. Walmart also partnered with Home Chef, Sunbasket, and Takeout Kit to offer delivered meal kits for two or four people, starting at $29.99.[25] Walmart's subscription-only store Sam's Club also teamed up to offer home delivery of groceries by partnering with a newer player on the scene: Instacart.

Exhibit 8 Size of the Fresh and Packaged Food Meal-Kit Service Market Worldwide from 2020 to 2027

(Market Size in Billions of US Dollars)



Data source: Koen van Gelder, "Global Meal Kit Service Market Revenue 2020–2027," Statista, February 4, 2022, https://www.statista.com/statistics/655037/global-direct-to-door-meal-kit-service-market-revenue/ (accessed Mar. 2, 2022).

Instacart Spies an Opportunity

Instacart was founded in 2012 by a former Amazon supply chain engineer named Apoorva Mehta, who had helped develop fulfillment systems to move packages from the warehouse to a customer's home. Mehta coded the initial Instacart app himself. It allowed customers to order groceries from partner stores to be delivered by an Instacart "shopper," who grabbed customer items from the shelves and delivered them to the customer's home quickly, sometimes in under an hour. Shoppers downloaded an app that provided work opportunities (like Uber) and paid them $20 or more per hour plus tip. Efficient shoppers could earn about $45 per hour.[26] Instacart charged a delivery fee between $3.99 to $9.99, depending on demand and external conditions (such as weather). The store and Instacart split the fee. There was also a subscription service that allowed unlimited deliveries, cheaper service fees, and no surge pricing for an annual $99 fee or a monthly $9.99 fee.[27]

The company partnered with national and regional retailers such as Albertsons, Aldi, Costco, Loblaw, Publix, Sam's Club, Sprouts, and Wegmans.[28] The company also offered alcohol delivery in more than 20 states, partnering with Albertsons, Aldi, BJ's Wholesale Club, the Fresh Market, and Total Wine & More. Later, Instacart expanded to a prescription delivery service, allowing medications to be delivered from partners such as CVS and Walgreens. By the end of 2021, Instacart had partnered with more than 600 retailers from almost 55,000 stores in over 5,500 cities in the United States (accessible by over 85% of US households) and Canada (accessible by 80% of Canadian households).[29]

One of the issues Thomas noted with Blue Apron's model was that some people liked to shop for ingredients themselves and buy in scale. Wasn't that how one saved money by cooking at home? Instacart had a place on its site that listed trending recipes. While Thomas didn't think Instacart's recipes were as creative as Blue Apron recipes, there were dishes like charred shrimp and pesto Buddha bowls, orange chicken stir-fry with rice noodles, egg salad avocado toast, and hasselback caprese chicken.[30] The customer could search for a recipe that looked good and, with one click, order all the ingredients, which would often make enough for a family to eat. There was also a part of the site dedicated to ready-to-eat meals for those who wanted to do minimal cooking.[31]

In October 2021, Sunbasket (founded in 2014) joined Instacart's marketplace, becoming the first meal-kit company on the same-day-delivery company's platform in select markets.[32] The partnership allowed customers to get the benefit of a meal kit without a subscription to a service. The price started at $11.99 per serving and customers could choose breakfast, lunch, dinner, or snacks on the following week's menu. Sunbasket catered to a wide variety of tastes and dietary needs with offerings called Chef's Choice, Paleo, Lean & Clean, Gluten-Free, Vegetarian, Pescatarian, Mediterranean, Diabetes-Friendly, Fresh & Ready, Pre-Prepped, and Carb-Conscious.[33]

The COVID-19 pandemic resulted in a surge for Instacart's business as customers quarantining at home rushed to have their food delivered. In the space of month (March to April) 2020, the company hired 300,000 workers. In March 2021, Instacart raised $265 million at a valuation of $39 billion from investors such as Andreessen Horowitz and Sequoia, along with Fidelity and T. Rowe Price.[34]

Uber Eats and the Delivery Platforms

Launched in 2014, Uber Eats was an online food-order platform that allowed users to purchase takeout foods from in-network partner restaurants. The food was delivered by people who logged on to the UberEats app and were paid $15 or more per hour. Uber Eats also allowed Uber drivers to increase their utilization and earnings by accessing demand during nonpeak transport times. Restaurant merchants benefited with incremental demand, a new mobile presence, and efficient delivery capabilities. Uber Eats charged a delivery fee of $2 to $8, based on the distance the driver had to go. For some orders, that fee could be between 13% and 40% of the total. Some complained that this fee was exorbitant, given the fact that the average restaurant profit per order was between 3% and 9% of revenue.

Uber Eats competitors included DoorDash, Grubhub (which was acquired by Takeaway for $7.3 billion in June 2021), Deliveroo, and Caviar. Uber acquired competitor Postmates for $2.65 billion in December 2020. Other rapid-delivery/quick-commerce platforms that had raised significant funding included Getir ($550 million in June 2021) and JOKR ($170 million in July 2021).[35]

Delivery platforms like Uber Eats made their money through restaurant commission fees (usually, restaurants paid between 15% and 30% of the price of the meal), customer delivery fees (between $2 and $8 collected from the customer), customer service fees, in-app advertising, and tips. Before the pandemic, the restaurant industry was growing about 3% to 4% per year. The trend toward convenience by Gen Z consumers who preferred prepared meals contributed to delivery sales that were growing at double the rate of the restaurant industry.

Then the pandemic hit, lockdowns were established, and delivery platforms like Uber Eats saw a 30% rise in new customers. Food delivery was estimated to be a $150 billion global market in 2021—it had tripled since 2017.[36] Thomas noted that in recent years, there had also been a proliferation of "dark kitchens" or "ghost kitchens": delivery-first or delivery-only restaurant models that lowered business overhead and thus could afford to pay delivery platforms higher commissions to be more prominently featured on the apps.

Decisions

It was Tuesday evening, the night before Thomas's recommendations were due to her boss. Thomas believed her research had given her a sense of the competitive landscape, but wasn't sure what to recommend. She wondered if a more granular approach would be helpful.

She thought of the Blue Apron Crispy Skin Salmon with Salsa Verde and Farro Salad she had made recently. "What if I tried to buy something like this from other competitors?" she wondered. Thomas knew she couldn't get the exact dish from an Instacart or Uber Eats, but thought it might be interesting to ask how much a similar dish (or the ingredients for it) would cost. Thomas went to the Blue Apron site, found the dish, and wrote out the ingredients:

2 skin-on salmon fillets
1/2 cup semi-pearled farro
1 zucchini
1 red onion
2 cloves garlic
1 lemon
1/3 cup salsa verde
1 and 1/2 tbsp golden raisins
1 oz. Castelvetrano olives
1/4 tsp crushed red pepper flakes

Thomas decided to build a spreadsheet showing approximate costs for the Blue Apron meal and similar meals or ingredients from Uber Eats, HelloFresh, and Instacart (Exhibit 9). The Instacart order came from Mariano's, a grocery near Thomas's apartment. She figured if she didn't want to pay the $8.99 delivery cost, she could walk a few blocks to the store herself. But wasn't her time worth more than that?

Thomas also wondered about the scale advantage inherent in supermarkets. Blue Apron hadn't turned a profit yet. Grocery stores had notoriously low margins—between 1% and 3% per item, typically.[37] But they could make private-label products, which yielded a 35% margin versus 26% for national brands.[38] Their goal was to maximize sales volume through the store, so Thomas figured the Instacart business could be helpful to them. But Thomas also thought about the scale in their buying. She knew that grocery stores often bypassed wholesalers to buy directly from local farms, just like Blue Apron did. But top grocery chains were quite a bit larger than Blue Apron. Kroger had sales of $132 billion in 2021.[39] And Walmart and Amazon were massive. Could Blue Apron really hope to compete in the changing landscape? How?

Exhibit 9 Cost Comparison of Blue Apron Crispy Salmon versus Alternatives

Blue Apron	Uber Eats	HelloFresh	Instacart	
2 skin-on salmon fillets	Blackened Atlantic salmon	10 oz. salmon	Citrus herb-rubbed salmon	10.99
1/2 cup semi-pearled farro	Cilantro relish	12 oz.Yukon potatoes	Alessi Farro porcini mushrooms	2.89
1 zucchini	Two sides	1 zucchini	Zucchini	0.55
1 red onion		1 lemon	Red onion	0.81
2 cloves garlic		1/4 oz. chives	2 cloves garlic	1.98
1 lemon		4 tbsp sour cream	Lemon	0.99
1/3 cup salsa verde		2 tsp Dijon mustard	16 oz. mild salsa verde	2.59
1 and 1/2 tbsp golden raisins		1 pouch veggie stock concentrate	15 oz. California golden raisins	4.39
1 oz. Castelvetrano olives			2.25 oz. ripe sliced olives	1.49
1/4 tsp crushed red pepper flakes			McCormick crushed red pepper flakes	3.29
Subtotal cost $ 9.99	$ 23.49	$ 11.99		29.97
Delivery costs $ 9.99	$ 8.71	$ 9.99		$ 8.99
Total cost $ 19.98	$ 32.20	$ 21.98		$38.96

Notes:

Blue Apron	30 minutes to cook two servings.
Uber Eats	Comparable to Salmon New Orleans from Red Lobster: blackened Atlantic salmon in Cajun butter sauce topped with tomato cilantro relish and served with two sides. 30- to 40-minute delivery time. Delivery cost assumes $0.49 service fee, 15% delivery fee of $3.52, and 20% tip of $4.70.
HelloFresh	Comparable to Creamy Chive Salmon dish (10 oz. salmon); 35 minutes to cook two servings.
Instacart	Products and prices taken from Instacart site in Chicago as of February 23, 2022. Delivery advertised in 50 minutes on Instacart site from Mariano's Grocery. Delivery. Costs from site are $3.99 (waived initial time), $3.00 service fee, and $2.00 priority fee.

Data sources: "Let's Get Started," Blue Apron, https://www.blueapron.com/pricing; "Red Lobster (2537 S. Wabash Ave)," Uber Eats, https://www.ubereats.com/store/red-lobster-2537-s-wabash-ave/UK-M3x_ARr-GlK93t-ADOw?diningMode=DELIVERY; "Personalize Your Plan," HelloFresh, https://www.hellofresh.com/plans; "Creamy Chive Salmon," HelloFresh, https://www.hellofresh.ca/recipes/creamy-chive-salmon-607ed34c1d1dfa1680046099 (all accessed Mar. 2, 2022).

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Case 6

Gap, Inc.

Sonia Syngal was appointed President and Chief Executive Officer of Gap Inc. in March of 2020. In an interview with the Stanford Graduate School of Business, Syngal directly addressed the 70% loss of revenue and $140 million in cash spending per week that occurred at the height of the COVID-19 pandemic, and how she plans to lead the executive leadership team to redefine their purpose. Syngal emphasized the decision to become "inclusive by design" and to use that as Gap's guiding North Star as it makes decisions, both big and small, going forward.[1]

Gap, previously known as The Gap Stores, Inc., seeks to become the most inclusive company in the world through implementing an action plan focused on strengthening employee, customer, and community belonging. The company uses something called the Authenticity Equation as a framework for its inclusive decision-making.[2] The framework uses three components of authenticity—a considered approached, a connected process and output, and consistent engagement—to ensure Gap's brands and products manifest its promise.

Implementation of this framework is mapped out in Gap's Power Plan 2023 strategy, a three- year vision put forth to grow purpose-led billion-dollar lifestyle brands that shape people's way of life and deliver consistent growth through omni-dominance, an approach to sales that integrates distribution, promotion and communication to provide customers with a seamless shopping experience.[3]

Although Gap has faced and still faces a great deal of volatility and uncertainty brought on by the COVID-19 pandemic and intense market competition, things are improving. In fact, Gap had $16.7 billion in revenue in the fiscal year ending in January 2022, slightly higher than pre- COVID revenue. The company also turned a fiscal year loss of $665 million in 2021 into a gain of $256 million in 2022. Can Gap continue to recover and perhaps become a fashion brand leader once again?

Inside the Company

After more than a decade of working in his parents' cabinet-making business, Don Fisher bought a string of hotels and began fixing them up. To make a little extra revenue, he leased out one of the ballrooms to a salesperson to use as a showroom for Levi's jeans. He observed a lot of energy in the ballroom, as people purchased Levi products, and especially the original 501 blue jeans. Inspired by that experience, Don, with his wife Doris, founded a store to sell blue jeans and records. It was 1969, and Don originally wanted to name the company "Pants and Discs," but the Fishers settled on "Generation Gap."[4] Gap became the short name for The Gaps Stores, Inc., and the company was registered. After a while, Gap introduced its own branded products and grew to operate retail and outlet stores worldwide specializing in selling casual apparel and accessories. Over the years Gap also expanded to include personal care goods for women, men, and children. The company eventually changed its legal name to Gap, Inc., by which it is known today.

Gap currently operates internationally under six lifestyle brands: Old Navy, Gap, Banana Republic, Athleta, Janie and Jack, and Intermix. Gap's global reach includes stores in the United States, Canada, the United Kingdom, France, Ireland, and Japan. Additionally, the company has franchised outlets in Indonesia, Oman, Qatar, the United Arab Emirates, Cyprus, Jordan, and Croatia. However, Gap's efforts to fit itself everywhere has caused a lot of difficulties. The company is planning to close all of its stores in the United Kingdom, Ireland, France, and Italy following a strategic review of its European business.[5]

In addition to overseas failures, Gap did not capitalize quickly enough on the digital e-commerce shifts that occurred throughout the fashion industry. It continued the tried-and-tested model of distributing the same product across markets with little variation. Gap watched passively as cheaper competitors, such as H&M, Zara, and Forever 21, captured younger online shoppers with their more efficient supply chains. Gap's complacency inhibited its ability to adapt and innovate. For example, teenagers left the brand as they did not want to be wearing the same sweatshirts that their mother bought them when they were ten. Once younger shoppers left the Gap brand, they never came back.[6] In contrast, stores like Uniqlo and Target have positioned themselves as the top providers of basic apparel, and brands like Madewell, H&M, and Zara cater to the fashion-conscious consumers of the world.

Mission

What started as a simple idea to make it easier to find a pair of jeans has developed over the years into a global mission focused on positive influence on people's everyday lives.[7] The mission statement Gap Inc. highlights on its website is "We grow purpose-led, billion-dollar brands that shape people's way of life."[8] This profound endeavor speaks to the emphasis Gap hasrecently put on becoming a value-driven enterprise.

Value Driven Culture of Inclusion and Belonging

From the beginning, inclusivity has been deeply embedded in Gap. Founders Don and Doris designed a retail experience for all by creating jeans that fit all body sizes, including Don's six- foot-four-inch frame.[9] Gender equality is one of Gap's three key values and Doris was a strong leader in this effort. For decades, Gap has stood for LGBTQ rights and has globally advocated by supporting the United Nations Foundation Free & Equal Campaign, participating in Out & Equal, fundraising for World AIDs Day, and promoting local volunteerism in the community.[10] From Banana Republic's True Hues collection, which focused on more inclusive product strategies for Black and diverse consumers, to Old Navy's recent Bodequality campaign, Gap designs its products with inclusivity in mind.[11] On its website, Gap states, "We believe that when you decide that inclusion isn't optional, not only do the gaps between us close, but a whole new world of possibilities opens."[12]

Consistent with its inclusivity focus, Gap has built and sustains a "culture of belonging." This culture is dependent on three key values that undergird its culture, operations, and brand: equality and belonging, gender equality and empowerment, and sustainability.[13] It protects these values through its Human Rights Policy that celebrates the dignity and worth of humanity. Gap embodies these values through the myriad of initiatives in which it invests resources and by empowering its employees to lead. Not only does Gap promote this culture for its employees, but it has also encouraged the creation of this type of culture for its manufacturers, suppliers, distributors, and foreign contractors. Additionally, Gap engages with competitors to ensure compliance protocols and to avoid conflicting expectations where suppliers are shared.

Gap continued to embody its cultural values towards equity and inclusion, gender empowerment, and sustainability throughout the COVID-19 pandemic. For example, despite lockdown limitations, 21% of Gap's workforce still found a way to give back to their communities and advocate for hope and an end to systematic racism.[14] These 24,000 employees collectively volunteered more than 160,000 hours of their time.[15] Additionally, Gap Foundation launched the Resilience Fund for Women in Global Value Chains to support the long-term pandemic recovery for local women-led organizations.[16] In June 2020, Gap publicly shared its new Equality and Belonging Strategy through 2025 Commitments to Change.[17] This strategy, titled *Create for All, with All 2025 Commitments,* focuses on celebrating and leveraging diversity, unlocking new opportunities, and creating an inclusive culture for employees, customers, and communities.[18]

To support workplace equity, Gap no longer requires "years of experience" on any listed job opening and no longer requires educational degrees for 99.7% of jobs below the vice-president level. In 2021, Gap almost doubled the number of Black, Indigenous and People of Color (BIPOC) employees participating in its Rotational Management Program compared to the prior year. Gap has also partnered with inclusion strategist Amber Cabral to host 29 "Real Talks" about topics such as systematic racism, microaggressions, unconscious bias, and held 10 "Allies & Advocates" workshop. Additionally, Gap now requires mandatory racial equity training for employees and has integrated inclusion and equity content into its employee learning curriculum, employee life cycle, and its Be One. Get One. cross-cultural mentorship program.[19]

To promote education and awareness, and bridge the gap between education and the next generation of BIPOC fashion leaders, Gap partnered with Harlem's Fashion Row (HFR) to provide more than $500,000 of "Closing the Gap" scholarships to Historically Black Colleges and Universities' (HBCUs) fashion departments. Gap also sponsored HFR's inaugural Fashion Playbook, targeted at youth, middle and high school, and college level students to provide digitalcontent, best practices, and tips for exploring career opportunities in the fashion industry.[20]

Sustainability

The Fishers built Gap Inc. with the purpose of creating new opportunities for the communities where their business operated. Gap has continued to embrace this central value by creating fair conditions for its workers and by minimizing its environmental damage. Gap has aligned its sustainability strategy with the United Nation's Global Sustainable Development Agenda. This agenda, along with the United Nations Guiding Principles on Business and Human Rights, the United Nations Sustainable Development Goals, and the Paris Agreement on Climate Change, creates a framework for Gap to add value to the planet and society.[21] From the first clothing design sketches to when customers clean Gap items from their personal closets, Gap sees the opportunities and risks for promoting social and environment responsibility and sustainability.

Gap integrates sustainability deeply into the business model so as to create greater impact across the value chains.[22] Sustainability is a key priority for Gap. The company has three focus areas that together help create a sustainable ecosystem: empowering women, enabling opportunities, and enriching communities.[23] Eighty-nine percent of Gap's manufacturing facilities and 80% of its strategic mills completed the Higg Facility Environment Module (FEM) Index, a sustainable apparel coalition.[24] Gap strongly believes in going beyond the basics of ethical business practices in order to embrace a broader, deeper responsibility to people and the planet.

Despite COVID-19 setbacks, Gap's 2020 Sustainability Report boasted the amazing progress it has made toward its sustainability goals. Gap reported the following 2020 progress:

- "Gap Inc. diverted 13 percent of its single-use plastics waste."

- "Gap Inc. increased the recycled content in its poly mailer bags from 35 percent to 50 percent in 2020, with the roll out scheduled for 2021."
- "New folding standards for Gap, Old Navy and Athleta have saved $13 million in freight costs and avoided more than 8 million pounds of plastic packaging."
- "Old Navy, Gap and Banana Republic used 100 percent recycled tape for all content and care labels, which has the potential to save 830 tons of plastic annually."
- "Old Navy has expanded its hanger recycling program to 600 stores, which will divert 2.2 million pounds of plastic from landfill annually. The program will be expanded to all stores by the end of 2021."
- "Athleta diverted 74 percent of the waste it generated."[25]

Executive Leadership Team

Sonia Syngal was with Gap for seventeen years before becoming Chief Executive Officer. Previously she was Executive Vice President or Global Supply Chain and Product Operations, Executive Vice President of Global Supply Chain and Managing Director for the company's European businesses, Senior Vice President for the company's International division, and Senior Vice President for the Company's International Outlet division.[26]

The Executive Leadership Team is comprised of talented executives who have held multiple leadership roles with Gap Inc. The promotion of internal talent has led to 70% of the current Executive Leadership Team having been with Gap Inc. for an average of 18 years.[27] Bios for the team are found in Exhibit 1.

Gap prioritizes having its global leadership team reflect its customers. In a July 2021 Stanford Business School podcast interview, Sonia Syngal shared, "We want to reflect customers. Our customers are 75% female. We reflect the diversity of America and we want to have that empathy and that understanding and that diversity of thought such that we can best service our customers."[28] Seventy-six percent of Gap Inc.'s global team is female, consistent with its female- dominant customer base.[29]

Exhibit 1 Leadership Bios

Sonia Syngal, Chief Executive Officer, leads the $16 billion business across all geographies and channels with a team of nearly 130,000 employees.

Most recently, Sonia led Old Navy from $7B to $8B in sales in just three years, expanding its North American presence to more than 1,200 stores, scaling its ecommerce site to the no. 4 largest apparel site in the U.S. and building competitive omni-channel capabilities. Prior to that, she was Executive Vice President of Global Supply Chain and Product Operations, responsible for managing Gap Inc.'s global supply chain and redefining a best-in-class product-to-market model for its portfolio of brands.

Since joining Gap Inc. in 2004, she has served in key leadership and general management roles including Managing Director for the company's Europe business, Senior Vice President for Gap Inc.'s International division and International Outlet division.

Prior to Gap Inc., Sonia had a successful career in Fortune 500 product companies, including 10 years at Sun Microsystems and six years at Ford Motor Co.

Sonia holds a master's degree in Manufacturing Systems Engineering from Stanford University and a bachelor's degree in Mechanical Engineering from Kettering University. She is a member of the Boys & Girls Club of America's Board of Governors and serves on The Gap Foundation Board of Trustees.

Katrina O'Connell, Chief Financial Officer, leads Gap Inc.'s global finance function.

With over 25 years at Gap Inc., Katrina has extensive experience across both brands and functions, from Brand Finance (both high-growth and mature) to Inventory Management to Investor Relations— and has a proven track record of driving a high-performance culture.

Most recently, Katrina served as Old Navy's Chief Financial Officer and head of Strategy & Innovation with global responsibility for the brand's financial performance, real estate portfolio, product/experience digital strategies, competitive intelligence and portfolio strategic planning. In addition, her various corporate roles focused on both financial budgeting and forecasting for Gap Inc.'s portfolio of brands (Old Navy, Gap, Banana Republic, Athleta), as well as engaging in Supply Chain, IT, Treasury and Investor relations work.

Katrina holds a bachelor's degree in Foreign Services from Georgetown University. She serves as a member of the Gap Foundation Audit Committee and as Board Chair of the Mount Tamalpais School in Mill Valley, CA.

Sheila Peters, Head of People and Culture at Gap Inc., leads the company's talent andcommunications functions.

With decades of experience at Gap Inc., Sheila has deep expertise leading and developing talentacross brands and functions and has held nearly every role within Human Resources. Most recently, she led Human Resources, Talent, and Communications at Old Navy.

Additionally, she led HR for Banana Republic, as well as, Corporate Human Resources whereshe was responsible for Talent Acquisition, Compensation & Benefits, Employee & Labor Relations, Talent Management, HR Strategy & Operations at Gap Inc.

She is a strong coach, educator and advocate to her teams and all employees, and believes that talent is the most important controllable investment. This is evidenced by her relentless pursuit toensure programs, initiatives and practices are in service to the company's employees and, ultimately, return value to the customer.

Source: Gap Inc. 2021. About: Leadership: Executive Leadership Team. https://www.gapinc.com/en-us/about/leadership/executive-leadership-team#:~:text=Sonia%20Syngal%20is%20the%20Chief%20Executive%20Officer%20of,channels%20with%20a%20te am%20of%20nearly%20130%2C000%20employees. Accessed October 8, 2021.

Exhibit 1 (cont.) Leadership Bios

Nancy Green, President & CEO, Old Navy, leads the value apparel brand that delivers thedemocracy of style through its affordable, on-trend styles for the family with unbelievable quality and one of the most inclusive size ranges in the industry.

With a proven track record of leading companies through successful transformations and periodsof significant growth, she brings purpose-driven leadership as well as a passion for customer-centric design and sustainability to her role at Old Navy.

During Green's more than 25-year tenure with Gap Inc., she has held executive leadership roles across the company's portfolio of brands, including leading Athleta, the active and wellness lifestyle apparel brand. During her time in role, the business grew from $250M to a nearly $1B, purpose-led business with significant earnings expansion. Through a 200-store growth strategy, her team built a community and customer relationship-driven store model, while also launching the brand's girls' line, Athleta Girl. Through an ambitious sustainability and social impact strategy, Nancy led Athleta to achieve B Corp Certification, which recognizes businesses that meet the highest standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose. She has also held leadershiproles at Shabby Chic and Pottery Barn.

Green is passionate about mentoring women in business, is a council member of the women's executive leadership organization, C200, and is a member of the Board of Directors for the UC Berkeley Haas School of Management, Center for Equity, Gender and Leadership. She is also anexecutive sponsor and steering committee member for Gap WIL, Gap Inc.'s women in leadership business resource group.

Green serves on the Gap Foundation Board of Trustees, the Gap Inc. Sustainability Board andthe Board of Directors for Allbirds, the certified B Corp footwear company. She holds a bachelor's degree from University of California, Berkeley.

Mark Breitbard, President & CEO, Gap Brand, leads Gap, one of the world's most iconic apparel brands and the authority on American casual style. In addition, he is responsible for the company's Franchise and Strategic Alliances and Licensing business.

Mark is a leader with clear vision and the proven ability to drive transformation and innovation. He has more than 25 years of retail leadership experience, serving in numerous products, creative and management roles at major global brands. He began leading Gap global in 2020 and has laid a foundation to turn the brand around through new positioning and a new operating model. Mark held leadership positions across Gap and was instrumental in delivering the product-led resurgence of Gap's North America business between 2010-2013.

In 2017, he rejoined Gap Inc. as CEO and President for Banana Republic and during that time stabilized the business and launched new access points, including a rental subscription service, Style Passport, and a partnership with thredUP, the world's largest fashion resale platform.

Prior to this, Mark served as chief executive officer at The Gymboree Corporation from 2013 until early 2017. From 2010 to 2013, Mark held leadership positions across Gap North America, where he was instrumental in delivering the product-led resurgence of Gap's North America business. He also served as chief merchandising and creative officer of Old Navy from 2009 to early 2010. Previously, Mark served in leadership roles at Levi Strauss & Co. and Abercrombie & Fitch.

Mark graduated from Vassar College and earned a Master of Business Administration from the Haas School of Business at the University of California, Berkeley.

Sandra Stangl, President & CEO, Banana Republic, leads this global brand that offers affordable luxury by using the finest materials with the latest fabric innovations to create timeless, modern, and versatile style.

With more than 25 years of retail leadership experience, Sandra has a strong background in driving design vision and successfully transforming and growing brands through new business extensions and lifestyle experiences. Most recently, she co-founded and was the Chief Merchant of MINE, a pure-play home business.

Previously, Sandra spent 23 at Williams Sonoma, where she was part of a small team that developed and launched two brands—Pottery Barn Kids and Pottery Barn Teen and held numerous leadership positions, including President of Pottery Barn, Pottery Barn Kids, and Pottery Barn Teen. Sandra also served as the President, Chief Merchandising and New Business Development Officer for Restoration Hardware.

Sandra holds a BFA in Design & Applied Arts from the University of California, Los Angeles and serves as a Trustee for the University of San Diego.

Mary Beth Laughton, President and CEO, Athleta, leads this certified B Corporation and premium fitness and lifestyle brand that creates versatile, performance apparel to inspire a community of active, confident women and girls.

With more than 20 years of retail and digital leadership, Mary Beth has a strong background in driving omni-channel growth through innovative experiences. Most recently, she served as Executive Vice President of Omni retail for Sephora US, where she led the retailer to impressive expansion in the digital space, increasing the company's online business 5X while improving store performance and growing the retailer's physical footprint.

Previously, Mary Beth spent nine years at Nike, where she held a variety of strategy, merchandising and e-commerce roles, including three years as General Manager for Nike's e-commerce business in Europe. She became a board member of Impossible Foods in August 2020 and was previously a board member of REI.

Mary Beth graduated from Indiana University and holds an M.B.A. from Harvard Business School. She lives in Mill Valley with her husband and two children.

(*continued*)

Exhibit 1 (cont.) Leadership Bios

Asheesh Saksena, Chief Growth Officer of Gap Inc., leads the company's strategic agenda, as well as growth initiatives for the future. He oversees Operations, Technology, Digital and Customer organizations, and Corporate Strategy.

Asheesh brings more than 30 years of transformational experience grounded in general management roles and best in class consulting, as well as in-house, large-scale corporate strategy and strategic growth roles.

Prior to joining Gap Inc., Asheesh served as President of Best Buy Health where he led the formation and operation of the brand's strategic diversification into Digital Health after serving as the company's Chief Strategic Growth Officer. During his time with Best Buy, he helped expand the company's addressable market and incubated new platforms for growth. He has also lead strategy and growth organizations at Cox Communications, Time Warner Cable, and as Partner at Accenture.

Asheesh holds a bachelor's degree in Mechanical Engineering from BITS Pilani (India) and an MBA from the University of Delhi.

John Strain, Chief Digital and Technology Officer for Gap Inc., has responsibilities for Technology, Product Management, Data and Analytics, and Loyalty and Payments. John also oversees the Digital business including eCommerce Strategy and Operations and Digital and Direct Marketing.

With almost 30 years in the retail technology and eCommerce space, John brings a customer-centric mindset to a delivery orientation that has resulted in a track-record of successful digital transformations.

Prior to joining Gap Inc., John was the General Manager of the Retail and Consumer Goods Industry for Salesforce. He also spent 11 years at Williams-Sonoma Inc. as the Chief Digital and Technology Officer where he was responsible for Technology, Product Management and Digital Marketing. He also spent 14 years as a management consultant.

John graduated from Santa Clara University where he was a member of the Retail Management Institute. He is a San Francisco Bay Area native, who currently lives in Marin County with his wife and children.

Sally Gilligan, Chief Growth Transformation Officer for Gap Inc., leads the long-term strategic direction of Gap Inc. along with members of the Senior Leadership Team. As head of the Strategic Growth Office, she oversees our strategic planning and new business development and operations in support of our growth initiatives. In this capacity, she leads the corporate development, strategy, new business operations, sustainability, Gap foundation, and government affairs organizations.

Sally has been with Gap Inc. for over 16 years, serving in a variety of roles in the organization with a focus on transformation, capability building and optimization. Most recently, Sally served as CIO, overseeing the company's technology transformation and organization that serves as the engine that drives retail, e-commerce and global enterprise technology for millions of customers. She also served as SVP of Product Operations and Supply Chain Strategy where she led a global team responsible for building and deploying capabilities to enable the end-to-end demand based operating model. This included sourcing & fulfillment strategy, product management for all operations design through inventory management and fulfillment, and advanced analytics for product costing, inventory, and network optimization.

Prior to joining Gap Inc., Sally has ten years of management consulting and financial services experience. Sally holds a Bachelor of Science degree from Georgetown University in Washington D.C. and a Masters in Business Administration from University of Chicago. She serves as Chair of the Gap Foundation.

Julie Gruber, Chief Legal and Compliance Officer and Corporate Secretary, leads the Legal, Compliance, Loss Prevention and Global Security functions for Gap Inc. As Corporate Secretary, she is a trusted advisor to the board and works closely with the Chairman of the Board and the CEO. Julie's teams protect the people, property, reputation and information of Gap Inc.'s employees, customers and communities.

Over her career, Julie has had the opportunity to lead a variety of disciplines, including Government Affairs, Sustainability, the Gap Foundation, Corporate Administration, and Employee Relations in addition to all aspects of Legal and Compliance. Julie established Gap Inc.'s Cyber Security and Privacy Council, co-founded the company's Risk Committee and chairs the Integrity and Corporate Crisis teams. During her tenure with the company, she has built a strong track record of leading Gap Inc. through various crisis, acquisitions, and global expansions. Additionally, she has significant experience across branding, intellectual property, and franchising.

An avid champion for diversity, Julie drove Gap Inc. to join the Leadership Council on Legal Diversity, an organization of more than 300 corporate legal officers and law firm managing partners dedicated to creating a truly diverse legal profession in the U.S. In addition, she led Gap Inc. to be one of the first corporate legal department sponsors of Diversity Lab's Mansfield Rule initiative, which helps drive and measure diversity across law firm leadership.

Prior to joining Gap Inc., she was an associate at Bronson, Bronson and McKinnon in San Francisco and clerked for the Honorable Ronald M. Whyte in the Federal District Court in San Jose. Julie is a graduate of the University of California's Hastings College of Law and received her bachelor's degree in Political Science from Yale University. Julie serves on the Board of LifeMoves - Breaking the Cycle of Homelessness and is on the Executive Committee for the American Heart Association's Bay Area Go Red for Women Campaign.

Employees

In an effort to be transparent and to highlight its emphasis on diversity, in 2013 Gap began publicly reporting diversity data for U.S. hires, the gender for all global employees, females in leadership globally, and new hires.[30] In 2019, Gap Inc. expanded these data categories to include the disaggregated employee demographic data and by company functional roles to include U.S. Headquarters, U.S. Distribution and Call Centers, U.S. Store Leadership, and U.S. Store Employees.[31] Equality and belonging groups (EBG) exist for the Asian Gap community, Black and African American Gap community, Latinx Gap community, parents and caregivers at Gap, LGBTQ+ Gap community, Veterans Gap community, and women and allies Gap community.[32]

Gap also believes in empowering its employees to develop solutions and participate in leading internal change. For example, the Color Proud Council, Gap's product inclusion initiative, was the result of its co-founder, Bahja Johnson, approaching President and CEO of Global Gap Brand, Mark Breitbard, to holistically discuss diversity at Gap and her own personal experiences. As their conversation was concluding, Bahja asked, "So what do you want to do? Should we start a council to start to tackle what inclusion can mean for all of us?" Breitbard responded with, "What do I want to do? What do you want to do? I will support you. I'll put you in contact with our Head of HR and our Head of Diversity."[33] This type of support from senior leadership – to listen to employees and create space for culture and product development shifts – is an incredible priority of Gap. The Color Proud Council has representation for all brands and functions and has contributed to positive change in product improvement, market integration, Gap employee learning, talent acquisition and retention.

Business Operations

Business Model

Gap Inc. is an international retail company comprised of six divisions of lifestyle brands: Old Navy, Gap, Banana Republic, Athleta, Janie and Jack, and Intermix. Each of these brand names has its own target market and retail offerings that afforded Gap Inc. recognition as fifth in sales of apparel retailers in the United States in 2020.[34] Gap Inc. operates worldwide with nearly 3,000 company-owned stores, over 500 franchise stores, as well as e-commerce sites.[35] Internationally, at least one of its brand name stores is present in North America, Europe, Asia, the Middle East, Oceania, South America, and Africa.[36]

Although Gap was originally founded as a means to fill the "generation gap," which was unique at the time, more recently it has mostly applied what might be called a "best value" strategy to its namesake stores, providing high-quality products at reasonable (but not the lowest) prices. However, by spreading its businesses across different price points of the retail apparel industry, the company also competes across multiple target markets through its diverse apparel sectors: low and medium-cost casual wear, business apparel, athletic apparel, children's clothes, and high-end fashion. In 2019, Gap announced a spinoff strategy for its Old Navy brand in order to allow Old Navy to flourish and not be weighed down by lagging performance of the other brands within Gap Inc.[37] The plan to split into two separate publicly traded companies was abruptly halted the following year as the preparation for the split had "shone a bright light on operational inefficiencies and areas for improvement," according to Robert Fisher, son of Gap's founders and acting interim CEO at the time.[38] As part of its business model, Gap not only focuses on its direct consumers who purchase its products, but allows consumers to become franchise owners. Gap also involves each of its partners in its shared vision through its recognition program called "Top Stitch," which acknowledges contributions from partners quarterly. For each partner that shares Gap's values

through its actions, Gap donates in the partner's honor to one of Gap Inc.'s non-profit partners, such as the Boys and Girls Clubs of America, CARE, Water.org, Good360, and NAACP.[39]

Growth Strategies

In its early years and throughout its expansion, Gap has continued to penetrate the retail apparel market with strong advertising campaigns and marketing efforts focused on the popular fashion and social trends of the time. When Gap first opened in 1969, a turning point in time for the United States, its mission was to offer apparel – Levi's jeans in particular – that appealed to multiple consumer generations. Since then, Gap has intentionally continued to address the needs of diverse consumers. Marketing and advertising campaigns over the years have featured popular celebrities and cultural icons, such as Salvador Dalí, James Dean, Joan Didion, Cindy Crawford, Spike Lee, Whoopie Goldberg, and Madonna.[40] Each of these celebrity cameos have historically promoted the Gap brand; however, more recent efforts with celebrities have promoted other brands under the Gap Inc. umbrella. For example, Gap strategically partnered with famous icons like Simone Biles and Sloane Stephens for its Athleta brand. Athleta's marketing campaign, "Power of She," reimagines value alignment for the role of community in gender empowerment.[41] On a recent earnings call, CEO Sonia Syngal said, "The brand's 'All Powerful' campaign saw engagement at double industry benchmarks and netted more than 160 million impressions across print and digital."[42]

As the diversity of its stores attest, Gap has developed its market over the years primarily by entering into new market segments. The Gap brand opened a GapKids store in 1986, expanded into babyGap just four years later. Old Navy was developed to fill the need for more value conscious consumers, while Hill City was a high-performance men's lifestyle brand that has since closed. In 2021, the company even entered the home goods market through a partnership with Walmart. Mark Breitbard, President and CEO of Gap brand, said in the press release, "Walmart is a global leader in the home space with extensive digital reach and distribution, and this partnership enables Gap to introduce a new category in a smart, scalable way. Gap Home at Walmart opens a new door for Gap as a lifestyle brand delivering timeless American style in all new ways. We are excited for this growth opportunity, enabling even more customers to fall in love with Gap."[43] Additionally, Kanye West signed a ten-year deal with the Gap brand for his Yeezy Gap line, a partnership through which the Gap brand hopes to attract more younger customers. Gap expects the Yeezy Gap brand will generate $1 billion of sales annually by 2026.[44]

In addition to a primary focus on internal growth through segment diversity, Gap has established partnerships with other retailers and non-governmental organizations, and has collaborated with popular brands and television shows that capture the popular spirit of the time. Gap has also acquired many companies along the way, such as Banana Republic, Athleta, and Intermix, that have further diversified its portfolio.

Although Gap's growth strategy has been ambitious over the years, it is also trimming its portfolio. In addition to its European withdrawal, it is closing roughly 350 Gap and Banana Republic stores in North America as leases expire in an effort to move away from malls, many of which were struggling even before the COVID-19 pandemic. This strategy has been deemed the

"Power Plan 2023" and is expected to save Gap $45 million in rent.[45] On the flipside, the Power Plan 2023 will focus more heavily on boosting sales with Old Navy and Athleta and moving Old Navy brick-and-mortar stores to smaller markets with populations of less than 200,000. In response to online sales growing by 54% in 2020, Gap Inc. adapted its marketing strategies to become a digital-first business.[46] Its marketing is personalized to the varied customers across each brand. Gap uses Artificial Intelligence analysis to strengthen its advertisement messaging and guide data-driven decision making.[47]

Global Supply Chain

Gap's supply chain is comprised of thousands of global employees who create high-quality products that are delivered in a timely manner. The company ships its products from supplier facilities to its distribution centers and then on to stores or directly to customers through a combination of sea, air, truck, and rail. Gap strongly believes that its products have a full life cycle that begins when the product hits the store and does not end until after it leaves the store and is worn by the customer.[48] They are uniquely positioned to initiate transformative changes across the retail industry through brand collaborations and mill partnerships with some of the best known vendors in retail.[49]

Gap consistently innovates its processes in order to execute a holistic approach to improving labor standards and working conditions.[50] Most companies in the apparel and fashion industry similar to Gap do not manufacture their own clothing and are dependent on suppliers who are often in parts of the world where the bargaining power of workers is weak. In an effort to safeguard the health and safety of employees in its supply chain, Gap has made sure its COVID- 19 guidelines are up to date and enforced, especially for garment manufacturing. Gap also pivoted its social and labor capacity building programs to be offered virtually so that learning would continue during the pandemic.[51]

Gap has built on its existing industry commitments by extending them to foreign contract worker requirements throughout all of its Tier 2 suppliers. For example, the work Gap has done with American Apparel and Footwear Association and Fair Labor Association Commitment to Responsible Recruitment in Taiwan has allowed workers to maintain full control over their passports and travel documents and freedom of movement and full control over the money they earn. All Gap Tier 1 facilities and Tier 2 strategic mills participate in industrywide efforts, including Social & Labor Convergence Program (SLCP) and/or International Labor Organization(ILO) Better Work by 2023 and 80% of Gap Inc. Sourcing will be allocated to green-rated factories by 2025. Gap is also working with other brands, such as Adidas, Lululemon, and Patagonia, to ensure similar compliance protocols and avoid conflicting expectations of shared suppliers.[52]

Financial Condition

During the fiscal year ending on January 30, 2021, Gap sales declined from $16.4 billion in to $13.8 billion. Part of Gap's response was a divestment of underperforming stores (see *Exhibit* **2**) as well as pulling out of Europe. Given this divestment strategy, the increase in revenue to $16.7 billion in the fiscal year ending in January 2022 is impressive. The company also turned a loss of $665 million into a gain of $256 million. Gap's stock price fell during the pandemic to as low as $9.80. On March, 2022, Gap was selling around $14 per share. Financial statements are found in Exhibits 3 and 4.

According to CEO Sonia Syngal regarding the difficulty of getting through the COVID-19 challenges: "We faced one of the most difficult years in our company's history and, throughout, our teams showed resilience and determination as we navigated unprecedented disruption in our industry to set a course for long-term growth. Our powerful brands moved to offense with purpose-led marketing and strength in relevant categories, like Active and Fleece, allowing us to gain meaningful market share quarter-over-quarter in a fragmented environment. This was enabled by our $6 billion online business and advantaged digital capabilities allowing us to expand our reach to more than 183 million customers this year."[53]

Exhibit 2 Store Opening and Closings

Between February 2020 and July 2021, Gap Inc. closed 7% of its total brick and mortar stores.

Store Count, Openings, Closings					
	Number of Store Locations 2/1/20	Number of Stores Opened	Number of Stores Closed	Number of Store Locations July 31, 2021	% change
Old Navy N.A.	1207	62	24	1245	3.1%
Old Navy Asia	17		17	0	−100.0%
Gap N.A.	675	3	136	542	−19.7%
Gap Asia	358	25	44	339	−5.3%
Gap Europe	137	5	52	90	−34.3%
Banana Republic N.A	541	4	84	461	−14.8%
Banana Republic Asia	48	8	8	48	0.0%
Athleta N.A.	190	24	2	212	11.6%
Intermix N.A.	33		2	31	−6.1%
Janie and Jack N.A.	139		20	119	−14.4%
Company Operated Stores	3345	131	389	3087	
Franchise	574	107	124	557	
Total	3919	238	513	3644	−7.0%

Source: Gap Inc. 2021. Investors: Real Estate. https://www.gapinc.com/en-us/investors/real-estate. Accessed October 5, 2021.

The External Environment

Competition in the Apparel Industry

The fashion retail industry in which Gap operates is highly competitive and fast-paced. There are thousands of retail brands that operate both brick-and-mortar stores and online space, locally and globally. The barriers to entry have become even lower with e-commerce making it possible for virtually anyone to establish an online brand or retail presence. Customers have high bargaining power when it comes to the apparel and fashion industry. Switching costs for consumers are negligible. Competition is based on many factors, including quality, price, trends, and affiliation with particular brands.

Although Gap has a diversified portfolio of companies that reach different markets and styles, competitors challenge Gap in each of its sectors. The Gap brand and Old Navy competes with the price points of global fast-fashion brands like Zara and H&M while Athleta faces head-on competition with Lululemon, Under Armor, and Nike. Banana Republic competes with brands like J. Crew, Ann Taylor, and Everlane that specialize in business apparel, as well as Zara, H&M, and department stores.

Societal Forces

In addition to fierce competitive rivalry within the retail garment industry, Gap also faces challenges due to broader environmental influences. Societal trends will always heavily impact the fashion industry. The most recent movement that has profoundly influenced retail companies is the "athleisure" trend, defined as "the general dressing down across our culture, high fashion brands turning sweats and tees into big ticket items, and retailers moving more performance apparel than ever before."[54] This trend, which arose prior to the COVID-19 pandemic, garnered further adoption because of the pandemic since many employees chose to work from home in order to mitigate the spread of the disease. Many companies had already begun to become more lenient with dress policies and the work-from-home movement, catapulted by the pandemic, will likely pave the way for this trend to continue to permeate into offices across the world.

Activism with regard to diversity, equity, and inclusion is beginning to show up in numerous companies' vision statements and efforts to promote it throughout all aspects of these companies' operations are growing. Gap has positioned itself at the forefront of this effort with its longstanding, clear values and bold marketing campaigns and messages. Gap has not, however, been perfect in its responses to this trend. For example, following the 2020 presidential election, in an effort to promote post-election unity, Gap tweeted an image of a red and blue hoodie with a headline that read, "The one thing we know, is that together, we can move forward." It immediately received backlash for being patronizing and tone-deaf at a time when political tension was high.[55]

Exhibit 3 Income Statement

Income Statement For the Fiscal Period Ending	12 months Feb-03-2018	12 months Feb-02-2019	12 months Feb-01-2020	12 months Jan-30-2021	12 months Jan-29-2022
Revenue	15,855.0	16,580.0	16,383.0	13,800.0	16,670.0
Total Revenue	**15,855.0**	**16,580.0**	**16,383.0**	**13,800.0**	**16,670.0**
Cost of Goods Sold	9,789.0	10,258.0	10,250.0	7,636.0	8,657.0
Gross Profit	**6,066.0**	**6,322.0**	**6,133.0**	**6,164.0**	**8,013.0**
Selling General & Admin Exp.	4,573.0	4,864.0	5,038.0	6,431.0	7,153.0
R&D Exp.	51.0	50.0	41.0	46.0	41.0
Other Operating Exp., Total	**4,624.0**	**4,914.0**	**5,079.0**	**6,477.0**	**7,194.0**
Operating Income	**1,442.0**	**1,408.0**	**1,054.0**	**(313.0)**	**819.0**
Interest Expense	(74.0)	(73.0)	(76.0)	(192.0)	(167.0)
Interest and Invest. Income	19.0	33.0	30.0	10.0	5.0
Net Interest Exp.	**(55.0)**	**(40.0)**	**(46.0)**	**(182.0)**	**(162.0)**
Currency Exchange Gains (Loss)	1.0	2.0	5.0	8.0	—
Other Non-Operating Inc. (Exp.)	—	(34.0)	—	—	—
EBT Excl. Unusual Items	**1,388.0**	**1,336.0**	**1,013.0**	**(487.0)**	**657.0**
Gain (Loss) on Sale of Assets	—	—	191.0	—	—
Asset Writedown	(28.0)	(14.0)	(337.0)	(557.0)	(9.0)
Insurance Settlements	64.0	—	—	—	—
Other Unusual Items	—	—	(339.0)	(58.0)	(325.0)
EBT Incl. Unusual Items	**1,424.0**	**1,322.0**	**528.0**	**(1,102.0)**	**323.0**
Income Tax Expense	576.0	319.0	177.0	(437.0)	67.0
Net Income	**848.0**	**1,003.0**	**351.0**	**(665.0)**	**256.0**
Supplemental Operating Expense Items					
Advertising Exp.	673.0	650.0	687.0	816.0	1,115.0
Selling and Marketing Exp.	673.0	650.0	687.0	816.0	1,115.0
R&D Exp.	51.0	50.0	41.0	46.0	41.0
Net Rental Exp.	NA	NA	NA	1,455.0	1,376.0

Source of data: Standard & Poor's Global NetAdvantage, Accessed March 18, 2022; figures in millions.

Economic Forces

Economic forces heavily influence the retail industry as well. Gap, along with many other retailers, most recently experienced this with the impact of COVID-19 on the global economy as it was forced to temporarily shut down. As the economy began to open back up, consumers were still hesitant to shop indoors and spending habits shifted. Consumers' personal savings rates increased and there was less in-person activity which decreased consumers' retail spending. The retail industry also faced a decrease in employment that is only now starting to rise. As a result, many retailers closed storefronts and are making efforts to reduce store count as online shopping continues to grow.

A growing concern for retailers in Gap's mainstay US market is inflation. As the Consumer Price Index (CPI) rises, consumers are likely to become more value-conscious. As a result, retailers are likely to face an even stronger price-driven promotional cycle of discounting, making it increasingly difficult to transition to a path that fosters growth and profitability. Consumers will likely increase online shopping in an effort to avoid spending on gas or to find better prices.[56]

With global operations, Gap is required to comply with various domestic, regional, and international laws, such as discrimination law, antitrust law, occupation law, health and safety law. The laws can directly or indirectly impact not only how the company operates, but also its operational costs. Gap puts an emphasis on comprehensive corporate compliance to ensure its employees and management meet legal requirements around the world and operate responsibly with integrity in everything they do. For example, of all the companies

Exhibit 4 Balance Sheet

Balance Sheet as of:	Feb-03-2018	Feb-02-2019	Feb-01-2020	Jan-30-2021	Jan-29-2022
ASSETS					
Cash and Equivalents	1,783.0	1,081.0	1,364.0	1,988.0	877.0
Short Term Investments	—	288.0	290.0	410.0	—
Total Cash & ST Investments	**1,783.0**	**1,369.0**	**1,654.0**	**2,398.0**	**877.0**
Accounts Receivable	282.0	321.0	316.0	363.0	399.0
Total Receivables	**282.0**	**321.0**	**316.0**	**363.0**	**399.0**
Inventory	1,997.0	2,131.0	2,156.0	2,451.0	3,018.0
Prepaid Exp.	158.0	157.0	148.0	104.0	110.0
Restricted Cash	1.0	1.0	—	4.0	—
Other Current Assets	347.0	272.0	242.0	688.0	761.0
Total Current Assets	**4,568.0**	**4,251.0**	**4,516.0**	**6,008.0**	**5,165.0**
Gross Property, Plant & Equipment	8,767.0	8,667.0	14,363.0	12,666.0	11,783.0
Accumulated Depreciation	(5,962.0)	(5,755.0)	(5,839.0)	(5,608.0)	(5,071.0)
Net Property, Plant & Equipment	**2,805.0**	**2,912.0**	**8,524.0**	**7,058.0**	**6,712.0**
Goodwill	109.0	109.0	109.0	109.0	207.0
Other Intangibles	95.0	92.0	121.0	61.0	90.0
Other Long-Term Assets	412.0	685.0	409.0	533.0	587.0
Total Assets	**7,989.0**	**8,049.0**	**13,679.0**	**13,769.0**	**12,761.0**
LIABILITIES					
Accounts Payable	1,181.0	1,126.0	1,174.0	1,743.0	1,951.0
Accrued Exp.	505.0	295.0	371.0	471.0	560.0
Curr. Port. of Leases	—	—	920.0	831.0	734.0
Curr. Income Taxes Payable	10.0	24.0	48.0	34.0	25.0
Unearned Revenue, Current	247.0	227.0	226.0	231.0	345.0
Other Current Liabilities	518.0	502.0	470.0	574.0	462.0
Total Current Liabilities	**2,461.0**	**2,174.0**	**3,209.0**	**3,884.0**	**4,077.0**
Long-Term Debt	1,249.0	1,249.0	1,249.0	2,216.0	1,484.0
Long-Term Leases	—	—	5,508.0	4,617.0	4,033.0
Other Non-Current Liabilities	1,135.0	1,073.0	397.0	438.0	445.0
Total Liabilities	**4,845.0**	**4,496.0**	**10,363.0**	**11,155.0**	**10,039.0**
Common Stock	19.0	19.0	19.0	19.0	19.0
Additional Paid in Capital	8.0	—	—	85.0	43.0
Retained Earnings	3,081.0	3,481.0	3,257.0	2,501.0	2,622.0
Treasury Stock	—	—	—	—	—
Comprehensive Inc. and Other	36.0	53.0	40.0	9.0	38.0
Total Common Equity	**3,144.0**	**3,553.0**	**3,316.0**	**2,614.0**	**2,722.0**
Total Equity	**31. 44.0**	**3,553.0**	**3,316.0**	**2,614.0**	**2.722.0**
Total Liabilities and Equity	**7,989.0**	**8,019.0**	**13,649.0**	**13,769.0**	**12,761.0**

Source of data: Standard & Poor's Global Net Advantage, Accessed March 18, 2022; figures in millions.

approached by *The New York Times*, only Gap, which placed orders with factories in Indonesia, Cambodia, India, and Jordan, specifically said it had investigated allegations made in the report that claimed that millions of dollars of wages had been withheld from garment workers.[57]

Technology

Retailers also face the issue of shopping mall closures and a transition to e-commerce. The future of the retail industry will be shaped by the digitization of shopping, both in-person and online. In order to attract younger consumers and anchor them at an early point in their purchasing lifetime, retailers will have to offer the latest technology available, which is challenging considering the rate of continuous development and innovation. Opportunities include technology that supports contactless payment, augmented and virtual reality, in-store digital screens with voice commands, virtual fittings, wayfinding, and livestream shopping events.[58]

Looking Forward

Over the last few years, Gap has experienced tremendous volatility in every aspect of its business as a result of changes in leadership, the COVID-19 challenges, and a forced acceleration of deeper reliance on the digital e-commerce part of its business. Gap's three-year vision, as detailed in its Power Plan 2023, is to grow purpose-led billion-dollar lifestyle brands that will shape people's way of life and deliver consistent growth through omni-dominance.[59] Will Gap successfully transition away from brick-and-mortar stores to become a leader in the retail e-commerce space? Will Gap's new brand partnerships captivate younger consumers and increase the life cycle of its customer base? Will Gap's latest diversification into the home good and baby gear markets enhance its brand or weaken it? Answers to these questions will have much to do with the longevity and financial performance of this American icon.

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Case 7

Haier: Organizing to Build a Smart Ecosystem Brand

Introduction

Yong Wu walked through Haier's Qingdao headquarters on his way to the weekly group strategy meeting. As leader of Haier's Internet of Food (IoF) sub-field, he oversaw the core business of kitchen appliances as well as products and services related to food and cooking. Since adopting a new strategy in 2019, Haier's business revolved around providing "smart home solutions".

Wu had joined Haier in 2001 as an intern after graduating from Tianjin Business School, starting out at the refrigerator factory in Qingdao, where he ultimately became director. From 2009 to 2014 he had worked internationally, managing two of Haier's acquisitions in Southeast Asia and Japan. In 2015, Wu returned to headquarters in Qingdao to focus on delivering "smart" products and solutions in the refrigerator, food and cooking space. He was made responsible for creating a platform focused on delivering novel 'food and kitchen experiences' to users. This involved encouraging an 'entrepreneurial' approach among the people working in the sub-field. In four years, Wu had turned it into an ecosystem with more than 1,000 partners covering 12 sectors including food, cooking, home decoration, supermarkets & retail, maternal & infant, and beverages. He was also tasked with providing feedback on how the recent evolution of Haier's organizing model and its ecosystem micro- communities (EMCs) could be better aligned with company strategy.

As he prepared for the strategy meeting, he wondered whether any changes needed to be made to the organizing model to continue building on the IoF's recent success.

Haier Group History

The Haier Group (Haier) is a China-based manufacturer of large and small household appliances and consumer electronics, founded in 1984 with collective ownership. By the late 1990s, the Chinese market was increasingly sophisticated, prompting a number of foreign refrigerator brands to enter the market. For Haier, the only way to survive was to focus on producing high-quality products and excellent customer service. Its initial success in growing the refrigerator business led to a government request that the company take control of failing companies. As a result, it acquired a string of local firms that covered nearly the entire range of home appliances.

By 2020, Haier had about 80,000 employees worldwide as well as a network of external partners who jointly developed and delivered co-branded products and services through Haier's distribution channels. Its seven brands–Haier, Casarte, Leader, Aqua, Fisher & Paykel, GE Appliances, and CANDY–were present in Asia-Pacific, Europe, the Americas, the Middle East and Africa. The Haier Group traded on the stock exchanges of Shanghai (A shares), Frankfurt (D shares) and Hong Kong (H shares) through its principal subsidiary, Haier Smart Home Co., Ltd., which in 2020 reported operating revenues of 209.7 billion RMB ($32 billion) and net profits of 8.9 billion RMB ($1.4 billion). In 2020, overseas operations represented 48% of total revenue (see Exhibit 1). In the ten years prior, gross profits in Haier's core appliance business grew 22 percent per year and revenues grew 20 percent per year.[1]

The Consumer Market and the Rise of Smart Products and Services

As Apple, Google, Facebook and Amazon transformed industries–including entertainment, cloud computing, advertisement, retail and logistics–by leveraging and building on their core products and services, it became increasingly clear that the competitive landscape for consumer goods was no longer confined to a company's own industry or market segment. Instead, Haier believed that the leading firms of the future would be companies that created an ecosystem around their products to deliver an integrated user experience. From the iPhone and the Apple Watch to Google Nest and Amazon Echo, the most successful products were personalized to users' changing needs and offered much more than a single function. They were linked to other products

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This case study was written by **Professor Michael Y. Lee**, Assistant Professor of Organisational Behaviour, Professor Wesley Wu-Yi Koo, Assistant Professor of Strategy, both at INSEAD, and Joost Minnaar, Co-Founder of Corporate Rebels. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Exhibit 1 Haier Smart Home's Key Accounting and Financial Data 2020

VII. KEY ACCOUNTING DATA AND FINANCIAL INDICATORS IN THE RECENT THREE YEARS

(I) Key accounting data

Unit and Currency: RMB

Key accounting data	2020	2019	Yoy change (%)	2018
Operating revenue	**209,725,821,099.44**	200,761,983,256.57	4.46	184,108,481,959.27
Net profit attributable to shareholders of the listed company	**8,876,593,208.19**	8,206,247,105.96	8.17	7,483,659,016.04
Net profit after deduction of non-recurring profit or loss attributable to shareholders of the listed company	**6,457,813,335.37**	5,765,164,700.75	12.01	6,601,505,599.79
Net cash flows from operating activities	**17,599,111,715.51**	15,082,630,942.73	16.68	19,142,782,481.20
	At the end of 2020	At the end of 2019	Yoy change (%)	At the end of 2018
Net assets attributable to shareholders of the listed company	**66,816,422,614.55**	47,888,319,765.92	39.53	39,742,745,893.42
Total assets	**203,459,495,879.65**	187,454,236,283.17	8.54	168,091,571,652.14

Note: Revenue of COSMO was no longer included in the fourth quarter of 2020 since the business of COSMO was stated by the end of September 2020. For example, business revenue of COSMO was not included in the fourth quarter of 2019, representing an increase of 8% and 20% in 2020 and the fourth quarter, respectively.

Source: 2020 Annual Report of Haier Smart Home Co., Ltd

with which they operated in tandem to deliver an integrated experience–hence, the term "smart".

With the rise of digital technologies and the internet of things (IoT), the ability to form links between products–like nodes in a network– expanded. Seamless connections between software and hardware gave rise to previously unimaginable levels of flexibility and adaptability that threatened to disrupt established firms across multiple industries.

Despite rising demand for smart solutions, however, smart products had proven hard to develop and manufacture. They often required participation by external partners, and collaboration between these disparate stakeholders was difficult as most ecosystems could not be governed hierarchically. For example, when Amazon first marketed Kindle e-readers in 2007, it faced resistance from publishers. To overcome the resistance, not only did Amazon provide financial subsidies and incentives, it also developed a novel security feature to ensure that e-books on the Kindle could not be easily duplicated and shared, allaying publisher concerns about intellectual property theft.[2]

Pursuing an Ecosystem Brand Strategy at Haier

From 2014, top managers at Haier saw the potential for an "ecosystem brand" strategy in the home appliances business. As Yong Wu put it:

> "As early as 2014, Haier started to think about transforming the traditional home appliances business into an ecosystem or platform. In 2015, we saw the phenomenon of smartphones and other smart appliances, and the direction of IoT and mobile internet was clear… Because IoT is about the connections between one appliance and other things, we started to explore what can form the basis of connection between home appliances."

Zhang Ruimin, chairman of the board and CEO of Haier Group, proposed to turn Haier's electrical appliances into networked devices that created "smart home solutions" centered around the needs of users. Employees were encouraged to integrate the internet and IoT into every product that Haier made. Over the next few years, the company recruited more software developers to 'software-ize' traditional home appliances, creating smart products that could connect through Wi-Fi or Bluetooth to other devices.

One example of a successful ecosystem that fulfilled Haier's vision was their Community Laundry business. This business was built on over forty thousand internet-connected washing machines across a thousand Chinese college campuses. Students could schedule and pay for the machines via a smart phone app. Haier built a platform that connected the 10 million users of the app with other relevant businesses, such as food delivery companies and dorm room furniture sellers. Haier took a share of revenues for every purchase on the platform.[3]

In October 2020, Haier unveiled a new brand called the "Three-winged bird" that sought to capture all of the company's smart product ecosystems under a single brand umbrella. These included, for example, smart products to personalize and synchronize the working of appliances to specific user behaviors, such as taking a nap. In this case, the user's voice activated three appliances– the electric curtain, the air conditioner and the humidifier– to create an environment conducive for napping (by raising the room temperature, closing the curtain, and increasing ambient humidity). The appliances also interacted and adjusted to each other in unison: the air conditioner and the humidifier adjusted their power levels depending on whether the curtains were closed or open. In addition to hardware devices working in concert, Haier's vision was to integrate other applications and e-commerce storefronts: imagine a smart mirror that could show and recommend new outfits and direct customers to clothing retailers' websites where they could purchase the items with one click.

In the first three quarters of 2020, Haier sold 687,000 smart home solutions, each consisting of multiple connected home appliances, other products and services, for a total of 7.2 billion RMB (1.11 billion USD in 2020), representing 25% year-over-year growth.

History of *Rendanheyi*: Haier's Unique Organizing Model

As of 2005, Haier's organizing model, rendanheyi (meaning "what is valued most by the customer is compensated best") was guided by the principle of "human value maximization". This involved motivating all employees "to be their own CEO", to aim for "zero distance to users", and to create an

Exhibit 2 Illustration of the Three-Winged Bird "scenario brand"

Source: Haier Group

ecosystem based on "co-creation and win-win". Although the principle had been consistently applied over the previous two decades, how it was manifested had evolved enormously.

2005-13 Market chain & ZZJYTs

Inspired by Michael Porter's value-chain concept, the first iteration of *rendanheyi* organized the business into "market chains" of strategic business units. Within a given market chain, goods and services were traded and transacted as if on the open market. The goal was to bring more entrepreneurial energy and market-based dynamics into the organization.

As a result of tensions that arose with turning collaboration into internal transactions and the desire that more teams be market-facing, there was a move towards a team-based structure, called Zi Zhu Jing Ying Ti (meaning "independent operating units") or ZZJYT. The 2,000+ ZZJYT units were organized into three tiers. Tier-1 consisted of marketing, product and manufacturing units performing core activities. Tier-2 delivered support services such as logistics, HR, IT, R&D and finance, and were intended to support Tier-1. Tier-3 provided the other ZZJYT units with strategic direction.

ZZJYT units were given the power to make their own decisions, essentially operating as mini start-ups. This radical change attracted employees who could sense entrepreneurial opportunity. In addition, it created an internal labor market where individuals bid for work from various ZZJYT units, mimicking the external labor market. As part of this change, 12,000 middle management jobs were eliminated–those managers either had to find a new role or leave.

However, after experimenting with variations of ZZJYT units, it became apparent that the Tier-1 units lacked the decision power to allocate the technical and financial resources to bring new products and services to market, and that the incentives were too weak to promote the type of entrepreneurial activity and risk taking envisioned.

2013-19 Platforms & MEs

To resolve weaknesses in the ZZJYT model, Haier restructured its 2,000 ZZJYT units into 4,000 micro-enterprises (MEs). There were 200 "user MEs" that were in direct contact with end-customers, and 3,800 "node MEs" that provided the user MEs with services and products via a competitive internal market system.

Each ME—both user and node MEs —comprised ten to fifteen employees and operated like a stand-alone enterprise, with its own balance sheet, own P&L, and lifespan (an ME could cease to exist if it underperformed for a prolonged period). It had the authority to develop and market their products and services–to be paid for by other (node) MEs or by end users. MEs could decide which other MEs to collaborate with, which staff to hire, and how to distribute rewards and set compensation. User MEs were free to procure resources from external partners when they felt that internal (node) MEs could not meet their needs.

The shift to MEs turned Haier into a network of loosely connected autonomous units, each with the authority to act in its own interest, reproducing the competitive dynamics of a marketplace. They were grouped by market segment into 20 or so platforms, whose role was to incubate new MEs, provide the necessary resources, create a system of internal contracting between MEs, establish "presets" or rules of engagement, and diffuse best practices.

This internal contracting system was not without tensions, as each ME's income was based on the performance of the unit - not the performance of the MEs they collaborated with, nor the larger platform they were part of. This incentivized MEs to focus on their own profits and performance even when it came at the expense of the company as a whole.

The tensions became more apparent when Haier saw a shift in customer demand towards "smart" products and services. MEs were encouraged to evolve their business model from selling standalone hardware products to one-time customers to building ecosystems around smart products and services that could generate recurring revenues from engaged, active users. The development of smart products and services required new levels of collaboration amongst MEs that had become accustomed to operating independently. To accommodate this new strategic focus, Haier again adapted its organizing model.

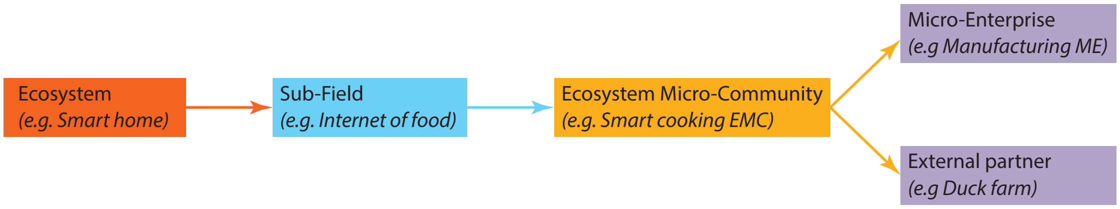
Evolving *Rendanheyi* to Deliver Smart Ecosystem Brands: Ecosystem Micro-Communities (EMC)

Initiated in 2019, the next evolution of the *rendanheyi* model was designed to facilitate Haier's transition from a traditional appliance manufacturer to an ecosystem that delivered smart products and services. To accomplish this, Haier introduced ecosystem micro-communities, or EMCs. Whereas platforms in the previous iteration of *rendanheyi* were collections of MEs grouped according to common product lines without any integration between them, EMCs were coordinated networks of MEs and external partners that worked collaboratively. Haier's new organization structure was built around EMCs that grouped into sub-fields, then ecosystems (see Exhibit 3).

EMC Case Study: The Peking Roast Duck Project

An early example of an EMC was the Smart Cooking EMC and its Peking Roast Duck Project. The leader, Yu Zhang, had worked for Haier for over 10 years before he took the reins of the Smart Cooking EMC: three years as a sales representative, five years working on Haier's high- end brand Casarte, then two years launching the similarly named Smart Kitchen ME. As ME leader, Zhang's vision was sparked by the nationwide lockdown in the early months of the COVID-19 pandemic when restaurants shut down. In the same way that many high-quality restaurants purchased "semi-finished" dishes

Exhibit 3 Conceptual Representation of Haier's Organizational Structure



Sources: A. K. Walker, 2005, Coca-Cola zeros in on growing no-calorie soda market, *Nashua Telegraph,* July 17, www.nashuatelegraph.com

and used professional equipment to finish the dishes presented to restaurant diners, he believed that Haier could offer a similar service to its customers to help them create restaurant-quality food at home.

Along with other employees, Zhang proposed the creation of the Smart Cooking EMC, which he officially registered on Haier's digital platform in April 2020. Their first product, Peking Roast Duck, was one of China's most famous dishes and consisted of slices of tender roast duck with crispy skin inside a thin crepe, with hoisin sauce, green onions and other condiments. Historical evidence of Peking Duck goes back to the Southern and Northern dynasties (420-589 AD), and it was first recorded at the imperial court during the Yuan dynasty (1271-1368) in the form of a recipe written by a royal physician which called for intricate preparation, including roasting the duck inside a sheep's stomach. By the Qing dynasty (1644-1912) it was consumed by the nobility and praised by scholars and poets.

It is made from white ducks raised in a free-range environment for 45 days, force-fed for 15 to 20 days to fatten them, then slaughtered and boiled. To enable the skin to crisp during the roasting process, air is pumped under the ducks' skin so that it separates from the fat. The ducks are then hung to dry and coated with maltose syrup to further enhance the crispiness of the skin, then roasted in either a traditional closed oven or smoked over a wood fire.

Given its complex preparation, Peking Roast Duck was viewed in China as a dish only for special occasions and meant going out to a fancy restaurant. Mingkai Yu, a member of the Smart Cooking EMC explained,

> All Chinese people think 'If we want to eat Peking Duck we need to go to some famous restaurant.' Even for elderly people, though it may be difficult for them to move from one place to another, they have to go [to the restaurant], because if you take home Peking Duck the taste of it will change.

Peking Duck was a powerful symbol of what the EMC hoped to achieve: a way for ordinary people to cook restaurant-quality dishes at home. If they could enable this, they could carve out a niche in the market. The complexity of the recipe, however, presented several challenges. For example, they had to identify a partner to source the specialty ducks, called *tián yā*, which are raised on only a few farms in China. Special packaging was needed to ensure the ducks were still fresh after transportation and storage. Once delivered to the customer's home, ducks had to be stored at a precise temperature to maintain freshness. They needed chefs to provide the recipe for preparing the duck, and customers required a programmable oven so the ducks could be roasted at the touch of a button (see Exhibit 4). Mingkai Yu explained the different partners with which EMC had to collaborate:

> The challenge is because we need to design the whole process from the ducks, the farms, the factories, and the cook's recipes to the IoT appliances and the cooking … We knew we could not do it alone because Peking Duck is a very complex dish and it involves a lot of special expertise. Therefore we need to work together with different teams. Inside Haier we can find MEs who are doing ovens or kitchen appliances or some MEs specialized in electronic control ... I'm in charge of IoT appliances and can do this part. But beside these parts, we still need to work together with external partners. For example, we outsourced the packaging work to a Chengdu-based company, and we also reached out to some professional cooks who worked in Beijing to cook Peking Duck … Among the cooks there is the ninth successor of the Restaurant, Quanjude, which is the most famous Peking Duck restaurant in China.

To coordinate activity across the various partner nodes (both internal and external), Zhang utilized an "EMC contract" that specified what was to be delivered by the partner, by when, and what the compensation or profit-sharing arrangement would be:

> For example, 10% of the profits will go to the cooks who sell the recipe to us … For the farms who sell ducks to us … before they were B2B, now they need to change to B2C, they need special packaging for home use, etc, and we also will negotiate a percentage of profit sharing with them, for example another 10% or 20% . I won't go into details on this because it's kind of a business secret. But at the end of the day, we can get 50 Renminbi by selling one duck,. We will use 30% of the profit for profit sharing among all internal MEs of Haier … the other 70% of the profit will go to the sub-field or go to the whole company,

Exhibit 4 Example of a Peking Duck oven

Source: Haier Group

and the company or the sub-field will use it as the bonus at the end of the year.

The EMC contracts were updated on a monthly basis to reflect contribution and changing work needs:

"For example, if you are a developer and this month you spent a lot of time developing a new recipe or programming a new recipe, your share will increase, it will be high this month. But next month, maybe you don't do a lot of work and your share will decrease."

Very little start-up capital was needed for the EMC. Partners were not guaranteed compensation. Incentives were based purely on the potential for future profits. Based on the initial assessment of the market opportunity and team capacity, Zhang's EMC was awarded several hundred thousand RMB of "value-added sharing space", basically a guaranteed profit- sharing pool if the EMC met its initial volume and revenue targets. The size of the pool attracted other MEs to bid for the goals set by Zhang. Ultimately, Zhang's EMC contracted with 11 nodes (internal and external) to help develop the product, including the Steaming Oven ME, the Food Materials ME, the Internet of Things Payment Scenario Interaction ME, the Finance ME, the Human Resources ME, and the User Interaction ME. In addition, 42 regional marketing centers joined the EMC.

The Smart Cooking EMC launched the Peking Roast Duck product—an integrated experience combining the packaged duck, smart oven, and phone app–for market testing in October 2020, a few months after conceiving the idea (see Exhibit 5). After tweaking the offering based on user feedback, they launched on the Haier Smart Home app. Samples were sent to more than 3,000 Haier stores for sale. In the first month, they sold 20,000 ducks and generated revenues of several million RMB, twice the original target. Chef Zhang Weili, who led the development of the recipe, cooking process and instructions earned several thousand RMB from profit sharing in the initial months after launch.

Even as the Smart Cooking EMC was launching the Peking Duck product, they were already reaching out to external investors, planning to spin off the EMC as an independent company - a process called "upgrading". For the EMC, it enabled access to outside capital and the potential for higher payouts. For Haier, it helped ensure strategic alignment by spinning off entities that were not core to its strategy while still sharing in their upside growth potential. Zhang explained:

Now, we are trying to establish an independent legal entity, and yes there is a committee inside Haier to make decisions in making investments. We will also attract some external VCs to invest in our MEs, and Haier will also make investments. Haier will establish a panel or a committee composed of our H.R. departments, legal department, financial department, and the strategy department and I will do a roadshow to the committee as the founder of the company

In the future our business will focus on selling dishes or selling a solution, how to cook a dish including the semi-finished products and the ingredients–all of these things … And this is not the main business of Haier Group, so we will become an independent legal entity separate from Haier …You can deem it as kind of an IPO, and Haier will be my shareholder. I won't be affiliated to Haier; we will become kind of a relationship between shareholders.

Exhibit 5 Example of Marketing Material for Haier's Peking Duck Project

Source: Haier Group

Based on its early success, the Smart Cooking EMC successfully spun off as an independent company. In November 2020, Zhang mortgaged his house and then invested over 1 million RMB (154k USD) in the new company. Together with 10 other EMC members they invested a total of over 2 million RMB (324k USD) in their own start-up.

Thereafter, the Smart Cooking EMC expanded its offerings by developing 16 new dishes with regional characteristics from around China, such as Beijing, Shandong, Fujian, Guangdong, and Sichuan.

EMCs as connectors of nodes

As illustrated by the example of the Smart Cooking EMC, EMCs were temporary structures that connected various internal MEs as well as external partners. They enabled Haier to bring various stakeholders together quickly and flexibly to collaborate on a new product or service. In contrast to MEs which were relatively stable, EMCs were highly dynamic. One EMC leader in the IoF sub-field explained:

> I think of EMCs as more like a connector, and MEs as more likely to meet a single demand or to have a single function. For example, any small team inside Haier can be an ME. An ME has a single function to meet, a single need from the user or from anybody inside Haier. But an EMC is kind of a connector. For example, my EMC connects over 20 nodes, they are 20 MEs, and we connect indirectly to 60 nodes and even more MEs, so this way we are a connector or coordinator of different resources.

An EMC could be created in a planned manner or more organically. For example, the IoF sub- field of which the Smart Cooking EMC was a part had seven different

EMCs. Five were initiated in a planned fashion. Other EMCs emerged more organically in response to customer feedback and as the vision evolved in response to new data. An EMC leader in the IoF sub- field, Hang Sun, recalled the origin and evolution of the seven EMCs:

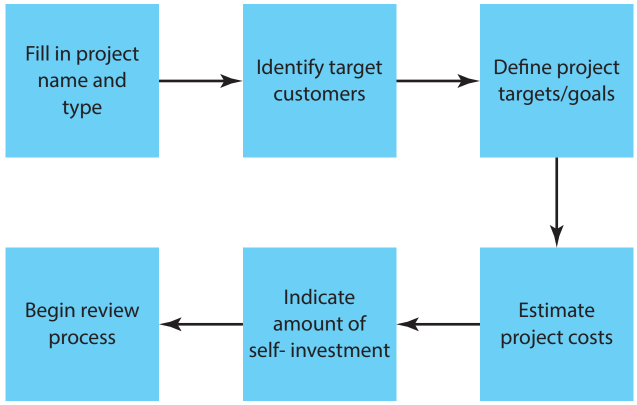
> [A]t the beginning we studied people's behavior related to a kitchen. No matter if you are poor or rich, healthy or not healthy, if you have a kitchen you must carry out the following actions: eating, buying food, storage, cooking, washing. And so these are the five EMCs we created or designed in a planned manner.
>
> Regarding the EMC of Kitchen Renovation and the Mother and Infant, these two EMCs were created in an emerging manner. Another example which is a mixture of both methods, is the EMC of Smart Cooking. Originally we wanted to develop it into an educational platform where we could do some offline or offsite education and teach you how to cook a dish. However, we received a lot of opinions and feedback from our colleagues, and, eventually, we made it an EMC to help customers fully accomplish the task of making dishes from semi-finished food.

Like the Smart Cooking EMC, which addressed the problem of making restaurant quality dishes at home, each of these EMCs aimed to build solutions that were complex and required integration across a variety of internal and external partners. For example, the EMC for Kitchen Renovation sought to address the widespread problem of small, antiquated kitchens by creating a service that would allow households to renovate and modernize their kitchen in three days. The ambitious vision required Haier to martial expertise both across Haier and outside the company.

Process of Creating an EMC and Attracting Bids to Participate

To create an EMC, formal evaluation and approval were required. Anybody could propose an EMC by submitting the long-term vision, an estimate of the resources required and the potential profit to an internal committee called the Great Shared Platform that comprised members of HR, legal, finance and others. Upon approval, the EMC was formally registered on Haier's internal digital platform, the "Workbench" (see Exhibit 6).

Exhibit 6 Procedures to Initiate an EMC Contract



Source: Based on internal company documents and interviews

Once registered, an EMC could start to attract resources and partners to achieve its vision by sharing its goals via the Workbench that others in the company competed for and bade on. Setting the right goals was an important and non-trivial part of the exercise. They needed to be specific enough so that the EMC leader and the Great Shared Platform could evaluate competing bidders, as Yu Zhang explained:

> I think the leader of an EMC is very important. Not everybody can be the leader of an EMC … Our work is kind of art. We need to make a specific reasonable achievable goal, which can also separate or select the best solution provider. For example, I cannot tell all of my MEs, "Who can design a machine which can make dumplings?" ... The oven producer can tell me 'I can do this and my cost is 10,000 Renminbi,' and the manufacturer of a pen can also tell me 'I can also do this and my cost is only 500 Renminbi,' so how can I decide? I need to make the demand or the need very specific so that I can select the best one.

Any individual or ME could bid on goals on the Workbench. To attract bidders, the vision and profit potential of the opportunity needed to be compelling. If an EMC struggled to attract bidders, it might indicate that the goal was unreasonable, the broader vision needed to be revisited, or that the EMC needed to look for external partners.

The bidding process was open to all. Senior leaders could also bid for roles in EMCs working alongside individuals who were junior to them. For instance, Hang Sun bid on goals from other EMCs. He explained:

> I also compete for the goals created by other EMCs or the EMCs under the framework of IoF. For example, sometimes an EMC will create a goal regarding R&D, regarding operations, regarding marketing or regarding some other views, and sometimes I take part in these EMC goals competing for a role in these opportunities. Because we don't have a bureaucratic system in Haier and … I think everybody who is able should take part in their role. In this way, I also want to take part in other EMC contacts so I can also share the profits in the future.

Sun acknowledged that sometimes individuals he worked with in an operating role in an EMC might view him as the boss. He explained:

> In my EMC all the people are of the same age and some of them are younger than me. Some of them were born in the 1990s and Chinese people born in the 1990s are very active in their mind. I never try to overrule them,

> I never try to suppress them, suppress their ideas. I always encourage discussion. And yes, there are some people who defer to me or think I'm the boss and they need to follow my instructions or my orders, but normally those are newcomers. As they spend more time here, they will know that they can talk very openly with me.

EMCs were able to quickly form and disband. Most EMCs had very few full-time employees dedicated exclusively to the work of the EMC. Most individuals working on a given EMC were also members of established MEs that paid their base salary. Compensation for EMC-related work typically came in the form of claims on future profits. Product development cycles were very short–many took just weeks or months from concept to launch. If EMCs were not successful in the market, workers lost interest and the EMCs disbanded.

The EMC Contract

The EMC contract was the key coordinating mechanism between EMC partners. In addition to specifying responsibilities, deadlines and profit-sharing arrangements, it was updated according to work needs. EMC contracts, including the profit-sharing percentages, were built on blockchain technology and were transparent to everyone in the EMC via the Workbench. A member of the Smart Cooking EMC explained:

> Mr. Zhang [the leader of the Smart Cooking EMC] has a requirement for all the MEs, for example, that by the end of next month we need to finish the programming of a recipe in a new device, a new oven. Mr. Lee applied and he got this task, so he needs to upload this task to his dashboard in the Workbench so that everybody can see that he has this responsibility. They will sign an EMC contract (Mr. Lee and Mr. Zhang) ... that by the end of next month you need to finish the programming of this new recipe in this new device. If you make it correctly, you can get a share of the profits, and if not you cannot get this profit. So everything will go following the contents of this contract.

The goals, targets, and compensation arrangements of each EMC contract were decided by the EMC leader and the Great Shared Platform but were the result of discussion between the EMC leader, other staff members, and the partners. The EMC leader needed to continually manage and negotiate with partner nodes to ensure that people were aligned and felt fairly compensated. This required the ability to effectively communicate the "why" behind profit sharing percentages. Yong Wu explained:

> The discussion process is very open and public and fair, and we adjust the profit- sharing mechanism once a month. For example, this month if you're not very happy with your share, you just tell me and the next month, if I think it is unfair for you, maybe I will compensate you with another bonus or another profit. So up to now I haven't had any problems with the profit sharing making anybody not very happy.

In addition, partners contracting with an EMC could contract with other MEs inside Haier to support the completion of their contracted work. For example, the Smart Cooking EMC contracted with the Smart Kitchen ME (focused on transforming traditional home appliances into networked appliances) to deliver a camera inside the oven that could determine when a food item was cooked. To facilitate this, the ME worked with a separate Artificial Intelligence ME inside Haier to help with the image-processing capabilities needed to accomplish this goal.

EMC contracts were also used with external partners. For example, with the Peking Roast Duck project, the EMC needed to contract with duck farms, specifying the volume of ducks, the packaging needed, and the share of profits.

To negotiate, establish, enforce, and periodically update contracts between the different partners in an EMC required communication and coordination. This meant a lot of meetings. A member of the Smart Cooking EMC, Tang Ying, described a typical working day:

> In the morning we will identify all the projects we need to drive for the day and what are the departments or teams involved and what the gaps are, and what kind of support we need, resources we need to drive these projects forward, and there's a lot of communication, a lot of meetings going on. And at the end of the day we will look at the progress we have made and the problems we still have and what are the things that we need to communicate with other departments, so there's a lot of meetings and communication going on during the day.

Looking Ahead

As Yong Wu surveyed the landscape, he was convinced that Haier's strategy of pursuing an ecosystem brand strategy was the right one. Early returns on the most recent evolution of the *rendanheyi* model–and the EMC structure–were positive and indicated that it was enabling the type of complex collaborations needed to deliver smart products and services. However, like earlier shifts in the *rendanheyi* model, the EMC model was not without its own challenges. One was how to harness the market-based entrepreneurial forces at the root of the model to align with the company's direction. While individuals and MEs had decision- making authority and the autonomy to pursue any entrepreneurial opportunities they judged valuable, these had to be sufficiently coordinated with the strategic direction of the broader organization. Yong Wu explained:

> [At the level of the leadership of the company] we need to make sure that MEs can compete, but the direction they are competing must align with the strategic direction of the company, for example to develop home appliance solutions instead of competing towards other goals.

Competition between MEs for various EMC goals could only exist when there were multiple buyers and sellers in the internal market and when MEs had the slack to take on additional projects. How to allow for enough but not too much slack was an ongoing concern. Yong Wu described the delicate balancing act:

> As leaders in Haier we also consider how to make sure that MEs are not doing the same thing, because ... that means there's a waste of time and input. For example, maybe only one solution will be used and other solutions won't be used–this will be a waste.

Haier generally relied on market forces to strike this balance. If an ME was not able to deliver competitive products or services to the EMC it was eventually phased out. But some wondered whether Haier should have greater oversight to shape the composition of the ME portfolio and ensure alignment between EMCs and corporate strategy. Centralized oversight was applied only at the formation stage of the EMC, which had to be approved by the Great Shared Platform, but should Haier include additional touchpoints, perhaps through an annual strategic review process? To manage slack resources, should Haier more actively monitor the performance of MEs and take the initiative to phase out the low-performing ones and spur new ones where there was greater demand and greater fit with the overall portfolio of MEs at Haier?

The *rendanheyi* model relied on the entrepreneurial behavior and capabilities of individuals to be successful. For those with big dreams and entrepreneurial drive, Haier's system presented an abundance of opportunities, but not everyone was cut out for it. Yu Zhang reflected on how Haier's system was good for some but not others.

> I think now Haier has such a good platform to encourage everybody to create their own business to be an entrepreneur of their start-up. It's a very good opportunity for me, it can help me realize my dream. But I think this mechanism is kind of a double- edged sword. If you are a passive person, you don't want to start your business, maybe you will be phased out of this mechanism quickly. But if you have a big dream and you are an entrepreneur, Haier's system can help you grow up rapidly.

The compensation structure at Haier provided low base pay, equivalent to the minimum wage of the province in which the company was based. To supplement this, Haier provided upside potential through numerous profit-sharing mechanisms. Individuals could receive high financial rewards for their efforts, but this was dependent on the performance of the MEs and EMCs of which they were a part. On average, about 40% of an employee's pay came from guaranteed wages, while 60% came from profit sharing. In addition, Haier's entrepreneurial system promoted a culture of high motivation and intense work demands. Acting as an entrepreneur entailed high workloads and work intensity, and could be overwhelming for some.

How to strike the right balance between unleashing the entrepreneurial drive and risk taking of its employees and providing sufficient predictable income for all its employees? What percent of an average employee's compensation should be guaranteed? It was 40% now, but should it be higher? What would be the trade-offs of doing so?

As Yong Wu considered these questions, he realized that Haier had to remain vigilant and continue to adapt its organizing model to fit an evolving strategy and emergent tensions. He wondered what recommendations to make in the group strategy meeting on how to adapt and refine the model in light of the questions and tensions he had observed.

Notes

1. *Source: 2020 Annual Report of Haier Smart Home Co., Ltd*
2. For more information on the e-book example, see "Wide Lens" by Ron Adner.
3. From "Humanocracy" (2021) by Gary Hamel and Michele Zanini

Case 8

The Hershey Company: Broken Pledge to Stop Using Child Labour[1]

In 2017, Michele Buck made history: she became the first woman president and chief executive officer (CEO) of the Hershey Company (Hershey),[2] a leading chocolate manufacturer in the US$98.2-billion[3] global chocolate confectionery market.[4] Two years later, she added "chairman" to her title.[5] The company's website, however, emphasized that as the chairman of the board and the 12th president and CEO, Buck had "two important roles—mom and business leader."[6] Indeed, she had three children,[7] and she was one of a clear minority of women leaders of Fortune 500 companies—41 out of 500 leaders were women in 2021.[8] Altogether, Buck had a notably impressive professional track record.

The company's record was not as sterling. Hershey ranked fourth-to-last behind Mars Incorporated (Mars), Nestlé SA, and Lindt & Sprüngli AG on Green America's 2019 Chocolate Company Scorecard (see Exhibit 1).[9] Although Hershey's quest was "to bring goodness to the world,"[10] the company had broken its 2001 pledge to eradicate "the worst forms of child labour" and "uproot child labor from its cocoa supply chain," according to a 2019 article in *The Washington Post*.[11]

Child labour was considered a global human rights challenge affecting 152 million children. The United Nations had set a Sustainable Development Goal (goal 8.7) to eradicate child labour "in all its forms" by 2025.[12] Pressure for greater supply-chain transparency and compliance with human rights had also increased in Europe and the United States in 2020 when with the *Slave-Free Business Certification Act* was introduced to US Congress.[13] If passed, companies in violation of the Act could be liable for $500 million in punitive damages.[14] In addition, on February 12, 2021, Hershey became one of seven defendants in an unprecedented US federal class-action lawsuit filed by International Rights Advocates on behalf of eight Malians "trafficked as children and forced to harvest cocoa in Côte d'Ivoire."[15]

An annual shareholders' meeting was set for May 17, 2021,[16] and Buck had to decide how to address these challenges since they pertained to the company's reputation, its core business model, and its corporate social responsibility.

Company Origins

The origins of Hershey dated back to the 1880s, when Milton S. Hershey founded the Lancaster Caramel Company in Lancaster, Pennsylvania (PA), United States. Inspired by the German chocolate-making machines featured at the 1893 World's Columbian Exposition in Chicago, Milton decided to enter the chocolate business the following year and founded the Hershey Company. By 1900, the chocolate business was doing so well that Milton sold his caramel company to focus on the mass manufacture of chocolate bars, building a plant in 1903 in Derry Township, PA (later renamed Hershey, PA), which became the largest chocolate manufacturing facility in the world at that time. Under his leadership, several innovative products were marketed, including Kisses (1907); Milk Chocolate with Almonds (1908); Mr. Goodbar, made with peanuts (1925); Krackel, made with crisped rice (1938); and Field Ration D, an emergency nutrition bar, which did not melt in tropical heat, to support the efforts of World War II.[17]

Following the war and Milton's death, the company grew through strategic acquisitions. For example, it acquired the manufacturer of Reese's Peanut Butter Cups and two pasta companies in the 1960s. Strategic acquisitions continued throughout the 1980s, including the purchase of the American operations of Cadbury Schweppes, which made Hershey the US manufacturer of Cadbury and Peter Paul products. Its diversification into the non-chocolate business also continued, albeit slowly and over a period of almost 25 years. For example, in 1996, Hershey acquired Leaf Brand's North American operation, which owned the Jolly Rancher and Payday brands, and in 2018, it acquired other healthy snack companies, including Amplify Snack Brands, which made SkinnyPop popcorn. Diversification was, however, limited, and Hershey later divested of its pasta business unit.[18]

In 1970, increased competition, particularly from Mars, forced Hershey to advertise to consumers for the first time.[19] This major shift ushered in an era of systematic reputation- and brand-building for Hershey. It was a necessary and notable departure from one of Milton's founding business principles: "Give them quality. That's the best kind of advertising in the world."[20] But implicit advertising through quality

Bertrand Guillotin wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

Exhibit 1 Green America's Chocolate Company Scorecard (2019)

Company	Grade	Labour Certification	Percentage of Cocoa Certified	100 Per Cent by 2020	Beyond Certification	Efforts to End Deforestation
Alter Eco Americas Inc.	A	Fair Trade Certified	100	Achieved	Targeted assistance for farmers	Palm oil-free; through certification; investing in agroforestry
Divine Chocolate Ltd.	A	Fair Trade	100	Achieved	44 per cent owned by the Kuapa Kokoo co-operative	Investing in cocoa farms in Sierra Leone so the farms become climate-friendly and do not hurt the rainforest
Endangered Species Chocolate LLC	A	Fair Trade	100	Achieved	Fully traceable; donates 10 per cent of profits to animals, habitat, and humanity	Through certification
Equal Exchange Co-op	A	Authentic Fair Trade	100	Achieved	Pre-harvest financing program	Matches fair trade and organic requirements; supporting farmers through building land resiliency
Shaman Organic Chocolates	A	Fair Trade Certified and Rainforest Alliance Certified	100	Achieved	100 per cent of profits donated	Through certification
Theo Chocolate Inc.	A	Fair for Life-Fair Trade Certified by IMO	100	Achieved	Negotiates higher prices to be paid to farmers	Investing in reforestation initiative
Tony's Chocolonely	A	Fair Trade	100	Achieved	Traceable cocoa; pays higher price for cocoa; agricultural training; CLMRS	Through certification
The Guittard Chocolate Company	B+	Fair Trade Certified	100	Achieved	Investing in the World Cocoa Foundation's Cocoa Livelihoods Foundation	Cocoa Forest Initiative Signatory; investing in agroforestry projects
Mars Inc.	C+	Fair Trade and Rainforest Alliance Certified	47	Pledged	Income diversifying program	Cocoa Forest Initiative Signatory
Nestlé SA	C+	UTZ Certified	42	Not pledged	CLMRS/cocoa plan	Cocoa Forest Initiative Signatory; no deforestation by 2020 commitment
Lindt & Sprüngli AG	C	Self-verified	86	Pledged	Traceability and verification; CLMRS	Cocoa Forest Initiative Signatory; commitment to no deforestation by 2025
The Hershey Company	C	Fair Trade Certified, UTZ Certified, Rainforest Alliance Certified	80	Pledged	Cocoa for Good: Investing in cocoa communities; CLMRS	Cocoa Forest Initiative Signatory; 72 per cent of farms mapped
Mondelēz International Inc.	D	Cocoa Life Certified	43	Not pledged by 2020 but by 2025	CLMRS	Cocoa Forest Initiative Signatory; mapped 63 per cent of farms, which are all not in priority protected area
Ferrero International SA	D	Fair Trade, UTZ, and Rainforest Alliance Certified	75	Pledged	Child labour education program	Cocoa and Forest Initiative Signatory
Godiva	F	N/A	N/A	Pledged but no update	N/A	Cocoa and Forest Initiative Signatory

Note: CLMRS = Child Labour Monitoring and Remediation System; IMO = Institute for Marketecology. On a scale from A to F, A+ indicates the highest grade, while F indicates failure.

Source: Compiled by the case author from "Child Labor in Your Chocolate? Check Our Chocolate Scorecard," Green America, accessed February 20, 2021, https://www.greenamerica.org/end-child-labor-cocoa/chocolate-scorecard.

and word of mouth ran its course amid the competitive landscape of the early 1970s. In 1973, another shift took place: Hershey stopped the company tours that had started in 1915 and opened Chocolate World, a museum about chocolate with interactive exhibits, in Hershey, PA. Chocolate World expanded domestically into other US cities and internationally in Singapore.[21]

The Founder and his Values

Among the American business titans of his time, Milton stood out as an anomaly. According to Michael D'Antonio, a Pulitzer-prize winning journalist who in his autobiography of Milton wrote, "He was tough-minded but fair. He wanted his workers and their families to live in dignity."[22]

Milton's generosity was grounded in the hard work and skills he had learned as a teenage apprentice of Joseph H. Royer, a confectioner in Lancaster, PA. Equipped with new skills and armed with a $100 loan from his aunt, Milton made the jump to entrepreneur status in 1876, opening his first candy store in Philadelphia, PA. After six years of working day and night to make the candies he was selling himself, Milton became ill and experienced increased debt, forcing him to sell this business.[23] He headed west, learned in Denver the importance of adding fresh milk to candies (it improved their quality and gave them a longer shelf life), opened a candy shop in Chicago (another failure), and then tried his luck in New Orleans—to no avail. Back on the East Coast, in New York, he opened another candy shop, which also failed.[24]

Returning to Lancaster, Milton's relatives refused to take him in or lend him yet more money to start another business. It was an old friend and former employee by the name of Henry Lebkicher, who had briefly worked for Milton in the Philadelphia store, who gave Milton a place to live and paid for him to bring his candy-making equipment back from New York to start Lancaster Caramel Co. Applying the fresh-milk innovation to caramels that he had learned in Denver, Milton created the unique Hershey Crystal A caramels. The quality and shipping stability of these new chewy caramels impressed an English importer so much that he placed an order large enough to enable Hershey to secure a $250,000 loan to build several plants. This was a major turning point, enabling the Lancaster Caramel Co. to spread across the United States and hire 1,300 workers by 1893. The next turning point was Milton's visit to the World's Columbian Exposition in Chicago. His insatiable entrepreneurial spirit combined with the engineering capabilities to mass produce helped him launch Hershey the following year.[25]

Milton died at age 88 in 1945 in Hershey, PA. He had built his business on solid corporate values and a unique corporate structure that included a trust to carry out philanthropic efforts after his death.[26] More than a century after its establishment, the Hershey Trust Company still served as the trustee for the Milton Hershey School (established in 1909), the M.S. Hershey Foundation, and the Hershey Cemetery.[27] The Hershey Trust Company was clear proof of Milton's generosity toward children. Also noteworthy was that the trust kept a minority stake in the company with a majority of the voting rights. While the trust only controlled 9 per cent of the shares, it controlled 80 per cent of Hershey's voting rights.[28] Among Milton's famous quotes, the following epitomized the values on which he had built his legacy: "If we had helped a hundred children it would have all been worthwhile," and "One is only happy in proportion as he makes others feel happy."[29]

The Hershey Company Today

Values

Even after two world wars and more than a century later, Milton's values were still present in the fabric of the company's culture—in its DNA—as offered on the corporate website:

> Rooted in Our Values
>
> Our founder, Milton Hershey, had a vision to make chocolate accessible to everyone. His dedication to creating a better world continues to inspire our mission statement or as we call it, our purpose, of making more moments of goodness.
>
> Our brands and values create a unique place in people's hearts and minds, differentiates our business and inspires our future growth.
>
> We are inspired by our long-standing values of togetherness, integrity, making a difference and excellence. These values make our company a special place to work and can be seen in the daily actions of each of our employees around the world.
>
> Caring for our people and communities, taking care of the planet, helping children succeed and making the best quality, affordable snacks for people everywhere to enjoy have driven us for more than 125 years and will continue to do so.[30]

Portfolio

With a portfolio of more than 80 global brands, Hershey was the number-one chocolate producer in North America. This portfolio included well-known chocolate and candy brands such as Hershey's Kisses, Reese's Peanut Butter Cups, Twizzlers, Mounds and Almond Joy candy bars, York peppermint patties, and Kit Kat wafer bars.[31] Hershey also made grocery goods—including baking products, toppings, sundae syrup, cocoa mix, cookies, snack nuts, breath mints, and bubble gum—and had expanded into popcorn and other savoury snacks.[32]

Hershey's products were sold to a wide range of retail outlets and wholesale distributors in North America and overseas. Approximately one-third of Hershey's products were sold to McLane Company Inc., one of the largest wholesale distributors in the United States. McLane, in turn, distributed Hershey's products to retailers throughout North America, including Walmart Inc. Only about 10 per cent of sales were overseas. Hershey was centered on the US market

Exhibit 2 The Hershey Company Net Income (in US$ '000)

Period Ending	2020-12-31	2019-12-31	2018-12-31	2017-12-31
Total Revenue	8,149,719	7,986,252	7,791,069	7,515,426
Cost of Revenue	4,448,450	4,363,774	4,215,744	4,060,050
Gross Profit	3,701,269	3,622,478	3,575,325	3,455,376
Selected Expenses				
Research and Development	0	0	0	0
Sales, General, and Administrative	1,890,925	1,905,929	1,874,829	1,885,492
Net Income	1,278,708	1,149,692	1,177,562	782,981
Net Income Applicable to Common Shareholders	1,278,708	1,149,692	1,177,562	782,981

Source: Compiled and summarized by the case author from "HSY Financials," Nasdaq, accessed March 5, 2021, https://www.nasdaq.com/market-activity/stocks/hsy/financials.

and enjoyed a 76.4 per cent household penetration rate in the US with 45.2 million people consuming Reese's peanut butter cups. In international markets, the company added regional brands such as Pelon Pelo Rico confectionery products in Mexico, IO-IO snack products in Brazil, and Maha Lacto confectionery products and Jumpin and Sofit beverage products in India.[33]

Marketing Strategy

Hershey's marketing strategy was anchored on strong and valuable brands; product innovation, derived from considerable corporate resources; and the consistently superior quality of its products. The company used a range of advertising and a variety of promotional programs directed toward its customers to stimulate sales of certain products at various times throughout the year.[34] In 2020, the company spent $517 million on advertising expenses.[35]

Overall, the company's vision was "anchored in four interconnected strategies: 1) driving growth by capturing more snacking occasions, 2) profitable and sustainable international expansion, 3) operating with best-in-class capabilities and partnerships, and 4) investing in people and communities.[36] To protect its brands and overall reputation—a key element of its marketing strategy—the company had signed the Cocoa Forest Initiative against deforestation, invested in Cocoa For Good, and earned several fair trade certifications (see Exhibit 1).[37]

Financial Performance

Hershey's marketing strategy had led to solid financial performance. From the time Buck became president and CEO in 2017, Hershey's revenue increased from $7,515 million to $8,149 million in 2020 and net income grew from $782 million to $1,278 million in 2020 (see Exhibit 2).

Hershey's research and development expenses were marginal for the period (see Exhibit 2), but the company did "a lot of consumer research" and innovated with packaging, according to Susanna Zhu, vice-president of the US supply chain operations for Hershey.[38] This lack of spending on research and development confirmed Hershey's reliance on marketing and strategic acquisitions to remain competitive.

Hershey also innovated through its digital transformation, according to Doug Straton, chief digital commerce officer for Hershey, capitalizing on digital consumer insights and increasing the efficiency of both its merchandising ecosystem and overall supply chain.[39] According to Buck, in addition to increased efficiencies, Hershey's focus on digital sales was generating "higher average selling prices in the e-commerce channel rather than in physical retail stores." This phenomenon had led her to conclude that, "for Hershey, search is the new shelf."[40]

The digital transformation, among other factors, had contributed to an increase in cash—from $380 million in 2017 to $1,143 million in 2020 (see Exhibit 3). Such financial performance would have pleased just about any CEO.

The CEO

Born into a working-class family with a father who had started working at age 14, Buck was characterized by one of her favourite recruiters as a "bootstrapper"—someone who was ambitious and eagerly pursued what she desired. She started working at age 12 as a babysitter and continued to work her way through college and graduate school, earning a master of business administration degree from the University of North Carolina. During that program, she discovered "a career that combined my analytic abilities, creativity, and strong interpersonal skills—a career in marketing and brand management."[41]

Buck joined Hershey in 2005 as the company's chief marketing officer, then worked her way up in the hierarchy.[42] Between 2017 and 2020, as CEO, Buck maintained or enhanced the power, value, and reputation of Hershey's brands, which were among the brands most loved by both kids and their parents (see Exhibit 4). Her brand management performance had also contributed to the expansion of the balance sheet's intangible assets category, which more than tripled from $369 million in 2017 to $1,295 million in 2020 (see Exhibit 3). As chairman of the board, president, and CEO, Buck was among five women and ten men who had come from different industries to govern Hershey.[43] She could tap into the bright minds of these seasoned executives, especially in tough situations where the probability of a disaster might have been low but certainly not inexistent.

Exhibit 3 The Hershey Company Balance Sheet (in US$ '000)

Period Ending	2020-12-31	2019-12-31	2018-12-31	2017-12-31
Current Assets				
Cash and Cash Equivalents	1,143,987	493,262	587,998	380,179
Short-Term Investments	0	0	0	0
Net Receivables	615,233	568,509	594,145	588,262
Inventory	964,207	815,251	784,879	752,836
Total Current Assets	2,977,905	2,117,102	2,239,181	2,001,910
Long-Term Assets				
Long-Term Investments	0	0	0	0
Fixed Assets	2,285,255	2,153,139	2,130,294	2,106,697
Goodwill	1,988,215	1,985,955	1,801,103	821,061
Intangible Assets	1,295,214	1,341,166	1,278,292	369,156
Total Assets	9,131,845	8,140,395	7,703,020	5,553,726
Current Liabilities				
Accounts Payable	1,378,875	1,273,121	1,215,250	1,217,086
Short-Term Debt / Current Portion of Long-Term Debt	512,870	735,672	1,203,316	859,457
Other Current Liabilities	0	0	0	0
Total Current Liabilities	1,891,745	2,008,793	2,418,566	2,076,543
Long-Term Debt	4,089,755	3,530,813	3,254,280	2,061,023
Other Liabilities	683,434	655,777	446,048	438,939
Deferred Liability Charges	229,028	200,018	176,860	45,656
Miscellaneous Stocks	3,531	5,772	8,545	16,227
Minority Interest	0	0	0	0
Total Liabilities	6,897,493	6,401,173	6,304,299	4,638,388
Stockholders' Equity				
Total Equity	2,234,352	1,739,222	1,398,721	915,338
Total Liabilities and Equity	9,131,845	8,140,395	7,703,020	5,553,726

Source: Compiled and summarized by the case author from "HSY Financials," Nasdaq, accessed March 5, 2021, https://www.nasdaq.com/market-activity/stocks/hsy/financials.

Exhibit 4 Hershey's Brand Rankings

Ranking Name	Publisher	2020	2019	2018	2017	Average
100-Top Most Powerful Brands	Tenet Partners, CoreBrand Index	8	9	x	2	6
Top 50 Most Valuable Food Brands	Brand Finance	21	22	21	x	21
Global RepTrak 100	Reputation Institute	46	55	67	62	58
The Brand Footprint Global Ranking Top 50	Kantar Worldpanel	x	41	39	44	41
Top 50 Prophet Brand Relevance Index US	Prophet	x	40	43	39	41
US RepTrak 100	Reputation Institute	x	2	6	8	5
Kids' Most Loved Brands	Smarty Pants	x	4	12	4	7
Parents' Most Loved Brands	Smarty Pants	x	5	5	4	5

Note: x = not ranked for that year.
Source: Compiled and summarized by the case author from "Rankings per Brand: Hershey's," RankingTheBrands.com, accessed March 5, 2021, https://www.rankingthebrands.com/Brand-detail.aspx?brandID=600.

From the start, as an astute marketer and brand manager, Buck had focused on the importance of reputation through brands, people, and purpose. In her blog relating to corporate priorities and Hershey's 2018 plan, Buck stated the following regarding iconic brands:

> We are fortunate to work on some of the most beloved brands in the marketplace. Our brand strength is one of the key pillars of our company's reputation [see Exhibit 4]. … We have one of the most trusted and respected corporate brands in America.[44]

On company purpose, she said,

> Sharing Hershey goodness has recently taken a notable new path with last month's launch of Cocoa For Good, a new cocoa sustainability strategy supported with a $500 million investment. Our work in cocoa-growing communities is critical to the long-term health of the cocoa sector and will help bring positive change for cocoa growers, their families and communities.
>
> Additionally, we look forward to updating our environmental strategy and human rights policies this year. We will be working on these important initiatives in partnership with The Ceres Company Network, to improve the sustainability and resiliency in our operations and supply chain.
>
> We have an aggressive business plan in 2018.[45]

As it turned out, Buck was prescient: implementing those priorities and an "aggressive business plan" would be challenging, especially regarding Hershey's global supply chain.

Supply Chain, Societal, and Legal Challenges

Hershey was ranked near the very bottom of Green America's Chocolate Company Scorecard (see Exhibit 1). Its supply chain-related challenges not only included issues with labour certification and efforts to stop deforestation but also included social expectations and beliefs captured in the institutionalized environmental, social, and corporate governance (ESG) initiatives.

In 2020, Hershey did not even make the top-50 list of best ESG companies. In fairness, no other chocolate manufacturer made that list either. However, Procter & Gamble Co., another company with a household name, like Hershey, but one focused on personal care, was ranked 33rd out of 50 companies for its performance against ESG expectations.[46] In 2018, the Edelman Earned Brand study revealed that "64 per cent of consumers around the world now buy on belief, a remarkable increase of thirteen points since 2017. These Belief-Driven Buyers will choose, switch, avoid or boycott a brand based on where it stands on the political or social issues they care about."[47]

Exacerbated by the 2020 worldwide economic shutdowns and higher shipping costs resulting from the COVID-19 pandemic, supply chain challenges were becoming bigger and global. In addition, legal pressures to improve supply chains and to source responsibly had also been increasing. In 2016, the US Congress had "finally made it illegal to buy products made by slaves," closing a loophole that had been in place since the *Tariff Act of 1930*—a loophole that many had conveniently ignored for generations. This landmark piece of legislation, signed by President Barack Obama, was expected to "give enforcement agencies more latitude to investigate companies that operate in industries known for forced and child labor, like the seafood or cocoa industries."[48] This regulatory pressure continued to increase in 2020 as a result of a number of measures: the United Kingdom had its published new guidance on the *Modern Slavery Act 2015*; the European Union introduced mandatory human rights and environmental due diligence legislation; and the United States introduction its *Slave-Free Business Certification Act*,[49] a bipartisan effort intended to impose liabilities of up to $500 million for deliberate violations.[50]

With these legal efforts as a backdrop, Hershey, Mars, and Mondelēz International Inc., three of the top five chocolate manufacturers in the world, imported $437 million worth of cocoa beans from Côte d'Ivoire and $192 million worth from Ghana in 2018.[51] These two countries, known for providing cocoa, the key ingredient for chocolate, accounted for 70 per cent of the world's cocoa production, with leading exports worth $3.6 billion for Côte d'Ivoire and $1.9 billion for Ghana. However, these numbers came at "a steep human cost" for these countries. In Côte d'Ivoire, 600,000 cocoa farmers made approximately $1 each per day and 891,500 children worked in cocoa agriculture. In the same year, Ghana had 800,000 farmers and 708,400 children working in cocoa agriculture.[52] These numbers suggested that the cocoa farms system producing most of the cocoa beans in the world was highly fragmented, with each farmer free to run their farm as desired. Such fragmentation would logically make it costly and difficult to track its participants (the farm workers) in terms of their age, salary, and origin across all farms in a region of the world where many people had been displaced due to war in the region (e.g., Mali).[53]

In addition, the industry had become more secretive in response to reports from organizations like the Food Empowerment Project, a US non-profit organization, about the industry's reliance on child labour, and in some cases, slavery, on West African cocoa farms. The Food Empowerment Project's report described the horrible working conditions and perils for children as young as 10 years of age, who earned less than $2 dollars per day in West Africa. While recognizing that "child slavery on cocoa farms is a difficult issue to fully address because the most serious abuses take place across the world," the report also acknowledged the responsibility of consumers in reducing some of the food industry injustices. Considering chocolate to be a luxury as opposed to a necessity such as fruits and vegetables, the Food Empowerment Project created a list of recommended vegan chocolates that did not source cocoa, and it "encouraged people not to purchase chocolate that is sourced from Western Africa."[54]

Hershey had also become more secretive about how it was obtaining its cocoa beans, according to NBC News—a report in the context of Hershey's dispute with the Coffee and Cocoa Council and the Ghana Cocoa Board. In their letter of November 30, 2020, Hershey was accused of "abuse of the derivatives market to impoverish the West African farmer." That abuse was characterized as "a clear indication of your [Hershey's] intent to avoid the payment of the Living Income Differential [LID]." The LID forced chocolate companies to pay an extra $400 per ton of cocoa beans to alleviate the poverty of three million West African farmers.[55]

Ivorian and Ghanaian cocoa regulators also accused Hershey of being "highly unethical and in conflict with the concept of sustainability," in reference to Hershey's sustainability programs, which aimed to resolve industry problems such as child labour abuses. Further, these regulators threatened to bar Hershey's sustainability programs, which had been a source of pride for Hershey in both countries. Responding to the letter the following day, the company's spokesperson, Jeff Beckman, wrote,

> We don't discuss our cocoa buying strategy. … That said, we have also bought cocoa from other origins around the world as part of our particular bean blend to achieve our unique Hershey's chocolate flavor profile. And we will continue to do so. This long-time practice of sourcing cocoa from around the world should not be conflated with avoiding paying the LID.[56]

Beckman added a warning that if West Africa cut ties with Hershey, the company would no longer be able to help the region's farmers. Beckman also described the company's programs that were geared toward "child labor monitoring and remediation, farmer training, [and] environmental protection" as well as other issues that Hershey had been tackling in earnest.[57]

By December 4, 2020, Hershey had agreed with West African regulators that it would buy beans from West Africa and pay the LID. NBC News concluded,

> The battle sheds light on a decades long problem in an industry riddled with child labor violations. A widely acclaimed documentary the BBC aired in 2000 first revealed just how prevalent the use of child labor had become. Nearly two decades later, a 2018 report about the cocoa industry in Ghana and Ivory Coast, published by the U.S. Labor Department, found that nearly 45 per cent of children living in agricultural households worked in cocoa fields, a total of at least 1.6 million children.[58]

In 2020, US cocoa bean imports increased by 1.2 per cent from 2019 and totalled $5.18 billion.[59] These cocoa beans, coming through the ports of Philadelphia, PA, and Camden, New Jersey—which together accounted for at least 70 per cent of US imports from Côte d'Ivoire and Ghana—were destined for 80 per cent of the processing plants strategically located within a 160-kilometre radius of the Delaware River. These manufacturing facilities would "grind these raw beans into cocoa powder, cocoa butter, and chocolate ingredients to make candy, ice cream, cookies and cakes."[60]

However sweet this process was, supply chain challenges persisted and legal pressures increased, while Hershey still had not honoured its 2001 pledge to stop using child labour. This apparent violation of corporate values was leaving Buck and her company exposed to major risks, such as litigation and reputational damage that could materialize from a boycott of its products on social media. Such a boycott could be devastating, cost Hershey hundreds of millions of dollars, and give an immediate advantage to several of its competitors. A boycott could also force Walmart, Hershey's single largest retailer, to distance itself from the chocolatier.

With a shareholders' meeting pending, Buck, as Hershey's chairman and 12th president and CEO, had to consider how to address the mounting pressures and daunting supply chain challenges. Indeed, these challenges were multi-faceted and impacted the core business model of this 127-year-old iconic American company. Her predecessors had failed in honouring a public–private partnership pledge made in 2001, officially known as the *Harkin–Engel Protocol*, to combat child labour in cocoa-growing communities.[61] The pledge was renewed on September 13, 2010, with government officials from Ghana and Côte d'Ivoire recommitting to the effort with $10 million in new funding from the United States and $7 million (with potential increases of an additional $3 million) from the chocolate and cocoa industry.[62] But still, in 2021, Hershey seemed to be missing the target.

What options were available to Buck to turn the tide and demonstrate not just Hershey's commitment to change, but its ability to make real change? The children in West Africa were dependent on choices made by leading corporate figures like Buck.

Notes

1. This case was written on the basis of published sources only. The interpretations and perspectives presented in this case may not represent those of the Hershey Company or any of its affiliates or any of its employees.
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Case 9

Hilton Worldwide Holdings Inc.

Conrad Hilton bought his first property, the Mobley Hotel, in sleepy Cisco, Texas in 1919 for $5,000. Since those humble beginnings, the Hilton Hotel empire has grown to be one of the largest and most respected global hospitality brands. Hilton's vision is simple and remains true to its founder, Conrad Hilton's aspirations; "to fill the earth with the light and warmth of hospitality."[1] As of 2021, the hotel brand has more than cashed in on Conrad's vision. Hilton operates more than 6,500 properties, across 18 hotel brands that span 119 countries.[2]

Since 2007, Hilton has been led by Christopher Nassetta, a seasoned hospitality industry executive (see Exhibit 1 for top management bios). Nassetta previously held a variety of senior leadership positions at Host Hotels and Resorts, Inc., a real estate investment firm focused on the hotel industry.[3] Under his leadership, Hilton has continued to make great strides. Fortune Magazine has ranked Hilton #2 on its list of the "World's Best Places to Work", and Hilton remains the only hospitality brand on the list. According to Nassetta, "our team members have always been at the heart of our success, and at a time when the light and warmth we share with the world has never been more important, we remain deeply committed to showing them the same hospitality they share with our guests."[4]

Hilton's mission and values not only support this dedication to its team members, but also a dedication to provide a warm experience for the more than 3 billion guests it has welcomed at its properties. According to Hilton, its mission is "to be the most hospitable company in the world – by creating heartfelt experiences for guests, meaningful opportunities for team members, and high value for owners and a positive experience in our communities."[5] Hilton supports its mission through six core values, using an easy to remember acrostic format from their company name, Hilton.

- **Hospitality**: We're passionate about delivering exceptional guest experiences
- **Integrity**: We do the right thing, all the time
- **Leadership**: We're leaders in our industry and in our communities
- **Teamwork**: We're team players in everything we do
- **Owners**: We're the owners of our actions and decisions
- **Now**: We operate with a sense of urgency and discipline[6]

Operational Strategy

Hilton operates in the hotel industry and its portfolio includes a wide array of hospitality experiences, which include "luxury lifestyle properties (Waldorf Astoria Hotels & Resorts, LXR Hotels & Resorts, Conrad Hotels & Resorts, Canopy, Tempo and Motto), full service hotel brands (Signia, Hilton Hotels & Resorts, Curio Collection, DoubleTree, Tapestry Collection and Embassy Suites), service hotel brands (Hilton Garden Inn, Hampton, Tru, Homewood Suites and Home2 Suites), and finally a timeshare brand (Hilton Grand Vacations). Geographically, Hilton operates in three distinct regions: (i) the Americas, (ii) Europe, Middle East, and Africa, and (iii) Asia Pacific. The Americas includes North America, South America, and Central America and represents 72% of Hilton's rooms, although in recent years Hilton has invested to build out its Asia Pacific footprint, especially in China.[7] Hilton's two main business segments are: Management and Franchise and Property Ownership.

Management & Franchise Segment

In 2020, 99% of Hilton's properties and 69% of Hilton's revenues were associated with its Management and Franchise segment. As of December 31, 2020, the Management & Franchise segment included 715 hotels and 5,646 franchised hotels consisting of 990,857 total rooms. The Management and Franchise segment includes all hotels Hilton manages for 3rd party owners and the franchisee hotels that license the "Hilton" brand. As the 3rd party manager of hotels, Hilton is generally responsible for supervising and on-site operations of the property. Hilton performs these services in exchange for management fees. As a franchisor of hotels, Hilton charges fees in exchange for the right to use the "Hilton" brand as well as other proprietary commercial systems such as reservation systems, marketing, and technology services.[8]

From a revenue perspective, Hilton's Management & Franchise segment earns revenue from two main sources: (i) franchise and licensing fees and (ii) base and incentive management fees. Hilton's licensing fees represent revenue earned from licensing the "Hilton" brand. For the right to "use" the Hilton brand, franchisees will pay Hilton fees that include monthly royalty payments, which are based on a percentage of the hotel's monthly gross revenue, and application initiation fees for when new hotels are entered into the system or there is a change of ownership. The base and incentive revenues that Hilton earns through hotel management services represent base fees, which are typically a percentage of the hotel's gross revenue, and an incentive fee, which is based on the hotel's operating profits and usually subject to a certain rate of return for the hotel owner.

Property Ownership Segment

In 2020, less than 1% of Hilton's properties and 26% of revenue were associated with its Property Ownership segment. Hilton's Property Ownership segment as of December 31, 2020 included 61 hotels totaling 19,400 rooms.[9] The revenues Hilton earns from its Property Ownership segment represent fees earned from normal hotel operations, room sales, food and beverage, and other hospitality services.

In recent years, Hilton has invested more heavily in its Management & Franchisee segments as they require less upfront and maintenance capital and offer a higher return compared to new investments in the Property Ownership segment. As previously mentioned, in 2020 Hilton earned 69% of its total revenue from the Management & Franchisee segment and moving forward the company aims to earn ~75% of its revenue from its Management & Franchisee segment.[10]

Growth Strategies

Hilton's "2030 Goals" include developing the Hilton Effect Foundation, which partners with local stakeholders ranging from governments to suppliers to industry leaders to build out Hilton's operational footprint, with the goal of increasing net units available by 397,000 rooms.[11] To do so, Hilton (i) recently completed the Hilton Garden Inn Nequén in Argentina, (ii) is partnering with Resorts World on a $4.3 billion Las Vegas resort, and (iii) is partnering with Country Garden, one of the largest developers in mainland China. Also, Hilton has continued opening new hotels and increasing new rooms despite COVID-19, which resulted in a net unit growth of 5.1% from 2019 to 2020. It's new project pipeline is a key item Hilton repeatedly champions on its investor calls, and its development market share is over three times larger than its main competitors Marriott and IHG.[12]

The company in more recent years has worked to solidify its brand, logos, and patents as it views these as key aspects that differentiate Hilton from competitors and have real meaning for consumers. The firm expects to continue growth via "Dry Deals." Dry deals do not require Hilton to contribute capital and rely on 3rd party investors to take on the associated financial risk while Hilton advises and provides management services during and after the build (i.e., incremental Management & Franchise revenue).

Hilton plans to grow its hotel customer base through continued benefits offered via the Hilton Honors membership. The system was originally created to maintain and reward customers who frequently travel for work, but has been expanded to include all consumers in an effort to increase customer loyalty and capture more of the pent-up post COVID-19 market demand. To further capture demand, Hilton rolled out its "Confirmed Connecting Rooms" program that allows friends and family to book rooms adjacent to each other. This program was designed to make finding adjacent rooms easier and more convenient for clients and was based on customer feedback.

Functional Resource Areas

Marketing

Hilton's marketing strategy is as diverse as the brands that it oversees. In 2019, Hilton led the hospitality industry in US TV advertisement spending, with over $100 million.[13] Overall, Hilton aggressively pursues advertising across all media channels. With so many brands in its portfolio, encompassing luxury lifestyle brands like the *Waldorf Astoria* to service hotel brands like *Hampton Inn*, Hilton pursues both a whole company marketing (enterprise) strategy as well as individual brand strategies. According to Chief Marketing Officer Kelly Smith Kenny, "The enterprise marketing strategy speaks to the broad base of consumers and our loyal customers who are members of Hilton Honors. Strong design targets, brand positioning and brand architecture are the keys to each brand meeting a unique consumer need." If the enterprise strategy is a swimming pool, the individual brand positions within their portfolio are dividers for the "swim lanes." Kenny also commented "all of our marketing strategies are grounded in deep consumer insight and rich data."[14]

For example, before launching its *Canopy by Hilton* brand in China, in addition to using traditional consumer research methods, Hilton also used neuroscience and brain monitoring to better determine actual Chinese consumer preferences. By monitoring brain activity and tracking eye movement, Hilton was able to understand unspoken emotional responses, likes, and dislikes of potential customers. Gary Steffen, Global Head of *Canopy by Hilton*, commented that "Hilton will continue to use human centered design approaches in its offerings to ensure its brand appeals to the evolving tastes and demands of discerning travelers."[15]

In 2019, Hilton launched a new enterprise campaign *Expect Better, Expect Hilton*. This campaign was built on market research showing that most travelers were unsure where they could go to receive the best hotel price or perks.[16] Hilton's *Expect Better, Expect Hilton* campaign introduced a price match guarantee and a series of additional perks like no-cost Wi-Fi, room selection, and digital keys.[17] In 2020, and to address travel concerns related to COVID-19, Hilton launched another enterprise marketing campaign, *To New Memories*. The campaign used heartwarming moments depicting people reconnecting and the new memories they will be able to make with Hilton. According to Mark Wesinstein, Senior Vice President and Global Head of Marketing and Loyalty, "(this campaign) is designed to unlock those possibilities with the assurances of the utmost in hospitality, cleanliness and flexibility Hilton hospitality is known for."[18]

Hilton also offers an award-winning Loyalty Program, *Hilton Honors*. This program allows guests to redeem points earned during stays for goods and services with Hilton and other brands. As such, Hilton has partnerships with over 70 companies for loyalty program perks and redemptions. These partner companies include airlines, rail and rental car companies, credit card providers, Amazon, Lyft, and more. According to Hilton, "the program provides targeted marketing, promotions and customized guest experiences."[19]

Human Capital Management

As of 2020 – across its managed, owned / leased properties, and corporate locations – Hilton employed over 140,000 persons.[20] Hilton believes human capital management is essential to its success as a hospitality company and believes in investing in its employees' enrichment. It has been recognized as the one of the "World's Best Places to Work" by Fortune Magazineand has been ranked as a best place to work more than 100 times by the Great Place to Work Institute. According to Michael Bush, CEO of Great Places to Work, "[Hilton's] employee innovation score is among the best on our list and they re-invent their experience every year.[21]

Unlike many corporations of its size, Hilton offers the same employee benefits to all of its employees, both hourly and salaried.[22] Hilton also invests in its employees' continued education and training. Through *Hilton University,* a global learning system that contains a robust library of learning resources, Hilton allows its employees to curate their own learning experiences and "follow training paths that are best suited for their goals and aspirations".[23] Hilton estimates that its employees spend around 40 hours a year on continuing education and training. In 2017, Hilton furthered its employee enrichment resources by launching *Thrive@Hilton.* This employee initiative emphasizes employee total well-being with a focus on mind, body, and spirit. In addition to offering *Thrive@Hilton* travel benefits, paid time off, parental leave, and education assistance, a hallmark of *Thrive@Hilton* is the *Thrive Sabbatical Program.*[24] This sabbatical allows Hilton team members the opportunity to take a four-week paid sabbatical and $5,000 to "spend time doing what is most meaningful to them".[25]

Hilton had to make significant changes to its human capital structure during the COVID-19 pandemic. In 2020, it instituted organizational changes that reduced global corporate headcount by 30%. Additionally, Hilton was forced to temporarily furlough 60% of its corporate employees. For the employees that remained, Hilton enacted a temporary salary reduction. Corporate employees received between a 10%-20% salary reduction and executive committee members had salaries cut by as much as 50%.[26]

Sustainability

In 2018, Hilton announced its "Travel with Purpose 2030" goals. These goals lay out a commitment to sustainability by doubling investment in social impact and cutting the company's environmental footprint in half by 2030.[27] To accomplish this initiative, Hilton has categorized its environmental impacts into four main focus areas: Energy and Carbon, Water, Waste, and Responsible sourcing.[28] The company is aggressively pursuing targets in these focus areas, and according to Daniela Foster, Senior Director of Responsibility, "the company became the first major hotel company to set approved science-based targets in line with the Paris Climate Agreement to reduce carbon emissions, and will be the first to adopt a global standard for sustainable tourism.".[29] For example, Hilton was the first hotel brand to commit to sending zero soap waste to landfills and currently operates the largest soap recycling operation in the hotel industry. As of 2021 Hilton reported it was "on track" or "making progress" on all of its 2030 goals.[30]

Impact of Covid-19

In 2020, the impact of the COVID-19 pandemic was felt throughout the hospitality industry. As mentioned previously, Hilton had to greatly reduce its global workforce to decrease overall operating costs and preserve liquidity. To assist the impacted employees, Hilton offered severance pay, access to its outplacement service, and extended access to Go Hilton travel discounts and Hilton Honors status.[31] Hilton also distributed $500,000 to its team members and their families to help cover medical expenses, groceries, and childcare for those most impacted by COVID-19. Hilton' trade association also helped advocate for owners and team members regarding the Paycheck Protection Program, tax relief, enhancements to unemployment, and relief from troubled debt.

From a business response perspective, Hilton worked with the Mayo Clinic's Infection Prevention and Control team and implemented "CleanStay" health and safety protocols, which developed social distancing guidelines, signage, and provided PPE to employees. Of these, the Digital Key became a popular feature, which Hilton plans to continue rolling out across its footprint. From a community perspective, Hilton partnered with American Express and Jose Andres World Central Kitchen to provide one million free room nights and 30,000 free meals to medical professionals and front-line workers.

Many 3rd party hotel owners within Hilton's portfolio experienced significant financing difficulties due to the pandemic with lenders and creditors. Hilton itself received a downgrade in its credit rating by S&P Global Ratings from BB+ to BB, with a negative outlook.[32]

Financial Status

Hilton Worldwide Hotels Inc., formerly Hilton Hotels, is a publicly traded New York Stock Exchange entity listed under the ticker symbol "HLT." The company had a market capitalization around $40 billion as of October 2021, with about 2% of shares owned by company insiders and the remaining 98% owned by institutional investors. Blackstone Group held a large stake in the company until 2018, when it decided to exit the hotel chain.

Due to the impacts of the COVID-19 pandemic, Hilton's revenues fell from $3.77 billion in 2019 to $1.6 billion in 2020, and earnings fell from $881 million to a loss of $715 million during the same time frame (see Exhibits 2 and 3). In response to financial distress, Hilton dramatically reduced its operating expenses and tapped the debt capital markets to end 2020 with over $4 billion in current assets. As the effects from COVID-19 began to subside in 2021, Hilton's revenues increased to $2.4 billion, and the company earned $410 million in net income, still not up to pre-COVID levels, but a vast improvement over 2020.

Hilton's External Environment

Hilton's business and operations are primarily impacted by the following drivers: (i) consumer demand / global economic conditions, (ii) changes in technology, and (iii) contracts / relationships with 3rd party owners, franchisees, and developers.[33] Consumer demand for Hilton's services is very closely linked to the general economy. A decrease in global demand / consumer spending quickly and directly impacts the hospitality industry, as consumers are quick to reduce their spending on luxury items or services during times of austerity. Most recently, and as previously discussed, the effects of the COVID-19 pandemic severely impacted Hilton as well as its competitors throughout the industry.

With regard to changes in technology, with the creation and popularity of home sharing / vacation home rentals competitors (i.e.; Airbnb and VRBO), the business model for the traditional hotel industry has been greatly impacted. More and more consumers are switching from traditional hotel chains in favor of Airbnb and VRBO; in fact, through June 2021, Airbnb reported over 83 million customer nights at its locations, and Airbnb and VRBO continue to invest heavily to advertise their brands. Through February 2021, Airbnb and VRBO spent a combined $30 million in advertising.[34]

Finally, contracts and relationships with 3rd party hotel owners, franchisees, and developers also remains a primary consideration and priority for Hilton. Hilton depends on long-term management and franchisee contracts with its 3rd party owners. As previously mentioned, most of Hilton's revenues are from its Management and Franchisee business segment and, going forward, Hilton aims to receive at least 75% of its revenue from this group of customers. If Hilton's relationships with these partners or their financial positions were to deteriorate, the Company's near-term and long-term viability would be significantly impacted.

Industry Competition

Hilton encounters robust competition as a hotel manager, franchisor, owner, and lessee. Hilton properties primarily compete with hotels, resorts, inns, and "other accommodation rental services" owned by local interests to national and international chains. Hilton has identified several key areas through which it competes with other hospitality brands. Most notably, the key areas identified include: "room rate, quality of accommodation, consistency of service, brand reputation, and ability to earn and redeem loyalty program points".[35]

Marriott International, Inc.

Starting out as an A&W Root Beer franchise in Washington D.C. in 1927, founders J. Willard Marriott and his wife Alice eventually shifted their business and opened the first motor hotel in Arlington, Virginia in 1956.[36] Since then, Marriott has become the largest hospitality brand in the world measured by both revenue and reach. It currently operates 30 brands and more than 7,000 properties across 131 countries.[37] At the end of 2020, Marriott had over $10 billion in revenue, compared to $4.3 billion for Hilton during that same period.[38] Like Hilton, Marriott operates a quality tier brand structure that covers Luxury, Premium, and Select tiers.[39]

Marriott made headlines in 2016 when it outbid China's Anbang Insurance Group to acquire Starwood Hotels & Resorts Worldwide, Inc for $13.6 billion.[40] Following the merger, Marriott International owned 1 out of every 15 hotel rooms globally[41].

IHG Hotels & Resorts (IHG)

Forged over time from both Pan American Airways and Bass Brewing, this U.K. based hospitality group owns popular hotel chains such as Holiday Inn, Crowne Plaza, and its flagship Intercontinental Hotels.[42] IHG is the third largest global hospitality brand by revenue, with $2.4 billion in revenue in 2020.[43] IHG oversees 16 brands, 6,000 hotels, and operates in 100 countries.[44]

In 2021, as a result of the COVID-19 pandemic, IHG restructured its portfolio and underwent a brand redesign. Formally known as Intercontinental Hotel Group, it added the descriptor "Hotels and Resorts" and restructured its 16 brands in 4 distinct "collections" to better help guests identify its offerings. The four collections are Luxury and Lifestyle, Premium, Essentials, and Suites. In addition, IHG updated its brand look and feel and changed the name of its loyalty program to be more inclusive of all travelers. According to the company, "With an updated identity, IHG is focused on strengthening perception, how it engages guests, hotel owners and colleagues and better promoting the breadth of its portfolio."[45]

Hyatt

A major player in the global hospitality industry, Hyatt Hotels Corporation earned $2.1 billion in revenue in 2020. While this makes Hyatt the fourth largest within the hospitality group by revenue, comparatively, its revenue was less than half of Hilton's and one-fifth of Marriott's during this same time period. The Chicago based company operates 20 brands and 1,000 hotel properties across 68 countries.[46]

Like its global hospitality competitors, Hyatt structures its brand across different quality tiers; however, according to CEO Mark Hoplamazian, Hyatt is "the only multi brand company focused exclusively on the higher end traveler."[47] As such, Hyatt has pursued a different growth strategy than industry giants like Marriott and Hilton. Hyatt differentiates by promoting health and wellness hospitality experiences and, in 2017, acquired the resort and spa group, Miraval Group, to expand its wellness offerings.[48] Hoplamazian noted that "our research has shown that our guests value wellness in an increasingly intense way."[49]

Airbnb

Envisioned in 2007 in a San Francisco apartment, Airbnb is a tech company that brokers connections between guests looking for places to stay and hosts who have open accommodations.[50] Airbnb does not own any of its locations; instead, it connects travelers with hosts who have homes, apartments, or residences in which they can stay. According to Airbnb, hosts make it "possible for guests to experience the world in a more authentic, connected way."[51] Travelers pay the hosts and Airbnb collects a fee for its services. Most commonly, Airbnb charges a split fee for guests and hosts - hosts pay a service fee of 3% of the total stay and guests pay a service fee of approximately 14% of the booking subtotal.[52]

Since 2007, Airbnb has grown to become a titan and, by many measures, has a larger reach than the largest global hospitality brands. It currently has 5.6 million listings worldwide, 4 million hosts, listings in 220 countries, and has welcomed over 1 billion guests.[53] It is estimated that in 2014, Airbnb reduced total hotel industry profits by 3.7 percent.[54] After its IPO in December 2020, Airbnb had an $86 billion valuation - more than Hilton, Marriott, and IHG combined on the same date.[55]

Other Influences

Hilton operates around the world and markets outside of the U.S. continue to offer new sources of growth, most notably China. Hilton views itself as a "local business that operates at a global level." The company engages on the local, state, and national level throughout its footprint and has a compelling list of benefits it brings to the communities and markets outside of additional jobs. Hilton also focuses on environmental protection / sustainability, fighting for racial justice, combating slavery and human trafficking, and many more initiatives. Hilton wants to enhance its ability to open new hotels throughout the world and in the markets that offer the highest ROI. Hilton supports several lobbying groups, trade associations, and travel associations in the United States and worldwide. In 2020, Hilton spent over $1 million in these lobbying efforts.[56] Hilton's trade associations provide publicity and financial support for various governments. These efforts, along with the additional tax revenue the company provides to the governments where it operates, make Hilton a sought a partner for local and international governments.

Another external influence Hilton contends with is access to credit and capital markets. Lenders are a critical stakeholder upon which Hilton and other hotel operators depend. COVID-19 hurt investor appetites for much of the hotel industry. Securing adequate capital and financing continue to be top priorities for Hilton as it attempts to grow its asset base.

Pressing Strategic Issues

As Hilton continues to build upon Conrad's vision, Mr. Nassetta and his leadership team face several challenges. How can the company best plan to address any future impacts from the COVID-19 pandemic or similar problems? How can Hilton stop the erosion of its market share due to newcomers like Airbnb? Also, what is the best approach to grow in developing markets, especially China? In order to successfully operate for another century, Hilton will need to plan for and address these issues in the near future.

Exhibit 1 Hilton Top Management

Christopher J. Nassetta - *President and Chief Executive Officer.*
Mr. Nassetta joined Hilton in 2007. Prior to joining Hilton, Mr. Nassetta was President and Chief Executive Officer of Host Hotels & Resorts, Inc. Prior to Host Hotels & Resorts, Inc., Mr. Nassetta co-founded Bailey Capital Corporation in 1991, where he was responsible for the operations of the real estate investment and advisory firm. Prior to founding Bailey Capital Corporation, he spent seven years at The Oliver Carr Company, ultimately serving as Chief Development Officer. In this role, he was responsible for all development and related activities for one of the largest commercial real estate companies in the mid-Atlantic region. Mr. Nassetta graduated from the University of Virginia McIntire School of Commerce with a degree in finance. He currently serves on the McIntire School of Commerce Advisory Board.

Kristin Campbell - *Executive Vice President, General Counsel & Chief ESG Officer.*
Ms. Campbell leads Hilton's global legal, compliance, government affairs and corporate responsibility functions, and joined Hilton in June 2011. Ms. Campbell is responsible for corporate governance, regulatory compliance, M&A, commercial transactions, and litigation. Ms. Campbell also oversees Hilton's global environmental, social and corporate governance (ESG) efforts. Prior to joining Hilton, Ms. Campbell was Senior Vice President, General Counsel, and Corporate Secretary for Staples, Inc., an international office products company. Prior to joining Staples, Inc. in 1993, Ms. Campbell worked at law firms Goodwin Proctor and Rackemann, Sawyer & Brewster.

Laura Fuentes - *Executive Vice President and Chief Human Resources Officer.*
Ms. Fuentes joined Hilton in 2013 and has led teams across Human Resources functions including recruiting, diversity & inclusion, learning & leadership development, total rewards, people analytics & strategy and HR Consulting. Most recently, she served as Chief Talent Officer. Prior to joining Hilton, Ms. Fuentes spent 6 years at Capital One Financial in various corporate strategy and Human Resources roles: leading workforce analytics, recruitment, and compensation functions for the organization. Prior to Capital One, she worked at McKinsey & Company. Originally from Spain, Ms. Fuentes holds a B.S. from the University of Virginia, a M.S. in Structural Engineering from the University of Texas at Austin and an M.B.A. from Columbia University.

Kevin Jacobs - *Chief Financial Officer and President, Global Development for Hilton.*
Mr. Jacobs leads Hilton's finance, real estate, development and architecture and construction functions globally and joined the company in 2008 as Senior Vice President, Corporate Strategy; was elected Treasurer in 2009; was appointed Executive Vice President & Chief of Staff in 2012; assumed the role of Chief Financial Officer in 2013; and added the role of President, Global Development in 2020. Prior to Hilton, Mr. Jacobs was Senior Vice President, Mergers & Acquisitions and Treasurer of Fairmont Raffles Hotels International. Prior to Fairmont Raffles, Mr. Jacobs spent seven years with Host Hotels & Resorts, ultimately serving as Vice President, Corporate Strategy & Investor Relations. Prior to Host, Mr. Jacobs had various roles in the Hospitality Consulting Practice of PwC and the Hospitality Valuation Group of Cushman & Wakefield. Mr. Jacobs is a graduate of the Cornell University School of Hotel Administration.

Source: Hilton Worldwide Holdings, Inc. 2021. www.hilton.com/en/corporate/executive-bios/

Exhibit 2 Income Statement*

	12 Months Dec-31-2017	12 Months Dec-31-2018	12 Months Dec-31-2019	12 Months Dec-31-2020	12 Months Dec-31-2021
Revenue	3,299.0	3,570.0	3,665.0	1,527.0	2,365.0
Other Revenue	105.0	98.0	101.0	73.0	79.0
Total Revenue	**3,404.0**	**3,668.0**	**3,766.0**	**1,600.0**	**2,444.0**
Cost of Goods Sold	1,269.0	1,332.0	1,254.0	620.0	679.0
Gross Profit	**2,135.0**	**2,336.0**	**2,512.0**	**980.0**	**1,765.0**
Selling General & Admin Exp.	449.0	454.0	437.0	304.0	390.0
R & D Exp.	—	—	—	—	—
Depreciation & Amort.	336.0	325.0	346.0	331.0	188.0
Other Operating Expense/(Income)	228.0	136.0	149.0	280.0	155.0
Other Operating Exp., Total	**1,013.0**	**915.0**	**932.0**	**915.0**	**733.0**
Operating Income	**1,122.0**	**1,421.0**	**1,580.0**	**65.0**	**1,032.0**
Interest Expense	(351.0)	(371.0)	(414.0)	(429.0)	(397.0)
Net Interest Exp.	(351.0)	(371.0)	(414.0)	(429.0)	(397.0)
Currency Exchange Gains (Loss)	3.0	(11.0)	(2.0)	(27.0)	(7.0)
Other Non-Operating Inc. (Exp.)	39.0	47.0	9.0	(9.0)	(8.0)
EBT Excl. Unusual Items	**813.0**	**1,086.0**	**1,173.0**	**(400.0)**	**636.0**
Restructuring Charges	—	—	—	(218.0)	—
Impairment of Goodwill	—	—	—	(104.0)	—
Gain (Loss) on Sale of Assets	—	—	81.0	—	(7.0)
Asset Writedown	—	—	—	(154.0)	—
Other Unusual Items	(60.0)	(8.0)	(10.0)	(48.0)	(69.0)
EBT Incl. Unusual Items	**753.0**	**1,078.0**	**1,244.0**	**(924.0)**	**560.0**
Income Tax Expense	(336.0)	309.0	358.0	(204.0)	153.0
Earnings from Cont. Ops.	**1,089.0**	**769.0**	**886.0**	**(720.0)**	**407.0**
Minority Int. in Earnings	(5.0)	(5.0)	(5.0)	(5.0)	3.0
Net Income	**1,084.0**	**764.0**	**881.0**	**(715.0)**	**410.0**
Supplemental Items					
General and Administrative Exp.	439.0	443.0	441.0	311.0	405.0
Net Rental Exp.	284.0	367.0	144.0	129.0	125.0

Source of data: Standard & Poor's Global NetAdvantage, Accessed March 18, 2022; figures in millions.

*Note: Does not include "Other revenues from managed and franchised properties" because these revenues and the costs associated with them are not attributable to Hilton stockholders. 10-K statements and business articles may include these other revenues and costs, which means that their figures may be different from what is included here. Inclusion or exclusion of these other items does not change figures in the balance sheet.

Exhibit 3 Balance Sheet

	Dec-31-2017	Dec-31-2018	Dec-31-2019	Dec-31-2020	Dec-31-2021
ASSETS					
Cash and Equivalents	570.0	403.0	538.0	3,218.0	1,427.0
Total Cash & ST Investments	**570.0**	**403.0**	**538.0**	**3,218.0**	**1,427.0**
Accounts Receivable	1,005.0	1,150.0	1,261.0	771.0	1,068.0
Other Receivables	36.0	—	—	—	—
Total Receivables	**1,041.0**	**1,150.0**	**1,261.0**	**771.0**	**1,068.0**
Prepaid Exp.	127.0	160.0	130.0	70.0	89.0
Restricted Cash	100.0	81.0	92.0	45.0	85.0
Other Current Assets	169.0	189.0	72.0	98.0	202.0
Total Current Assets	**2,007.0**	**1,983.0**	**2,093.0**	**4,202.0**	**2,871.0**
Gross Property, Plant & Equipment	803.0	848.0	1,756.0	1,604.0	1,504.0
Accumulated Depreciation	(450.0)	(481.0)	(509.0)	(486.0)	(505.0)
Net Property, Plant & Equipment	**353.0**	**367.0**	**1,247.0**	**1,118.0**	**999.0**
Long-Term Investments	11.0	16.0	—	—	—
Goodwill	5,190.0	5,160.0	5,159.0	5,095.0	5,071.0
Other Intangibles	6,276.0	6,156.0	6,078.0	5,823.0	5,835.0
Deferred Tax Assets, LT	111.0	90.0	100.0	194.0	213.0
Other Long-Term Assets	280.0	223.0	280.0	323.0	452.0
Total Assets	**14,228.0**	13,995.0	14,957.0	16,755.0	15,441.0
LIABILITIES					
Accounts Payable	282.0	283.0	303.0	224.0	274.0
Accrued Exp.	1,756.0	1,431.0	1,448.0	1,175.0	1,645.0
Curr. Port. of LT Debt	46.0	16.0	—	—	—
Curr. Port. of Leases	—	—	170.0	226.0	194.0
Curr. Income Taxes Payable	12.0	—	—	—	—
Unearned Revenue, Current	366.0	350.0	332.0	370.0	350.0
Other Current Liabilities	—	535.0	618.0	436.0	556.0
Total Current Liabilities	**2,462.0**	**2,615.0**	**2,871.0**	**2,431.0**	**3,019.0**
Long-Term Debt	6,323.0	7,041.0	7,785.0	10,317.0	8,599.0
Long-Term Leases	233.0	225.0	1,245.0	1,167.0	1,024.0
Unearned Revenue, Non-Current	829.0	826.0	827.0	1,004.0	896.0
Pension & Other Post-Retire. Benefits	165.0	145.0	134.0	143.0	25.0
Def. Tax Liability, Non-Curr.	931.0	898.0	795.0	649.0	700.0
Other Non-Current Liabilities	1,594.0	1,687.0	1,772.0	2,530.0	1,997.0
Total Liabilities	**12,537.0**	**13,437.0**	**15,429.0**	**18,241.0**	**16,260.0**
Common Stock	3.0	3.0	3.0	3.0	3.0
Additional Paid in Capital	10,298.0	10,372.0	10,489.0	10,552.0	10,720.0
Retained Earnings	(6,981.0)	(6,417.0)	(5,965.0)	(6,732.0)	(6,322.0)
Treasury Stock	(891.0)	(2,625.0)	(4,169.0)	(4,453.0)	(4,443.0)
Comprehensive Inc. and Other	(741.0)	(782.0)	(840.0)	(860.0)	(779.0)
Total Common Equity	**1,688.0**	**551.0**	**(482.0)**	**(1,490.0)**	**(821.0)**
Minority Interest	3.0	7.0	10.0	4.0	2.0
Total Equity	**1,691.0**	**558.0**	**(472.0)**	**(1,486.0)**	**(819.0)**
Total Liabilities and Equity	**14,228.0**	**13,995.0**	**14,957.0**	**16,755.0**	**15,441.0**

Source of data: Standard & Poor's Global NetAdvantage, Accessed March 18, 2022; figures in millions.

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Case 10

Jio and Facebook: Adding Value through an Alliance

At the core of the partnership is the commitment that Mark Zuckerberg and I share for the all-around digital transformation of India and for serving all Indians.

Mukesh Ambani[1]

In April 2020, technology firm Facebook Inc. (Facebook) agreed to buy a minority 9.99 per cent stake,[2] worth US$5.7 billion,[3] in the Indian telecommunications (telecom) company Reliance Jio Infocomm Limited (Jio), controlled by Reliance Industries Limited (RIL). This was the largest investment by a technology company and the largest foreign direct investment in the technology sector in India. RIL's chairperson and managing director, Mukesh Ambani, announced that one of the goals of the Facebook deal was to reduce RIL's debt by 2021. Jio expected to benefit by being able to exploit firm-specific competencies, access new markets, and increase its market presence and user base. The company would also gain access to complementary resources, institutional legitimacy, and organizational capabilities. Firms formed alliances not only for differentiation but also to prevent others from gaining a competitive edge by accumulating more capabilities; how could Jio ensure a co-operative and complementary partnership (despite their differences with Facebook) in order to succeed and set a precedent for future international alliances?

Reliance Industries Limited

In 2020, RIL was a global player in the integrated energy value chain, and it had a growing presence in retail and digital services in India. It operated through six reportable business streams: refining, petrochemicals, oil, gas, organized retail, and digital services. It was the largest publicly traded company in India in terms of market capitalization and the largest private-sector organization in India. On October 18, 2007, RIL became the first Indian company to have a market capitalization in excess of $100 billion (see Exhibit 1). RIL, with a value of ₹1,477.55 billion,[4] was the largest merchandise exporter in India. The firm was ranked at 106 by the 2019 *Fortune* Global 500 list. RIL was contributing 5 per cent of total revenues to the government of India from custom and excise duty. RIL accomplished a market valuation of ₹13 trillion and it was the only Indian firm to achieve this. RIL was also the highest income tax payer in Indian market.[5]

RIL's upstream businesses comprised the complete value chain, from oil exploration, appraisal, and development to hydrocarbon production. Jio, which took its name from the mirror image of the word *oil*, started its commercial operations on September 5, 2016, and its performance had been unprecedented. The company gained more than 100 million subscribers in only five months, which it claimed was the fastest-ever customer acquisition by a telecom service provider or social media platform, including Facebook and Twitter. The company commenced operations by offering free data and voice calling for the first three months, and then extended the offer by another three months, which was beneficial for many smartphone users.

Facebook

Facebook, headquartered in Menlo Park, California, was a US social networking platform that allowed customers to share ideas, opinions, pictures, videos, and other activities.[6] The company owned Messenger, WhatsApp, and Instagram, platforms that allowed people around the world to engage in real-time communication.[7] Facebook facilitated and distributed advertising from marketers to consumers, who were targeted on the basis of their social behaviour, age, location, taste, interests, and gender. The company had a presence in Asia-Pacific, Europe, Africa, the Middle East, and the Americas. Oculus, a virtual reality (VR) technology and content platform, was one of its offerings.[8]

Facebook classified its business into two reportable segments: (1) advertising and (2) payments and other fees.[9] The company reported revenues of $55,838 million for the fiscal year (FY) ended December 2018, an increase of 37.4 per cent over FY 2017.[10] In FY 2018, the company's operating margin was 44.6 per cent; in FY 2017, it was 49.7 per cent. The company recorded a net margin of 39.6 per cent in FY 2018 and 39.2 per cent in FY 2017. Facebook had become a global giant, with 2.5 billion users and a market cap of $479.2 billion.[11] In FY 2019, it reported a net income of $18.5 billion on $70.1 billion in revenue (see Exhibit 2).[12]

Prashant Salwan, Shailesh Pandey, and Srinivasan R Iyengar wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

Exhibit 1 Reliance Industries Limited Financials (₹ Billions)

	FY 2019	FY 2018	FY 2017	FY 2016	FY 2015
Revenue	6,116.45	5,828.45	5,810.20	4,082.65	3,301.80
Gross Profit	1,915.03	1,744.73	1,475.02	1,022.71	7,42.69

Note: ₹ = INR = Indian rupee; FY = fiscal year.

Source: Company data.

Facebook's chief executive officer, Mark Zuckerberg, and several other Harvard University students founded Facebook in 2004,[13] using the company's original name, FaceMash, and then modifying this to The Facebook and subsequently Facebook. Zuckerberg and his co-founders launched the service for Harvard students but quickly expanded it to other universities and, later, the general public.[14]

Acquisitions had been key to Facebook's business and revenue growth. Its strategy was to buy potential rivals before they could become too big. In the process, the company sometimes paid exceptionally high acquisition prices. Because of potential anticompetitive practices, the company had also drawn attention from the US Federal Trade Commission, which had recently demanded data on unreported purchases from Facebook and other big technology (big tech) companies.[15] Facebook had acquired WhatsApp, Instagram, Oculus VR, Onavo, and Beluga within the past nine years (see Exhibit 3).[16] It had 346 million active users in India in 2020.[17]

Jio's Alliances

Aiming to be India's largest digital lifestyle company, Jio had entered into alliances to bring the best resources from around the world to create value for its customers. Over the months from April to July 2020, leading technology investors, such as Facebook, Silver Lake Partners, Vista Equity Partners, General Atlantic, and KKR and Co. Inc., had aggregate investments of ₹785.62 billion in Jio Platforms Inc. (Jio Platforms) (see Exhibit 4).[18] RIL had raised more than ₹1,688.18 billion in just 58 days through investments from global technology investors; this included ₹1,156.93 billion from global investors and ₹531.24 billion for rights in Jio, raised on May 20, 2020 (see Exhibit 5).[19]

Strategy Analysis: Intersectoral Strategic Alliances

Companies used alliances as strategic vehicles to expand their products and their geographic or customer reach. Studies showed that the success of alliances varied. Firms had achieved and maintained success when they possessed alliance management capabilities—that is, superior organizational capabilities to manage the alliances.[20] In an era in which alliances had become an important strategy, this capability was considered a competitive advantage.

Cross-border alliances provided multinational firms with opportunities to stabilize resource exchanges, smooth global operations, increase market presence, and achieve faster market entry. They also helped them maintain a higher level of corporate flexibility than other modes of entry into markets, such as mergers and acquisitions. Strategic alliances were used not only to enable firms to withstand competition but also to increase firms' competitiveness. As market opportunities emerged, firms used alliances to enhance their capabilities to meet increasing demand while utilizing their partners' resources.

Jio's Strategy

Jio used the bait-and-hook model, offering the basic product (i.e., the bait) at low or no cost and selling a complementary product or refill (i.e., the hook) at comparatively higher prices. In this model, the complementary product was usually essential to the effective use of the core product. For example, Jio gave out free 4G SIM cards with free phone calling, data, and over-the-top (OTT) media services that enabled non-4G users to switch to 4G voice over long-term evolution (VoLTE) handsets and the Jio ecosystem. Jio also practised penetration

Exhibit 2 Facebook Financials (US$ Billions)

	FY 2019	FY 2018	FY 2017	FY 2016	FY 2015
Revenue	70.697	55.838	40.653	27.638	17.928
Gross Profit	57.927	46.483	35.199	23.849	15.061

Note: FY = fiscal year.

Source: Finance, Yahoo. 2019. Income StatementExpand All. December 30. Accessed May 27, 2020. https://finance.yahoo.com/quote/FB/financials/?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAF6jJLS_kfwQc-1Cl76Ip7Bb2UE5-GQvT7rkErVTMF3AOrH2wSyuD110wiWXc8bdADjqR8moreuY2dZyJ1IFisVhGfRue_swj-eAzmD9Nm1xSuL0FrbLCBlE0NOvh5-.

Exhibit 3 Companies Acquired by Facebook INC.

Acquisition	Details
WhatsApp	**Type of Business:** Mobile messenger service **Acquisition Cost:** $19.0 billion **Acquisition Date:** February 19, 2014 **User Base at Acquisition:** 500 million monthly users growing by one million per day. WhatsApp, an internationally available messenger and calling service, was launched in 2009 as a low-cost alternative to standard text messaging services. Throughout much of its history, WhatsApp allowed users to send messages and make calls directly to other users free of cost, regardless of location or usage patterns. Users could also share photographs, videos, and documents on the platform. Facebook bought WhatsApp when the smaller company boasted more than 400 million active monthly users, which made it a fast-growing potential rival. The price paid by Facebook, the highest-ever acquisition price for a private company, was based on WhatsApp's growth potential. WhatsApp had been one of the world's top apps. Since 2018, it had surpassed Facebook Messenger to become the most popular over-the-top app, after Facebook and YouTube. Regarding monthly active users, WhatsApp was second only to Facebook. When WhatsApp was acquired by Facebook, it was an independent company that had recently been valued at $1.5 billion. The revenue generated by WhatsApp was unclear. By some estimates, it could be as high as $5 billion in 2020.
Instagram	**Type of Business:** Photo- and video-sharing app **Acquisition Cost:** $1 billion **Acquisition Date:** April 9, 2012 **User Base at Acquisition:** 30 million Instagram, a photo- and video-sharing social networking platform, was launched in 2010. Users could upload, edit, and tag photos and videos. Even though it had been receiving significant attention from venture capital firms and other investors, the company had remained independent until it was acquired by Facebook for $1 billion in 2012. Some estimates were that Instagram generated more advertising revenue than its parent company. When it acquired Instagram, Facebook opted to develop the Instagram app independently from its main platform, and Instagram remained a separate platform. The purchase price for Instagram, which at that time was generating no revenue, reflected Facebook's strategic decision to pay a premium for young companies.
Oculus VR	**Type of Business:** Virtual reality (VR) technology company **Acquisition Cost:** $2 billion **Acquisition Date:** March 25, 2014 Just weeks after announcing its acquisition of WhatsApp, Facebook followed up by buying VR hardware and software company Oculus VR. Founded in 2012, the company was best known for Oculus Rift, a VR headset that was designed for video gaming. Since Facebook's acquisition of Oculus VR in 2014, the subsidiary had made multiple acquisitions of its own. Perhaps the most prominent was the 2015 acquisition of Surreal Vision, a company specializing in 3D scene mapping reconstruction. At the time Facebook acquired Oculus VR, the company had produced only a prototype of its popular headset product. Facebook's acquisition gave it an instant presence in the VR market at a time when developers were showing growing interest in VR.
Onavo	**Type of Business:** Mobile web analytics company **Acquisition Cost:** $100–$200 million (estimated) **Acquisition Date:** October 2013 Founded in 2010, Israeli company Onavo performed web analytics on mobile apps to determine customer usage. Facebook acquired Onavo in October 2013 for an undisclosed amount that some analysts estimated at $100–$200 million. At the time of acquisition, it was an independent company. Although Onavo was not one of Facebook's largest acquisitions, its technology might have influenced Facebook to make crucial early decisions about acquiring other apps and companies. Onavo was occasionally classified as spyware, and this criticism forced Facebook to pull it from the app stores for iOS and Android devices.

Exhibit 3 (cont.) Companies Acquired by Facebook INC.

Acquisition	Details
Beluga	**Type of Business:** Messaging services **Acquisition Cost:** Undisclosed **Acquisition Date:** March 2, 2011 Beluga, a messaging service, was acquired by Facebook one year after its founding in 2010. Facebook acquired Beluga for an undisclosed sum in the midst of the start-up's fundraising. Through this acquisition, Facebook gained the technology that would eventually become its highly successful Messenger platform. Thus, Facebook again expanded its offerings and eliminated a potential rival.

Note: All dollar amounts are in US dollars; app = application.

Source: Compiled by the case authors based on data from Ellen Simon, "How Instagram Makes Money," Investopedia, June 29, 2019, accessed July 1 2020, www.investopedia.com /articles/personal-finance/030915/how-instagram-makes-money.asp; Nathan Eiff, "5 Companies Owned By Facebook," Investopedia, April 1, 2020, accessed May 27, 2020, www .investopedia.com/articles/personal-finance/051815/top-11-companies-owned-facebook.asp; "Facebook Buys Stake in Four-Year-Old Indian Start-Up Meesho; Here's Why," Business Today, June 14, 2019, accessed May 17, 2020. www.businesstoday.in/technology/news/facebook-buys-stake-in-four-year-old-indian-start-up-meesho-here-why/story/356022.html.

Exhibit 4 Reliance Jio Infocomm Limited's Alliances

Alliance	Details
Facebook	Facebook, which was headquartered in Menlo Park, California, acquired a 9.9 per cent stake in Reliance Jio for ₹435.74 billion. The deal, which was announced in April, gave Mark Zuckerberg's social media giant a firm foothold in India. The deal valued Jio at ₹46,200 trillion ($65.95 billion) and was Facebook's biggest since its 2014 purchase of WhatsApp for $22 billion. Jio, in return, was able to significantly reduce the RIL conglomerate's debt.
Silver Lake Partners	Less than two weeks later, private equity giant Silver Lake Partners bought a 1 per cent stake in Jio for ₹56.5575 billion. The deal with the US firm valued Jio at ₹51,500 trillion, a 12.5 per cent premium over the value indicated by the social media network.
Vista Equity Partners	US-based private equity firm Vista Equity Partners (Vista), the world's largest tech-focused firm, acquired a 2.32 per cent stake in Jio for ₹113.67 billion. This investment gave Jio Platforms an equity value of ₹49,100 trillion and an enterprise value of ₹51,500 trillion. Vista's investment was at a 12.5 per cent premium over the deal with Facebook. The deal indicated Jio's status as a next-generation software and platform company.
General Atlantic	On May 17, Reliance Jio sold a 1.34 per cent stake to New York–based General Atlantic, a private equity firm, for ₹65.9838 billion. The deal was General Atlantic's largest investment in Asia. "This investment values Jio Platforms at an equity value of ₹49,100,000 trillion and an enterprise value of ₹51,600,000 trillion. General Atlantic's investment will translate into a 1.34 per cent equity stake in Jio Platforms on a fully diluted basis," the company said in a statement. General Atlantic was a leading global growth equity firm with a 40-year record of investing in the technology, consumer, financial services, and health care sectors.
KKR and Co. Inc.	Reliance Industries Limited announced on May 22, 2020, that KKR would invest ₹113.67 billion in Jio Platforms. With this transaction, Jio Platforms achieved an equity value of ₹4.91 trillion and an enterprise value of ₹5.16 trillion. This was KKR and Co. Inc.'s biggest investment in Asia and translated into a 2.32 per cent equity stake in Jio Platforms on a fully diluted basis.

Note: All dollar amounts are in US dollars. ₹ = INR = Indian rupee.

Source: Compiled by case authors using data from Press Trust of India, "General Atlantic Picks 1.34 per cent Stake in Reliance Jio for Rs 6,598.38 Crore," *New Indian Express*, May 17, 2020, accessed June 3, 2020, www.newindianexpress.com/business/2020/may/17/general-atlantic-picks-134-per-cent-stake-in-reliance-jio-for-rs-659838-crore-2144545.html#:~:text =General%20Atlantic's%20investment%20will%20translate,22%20for%20Rs%2043%2C574%20 crore; "Facebook-Jio Deal: Read What Mark Zuckerberg Has to Say," *Hindustan Times*, April 22, 2020, accessed May 2, 2020, https://tech.hindustantimes.com/tech/news/facebook-jio-deal-read-what-mark-zuckerberg-has-to-say-story-EJyBYTez FAKfIRZA6aIppO .html#:~:text=Facebook%20now%20owns%209.9%25%20stake,values%20Jio%20at%20%2465.95%20billion; Aneesh Phadnis and Ram Prasad, "Silver Lake Checks into Jio Platforms, Snaps Up 1.15% for over Rs 5,600 Cr," *Business Standard*, May 5, 2020, accessed May 12, 2020, https://www.business-standard.com/article/companies/us-based-silver-lake-buys -1-15-stake-in-jio-platforms-for-rs-5-656-cr-120050401334_1.html; "PE Giant Silver Lake Buys Stake in Reliance Jio for Rs 5,655.75 Crore, at Higher Valuation than Facebook Deal," Moneycontrol.com, May 4, 2020, accessed May 17, 2020, https://www.moneycontrol.com/news/business/private-equity-firm-silver-lake-buys-stake-in-jio-platforms-5217451.html; Romita Majumdar, "Vista Equity Partners Buys 2.32% Stake in Jio for ₹11,367 Crore," *Mint*, May 8, 2020, accessed May 20, 2020, https://www.livemint.com/companies/news/vista-equity -partners-buys-2-32-stake-in-jio-for-11-367-crore-11588960913649.html; Reliance Industries Limited and Jio Platforms Limited, "KKR to Invest ₹ 11,367 Crore in Jio Platforms," press release, May 21, 2020, May 26, 2020, https://www.businesswire.com/news/home/20200521005812/en/KKR-to-Invest-%E2%82%B9-11367-Crore-in-Jio-Platforms.

Exhibit 5 Funds Raised by Reliance Jio Infocomm Limited Through Alliances

Investments in Jio as of May 26, 2020 Company	Amount (₹ Billions)	Stake (%)
Facebook Inc.	435.74	9.99
Silver Lake Partners	56.56	1.00
Vista Equity Partners	113.67	2.30
General Atlantic	65.98	1.34
KKR and Co. Inc.	113.67	2.32
Mubadala	90.93	1.85
Silver Lake Partners (additional investment)	45.46	0.93
Abu Dhabi Investment Authority	56.83	1.16
TPG Capital	45.46	0.93
L Catterton	18.94	0.39
Saudi Public Investments Fund	113.67	2.32
Total	**1,156.91**	**24.70**

Source: Compiled by the case authors based on company data.

pricing, keeping its product prices artificially low to gain market share quickly. It did this for new product launches on the understanding that prices would be raised at the end of the promotional period, after the company's market share objectives had been achieved.

Jio also used diversification as a growth strategy to gain market share in different domains. It diversified its product portfolio in areas such as telecom, OTT, health care, retail, e-commerce, the Internet of things (IoT), VR, and augmented reality (AR).

Changes in the Telecom Industry after Jio's Entry

The telecom industry was undergoing a number of significant changes around the time of Jio's entrance.

Ultra-Cheap Data

Before Jio's entry into the telecom industry, data plans were expensive, and consumers had to pay up to ₹450 for one gigabyte (GB) of data. The highlight of Jio's launch offer was the free data it offered to consumers (4 GB of high-speed 4G data per day). Once customers reached this limit, they would get continued data at 128 kilobytes per second. The company eventually charged its customers fees after the incumbent operators protested. However, the fees were so low that consumers paid approximately ₹10 per GB of 4G data—an offer that no other operator could match. Jio's data prices were among the lowest in the world. The company took advantage of the changing consumer trend away from voice toward data consumption and shifted its focus away from the voice-calling price wars to the data price wars.[21]

Increased Consumption of Online Content

India had experienced an exponential rise in the consumption of online content since free data became available. Jio claimed that India's data consumption grew from 0.2 billion GB to 1.2 billion GB in six months, with the average consumer now using 10 GB of data per month.[22]

Free Voice Calling

Voice calls became free for all consumers across all telecom networks when Jio launched operations. The company stated that local and subscriber trunk dialling (STD) calls from its network to other networks would be permanently free, and its rivals eventually followed suit, offering pre- and post-paid packages with free bundled minutes for STD and local voice calls to all networks. Jio stated that its network carried 2.5 billion minutes of free calls per day for customers.[23]

Proliferation of 4G Smartphones

After Jio launched its services, the 4G smartphone market grew rapidly because of free access to its 4G network. Although 4G handsets became available in the affordable segment in late 2015, 4G VoLTE-capable smartphone prices dropped to ₹2,999 after Jio's launch. Indeed, according to data from the International Data Corporation and Morgan Stanley Research, 95 per cent of the smartphones sold in India in the first quarter of FY 2016 (September to December) were 4G capable.[24]

Faster Mobile Data

With 4G becoming the norm, mobile data speeds increased significantly over the 3G networks that most people had used. A June 2020 report from the Telecom Regulatory Authority of India (TRAI), using its My Speed application (app), indicated that Jio offered average download speeds of approximately 18 megabytes per second (Mbps), while the incumbents delivered speeds of approximately 10 Mbps.[25]

Facebook's Strategy

The strategic alliance between Facebook and Jio was a voluntary arrangement in which resources from both firms were combined to create synergies. The market presented limited opportunities and resources that both firms needed to access. Facebook increased its market share by establishing alliances with telecom and mobile manufacturing companies, thus ensuring that its products were installed by default to increase the number of users who accessed its social media services through the Facebook mobile app.[26]

Facebook used diversification to support an intensive growth strategy with the main objective of establishing new businesses. For example, the company acquired Oculus VR in order to offer VR technology to complement its social networking services. This intensive growth strategy supported Facebook's strategic objective of acquiring or establishing new subsidiaries or businesses to increase revenues and its market reach. The implementation of this cost leadership generic competitive strategy was undergirded by cost minimization.[27]

Benefits of the Jio–Facebook Alliance

RIL's total investment in Jio was approximately ₹18,000,000 trillion. Therefore, what effectively cost the company approximately ₹180 billion (a 10 per cent stake) was sold for more than three times that amount (₹435.74 billion) to Facebook.[28] It could be considered that the value created by Jio through a successful business model of staking a claim was thrice the value of the initial investment. Beyond this, what did these two giants gain from this deal? Few theories explained the implications for the companies and for consumers. The partnering of these two powerful platforms would not only create richer consumer experiences but also provide 400 million consumers with access to the digital India dream. The Facebook–Jio deal was much deeper than it appeared on the surface; it was central to a well-considered philosophy that could ultimately reap large returns in ushering in a hyperlocal digital India.[29] Jio had the potential to leverage its online and brick-and-mortar retail customers with Facebook's subscriber base.

Several factors made the alliance beneficial for both companies.

Reliance Industry Limited's Ecosystem

RIL's entry into the telecom industry with the launch of Jio laid the foundation for India's digital transformation.[30] RIL's loss-leader strategy of offering free phone calling, short messaging service (SMS), 4G data, and OTT services enabled it to become India's largest telecom company. Jio built an ecosystem that included telecom, digital services, and information technology infrastructure. Jio was poised to capture the market for fibre to the x, a fixed-line fibre-optic broadband connection that was currently under-penetrated. It would be able to offer JioTV to its subscribers, thereby disrupting the satellite television industry.

Reliance Industry Limited's Ambition to Be Debt-Free

Facebook's investment would help RIL achieve its goal of being debt-free by early 2021. Jio was expected to retain ₹150 billion of the cash from the Facebook deal. The remainder would be used by RIL, which would lower its debt by redeeming the optionally convertible preference shares it held. This investment was expected to reduce RIL's debt by ₹500 billion. In December 2019, RIL's gross debt was more than ₹3 trillion, and its net debt was ₹1.53 trillion.[31]

Facebook's Penetration in India

India accounted for the highest percentage of Facebook's 2.44 million monthly active users. Approximately 20 per cent of WhatsApp's more than two billion users were in India,[32] where Internet use was still limited to a few apps, such as YouTube and WhatsApp, which had become household names. The number of Facebook users in India was expected to increase from 281 million in 2018 to 444.2 million in 2023, indicating that the user base was growing steadily.[33]

Regulatory Woes

Facebook needed an Indian representative, and its investment in Jio was a safeguard against the political risks of entering India, which included intense scrutiny of big tech, particularly foreign companies, by law enforcement and concerns about the management of the sensitive data of Indian citizens and organizations. Facebook had previously been criticized for issues ranging from net neutrality to Pegasus spyware.[34] It had also come under increasing scrutiny from the Indian government, and this had negatively affected its image. This deal could prompt Facebook to leverage Jio's user base to allay some of these fears by investing in India's growth. The alliance could create many opportunities (see Exhibit 6).

Connecting Online and Off-Line Businesses

The Jio–Facebook alliance enabled both companies to access new markets, expand their geographic reach, obtain cutting-edge technology, and complement their skills and core competencies relatively quickly. Thus, the alliance was important for both companies. JioMart, Jio's new digital commerce platform, and WhatsApp would enable nearly 30 million small Indian *kirana* shops[35] to engage in digital transactions with the customers in their neighbourhoods, as local vendors and small kirana businesses would be able to register on JioMart and receive orders through WhatsApp.[36]

Through its features, WhatsApp, the new super app, facilitated many activities and transactions (including gaming and retail commerce) for 60 million small businesses across India. The model had been very successful in other Asian countries, such as China, Korea, and Japan. Apps such as WeChat, Line, and Kakao Talk also enabled gaming and retail commerce activities. WhatsApp saw an opportunity to

Exhibit 6 Opportunities Created Through the Jio–Facebook Deal

Opportunities Created	Details
Penetrate the Unorganized Retail Sector	Bringing WhatsApp and online grocery delivery platform JioMart together allowed Facebook to connect millions of consumers with neighbourhood *kirana* stores and the other small businesses that continued to be the backbone of India's unorganized retail sector. Industry estimates indicated that the target audience was likely to be approximately 60 million small businesses across the country. Reliance termed this business model "new commerce." The model aimed for inclusive growth that included the kirana stores rather than perceiving them as a threat.
Enable Social Commerce	Facebook could facilitate a burgeoning social media marketplace in which resellers, SMBs, and micro-entrepreneurs could connect with potential customers or buyers. This was not the first time Facebook had shown an interest in this growing community. In 2019, it bought a minority stake in Meesho, one of India's fastest-growing social commerce platforms.
Drive Digital Payments	The deal was also expected to help Jio and Facebook compete with digital payment financial technology players—such as Walmart-owned PhonePe, Alibaba-backed Paytm, Google Pay, and Amazon Pay—in the Indian digital payment space, which was expected to increase fivefold to reach US$1 trillion by 2023. WhatsApp Pay was launched in India on February 7, 2020. Although it had faced regulatory issues around data localization, efforts were being taken to get regulatory approval. The deal could allow WhatsApp Pay to compete with services such as Google Pay, PhonePe, and Paytm. Frost & Sullivan's analysis indicated that WhatsApp would eventually allow consumers to pay for items bought on JioMart.
Expand Economic Opportunities	This partnership would expand Facebook's economic opportunities, especially its digital advertising platform, in India. This partnership also augured well for India, where WhatsApp was the top messaging app. WhatsApp and Facebook had helped to provide Internet access to millions, and this partnership would continue to accelerate the shift toward digitization. Over the long term, this could also have a positive effect on employment, with new supply chain and delivery jobs added.
Leverage India's Internet	Jio had built a future-proof infrastructure. Broadband Internet in Indian homes and small and medium-sized enterprises would be powered by 5G and pan-Indian fibre-optic cable. With this alliance, Facebook got to own a stake in India's Internet and communications infrastructure. Regarding the Facebook–Jio Platforms deal, the two companies could leverage each other's strengths to build a connected ecosystem comprising payments, telecom, and off-line and online commerce in a previously unseen manner.

Note: SMB = small and medium-sized businesses.

Source: Compiled by the case authors using data from Kiran Kumar, "Five Reasons the Reliance Jio Deal Is a Win-Win for Facebook," Frost & Sullivan, April 23, 2020, accessed May 22, 2020, https://ww2.frost.com/frost-perspectives/five-reasons-the-reliance-jio-deal-is-a-win-win-for-facebook/#:~:text=Frost%20%26%20Sullivan's%20analysis%20indicates%20that,the%20messaging%20app%20as%20well.&text=WhatsApp%20and%20Facebook%20have%20helped,shift%2.

become the marketplace of the future, especially in India, where it was reaching out to almost as many users as the Internet itself.

The only announcement thus far regarding precisely how the two entities would collaborate had said that they would do so through JioMart, Jio's electronic retail business.[37] WhatsApp could easily enable millions of small, family-owned stores nationwide to have a presence on JioMart. Jio could use location data to curate local businesses, and WhatsApp could enable hurdle-free connections and orders between customers and traders. In addition, RIL's strong retail supply chain network could provide support for the kiranas.[38] Currently, the kiranas' biggest challenge was their supply chains, inventory management, and inability to match the deals offered by organized retailers.[39]

Value Creation through WhatsApp

Unsurprisingly, a majority of Indian WhatsApp users lived in urban rather than rural areas. Between 2017 and 2018, WhatsApp had seen a significant (18 per cent) increase in urban users. Interestingly, WhatsApp also saw a surge in rural usage, which more than doubled by 2018 to reach a penetration level higher than that for urban penetration in 2017.[40]

WhatsApp usage increased across all socio-economic groups. While wealthier Indians made up a higher proportion of users, the most significant increase in usage was among those classified as lower income. Between 2017 and 2018, usage increased sixfold in this income bracket and more than twofold among the middle class.[41]

The results by age were relatively predictable. WhatsApp usage was higher among younger people; however, both WhatsApp and Jio saw an increase of roughly two-thirds. Despite a stronger percentage increase, usage among older demographics lagged behind that in other age groups. As of May 2018, three million businesses had signed up for WhatsApp Business.[42] Businesses could contact only those people who had provided their numbers and agreed to be contacted. The goal was to improve client–customer communication for small and medium-sized businesses (SMEs). During the Covid-19 pandemic, WhatsApp Business facilitated ordering and fulfillment, and other communication with customers.[43]

In August 2018, WhatsApp launched the WhatsApp Business application programming interface, which allowed businesses to respond to customer messages. The WhatsApp revenue model had never delivered high returns. In February 2014, before WhatsApp was acquired by Facebook, WhatsApp's revenues were a relatively meagre $1.3 million.[44]

India's Digital Transformation

The synergy between Jio and Facebook would help to realize Prime Minister Narendra Modi's Digital India mission, with its two ambitious goals: ease of living and ease of doing business.[45] The Facebook–Jio deal, with its focus on expanding hyperlocal e-commerce to Tier 2 and Tier 3 cities and even rural areas, could be a major catalyst in India's digitization story.[46] Jio had become the market leader with 370.1 million subscribers, followed by Vodafone Idea Limited, with 332.61 million; Bharti Airtel Limited, with 327.3 million; Bharat Sanchar Nigam Limited, with 118.21 million; Mahanagar Telephone Nigam Limited, with 3.38 million; and Reliance Communications Limited, with 0.02 million.[47] Jio had built a massive infrastructure that had democratized digital connectivity for more than 370 million Indian citizens.

Facebook had built a strong distribution network in India, with more than 400 million users on WhatsApp, more than 280 million on Facebook, and more than 88 million on Instagram.[48] Access to this network could allow small kiranas to use digital technology to grow their businesses and create new employment opportunities.[49] These opportunities could be extended to other key stakeholders in the Digital India mission, such as *kisans* (agricultural workers), SMEs, educational institutions, and health care providers. The investment in Jio was Facebook's third in India since it had acquired Meesho, a social commerce app, and Little Eye, a start-up that built analytical tools for mobile app developers. According to Facebook's press release on the Jio deal, this acquisition represented the company's investment in India's future—a claim that was helped by the perception of Jio as a symbol of the Swadeshi or Make in India digital initiative.[50] The deal would give Facebook access to the data Jio had gathered from its smartphone subscribers and could also bring about a power app that combined Jio's and Facebook's services.

The Indian e-commerce sector was expected to grow from $30 billion in 2018 to $200 billion by 2028.[51] While Amazon.com Inc. and Flipkart (owned by Walmart Inc.) currently controlled more than 60 per cent of India's e-commerce market, according to market intelligence firm S&P Global,[52] Jio and Facebook had an edge regarding data acquisition. The deal that had paired local commerce with social media had also created one of India's biggest data platforms, which would be difficult for other e-commerce players to match quickly. RIL was also negotiating the acquisition of Future Group, the pioneering organized-retail group with a presence in cities. Its stores included Big Bazaar, FBB, Food Bazaar, Food Hall, HomeTown, Brand Factory, and Planet Sports.[53] Future Group had recorded more than 600 million customer visits in a year to its 2,000 retail stores, which occupied more than 2.2 million square metres of space in more than 400 cities and towns. The conclusion of the deal would further strengthen RIL's position in retail.[54]

Future Initiatives

Jio's launch had been influenced by the dream of India's digital *sarvodaya*—an inclusive digital rise that would improve the quality of life for every Indian and propel the country to the position of the world's leading digital society. Jio provided a range of digital services in its ecosystem: free 4G voice calling, free SMS, Jio Drive cloud storage, JioChat, JioMoney, and OTT apps such as JioTV, JioCinema, JioSaavn, JioSecurity, JioHealthHub, and JioMart. Jio also offered JioFiber Internet and a set-top box, JioSTB. Future projects included smart-home IoT services for smart televisions, speakers, cameras, gas leak sensors, and door locks—devices and services that were connected to the Jio ecosystem through JioFiber (see Exhibit 7). The Jio Smart Car, a small on-board diagnostics device, worked like a JioFi hotspot for 10 devices if plugged into a car's port; it could capture all the information about a car, including fuel and brake fluid levels, battery life, and mileage. The Jio Car Connect app recognized drivers' patterns and use of features such as locks, headlights, power windows, and remote location trackers, and a "fencing" option could track speeds and distances and even provide an alert if the car went beyond a specific area.

Facebook was investing heavily in small businesses, and India's position as a hub for small and medium businesses was ideal for the company's social networking plan.[55] Facebook could leverage Jio's diverse communications network division to reach these businesses and to provide online access to enable them to expand their portfolios.

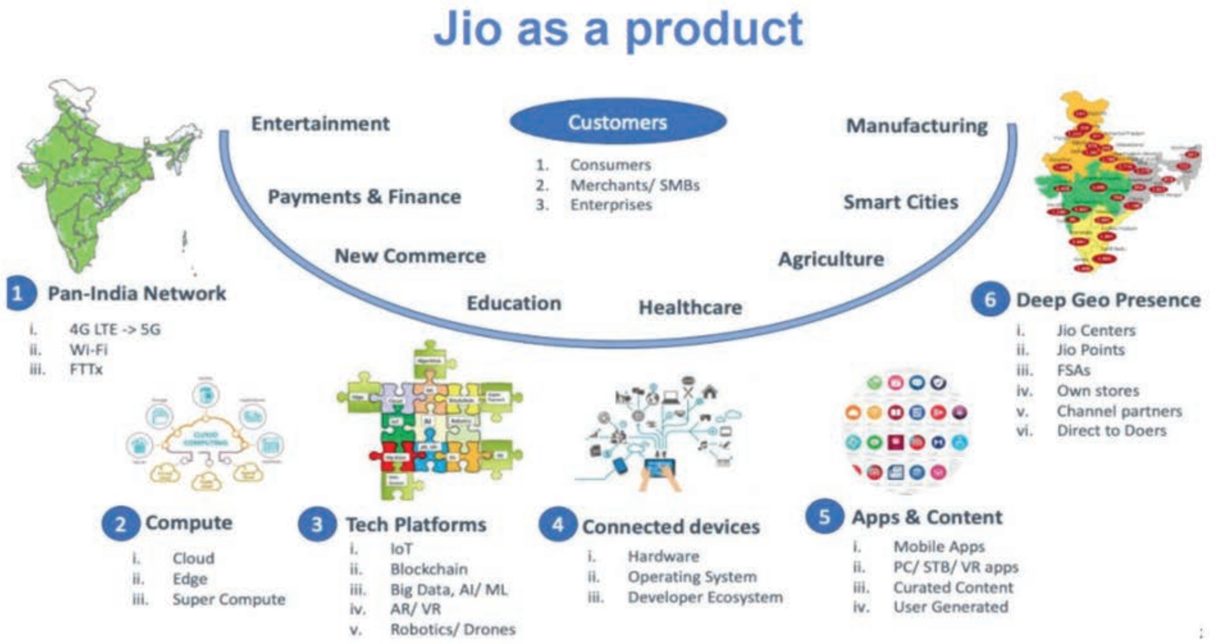
Blockchain and Cryptocurrency

The Facebook and Jio alliance would also provide a basis for blockchain and cryptocurrency infrastructure and applications in India. In August 2019, Jio announced that it had installed one of India's largest blockchain networks, with tens of thousands of nodes. At that time, Ambani stated that blockchain technology would engender trust and deliver unprecedented security, automation, and efficiency for almost any type of transaction.[56] While Jio was building a blockchain network with thousands of nodes, Facebook was working on the Calibra project, which aimed to provide service for 1.7 billion unbanked people around the world. It was hoped that blockchain technology would have a promising future in India.[57]

5G Networks

Facebook had previously partnered with a telecom provider in Japan, taking advantage of that country's 5G networks to provide AR and VR products. It also ran the Telecom Infra

Exhibit 7 Jio's Presence in the Indian Market



Note: FTTx = Fiber to the x ; IoT = Internet of things; AI = Artificial intelligence ; AR = Augmented reality ; VR = Virtual reality; PC = Personal Computer; STB = Set Top Box ; FSA = Flexible spending account.

Source: Company documents.

Project, which aimed to create open-source telecom equipment to promote the development of affordable telecom infrastructure in under-connected areas. A strategic partnership with India's largest telecom operator would also be key to Facebook's future plans, particularly those relating to VR and IoT, whose success would depend on 5G access. Jio had reportedly developed its own end-to-end 5G technology and had sought the TRAI's approval for 5G trials. This investment in Jio's platforms could give Facebook access to the 5G technology and telecom infrastructure it needed while insulating it from the accompanying regulatory scrutiny and compliance.[58]

The Future for Jio and Facebook

Jio's management wanted to advance their strategic alliance to gain access to Facebook's customer bases and deeply integrated ecosystems. This partnership could upend India's e-commerce market. Jio had its own messaging apps, movies, and health care, which it had not been able to monetize. Joining the country's most widely used communication platform could boost its hopes of becoming a retail giant and speed up India's transition to digital commerce. Jio, in partnership with Facebook, could be very competitive because it had more insights into consumers. The increasing pace of global business and the demands and sophistication of customers had resulted in dramatic changes in the competitive landscape. Markets had been changing so quickly that it was very difficult for a single company to have all the necessary resources, including information, and to maintain the current technology and competencies needed for entry and success. Non-technology companies, such as RIL, had moved into digital services and were willing to form partnerships with new-age companies to benefit their businesses. Fewer conventional companies had made this transition as successfully as Jio had in petrochemicals, refining, retail, and, most recently, digital services. Jio had entered into strategic alliances to capture windows of opportunity in favourable markets. How could Jio ensure a co-operative and complementary partnership (despite their differences with Facebook) in order to succeed and set a precedent for future international alliances?

Notes

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Case 11

Marriott International: Hospitality's Uncertain Future

Success seems to be connected to action. Successful people keep moving. They make mistakes, but they never quit.

— J. Willard Marriott[1]

Stephanie Linnartz, group president of consumer operations, technology, and emerging businesses at Marriott International (Marriott), sat back in her chair and closed her laptop with a heavy sigh.[2] She had just rewatched the video message that her boss, Marriott CEO Arne Sorenson, had released on Twitter to address all Marriott employees on March 19, 2020, during the early days of the COVID-19 global pandemic. To say the last 18 months had been challenging for Linnartz would be a tremendous understatement. In the spring of 2019, she had learned with a heavy heart that Sorenson had been diagnosed with stage 2 pancreatic cancer and would undergo chemotherapy, radiation, and immunotherapy treatments to fight the disease. Although doctors caught the cancer early and Sorenson had expressed his commitment to "continue working at the company [he] love[d]," Linnartz felt heightened pressure to continue driving success and innovation across the critical business functions she managed. The hospitality industry had experienced a number of significant disruptions in recent years, driven by such trends as the sharing economy, shifting consumer preferences toward personalization, and advancements in hotel-related technologies.

Linnartz had grown up in the hospitality business and had been part of the Marriott family for nearly 25 years. Having started as a financial analyst for Marriott in 1997, she rose through the ranks to become an integral member of Marriott's executive team due to her distinct ability to forecast and manage shifts and disrupters in the industry. Under her leadership, Marriott had developed and incubated new lines of business related to the company's loyalty program, Marriott Bonvoy (Bonvoy), and more recently had launched a new premium home rental offering, Homes & Villas by Marriott International. Given these successful innovations, Linnartz had begun 2020 with tremendous optimism about Marriott's future; as the largest hospitality company in the world, Marriott had seemed well positioned to maintain industry leadership into the foreseeable future. However, neither Linnartz nor anyone else at Marriott had anticipated the unprecedented effects of the global pandemic.

First discovered in Wuhan, China, in December 2019, the deadly COVID-19 virus rapidly spread to every corner of the globe and immediately disrupted all aspects of normal life. Government, health, and corporate leaders across the world grappled with how to respond to the pandemic, which had started as a health crisis but quickly became an economic one as well. Because Marriott operated 11 hotels in Wuhan and another 350 across greater China, Linnartz and the Marriott team witnessed early warning signs of the virus's quick and lethal impact on the hospitality business. By the first week of February 2020, before COVID-19 had officially been declared a pandemic, Marriott was already feeling its effects. Sorenson discussed the virus's severe impact in his March 2020 message to Marriott's associates:

> In terms of our business, COVID-19 is like nothing we've ever seen before. For a company that's 92 years old, that's borne witness to the Great Depression, WWII, and many other economic and global crises, that's saying something. Here are the facts. COVID-19 is having a more severe and sudden financial impact on our business than 9/11 and the 2009 financial crisis combined. The worst quarter we had in those earlier crises saw a roughly 25% decline in hotel revenues, on average, across the globe. In this case, which began in greater China in January, we quickly saw a 90% decline in our business in China. In the two months since, we have seen COVID-19 extend to the rest of the world. In most markets, our business is already running 75% below normal levels.
>
> The principal challenge we face is obvious. The restrictions on travel, gatherings of people, and required social distancing is having an immediate impact by depressing demand for our hotels. As a result, we have hotels around the world that can't operate without incurring substantial economic losses and risking permanently their ability to reopen when this gets behind us. This has caused hundreds of hotels to close or start the process of closing until such time as demand begins to return. I can tell you that I have never had a more difficult moment than this one. I have never been more determined to see us through than I am at this moment.[3] (See Exhibit 1 for full transcript.)

Nearly eight months had passed since Sorenson had tweeted this video message, and the world looked like a drastically different place. As Linnartz gazed out the window of her family's home in Washington, DC, she reflected on how the pandemic had created an unpredictable crisis for an industry already experiencing substantial upheaval. Even before COVID-19's arrival, technology and digital transformation were disrupting nearly every aspect of the hospitality business by ushering

This case was prepared by Jared D. Harris, Samuel L. Slover Associate Professor of Business Administration; Scott Snell, E. Thayer Bigelow Professor of Business Administration; and Katharine Harrison (MBA '20). It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

Exhibit 1 Marriott International: Hospitality's Uncertain Future

Transcript, CEO Message to Marriott Employees, March 19, 2020

Hello Marriott Associates. I'm here to give you an update on Coronavirus, or COVID-19, on our business and the steps we're taking to respond to it. Because of the profound impact COVID-19 is having on so many of us around the world, this is the most difficult message we have ever pulled together.

Our team was a bit concerned about using a video today because of my new bald look. Let me just say that my new look is exactly what was expected as a result of my medical treatments. I feel good and my team and I are 100% focused on overcoming the common crisis we face. Now let's talk about that crisis, COVID-19. Let's start with the health challenge itself. Across our company, the number of COVID-19 infected associates is low, and I am grateful for this. I want to acknowledge the associates who are dealing with it as a patient, parent, family member, or friend, and the hundreds of Marriott colleagues who are at this minute quarantined. Our well wishes and thoughts are with all of you.

In terms of our business, COVID-19 is like nothing we've ever seen before. For a company that's 92 years old, that's borne witness to the Great Depression, WWII, and many other economic and global crises, that's saying something.

But here are the facts. COVID-19 is having a more severe and sudden financial impact on our business than 9/11 and the 2009 financial crisis, combined. The worst quarter we had in those earlier crises saw a roughly 25 percent decline in hotel revenues, on average, across the globe. In this case, which began in Greater China in January, we quickly saw a 90 percent decline in our business in China. In the two months since, we have seen COVID-19 extend to the rest of the world. In most markets, our business is already running 75 percent below normal levels.

The principal challenge we face is obvious. Governments all around the world are taking the steps to contain COVID-19. The restrictions on travel, gatherings of people, and required social distancing, is having an immediate impact by depressing demand for our hotels. As a result, we have hotels around the world that can't operate without incurring substantial economic losses and risking permanently their ability to reopen when this gets behind us. This has caused hundreds of hotels to close or start the process of closing until such time as demand begins to return.

Given these circumstances, we have been forced to take proactive steps to respond to the crisis and are putting into place business contingency plans, globally. While pieces of these continent contingency plans vary, given the differences in local laws in the geographies where we operate, certain elements are universal.

We've worked to take controllable costs out of the business, like suspending all nonessential travel. We have paused all new hires, with the exception of a small number of mission-critical positions. We have stopped all hotel initiatives for 2020 and have gone dark on our brand marketing and advertising during this period. Both Mr. Marriott and I will not be taking any salary for the balance of 2020 and my executive team will be taking a 50 percent cut in pay.

Above property around the world, we are moving to shortened work weeks and in the US we are also putting in place temporary leaves for at least the next 60 to 90 days that will impact most associates at our headquarters and above-property locations. At the property level, contingency plans vary by geography and hotel occupancy rates, but for open hotels, include closing food and beverage outlets, reducing staff and closing floors of hotels. More details about these actions and what they mean will be shared through local HR teams.

If there is any good news visible today, it is the signs of early recovery in Greater China. China appears to have succeeded in reducing the spread of COVID-19 through strong counteractions. China is now bringing manufacturing back online, and we are seeing some early signs of lodging demand begin to return. If this holds, it may bode well for the course of this epidemic in other parts of the world.

In two weeks, I will mark my eighth anniversary as CEO, a position I accepted on the heels of two legends in hospitality. As a leader, I have experienced so many wonderful highs and a good number of challenging lows. I can tell you that I have never had a more difficult moment than this one. [gets choked up]

There is simply nothing worse than telling highly valued associates, people who are the very heart of this company, that their roles are being impacted by events completely outside of their control. I have never been more determined to see us through than I am at this moment.

While it is impossible to know how long this crisis will last, I know we as a global community will come through the other side and that when we do, our guests will be eager to travel this beautiful world again. When that great day comes, we will be there to welcome them, with the warmth and care we are known for the world over.

As I close, I encourage you to please take care of yourself, your friends and family, and the community around you. I wish you good health and a sense of optimism. Together, we can and we will overcome this and we'll thrive once again.

Source: Marriott International (@MarriottIntl), "A message to Marriott International associates from President and CEO Arne Sorenson," Twitter, March 19, 2020, 10:00 a.m., https://twitter.com/marriottintl/status/1240639160148529160?lang=en (accessed Jul. 20, 2020).

in new competitors, inspiring new concepts of travel, catalyzing new ways of working, and changing the key factors required for success. In a 2019 interview, she had discussed this growing pressure:

The world is crazy fast in terms of evolution. Companies that don't innovate and change at an even more rapid pace than they did a decade ago probably aren't either going to be around and/or be healthy. The growth of technology

> and the world population has forced companies like us—even though we had innovation in our DNA—to step up our game.[4]

Marriott had always been a company that knew how to adapt with the times, and Linnartz believed that her business units—consumer operations, technology, and emerging businesses—played a critical role in shaping the future of the company. Nevertheless, the pressures on the industry were truly unprecedented. An already-turbulent industry evolution, complicated by the massive societal impact of COVID-19, made the future unclear, both for Marriott and for the larger industry. How do you plan for a future that is so uncertain?

Marriott International: A History of Continuous Reinvention

John Willard Marriott and his wife Alice opened the first A&W root beer franchise in Washington, DC, on May 20, 1927. The couple grew that business into several full-service restaurants under the name Hot Shoppe throughout the Washington, DC, area. Constantly looking for ways to enhance his offerings, Marriott purchased a vacant lot adjacent to one of the Hot Shoppe locations and opened the first drive-in service restaurant on the East Coast. Its instant success led to the addition of drive-in services at all three of Marriott's Hot Shoppe locales. Later, he noticed that customers often stopped by on their way to the airport to pick up a boxed lunch to eat on their flight, so Marriott expanded into airline catering. By 1953, what had started out as a modest nine-seat root beer stand on 14th Street had grown to 56 restaurants that served 30 million customers per year. In that same year, 1953, Marriott decided to take his company public under the name Hot Shoppes, Inc. The initial offering was priced at $10.25 per share and sold out within two hours of trading.

In 1957, under the management of J. Willard Marriott's son, J.W. Marriott, Jr. (Bill), the world's first motor hotel was established in Arlington, Virginia. Over the ensuing years, the company continued to diversify its interests in the hotel and restaurant business, acquiring the Big Boy and Roy Rogers family restaurant chains in the late 1960s and Farrell's Ice Cream Parlour in 1972. The company even expanded into theme parks, opening Marriott's Great America in California and Illinois, and to cruise ships, partnering with Sun Line to become the first lodging company to enter the cruise business.

In 1964, Bill was appointed president of the company and he became CEO in 1972; the company changed its name from Hot Shoppes, Inc., to Marriott Corp. in 1967.[5] During his early tenure, Bill witnessed a meaningful increase in travel that accompanied the expansion of the US interstate highway system and the introduction of the "Jumbo Jet" in the early 1970s, opening up the skies for millions of people who previously could not afford to travel by air. With travel trending upward, Bill identified an opportunity to build out the company's hotel business, opening 32 new hotels by 1975.

Under Bill's leadership and in true Marriott fashion, the company began yet another reinvention process, shifting its hotel business model from hotel ownership to property management and franchising. Under this model, Marriott would no longer own the hotels, but rather the company would provide its Marriott brand name and services to third-party owners who would pay Marriott a management or franchising fee in return. Although the decision to shift business models was initially driven by the company's strained balance sheet, including cash flow issues brought on by the 1976 recession, it ultimately proved to be a prudent move that would forever change the company. The innovative decision to pursue an "asset-light" strategy relieved Marriott of much of the heavy capital investment that had previously been required, which in turn accelerated its hotel expansion plans, generated significant and stable cash flow, improved return on capital, reduced its debt burden, and solidified Marriott's leading position within the industry.

In the early 1980s, Bill began the process of expanding Marriott's portfolio of brands, each focusing on different segments of the hospitality market. In 1983, Marriott debuted the Courtyard by Marriott hotel, which offered lodging for business travelers and marked the first time a major hotel company had gone "down market" in its offerings. The next year brought the addition of JW Marriott, a luxury offering named in honor of Bill's father. With the opening of the first Fairfield Inn and Marriott Suites hotels in 1987, Marriott officially became the first lodging company to offer an extensive portfolio of brands to its customers. Marriott also served as a pioneer in the extended-stay business, acquiring the Residence Inn brand in 1987.

The business transformation that Bill had initiated in the 1970s culminated in the company's split in 1993 into Marriott International, the hotel management and franchising company headed by Bill, and Host Marriott International, a hotel ownership company led by his brother, Richard Marriott. Having divested from all divisions that fell outside Marriott's core hotel business, Bill was able to devote his full attention to his quest to become the number-one hospitality company in the world.

When Bill reached his 80th birthday in 2012, he stepped down as CEO and turned the reins over to Sorenson, the first non–family member to hold this position. Sorenson had joined Marriott in 1996 as a general counsel focused on M&A, eventually serving as president and COO for three years prior to his CEO promotion. In 2016, pursuant to his M&A roots, Sorenson led the successful acquisition of Starwood Hotels & Resorts for $13.6 billion, adding 11 new brands to Marriott's portfolio. The acquisition not only doubled Marriott's presence outside the United States, but it also made Marriott the largest hotel company in the world, with more than 5,800 properties and 1.1 million rooms in over 110 countries—that equated to 1 out of every 15 hotel rooms across the globe. According to Sorenson, Starwood's diverse collection of brands was a key driver of the acquisition: "We've got an ability to offer just that much more choice. A choice in locations, a choice in the kind of hotel, a choice in the amount a customer needs to spend."[6] By the start of 2020, three years into the Starwood integration, Marriott operated in 134 countries and boasted a compelling collection of 30 brands (see Exhibit 2 for a breakdown of its full brand portfolio).[7]

Exhibit 2 2019 Marriott Brand Portfolio by Geographic Distribution

		North America	Europe	Middle East & Africa	Asia Pacific	Caribbean & Latin America	Total
Luxury							
JW Marriott®	Properties Rooms	30 16,853	7 2,205	6 3,327	40 15,080	13 3,597	96 41,062
The Ritz-Carlton®	Properties Rooms	39 11,410	13 3,079	13 3,523	33 8,207	8 2,081	106 28,300
W Hotels®	Properties Rooms	26 7,672	7 1,423	5 1,850	14 3,788	6 1,074	58 15,807
The Luxury Collection®	Properties Rooms	16 4,799	47 6,962	10 2,411	31 7,883	14 1,188	118 23,243
St. Regis®	Properties Rooms	10 1,968	7 1,002	5 1,426	20 4,812	3 448	45 9,656
EDITION®	Properties Rooms	4 1,209	3 381	1 255	2 651	– –	10 2,496
Bulgari®	Properties Rooms	– –	2 143	1 120	3 260	– –	6 523
Premium							
Marriott Hotels®	Properties Rooms	340 134,412	97 24,595	25 8,119	83 28,000	30 8,033	575 203,159
Sheraton®	Properties Rooms	189 72,039	62 17,054	31 9,910	130 47,878	35 9,682	447 156,563
Westin®	Properties Rooms	130 53,097	18 6,024	7 1,839	58 17,872	12 3,640	225 82,472
Renaissance Hotels®	Properties Rooms	86 28,597	34 8,049	4 1,035	42 14,535	9 2,745	175 54,961
Le Meridien®	Properties Rooms	21 4,480	15 5,021	23 6,526	49 12,903	2 271	110 29,201
Autograph Collection Hotels®	Properties Rooms	108 22,463	53 7,165	9 1,906	9 2,364	13 3,751	192 37,649
Delta Hotels by MarriottTM (Delta Hotels®)	Properties Rooms	72 17,376	5 729	1 360	1 339	– –	79 18,804
Gaylord Hotels®	Properties Rooms	6 9,918	–	–	–	–	6 9,918
Marriott Executive Apartments®	Properties Rooms	– –	4 361	9 1,029	17 2,959	2 240	32 4,589
Tribute Portfolio®	Properties Rooms	21 4,445	8 905	– –	8 1,107	3 155	40 6,612
Design Hotels®	Properties Rooms	1 248	3 542	– –	– –	– –	4 790

Exhibit 2 (cont.) 2019 Marriott Brand Portfolio by Geographic Distribution

Select		North America	Europe	Middle East & Africa	Asia Pacific	Caribbean & Latin America	Total
Courtyard by Marriott®	Properties Rooms	1,053 146,602	68 12,892	7 1,487	72 16,931	41 6,717	1,241 184,629
Residence Inn by Marri-ott®	Properties Rooms	833 103,038	12 1,477	3 301	– –	2 249	850 105,065
Fairfield by Marriott®	Properties Rooms	1,001 94,063	– –	– –	42 7,050	14 2,036	1,057 103,149
SpringHill Suites by Marriott®	Properties Rooms	456 54,033	– –	– –	– –	– –	456 54,033
Four Points® by Sheraton	Properties Rooms	159 23,847	18 2,778	17 4,371	75 18,561	20 2,686	289 52,243
TownePlace Suites by Marriott®	Properties Rooms	418 42,378	– –	– –	– –	– –	418 42,378
Aloft® Hotels	Properties Rooms	119 17,647	10 1,801	8 2,012	29 6,598	10 1,644	176 29,702
AC Hotels by Marriott®	Properties Rooms	63 10,720	83 10,631	1 188	– –	12 1,922	159 23,461
Protea Hotels by Marri-ott®	Properties Rooms	– –	– –	80 8,359	– –	– –	80 8,359
Element® Hotels	Properties Rooms	42 5,785	2 293	1 168	6 1,253	– –	51 7,499
Moxy® Hotels	Properties Rooms	21 4,149	37 7,451	– –	4 609	– –	62 12,209
Residences & Timeshare							
Residences	Properties Rooms	60 6,557	8 298	3 308	14 2,132	10 573	95 9,868
Timeshare	Properties Rooms	72 18,668	5 919	– –	5 471	9 2,463	91 22,521
Total Total	**Total Properties**	**5,396**	**628**	**270**	**787**	**268**	**7,349**
	Total Rooms	**918,473**	**124,180**	**60,830**	**222,243**	**55,195**	**1,380,921**

Source: *2019 Annual Report*, Marriott International, http://media.corporate-ir.net/media_files/IROL/10/108017/marriottAR19/10k-item1-p2.html (accessed Jul. 24, 2020).

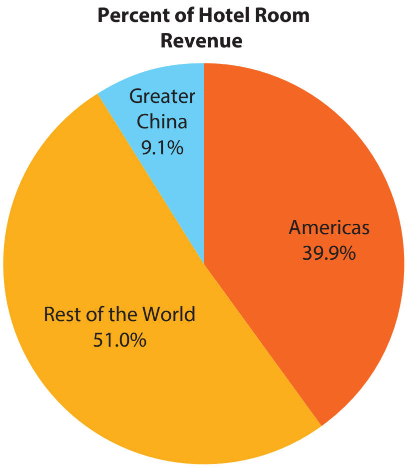
The Global Travel and Hospitality Industry

The number of international tourist arrivals worldwide grew dramatically from 165.8 million in 1970 to 1.5 billion by the end of 2019.[8] This explosive travel boom was driven by global population growth, increased urbanization, and the rise of a global middle class with higher disposable incomes. As travel evolved over those 50 years, the expectations of the modern traveler also became more complex and sophisticated. Gone were the days when guests were content to find bathrobes and stocked minibars in their hotel rooms. The traveler of 2019 expected modern and authentically designed rooms, equipped with the latest technology, as well as personalized and high-quality services. Moreover, in recent years there had been a meaningful shift in focus across the hospitality industry to experiences over products, driven primarily by millennials and Gen Xers, who were set to enter their peak travel years and comprise a majority of worldwide travelers. The hospitality industry had evolved to meet the preferences and demands of the modern traveler, embracing new business models, technologies, and ways to personalize offerings.

In 2019, the global hotel industry brought in a record $535 billion in total room revenues, rounding out a decade of consecutive revenue growth.[9] The hotel market comprised over 700,000 hotels and 18 million rooms, 54% of which were affiliated with a global or regional brand.[10] The majority of hotel rooms were concentrated in relatively few countries, with the United States, the long-standing largest hotel market, accounting for nearly 40% of worldwide room revenue (see Figure 1).[11] Nevertheless the global hotel landscape remained largely fragmented, with the top five players in the hotel industry—Marriott, Hilton Worldwide (Hilton), InterContinental Hotel Group, Wyndham Hotel Group, and Accor—accounting for only 25% of total worldwide market share, though they controlled 58% of the development pipeline of hotels in planning or under construction.[12] Each of the leading hoteliers operated a variety of brands within the economy/budget, midscale, upscale, and luxury segments, accommodating a wide range of consumer preferences and price points (see Figure 2).[13]

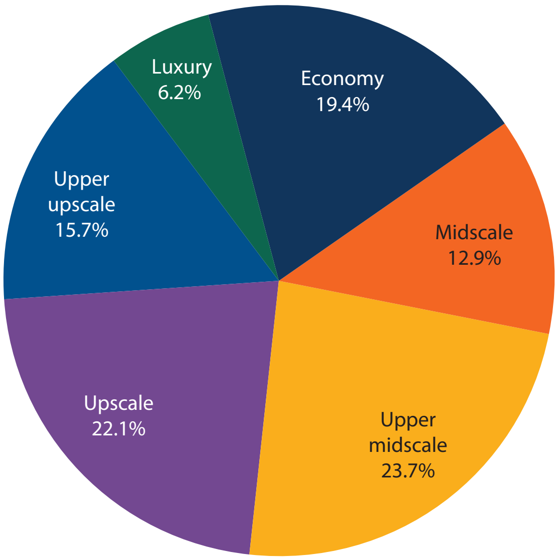
Marriott remained the world's largest hotelier, with approximately 42% (or 409,000) more hotel rooms than its top competitor, Hilton. However, from a property standpoint, the Wyndham Hotel Group portfolio was the industry leader, with over 9,000 properties worldwide in its portfolio (see Exhibit 3 for largest hotel companies by room, property, and countries of operations). There were considerable regional differences that affected how hoteliers, both large and small, positioned themselves to succeed. Affiliation with a national or regional brand via franchise or management agreement had remained the dominant model within the United States, as approximately 72% of all US hotel rooms were brand affiliated.[14] Looking outside the United States, however, brand affiliation was significantly less common. Most international markets had historically been composed of smaller hotel chains and independent operators, though this appeared to be changing as the larger hoteliers had experienced greater consolidation in recent years.[15] In keeping with these trends,

Figure I Geographic breakdown of global hotel room revenues (2019).



Source: Unless otherwise noted, all figures created by authors.

Figure 2 Global hotel industry rooms by price segment (2019).



Marriott held approximately 16% of the US market share (based on number of rooms), while it maintained less than 4% market share outside the United States in 2019.

The hotel industry had long been characterized by its cyclical nature, with periods of rapid hotel expansion and development followed by periods of adjustment and recovery. Demand for hotel rooms generally tracked with broader macroeconomic trends, with financial downturns and other global, national, or regional conditions impacting the industry's financial results and growth. During the Great Recession of 2007–9, for example, demand for hotel rooms dropped significantly from its peak in 2007, forcing many of the major hotel players to pursue operational cost cuts and efficiency measures. As the industry rebounded from this crisis, hotel demand grew steadily every subsequent year in the United States, leading to a record-setting expansion phase in which demand for rooms outpaced supply growth from 2010 through 2018. Historically, room supply growth had served as an indicator of the attractiveness of the hotel industry from an investor's perspective. In 2019 alone, there were 200,000 rooms in the global construction pipeline, led by Marriott, which controlled 19% of these projects. In addition to economic cyclicality, global hotel brands faced meaningful risk from a wide variety of other sources, including cyberattacks and fraud, natural disasters, changes in governmental or travel policies, and geopolitical tension.

Disruption in the Hospitality Industry

The three decades beginning in the 1990s was a period of substantial change and disruption across the hospitality industry. The emergence of the internet in the late 1990s introduced travel-related e-commerce sites, such as Expedia and Priceline, and social networks, such as TripAdvisor. These industry innovations had a meaningful impact on consumers and

Exhibit 3 Largest Hotel Companies by Room, Property, and Country of Operation, 2019

Company Name	Number of Rooms	Number of Properties	Number of Countries of Operations
Marriott International	1,380,921	7,349	134
OYO	1,200,000	44,000	80
Jingjiang Holding	1,000,000	10,290	68
Hilton Worldwide	971,780	6,110	119
Intercontinental Hotels Group (IHG)	883,563	5,903	100+
Wyndham Worldwide	831,025	9,300	90
AccorHotels	739,537	5,036	100+
Choice Hotels International	590,897	7,153	40+
Huazhu Group Ltd.	536,876	5,618	2
Best Western Hotels & Resorts	294,334	4,700	100+

Note: OYO = OYO Hotels.

Data sources: Abhishek Gupta, "Annual Report Card FY 2019," *Official OYO Blog*, February 17, 2020, https://www.oyorooms.com/officialoyoblog/2020/02/17/annual-report-card-fy-2019 (accessed Sept. 12, 2020); "About Us," Best Western Hotels & Resorts, 2020, https://www.bestwestern.com/en_US/about/press-media.html (accessed Sept. 13, 2020); "About Jin Jiang Hotel," Jin Jiang Hotel, 2020, http://www.jinjianghotels.com/aboutus.html (accessed Sept. 12, 2020); *Annual and Half Yearly Information: Hotel Portfolio – December 2019*, Accor, 2019, https://group.accor.com/en/investors/events-and-announcements/annual-and-half-yearly-information (accessed Sept. 12, 2020); *2019 Annual Report*, Choice Hotels International, 2019, https://www.annualreports.com/Company/choice-hotels-international-inc (accessed Sept. 12, 2020); *2019 Annual Report*, Hilton Worldwide, 2019, https://ir.hilton.com/financial-reporting/annual-reports (accessed Sept. 12, 2020); *2019 Annual Report*, Huazhu Group Limited, 2019, https://ir.huazhu.com/financial-information/annual-reports (accessed Sept. 12, 2020); *Annual Report 2019*, Intercontinental Hotel Group, 2019, https://www.ihgplc.com/-/media/ihg/annualreports/2019/pdf/ar-report-2019/ihg_2019ar.pdf?la=en&hash=9F491366E66A68491D6C545E1692F43F (accessed Jul. 26, 2020); *2019 Annual Report*, Marriott International, 2019, http://media.corporate-ir.net/media_files/IROL/10/108017/marriottAR19/10k-item1-p2.html (accessed Jul. 24, 2020); *Annual Report 2019*, Wyndham Hotels & Resorts, SEC Form 10-K, 2019, https://sec.report/Document/0001722684-20-000007/ (accessed Sept. 12, 2020).

hotel operators alike, shifting power to consumers through increased ease of price comparisons and the introduction of peer evaluations through customer reviews. The "sharing economy" brought more changes in the mid-2000s, with companies like Airbnb and HomeAway taking the hospitality market by storm and proving to be huge industry disruptors. More recently, the advent of the "experience economy" found customers favoring experiences over material possessions, leading them to look for more personalized, unique, and authentic experiences while traveling, with hotels as primary providers or brokers of these experiences.

Online Travel Agencies

In October 1996, Microsoft launched what was then called Microsoft Expedia Travel Services, the world's first online travel agency (OTA). Although the product premiered during the internet's early days, it would have a lasting impact on the way consumers researched, planned, and booked their travel, including hotel reservations. Priceline was launched a year later, its founders having been inspired by the idea that they could use the internet to drive demand to fill what they believed to be millions of empty hotel rooms and airline seats.

The emergence of OTAs revolutionized personal travel, transforming what had previously been a complex and frustrating task into a much more accessible, flexible, and even fun experience for those looking to book their own travel. OTAs introduced comparison shopping and price transparency, giving customers the ability to browse and book hotels, flights, rental cars, and other travel-related services. Consumers liked the convenience of OTAs, which provided a comprehensive centralized marketplace for a wide range of travel needs, allowing travelers to compare options across brands and bundle different travel services (e.g., flight, hotel, and rental car) together. Some recognized OTAs as the "original digital disruptors," as these companies were first-generation internet businesses that identified an unmet customer need and created digital solutions that became the first stop for prospective travelers. These platforms were able to aggregate and digitize data to create economical, do-it-yourself travel planning, a concept that was unheard of before their launch.[16]

The immediate success of OTAs led to a period of incredible growth for both the travel industry and the OTAs themselves. The relationship between hotel owners and OTAs had long been a marriage of convenience, each party depending on the other to help drive profitability across their businesses. Over the last two decades, the OTA sector experienced massive consolidation, which continued to shift the balance of power in the hotel-OTA relationship. By 2020, there were two dominant OTA players—Expedia and Booking

Holdings (previously Priceline)—that essentially formed a duopoly in the online travel agency industry. Expedia's company umbrella included Hotels.com, Orbitz, Travelocity, and HomeAway, which the company had acquired in 2015 for $3.9 billion. The Booking Holdings business was also composed of a collection of brands, including Booking.com, Priceline, Agoda, Kayak, and OpenTable, which it acquired in 2014 for $2.6 billion.

Booking Holdings entered 2020 as the world leader for booking online accommodation reservations, reporting an 11% annual increase in room nights booked (to 845 million) across the 2.58 million properties listed in over 230 countries on its platform in 2019. Expedia trailed with 389 million room nights booked, which reflected about 70% of its total worldwide revenue in 2019. Global travel market research firm Phocuswright predicted that hotel bookings via OTAs would grow to approximately 25% by 2022, presenting a clear threat to many of the large hotelier's direct booking businesses.[17] Indeed, Marriott's relationship to OTAs embodied the typical hotel "frenemy" dynamic: the consolidated OTAs helped increase hotel occupancy by funneling customers to the company's properties, but they also exerted powerful market pressure. Not only were Marriott's margins lower from business generated by OTAs, but the OTAs undermined Marriott's value proposition to its hotel property owners, who regularly looked to Expedia and Booking Holdings to fill gaps between reservations generated from Marriott's internal systems. Hotel owners were required to pay a fee to the OTA for every room it booked *in addition* to the standard management or franchise fee they paid to Marriott for similar services. As such, Marriott needed to prevent hotel owners from shifting to work exclusively with OTAs for booking services, potentially dropping Marriott and its respective services and fees.

Marriott's scale—particularly after its merger with Starwood—gave it increased bargaining power with OTAs, something highly desirable given the recent shifts in power across the hospitality industry. In a maneuver designed to reduce distribution costs and further weaken OTAs, Marriott followed Hilton's lead and introduced a number of new strategies and campaigns to drive consumers toward its direct booking channels. In 2015, as OTAs continued to take share of room bookings—OTAs were booking 8% of rooms, up from 4% only four years earlier[18]—Marriott launched its "It Pays to Book Direct" marketing campaign to drive customer awareness around the benefits of Marriott's direct booking channels and loyalty membership programs, including its Best Rate Guarantee. In 2016, Marriott introduced Marriott Rewards Members Rates, an exclusive rate for its loyalty members who booked directly through Marriott's online, call center, or app channels. Additionally, Marriott allowed its loyalty members to earn points only for direct bookings, not for those made through an OTA. While these strategies proved successful, Marriott went a step further in 2018, when its contract with Expedia was up for renegotiation. Marriott had historically paid Expedia a commission fee of about 12%, but it aimed to negotiate the fee downward; the company was the first hotelier to directly take on one of the major OTAs. This was possible not only due to Marriott's size, but also because of the value of Marriott's now-combined loyalty program; indeed the acquisition of Starwood's guest loyalty program, Starwood Preferred Guest (SPG), had been a "central, strategic rationale for the transaction" in the first place.[19] The acquisition merged Marriott's two legacy loyalty programs, Marriott Rewards and Ritz-Carlton Rewards (with over 57 million combined members) with the industry-leading SPG program (21 million members) under one comprehensive umbrella, Bonvoy, making it one of the largest and most comprehensive loyalty programs in the world, with over 110 million members. This increased Marriott's leverage. In April 2019, Marriott and Expedia announced they had reached a new multiyear agreement that satisfied both parties.

Bonvoy was perceived as the industry-leading loyalty program. It rewarded members with points that could be used toward free hotel stays across Marriott's entire portfolio of brands, "from overwater bungalows, to mountainside ski resorts, to iconic urban landmarks."[20] Travel experiences through the company's Marriott Bonvoy Tours and Activities program were also available, as were miles with participating airlines, among other benefits. Following the unification of the three programs, members could earn, on average, 20% more points per dollar spent and achieve Elite Status faster than before. Marriott's loyalty program had driven substantial repeat business for the company, with members booking over 50% of all room nights in 2019. Marriott's direct relationship and interactions with its Bonvoy members allowed the company to collect massive amounts of data on its guests' behavior and preferences, which it was prevented from doing when customers booked with an OTA. As guests increasingly came to expect personalized offerings during their hotel stays, Marriott could operationalize these data insights to create customized and seamless experiences for guests. In 2018, Linnartz shared her thoughts on the evolution of Marriott's loyalty program:

> Guests are willing to give us information about themselves, and they expect that we use it to enhance their experience. Whether it is preference in pillow type or recommendations for local experiences once they've arrived at the destination, they expect us to leverage the information they've provided to personalize their experience and anticipate their needs. That is how we build loyalty and strengthen the relationship between our company and our guests.[21]

Marriott also offered loyalty members access to its experiential platform called Marriott Bonvoy Moments, where members could apply their points to 120,000 experiences across 1,000 global destinations. Members could choose from a wide variety of cooking, entertainment, sports, and other once-in-a-lifetime cultural experiences, powered through partnerships that Marriott established with brands such as the National Football League (NFL), New York's Madison

Square Garden, and even the championship F1 racing team, Mercedes-Petronas. These perks constituted the primary way Marriott worked to entice customers away from using OTAs.

Nevertheless, the OTA market was poised for more disruption, as new powerhouse competitors continued to enter the fray. In recent years, Google had been slowly building up its own travel brand, which was second behind Expedia as the go-to option for travel search. In May 2019, Google revealed its streamlined travel-planning platform, Google Travel, which consolidated Google Flights, Google Hotels, and its other services under one comprehensive booking site. Google stood to benefit from the immense amount of data it already possessed from its users, accrued from Google internet search, Gmail, Google Calendar, and Google Maps, which put Google in a prime position to provide personalized offerings and experiences, with research, itineraries, and reservations all housed under one roof. As the importance of user data intensified, it was possible that other large tech companies with substantial treasure troves of detailed user data—like Amazon, Facebook, or Apple—would pose future competitive threats in the industry, though these companies had not yet made significant investments in this space nor had they announced plans to do so.[22]

The Rise of the Homesharing Economy and Airbnb

The "sharing economy" described a transformative, massive societal and economic shift that emerged in part due to the spread of internet-based technologies and social networks, resulting in online community marketplaces built around the sharing or temporary exchange of resources, such as rooms, services, skills, or cars. This concept quickly sparked the launch of start-up businesses structured around this economic model; in the hospitality sector, Airbnb most successfully capitalized on the idea of sharing temporary accommodations. Airbnb was founded in 2007 by Brian Chesky, Joe Gebbia, and Nathan Blecharczy, and by 2011 it had achieved coveted "unicorn" status, reaching a valuation of over $1 billion. What began as a "way to make a few extra bucks" evolved into one of the world's largest two-sided marketplaces, becoming a formidable enterprise with more than 7 million listings in over 100,000 cities across 220 countries and regions,[23] creating a new segment that prompted the launch of several other successful home-sharing competitors, including VRBO, Homestay, FlipKey (owned by TripAdvisor), and Vacasa. Airbnb quickly expanded beyond its initial business of room rentals to offer full apartments, homes, villas, and other unique vacation rentals, as well as localized experiences for its guests; for instance, as of mid-2020, there were over 29,000 tiny houses, 5,000 castles, and 3,000 treehouses listed on Airbnb. Airbnb has accommodated over 400 million guests at an average rate of $100 per night, with its hosts earning over $80 billion.[24] Airbnb at one point received a private valuation of $38 billion, at the time exceeding that of Expedia ($15.4 billion) and Hilton ($30.9 billion), but falling behind Booking Holdings ($85 billion) and Marriott ($49 billion). However, the onset of the COVID-19 pandemic necessitated an emergency round of additional funding for Airbnb, with its valuation in April 2020 almost halved to $18 billion.[25] Nevertheless a surge in summer 2020 bookings put Airbnb on track for an S-1 filing scheduled for November 2020, [26] suggesting an IPO with proceeds of $3 billion and a valuation that could once again exceed $30 billion.[27]

Unlike hoteliers, home-sharing platforms did not provide the actual accommodation service or make any capital investments in real estate or hotel assets. Instead—in much the same way ridesharing app Uber matched riders and drivers—these platforms simply connected guests with private providers of accommodations. By leveraging search and matching algorithms to help users quickly sort through and select their desired listing, companies like Airbnb served as booking services for guests and clearinghouses for the associated economic transactions, processing all payments between guests and hosts. Airbnb's platform was free to access for guests and hosts alike, creating strong network effects and helping the company quickly generate a significant user base. Airbnb collected service and commission fees from both guests and hosts. Based on the type of reservation they made, guests were charged a nonrefundable service fee that typically fell under 14.2% of the booking transaction price. Hosts were typically charged a 3% to 5% commission fee, and Airbnb also offered its hosts access to "smart" pricing analytics, providing them with optimal data-driven rate recommendations.

Because Airbnb's platform offered such a wide variety of accommodations, most of them listed by hosts who were new to the hospitality sector, transparency and accuracy were vital in managing guest and host expectations. Airbnb implemented a number of features to help build community trust, including professional photographs for listings and a robust profile and review system. In addition, guests and hosts could get to know one another prior to their reservation via detailed profile information and a messaging platform. Following their stays, guests and hosts provided feedback on each other, with guests rating the accommodation's features, cleanliness, and truth in advertising, and property owners rating the courtesy of guests. Airbnb maintained complete control over all payment processing and did not pay hosts until 24 hours after guest check-in, providing a safeguard for disputes. This approach essentially "crowdsourced" quality control and the enforcement of standards, functionality that had traditionally fallen on hotels to perform. By 2019, Airbnb hosts and guests had left over 250 million reviews, which the company referred to as a "currency of trust that cannot be replicated."[28]

Airbnb's initial launch was largely geared toward a niche segment of leisure travelers who were looking for affordable, localized alternatives to a traditional hotel. Many of these users were budget-conscious travelers and belonged to the tech-savvy millennial and Gen-Z generations. They tended to be more adventurous and to care less about the typical services and predictable quality that big-brand hotels historically offered guests, instead favoring local, trendy neighborhoods with bigger rooms, communal spaces, and unique experiences.

Home sharing was generally considered a cheaper option than a hotel, although this was not always the case, as prices were dependent upon the city and listing and property characteristics. However, according to Airbnb data from 2016, an Airbnb was generally cheaper than a hotel room in 7 of the 12 major US cities.[29] In addition, Airbnb hosts tended to accommodate guests for longer stays than hotels did. For example, in New York City, Airbnb data showed that Airbnb guests stayed, on average, 2.5 days longer than hotel guests in 2017.[30] By 2019, 53% of Airbnb guests were female, and its average guest was 35 years old; these figures contrasted with those of the traditional hotel industry, whose average guests tended to skew older and more male. While the millennial demographic still comprised Airbnb's largest pool of hosts and guests at 58%, the company had made a concerted effort to broaden its user base, targeting young families, high-end travelers, and even the business segment. These efforts proved fruitful, with Airbnb capturing nearly 20% of all US consumer spending on lodging during 2018, driven by a staggering 30% growth that year in Airbnb revenue in the United States; while falling short of consumer spending at Marriott, this exceeded what consumers spent on Hilton and its subsidiary brands that year. The US market had the most Airbnb listings at 660,000, followed by France (485,000), Italy (340,000), Spain (245,000), and the United Kingdom (175,000); and guests could find listings in 98% of the world's nations.[31] Within countries, geographic market penetration varied significantly; in the United States, New York, Seattle, Washington, DC, New Orleans, San Francisco, Los Angeles, and Denver were major markets, with other markets having fewer listings.

Airbnb had also made significant investments to position itself for growth. Specifically, it launched several new initiatives and offerings, including Airbnb Experiences, one-of-a-kind local activities that immersed guests in the host's unique world. Airbnb for Work represented its effort to tap into the robust business-travel market, and it was an immediate success, accounting for 18% of bookings by 2018. Airbnb Plus constituted a new premium tier that was added to the platform following the company's 2017 acquisition of Montreal-based Luxury Retreats, and along with Airbnb Luxe, provided travelers with access to handpicked homes and villas across the world, each with its own 300-point checklist. The company even expanded into the boutique and independent hotel space with its acquisition of HotelTonight for approximately $400 million in 2019. By expanding its core offerings, Airbnb sought to attract travelers who might not initially have considered the home-sharing platform's traditional options but who would typically have opted to stay at a luxury hotel. Airbnb's extension into luxury was also intended to elevate the experiences of Airbnb's existing network of users, who, the company perceived, were "growing up. Someone who was sharing homes for under $100 a night when they started with Airbnb is now booking places that are $1,000 a night."[32]

As a pioneer in the home-sharing market, Airbnb initially operated in a regulatory gray area. While traditional hotels had long been required to adhere to regulatory requirements including zoning laws, occupancy or lodging taxes, and safety and accessibility standards, Airbnb was initially able to skirt around many of these requirements. However, as it grew, many municipalities became concerned about the company's effect on vacancy rates and affordability in residential rental markets, not to mention the lost tax revenue due to Airbnb's shirking of regulations. Many regulators introduced new measures deterring property owners from offering short-term rentals. After initially fighting this oversight, Airbnb eventually worked to create solutions that satisfied these stakeholders. By the end of 2019, the company had reached a landmark cumulative $2 billion in tourist-related taxes collected and remitted to local governments on behalf of its global host community over the previous four years. Airbnb also worked to establish more than 400 agreements with local, state, territorial, and national governments to streamline and facilitate tax collection for hosts.

Home-sharing platforms were not initially viewed as a competitive threat to major players in the hospitality industry; even as late as 2017, Marriott's CEO Sorenson had suggested that "so far, the impact of Airbnb has not been profound to our business. In many respects, they are selling a different product."[33] However, as Airbnb's remarkable growth continued, this dismissal rapidly melted away and hoteliers instead began to see Airbnb and the entire emerging sector as a hallmark of the rapidly evolving hospitality industry, representing a source of both competitive worry and potential innovation. Sorenson himself came to recognize Marriott's opportunity within this changing landscape:

> With 30 brands and 6,000 hotels in 120 countries and loyalty programs, how do you create an ecosystem of customers that basically say "I really don't need to go anywhere else. I don't need to go to Expedia. I don't need to go to Hilton. I don't need to go to Airbnb because no matter where I'm going, you're going to have a range of choices for me, and I know you're going to take care of me."[34]

Homes & Villas by Marriott

As Marriott continued to seek new ways to compete in the evolving hospitality industry, in 2019 Linnartz spearheaded the launch of Homes & Villas by Marriott, a premium home-rental platform that served as a natural extension of Marriott's core hotel business. Marriott's decision to expand into this complementary space was the result of Linnartz's successful 2018 pilot program in Europe under its brand extension, Tribute Portfolio Homes. Through the pilot program, which offered 500 home rentals in select European locales, Marriott learned that 90% of its guests were members of Bonvoy and over 75% were leisure travelers, accompanied by family and friends. Moreover, the average pilot program guest stayed for five nights or more, which was more than triple the average 1.5-night stay in Marriott's traditional hotels. Linnartz had also led a survey of Marriott's most loyal customers regarding their engagement with the home rental market, and discovered that 30% of those polled had stayed in a home rental during the prior year, typically for events that were better suited to entire homes than traditional hotel rooms, such as bachelorette parties or family reunions.[35] Together, the survey insights and success of the European pilot program served to alleviate internal worries that Homes & Villas would cannibalize Marriott's core hotel business. As Linnartz explained, people experienced "different trip purposes. Sometimes it's a cool weekend with friends at a beach house and then a kid's soccer tournament and you need a Courtyard. Home sharing is another offering."[36]

Under Linnartz's leadership, Marriott decided to differentiate Homes & Villas offerings from other established players by competing only in the premium and luxury space. While Airbnb and VRBO were known to offer everything from luxury beach houses to tree houses to funky shacks, Marriott focused only on high-end properties run by third-party hospitality management companies (HMCs) that were responsible for vetting new homes and locations, in addition to managing on-site logistics to ensure the guest experience would meet Marriott's strict standards of quality and service. Specifically, the HMCs were tasked with providing guests with a professionally cleaned home, along with 24/7 support, high-speed Wi-Fi, luxe linens, and amenities. Linnartz hoped to create a Marriott "ecosystem" that would meet all the varying needs of its guests—leisure and business travelers alike. Rather than looking to Airbnb or Expedia for their short-term rental needs, guests could simply access the Homes & Villas section of Marriott's website to search for their desired housing accommodations. Linnartz explained the company's decision in simple terms: "It will all be connected and interrelated,"[37] and "we actually believe it is complementary and additive to our core business."[38] Based on insights gleaned from the 2018 pilot program and survey, Linnartz also felt it was crucial to integrate the Homes & Villas offering into the Bonvoy rewards program to further strengthen loyalty among its members. Under Linnartz's direction, Marriott allowed its Bonvoy members to apply their earned points toward villa stays as well as other experiential reward offerings like cooking classes, tours, and concerts.

By the end of 2019, Marriott offered more than 6,000 homes in over 190 locations around the world, many in places where Marriott did not currently operate a hotel. Guests had their choice of a variety of accommodations, including a six-bedroom villa in Sorrento, Italy, with an infinity pool overlooking the Mediterranean Sea; an oceanfront villa in Anguilla with a private beach and a personal butler and house staff; and even an 18th-century Irish castle that slept 17 and featured a private lake for boating and fishing.[39] Based on her extensive experience in the hospitality business and her understanding of evolving consumer trends, Linnartz felt confident that this was a crucial investment that would position Marriott to succeed in the future and remain competitive against players like Airbnb. Linnartz had also witnessed Marriott's traditional competitors such as Hyatt and AccorHotels struggle to succeed in home sharing, and she was committed to making Marriott the first traditional hotel company to profit from this space.

COVID-19: The Black Swan Event of 2020

On March 11, 2020, the World Health Organization (WHO) officially declared the novel coronavirus COVID-19 a global pandemic. The pandemic quickly brought the world to a complete standstill: countries closed their borders, hospital systems were pushed to the brink of collapse, and the global economy experienced the most dramatic recession in over half a century. Despite governments' efforts to inject stimulus into the global economy, the pandemic forced many businesses to suspend operations or permanently shut down, derailing employees' careers and often leaving them without income. For instance, the unemployment rate in the United States alone rose from 3.8% in February 2020 to 14.7% by April 2020. By June, nearly 33 million Americans were receiving jobless benefits; this was roughly five times the number receiving jobless benefits during the peak of the Great Recession of 2007–9. Similar effects unfolded all around the world, creating an unprecedented medical, social, and economic crisis. COVID-19 emerged as an extraordinarily high-impact "black swan" event, forcing companies across the world to rethink the way they did business and transforming entire global industries. Although the virus affected every industry across the globe, the hospitality sector was undoubtedly one of the hardest hit. The pandemic represented a "critical juncture" for the industry,[40] as the dramatic reduction of revenue posed an existential threat.

As part of a US government-sponsored COVID-19 relief package, more than 8,100 hotel businesses across the country received federal funding of $150,000 or more. In addition to supporting individual hospitality properties, relief funds also went to hotel owners, management companies, and hospitality-related start-ups such as Softbank-backed OYO Hotels. In total, 81 lodging borrowers received loans of $5 million or more, and another 1,200 received loans ranging from $2 million to $5 million, all in an effort to retain hospitality workers and keep hotel properties afloat (see Exhibit 4). However, in a May 2020 survey conducted by the American Hotel and Lodging Association (AHLA), over 50% of respondents reported that the loan amount received was not enough to rehire their staff, and with little to no revenue expected, many operators anticipated permanent hotel closings and job losses.[41] An April 2020 AHLA report indicated that 70% of hotel employees had been laid off or furloughed, as 8 in 10 hotel rooms across the United States remained empty. With the crisis showing few signs of abating,

Exhibit 4 COVID-19 Relief Loans for Hotel Businesses: Top Five US States

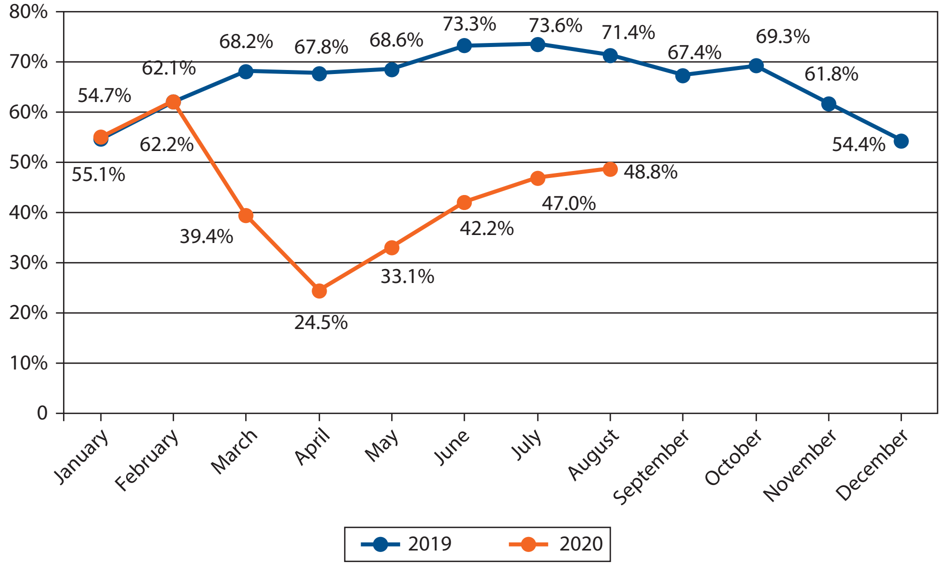
Loan Amount Range	State	Number of Loans	Jobs Retained
$5-10 million	California	16	6,910
$5-10 million	Texas	11	4,856
$5-10 million	New York	8	2,675
$5-10 million	Florida	3	1,343
$5-10 million	Illinois	2	1,000
$2-5 million	California	70	16,672
$2-5 million	Florida	48	13,191
$2-5 million	Texas	26	8,232
$2-5 million	New York	48	7,821
$2-5 million	Illinois	16	3,544
$1-2 million	California	122	17,835
$1-2 million	Florida	83	13,423
$1-2 million	New York	109	13,207
$1-2 million	Texas	39	6,624
$1-2 million	Illinois	21	3,514
$350,000-1 million	California	385	24,548
$350,000-1 million	Florida	233	15,078
$350,000-1 million	New York	242	13,544
$350,000-1 million	Texas	155	10,218
$350,000-1 million	Illinois	90	5,987
$150,000-350,000	California	735	20,372
$150,000-350,000	Florida	426	11,817
$150,000-350,000	Texas	298	9,438
$150,000-350,000	New York	336	8,437
$150,000-350,000	Illinois	115	3,997

Data source: Kevin Sun, "SBA Paycheck Protection Program Loan Level Data," Small Business Association (SBA), 2020, https://home.treasury.gov/policy-issues/cares-act/assistance-for-small-businesses/sba-paycheck-protection-program-loan-level-data (accessed Aug. 3, 2020).

the data reflected that COVID-19's impact generated the worst year on record for hotel occupancy, a dramatic decrease from the prior year's business (see Exhibit 5). Moreover, with close to 1.6 million hotel employees currently without a job, following the loss of 3.9 million hotel-supported jobs that had been eliminated since the beginning of the crisis, the "human toll of this public health crisis has been absolutely devastating for the hotel industry," with the sector likely to be "one of the last to recover."[42]

With the widespread adoption of shelter-in-place restrictions and substantial changes to company travel policies, individuals worldwide transitioned to work remotely

Exhibit 5 US Hotel Occupancy Rates, 2019 versus 2020



Source: Based on "AHLA Report: State of the Hotel Industry Analysis: COVID-19 Six Months Later," American Hotel & Lodging Association, August 31, 2020, https://www.ahla.com/sites/default/files/State%20of%20the%20Industry.pdf (accessed Sept. 10, 2020).

from home, as nonessential businesses remained shuttered. Fear for their health and economic well-being triggered a substantial drop in both consumer sentiment and willingness to travel. As consumers planned for a prolonged period of financial uncertainty, a McKinsey global study released in July 2020 found that most individuals intended to continue to shift their spending largely to essentials, such as grocery and household supplies, while planning to substantially cut back on most discretionary categories including hotel and travel.[43] Consequently, airlines had taken a major hit in business along with hotels; forecasters estimated that airlines were unlikely to see a return to 2019 passenger volumes until at least 2023 or 2024. In the near term, the industry was expected to continue burning cash, due to rising debt service pressures and depressed ticket sales.

The extent to which previous patterns of travel and hospitality would return was highly uncertain, and any recovery experienced was expected to be uneven across segments and more prolonged compared to many other industries. For instance, business and leisure travel would undoubtedly recover at different speeds, as would domestic and international travel. Demand for business travel was projected to return sporadically, as companies attempted to revise their policies for both nonessential and essential travel and many companies across the globe shifted to video-conferencing instead of nonessential travel; given the sudden forced shift in workplace dynamics, some forecasters anticipated that certain types of business travel would never return to pre-COVID-19 levels.

Marriott's Path Forward

Since the virus's initial outbreak, Marriott had been forced to take a number of radical but proactive steps to mitigate the severe financial and operational impacts of COVID-19 on the business; the company ended the first quarter of 2020 with $12.23 billion in debt and $1.76 billion in cash. In order to strengthen its business and significantly reduce costs, Marriott announced in mid-March that it would implement reduced work-week schedules while also placing approximately two-thirds of its 174,000 worldwide employees on furlough for the following 60–90 days. This amounted to roughly 115,000 associates—at corporate headquarters and at Marriott's hotel properties—who would not be paid salaries but would still retain health care benefits. On May 27, Marriott extended these initial measures and furloughs, which remained in place through October 2020. In other cost-cutting measures, the company suspended all nonessential travel, paused all new hires, and blocked all hotel initiatives for 2020, including its brand marketing and advertising programs. Sorenson and Bill also reported that they would not take a salary for the balance of 2020, and the executive team would receive a 50% pay cut for the year. Marriott estimated these measures would reduce 2020 corporate general and administrative costs by at least $140 million.

To accommodate and support its guests, Marriott introduced more flexible reservation policies, allowing changes or cancellations up to 24 hours prior to arrival at no additional cost. The company also put in place a multipronged approach designed to meet the health and safety challenges of COVID-19. In early May, Marriott announced its "Commitment to Cleanliness" initiative, which included the creation of the Marriott Global Cleanliness Council, the introduction of new and advanced cleaning technologies (including electrostatic sprayers), and cleaning regimen changes and contactless services to meet higher cleanliness standards; the company stated in a press release that "our founder, J.W. Marriott, used to personally inspect kitchens and guest rooms for cleanliness during his hotel visits. A high standard of cleanliness is in our DNA."[44]

For its Bonvoy members, Marriott worked quickly to adjust its program, announcing that it would extend the status its members earned in 2019 through February 2022, pausing all point expirations until February 2021. It also introduced a new offering to its online platform that allowed members to go on virtual tours of over 2,500 museums and galleries across the world, as well as explore cultural landmarks and natural wonders such as the Great Wall of China and the Sahara Desert via satellite and drone. For Bonvoy members who were cobranded credit card holders, Marriott communicated such offerings as 6× points that could be earned for grocery shopping, reminding members that even when they weren't traveling, the Bonvoy loyalty program could deliver significant benefits.

In terms of Marriott's hotel operations, by the end of April 2020, about 2,000 of its 7,300+ hotels across the world remained temporarily closed. Within the United States, roughly 1,000 of its 4,000 hotels were forced to suspend operations. For the properties that remained open, Marriott implemented contingency plans that required the closing of food and beverage outlets, the reduction of hotel staff, and the closing of full floors. To support its franchise and management affiliates, Marriott temporarily deferred the implementation of most brand standards, including delaying renovations due in 2020 by one year. It also took steps to significantly reduce the costs related to programs and services for which its affiliates were obligated to reimburse it.

But all these initiatives were mostly geared toward a triage-like response to the pandemic and oriented toward survival. While Linnartz was pleased with the contingency plans that the company had implemented in the early days of the pandemic and was confident that the team would continue to adapt these plans to meet the evolving nature of the pandemic, she was actually more concerned about Marriott's uncertain future, given the uncharted territory that lay ahead for the entire industry. How should the company position itself going forward? What did the future of hospitality hold, both until the pandemic conditions improved and beyond? Airbnb CEO Brian Chesky had gone "on record" as saying that "travel will never, ever go back to the way it was pre-COVID; it just won't."[45]

Linnartz thought about the challenging road that lay ahead for the company. How could Marriott leverage the current and emerging constraints and trends to invent a new future for itself and adapt to this rapidly evolving and uncertain environment? What options might the firm consider, and how should it best prepare? What other measures should it take to support its guests and loyalty members and keep them feeling safe and engaged with the Marriott brand? How should she best work to position the company not only to survive *today*, but also to thrive in the uncertain hotel industry of the future?

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Case 12

Meta: Facebook's Pivot to the Metaverse – A Path to Dystopia or Blue Ocean Utopia?

Source: Image: Facebook

At just under three billion active daily users, more people on earth use Facebook than the population of China and India combined.[1] Despite the company's young age, few other businesses in world history have ever enjoyed this level of reach or influence. Facebook has arguably grown into one of the most powerful business entities in history. As of November 2021, its market capitalization stands at a towering $950 billion.

However, storm clouds are approaching. On one hand, the company faces repeat political scandals, and on the other, having signed up virtually every person on earth able to use their core social media product, the firm is approaching the upper boundary of what's possible for organic growth. There is nobody left to sign up who is vaguely interested. Young people especially reject Facebook outright, though they flock to the Facebook-owned Instagram social network.[2]

In the past, Facebook, like many companies, relied partly upon growth by acquisition. In 2012, they purchased Instagram for $1 billion, and in 2014, followed up by purchasing the messaging and video-calling app WhatsApp for $19 billion and virtual reality goggle maker Oculus for $2 billion. However, the wall against organic growth, coupled with social and political problems, makes additional meaningful growth by acquisition unlikely.

In response to these challenges, on October 29, 2021, Facebook co-founder and CEO Mark Zuckerberg announced a strategic pivot.[3] He changed the business's name to Meta and announced his intention to spend an initial $10 billion, and more in the future, to create a metaverse. "Our overarching goal across all of these initiatives is to help bring the metaverse to life," said Zuckerberg.[4] "I think over the next five years or so, in this next chapter of our company, I think we will effectively transition from people seeing us as primarily being a social media company to being a metaverse company."[5]

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This case study was written by Michael Olenick, Executive Fellow at the INSEAD Blue Ocean Strategy Institute, under the supervision of W. Chan Kim and Renée Mauborgne, Professors of Strategy at INSEAD. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Origin of Metaverses

> Hiro is approaching the Street. It is the Broadway, the Champs Élysées of the Metaverse. It is the brilliantly lit boulevard that can be seen, miniaturized and backward, reflected in the lenses of his goggles. It does not really exist. But right now, millions of people are walking up and down it.
>
> —Neal Stephenson, *Snow Crash*

The roots of the metaverse concept come from the influential 1992 science fiction book *Snow Crash*. Neal Stephenson envisioned a fully immersive virtual world where people work, play, socialize, spend, and scheme. Stephenson coined the term *metaverse* to describe his world, painting the real world outside the virtual reality goggles as a drab suburban dystopia.

In Stephenson's world, outside the goggles, income disparity has reached critical levels, with countless people surviving as delivery drivers overseen by computers that optimize their work much like factory machinery might be optimized. Hiro, Stephenson's hero, lives in a storage locker. But by putting on his virtual reality goggles and headphones, Hiro is transported into the metaverse, a fantastical world of fun, excitement, adventure, and vastly better housing. The outside world remains drab and depressing, but except for food, it doesn't much matter.

Zuckerberg's Metaverse

The link between Facebook and *Snow Crash* is not coincidental. In 2014, former Facebook data scientist Dean Eckles said new Facebook product managers were required to read *Snow Crash*.[6] Since then, Zuckerberg has been working hard to remove the fiction part of Stephenson's sci-fi novel, apparently overlooking the dystopic nature of Stephenson's vision (Appendix A).

Announcing what *his* metaverse might look like, Zuckerberg zaps himself into a digitized representation of a house that starts from a wireframe then quickly fills in with details.[7] Light pours in, much like it might in a Palo Alto home, but the size of the space feels larger than anything the Palo Alto zoning board would permit. Art adorns the walls but so do spacesuits and suits of armor. Look closely and you notice the view outside one window is a tropical island, but outside another, a Tahoe winter. It's a subtly magical place.

There's a feeling of privacy, of being in a private space, even if both the feeling and space are entirely illusory. Watching Zuckerberg's vision, it's difficult to ignore that the space isn't genuinely private – especially if the user wearing the goggles lives in a shared physical space– but that the virtual world, run by Meta, also suffers the same privacy issues Facebook famously struggles with.

Mark receives a call from a disembodied voice and lifts his hand, much as he would if he were carrying a phone, which is both impossible and unnecessary in this virtual world. A popup appears in thin air, above his wrist, inviting him to "Space Room." The popup looks like a messenger window, complete with a voice transcribed to speech bubbles. Before beaming himself to the Space Room, he's "just gotta find something to wear" and so flips through a few outfits, choosing one that inexplicably looks identical to the outfit he's already virtually wearing in his metaverse house.

Space Room has four people waiting for him, three dressed normally and one rendered as a robot. They're playing cards that float in the air, as one of the meeting participants also does. The group quickly decides to call another person, Naomi, and again Mark lifts his arm as if holding a phone. Although there is no need or place for a phone in this metaverse, a typical smartphone interface appears.

Zuckerberg calls, and Naomi answers with video, standing with a flesh-and-blood friend on a decidedly non-virtual city street. Although she's with somebody else, walking through the streets of New York City, Mark asks, "Shall we deal you in" to the game? Unphased by the odd request to ignore her friend and zap to a virtual spaceship while walking with a friend, she instead refers to an artist in Soho "hiding AR [augmented reality] pieces for people to find." She zaps them "3D street art" that looks like somebody spilled a plate of spaghetti at the international space station, with strands floating above a table. "Stunning," somebody remarks offscreen.

We return from the demo metaverse to reality. In 2010, Zuckerberg famously declared "privacy is a social norm of the past," but he now stares at the camera and deadpans "privacy and safety need to be built into the metaverse from day one."[8] To emphasize the point, the verbiage also appears on-screen, the only words spelled out as well as being spoken. Mark barely blinks, and it's hard not to think he looks more like a man reading a forced confession or maybe a statement from the Meta legal team – than a true believer in privacy. Even then, it's difficult to overlook the passive verbiage "*need to be* built," as opposed to the more definite "*will* be built."

Getting back to his planned new world, Zuckerberg explains that users will have virtual homes, workplaces, and games in the metaverse. Physical products that display anything which can be digitized in the real world will be replaced by virtual metaverse products. For example, there is no need for a real phone in the metaverse: it is replaced by a phone application that presumably has both instant (and likely free or very low priced) upgrades. Televisions, computer screens, books – really, almost anything people can't rest on or eat – will be transformed from a physical thing into a digital app. Many products needn't be more than a digital copy of their physical form. For example, the Meta-owned Oculus Netflix app is already a 3D projection of a cozy living room with a large virtual television screen.

Your Personal World

Zuckerberg's choice of worlds was relatively tame. There's no reason for that suit of armor to hang on the wall; users may as well wear it, helmet and all, or even add a virtual horse to complete the outfit. They may even choose to *be* a horse.

Metaverse users can transport to, say, Paris or New York, or some fusion of the two like the Chinese cities that reproduce other places.[9] There's no reason to be tied to *any* physical space or time. If you'd prefer to live in the medieval era, the metaverse can make it so, at least within your goggles. Language barriers will quickly break down as artificial intelligence (AI) translation systems rapidly improve. Virtually anything is possible in the metaverse.

Metaverse technology may improve upon the positive elements of social media, connecting people to their families and tribes no matter where they are in the world. Shrinking physical distance can shrink geographic advantages, enabling collaboration between workers from Bangalore, Bangkok, Bavaria, and the Bay Area. Business meetings in a metaverse will have less environmental impact than far-flung meetings in real life and can offer interactivity well beyond video chats to encourage creativity and cooperation. Talent could be tapped, and physical borders transcended, no matter where in the world a person physically resides.

In the metaverse, people with physical disabilities regain independence and a form of mobility. Loneliness can be mitigated, especially for the elderly as the goggles bring them to a friendlier world in which they can project their bodies to again be young and healthy. People can find cross-cultural experiences no matter where they live or what their personal level of wealth. Visiting Paris will require nothing more than a snap of one's virtual fingers, enabling anybody to digitally sit on the edge of the Seine, transporting them there virtually, instantly, and potentially for free.

Dull Zoom classes can theoretically become 3D representations of a regular classroom that better enables full-blown interaction. Every student can have access to the latest laboratory equipment, all produced virtually, and be able to experiment to their heart's content without worries about hurting themselves or their school. Real-world frogs will jump with delight as dissections become virtual. Everything from human anatomy to the internals of jet engines can be taught to students, enabling them to potentially learn in more detail and at a better pace than by using scarce materials which may not be accessible to all.

As apps replace physical things, the environmental footprint could theoretically be dramatically reduced. There'll be no more old phones or televisions, all replaced by digital representations of the same with no more harmful environmental impact than streaming a movie. Even the need for clothing could potentially be greatly reduced, with digital fashions for one's online avatar interchangeable and instantly updated to the latest from Paris and Milan while the flesh-and-blood person wearing the goggles remains in sweatpants and a comfortable sweater. Aside from maybe oil companies and commercial property owners, few will likely miss the rush hour commute even though remote work comes at the cost of lost real-world interactions and touch. Because of work-from-home changes brought about by COVID, we're already seeing "dead" towns in remote places spring back to life, a trend that may well accelerate. The rural/metro divide may well shrink, bringing people potentially closer to where the food they eat is grown but also more physically removed from their colleagues and friends.

Trouble in Paradise

This raises a fundamental question: will people *want* to be plugged in or want their children plugged in for hours every day?

There are well-established physical and mental health issues associated with excessive screen use. Minimally, incessantly staring at screens is hard on the eyes. Staring into goggles, which are even closer than screens, is likely to raise further questions about the effects of nearby electronics on health, including and especially on vision. There is also the couch potato effect: sitting around for long periods connected to screens or phones has the potential to accelerate a sedentary lifestyle, which is not aligned with people's physical health and well-being. Indeed, as seen in the US, obesity is surging.[10] The human body was made for movement, and long-term health rests on it.

Although some people may play in the metaverse while on exercise equipment, it still risks inducing a fundamental and widening disconnect between people, nature, and the real world of our planet. Walking amongst trees and plants to the wonder unfolded by a cool breeze or gentle rain or the healing power of watching the ocean swell are known to be beneficial to people's emotional and physical well-being. There is a reason the planners of major cities like New York created enormous nature parks in their centers, and despite years of increasing congestion, nobody has ever seriously suggested encroaching upon them. In New York City, for example, even the suggestion of development inside Central Park would be akin to heresy. Nature is important to the human psyche, and a digital representation of a natural setting isn't the same.

Further, given Meta's historic privacy problems, there is the fundamental issue about whether the public can trust the renamed company, Meta, with the type of enormous power a digital world enables. For example, when users hide an advertisement on Facebook the company asks why the user does not like the ad. The first option is "Too personal" and the third is "Knows too much." Both choices suggest Meta realizes their insight into a user's psyche can be perceived as an invasion of personal privacy.[11]

There is also the issue of Meta's control and power. For example, should Meta decide it doesn't like somebody or a group of people, it could theoretically lock them out, making them disappear temporarily or permanently from the site. That already happens on Facebook, but people do not lose their ability to go to work, which could and would happen if the metaverse is built according to Zuckerberg's vision. Additionally, the same problem exists where traditional news organizations are drawn to produce "click bait," stories and headlines lacking context or even containing outright incorrect information, designed to draw in readers and viewers who are then monetized for advertisers like a farmer milks a cow. There's no indication of how the metaverse might mitigate these issues, or even if Meta believes them to be a problem or if all sides of society would trust Meta to make moderation decisions in an unbiased, consistent, even-handed way. If all sides of society do not trust Meta to address such issues in a fair way by applying the same criteria across all content, given Meta's far- reaching influence, its metaverse could trigger societal conflict with real-world consequences.

Facebook itself is already a metaphorical public square, but the metaverse seems to be a step towards an even larger one, a blending of the physical and digital worlds. This enables the stuff of dreams, though dreams can easily turn to nightmares. Zuckerberg's world may be a paradise for the public, though it is also certain to attract the fraudsters, predators, and all manner of other parasites that social media currently struggles with. It's unclear how Meta will manage this issue.

Given the rushed rollout of the name change from Facebook to Meta, it's difficult to minimize these concerns as Meta struggles with mounting challenges and its business practices increasingly being called into question.[12]

Screen/Gaming Addiction

In 2021, the Chinese government severely limited gaming time for children under 18. "Protecting the physical and mental health of minors is related to the people's vital interests, and relates to the cultivation of the younger generation in the era of national rejuvenation," said a Chinese government official quoted by an official government news source.[13] In addition, controlling access to gaming also serves as an extension of the Great Firewall.

While the metaverse will not be a game per se, Meta aims to create a never-ending virtual world that people will hardly ever want to leave, raising analogous concerns of addictive behavior. The World Health Organization (WHO) lists "gaming disorder" as a type of addictive behavior resulting in "marked distress or significant impairment in personal, family, social, educational, occupational, or other important areas of functioning."[14] Game addicts exhibit impaired control over gaming, give increasing priority to gaming over other life interests, and escalate their gaming despite negative consequences, according to the WHO.[15] "If you are living in an online world, there is a risk of a disconnect from your physical self, which is particularly dangerous," according to Dr. Louise Theodosiou, an adolescent psychiatrist. "If you have something distorting the relationship between the emotional and analytical parts of the brain, it's potentially damaging and also very compulsive."[16]

While it's unlikely that Meta *purposefully* wishes "negative consequences" on their users, it is unclear if Zuckerberg believes transferring a large part of a person's life into his metaverse is negative. However, as former Google "design ethicist" Steve Inskeep puts it, the industry is "less and less about actually trying to benefit people and more and more about how do we keep people hooked."[17]

Countless stories of gaming and internet addiction are easy to find. One teen on the site GameQuitters.com recounts staying up until 5:00 AM gaming when he was seven or eight years old, followed by years of impaired schooling and even outright theft to support his gaming habit. "I was stagnant, not growing, and just living with this constant desire to be playing games," wrote the author.[18] Another recovering adolescent game addict writes: "I started playing [video games] when I was around 9 years old. I played because I found it fun, but after a while I played mostly because I preferred it over socializing and confronting my problems."[19]

Throughout the world, there are in-patient internet and gaming addiction clinics, much like their substance abuse counterparts. One website lists "luxury rehabs … focused on detoxing from technology for teens and young adults."[20]

Convincing parents to invest in more computer hardware to enable ever more screen time may prove an uphill battle. In addition, while Western countries have not taken the Chinese approach to limit young people's screen time (though they restrict alcohol and tobacco sales to adults because of their addictive and destructive properties), if screen time evolves to be seen as similarly dangerous, especially among youth, it's not too farfetched to believe some level of regulation may be forthcoming in Western countries as well.

A Real-Life Business Model for a Virtual World

> Put a sign or a building on the Street (of the metaverse) and the hundred million richest, hippest, best-connected people on earth will see it every day of their lives.
>
> —Neal Stephenson, *Snow Crash*

Even dating back to Stephenson's original vision, metaverses have massive profit potential. But specifics about their business model, for Meta and other metaverses, remain blurry.

Conspicuously absent in Zuckerberg's announcement were answers about how the firm plans to financially profit from the metaverse. As noted above, he stated that they will be investing an enormous amount of capital, at least $10 billion in the first year and more in subsequent years, to build the technology. He also stated that they will lose money for a long time investing in their metaverse. But as a company with annualized revenues of $116 billion and profits of $36.8 billion (based on projecting Q2 2021), Meta has extraordinarily deep pockets for future investment.

Zuckerberg needn't worry about Wall Street getting antsy. As of Q3 2021, his personal net worth is about $120 billion. He purchased the Palo Alto houses around his own to protect his privacy and owns an enormous Hawaiian estate. Due to the way Meta is structured, Zuckerberg controls 58% of the voting rights, a figure virtually impossible to dilute with publicly traded shares.[21] Meta Class A shares, the ones the public trades, receive one vote, but the business is controlled by Class B shares which each receive ten votes and are not publicly traded. These Class B shares are overwhelmingly owned by Zuckerberg (see Appendix B). Zuckerberg has the right to unilaterally decide the business's investment priorities. Should he decide to spend all Meta's profits plus more on the metaverse for the foreseeable future, ordinary investors who disagree have little recourse but to sell their stock.

There is an enormous amount of revenue potential in buying and selling digital things. Apple realized 2019 profits of $8.5 billion from gaming alone, a figure disclosed in a recent lawsuit.[22] Since Apple captures one-third of the money spent, we can extrapolate gamers spent about $25.5 billion on iOS games alone in 2019. Industry estimates are that global gaming revenues will reach $198 billion by 2024. Still, it's difficult to imagine Meta will abandon its traditional core market of selling highly targeted advertising.

On November 9, 2021, the firm did announce, after the Meta pivot, that they'll stop enabling ad targeting based on health, race, ethnicity, political affiliation, religion, sexual orientation, and other similarly sensitive attributes. It's too early to know if the changes reflect a heartfelt pivot towards privacy or are in response to, for example, an ongoing lawsuit by the US Department of Housing and Urban Development, which sued Facebook for enabling illegal advertising based on race, religion, and national origin.[23]

Meta Isn't the Only Metaverse

Other tech firms besides Meta have built or are building or exploring metaverse technologies but describe a vision and business model with more tangible benefits.

"With our metaverse stack, you can start with the digital twin, building a rich digital model of anything physical or logical, whether it's assets, products, a complex environment spanning people, places, things, and their interactions. The digital twin is bound to the physical world in real-time so you can monitor the environment and collaborate within it using mixed reality. You can run simulations. You can apply AI to analyze and predict future states," said Microsoft CEO Satya Nadella.[24]

Epic games profits from their early metaverse by selling virtual goods such as outfits and dances. They're also pushing ahead into a full-fledged metaverse focused on their popular game, Fortnite. "What (metaverse-like technology) exists right now, it's based on algorithmic feeds that are driven by ad revenue, not a model," said Sima Sistani, whose company, *House Party*, was acquired by Epic, where she remains as head of community. "That instantly takes you into polarized worlds. If you are putting joy at the center of what you're doing, and not ads, and the goal is collaboration, the goal is fun, the goal is participating, making new friends, those are just super different incentives and motivations."[25]

Inside Fortnite, Epic hosted a series of several metaverse-like concerns. Ariana Grande performed in August 2021.[26] Her concert is difficult to describe but features a virtual Ariana Grande breaking through and flying through lights, then surfing over multicolored water into an arena that doesn't exist in the real world. As her music plays, she floats hanging from an umbrella in a multicolored universe with clouds shaped like hearts, leaping and twirling in ways that would be impossible in real life. Later, Grande wanders through space looking infinitely more stylish and lots more interesting than Zuckerberg, dancing with otherworldly planets below and stars above.

About a million people watched the concert at any one time. While tickets were free, it's not hard to imagine better virtual "seats" being sold or maybe non-fungible tokens (NFTs), much like collectible merchandise from a traditional concert. It's more difficult to imagine how the worlds enabled by these technologies could fail to be profitable rather than the myriad ways creative strategists and marketers could use the technology to profit.

Roblox is also building metaverse technology with a simple but powerful programming environment where users, two-thirds of whom are 15 years old or younger, build and play in 3D virtual worlds. Besides the newer offerings, the best-known original metaverse, Second Life, still exists, though with far fewer users than in its heyday in the early aughts.[27]

The Public Speaks

Facebook did not enable comments about the announcement of the name change to Meta and its metaverse on their own pages despite comments being arguably the single most important component of Facebook after posts.[28] However, a glance at other social media helps explain their reluctance: reaction to Meta's push to build a metaverse can best be described as unenthusiastic.

A Twitter user, channeling what he believed Zuckerberg was saying, wrote: "Now that I've turned actual reality [into] a dystopian nightmare, I'm back to sell you a new virtual reality where everything is wonderful. Trust me!" Others were less kind. Another comment read: "Tired of meeting people in real life? Try our ad-supported metaverse where we connect pedophiles to children and hate-filled people to toxic streams of disinformation."[29]

Students, one of the core target audiences, were skeptical. When asked why Meta was focused on a metaverse, Damien Theriault, a second-year New Brunswick student, said: "Money. It's always about the money."[30] Others claim that Meta is co-opting various lesser- known metaverses. "They are essentially trying to build what many of us have been building for years, but rebranding it as their own," said Ryan Kappel.[31]

Several people were gentler but suggested Meta has work to do on their core products before launching any new ones. "I think we'd all prefer you all fixing and perfecting what you've already built before focusing on what's next. Lot of work needs to be done here. Far too much to divide your attention with some future project," said Twitter user Awale Ahmed Ali.[32] "Facebook's new name is Meta," said CNN's Donnie O'Sullivan after the announced name change. "It still has all the same problems it had this morning."[33]

A smaller number of users were supportive. "People normally disrespect and FUD (spread Fear, Uncertainty, and Doubt) about other projects in which they are not invested because they think the money going to that one project isn't going to their project," wrote Twitter user SafeMoon. "People, there's so much money out there you can't even comprehend. There's lots of room for everyone."[34]

Expert opinion was more serious, and more ominous, citing research that parents should be especially wary of the new virtual reality metaverse. "Adults appear to control and regulate their [VR] presence experience by critically evaluating and monitoring the presented [virtual environment] stimuli … Children on the other hand did not, or at least to a greatly reduced extent," wrote the research team of Thomas Baumgartner, a neuroscientist at the University of Zurich.[35]

Others agree the metaverse has the potential to intensify already problematic child behaviors. "When compared to the non-immersive VR condition (watching … a television screen), children in VR showed a significant deficit in inhibitory control," wrote Stanford Professor Jeremy Bailenson in his virtual reality book, *Experience on Demand*. "How children react to media is of particular concern because their prefrontal cortex, the area that is associated with emotion and behavior regulation, is not completely developed. VR engulfs us … We slide occluding goggles over our eyes and cover our ears with headphones, overriding our two primary sense systems with simulated digital signals …VR is the apotheosis of every media fear and fantasy we've ever had."[36]

Another expert notes that virtual reality technology makes monitoring children's behaviors especially challenging. "It's already hard to monitor what your kids are doing, but at least you can look over their shoulder at a screen," said Michigan State University media professor Rabindra Ratan. "When they're in VR, they're blocked off, you can't really see what they're doing. Parents need to understand kids' games, what they're playing, why they're playing them, who they're playing them with. You have to be an informed consumer right along with them."[37]

Metaverse Technology

In his announcement of Meta, Zuckerberg focused quite a bit on metaverse technology and did not shy away from tech-related terminology. "Today we're introducing the presence platform, which is a broad range of perception and AI capabilities that empower developers to build mixed-reality experiences," Zuckerberg said. His use of the term "platform" could be interpreted to mean that the firm aims to create a metaverse of metaverses, a universe controlling traffic to metaverses much as Google controls search results.

Following on, he went into detail about the difficulty of programming virtual hands that mimic real-life hand movements and brought in the former head of Facebook Reality Lab and now Facebook Chief Technology Officer Andrew "Boz" Bosworth in his announcement video.[38]

"Realistic presence is the key to feeling connected in the metaverse," Bosworth says in the video. "Things like environmental understanding, content placement and persistence, voice interaction, standardized hand interactions. In fact, let's start with hands. The human hand is an engineering marvel. Bringing hands into VR was no easy feat … Today, we're introducing the Interaction SDK, a library of components that will make it easy to add hand interactions to your apps."

"That's pretty exciting!" answers Zuckerberg, using a definition of "exciting" that clearly targets software developers.

One of Zuckerberg's lead advisors on metaverses is Matthew Ball, a venture capitalist at EpyllionCo and former head of strategy at Amazon Studios. "I thought Matthew Ball's essays were great, and anyone who's trying to learn about [the Metaverse] … he wrote a nine-part piece on a bunch of the different aspects of what the metaverse could be, and I highly recommend all of them," Zuckerberg wrote.[39]

Ball argues a fully functional metaverse must have certain attributes.[40] It will:

1. Be persistent, an experience that never ends;
2. Be synchronous and live, a real-time community just like real life;
3. Scale indefinitely – a metaverse will support unlimited users, though regardless of the total number, individual users will each have their own sense of self, as in real life;
4. Include a fully functional economy;
5. Span across networks, much as the web itself is not tied to any single website; and
6. Offer "unprecedented interoperability" much like real life–a product acquired in one metaverse will work in an entirely unrelated one.

Charting Towards a Blue Ocean?

> "What is your ultimate objective? As you know, we are all in this together, so you may share your thoughts with me." [Hiro replies] "I'd prefer a little more discretion in this case …" "Too late for that, Hiro," says another voice.

According to Ball, "Metaverses are a blue ocean opportunity.[41] Look at the classic categories that have been merged with the internet. They don't displace. Telecom, banking. In mobile, we see Venmo, Square, Stripe that are predominantly around mobile. Skype still exists but WhatsApp is much larger. In the metaverse, we see cryptocurrencies and Discord and Fortnite beginning to supplant traditional platforms. All those are larger than they've been because the economy grew so much. Those are new companies that emerged to found blue oceans.

"Developers are the one limitation where you do see more direct competition," Ball says, comparing the need for tech companies to attract developers to the need for movie studios to attract talent. "In Hollywood, we bid for creatives but don't necessarily compete for viewers … Better, faster, cheaper for developers will lead to better profits for developers. Devs always go to where the profitability is. Nobody invests in learning a language nobody speaks."

Questions

1. *Is Meta's metaverse on track to offer a leap in value to users, or is it more akin to technology innovation that advances technology without necessarily delivering a compelling leap in value for users? Explain your thinking.*
2. *Meta's vision has social, economic, and environmental implications. Enumerate what you see as the strengths and weaknesses of its metaverse across these dimensions and how to ameliorate some of the weaknesses or concerns to better link Meta's technology to a leap in value.*

3. *If Meta realizes its intention of creating one enormous metaverse, it will yield even greater political, social, and economic power for the business. Are there safety issues with one business holding this much control? How could this best be mitigated – a breakup of the business? government regulation? something else?*
4. *Matthew Ball argues that it is developers who will control the metaverse, the digital creators who will build what Meta hopes to be a blue ocean, a new market space that is a win for society and customers. Do you agree? Why or why not?*
5. *If Meta is committed to using less data for targeted advertising, as it claims, what might be its business model?*

Notes

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41. Interview with Matthew Ball, Sept. 6, 2021.

Appendix A

Snow Crash

Amazon's *Snow Crash* page:
https://www.amazon.com/Snow-Crash-Neal-Stephenson-ebook/dp/B002RI9KAE/ref=sr_1_1

Neal Stephenson

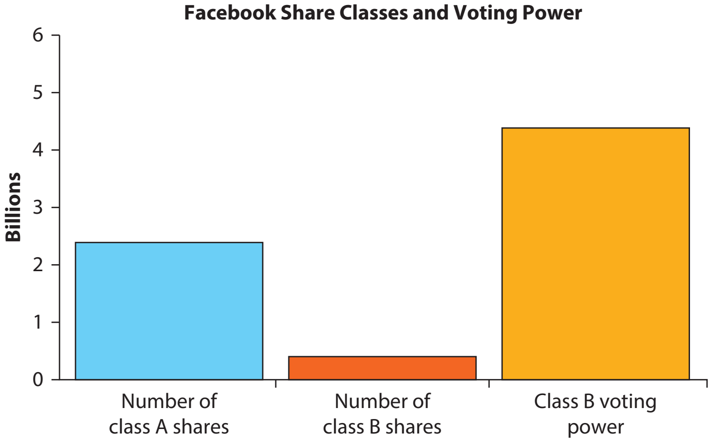
"This Snow Crash thing—is it a virus, a drug, or a religion?"
Juanita shrugs. "What's the difference?"

The only relief from the sea of logos is within the well-guarded borders of the Burbclaves. Is it any wonder that most sane folks have forsaken the real world and chosen to live in the computer-generated universe of virtual reality?

In a major city, the size of a dozen Manhattans, is a domain of pleasures limited only by the imagination. But now a strange new computer virus called Snow Crash is striking down hackers everywhere, leaving an unlikely young pizza delivery man as humankind's last best hope.

Appendix B

Facebook Class A and Class B Shares



Source: Morningstar

https://www.morningstar.com/articles/1061237/how-facebook-silences-its-investors

Case 13

Streaming the Future: Netflix's Global Expansion

Out of the 7.7 billion people on the planet, only 371 million are native [English] speakers. And yet, historically, the majority of entertainment content in the world has been produced in Hollywood in the English language. It's in that disconnect that we see a tremendous opportunity.[1]

—Greg Peters, Netflix Chief Product Officer (2019)

Streaming the Future

On the morning of November 10, 2020, Anna Mallett sat at her desk at Independent Television News (ITN) in London and gazed out the window.[2] She knew the day would be full of commotion; in the early morning hours, the announcement of her imminent departure as ITN's CEO had been made public in a press release from Netflix. Mallett was assuming the expansive role of Netflix's vice president (VP) of Physical Production, in which she would oversee all production in the United Kingdom and all local-language production across Europe, the Middle East, and Africa (EMEA); Mexico, Central America, and South America (LATAM); and East Asia, South Asia, Southeast Asia, and Oceania (APAC). While she would miss her CEO role as well as the team she had built at ITN over the past year and a half since joining in April 2019, Mallett was ecstatic about the opportunity to join Netflix and lead the company's local production efforts throughout most of the globe.

Nevertheless it was a huge responsibility, and as a practical matter, it would dramatically change Mallett's rhythms of work, operations, and leadership. She recognized that the role would require all the expertise she had gained over the preceding decades. While ITN was one of the largest independent television production companies in the United Kingdom—focused largely on the news programming of Britain's ITV, Channel 4, and Channel 5—Mallett knew she would also need to draw on her previous experience at the British Broadcasting Corporation (BBC), where she had led BBC Studioworks and directed the BBC's overall commercial strategy,[3] overseeing high-profile shows like *Strictly Come Dancing* and the venerated serial science fiction drama *Doctor Who*.[4] She would likely find valuable the seven years she had spent at the Boston Consulting Group in London, where she had focused on media and retail, and even her MBA from Harvard Business School and her DPhil from Oxford. In many ways, Mallett saw all her training and experience as having prepared her for this moment. And it was a moment she was eager to seize. As she stated, "I am thrilled to be joining Netflix at this exciting time as the company continues to accelerate its production of great stories from all over the world. Netflix is a creative powerhouse, and I am looking forward to working with my exceptional new colleagues across the UK, EMEA, LATAM and APAC to bring the very best films and series to audiences everywhere."[5] She would be reporting to Ty Warren, Netflix's VP of Worldwide Production, who had suggested that Mallett's hire came at a crucial time for Netflix; she would bring "a wealth of global production experience and strategic expertise to our production team as we continue to expand our investment in original programming throughout the world."[6]

After 2020 Q2 earnings posted another quarter of massive growth in paid subscribers, Q3 earnings showed a substantial slowdown in new subscriptions, totaling 28.2 million for the first three quarters of 2020. The 26 million added subscribers through the first half of 2020 represented a more than 100% increase over 2019, but the drop in new additions to 2.2 million in Q3 fell short of expectations and caused concern.[7] Nevertheless, Netflix's impressive growth outside of the United States and Canada in recent years—more than half of paid subscribers now lived in the European Union, Latin America, or Asia—put the company in a good position to continue to capitalize on the massive uptick in digital consumption resulting from COVID-19. Despite the pandemic pausing production on various studio projects, both in the United States and abroad, Netflix had been able to keep its global member base satisfied with a steady stream of new content acquisitions and original releases.

Yet, as the company acknowledged,[8] the favorable bump in performance during the first half of 2020 was best treated as an aberration, and Netflix should not allow short-term gains to distract from the reality that the pandemic-stricken future was rife with uncertainty; the downtick in new subscribers in Q3 illustrated some of that unpredictability. Competition was more intense than ever before, with nearly every major entertainment company now pushing its own streaming service and many boasting back catalogs of content going back several decades. How could Netflix continue its impressive growth and stay true to its mission of providing entertaining and valuable content to more and more customers all around the world? What would be the role of local content production across the globe in Netflix's continued growth and

This public-sourced case was prepared by Jared D. Harris, Samuel L. Slover Associate Professor of Business Administration; Dennie Kim, Assistant Professor of Business Administration; and Renzo Vasquez (MBA '21). It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

success? These questions fell squarely on Mallett's shoulders as she assumed her new role at the company.

From Red Envelopes to Oscars

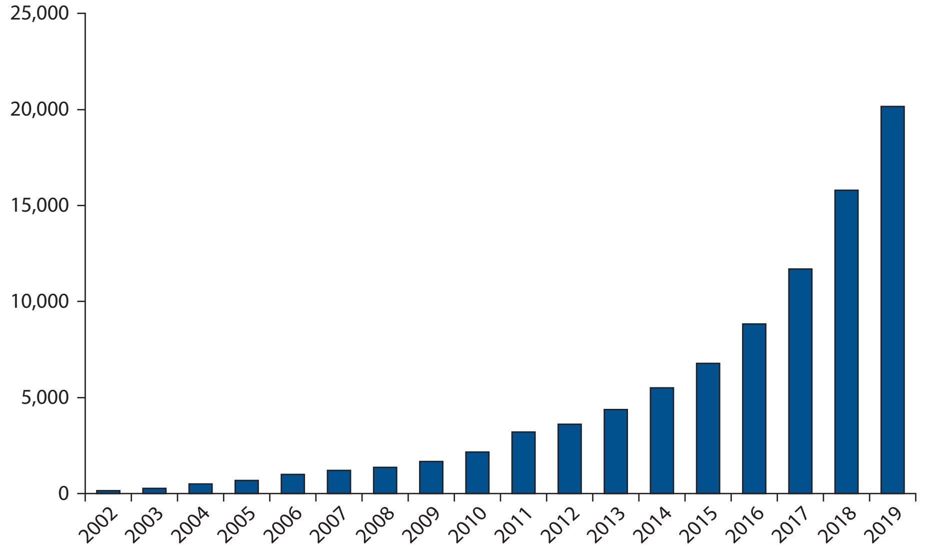
Founded in 1997 by Reed Hastings and Marc Randolph in Scotts Valley, California, Netflix started as an online DVD subscription service, mailing red envelopes containing movies and ultimately helping to usher in the demise of brick-and-mortar video rental stores, such as Blockbuster and Hollywood Video. In 2007, sensing the evolution in media consumption, Netflix transitioned to a subscription video-on-demand (SVOD) model, becoming a pioneer in this service—though not before the now-famous Qwikster misstep, when Netflix tried to spin off its DVD rental business as a separate entity.[9] By 2020, Netflix was the world's leading subscription-based streaming-entertainment service provider, with a presence in over 190 countries, and it was recognized as a major production company, with eight Academy Awards for motion pictures and more than 30 Emmy Awards for television.[10]

Netflix's core business was its SVOD service model, in which the company received monthly fees from subscribers, who in turn had unlimited access to a unique, region-specific library of both licensed and Netflix-original content, such as television shows and feature films, that could be streamed on demand.[11] Most users could access Netflix through a number of different platforms, including personal computers, smartphones, tablets, smart televisions, and video game consoles. This model had been wildly successful for Netflix and had since been imitated by numerous international and domestic competitors around the world. In Q2 2020, Netflix generated USD6.1 billion in revenue, with nearly 193 million paid memberships across the globe.[12] Even prior to the significant increase in growth due to COVID-19, Netflix's revenues had grown at an average rate of 33% annually since its IPO in 2002 (Exhibit 1), and net income grew 98% on average, annually, yielding net earnings of USD1.87 billion in 2019.[13] As of the end of October 2020, Netflix's market capitalization was estimated at nearly USD222.8 billion, with a price per share of USD504 (Exhibit 2).

Netflix's performance was particularly impressive given the intense competition it faced from other SVOD services such as Hulu and Amazon Prime, more traditional cable television providers, transactional video-on-demand services like Apple TV, free or ad-based services like YouTube, and countless other forms of digital entertainment that could occupy a potential subscriber's leisure time. While being one of the first movers in the industry may have helped initially, it did not explain how Netflix was able to defend against new entrant after new entrant, in particular competing services from companies that owned the content Netflix had previously licensed.

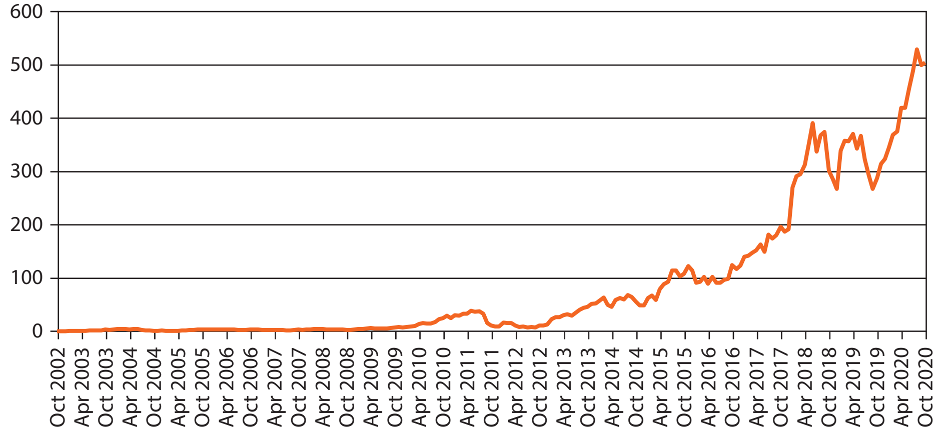
Instead, Netflix's survival and success could be attributed to its strategic investments in technology, internationalization, and content, all of which complemented one another. Put simply, while Netflix's streaming platform was the technology that most members associated with the company, it was in many ways secondary to the invaluable data on user preferences that the company captured. At a baseline, this data could be used to simply update each user's recommendations, but taken further it could be used to generate broader insights into the behavior of certain demographic groups. Once it was armed with this knowledge, it was only a matter of time before Netflix began to acquire and produce original content, starting with the critically acclaimed *House of Cards* television series, which it won in a competitive bid against HBO.

Exhibit 1 Netflix's Revenues from 2002 to 2019 (in millions of US dollars)



Source: Unless otherwise noted, all exhibits created by authors using publicly available data.

Exhibit 2 Netflix Stock Price (in US dollars)



This important strategic move was a milestone in Netflix's evolution that began to reduce its dependence on other companies, while simultaneously increasing the unique value of its service. Consequently, Netflix's growth could be seen as more than simply a push to increase revenue: it was also a way to enhance its own unique capabilities and resources. As Netflix expanded to more members, in more countries, with a library of increasingly diverse content, the data it was able to collect and utilize became even more powerful, enabling it to make increasingly informed and efficient decisions about the types of content that it licensed and produced.[14]

Netflix's Global Expansion

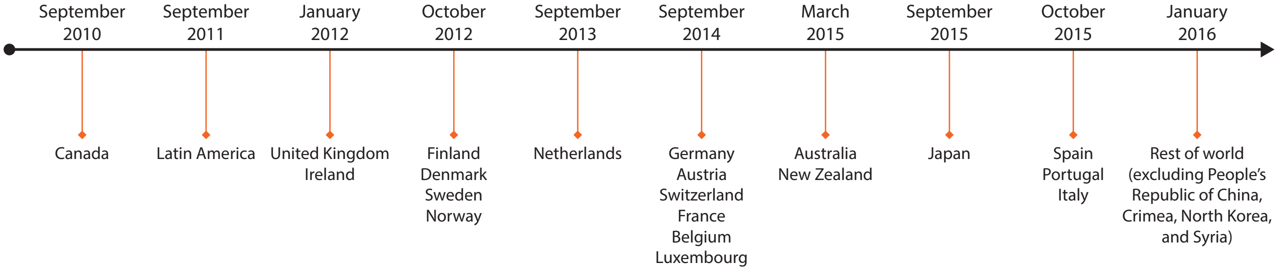
Netflix's process of global expansion had become a key to its success, but its international expansion hadn't happened all at once. Rather, Netflix's global expansion strategy had unfolded in several phases. First, the company carefully selected its initial adjacent markets in terms of geography and market similarity.

In 2010, three years after launching its streaming service, Netflix expanded outside the United States for the first time, bringing its streaming service to the Canadian market.[15] Canada was the United States' largest geographic neighbor and shared many demographic and cultural similarities with the United States, allowing Netflix to "develop its internationalization capabilities" in a location where the "challenges of foreignness were less acute."[16]

This allowed Netflix to develop the knowhow to expand into a more diverse set of markets shortly afterward. Just one year later, Netflix launched its service across 43 countries in Latin America. Between 2012 and 2015, the company continued its expansion, reaching the United Kingdom, Ireland, Sweden, Denmark, Norway, and Finland in 2012; the Netherlands in 2013; Austria, Belgium, France, Germany, Luxembourg, and Switzerland in 2014; and Spain, Italy, Portugal, Australia, New Zealand, and Japan by the end of 2015. This faster and "more-extensive international expansion" continually drew upon lessons learned and was influenced by each new market's "degree of attractiveness" that incorporated "shared similarities, the presence of affluent consumers, and the availability of broadband internet."[17]

Then, just a month later in January 2016, Netflix went live in another 130 countries throughout Africa, the Middle East, and Asia (Exhibit 3).[18] To achieve this "much accelerated pace" of international expansion, the company employed everything it had learned from its global experiences so far, including an understanding of how to determine the "content people prefer, the marketing they respond to, and how the company needed to organize itself."[19] The expansion into markets that were further removed, both culturally and geographically, required Netflix to invest in more localized content, as well as make technological investments that involved

Exhibit 3 Netflix's Global Expansion



Source: Adapted from Galileo Russell, "When Will Netflix Start Producing Cash Flow?," Seeking Alpha, July 26, 2017, https://seekingalpha.com/article/4090754-when-will-netflix-start-producing-cash-flow (accessed Feb. 4, 2022).

big data analytics. These investments facilitated the "mastery of local contexts, including the ability to acquire local knowledge and to demonstrate sensitivity and responsiveness."[20]

Given its operations in so many international locations, Netflix was able to try different approaches in different markets, relying on customer usage data to help determine which offerings worked best in various regions; as the number of Netflix's international subscribers grew, the "performance of its predictive algorithms" continued to improve.[21] By Q1 2017, the company had realized its first profits from the international streaming segment. This encouraging milestone fueled further investment in global growth.[22] By Q2 2017, international subscribers had exceeded its domestic ones for the first time in its history.[23] By 2018, international streaming had produced more revenue for the company than domestic streaming,[24] and the United States no longer boasted the most streaming titles, having been surpassed by Japan.[25] Amid increasing competition and slowing growth in the domestic market, the considerable opportunities in the international arena made it clear that Netflix's future success would be driven by its global aspirations (Exhibit 4). As it continued to both literally and figuratively translate the value of its service for global audiences, the company had to continue to make critical decisions in several key areas, such as content, pricing, and a number of other operational issues associated with global expansion.

Content

Netflix's core business model relied on licensing content from intellectual property (IP) owners in order to make it available on the streaming platform. However, Netflix needed to negotiate licenses for each country where the content would be available. Moreover, as an American company that primarily catered to American audiences, Netflix predominantly dealt in content that would appeal to the domestic market. While this might not be a major issue for expansion to a country like Canada, it was not a foregone conclusion that the same content would be as desirable for customers in France, India, or Nigeria—countries that not only differed culturally but also had their own robust film and television industries.

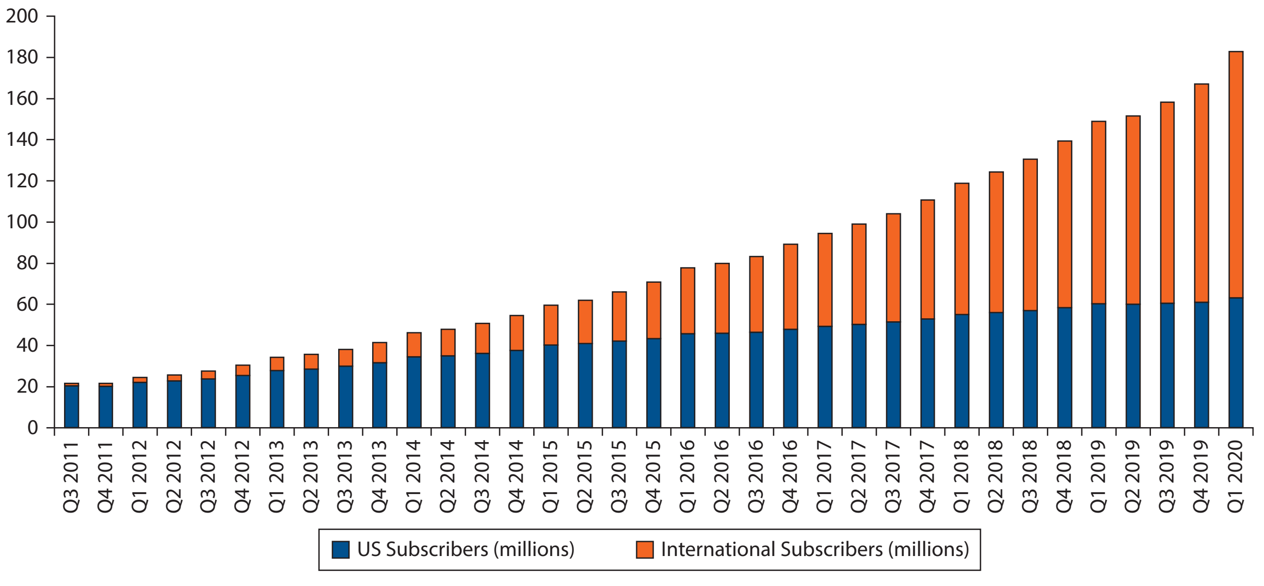
One key strategy that Netflix employed to address some of these challenges was to become the IP holder for original content. This step would at least eliminate the need to manage thousands of licenses across a few hundred different markets. Moreover, despite the considerable investments that were required to acquire and develop high-quality content, at first predominantly in the United States, the ability to easily roll it out to millions of subscribers across the globe made the cost accounting a bit more favorable.

Yet this strategy could not address the additional challenge of accommodating differences in cultures and customer preferences. To overcome this hurdle, Netflix secured licenses to local content in various countries and found that, in many markets, subscribers preferred these programs over US content that was subtitled or dubbed. Perhaps more importantly, Netflix also learned that global audiences simply had a taste for high-quality content, no matter the language or cultural differences. For example, the Spanish crime drama series *Money Heist* made Netflix's top-10 most-viewed lists in more than 70 countries.[26] Similarly, Netflix brought television shows and films from several Asian markets to Western audiences, touting this content as "made in Asia[,] watched by the world."[27]

Pricing

The other problem that Netflix had to solve was how much it should charge customers for its streaming service. Since content was licensed separately for each market, and because different audiences could perceive the same content differently, the value of Netflix's service could vary from country to country. Moreover, subscribers'

Exhibit 4 Domestic and International Subscribers by Quarter (in millions)



willingness and ability to pay was another important consideration in certain parts of the world. Whereas Netflix gradually increased prices in established markets like the United States (Exhibit 5), price sensitivity was a significant concern for newer markets.

Consider the example of Netflix's foray into the Indian market beginning in 2016. [28] With a population of more than one billion, India was clearly one of the most attractive markets to enter, even more so because of the massive popularity of films there. By 2018, Netflix had ramped up investments in local content and marketing. "It's been the fastest investment we have ever made in any country since we launched. This really reflects the richness of content creators we can draw on—the best of Indian storytellers to create high-quality original series and movies," said Michael Spiegelman, VP of Global Product Innovation.[29]

However, despite this enthusiasm, Netflix faced a major hurdle: its service was more expensive and had less local-language content than its competitors. In other words, the Netflix service simply was not a good value for many Indian customers. In early 2019, a Netflix subscription started at INR500 (about USD6.61) per month; Hotstar, the market leader, charged its customers INR365 (USD4.83) per *year* and held 70% market share.[30]

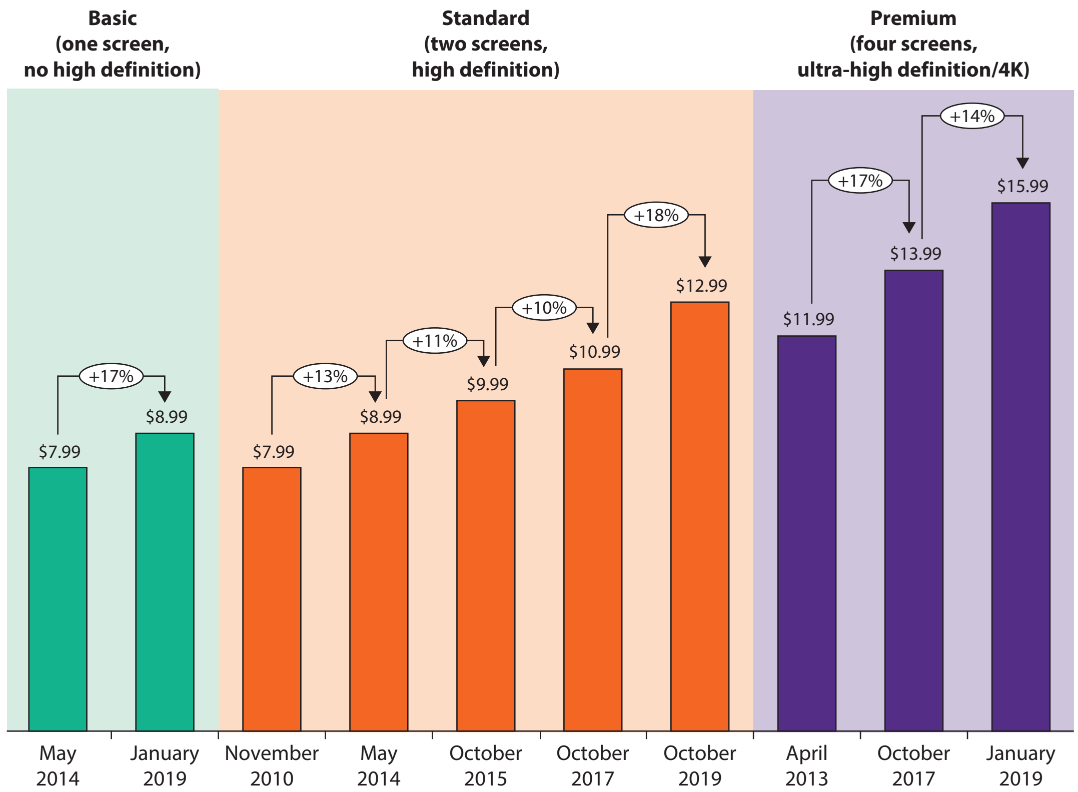
In response, Netflix began implementing new pricing schemes.[31] By the middle of 2019, Netflix rolled out an innovative "mobile-only" plan to offer its service for a fraction of the cost (INR199 per a month). By the end of 2019, Netflix CEO Reed Hastings announced the company's plans to invest INR3,000 crore[32] (over USD400 million) on original and licensed content within the Indian market,[33] an increase of 350% over its previous content budget for India.[34] By tailoring its service and pricing to better align with the demands and preferences of Indian customers, Netflix was able to achieve an eightfold increase in revenue (INR58 crore to INR470 crore) and a 25-fold increase in profits (from INR20 lakh[35] to INR5.15 crore), both relative to the prior year, by the end of 2019.[36] Building off these successes on the subcontinent, Netflix launched mobile-only plans in Indonesia and Malaysia, with similar results, fueling Netflix's rapid growth in the APAC region.[37] Between Q4 2019 and Q1 2020, the percentage of subscribers in the APAC region grew from 9.7% to 10.8% thanks to the addition of approximately 3.6 million new subscribers (Exhibits 6 and 7).

Successes in Asia, and other parts of the world, were proving more important than ever before for Netflix to sustain growth. While Netflix was never without competition in the streaming business, rivalry was about to become even more intense for the SVOD leader.

Other challenges

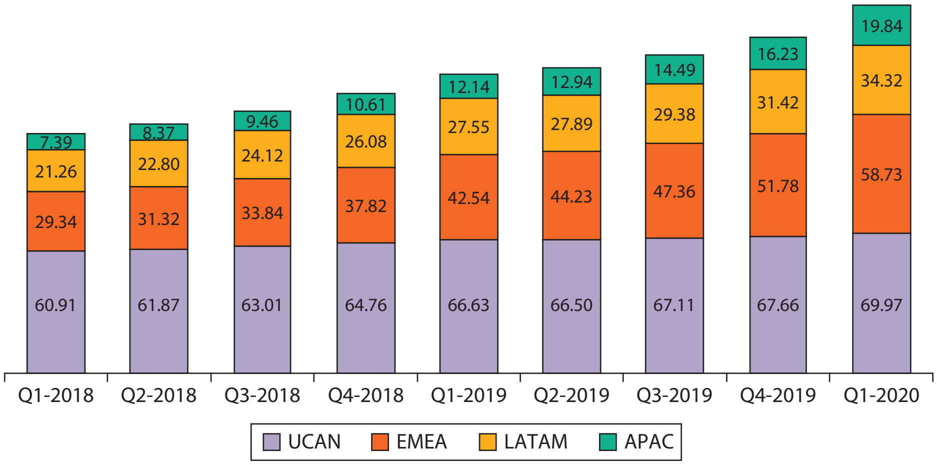
Beyond the fundamental functions of content development and product pricing, Netflix also employed a localized

Exhibit 5 Netflix US Subscription Price Increases, by Tier



Source: Created by authors based on data from Statista.

Exhibit 6 Netflix Total Subscribers by Region

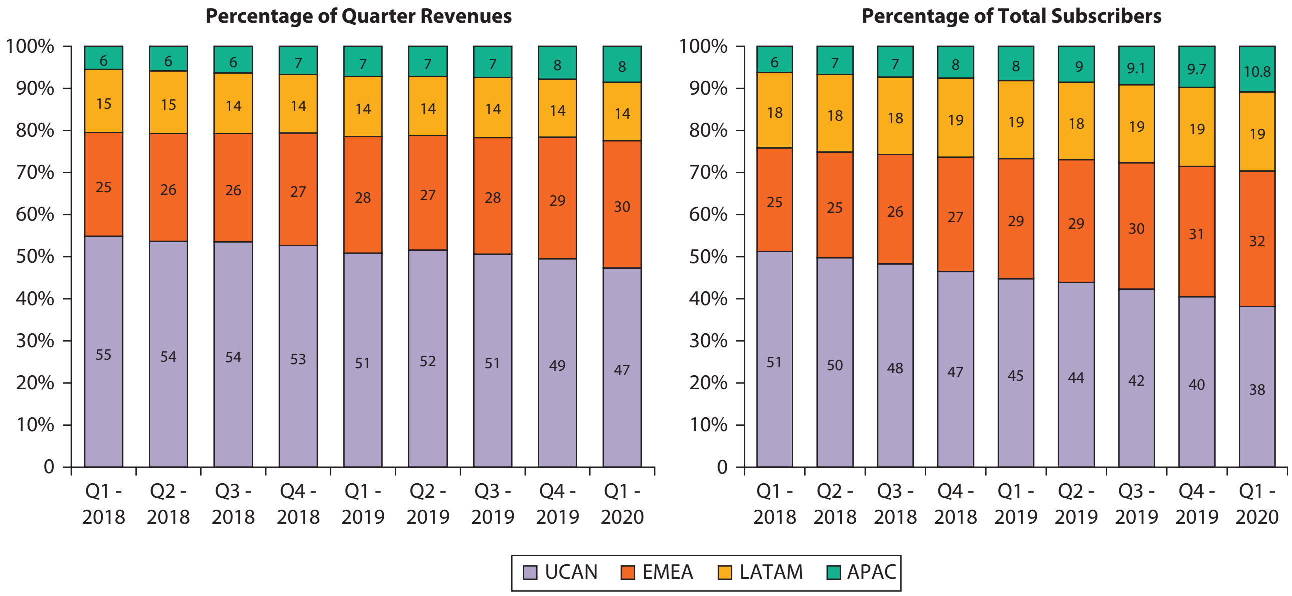


Note: UCAN = United States and Canada; EMEA = Europe, the Middle East, and Africa; LATAM = Latin American; and APAC = the Asia-Pacific Region.

approach that provided a crucial degree of flexibility. International markets varied widely, requiring the company to secure content deals region by region. Netflix also faced a "diverse set of national regulatory restrictions" that dictated programming criteria and limited the availability of certain content in local markets.[38] Furthermore, international subscribers often preferred local-language programming, requiring the company to add subtitles and dubbing to streamed content, and local languages to its user interface. And the complexity posed by language differences didn't stop there; support for "a range of device, operation, and payment partnerships" also needed to be developed,[39] and simple translation didn't address all challenges with customers, either.

For instance, language changes also posed design challenges; as text was translated from English to other languages, it tended to "expand both horizontally and vertically," potentially degrading user experiences on foreign language versions of Netflix's user interface, as text "gets cut off, calls to action are only partially visible," or the "layout just looks wrong."[40] These challenges—simply posed by language translational issues—prompted Netflix to employ a technology called "pseudo localization," which was a way for designers to anticipate how the translated text would

Exhibit 7 Revenue and Subscriber Share by Region, per Quarter



Note: UCAN = United States and Canada; EMEA = Europe, the Middle East, and Africa; LATAM = Latin American; and APAC = the Asia-Pacific Region.

appear, facilitating better approaches to design and layout[41] and supporting rapid expansion of services. For instance, within six months of entering Poland and Turkey in 2016, Netflix had added local languages to its websites, made subtitles and dubbing available on its streaming content, and continued to engage with early adopters and iterate quickly.[42] Expanded language offerings also facilitated even greater personalization algorithms, varying by region, for its global library of content.

Local regulations and language translational challenges were far from the only hurdles associated with localized market penetration, however. Netflix needed its localized programming content to "feel true and authentic to the country it originates from," because, as former Netflix executive Erik Barmack explained, "a show in India has to feel loved in that market first for it to have any strategic value."[43] Achieving this outcome required a deep knowledge of local cultures, across a number of political, institutional, technical, customer, and competitor domains. International expansion and success remained a complex, multi-stakeholder and multi-disciplinary challenge for organizations seeking wide global distribution and presence.

The Streaming War Intensifies

In the United States, Netflix's home market, SVOD was an increasingly crowded and fragmented space in 2019, with leaders Netflix, Amazon Prime, and Hulu pitted against one another and an ever-growing number of new entrants. Services like YouTube, Direct TV NOW, HBO NOW, Sling TV, and CrunchyRoll[44] never posed major threats, but 2019–20 ushered in serious competitive pressure from major IP holders, such as Disney+ (Disney, Fox), HBO Max (Time Warner), and Peacock (NBCUniversal), and new competitors investing heavily into premium original content, such as Apple TV+. Not only did this affect Netflix's content—for example, hugely popular movies and shows for Netflix like the Marvel Cinematic Universe films, *Friends*, and *The Office* were the IP of Disney, Time Warner, and NBCUniversal, respectively—but it also threatened subscriber numbers and Netflix's ability to acquire new content in the future.

Another notable characteristic of the new wave of competitors was that services like Disney+ and Apple TV+ were global ventures from launch, and they had distinct advantages that enabled them to quickly build a subscriber base. Apple could rely on its massive network of devices, from smartphones to laptops. Additionally, it offered a free year of Apple TV+ to customers buying a new device in 2019, which enabled it to quickly reach an estimated 33.6 million US subscribers.[45] Disney, by contrast, relied on its vast international experience, world-class brand, and some of the most successful IP in cinema history, from the original library of Disney classics, to Pixar, *Star Wars*, and Marvel. Consequently, it was not a huge surprise that Disney+ boasted more than 60 million subscribers by August 2020, less than one year after its launch.

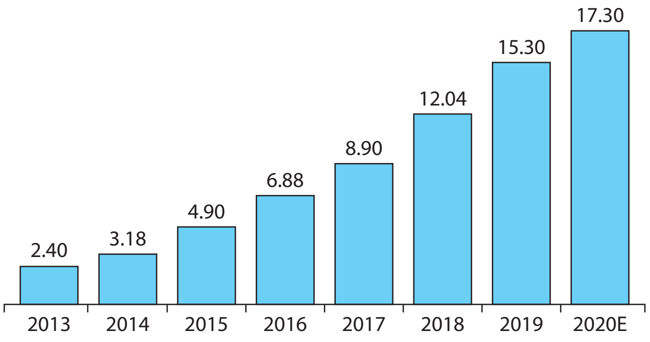
The relative ease with which major studios could launch competing services meant that Netflix faced heightened competitive pressure and uncertainty moving forward. For example, when the impending launch of Time Warner's service threatened the availability of *Friends*, Netflix paid USD100 million to retain its license for one more year until the acclaimed television show moved over to HBO Max in 2020.[46] NBCUniversal agreed to a USD500 million five-year deal, beginning in 2021, for *The Office*, effectively outbidding Netflix for one of its most popular TV shows. The escalation of costs was unlikely to apply to licensed content alone; with more competitors with deep pockets, the bidding for new creative projects was also likely to intensify as an increasing number of notable writers, directors, producers, and actors aligned themselves with streaming platforms to secure more creative freedom and, just as important, massive paychecks.[47] With subscribers able to jump to competitors with only a few clicks, the only way to increase the opportunity and switching costs was to continue to provide highly desirable content. Consequently, despite Netflix's enviable market position, the competitive balance could potentially shift very quickly.

Pandemic Impacts Competition

Of course, it was not simply escalating competition that Netflix faced in 2020. There was also the matter of the global COVID-19 pandemic, which first affected Asian countries but hit European markets and the United States especially hard. On one hand, a global event that forced hundreds of millions of people to shelter in place and work from home could be seen as good for the streaming business. Indeed, in the second quarter of 2020, Netflix's revenue was up 25% compared to Q2 2019, and it added 10.1 million new subscribers that quarter compared to 2.7 million in Q2 2019.[48] On the other hand, the pandemic did not do Netflix any favors considering the importance of content—production on nearly all projects screeched to a halt for several months and it was unclear when work would restart in some parts of the world.

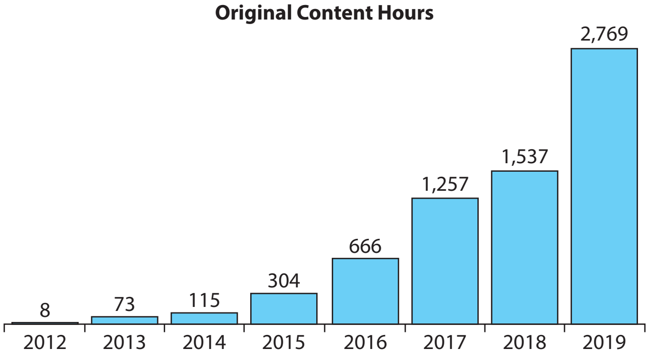
On a broader level, the pandemic also caused a sea change for the television and film industries. Movie theaters were shut down in many countries; major studios delayed releases; and companies began experimenting with launching multimillion-dollar films on streaming services. The live-action version of Disney's *Mulan*, which was delayed from its original March 2020 release, went straight to streaming on Disney+ under a "premium fee" model in which most subscribers could purchase access to the film for approximately USD30—a higher price point than was typical for digital film purchases, but perhaps lower than the cost of a three- or four-person family outing to the theater. While it was still unclear how successful this supposedly one-time "strategy shift"[49] was for Disney, some estimates suggested that it may have been a relatively successful experiment,[50] despite piracy,[51] boycotts,[52] and critical reviews.[53] By contrast, *Tenet*, a much-anticipated movie by acclaimed director Christopher

Exhibit 8 Netflix's Spending on Content (in billions of US dollars)



Note: E = estimate.

Exhibit 9 Original Content Hours Produced by Netflix

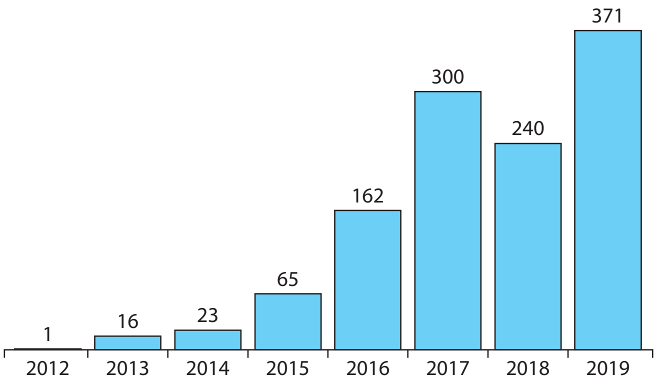


Nolan, pushed forward with a theater-only release at the end of summer 2020 and ended up flopping at the box office; not even big names and a USD200 million budget could overcome the pandemic.[54]

Looking to the Future

The pandemic showed no signs of abating as Mallett assumed her new role at Netflix. She looked toward the end of 2020 and the holiday season, wondering what was in store for Netflix. The future of the streaming business was already becoming more uncertain due to the proliferation of competing services and the continued growth of alternative media formats like TikTok and Twitch, as well as substitutes such as video games. Now, with the impact of COVID on the production of new content and customer behaviors, it was even more unclear what the "post-COVID" world would look like.

Exhibit 10 Original Content Titles Produced by Netflix



Surely, Netflix stood to benefit in the short term from more families staying at home and relying on media that they could consume without going outside. But how durable would this growth be once, for instance, a vaccine became widely available? Similarly, how would customer attitudes change as the pandemic continued, and after it passed?

In terms of Netflix's business model, high-quality IP was becoming increasingly difficult and costly to acquire, but Netflix had made big bets on its ability to do so on a global scale (Exhibits 8, 9, and 10). The company spent approximately USD15.3 billion on content in 2019, with 80% of its content spending allocated to produce original content in 2020. It released 371 shows and movies in the United States alone in 2019, a 55% year-over-year increase. But as Netflix ventured further into the business of production and awards shows, did it risk increasing exposure to the traditional "blockbuster"-driven industry, where many failed investments were offset by a small number of huge successes? Would investing in high-quality content alone be enough, or did Netflix have to reconsider what value it provided to its members?

One thing seemed almost certain: growth would have to come from abroad.[55] In order to capture these opportunities, though, Netflix had to stave off competition from international services, such as Amazon Prime, Disney+, and soon, HBO Max, as well as countless local competitors in nearly 200 countries. Riding the wins of positive quarterly reports for the first half of 2020, now was as good a time as any to seriously consider what the future held in store for the company as it moved its global streaming business forward.

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Case 14

NIO: Battling Tesla with Battery as a Service

"Buying is a profound pleasure" were the wise words of Simone de Beauvoir, the noted existentialist author, on the salutary effects of material acquisitions on the human psyche.[1] While they were spoken more than half a century ago, the impact of acquisitions on consumer utility remained relevant, but with a caveat. A research report had found that while consumers had the same adrenaline rush from material acquisitions, the methods of acquisition had changed.[2] Over the last two decades, consumers had been reducing their purchase of physical goods as a percentage of their total household expenditure, and instead, spending more on services and experiences. They preferred to access physical goods on a needs basis, in a shorter timeframe. There was a similar trend in the B2B sector as well; businesses had been lowering the share of illiquid assets like property, plants, and equipment as a fraction of their assets, and outsourcing more activities.[3] Was this change in consumer preferences permanent or transient? Could firms offer their products using alternative means (for instance, as a service) to take advantage of this change? NIO's CEO and founder, William Li, was likely betting that the change in consumer preferences was indeed permanent.

On August 9, 2021, NIO shares rebounded 3.1% to reclaim the 50-day and 200-day moving average indicators after a 16% fall in stock price the previous month.[4] NIO was one of the strongest competitors of Tesla in the electric vehicle (EV) market in China. While 100% of the firm's sales came from China, it had plans to expand globally in the near future.[5] Many investors and stock analysts in the market were closely watching NIO to see if it could mirror the path Tesla had taken to become a strong global competitor. While Tesla was the clear leader across all markets in the EV sector, the competition was intense, and NIO had launched battery-as-a- service (BaaS) as its unique selling point to attract consumers and compete against rivals. In a press release, William Li had stated, "We believe products and technology must change along with the way people use them and their entire ownership experience. We want consumers to feel optimistic about owning a car."[6]

NIO had launched BaaS in 2020 to offer battery charging and swapping services to EV owners for a small monthly subscription fee. BaaS users could buy a NIO car without the battery, resulting in savings of more than US$10,834 (CNY 70,000)[7] on all NIO models.[8] This brought the EV to a similar price bracket as fuel-run cars, making it attractive to a wider range of consumers. It also improved NIO's price competitiveness against larger EV manufacturers like Tesla in the cutthroat market.[9] Moreover, it allowed the firm to enjoy the subsidies that had been extended by the Chinese authorities in April 2020 to EVs priced below US$46,400 (CNY 300,000) if they supported battery swapping.[10] The Chinese government had offered these subsidies with the stated intention of accelerating the move from fossil fuel vehicles to EVs.

EVs were an important element of the strategy in the transportation sector to act on climate change and contribute towards a circular economy. They offered a more environment friendly and sustainable way of life to consumers, and NIO and Tesla were leading the way in producing next generation EVs. There was also an increasing push from environmental agencies to allow used batteries from EVs to be reused for other projects (like home solar) to extend their shelf life, and only discarding them once their full usage capabilities had been extracted.[11] Hence, the BaaS service was seen as an effective solution to combat the environmental impact of batteries. Individual car owners did not own and dispose the batteries; instead, the vehicle manufacturer would retain the batteries for reuse and disposal. Managing the usage of batteries at an organisational level ensured that batteries could be reused in a more environment friendly manner. BaaS was also useful to the consumers living in smaller houses/apartments where they did not have the infrastructure to charge their cars.[12]

However, setting up the infrastructure to support BaaS (i.e. charging and swapping stations at various locations) was an expensive affair.[13] Moreover, these stations could be used for charging only NIO cars and not other EVs. Besides, the technology for batteries had improved to the extent that they could last longer in terms of miles travelled based on a single charge, reducing the need for frequent recharge/swaps at charging/swapping stations. Given the scenario, was NIO's BaaS venture a sustainable business model? Could it provide the company with a strong competitive advantage?

Climate Change, Electric Vehicles and the Circular Economy

EVs had seen growth primarily because of the climate change agenda, which had been a topic of international discussions for the last two decades. A global panel on climate change had forecasted a temperature rise of 2.5 to 10 degrees Fahrenheit over the next century due to global carbon emissions with transport accounting for around one-fifth of the total emissions.[14] Road transport accounted for three-quarters of

This case was written by Professor Shantanu Bhattacharya and Lipika Bhattacharya at the Singapore Management University. The case was prepared solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

those emissions, i.e., 15% of the total carbon dioxide (CO_2) emissions globally.[15] EVs were perceived as a reliable solution towards reducing road transport emissions, as they did not directly use fossil fuels and other carbon emitting sources of energy.[16]

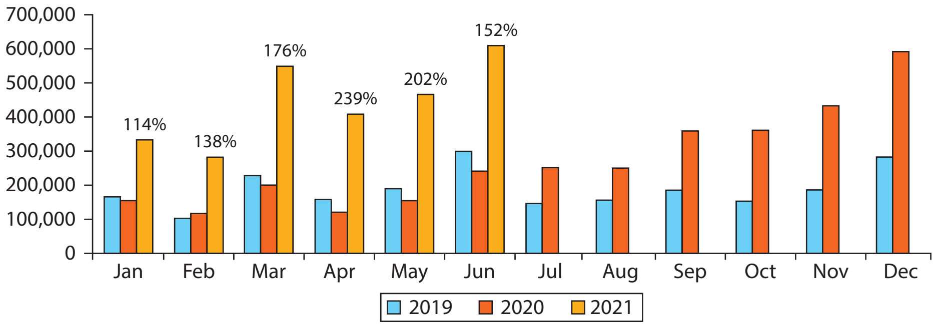
While EVs had been around for decades, it was only in the early 2000s that governments and automakers started promoting them as a key technology to curb oil use and fight climate change.[17] Subsequently, demand for EVs started to grow, and in 2010, the first modern, all electric, five- door family hatchback EV (Nissan Leaf) was launched by Nissan for the mass market.[18]

Over the next decade, many start-ups that specialised in manufacturing EVs emerged, and Tesla soon became the market leader for the growing EV market. Many large auto manufacturers also entered the EV market and launched new all-electric models in several consumer categories.[19]

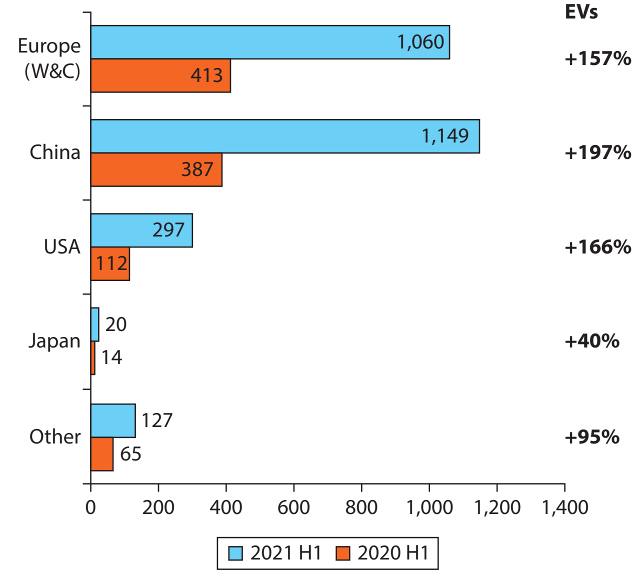
EV sales increased from 17,000 in 2010 to 2.1 million by 2019, with China accounting for 47% of the global sales.[20] The global EV market was expected to grow to 125 million vehicles by 2030 (refer to **Exhibit 1** for Global EV Growth).[21] Many traditional auto manufacturers had started to focus purely on EV models and halt traditional car manufacturing for the future. For example, General Motors had set targets to stop selling new gasoline-powered cars and light trucks by 2035; Volvo had decided to pivot to a hybrid and all-electric line-up by 2030.[22 23]

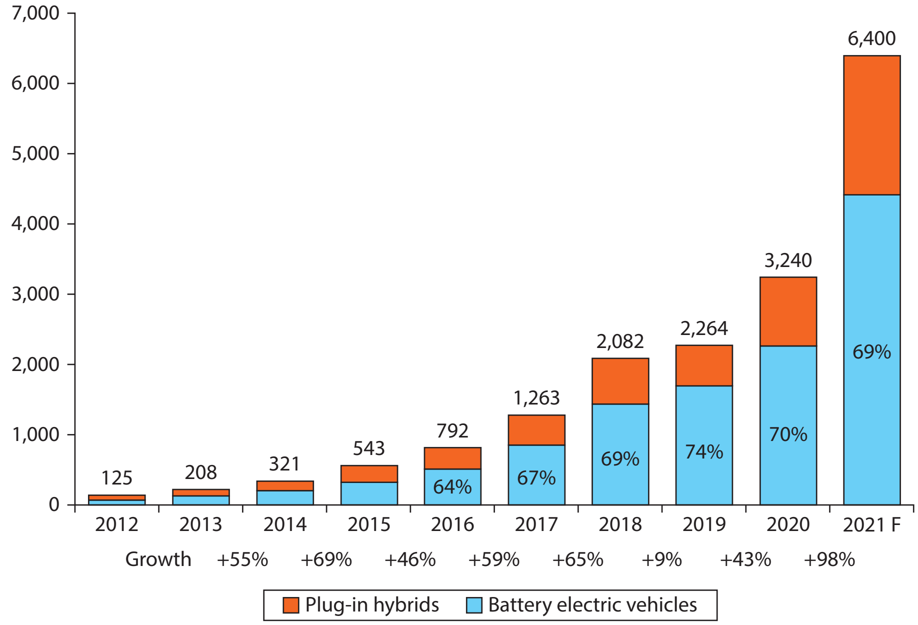
However, while EVs were expected to reduce the climate impact and pollution problems of transport, many of the materials used in the batteries were toxic and rare.[24]

Exhibit 1 Global EV Growth (Sales)



Source: Roland Irle, "Global EV Sales for 2021, EV-Volumes", EV-volumes.com, https://www.ev-volumes.com/, accessed September 2021



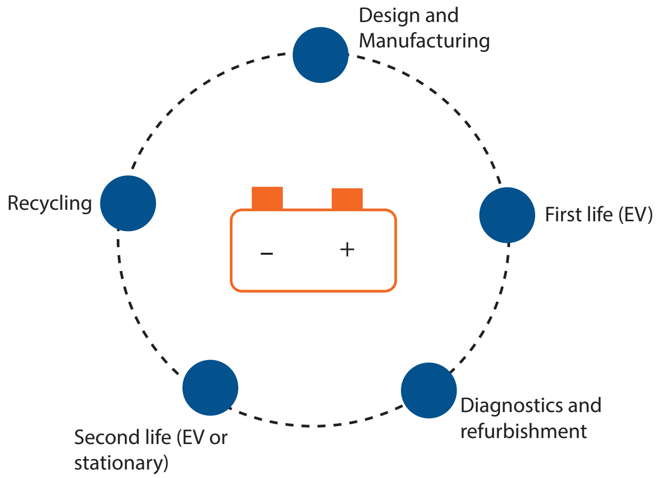


Source: Roland Irle, "Global EV Sales for 2021, EV-Volumes", EV-volumes.com, https://www.ev-volumes.com/, accessed September 2021

In fact, by 2025, 250,000 metric tons of EV lithium-ion batteries were expected to reach end-of-life for vehicles.[25] However, despite being non-usable for vehicles, these batteries could still retain 70–80% capacity and could potentially be used for other purposes.[26] Finding a second life for disposed batteries was essential for making EVs sustainable.[27] Reusing batteries from EVs could slow down the resource cycle by extending their life through recycling.[28] Extending the battery life cycle was therefore a crucial aspect in improving EVs contribution to overall sustainable development and circular economy. Notably, capturing the value left in a product after use was the cornerstone of a circular economy.

However, EV consumers were mostly individuals and taxi companies that had little incentive to recycle the batteries. Besides, conducting such recycling activities for end

Exhibit 2 Circular Economy EV Battery Value Chain



Source: Adapted form Cai Wenlong et.al., "A Review on Energy Chemistry of Fast-charging Anodes", Chemical Society Reviews 49(12), June 2020, A_review_on_energy_chemistry_of_fast- charging_anodes/figures?lo=1, accessed September 2021.

consumers was a headache for manufacturing companies and entailed cumbersome tracking and collaborations with multiple collection, servicing and recycling agencies. In 2020, it was estimated that only 5% of EV batteries were recycled globally.[29] Governments had taken note of this problem, and regulated manufacturing companies to ensure the sustainability of their products.[30]

Many EV companies had come up with different strategies to tackle the battery problem. Nissan, for example, was reusing old batteries from its Leaf cars in automated guided vehicles used to deliver parts to workers in its factories.[31] Volkswagen had a similar approach; it opened a recycling plant in Salzgitter, Germany, to recycle up to 3,600 battery systems per year.[32] A research study had concluded that lithium-ion batteries could have a profitable second life as backup storage for grid-scale solar photovoltaic installations, where they could operate for a decade or more in a less-demanding role.[33]

Nissan and Renault had also started reusing batteries to serve the household energy storage market, with solar panels in the UK as their core customer segment. [34] Many third-party entrepreneurs had established second life battery businesses; for example, energy control solution company Relectrify in Australia had introduced battery management systems to squeeze more value out of used batteries and facilitate the transition of batteries into a second life in residential solar storage.[35]

However, while technology solutions for battery reuse were advancing, economic and regulatory aspects did not yet provide sufficient infrastructure, framework and incentives for efficient battery cycles (refer to **Exhibit 2** for further details on the Circular EV Value Chain).[36] As of 2021, the global capacity of recycling EV batteries stood at 180,000 metric tonnes while in comparison, just the number of EV's introduced on the road in 2019 could generate 500,000 metric tonnes of battery waste. Thus, it was evident that battery waste posed a significant climate risk, which could dampen the circular economy benefits of EVs in the long run.[37]

The EV Market in China

China was the world's largest EV market by demand and sales volume in 2020, constituting 41% of all EVs sold worldwide.[38] The country had tried to promote EVs to consumers in small and large cities, with the aim of reaching its carbon emission peak before 2030 and achieving carbon neutrality by 2060.[39] EV sales in China were mostly concentrated in large cities with over five million residents, like Shanghai and Beijing.[40]

The Chinese government had tried to promote EVs since 2009 by offering subsidies, tax waivers, and charging points to encourage manufacturers and consumers. It had also implemented other measures like licensing policies to limit the number of petrol cars on roads using a car plate lottery system, with winning rates as low as 1% or below, thereby forcing consumers to switch to EVs. [41] However, consumers (especially in smaller cities) were still not keen, primarily because of EV's higher costs compared to traditional vehicles.[42] The price of a standard five seater fuel based top-tier car was about US$ 34,150 (Nissan Altima)[43]; whereas the price of an EV was more than double that amount (Tesla Model X for example was around US$ 89,900)[44].

Demand for cars in China was on the rise and analysts had predicted that over 70% of new car sales (including EVs) globally would come from China by 2030.[45] Chinese buyers were big fans of SUVs, especially of models from global luxury brands like Mercedes, BMW, and Audi. Tesla was the undisputed market leader of the EV market in China, focusing on mass market and luxury cars, and accounted for about 51% of the EV sales in early 2020.[46] NIO accounted for 16% of market sales in the same period and focused on luxury cars. The bestseller in the market, however, was Hongguang Mini EV (a micro car built by a local manufacturer), which sold about 270,000 units in 2020.[47]

The EV market in China had mainly flourished because of government subsidies that enabled local original export manufacturers (OEMs) to sell EVs at affordable prices. However, EV sales had plunged after the Chinese government cut subsidies by up to 50% in June 2020. The overall sales of new energy vehicles (including EVs) in China had dropped by 7% year-on-year after these subsidy cuts, marking the first fall in this market after more than two years.[48]

However, despite the pullback of subsidies, the China EV market had managed to regain its surge by early 2021. Analysts predicted that the country would continue to maintain its leading market position for the next decade.[49] EV sales in the country were driven by government policy and increased consumer demand, as EV prices continued to decline while its quality continued to improve. Analysts believed that Chinese producers would start to target international buyers in the coming years, given that they already had a head start on manufacturing at scale over the West and that government subsidies to the industry were starting to decline.[50]

NIO

NIO was founded by Chinese entrepreneur William Li in Shanghai, in November 2014. Hailing from a low-income family in a rural province in eastern China, Li had humble beginnings.[51] He grew up in the mountains with his grandparents and herded cattle as a child. After graduating with a computer science degree from Peking University, Li took on several part-time jobs to support himself, before venturing out as an entrepreneur. In 2000, he launched auto information website Bitauto, which listed its IPO in 2010 and raised US$127 million on the New York Stock Exchange (NYSE).[52]

Li then went on to establish NIO in 2014, as he believed that there was a growing opportunity for new entrants in the EV sector. The company's Chinese name Wei Lai meant "Blue Sky Coming", and originated from a vision of a future filled with blue skies. The company believed that improved smart electric car technologies, coupled with better experience of car ownership, could drive increased appreciation and adoption of smart electric cars, leading to a more sustainable future for the planet.[53] NIO attracted many top-grade investors, including Tencent, Temasek Holdings, Sequoia, Lenovo and TPG.[54]

Li was often dubbed as the Elon Musk (Tesla's founder) of China. His company's first EV product was a sports car named EP9, which boasted of an attractive design, high driving performance, powerful acceleration, and state of the art technology.[55] The EP9 quickly gained popularity as a premium car and motivated NIO to launch its first mass manufactured model, ES8, in 2017. The ES8 was a 7-seater SUV aimed at the luxury automobile market. As NIO did not have its own manufacturing plant, it collaborated with state-owned auto manufacturer Jianghuai Automobile Group Co (JAC) to build the vehicles. By 2018, NIO had captured 19% of the market in China.[56]

In September 2018, NIO went public and raised US$1.8 billion from its IPO on NYSE.[57] It then launched another SUV model, the ES6, a five-seater high-performance premium electric SUV. Soon after, in December 2018, NIO launched a five-door, five-seater crossover SUV ES9 with a sloping rear section and the largest panoramic sunroof 'in its class' (refer to **Exhibit 3** for NIO EV models). User experience was key to NIO, as Li had shared,

> The user experience is not only about the functional experience of the car - like acceleration, speed, and power, but also about the emotional experience. If you want to redefine the industry and the product, you must redefine the youth experience of the industry. In all industries in the future, user experience of a car brand should include four parts: car parts, service, digital touchpoint, and beyond its life, what the car will bring to you.[58]

After a few successful years, NIO faced troubled times, in 2019, when the Chinese government started to pull back subsidies for EV manufacturers. Withdrawal of subsidies, along with the departure of a few key executive and vehicle recalls, hurt NIO's business dramatically, plummeting investor confidence in the company. Shares dropped from an IPO high of US$6.26 in 2018 to a low of US$2 in 2019.[59] Notably, NIO recalled nearly 5,000 of its ES8 high- performance electric SUVs after a series of battery fires in China, followed by a subsequent investigation that revealed a vulnerability in the car model that posed a safety risk.[60]

To cope with the difficulties, NIO sought additional funding, and found a new lifeline when the local government of Hefei agreed to invest US$1.08 billion (CNY 7 billion) in the company. Li subsequently set up a joint venture manufacturing unit (with state-controlled automaker JAC Motors) at Hefei, the capital of Anhui province in China, in 2020. The deal also involved the building of an EV industry park, called NeoPark, in collaboration with the Hefei government to produce one million cars annually.[61]

Following its deal at Hefei, NIO gained renewed momentum and quickly recovered from its business slump in 2019. In the first quarter of 2021, vehicle sales at NIO accounted for revenues of US$1.1 billion (CNY 7.4 billion), representing

Exhibit 3 NIO EV Models

Robert Way/Shutterstock

Carrie Fereday/Shutterstock

Source: Flickr Commons, https://www.flickr.com/commons/usage/, accessed September 2021.

an increase of 490% from the first quarter of 2020 and an increase of 20% from the fourth quarter of 2020. [62] The company also introduced strategies to expand outside China to gain global market share and established teams in the U.S. and Europe.[63] Li shared,

> We are a global company. We have offices in Shanghai, Munich, London, and Silicon Valley. We targeted the China market first, but we intend to target other global markets also. We have more than 1,000 people outside China.[64]

In May 2021, NIO entered Norway, its first expansion overseas since its inception. Norway was the first country in the world to have higher sales of EVs compared to traditionally powered vehicles. In 2020, EVs accounted for nearly 55% of all car sales in the country.[65] NIO's strategy was to use Norway as a springboard for its expansion into Europe – which was the second largest market for EVs globally following China. By 2022, NIO aimed to enter five more European countries, to cater to an estimated demand of 95,000 vehicles yearly. EVs were supported by subsidies in the European market to drive the region's commitment to climate change and NIO was hoping to tap on this support to expand in the market. Establishing battery swapping stations and offering BaaS services formed a key part of NIO's strategy in Europe, just as in China.[66]

Battery Swapping and BaaS

Battery swapping in the EV industry was not a new concept. The industry had tried and tested several ways of designing an effective solution for battery swapping to overcome the high costs of charging and replacing batteries. The first approach was introduced in 2007 by an Israeli start- up called Better Place that allowed its customers to switch their batteries in a fully automated station using a membership card.[67] In 2013, Tesla had introduced a swapping station, where consumers could drive in to get their batteries replaced.[68] However, consumers in the U.S. (Tesla's biggest market) were not impressed with this solution and preferred to use home and public chargers, given their lifestyle and the conveniently available infrastructure of public charging stations. Both Tesla and Better Place dropped their swapping approaches eventually, as it did not make business sense to build stations when consumer demand was minimal.

In China, battery swap technology had already been tested for personal and commercial vehicles in five cities before it was launched by NIO.[69] However, although swap stations tried to replicate the experience of existing gas stations, there were still issues that prevented their widescale implementation.[70] Most swapping stations were concentrated in larger cities like Beijing and the cost of installing a charging station was huge – approximately US$500,000. Moreover, swapping stations were not standardised, which meant that EV owners could only swap batteries at their own brand's stations.[71]

However, despite the constraints, battery swapping had several benefits. It could reduce the peak consumption of electricity by centralised charging and avoided grid overloading due to mass EV charging. Empty batteries could be charged when electricity was cheap and demand was low. Battery swapping was also quick to execute and typically took a couple of minutes. Additionally, providing swapping services as a BaaS to consumers helped reduce the risks related to inefficient battery disposal.[72]

NIO BaaS

NIO had realised early in its business that batteries could add significant costs to EVs, which were competing against traditional fuel-run cars in the market. Removing the cost of the battery from the product could reduce its price significantly and potentially increase its attractiveness to consumers.[73] Making batteries more affordable, accessible and reusable was also necessary from the circular economy perspective and for realising the Chinese government's ambition of having one in five vehicles driven by non-fossil/non-fuels by 2025.[74]

NIO batteries were manufactured using cell-to-pack technology, to achieve an energy density that was higher than a conventional battery pack by about 37%.[75] The batteries were also lighter and used 40% fewer components than standard batteries.[76] All batteries were monitored by a cloud-based battery management system, which included features like thermal propagation prevention and smart parameter adjustments for environment conditions to improve battery performance.[77] Consumers who brought a NIO EV with the battery could enjoy lifetime free battery swap services and out-of-town free power services of up to six times per month.[78] Battery charging and swapping services were offered to consumers using an integrated power solution.

The NIO power solution consisted of four comprehensive battery services: a home charging solution (Power Home), a battery exchange (Power Swap) service at swapping stations, a mobile charging service provided through on-call service trucks (Power Mobile), and a 24-hour on- demand pick-up and drop-off charging service (Power Express). NIO vehicles were also compatible with publicly accessible charging network in China of over 214,000 charging piles, 59.6% of which were superchargers (fast chargers).[79]

Although NIO had home charging solutions for its batteries, very few homes in China had the infrastructure to support installation of home charging points, as a majority of its EV consumers were from large cities and lived in high-rise condominiums.[80] Hence, NIO realised that to attract more customers, it would have to focus more on the option of charging the EV batteries in a swapping station. The government had also launched a support scheme in 2020 to promote the setting-up of swapping stations to lure more consumers to buy EVs, in a bid to control pollution from fuel-based vehicles.[81] These reasons further motivated NIO to expand its swapping station network and offer BaaS services to its consumers.[82]

In early 2020, NIO started offering subscription plans for its battery services, which would allow consumers to buy its vehicles without the battery. Removing the battery reduced the purchase price of the NIO vehicles by over US$10,834.[83] In the subscription plan, buyers would pay a monthly fee of US$152 (CNY 980) to lease a battery and could use free charging and swapping services as part of the BaaS subscription.[84] The services were offered through a mobile internet-based solution that managed an extensive network of battery charging and swap facilities.

NIO had opened its first battery swapping station in 2018; however, it took a few years for its battery swapping services to accelerate interest amongst consumers. By October 2020, NIO had completed one million swaps and by May 2021, it had completed two million swaps.[85] By June 2020, NIO had built 135 swap stations across 59 cities in China.[86] However, the number of swapping stations were far below NIO's original plans of setting up 1,100 units by 2020. This slow growth was attributed to NIO's cash flow crisis in 2019, which was alleviated through its subsequent deal with the local government of Hefei.[87]

The power swap locations were connected through its automated power solution across numerous cities in China to provide improved battery supply and services at its swapping locations. The automated solution also inspected every battery pack removed from a vehicle for electrical performance before recharging it for the next user. If a fault was identified, the battery was taken out of circulation and sent for repairs.

In terms of footprint, NIO swapping stations were as large as three parking spaces. The changing process was fully automatic; the car was driven into the station where it was serviced by a car lift-battery replace system that replaced the batteries automatically.[88]

Key Features of NIO BaaS

NIO's bet on BaaS hinged on several key factors. Firstly, the battery swaps at the swapping station were fast; on average, it took three to five minutes for a battery swap – replacing the existing battery in the vehicle with a fully charged battery, compared to 75 minutes for a full charge at a supercharger.[89]

Secondly, the battery swaps were also slightly cheaper than other battery alternatives for EVs. NIO's service offered six swaps a month in its monthly subscription price, which provided about 1,500 miles of range. The math for the subscription amounted to US$0.10 per mile, which was slightly lower than the estimated US$0.104 per mile cost for using Tesla superchargers.[90]

Thirdly, swapping batteries also motivated NIO customers to opt for battery upgrades when a more advanced battery pack was available, which helped preserve the car's performance and resale value and mitigate broader concerns of battery degradation.[91] In order to ensure that new batteries could fit with old cars, NIO had standardised its battery sizes, thereby also enabling its batteries to become a replaceable module in the broader construction of the vehicle (refer to **Exhibit 4** for more details on NIO EV Price details with BaaS).

Fourthly, batteries were an important consideration in the EV market; market dominance of an EV producer was highly correlated with who could build the best battery technology. NIO's BaaS had helped in this aspect by allowing the company to invest in battery technology without worrying about replacing older batteries.

BaaS also created two sources of revenue - a monthly recurring revenue from battery service subscriptions and the other from upgrade requests for newly launched batteries. By early 2021, approximately 40% of NIO owners had already opted for battery subscriptions. [92] With approximately 75,500 NIO EVs on the road, analysts estimated that the subscription service generated about US$4.5 million in monthly recurring revenue, or US$54 million in annual revenue.[93] This revenue was expected to increase further as NIO expanded production, increased subscription penetration among existing

Exhibit 4 NIO EV Price with BAAS

Price Benefits	ES8	EC6	ES6
Seats	70-100kWh	70-100kWh	70-100kWh
MSRP	US$ 73,389 to US$ 82,484	US$ 57,736 to US$ 66,836	US$ 56,167 to US$ 65,267
Post-Subsidy Price	US$ 70,884 to US$ 79,701	US$ 55,194 to US$ 64,012	US$ 53,626 to US$ 62,443
Price with BaaS	US$ 59,901 to US$ 59,619	US$ 44,212 to US$ 43,930	US$ 42,643 to US$ 42,361

Sources: NIO, "Battery as a Service", https://www.nio.com/baas, accessed September 2021.

NIO Battery Swap Station

Source: Flickr Commons, https://www.flickr.com/commons/usage/, accessed September 2021.

consumers, and grew its network of swap stations.[94] In July 2021, NIO unveiled its 'NIO Power 2025' plan to further expand its BaaS initiative and completed 301 battery-swapping stations across the country, with plans to reach the 3000 mark by 2025.[95]

Competition with Tesla

While NIO was a much smaller company than Tesla in terms of market capitalisation, market share, global presence, and production capacity,[96] its stock had garnered considerable media coverage and attracted the attention of analysts worldwide.[97] NIO's stock had seen as much volatility as Tesla's since its IPO, and had soared from US$3.27 in May 2020 to US$61.95 in January 2021.[98] In comparison, Tesla had seen a steeper jump advancing from US$49.58 in October 2019 to US$439.67 in October 2020, and US$880.02 by January 2021.[99] Tesla's market capitalisation was at US$715.35 billion, while NIO's was at US$67.88 billion as of August 2021. But despite being one-ninth the size of Tesla and overcoming a near brush with bankruptcy in 2019, NIO had posted a 190% year over year delivery growth in quarter two, 154% growth in quarter three, and 111% growth in quarter four of 2020.[100]

Tesla possessed a much larger manufacturing capacity than NIO, and owned four operational factories in Fremont, Nevada, New York, and Shanghai (with Fremont and Shanghai producing vehicles and the other two producing solar/battery technology). Tesla's global production had increased by 39.6% year-over-year to 509,737 units by 2020.[101] The automaker's success was mainly driven by an increase in EV demand in China (where the economy had recovered quickly from the impact of the Covid-19 pandemic) and an expansion of demand in the US.

Tesla started manufacturing in China at its Shanghai Plant in 2019 to promote local vehicle production, reduce costs, and expand its profit in China. Notably, the company had delivered 137,000 EVs in China and posted an increase of 28.3% on its revenues year-over-year, hitting US$31.5 billion in 2020.[102] In comparison, NIO operated only one factory, with an annual capacity of around 90,000 vehicles, and had delivered 36,721 vehicles in 2020. The company had plans to increase its manufacturing capacity to 240,000 vehicles per year by 2021.[103]

Tesla's supercharger network had also helped strengthen its competitive moat. Setting up a supercharger station was less expensive than a swapping station and could cost between US$100,000 to US$ 175,000.[104] The company had installed 6,000 supercharging stations in China and more than 20,000 superchargers globally. However, analysts had argued that these numbers were not enough for its customers, as there were over 1.2 million Tesla vehicles on the road worldwide.[105] Owners in high density areas were often plagued with long lines as demand for the Tesla chargers exceeded supply. Besides, each charging session could take on average 45-50 minutes leading to long wait times and congestion at the stations.[106]

In contrast to Tesla's charging stations, many industry analysts perceived NIO's BaaS as a powerful competitive strategy. Battery swaps were not only more time efficient than battery recharging, but also easy to provide as a subscription offer, enabling the manufacturer to sell the vehicle at a cheaper price by removing the price of the battery and offering it as a service. Swaps also provided fully charged batteries that could last for a longer range (about 380 miles) than a recharge (a 45-minute recharge provided about 228 miles) at a supercharger.

Both Tesla and NIO provided battery packs of 100 kWh, and while Tesla intended to continue providing similar weightage batteries in the future, NIO had plans to start delivering 150 kWh battery packs in 2022[107], which could further reduce charging costs.[108] However, Tesla was also trying to implement battery cost reduction measures, albeit with a different strategy, and this posed a threat to NIO's BaaS. Tesla had plans to produce lithium-ion batteries in-house at half the cost of its existing batteries with an annual production capacity of 100 GWh batteries (for 1.4 million EVs) by 2022.[109] Tesla was also trying to enhance its partnerships with battery suppliers and directly source materials for the batteries to bring down battery costs.[110]

Additionally, Tesla was planning to launch fully autonomous cars in the near future, as it felt that this was the ensuing fate of the automobile industry.[111] NIO had similar predictions for the future, and had announced a partnership with artificial intelligence (AI) chipmaker Nvidia, to accelerate progress towards building autonomous cars.[112]

Despite Tesla's large lead, analysts believed that regulators were unlikely to favour a monopoly in the EV market, and smaller competing companies like NIO could benefit from regulatory controls and remain in the run.[113] In markets like China, government strategies to build internal competition and bring down prices of EVs significantly could further curb Tesla's growth in the future.[114] Overall, analysts predicted that market competition in the EV sector would continue to be cutthroat, with new emerging players having ample opportunities to capture market share.[115] This posed a promising market for existing players like NIO, as well as new incumbents planning to enter the EV market.[116]

Battery Technology: A Possible Game Changer?

In addition to its niche BaaS strategy, NIO had also used a diversification strategy to remain competitive in the market, and stand up against Tesla. Beyond EVs, NIO had diversified its business in 2018 and added two new businesses under its belt – NIO House and NIO Life. NIO House was a concept store with home design products that gelled with NIO cars to provide owners an opportunity to become connoisseurs of NIO designs.[117] Similarly, NIO life was an e- commerce mobile app selling NIO lifestyle products to consumers, aimed at expanding NIO's brand philosophy. Since its launch, NIO's online store had roped in over 500 designers around the world, developed 813 new products, and sold these products to over 2.8 million customers in China (refer to **Exhibit 5** for NIO House store).[118]

It was NIO's BaaS, however, that had managed to garner the maximum media attention, and was lauded as an innovative concept and the firm's unique selling point in the competitive EV market. Nonetheless, many analysts had opined that while NIO's BaaS and large-scale implementation of swapping stations could provide the company with an immediate advantage in the market, it was unlikely to provide much competitive sustenance over the long run.[119] This was primarily because battery technology was evolving rapidly and charging times were predicted to reduce dramatically in the near future.[120]

EV's with lithium-ion batteries were expected to give way to vehicles with lithium-iron phosphate and other technologies that could cut costs, extend vehicle ranges to 400 miles or more between charges, and enable batteries to last as long as a million miles.[121] EVs were expected to become more useful as their ranges increased, and provide a better value proposition because the batteries could have resale value and last longer than the cars they were sold with. This was also in line with the goals of governments and industries to move towards a circular economy.

Additionally, new EV technology could make electric vehicles as cheap as those powered by petrol, and the EV price would no longer pose a cost barrier.[122] On a separate note, analysts had raised concerns over NIO's battery swapping strategies, arguing that setting up battery swapping infrastructure and swapping stations was expensive, and hence needed to fulfil long-term needs of consumers to make business sense.[123] However, with the battery technology advancing so quickly, it seemed unlikely that swapping stations would remain relevant over the long time horizon.[124]

Amidst such strategic concerns, would it make more sense for NIO to halt its battery-swapping infrastructure and focus on the battery technology itself? Alternatively, could NIO continue to benefit from its BaaS services, and make it its winning strategy? How could it explore opportunities with BaaS to make its EVs more sustainable in the future? What other strategies could NIO explore to compete with the EV giant Tesla? Would the battery-swapping model continue to be relevant in the future? In which other industries could battery swapping prove to be a plausible business model? Could the as-a-service model help propagate a circular economy?

Exhibit 5 NIO House Store

Werner Rebel/Shutterstock

Source: Flickr Commons, https://www.flickr.com/commons/usage/, accessed September 2021.

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Case 15

Pacari Chocolate: Building a Brand that Brings Joy from Tree to Bar

"Pacari is a company that was born from a dream. A dream that seeks to generate a positive impact on earth, changing the world's history through its chocolate."[1]

"Our fundamental mission is to take care of the planet by giving back the life it brings to us through a quality and socially responsible international chocolate."[2]

Source: Pacari.com

Carla Barbotó and Santiago Peralta founded SKS Farms in Ecuador in 2002 as a family business selling organic flowers. In 2008, they gave up the flowers in favour of chocolate. Their chocolate—Pacari—grew to become an award-winning premium brand. From 2012 it was named "World's Best Chocolate" at the International Chocolate Awards in London for five consecutive years. Certified Fair Trade, kosher, and organic, Pacari chocolate is used by top chefs including Chile's Carolina Bazan and Rodolfo Guzman, Colombian chef Jorge Rausch, Michelin-starred chefs Martin Berasategui, Paco Perez, and Maria Jose San Roman, And Ecuador's Carolina Sanchez. It was also a favourite of Oprah Winfrey.

By 2021, with net sales expected to reach US$6 million and a staff of 77, Pacari was present in 42 countries, selling 67 different SKUs ranging from cocoa powder to chocolate bars (see Exhibits 1, 2 and 3). It was unique in terms of its quality, ethical standards (see Exhibit 4) and origin—100% Ecuadorian from the farm to the final product.

The challenge was now to take Pacari to the next level—targeting revenues of US$20 million by 2026 (see Exhibits 5 and 6).

Origins of the Global Chocolate Industry

The word "chocolate" comes from the Aztec "xocoatl"—which signifies a bitter drink brewed from cocoa beans. The Latin name for the tree, Theobroma cocoa, means "food of the gods". Chocolate consumption is believed to date back 4,000 years to pre-Colombian cultures of Mesoamerica and the Olmec,[3] although recent research suggests that Ecuador's cocoa heritage could date back 5,200 years, 1,700 years before it reached Mexico.[4] Beans were used as currency in ancient times, when the Mayans and Aztecs believed they had magical properties. Following the Spanish colonization of the Americas, cocoa beans came to Europe (see Exhibit 7). By the 20th century, the word 'chocolate' applied to a range of products—often richer in sugar, milk powder and additives than cocoa, and made from the hardiest (but least flavour-some) beans.

In the 21st century, a growing interest in high-quality, non-industrial chocolate derived from sustainably grown cocoa was transforming the industry. For example, Hershey's expanded its artisanal chocolate line, purchasing smaller producers known for premium chocolate such as Scharffen Berger and Dagoba, and independent chocolatiers continued to flourish.[5]

By 2020 the global chocolate confectionery market was worth US$106 billion, up from US$100 billion in 2015.[6] It was dominated by six conglomerates that together accounted for 57.7% of the market: Mars Inc. (13.7%), Mondelez International (12.5%), Fererro International (10.7%), Nestlé SA (8.9%), Hershey Co (6.6%) and Chocaledefriken Lindt (5.3).[7] These global chocolate giants bought cocoa directly from farmers (through tier 1 suppliers who worked with farmers' cooperatives) and semi-processed cocoa from processors. (Note: "Cocoa" refers to the tree, the beans, and the powder. "Chocolate" refers to the processed product).

This case study was written by Amitava Chattopadhyay, Professor of Marketing and the GlaxoSmithKline Chaired Professor of Corporate Innovation at INSEAD, Fabrizio Noboa and Alexandra Velasco, both Professors at Universidad San Francisco de Quito, USFQ Business School, Anne-Marie Carrick, Senior Research Associate, and Andrew Lee, Research Associate, both at INSEAD. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

The support of Carla Barboto and Santiago Peralta, co-founders of Productos SKSfarms Cia Ltda, is gratefully acknowledged. The funding for this research through the Patrick Cescau/Unilever Endowed Fund is also gratefully acknowledged.

Exhibit 1 Income Statement for Productos SKS Farms CIA. LTDA.

		2018	2019	2020
Revenue		5,361,329.84	4,793,484.73	4,018,432.19
Cost of Goods Sold		2,906,952.71	2,662,189.98	2,545,965.54
	GROSS PROFIT	**2,454,377.13**	**2,131,294.75**	**1,472,466.65**
Sales Expenses		1,002,019.69	1,114,619.02	730,449.20
Administrative Expenses		877,584.12	755,490.54	867,721.66
Financial Expenses		126,249.98	95,731.34	155,594.94
	TOTAL EXPENSES	**2,005,853.79**	**1,965,840.90**	**1,753,765.80**
	EBITDA	**448,523.34**	**165,453.85**	**281,299.15**

Source: Pacari

Exhibit 2 Pacari Sales by Market (Value)

Country	% Share of Pacari Business
Ecuador	60
Chile	20
Germany	3
Paraguay	3
Dubai	2
Spain	1.5
Canada	1.5
USA	1
UK	1

Remaining 7% spread across some 30+ countries, including Japan, Malaysia, Egypt, France, Switzerland, Sweden, Italy, Mexico, Peru, Guatemala, Singapore, New Zealand, Australia, and Israel.

Source: Pacari

Exhibit 3 Pacari Sales by Product and Geography

Product Type	% of Product Portfolio in Ecuador	% of Product Portfolio Internationally
Chocolate Bars	55	70
Cocoa Liquor[38]	20	15
Chocolate Covered Fruits	10	5
Sweeteners, Nibs, Cereals, Spreads, Ice Cream*	5	5
Gift Boxes	10	5

* Sold only in Ecuador through the Pacari flagship store in Quito.

Source: Pacari

The processors bought beans from farmers or tier 2 suppliers to make cocoa powder, butter, liquor and other types of fats for use by chocolate manufacturers. Three players dominated the processing industry: Barry Callebaut (1.02 million metric tonnes), Cargill (750K metric tonnnes), and Olam (950K metric tonnes). It was a capital-intensive, low-margin business.

Chocolate is sold in various formats. In 2020, tablets[8] were the most popular, with sales exceeding US$28 billion, countlines US$25 billion, boxed assortments US$18 billion, and chocolate pouches/bags US$17 billion. The majority is sold in supermarkets, hypermarkets and independent grocers. Chocolate is mass produced and mass consumed. The Swiss have the highest per capita consumption (see Exhibit 8) and the US is the world's largest importer.[9]

The Cocoa Supply Chain and Players

Cocoa requires special conditions to grow, which are mainly found in the region 20° north and south of the equator (the 20/20 zone). There are many steps involved in making chocolate, from cultivating the trees, harvesting the beans, to packaging the confectionery (see Exhibit 9). First, farmers grow, ferment and dry the beans. Some are organized in cooperatives/associations, but most are independent. The beans are transported to exporters, traders and processing companies, which roast, grind and transform them into semi-finished cocoa products (liquor, butter and powder) for use by chocolate manufacturers.

There is a vast divide between producers and consumers—the former living in poverty, the latter indulging their love of luxury products.[10] In 2020, Ivory Coast was the largest exporter of cocoa, accounting for 43.9% of global exports worth US$2.37 billion, while neighbouring Ghana had 14.17%. The two countries were home to 2.5 million cocoa farmers who earned less than a dollar per day (well below the 'poverty line' of US$1.90). An estimated 1.5 million children worked in cocoa production, often illegally.[11] The problem

Exhibit 4 Ethiscore of Chocolate Producers

Using the Tables

Ethiscore: the higher the score, the better the company. Scored out of 14. Plus up to 1 extra point for Company Ethos and up to 5 extra points for Product Sustainability.

Green (good) = 12+
Amber (average) = 11.5–5
Red (Poor) = 4.5–0

■ = worst rating
□ = middle rating
= best rating/no criticisms found

Brand	Ethiscore (out of 14 + 6 extras)	Environment: Environmental reporting	Environment: Climate change	Environment: Pollution & Toxics	Environment: Habitats & Resources	Environment: Palm oil	Animals: Animal testing	Animals: Factory farming	Animals: Animal rights	People: Human rights	People: Workers' rights	People: Supply chain management	People: Irresponsible marketing	Politics: Arms & Military supply	Politics: Controversial technologies	Politics: Boycott call	Politics: Political activity	Politics: Anti-social finance	Politics: Tax conduct	+ve: Company Ethos	+ve: Product sustainability	Company group
Pacari [F,O,S,V]	18.5																			▲	3.5	Pacari Chocolate, LLC
Beyond Good [F,O,S,V]	18		□																	▲	3.5	Beyond Good
MIA [FS]	17																			▲	2	Kuanza Ltd
Ombar [F,O,V]	17		■																	▲	3	Mood Foods Ltd
Plamil [F,O,V]	17										□									▲	2.5	Plamil Foods Ltd
Fairafric [F,O,S]	16.5							□	■											▲	3	Weinrich/Fairafric/Reimers
Moo Free [O,V]	16.5		□																	▲	2	Moo Free Ltd
Vego [F,O,V]	16.5		■																	▲	2.5	VEGO Good Food UG
Booja Booja [O,V]	15.5		□								□	□								▲	2	Mr C G Mace
Chocolat Madagascar 'milk' [V,F,S]	15							■	■						□					▲	2.5	Ramanandraibe family
Cocoa Loco [F,O]	15		■						■											▲	2	Payne Family
Chocolat Madagascar [F,S]	14.5							■							□					▲	2	Ramanandraibe family
Equal Exchange [F.O]	14	■	■						■											▲	2	Equal Exchange Inc
Seed and Bean [F,O]	14		■						■		□	□								▲	2	Organic Seed & Bean Co Ltd
Biona [O]	13	■	■								□	□								▲	1	Windmill Organics Ltd
Divine [F,O]	12.5	■	■					■	■						□					▲	2	Ludwig Weinrich/Kuapa Kokoo
Tony's Chocolonely [F,S]	12.5	■	■					■	■						□					▲	2	Tony's Factory B.V.
Traidcraft [F,O]	12	■	■				□	■	■						□					▲	2	Traidcraft Foundation
Willies [F,S]	11.5	■	■					■	■						□						2	Willies Cacao Ltd
Waitrose Duchy [F,O]	10.5		□	■	□		□			□	■		□							▲	2	John Lewis/The Prince's Charities
iChoc [O,V]	10	■	■			□		■	■			□			□						1.5	Ludwig Weinrich GmbH & Co. KG
Vivani [0]	9.5	■	■			□		■	■			□			□						1	Ludwig Weinrich GmbH & Co. KG
Montezuma's "milk" [O,V]	9	■	■	□			■	■	■		□				□						1.5	Revenge Holdings Ltd
Hotel Chocolat "milk" [V]	8.5	□	■			■		■	■		□	□			□						0.5	Hotel Chocolat Group Plc
Ritter Sport	8.5	■	■			■		■	■			□			□							Alfred Ritter GmbH & Co. KG
Hotel Chocolat	8	□	■			■		■	■		□	□			□							Hotel Chocolat Group Plc
Co-op [F]	7		■	□	□	□	□	■	■		□		■		□		■	□		△	1	Co-operative Group Ltd
Lindt	7	□	□			□		■	■	□	□	□			□		□	□	□			Lindt & Sprüngli AG
Marks and Spencer [F]	7		□	■	□		□	■	■	■	■				□		□	□			1	Marks & Spencer Group plc
Waitrose [F]	5.5	□	■	■	■		□	■	■	■	■		■		□			□		△	1	John Lewis Partnership
Ferrero, Kinder, Thorntons	5	□	□	□		□		■	■	□	■	□	□				■	□	■			Ferrero International SA
Godiva	5	□	■		□	■		■	■	□	□	■	□		□				■			Yildiz Holding A.S
Aldi [F]	4.5	□	■	■	■	□	■	■	■	□	■	□			□			□	□		1	Aldi South
Hershey's	4	□	■	□		□		■	■	□	■	■			□		■	□	■			The Hershey Trust Company
Lidl [F]	4	□	■	■	■	■		■	■	■	■	□			□		□		■		1	Schwarz Group
Guylian	3.5	■	■	□		■		■	■	■	□	■			□			■	■			Lotte Group
Morrisons [F]	3.5	□	■	■	■	□	■	■	■	□	■		■		□	□		■			1	Wm Morrison Supermarkets plc
Sainsbury's [F]	2.5	□	■	■	■	□	□	■	■	■	■	□	■		■			□	■		1	J Sainsbury plc
Galaxy "milk" [V]	2	□	■	□	■	□	■	■	■	■	■	■	□		□		■	□	■		1	Mars Inc
Green & Black's [F,O]	2	□	■	□	□	□	■	■	■	■	■	■	■		□	□	■	■	■		2	Mondelez International
Maltesers [F]	2	□	■	□	■	□	■	■	■	■	■	■	□		□		■	□	■		1	Mars Inc
Galaxy Smooth Milk [RA]	1.5	□	■	□	■	□	■	■	■	■	■	■	□		□		■	□	■		0.5	Mars Inc
Mars	1	□	■	□	■	□	■	■	■	■	■	■	□		□		■	□	■			Mars Inc
Tesco [RA]	1	□	■	■	■	□	■	■	■	■	■		■		□		■	■	■		0.5	Tesco plc
ASDA [RA]	0.5	□	■	■	■	■	■	■	■	■	■	■	■	■	□		■	■	■		0.5	Walmart Inc.
Kit Kat, Nestlé [RA]	0.5	□	■	□	■	■	■	■	■	■	■	□	■		■	■	■	□	■		0.5	Nestlé SA
Cadbury	0	□	■	□	□	□	■	■	■	■	■	■	■		□	□	■	■	■			Mondelez International

[0] = organic [F] Fairtrade [RA] = Rainforest Alliance [S] = goes beyond certification [V] = vegan

Using the Tables

Positive ratings (+ve):

Company ethos:
▲ = full mark
△ = half mark

Product sustainability:
Various positive marks available depending on sector.

Best Buys are highlighted in blue

Source: Ethical Consumer, January/February 2021, p. 12

of deforestation has intensified as impoverished farmers encroach on forest land to plant cocoa.

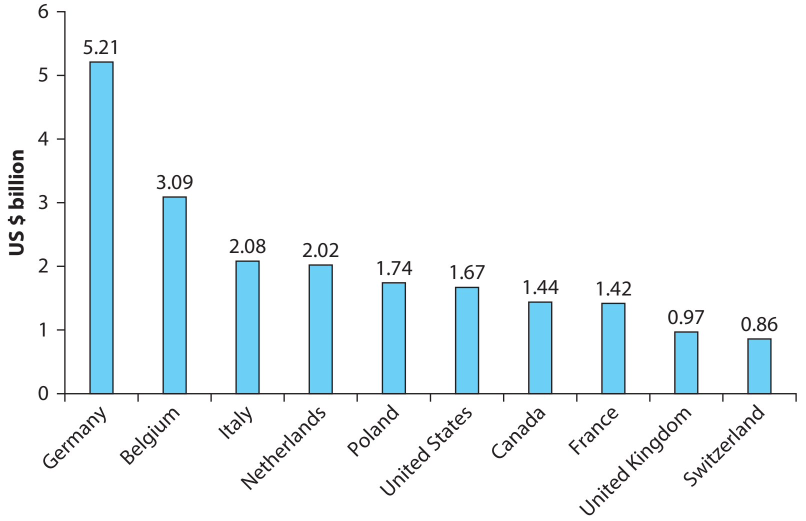
Cocoa imports are highest in developed countries. The Netherlands, for example, is in the top ten importers of cocoa-based products and a top exporter. Prices world-wide are determined on the London NYSE-LIFFE and New York ICE Cocoa Futures markets.

Ecuador's Cocoa Heritage

> "Ecuador sits on a gold mine of cocoa...The nation is now famous for its single-origin chocolate." [12]

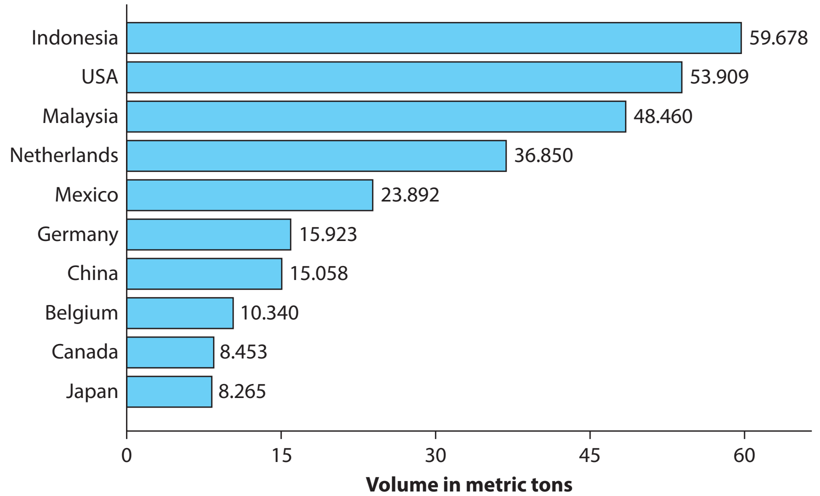
Cocoa trees, which are native to lowland rainforests of the Amazon and Orinoco river basins,[13] were first grown on

Exhibit 5 Imports of Chocolate by Country



Source: UN Comtrade via Statista, accessed November 2020.

Exhibit 6 Principal Export Destinations of Chocolate Products from Ecuador—2018[39]



Source: ANECOCOA, 2019 SECTOREXPORTADORDE COCOA, accessed November 2020. http://www.anecocoa.com/index.php/en/estadisticas/estadisticas-actuales.html

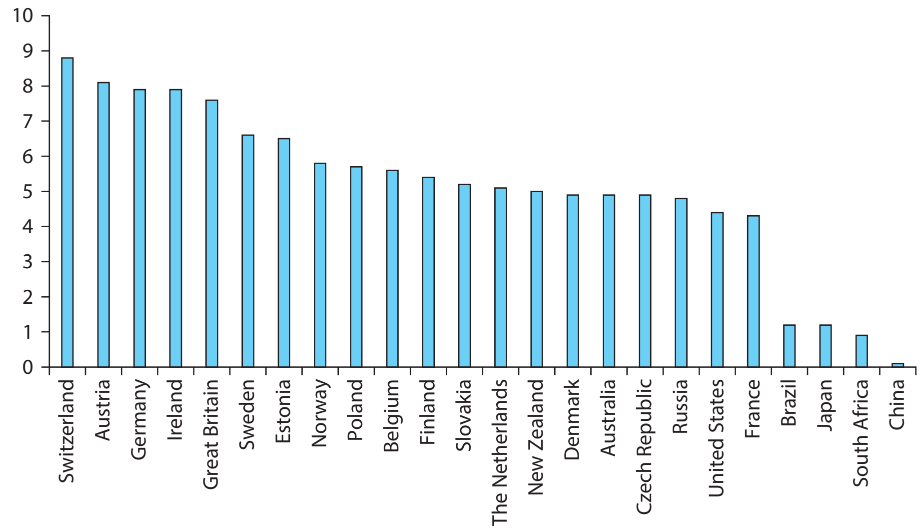
Exhibit 7 History of Chocolate

Sweetened chocolate did not exist before the Europeans found their way to the Americas. European taste buds found the bitter taste unpleasing and added sugar. By the 17th century, chocolate had become a fashionable drink throughout Europe with its nutritious, medicinal and allegedly aphrodisiac properties. It remained, however, a luxury product reserved for the wealthy. With the invention of the steam engine, enabling mass production in the late 1700s, chocolate became more accessible to the masses.

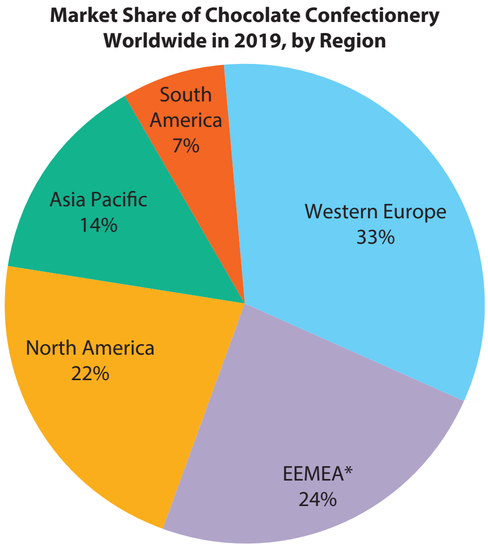
In 1828, a Dutch chemist discovered how to make powdered chocolate by removing half the natural fat (cocoa butter) from chocolate liquor, pulverizing the remainder, then treating the mixture with alkaline salts to remove the bitter taste. His invention, "Dutch cocoa", led to the creation of solid chocolate. In 1847, Joseph Fry learned how to make a mouldable chocolate paste by adding melted cocoa butter to Dutch cocoa. By 1868, a company called Cadbury began marketing boxes of chocolate confectionery in England. Milk chocolate hit the market a few years later, pioneered by the Swiss company Nestlé.

Source: Authors' research, various sources

Exhibit 8 Global Chocolate Consumption (kg per capita) by Key Countries (2017)



Source: Lindt & Sprüngli - Annual Report 2017, page 55 via Euromonitor and Statista 2020.



Source: Euromonitor, 2019 Statista

plantations in Ecuador in 1879, on San Cristobal Island.[14] The country's importance in global cocoa production was undeniable until the 1900s, when the trees were ravaged by disease and bananas came to replace cocoa as the main export crop.[15] By 2020, Ivory Coast, Ghana and Cameroon were the dominant cocoa producers, supplying respectively 44%, 14% and 9% of global cocoa.16 Ecuador was in fourth place with 7.4%.

The global trade in cocoa beans was valued at US$6.17 billion.[17] Ecuador's cocoa exports earned US$764 million, of which US$657 million (86%) was from beans. The bulk of it—80%—was cultivated on the coast in the Manabí, Los Rios, Esmeraldas and Guayas regions. The remainder was grown in the Amazon provinces and a few plantations in the south.[18]

While Ecuador was the source of a mere 7% of the world's cocoa, it produced 45% of Fino de Aroma beans, the highest quality classification.[19] Locally known as "Arriba Nacional", the beans were from the Forastero cocoa tree native to Ecuador and yielded the purest and rarest form of cocoa. Fine flavour cocoa (FFC) is famous for its distinct flavour (nutty, fruity with a hint of orange and jasmine). The variety of the tree, the type of soil and local climate influenced the flavour profile - akin to the terroir in wine-growing regions. Attracting interest from chocolatiers worldwide, FFC had secured a good reputation for Ecuador's chocolate for over a decade.

Small farmers (owning between one and five hectares) made up 90% of Ecuador's cocoa producers, of which 60–70%[20] lived below the poverty line. Relying on traditional cultivation methods to grow the Arriba Nacional trees, they did not use insecticides and chemical fertilizers and grew native plants like yams and coconuts alongside the cocoa.

Exhibit 9 From Bean to Bar

Sources: Cacoa Magazine, Bean to Bar: How Chocolate is Made, September 19, 2019 readcacao.com blog

1. Harvesting
The cocoa tree (Theobroma cocoa) grows in tropical climates throughout the world and has the unusual trait of having both flowers and fruit on the tree at the same time. The fruit of the tree is known as the cocoa pod, which grows on the trunk and branches. Each pod ripens at a different time, so expertise is needed in choosing the right time to pick the pod. Picking is usually done with a machete, and great care is needed to ensure that the flower cushion on the tree is not damaged so that more pods can grow in the future.

© International Cocoa Organization

source: https://www.icco.org/harvesting-post-harvest-new/

2. Fermenting
After the pods are opened and the beans are exposed to oxygen, the fermentation begins. The beans and pulp may be contained in banana leaves or wooden boxes, which contain holes for excess liquid to escape. The beans are mixed or turned to enable this process and the temperature naturally raises to 40–50C. This stage is a major factor in developing the cocoa flavour and can take up to eight days, depending on the bean type.

3. Drying
Following the fermentation stage, the beans contain a high level of moisture, which needs to be reduced in order to avoid overdeveloping, which can adversely affect the flavour. In most origins, cocoa beans can be sun-dried. In wetter climates, however, this is not possible, so alternative methods are used. For example, in Papua New Guinea, beans are dried using open fires, giving them a distinctly smoky flavour. Once dried, the beans are then sorted and bagged, before being shipped to makers around the world.

4. Roasting
The next step is for chocolate-makers to roast their dried cocoa beans. The roasting time and temperature will vary by bean type and quality, as well as the objectives of the chocolate-maker. In addition to being an important factor for flavour development, the roasting process also further reduces the moisture content and kills off any lurking bacteria.

5. Cracking & Winnowing
Following the roasting process, the outer shell becomes thin and brittle. The beans are then cracked manually or with a machine, after which the shells can be winnowed from the bean kernels, also known as cocoa nibs. The cocoa nibs are used in the production of chocolate, whereas the antioxidant-packed shells can be used for other purposes, such as making cocoa tea or even garden fertiliser.

6. Grinding & Conching
These two processes are commonly combined into one with the use of a melangeur. First, the nibs are ground into a thick paste known as cocoa mass. This paste consists of both cocoa solids and cocoa butter, the natural fat of the cocoa bean. During the conching stage, some chocolate-makers add extra ingredients such as sugar, milk or vanilla. This step may take anything from two hours to two days, and the particulars of the process are crucial as they will affect the final texture and flavour.

7. Tempering
This is the process of raising and lowering the temperature of the chocolate so that it is formed into the right consistency through the treatment of the crystals. Without tempering, the chocolate would be dull and crumbly, missing the tempting

(cont.)

Exhibit 9 (cont.) From Bean to Bar

shine and recognisable snap of a finished chocolate bar. This is traditionally done by hand but the process can also be sped up with a tempering machine.

8. Moulding

Once tempered, the melted chocolate is poured into the chosen mould and tapped against a hard surface to remove air bubbles. Craft chocolate-makers often do this by hand, while for larger manufacturers the process is mechanised for efficiency.

9. Wrapping

After the chocolate has cooled and solidified it is inspected for quality control. The final bar is then carefully wrapped in foil or paper packaging to keep it fresh and labelled with a best before date and ingredients list. After the long journey from bean-to-bar, the chocolate is finally ready to be enjoyed!

Source: Cocoa Magazine, Bean to Bar: How Chocolate is Made, September 19, 2019
https://readcocoa.com/blog/bean-to-bar-how-chocolate-is-made/

© International Cocoa Organization
source: https://www.icco.org/harvesting-post-harvest-new/

© Pacari.com
https://www.pacari.com/sustainable-cacao-community/?lang=en

They also grew the hybrid cocoa CCN-51 variety developed in the 1960s by an Ecuadorian agronomist for its resistance to disease. This accounted for 72% of the country's cocoa production (on large-scale monoculture plantations) because of its higher productivity. However, the cocoa was more acidic and bitter than fine flavoured cocoa. Some manufacturers refused to include it in their recipes, but others including giants Mondelez and Barry Callebaut favoured its introduction. This put FFC at risk of extinction, despite its superior taste and quality.

Cocoa was the most lucrative cash crop for Ecuadorian farmers. Most was exported to the US and EU as beans. The industry provided jobs for 5% of the country's economically active population and 15% in rural areas. [21, 22]

Ecuador's Chocolate Industry 2020

In 2020, the chocolate industry in Ecuador was valued at US$125.8 million.[23] The largest player in the local confectionery market was Universal Sweet Industries (La Universal) with 22.9% (see Exhibit 10). Manicho, a 28g chocolate and peanut countline, was its most popular offering. Line extensions included bonbons, white chocolate, chocolate chip cookies and spreadable chocolate. Second was Nestlé Ecuador (11.1%), then Unidal Ecuador (subsidiary of Arcor of Argentina; 10%), Cia Nacional de Chocolate (8.1%) and Ferrero del Ecuador (5.6%). Smaller producers, including Pacari (3.8%), had begun to take a share of the domestic market.

Pacari—A Global Brand from Ecuador

> "Made in Ecuador with local and international flavours. Pacari means Nature in Quechua"[24]

Pacari was the brainchild of Carla Barboto and Santiago Peralta, who in 2002 created SKS Farms, building on Carla's experience of organic farming gained during a year studying in Vermont, USA. They sold organic flowers to the USA through Whole Foods but became disillusioned by consumer attitudes—customers were less concerned about the environment and more about themselves. Helping the environment wasn't enough; they needed personal benefits from the purchase. This prompted them to expand to organic fruit, vegetables and cocoa, since consumers were increasingly convinced of the benefits compared with industrially farmed and genetically modified produce.

Although SKS Farms processed cocoa from 2003, it was only in 2008 that Pacari was launched[25] as the first brand to manufacture premium, single-origin, organic chocolate, 100% from Ecuador. When they started Pacari, the couple had no training in the cocoa and chocolate sector. Within six years they were exporting bars and "challenging the market and mentality of a globalized world."[26] Pacari was the first chocolate company to receive biodynamic certification from Demeter International.[27]

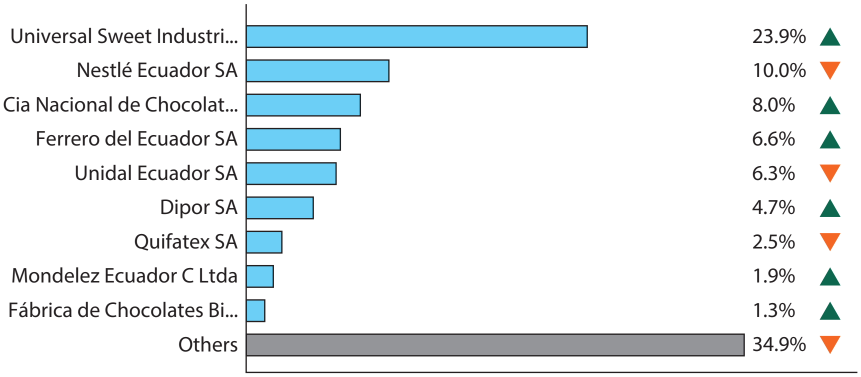
Building a Sustainable Cocoa Farming Community

> "Each bar of chocolate is the result of a human process. It is the manifestation of the soul of the community, inspired by a sustainable and ancestral culture of chocolate."[28]

From the outset, Carla and Santiago were determined to be a "tree-to-bar" operation – "From the farmer to the consumer" was a statement not a slogan. They couldn't understand why Ecuador exported beans and imported chocolate.

> "We cut out the middleman, we traded directly with small producers at a time when no one was talking to these guys. They were the losers in the big export game—and no one was talking vegan, biodynamic, or organic. We paid above market prices, offering an incentive for quality control and loyalty."[29]

Exhibit 10 Competitive Landscape in Ecuador Chocolate Market (% value share)



Source: Euromonitor, Chocolate Confectionery in Ecuador, 15 September 2020.

Universal Sweet Industries (La Universal) is Ecuador's national manufacturer of confectionery. Though the company was incorporated in 2005, it has had a much longer standing presence in Ecuador, having recently celebrating its 130th anniversary. Since 2018, Universal Sweet Industries has seen a decline in revenue with a net sales of US$41 million USD in 2019, down 35% from 2017. Manicho, the company's leading chocolate brand, is also Ecuador's most popular and recognisable chocolate with a brand share of 19.3%.

Source: Euromonitor, Chocolate Confectionery in Ecuador—Analysis, September 2020.

Source: La Universal, Manicho, https://usi.com.ec/product/manicho

Unidal Ecuador is owned by multinational Arcor, and is an importer and distributor of confectionery manufactured from South American countries such as Argentina, Peru, Chile, and Brazil. Incorporated in 1996, the company currently has 14 employees. In 2019, Unidal generated a net sales revenue of US$16.566 million with an operating profit of US$1.051 million. Its chocolate brands Bon o Boon, Nikolo, and Golpe are among the most popular chocolate brands in Ecuador.

Source: EMIS University, Unidal Ecuador S.A. (Ecuador), accessed November 2020.

Source: Latin Flores, Bombones Bon O Bon—Negro, https://www.latinflores.com/es/bolivia/7105-chocolates/bombones-bon-o-bon-negro- p15384.html?osCsid=agr4q3gdibaplkdvgb-25knt0h1

Compania Nacional de Chocolate is a Colombian based confectionery company owned by the Nutresa group. It produces and distributes from multiple Latin American countries including Ecuador. The company produces 27 different brands of confectionery products including Jet which is among the leading brands in Ecuador. Its net sales revenue for 2019 was US$975 million with an operating profit of US$135 million. It has a total of 2,335 employees.

Source: EMIS University, Compania Nacional de Chocolate, accessed November 2020.

Source: Amazon.com, Chocolates Jet Milk Chocolate Leche, accessed Novermber 2020, https://www.amazon.com/CHOCOLATES-JET-MILK-CHOCOLATE-LECHE/dp/B008HQ15I0

The couple approached farmers who produced organic cocoa. Farmers in the Guayas region were tied into 10-year contracts with major European buyers, so they had no choice but to approach regular cocoa farmers. In search of suitable partners, Santiago travelled to the regions of Los Rios, Esmeraldas and Manabi, where the climate and type of soil would make for variations in flavour. He also contacted small-scale farmers who cultivated from one to ten hectares with the biodiversity to enhance flavour variations. These farmers used traditional farming practices (without chemicals, pesticides or industrial fertilizer). This ensured that Pacari chocolate would be chemical-free even if farmers were not yet officially certified organic.

In his quest to find suitable cocoa, Santiago discovered the harshness of the farmers' existence. Trapped in a cycle of poverty, it was hard for them to save any money. Getting paid once a year in July meant that by December they were struggling financially. To generate more income, many farmers had shifted to cultivate CCN-51 cocoa trees to ensure higher productivity. The price difference between FFC and CCN-51 cocoa was insignificant.[30] Their previous experiences had left farmers wary—some collectives had been robbed of their produce based on outsiders' knowledge of when the cocoa beans had been fermented, dried and were ready for sale. Others had been approached by buyer organisations that did not follow through on their propositions.

Building trust was therefore the first priority, if Pacari was to persuade them to work towards organic certification. Carla explained:

> "The going farm-gate rate at the time for non-certified organic [chemical free] beans was US$70 per quintal [100Kg], but we offered US$150. Once they are certified organic, we paid US$200. This is a great incentive for the farmers to persevere with the organic certification plan—and we help them obtain this. This ensured that all the cocoa we used was organic even though a small portion had not yet been officially certified.
>
> In the countryside there is no credit, and the farmer has to pay cash for everything. Therefore, at the beginning we paid 100% in advance. However, this did not allow us to reward or penalise according to good or bad quality:

when the farmer arrived with his product, we had already paid the full value, so we had to accept the beans regardless of the quality. Later, we agreed to pay 50% down with the remainder on receipt of the product. This way, we did not affect the farmer's income stream, but we could adjust the payment if necessary, according to the bean quality, although we very rarely returned dried cocoa beans."

The higher rate encouraged farmers to work with Pacari and cultivate the Arriba Nacional beans. Pacari could support farmers willing to switch back to the Arriba Nacional trees thanks to a loan earmarked by the Inter-American Development Bank. The renaissance of these high-quality beans that had become endangered put Pacari on the map.[31]

Initially, Pacari could not purchase the farmer's entire crop and encouraged farmers to sell beans to other chocolate companies on condition they received the same price that Pacari offered. Carla noted:

> "We made not only a change in the pricing of cocoa but in the mindset of cocoa farmers in Ecuador. Pacari has helped farmers recognise the worth of their products and demand higher rates for their beans—to ask for more, whether it's from Pacari or another buyer. By paying higher rates, we also discourage farmers from focusing on short term goals that produce lower quality beans for the sake of higher yields."

Pacari supported farming communities through training and infrastructure to improve bean quality. This was crucial for farmers who lacked the facilities for the post-harvest process and had to pay high rents during that part of the season. The president of one farming community in Santa Rita described how their lives had been transformed through Pacari's support:

> "Before meeting Santiago in 2012, our community had never fermented our beans. We would often dry our cocoa beans on the roadside. Santiago taught us new methods for the post-harvest process and built us fermentation boxes and cots for drying the beans. They also taught us how to graft new shoots onto older trees. Through methods like these we have seen a significant increase in our yield."

Pacari taught the farmers how to become biodynamic—an integral part of its philosophy. An expert trained the farmers on site once a year, customised according to the climate and type of soil in each region. Not all the farmers were certified biodynamic, but the expert helped them to use the relevant techniques. Carla explained:

> "Teaching the farmers biodynamic agriculture is good because it is a holistic way of agriculture. The requirements are stricter than organic as the entire farm needs to be treated with biodynamism, not just a specific plant or product. At the same time, biodynamic agriculture is less expensive as we teach the farmers how to prepare and apply biodynamic fertilizer on their own so that they don't need to purchase additional fertilizers."

Farmers working in coops cultivated their own crop, and when ready to sell, sold the pods to the coop. The coop received an advance from Pacari, visually checked the beans to ensure there was no fungus and the flesh was white, paid the farmers, then fermented and dried the cocoa before delivering the dried beans to Pacari's factory in Quito, which paid the transport cost of the five-hour journey.

Once they reached the factory, 100 beans were sampled. If 85% were fermented it was considered fine cocoa. They were tasted to ensure the desired flavour. If a farmer tried to sell Pacari low-quality cocoa, he would be thwarted by stringent quality checks and reminded that he could only get better rates for high-quality cocoa. The beans were inspected visually and organoleptic tests were used to verify quality.[32] Standards were high and certified producers had to follow strict guidelines to assure organic production.

Initially, Carla and Santiago had no idea about processing beans and making chocolate, but they came to believe it was for this reason that they went beyond the industry "standard", learning by trial and error—an approach "that generates a better chocolate".[33] Santiago noted:

> "We learned alongside the farmers, designing equipment to better ferment and grind cocoa beans. It gave us a real understanding of how production affects flavours. We began getting fantastic quality."

They invented their own machines to clean and roast the dried cocoa beans, experimenting with different levels of roasting and grinding to determine what gave the best flavour. They took single-origin cocoa batches to capture interesting flavour profiles by blending beans from different "terroirs" such as Esmeraldas, Los Rios, and Manabi, launching varieties named after the terroir. As the first tree-to-bar, single-origin organic chocolate made in Ecuador, their reputation was built on local ingredients, with flavours such as Andean rose, guayusa and wild blueberries from Imbabura.

All elements of the process came under scrutiny to ensure they were humane and sustainable. One example was changing the weight of cocoa bags–145lbs–which dated from the era of slavery when it was considered the most a person could carry. Carla and Santiago cut the size of the bags by 50lbs.

As community was of upmost importance, once the final product was ready, they took samples to the farmers who had cultivated the cocoa. Santiago noted:

> "It was the first time they had eaten the chocolate they helped create. Each farmer involved with Pacari is part of our team. Pacari is more than a chocolate brand. It is a brand of people. Pacari's success is the farmers' success. Each award that Pacari has won is translated into recognition for the brand and visibility for the farmers."

The result was that farmers started to take pride in their produce as representatives of Ecuadorian cocoa worldwide.

In 2013, Santiago became the first person from Latin America to be named "Outstanding Chocolate Maker" by the Fine Chocolate Industry Association, providing valuable visibility for the brand. This and other awards helped the farmers too, as it signaled high quality to potential buyers. Community collaboration led to the construction of an information centre (Ruta de Chocolate y Cocoa) where tourists could learn about the history of cocoa and the Quechua culture.

Originally, Pacari sold bulk products including cocoa liquor/ paste (pure cocoa mass in a solid or semi-solid form), powder (cocoa beans that were ground into a powder) and nibs (chips of crushed cocoa), but this did not generate the value they sought. Santiago explained:

> "Some of the companies we were supplying used our products to develop high-quality products such as chocolate bars and then raked in the profits. One company was even bought by Hersheys for US$16 million after using Pacari's paste."

So Pacari shifted from bulk products to a branded business. With bulk products, institutional sales had represented 90% of the business; after the change in focus this fell to 20% and branded products accounted for 80%. This generated a 15% increase in volume. Santiago noted:

> "I want to build a relationship with the final consumer. Once a final consumer gets hooked on Pacari and its philosophy, they will become an ambassador for our brand. This wouldn't be possible if we focused on bulk products. In two years, we probably won't be selling any more bulk products. This is also to avoid competition from other brands using Pacari to develop their own products."

By 2021, Pacari's factory was producing 40,000 50-gram bars a day, with the capacity to double production, and was on a path to tripling it.

Building the Brand

Entering the market for branded chocolate was ambitious given that it was saturated. Pacari needed to differentiate itself in terms of consumer perceptions by developing a brand that reflected the company's mission and values. Its philosophy (Exhibit 11) echoed the founders' approach to life: respect the basic principles of *Mother Earth* by caring for it and giving back the life it provides. They believed in community and sustainability as the new norms for business, and in the core values of respect, trust, leadership and sustainability. In line with this, the name Pacari was chosen, meaning "dawn" or "nature" in Quechua-speaking countries. Santiago explained:

> "Dawn means the beginning of a new day, which is our story—where we change all this blindness. Dawn is the time light is coming and we will see things clearly. Nature is another beautiful word that is applicable because everything we do is related to nature; we are sustainable. After this we put in 'premium organic chocolate from tree to bar.'"

The design of the logo was based on a petroglyph dating back 5,000 years.

> "The man and a tree depict the story of a farmer and food. The farmer takes care of and fixes the tree, and the tree feeds the farmer. It portrays a joyful and simplistic relationship. It also supports the trend 'you are what you eat' and reflects our brand and personal story."

The product offerings were equally distinctive:

> "The market is full of cheap chocolate, but we are creating a niche of quality products. Mass-produced chocolate is boring. Customers are looking for something with personality, like the wine industry 25-30 years ago. Little by little it is changing as more people are educated about the different flavours and terroir. If you put together some new flavours, such as one we just launched with juniper, which is really like a gin tonic—it's fantastic. But no one has done that before. Why? Because the industry has been kind of lazy about introducing new products and refreshing the market" (see Exhibit 12).

Consistent with its name and philosophy, Pacari began using biodegradable packaging in 2019 (that would decompose in 180 days, unlike plastic that takes centuries).

At the Pacari store, customers were encouraged to purchase products by weight (including cocoa powder, coconut sugar, chia and organic muesli). People who purchased chocolates "paper-free" by using their own container received a discount.[34]

> "We want to create awareness in consumers and in industries. We have found a way to offer a quality product that does not pollute the environment. Our business model 'From the tree to the bar' supports our mission of respecting the principles of the earth, caring for it and giving back what it gives us."[35]

Brand Communication

Word of mouth was key to promotion. Carla and Santiago wanted the Pacari story to be meaningful for the consumer. They did not invest in advertising, preferring to build relationships with well-known chefs such as Martin Berasategui, Paco Perez, Maria Jose San Roman and Carolina Sanchez, who were committed to quality and sustainability and could act as influencers. Santiago explained:

> "These chefs are people who really care. They buy from us because they love the product, our story and philosophy. Our marketing is through these 'chef influencers' Our product is good, but the chefs are also drawn by the personal relationship we have built with them and who also support the ethics behind the business…it's a different way of getting word out about the Pacari brand."

Exhibit 11 Pacari Mission and Values

"Turning back to its natural state by respecting the basic principles of Mother Earth. Simply by caring for it, and by giving back the life it provides. That is our mission, through organic habits, fair trade, and biodynamics we want to create new forms of agricultural practices."

Respect
For us, the history of our products and our chocolate is a unique treasure. That is why, in our processes, we are always looking out for the rich historical heritage: OUR COCOA.

Trust
We work directly with more than 3500 small-scale farmers. By working without intermediaries, we generate trust and transparency giving them fair prices for their product. We also share knowledge about organic and biodynamic processes, which allow them to obtain a better product while taking care of their piece of land.

Leadership
We have become a reference of quality and production processes in the category. By prioritizing the producer and helping him to generate quality crops in an organic way, he can take care of his land and his future.

Carla Barbotó and Santiago Peralta Source: Pacari, Know Our History, 2019, https://www.pacari.com/history/?lang=en

Sustainability
It is fundamental for us to generate a positive impact in the world. It is our responsibility to promote a sustainable and harmonious development, alongside with our producers. Together with nature, sharing culture and sustainable practices to whoever is listening.

Source: Pacari, Know Our History, 2019, https://www.pacari.com/history/?lang=en

To reach a broader group of influencers and convince distributors to carry their products, Pacari held regular tasting events throughout Ecuador and internationally (over 50 by the end of 2020) in diverse locations such as shopping centres and hotel function rooms. Santiago travelled to these events until the COVID-19 pandemic hit in 2020, switching to zoom sessions with "chocolate kits" sent ahead of the virtual meeting:

"I was doing zoom chocolate tastings at least once a week, including tastings with some well-known chefs worldwide. One, was with a Michelin-starred chef from a restaurant in Jayda in Spain, who is Ecuadorian, and knows many other Michelin star chefs. This led to a Michelin star tasting—we wouldn't have been able to reach so many people so quickly without these zoom tastings. It has also saved me time and money by not travelling."

Exhibit 12 A Selection of Pacari's Tropical Flavours

Source: Pacari.com

Pacari had an interesting story to tell in terms of its social impact, ethics and sustainability angle, and also how Carla and Santiago worked together despite having no previous industry knowledge to build an Ecuadorian brand that won accolades for quality (see Exhibit 13). It was featured in news outlets like Nat Geo, CNN, NBC News, channel T13, The New York Times and the like.

To reach the end consumer, beyond the chefs who acted as influencers through mentioning Pacari chocolate in their social media posts, Pacari promoted their posts on its Facebook page. Chefs were given personalized gift boxes (with the name of their restaurant) containing samples that could be given to celebrity guests in the hope they would promote Pacari on social media. Pacari used Instagram (85K followers on its Spanish language account) and Google ads, as mass media advertising was beyond its reach.

In Ecuador, tastings were held at the Pacari flagship store in Quito, targeting shoppers, F&B personnel and distributors. Opened in 2019, the Pacari Experience House sold the products, had an in-house café, and offered cocoa tours and chocolate tastings. By 2021, Pacari had opened two more outlets in Quito, with sales accounting for 15% of the company's total. New products were tested in the shop, offering an opportunity to observe customers' reactions "live". Santiago explained how it worked:

> "There is no single medium but many layers that have allowed us to build the Pacari brand. Holding tastings at events, and at our store, where before the pandemic, we could have 2–3 times a day, allowing us to get people to try our chocolate and understand the story behind the brand and what we are trying to do.
>
> Having these tasting trials has helped us to gauge what type of products we will develop in the future, for example, the forthcoming Nutella-like product that we are promoting. It's an organic cocoa-based spread with hazelnut that we are prototyping in the shop. Another example is coconut sugar and other types of non-chocolate products. We also sell vegan ice cream. So it's not just about selling chocolate, but all the products where we can discuss the organic process of cocoa. That's why we call it the 'Pacari experience house.'"

A mere 3% of sales came from its online platform, with the remaining 79% from supermarkets. According to the largest supermarket in Ecuador, Pacari dominated sales of dark chocolate with 70% market share,[36] commanding a premium price per gram over the most popular brand of chocolate in Ecuador, Manicho.[37]

Challenges

By the beginning of 2021, Pacari was selling more directly to consumers, removing the middlemen, "some of whom were not helping us". In the US, it was distributed through Amazon, which provided a platform to reach discriminating chocolate lovers and also provided fulfilment services.

However, if Pacari was to grow from revenues of US$6 million in 2021 to US$20 million by the end of 2026, it had to address the following issues:

1. Was the positioning that had helped achieve US$6 million in sales sufficient to reach its goal of US$20 million? Should the company modify its positioning and leverage its roots in sustainability more aggressively?
2. While its manufacturing capacity was easy to scale to meet revenue goals, could Pacari source a sufficient quantity of organic Arriba Nacional cocoa beans to triple the current volume?
3. Should Pacari continue to focus on all 42 countries where it had a presence, or should it be more selective? If so, how should it identify which ones to focus on?
4. Consumer knowledge of Pacari remained low and distribution was difficult in markets beyond Ecuador. How should it grow brand awareness outside its home market where it did not have connections to celebrity chefs to act as influencers?
5. Despite visibility from its PR efforts how could Pacari be more strategic in its efforts to gain media attention?

Exhibit 13 Pacari Awards

Source: Pacari, Know Our History, 2019, https://www.pacari.com/history/?lang=en

Notes

1. Pacari, Know Our History, 2019, https://www.pacari.com/history/?lang=en
2. Pacari, 2019, https://www.pacari.com/?lang=en:
3. *Smithsonian Magazine*, A Brief History of Chocolate, accessed November 2020, https://www.smithsonianmag.com/arts-culture/a-brief-history-of-chocolate-21860917/
4. *The Guardian*, Origin of chocolate shifts 1,400 miles and 1,500 years, accessed November 2020, https://www.theguardian.com/science/2018/oct/29/origin-of-chocolate-shifts-1400-miles-and-1500-years- cocoa-ecuador
5. *Smithsonian Magazine*, A Brief History of Chocolate, accessed November 2020, https://www.smithsonianmag.com/arts-culture/a-brief-history-of-chocolate-21860917/
6. Chocolate Confectionery in World, Datagraphics, Euromonitor, Updated July 2021.
7. Statista, Mondelez International Dossier, page 3, 2020.
8. Chocolate confectionery has three basic formats: tablets, bonbons, and bars or countlines. Chocolate tablets are solid and usually rectangular. Bonbons are small pieces of chocolate normally filled with sweet stuffing and sold in assorted boxes. Countlines, or chocolate bars, are individually wrapped, small oblong bars made of layers of different products that could include cookies, fruits, nuts, or caramel and are completely covered by chocolate (one layer could also be more chocolate).
9. Statista, Leading importers of chocolate and chocolate containing products worldwide in 2018, by country, accessed Nov 2020.
10. INSEAD case study (6616): Tony's Chocolonely. The Road to 100% Slave-Free Chocolate? By Viktor Pot and Luk N. Van Wassenhove, 2021.
11. INSEAD case study (6616): Tony's Chocolonely. The Road to 100% Slave-Free Chocolate? By Viktor Pot and Luk N. Van Wassenhove, 2021, https://publishing.insead.edu/case/tonys-chocolonely
12. Sarah Barell, *National Geographic*, Where to find some of the world's best chocolate, 9 November 2020, https://www.nationalgeographic.com/travel/destinations/south-america/ecuador/inside-a-thriving-sustainable- chocolate-industry/
13. https://www.britannica.com/plant/cocoa
14. EMIS Insights – Ecuador Agriculture Sector Report 2020_2021
15. Matt Miller, *AJOT*, Ecuador's niche cocoa business looks to expand, 13 April 2020, https://ajot.com/premium/ajot-ecuadors-niche-cocoa-business-looks-to-expand/P1
16. Matt Miller, *AJOT*, Ecuador's niche cocoa business looks to expand, 13 April 2020, https://ajot.com/premium/ajot-ecuadors-niche-cocoa-business-looks-to-expand/P1
17. https://www.tridge.com/es/intelligences/cocoa-bean
18. Cocoa beans grew best in a combination of mineral rich volcanic soil and a warm climate.
19. Fine or Flavor Cocoa - International Cocoa Organization (icco.org)
20. Importantly, notwithstanding poverty, there were no reported concerns about deforestation or the use of child labour in the Ecuadorian cocoa plantations. There is no specific data on Ecuadorian farmers. The authors based this calculation on the following thesis https://cybertesis.unmsm.edu.pe/bitstream/handle/20.500.12672/6536/Toscano_rd.pdf?sequence=1&isAllowed=y
21. ANECOCOA, 2019 SECTOREXPORTADORDE COCOA, accessed November 2020.
22. It was estimated that 400,000 families worked in cocoa cultivation - 70% small producers, 20% medium and 10% large producers.
23. Euromonitor, Chocolate Confectionery in Ecuador—Analysis, Sept 2020.
24. Pacari, Know Our History, 2019, https://www.pacari.com/history/?lang=en
25. https://www.theepochtimes.com/new-world-chocolate-with-a-conscience_280941.html?welcomeuser=1
26. https://www.theepochtimes.com/new-world-chocolate-with-a-conscience_280941.html?welcomeuser=1
27. Biodynamic agriculture is a form of alternative agriculture very similar to organic farming, but it includes various Aesoteric concepts drawn from the ideas of Rudolf Steiner (1861–1925). Initially developed in 1924, it was the first of the organic agriculture movements
28. Pacari, Know Our History, 2019, https://www.pacari.com/history/?lang=en.
29. Sarah Barell, National Geographic, Where to find some of the world's best chocolate, 9 November 2020, https://www.nationalgeographic.com/travel/article/inside-a-thriving-sustainable-chocolate-industry
30. Farmers normally sell to intermediaries. Most of the intermediaries mix different cocoa varieties because it's easier them to sell to mass markets/grinders. Few intermediaries are focused, meaning they sell to small grinders, who look for fine flavour cocoa. Those intermediaries pay higher. According to experts in the sector, specific batches of Aroma cocoa have received a premium between 8% and 20% than the official NY stock exchange price.
31. Sarah Barell, National Geographic, Where to find some of the world's best chocolate, 9 November 2020, https://www.nationalgeographic.com/travel/article/inside-a-thriving-sustainable-chocolate-industry
32. The term organoleptic refers to the aspects of food, water or other substances that an individual experiences via the senses. Sensory testing is a scientific discipline used to evoke, measure, analyse and interpret responses to products that are perceived by the senses of sight, smell, touch, taste and hearing. The terms organoleptic and sensory were, historically, interchangeable. https://www.sensoryspectrum.com/post/organoleptic-testing-or-sensory-testing
33. JMÉNDEZ, El Progresso, Santiago Peralta: de campesino a mejor chocolatero, 11 December 2016, https://www.elprogreso.es/articulo/sociedad/la-historia-de-santiago-peralta-de-campesino-mejor-chocolatero- delmundo/20161211143305391963.html#:~:text=Santiago%20Peralta%20pas%C3%B3%20de%20ser,de%20Chocolate%20Fino%20(FCIA).
34. JMÉNEZ, El Progresso, Santiago Peralta: de campesino a mejor chocolatero, 11 December 2016, https://www.elprogreso.es/articulo/sociedad/la-historia-de-santiago-peralta-de-campesino-mejor-chocolatero- delmundo/20161211153305391963.html#:~:text=Santiago%20Peralta%20pas%C3%B3%20de%20ser,de%20Choc olate%20Fino%20(FCIA)
35. El Universo, Chocolates Pacari ahora se vende al granel y deja atrás los empaques de carton [Pacari chocolates are now sold in bulk, leaving cardboard packaging behind], 23 September 2020, https://www.eluniverso.com/noticias/2020/09/23/nota/7988200/chocolate-pacari-granel-venta-ecoamigable- ecuador
36. By dark chocolate bars, Santiago means chocolate with no milk.
37. According to chocolate experts, the average price per gram of chocolate paid by customers in Ecuador in 2019 was US$0.0165. Pacari sold its 50-gram tablets at US$2.25 (US$0.045 per gram), almost triple the average cost. It garnered a similar premium compared to the leading Ecuadorian brand, Manicho, which sold for US$0.0178 per gram.
38. Sold to B2B clients such as chefs and chocolatiers.
39. Semi processed products (no beans)

Case 16

Developing a Sustainable Ecosystem Community: The Port of Antwerp

© Port of Anvert

The 120 square kilometre[1] Port of Antwerp is one of the largest in the world (Europe's second largest seaport, after Rotterdam) and home to more than 900 businesses. For centuries it has been integral to the economy of the Belgian city and vice versa. It is a major hub for the import and export of liquids, dry bulk and containers at the centre of a vast network of inland waterways, railways and road infrastructure.

Traditionally, the Port Authority acted primarily as a landlord, awarding concessions to companies for industrial operations, warehousing and other terminal activities, but its new ambition was to position itself as a community builder, facilitating connections between its many stakeholders for their mutual benefit and to ensure that the port remained an attractive cargo destination and would continue to provide jobs for over 144,000 workers in the future.

Originally, the market leader for handling break bulk and dry bulk, the Port of Antwerp was host to a rich ecosystem of industrial companies that had chosen it as a base for logistics reasons. Antwerp hosted Europe's largest chemical cluster, with refineries such as BASF, Total, Exxon, Ineos, Covestro and others. The port's importance as a logistics hub extended throughout north-west Europe. Goods arriving from overseas were shipped via barge, rail, pipelines and road, while goods from across the hinterland were transported to Antwerp to be shipped overseas. Container traffic was a big part of the success story and had seen spectacular growth.

Yet the port was falling victim to its success. Despite steadily increasing infrastructure, increasing capacity was a challenge – it took years for new capacity to become operational. The growth in size of container vessels meant that it had to handle larger cargo sizes and longer operating peaks at the terminals, compounding the capacity problem. Container transit was also subject to uncontrollable factors such as weather and river levels, culminating in a capacity shortage on the maritime quays of the main terminal and

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This case study was written by Lisa Duke, Researcher and Doctoral Candidate, and Gabriel Szulanski, Professor of Strategy at INSEAD. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Extra materials are available at https://publishing.insead.edu/case/port-of-antwerp.

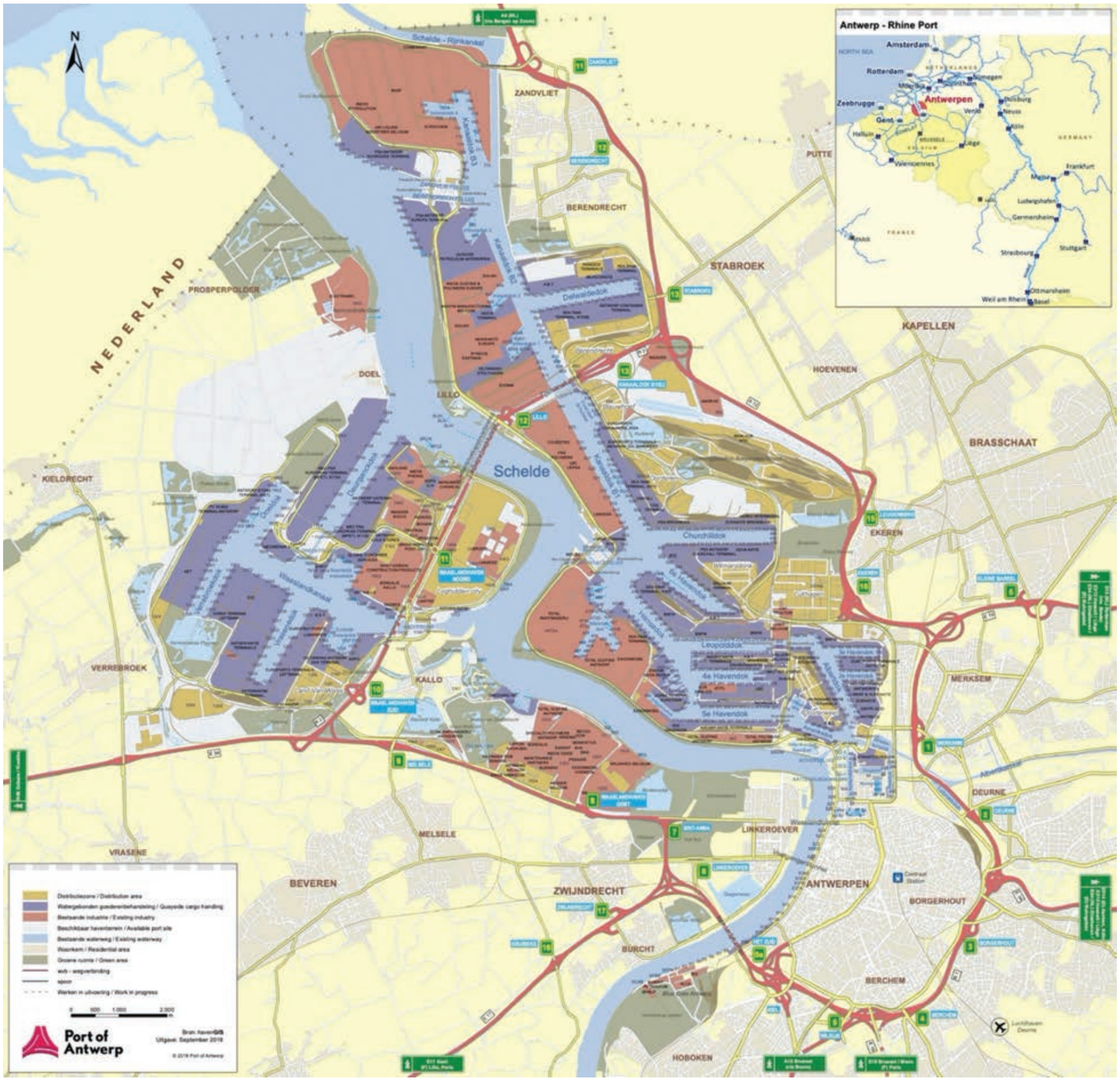
long delays to barge operations. On average, a barge visited six terminals in the port area (maritime terminals, empty depots, mixed terminals), with containers to load and unload at one or more, and regularly lost up to three days in delays. In the absence of service level agreements (SLA) contracts with the terminal operators, barge owners had to wait for a free slot. Delays were compounded throughout the chain all the way to the end-customer, leading to higher logistics costs, the risk of deep-sea vessels sailing without cargo, and freight handlers switching from barge to road transport, which increased congestion. The costs from delays – an estimated EUR 48 million per year – were absorbed by the barge operators.

If the port were to get a reputation for delays, shippers would go elsewhere and the container supply chain would collapse. Despite various projects to optimize cargo handling in the port, there was a need for a more proactive approach and systemic change.

The Port of Antwerp

The Port Authority offered concessions, typically for 50 years, to industrial companies and logistics operators. It had oversight of all the companies and stakeholders in the port (see Exhibit 1). Antwerp handled different types of freight cargo, including break bulk,[2] rolling material, liquid bulk, dry bulk

Exhibit 1 The Port of Antwerp Showing the Maritime Terminals



Source: Port of Antwerp

and containers (see Exhibit 2). It was Europe's market leader in handling steel and fruit and coffee storage, and the largest integrated chemical cluster.

Among its strengths was its pragmatic, flexible approach. Whereas the port of Hamburg refused to accept cargo without the correct import/export paperwork on arrival, Antwerp was willing to accept cargo and allow the paperwork to be obtained thereafter. Located 80km inland on the River Scheldt, as the furthest inland port in Europe it offered freight forwarders fast and inexpensive connections to the hinterland through multiple modes of transport: road (56%), rail (8%) and barge (36%). The aim was 42%, 15% and 43% respectively by 2030.

Exhibit 1 shows the locations of the Deepsea Container Terminals. From the Scheldt estuary it took eight hours to sail to the terminals – deep-sea vessels being steered by a pilot rather than the ship's captain.

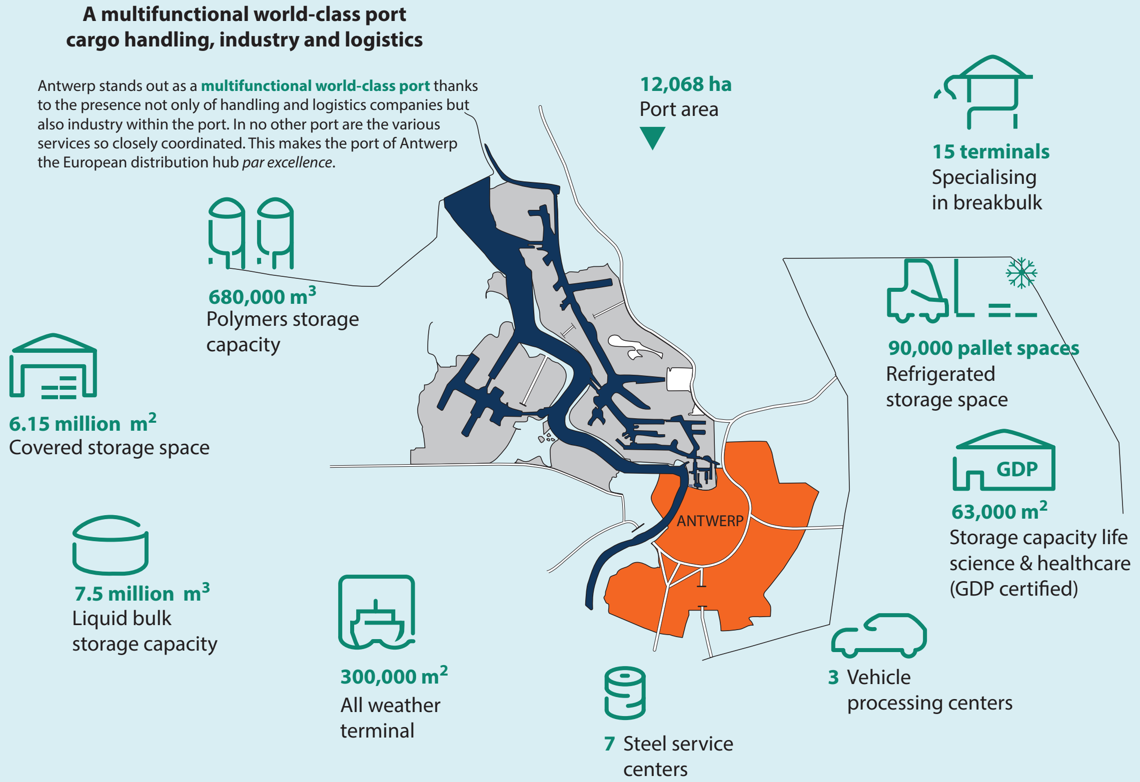
Antwerp's Link to Inland Waterways[3]

More than 550 million tonnes of cargo were shipped across 40,000 km of inland waterways in Europe (Figure 1). The largest river, the Rhine, had two thirds of the volume of transport on these waterways (300 million of a total 550 million tonnes). It was part of the Rhine-Alps corridor that stretches from the Netherlands to Italy via Germany, France and Switzerland. Bordered by densely populated economic and industrial regions, it has been a vital part of transport and industry for centuries. The North-South axis of inland waterways from northern France through Belgium and the Netherlands accounted for almost 20% of the traffic volume (100 million tonnes per annum). Large waterways include the Rhine and canals between the Netherlands and Belgium, where up to 300 TEU can be carried. As a main hub for hinterland traffic within Belgium and with the Rhine corridor, the Port of Antwerp had a competitive advantage.

Exhibit 2 Facts About the Port

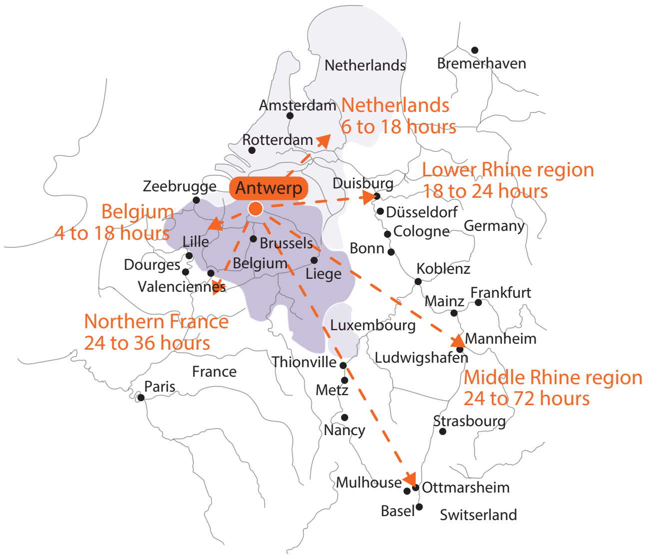
Facts about the Antwerp port area

- **Surface area: Right bank 6,784 hectares / Left bank 5,284 hectares**
- **Length of roads: 358 km**
- **Length of railway lines: 1,047 km**
- **Length of pipes: 1,000 km**
- **Length of quays: 169 km useful mooring length, 120.6 km of quay walls**
- **Number of locks in use: 7**
- **Number of bridgets: 24**
- **Number of docks: 40**
- **Number of terminals: 86**



Source: Port of Antwerp

Figure 1 Hinterland Links from the Port of Antwerp



Source: Port of Antwerp

Antwerp's Competition

Various ports along the North Sea coast were in competition for cargo flows to and from north-west Europe: Hamburg and Bremerhaven (Germany), Rotterdam (Netherlands), Antwerp and Zeebrugge (Belgium) and Le Havre (France). Le Havre and Zeebrugge are much smaller. Hamburg, Antwerp and Rotterdam the three largest. Hamburg's hinterland connections were less strong than Antwerp's and Rotterdam's Antwerp accounted for 76% of the total freight volume of Flemish ports. Rotterdam, 100km to the north, offered easier access for maritime vessels due to its location on the coast. Rotterdam serviced 14,595 maritime vessels and 52,000 inland vessels a year. Its connections with the hinterland were strong, sharing Rhine cargo with Antwerp, and it employed 385,000 people (directly or indirectly). It was developing a Container Exchange Route (CER), leveraging data from companies in the port, that will bundle containers so that trains, barges and feeder vessels will no longer have to call at all terminals individually.

A significant threat to all North Sea ports was increased Chinese investment in European ports as part of its 'Belt and Road' initiative, with control moving eastwards. Of the top 10 busiest ports in the world, seven (including Hong Kong) were in China, with Singapore (#2), South Korea's Busan (#7) and UAE's Dubai (#9). Rotterdam was 11th, Antwerp 14th, Hamburg 19th, and Bremerhaven 27th. Chinese companies had stakes in terminals in Rotterdam, Antwerp, and Hamburg. China's COSCO held a majority 51% stake in the Port of Piraeus in Greece. It planned to make Piraeus the biggest commercial port in Europe and a strategic hub between Europe, Asia and Africa. Ships from Asia typically transit via the Suez Canal and cross the Mediterranean before heading to the North Sea ports.

Future Trends

Antwerp had to plan for increases in future demand to remain competitive, taking the following trends into account.

Increasing Demand

Container traffic was largely handled by three companies, PSA, DP World and MPET. There were also mixed terminals and empty depots. Demand for container freight grew significantly in the last decade.

The Energy Transition and Implications for Multimodal Transport

The Port was aware of emissions and climate targets from the EU – emissions from port operations as well as from road haulage. The European Parliament had called on the European Commission to encourage and increase multimodal transport, strengthening inland waterways as a priority.[4]

Shifting Economics and Powerbase of Different Modes

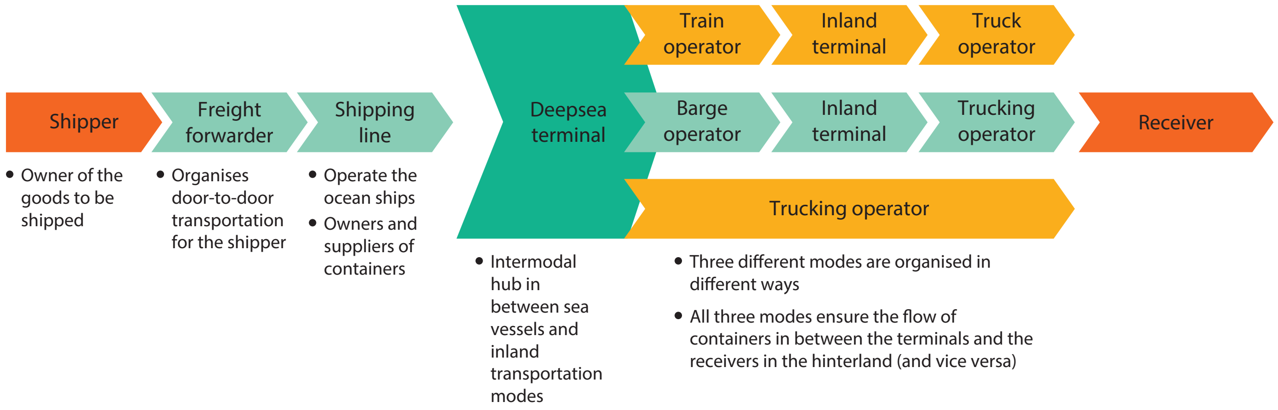
The container freight value chain involved a large number of stakeholders (Figure 2) who worked with various arrangements/conditions but not necessarily a contractual relationship. The majority of barges in Antwerp were contracted by shippers in the hinterland, who had no contracts with the shipping lines. Merchant haulage in Europe accounted for up to 80% of total inland freight, with carrier haulage the remainder.[5]

Over the past decade, consolidation between shipping lines had resulted in three alliances – Ocean Alliance, The Alliance, and 2M Alliance[6] - together accounting for 80% of the overall container trade and 95% of total ship capacity on East-West trade lanes.[7] Further consolidation was likely. Thanks to SLAs with the terminal operators, shipping lines took priority over barges at terminals.

For short distances, competition between trucks and barges was high. Whereas trucks could transport a single TEU container from point to point, with barge transport, last-mile handling by truck had to be added to the cost. Over longer distances, rail and barge were more attractive. The largest barges could transport up to 330 containers to various destinations in the European hinterland. Barges benefit from economies of scale and the ability to stop at ports along the way. In every mode there was significant competition, which drove down freight prices. This trend was likely to continue.

While shippers largely decided who to contract with, the influence of shipping line alliances was increasing. They could easily switch port networks and within a port could create competition between terminal operators and between other port service providers, potentially driving down margins and lowering rates of return on investment for the port industry.[8]

Figure 2 Container Logistics



Source: Authors

Ever-Larger Vessels

Economies of scale could be seen from the size of container vessels. Between 1968-2014 container capacity increased 1,200%, and the trend would continue. As vessels grew larger, they required longer quays and taller cranes to load/unload them. Not every terminal could accommodate the largest ships. At some ports the water level was too low to accommodate heavier vessels. Larger deep-sea vessels meant larger call sizes and increased peak times in the terminals, compounding capacity issues.

A decade earlier, vessels made more calls in Europe, visiting different ports. The new trend was to use terminals as 'hubs' to transship cargo to further destinations in Europe served by smaller seagoing vessels. To enjoy scale benefits, vessels had to be full, which was not easy to achieve. Overloading the hinterland was another concern. Whether by barge, truck or rail, it added further pressure on inland infrastructure, creating delays and road congestion.

Automation

The degree of automation differed across the terminals in Antwerp, but there were no fully automated ports. Automation covered three main areas:

- Port gates – identifying and recording every truck entering or leaving the port. Additional security checks, verification and customs
- Ship-to-shore cranes – for loading and unloading, deployed in some ports
- Stacks and inventory – unmanned stackers operate on the quayside and in the yard

Port management software supported terminal operators for port and business operations. Terminal operations included planning and scheduling of ship movements to quayside berths, registration and follow-up vessel call details. Yard operations included location of containers and accompanying detailed instructions. Planning of berths considered ships' size, the buffer required between vessels, and number of cranes (and of gangs) to unload and load a vessel. This meant knowing how much cargo to unload/load and scheduling tugboats to get the vessels in and out of the terminal. Further automation and digitization was likely throughout terminal operations.

Notes

1. Equivalent to 20,000 football pitches.
2. Break bulk includes metal products, forest products, perishables, project cargo, granite. Rolling material includes cars, vans etc. Liquid bulk included petroleum derivatives, chemicals, and crude oil. Dry bulk included fertilizer, sand, gravel and minerals, coal, grain and seeds, and other dry goods.
3. Figures taken from the 2016 Annual Report "Inland Navigation in Europe: Market Observation", Central Commission for the Navigation of the Rhine, https://inland-navigation-market.org/wpcontent/uploads/2019/08/ccnr_2016_OM_Q2_EN_om16_II_en-min.pdf
4. European Parliament report "Logistics in the EU and multimodal transport in the new TEN-T corridors", Rapporteur Inès Ayala Sander, 19 January 2017: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P8-TA2017- 0009&language=EN
5. Merchant haulage was the inland movement of containers directly by the shipper using his own nominated haulage contractor. Carrier haulage was the inland movement of containers under the control of a shipping line using a haulage contractor nominated by the carrier, https://container-xchange.com/blog/carrier-merchant-haulage/
6. Ocean Alliance (CMA, CGM, COSCO, OOCL, APL, Evergreen). The Alliance (NYK Group, MOL, "K" Line, Hapag Lloyd, UASC, Yang Ming). 2M Alliance (Maersk & MSC, HMM and Hamburg Sud)
7. https://www.confetra.com/wp-content/uploads/Impact-of-Alliances_Final.pdf
8. https://www.confetra.com/wp-content/uploads/Impact-of-Alliances_Final.pdf

Case 17

Re: Build Manufacturing—Reimagining the Conglomerate

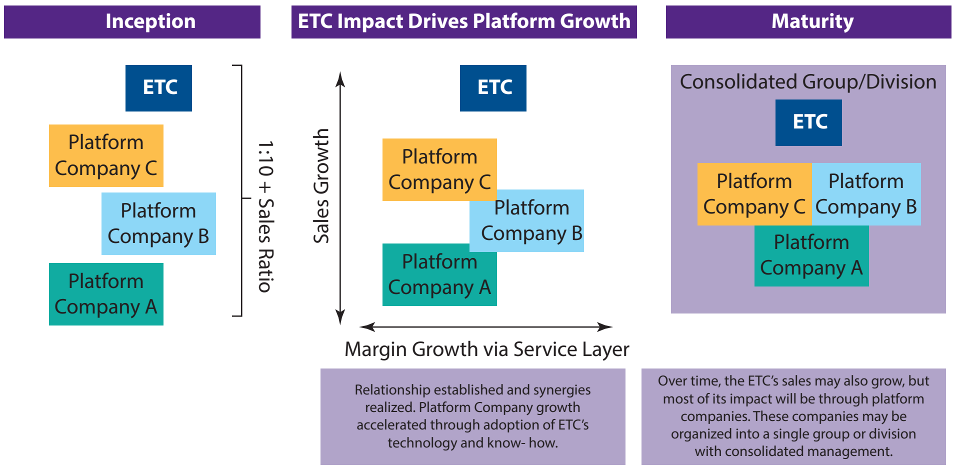
In October 2021, Miles Arnone, CEO of Re:Build Manufacturing (Re:Build), was at the Warrior Ice Arena, the practice facility of the National Hockey League's Boston Bruins, and the home ice of the Boston Pride women's professional ice hockey team.[1] Arnone, who with partners had bought the National Women's Hockey League team in 2019, was sitting in one of the bright yellow seats as the Zamboni resurfaced the ice before a practice session. He faced the rink, on the far side of which gigantic windows opened to a view of the Massachusetts Turnpike with cars and trucks whizzing by. Arnone's thoughts were elsewhere. Re:Build's leadership was considering acquiring one of three platform companies. He contemplated the pros and cons of each candidate company and anticipated discussing with his colleagues the results of a screening exercise, just one element of Re:Build's acquisition decision-making process.

Founding Hypothesis and Thesis

Re:Build's founders hypothesized that technological and geopolitical developments were rendering conventional industrial enterprises obsolete, and that a range of technical and managerial advances could dramatically enhance the performance of small- to mid-sized industrial and engineering-centric enterprises. They believed that advances had not been systematically applied to this cohort and that geopolitical developments, environmental concerns, and market demand for rapid fulfillment and increased customization at mass-production prices would reshape the commercial landscape, creating opportunity for a new industrial model. Their thesis was that industrial enterprises had to shift to a new form of conglomeration built around technology-enabled collaboration. They thought such a shift was necessary for American small- to mid-sized manufacturers if they were to survive, because the next wave of competition would come around the deployment of common technologies that would be difficult to master at the local level. In Re:Build's model, enabling technology companies (ETCs) embodied these technologies. ETCs did not need to be large. Their capabilities were to be leveraged in platform companies, which was where scale was most important to achieve. Re:Build defined platform companies as ones of moderate to substantial scale whose processes and/or products could be dramatically improved by the integration of technologies from adjacent industries.

While platform companies could also be improved through a workplace design methodology like Lean's 5S system of continuous improvement, Re:Build considered such an initiative to be a necessary but not sufficient element for success. Suitable platform companies would need technological enhancement of their products or services, and Re:Build would need to own or control that technology. Acquired platform companies would leverage enabling technologies and services to increase the value of their own offerings. The adoption of enabling technologies by the platforms also increased the value of ETCs (see Exhibit 1). Re:Build

Exhibit 1 How Enabling Technology Companies (ETCs) Impact Platform Companies



Source: Unless otherwise noted, all exhibits based on company documents, used with permission.

founders believed that the existence of both ETCs and platform companies within the same construct would dramatically reduce friction and time associated with promulgating new technologies and methods (see Exhibit 2 for examples of enabling technologies and capabilities).

The founders contended that industrial conglomerates—like Danaher Corporation (Danaher), General Electric Company (GE), Royal Philips (Philips), and Westinghouse Electric Corporation (Westinghouse)—were effective after World War II and into the 1980s because of their management's business acumen (sophistication), group financial resources and expertise, operational expertise (e.g., Six Sigma, Taylorism), information technology (IT) systems built on in-house servers, and ability to source and distribute globally. However, by the second decade of the new millennium, the skills and resources that differentiated conglomerates were broadly available. For example, private equity was providing large amounts of capital and expertise to stand-alone businesses, while IT systems (e.g., enterprise resource planning [ERP], customer relationships management [CRM]) were more affordable and accessible through cloud computing. "We believe that the industrial conglomerate is ripe for reinvention," Arnone said. Danaher's 2016 division into two companies (the new one was named Fortive) and GE's 2021 announcements that it planned to split into three businesses offered evidence that the old industrial conglomerate model had run its course.

Mission and Philosophy

In 2020, Arnone and Jeff Wilke launched Re:Build. The idea was to help create a new model for rejuvenating the US industrial base by acquiring companies with the intention of very tightly integrating them with other businesses and leveraging technical capabilities across the companies. "When we buy a company, we anticipate that we will never sell it," Arnone said. "It does not mean we would not sell it, but we have a long-term holding horizon." Arnone was quick to point out that Re:Build was not a private equity firm. (Exhibit 3 highlights how Re:Build differed from private equity, according to the company.) "It is not a portfolio approach to acquiring businesses," he explained. "Our goal is to acquire businesses that we can essentially have collaborate in a way that generates additional value and benefit for the customers and the shareholders and employees as well." According to Arnone, Re:Build was very focused on creating jobs; he acknowledged the challenge: "As you can imagine there's a natural tension between automation and jobs. Our view is that there's also a lot of advances in technology and management that can enhance the performance of small

Exhibit 2 Examples of Enabling Technologies and Capabilities, Described by Re:Build

Rapid production methods such as 3D printing that can disrupt manufacturing paradigms. Move to lot size of one.
Deployment of Lean in core operations–this is a never-ending saga for younger/newer firms. In the United States, this is still not as broadly practiced as one would hope.
Deployment of Lean in support/service operations–very nascent in the United States and less developed throughout the world.
Artificial Intelligence (AI) /Machine Learning decision-making tools for business judgments (e.g., quality/production decisions) are necessary as the speed and volume of business increases.
Big data: Optimizing marketing, sales, and product or service characteristics requires massive volumes of data to be digested and turned into insightful information on cloud-based platforms.
Automation: The deployment of sophisticated automation, which was previously limited to large-scale industrial manufacturers, is becoming accessible to companies sub-$25 million in scale.
Internet of things (IoT): Almost every product/service will have an IoT component in the future. Most small- to mid-sized businesses are way behind the curve here.
Embedded big data and AI in products/services separate from the use of these tools in corporate decision-making: these features will become embedded in many products and services.
Smart products: The processing power embedded in all products is increasing exponentially.
Sensor fusion: Sensors are ever cheaper and smaller. Combine this with local (or accessible) product-level computation, and many new capabilities are possible.
Field-programmable gate arrays (FPGAs) allow products of small- to mid-volumes to embed substantial decision-making, industrial organization (IO), data collection, and communication capabilities. Many firms are ill-equipped to deploy.
Materials: Advances in material science and processing can dramatically alter design parameters and product capabilities, often requiring new manufacturing methods as a result.

Exhibit 3 How Re:Build Differed from Private Equity

Long Investment Horizon—achieving our goals requires a timescale that closed-end PE funds cannot accommodate. Private equity reward structures can drive "buy and flip" behavior, which in this context would depress long-term value and leave money on the table.

Truly Thesis-Driven—Re:Build is an industrial tech pureplay. Substantial value is derived from thesis-driven buildout of platforms vs. investment banker-driven opportunistic deal execution.

Tight-knit Collaboration Drives Value—Private equity firms need to isolate entities for re-sale, and therefore rarely rely on cooperation between different platforms to achieve returns. Valuation, incentive and time-line issues drive management teams at PE firms apart rather than together. Re:Build drives value generation through cooperation across the firm.

Culture—Because PE investments are independent "islands" and hold times are short, less effort is typically put into building a sustainable, value-driving culture. A strong, consistent, corporate culture is a core element of the Re:Build strategy.

Source: Unless otherwise noted, all exhibits based on company documents, used with permission.

to midsize businesses that can actually lead to job creation." He added,

> [I]n the US, the labor pool is not a low-cost labor pool, and frankly, we don't want it to be. You need a different way to go about that than just slinging inexpensive labor at the problem. Our approach is to invest in advanced technologies that can drive substantial, meaningful change in products or production processes, and then acquire and build businesses around those technologies that we can improve by deploying that technology across these businesses. Much industrial power and prowess has moved to China and Asia. If 25 years ago you said that this would be the situation, few people, if any, would have believed you. I think that there can be substantial shifts to bring work back, even today, because there are a lot of levers in the United States in the way the country is organized, in terms of the economy, the government, the educational system, and the use of technology, that can give us a lot of industrial capability and power and the ability to grow.[2] . . . We have to use technical leverage, we have to identify technologies before they are ultra-mature and then use those as to drive business, and we are going to have to do that, over and over and over again.

The Re:Build Way

Arnone and the company's leadership (see Exhibit 4) wanted to establish values and principles by which it and the companies it acquired would operate. These leaders established 16 tenets that they called the "Re:Build Way" (see Exhibit 5). When Re:Build was considering a company to acquire, these tenets were a focus of discussion. Arnone explained,

> Ensuring that our values and our principles are aligned with prospective companies is essential. Literally, the first meeting we attend with the prospective company's management team, I bring The Rebuild Way with me. We walk through that, and we say, "look there's lots of things that are negotiable, but our values and principles are not." We work with companies to make sure that they are going to be comfortable with our values and principles. We only bring companies into the fold that we think are compatible around those areas.
>
> For example, our use of the Re:Build Way led us to a very effective policy of bringing standardization around COVID-19 practices to our plants given different sites and geographical biases. We've moved our businesses' vaccination rates up and had to also undertake some tough decisions with respect to management at one site.

Once it acquired a business, Re:Build gave that company's leadership a measure of autonomy. "We don't want to have total top-down management, because when you do that, you accelerate the rate at which you calcify and then you decelerate the rate at which you can accept new innovation," said Arnone.

Corporate Service Layer

Still, Re:Build had a corporate service layer, which leadership considered an important feature and was key to generating value for ETCs and platform companies Re:Build acquired. Corporate services included operations and engineering management (i.e., Lean, Six Sigma, standardized operating practices and systems), recruiting (C-suite, middle management, project-oriented staffing), strategy and governance, financial expertise and access to capital, networking across the value chain, expert guidance and context, shared services (e.g., ERP, CRM, and so on), and M&A.

Two Tracks

Re:Build acquired and built businesses along two tracks: ETCs and platform companies. (See Exhibit 6 for an illustration of company structure and organizational relationships.)

ETCs were typically smaller (no more than $15 million in sales), tended to be more adolescent in nature, were

Exhibit 4 Re:Build Leadership Team

Miles Arnone, CEO
Managing partner and cofounder of Cannon Capital (2016–2020)
20+ years of investment and operating experience; 13 years at American Capital
Principal inventor on 200+ patents
Founded three start-ups
Former president, CEO of various industrial businesses (Boston Digital, Campbell Grinder, Bridgeport Machine Tool Co.)
Education: (2) MS and BS (Massachusetts Institute of Technology [MIT])

Michael Foley, COO
Private equity partner, Artemis Capital (2016–2019)
25 years experience in advanced materials, optics and electro-optical systems, instrumentation, and industrial technology companies. 13 US patents.
Reflexite (1997–2013), named COO in 2001 and CEO in 2006
Vice president/general manager of IEC Labsystems, a subsidiary of Life Sciences International (LON: LSI).
Education: BS, MS, and PhD (MIT)

Gordon O'Brien, CFO, CIO
Managing partner and cofounder of Cannon Capital (2016–2020)
25+ years of investment experience; 18 years at American Capital (ACAS)
ACAS president (2008–2016)
20+ years structuring private equity investments, negotiating debt agreements, managing portfolio companies
Chairman, The Middleby Corporation (NAS: MIDD)
Education: MBA (University of Chicago Booth School of Business), BS (Wharton School of Business)

Jeff Wilke, Chairman
Amazon's CEO of Worldwide Consumer (2016–2021)
20+ years in senior management at Amazon: first 7 years building global operations
6+ years at Allied Signal in GM and operations roles in plastics, metals, electronics, pharmaceutical segments
Education: BS in Chemical Engineering (Princeton University), (2) MS (MIT)

Source: Re:Build Manufacturing, https://www.rebuildmanufacturing.com/ (accessed Jul. 28, 2021).

Exhibit 5 The Re:Build Way

01 We care about our team members and put their safety before anything else.

02 Machiavelli was wrong! Winning at all costs is not winning at all. At Re:Build we want to be as proud of the path taken as the result achieved.

03 We recognize diversity as a source of value. We welcome and respect people from all walks of life. We encourage constructive dissent.

04 We protect the environment and devote significant resources to science-based sustainability programs.

05 We listen carefully and non-defensively to customers, suppliers, and community members.

06 We are honest in all our dealings and seek mutually beneficial arrangements. We do not partake in zero-sum behaviors.

07 We are open in our communications, accountable for our actions, reject corrupt behaviors, and expect the same of other stakeholders.

08 We buy businesses to build them over the long-term. We do not buy businesses with a plan to sell them.

09 We seek to improve the communities where Re:Build operates with a focus on apprentice programs and STEM education.

10 We use rigorous systems to ensure we hire and onboard team members who will be successful team members long term.

11 We provide long-term, meaningful opportunities for our team members to maximize both their contribution to Re:Build and their earning potential.

12 We provide forums for team members to share their knowledge and experience and refine their mental models. Re:Build is a learning organization.

13 We celebrate individual achievements but reserve the greatest accolades for team performance. The best ideas and solutions are rarely the product of a person working in isolation.

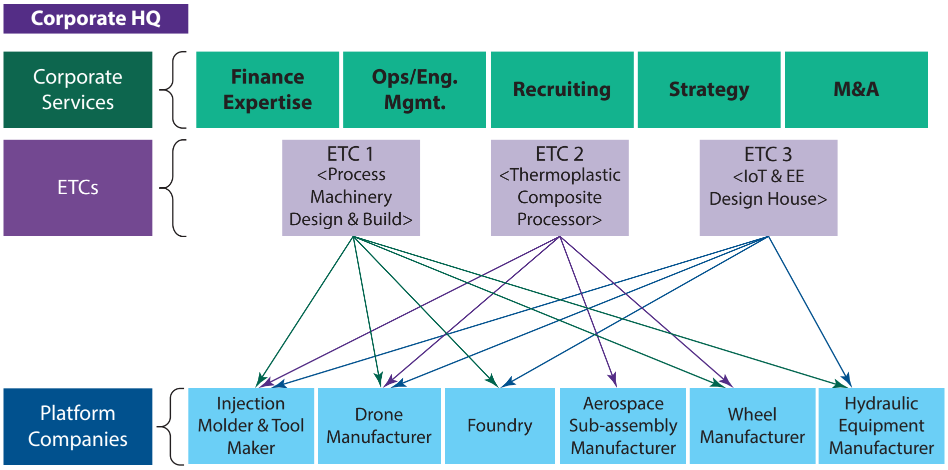
14 We focus on and measure inputs we control and expect excellent performance on input metrics to create long-term value.

15 We utilize Lean and continuous improvement as we strive for zero defects, lower cycle times, and minimal waste. We design quality into our products and systems.

16 We implement systems to ensure improvements last and identify and reward champions who propagate them across the company.

Source: "The Re:Build Way," Re:Build Manufacturing, https://www.rebuildmanufacturing.com/our-principles (accessed Jul. 28, 2021).

Exhibit 6 Re:Build Structure



underserved by bankers and private equity firms, and had technologies with demonstrated commercial viability. Re:Build acquired ETCs through ground-up research and sourcing outside of conventional channels, and the acquisition of these businesses was the critical enabling function for Re:Build. During the first year post-acquisition (Phase 1), the corporate service layer helped to prepare the ETC to support platforms by professionalizing and streamlining operations, scaling management and processes, and refining product and service offerings. (All this could be undertaken in the context of current existing businesses.) Afterward (Phase 2), the ETC was ready to support platform companies and to provide services, products, equipment, or other support to reposition and redefine the target businesses. This process, Re:Build leadership believed, benefited the ETC by driving commercially oriented relationships, providing deep customer insights, and allowing further refinement and expansion of the ETC's technical and business capabilities.

Platform companies tended to be larger ($25 million to $100 million in sales) and were targeted for acquisitions based upon Re:Build's ability to upgrade their performance by operational enhancements, driving efficiencies, and the adoption of technology from in-house ETCs. Platform companies were sourced through more conventional channels (e.g., investment banks) with the understanding that Re:Build's application of ETC technologies would drive them to higher levels of sales, profitability, or both. Sourcing took place in the context of a well-developed thesis. During Phase 1, post-acquisition, the acquired company would utilize the corporate service layer to grow and improve operations (such as refine management and strategy and implement operational best practices, and so forth). Phase 2 commenced once an ETC was ready to transfer or integrate technology to support the platform company's growth. Platform companies then became enabled.

Three Theses

Re:Build was organized around three theses—Advanced Materials, Total Production Solutions (TPS), and Engineering Services.

Advanced Materials provided engineering, development, prototyping, and production of advanced composite and metallic components for a wide range of applications and industries. Within Advanced Materials, the ETC-driven technology involved highly automated novel production processes for producing thermoplastic composites for standalone components or components integrated with thermosets and metals.

Total Production Solutions was the company's integrated offering of manufacturing, supply chain, and engineering design services. Arnone described TPS as end-to-end contract manufacturing engineering for customers and explained a spate of demand:

> We are being overrun by a tidal wave of companies that want us to produce their products domestically, that were being made offshore, to reshore them. This is very challenging. The typical path for a company is you start by sending parts manufacturing offshore, but you keep assembly and engineering. Then over time you offshore the assembly as well. Then during the next economic downturn you may give up some of your engineering capabilities. Before you know it, you have become a sales and marketing company. You start telling people how wonderful it is because you are asset light, control the market, without all these costs of making stuff. Then you want a new product, you call your supplier up wherever they may be, China or somewhere else, and they tell you what the product is going to be. Now all of a sudden, you don't have differentiation and the supplier is also likely coming into the market through

other players, your competitors. It is a really a difficult situation to find oneself in. Consequently, there are a lot of US companies that are desperately trying to reshore production and engineering. But after having moved this offshore for a decade or more, they have lost those skill sets. They are looking to companies like ours to try and help them come a little bit closer to do to what they used to do.

Engineering Services provided a broad range of engineering solutions that acted as force multipliers in a production setting. This included IP generating designs for custom products intended to add value and performance to the custom components that Re:Build companies manufactured.

By mid-2021, Re:Build had raised more than $425 million and made six acquisitions in Engineering Services and Advanced Materials, with seven facilities in five states.[3] (See Exhibit 7.) The company started with thermoplastic and thermoset composites, titanium, and aluminum-based manufacturing within Advanced Materials, as well as manufacturing and process automation within Engineering Services.

Exhibit 7 Re:Build Companies

Oribi Composites Accelerated, Commerce City, Colorado (acquired late 2020)

ETC

- **Advanced thermoplastic materials**
- **Capabilities: in-house engineering, full-scale manufacturing (in United States)**
- **Markets: aerospace, industrial, medical, protective equipment, sporting goods, transportation**

Composite Resources, Rock Hill, South Carolina (acquired March 2021)

Platform

Composite components

- **Capabilities: program management, design, tooling design and production, component production, composite machining, coatings, quality**
- **Markets: aerospace, defense, unmanned applications (sea, aerial, land), space, automotive, satcom**

The Pilot Group, Monrovia, California (acquired November 2020)

ETC

- **Incorporated 1990**
- **Services: machine design and fabrication, control systems design, electronics design**
- **Clients: Boeing, Baush & Lomb, Alcon, Pratt & Whitney**

Cutting Dynamics Inc., Avon, Ohio (acquired May 2021)

Platform

- **Began in 1985**
- **Services: engineering, kitting, manufacturing, assemblies, hydroforming, hot forming titanium, composites, and thermoplastic composites**
- **An experienced manufacturer of thermoplastic carbon fiber products**
- **Markets: aerospace (commercial and defense)**
- **140 employees**

Wonder Machines Services Inc., Avon, Ohio (acquired June 2021)

Platform Bolt-on Acquisition for Cutting Dynamics Inc.

- **Founded in 1976**
- **Capabilities: CNC milling, CNC turning, True 5X-Axis CNC machining**
- **Offer precision CNC machining for prototype, short-run, or production volumes**
- **Operates 24 CNC machining centers**

Computer Numerical Control (CNC) machining was a manufacturing process in which pre-programmed computer software dictated the movement of factory tools and machinery.

DAPR Engineering LLC, Nashua, New Hampshire (acquired August 2021)

ETC

- **Established 2014**
- **Engineering Services: customer automation, engineering analysis, industrial equipment development, turnkey build and integration**
- **Industries: agriculture, biopharma, energy, food, life science, oil and gas, semiconductor, to name a few**
- **About 70 clients, worldwide**

Source: Individual company websites (accessed Jul. 28, 2021).

(Exhibit 8 illustrates how one acquisition of an ETC—Oribi Manufacturing—could impact platform companies.) As Wilkie, Re:Build chair, explained,

> There's a lot of engineering that goes into the application of certain materials for certain parts, components and ultimately finished goods…So we started with advanced materials in part because we think if we could demonstrate great engineering work and great finished product work in advanced materials, then we can start to build around it and build more and more complicated sub-assemblies and then people can ultimately locate in the US. You'll have people building finished goods factories right next to those tiers of suppliers who can co-engineer with them and start with the materials and basic assemblies that are needed to assemble their final product.[4]

Growing Re:Build

Arnone and the Re:Build leadership team projected that Re:Build would have 12 companies in the fold—nine platform companies and three ETCs—by the end of the company's fifth year in operation. After less than two years operating, Re:Build was ahead of schedule and poised to add another company before the end of 2021. Leadership had identified three companies as possible acquisition candidates (see Exhibit 9). Arnone said,

> As we've progressed, we have been investing more heavily in smaller-scale firms with ETC-like characteristics. This has been caused by (a) a very overheated M&A market, and (b) opportunistically our outreach to engineering services businesses has gone quite well…and we see these companies as serving as ETCs but also a window into many companies and industries that can inform our pursuit of platform companies going forward. As we've built this ETC-centric group of companies, we are in a position heading into 2022 to now affect the acquisition of, and upgrading of, platform companies much more so than we would have been had we bought an ETC, then a platform, then another ETC, then maybe two platforms, etcetera.

When considering an acquisition, leadership applied a screening process to evaluate a platform company. The screening process required a score of at least 70% for a candidate company to move to the next stage of due diligence. There were three primary elements to the scoring:

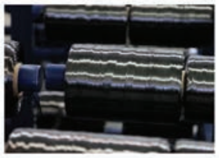
Potential improvements considered the strength of opportunities to improve performance by enhancing leadership, transforming the current business model or pivoting to capitalize on a market opportunity, ramping up sales, and/or restructuring the sales function. A higher score indicated a greater potential to make improvements to drive value.

Existing characteristics considered the present strength of the company regarding market position, leadership, product offerings, and customer base. A higher score indicated a stronger characteristic.

Platform-specific characteristics considered the fit with the Re:Build model and the Re:Build Way and looked at the size and stage of the company being considered, its scalability and potential to grow and/or contribute to the growth of the Re:Build family of companies, and its company culture. Senior associate Chris Sachs (Darden MBA '21) elaborated on identified potential: "How will this company we are considering acquiring fit within the broader spectrum of the companies we have amassed to date? Will it potentially deliver value to the other businesses under our umbrella? That's ultimately our objective and that's why it has a category weighting of 10. The ability of all of our platform companies and ETCs to collaborate with each other is really what separates Re:Build from being a private equity firm." A higher score meant a stronger fit.

Exhibit 8 How ETCs Impact Platform Companies

ETC



Current ETC Example: Oribi Manufacturing

Oribi Manufacturing is a leader in highly engineered thermoplastic composite manufacturing, and proprietary manufacturing equipment (built in-house) that brings composites to higher volume applications.

Oribi can apply its engineering know-how to a variety of end-markets to create products with superior strength-to-weight ratios and price points.

Platform Company

Acquire: Aero Seat Manufacturer

Current state: produced using thermoset composites
Core technology adoption: apply thermoplastic composite production technologies, lean, and automation.
Benefits: increase cost-effectiveness and performance attributes, all while leveraging existing customer relationships, reputation, logistics, etc.

Platform Company

Acquire: Aerospace Structures Manufacturer (defense oriented)

Current state: produced using thermoset composites. Labor intensive processes.
Core technology adoption: apply thermoplastic composites, apply automation lean processes.
Cross Platform: Deploy common plying and kitting systems.
Benefits: increase cost-effectiveness and performance attributes, utilize aero/mil certs.

Exhibit 9 Acquisition Candidates

	Project Rush	Project Jaws	Project Intrepid
Description	Provides mechanical and process engineering and design, automation and systems integration, skilled trades fabrication and maintenance services. Primarily serves manufacturing, chemical, glass, pharmaceutical, oil and gas, and food and beverage industries.	A market-leading provider of automated workholding solutions, including solutions to secure machine parts in place, prevent vibration during machine operation, and so on. Provides manual, commodity, and automated clamping solutions.	Custom injection molder specializing in highly engineered, tight-tolerance products with a core focus on advanced manufacturing innovations and processes. Two operating units at different locations: medical (i.e., diagnostic, vascular, and labware applications) and PIC (i.e., medium-to-high-volume proprietary packaging [e.g., food condiment containers, cannabis containers], industrial [e.g., breathalyzer components], and consumer products [e.g., fishing line spools]).
Capabilities	**-Technological and application engineering expertise across multiple industries** • Bulk material handling • Recipe-based batch control systems • Media-based roll-to-roll systems • Skid-based systems • High-pressure test systems **-Full-Spectrum Automation Integration and Fabrication Services Provider** • Process and machine design engineers • Automation integrators • Systems fabrication, skid and machine building **-Extensive fabrication and machine-build capabilities** **-High value-add applications and engineering expertise**	-Core product focus on hydraulic clamps serves complex computer numerical control (CNC) machining processes. -Specializes in hydraulic clamps for high-pressure applications–the fastest-growing segment of the market–expected to grow 14% per annum 2021 to 2025.	**-In-house expertise** • Concept, design, and engineering • Tooling, design, and build • Highly automated injection molding • Automated testing and quality control • Enhancement and sustainment **-Core competencies** • Engineering, design, and pre-production • Production, testing, and quality control • Shipping and order fulfillment

	Project Rush	Project Jaws	Project Intrepid
Founded	1985	1974	1980
Region	Northeast	Midwest	Mountain West
Employees	~170 full-time, ~20 part-time	~130 full-time, ~5 part-time	~130
Revenue	$34 million (2021F)	$33 million (2021E)	$32 million (2021F)
Ebitda	$3 million adj. (2021F)	$11 million adj. (2021E)	$7 million adj. (2021F)
Growth	• Factory automation market is expected to reach $230 billion by 2025 from $150 billion in 2020, at a CAGR of 8.6%. • There are key growth opportunities in green energy, and pharma & life sciences. • Company's large multinational customer base presents substantial growth opportunities.	• Automation trends are benefiting the workholding industry. • Total US addressable market for work holding is between $1 billion and $2 billion.	• There is growth opportunity to expand beyond Rocky Mountain region.

Exhibit 9 (cont.) Acquisition Candidates

	Project Rush	Project Jaws	Project Intrepid
Leadership	• Founder is CEO and CFO. • COO joined in 2003 from Corning.	• Leadership team has 17+ years' experience with company and 24 years industry experience.	• Over last 5 years, founder, chair, and CEO transitioned day-to-day operations to current management team with 150+ years of combined industry experience.
Facilities	~128,000 square feet (SF)	~50,000 SF manufacturing	~140,000 SF
Comments	• 93% of revenue from North America / 7% revenue international • Company culture built on the foundation of its hardworking, flexible, and committed people • Low customer concentration • Generates revenue through two major project types: "Time and Materials" billed to customer as incurred with predictable profitability and "Fixed Fee" recognized on percentage completion basis with cost underrun/overrun potential that is well managed by the company • Large consolidation opportunity in highly fragmented market (automation market is composed of many small, regional players)	• PE firm majority owners • One of the only manufacturers selling directly to fixture builders, machine tool original equipment manufacturers (OEMs), integrators, and end users • 24% of sales from outside the United States • Exports to 29 countries • Top 10 customers account for about ⅓ of revenue • Fragmented market • Promote from within culture	• Innovation central to the culture • Leading custom injection molder in Rocky Mountain region • Revenue from two sources: injection molding and mold (tooling) sales • Modern facilities • Opportunity for growth in cannabis market

Note: Data are somewhat disguised. Financial and other company information is approximate.

Of the three companies under consideration in October 2021, only one—codenamed Project Rush—achieved the 70% threshold (see Exhibit 10).

The Drive to Win

As the Zamboni made its final turn, and the hockey players waited to take to the ice, Arnone was in good spirits. The Pride team was expected to contend for the league championship, and Arnone believed that Re:Build was on its way to redefining the conglomerate. Adding a company to the Re:Build stable was no small decision and getting it right would be another step forward in creating a "new" type of conglomerate—one where each company worked together to share technology, knowledge, and ideas. Would the company codenamed Project Rush be a good fit? While it did achieve the 70% scoring threshold necessary to be considered, it was time for Arnone and his leadership team to discuss the screening results. Two other companies were under consideration as well. It was time to decide where to focus, given limited bandwidth in Re:Build's M&A team. What in-depth information would the leadership need in order to decide whether to pursue Project Rush, or one of the other two?

Exhibit 10 Platform Company Screen

		Project Rush		Project Jaws		Project Intrepid		Category Weighting	
		A	B	A	B	A	B	C	D
	Potential Improvements	Points (0–10)	Weighted Score	Points (0–10)	Weighted Score	Points (0–10)	Weighted Score	0–10	%
A	Unstructured/unprofessionalized	5	5.7%	3	3.4%	4	4.6%	10	11.5%
B	Business model transformation / pivot required	6	4.8%	5	4.0%	7	5.6%	7	8.0%
C	Pending ramp up for rapid sales growth	8	9.2%	2	2.3%	8	9.2%	10	11.5%
D	Unfocused sales effort that can be restructured	9	10.3%	9	10.3%	8	9.2%	10	11.5%
	Improvement Score		**30.1%**		**20.1%**		**28.6%**	**37**	**42.5%**
	Existing Characteristics	**Points (0–10)**	**Score**	**Points (0–10)**	**Score**	**Points (0–10)**	**Score**		
A	Market leader	7	3.1%	8	3.5%	4	1.8%	7	4.4%
B	Strong CEO there or bringing in	7	2.2%	7	2.2%	5	1.6%	5	3.1%
C	Diversified offering	8	3.0%	7	2.6%	7	2.6%	6	3.8%
D	Diversified customer base (end market)	8	3.0%	7	2.6%	6	2.3%	6	3.8%
	Existing Characteristics Score		**11.3%**		**10.9%**		**8.2%**	**24**	**15.0%**
	Platform Specific Characteristics	**Points (0–10)**	**Score**	**Points (0–10)**	**Score**	**Points (0–10)**	**Score**		
A	Right size, stage	7	8.8%	8	10.0%	8	10.0%	10	12.5%
B	Identified potential	8	10.0%	6	7.5%	7	8.8%	10	12.5%
C	Scalable	9	6.8%	6	4.5%	7	5.3%	6	7.5%
D	Culture	7	7.0%	7	7.0%	5	5.0%	8	10.0%
	Platform Specific Score		**32.5%**		**29.0%**		**29.0%**	**34**	**42.5%**
	Total Score		**73.8%**		**60.0%**		**65.8%**		

Column	Title	Inputs / Calculations
A	Points (0–10)	Evaluators input their scores for Rows A to D
B	Weighted Score Score Score	Potential Improvements: (Column A)*(Column D/10) Existing Characteristics: (Column A/10)*(Column D) Platform Specific Characteristics: (Column A/10)*(Column D)
C	Category Weighting 0–10	Weights fixed by Arnone and leadership for Rows A to D
D	Category Weighting %	Sum of Column D*(Column C Row /sum of Column C)

Notes

1. This is a field-based case. All information and quotations, unless otherwise noted, derive from author interviews with company representatives. Some data are disguised.
2. Todd Bishop, "After Helping Amazon Reinvent Commerce, Jeff Wilke Turns Attention to Reviving U.S. Manufacturing," Geek Wire, July 10, 2021, https://www.geekwire.com/2021/helping-amazon-reinvent-commerce-jeff-wilke-turns-attention-reviving-u-s-manufacturing/ (accessed Jul. 27, 2021).
3. https://www.geekwire.com/2021/helping-amazon-reinvent-commerce-jeff-wilke-turns-attention-reviving-u-s-manufacturing/.
4. https://www.geekwire.com/2021/helping-amazon-reinvent-commerce-jeff-wilke-turns-attention-reviving-u-s-manufacturing/.

Case 18

Uber: The Turbulent Rise of "Everyone's Private Driver"

The world has changed, and we must change with it.

—*Dara Khosrowshahi, Uber CEO*[1]

Noor "Nadia" Jaseem ended the Zoom staff meeting with a sigh. Six months of looking at her colleagues in little boxes on her computer screen had taken its toll, and while Jaseem appreciated the fact that this technology was available to keep Uber Technologies, Inc.'s (Uber's), managers and executives working through the pandemic, the unusual circumstances of maintaining social distancing added another layer of difficulty to an already challenging situation. This morning's meeting had been particularly contentious. Jaseem, the product division's senior program manager, had spent time with Uber's senior leadership team discussing the increasingly worrisome revenue forecast.

Uber ridership had dropped precipitously since the onset of the pandemic in March, and while other ride-hailing companies were faring no better as October 2020 arrived, the sector's overall poor performance offered little comfort. Pre-pandemic times had been tough enough—Uber had suffered a $8.5 billion loss in 2019, a post–initial public offering (IPO) depressed stock price, increasing competition, rising public scrutiny of its rider safety protocols, and heightened regulatory pressure on the employment classification of drivers, among other issues. CEO Dara Khosrowshahi had publicly rolled out a bullish vision for Uber's profitable future, suggesting that Uber would demonstrate profitable growth through "continuous innovation, excellent execution, and the unrivaled scale of our global platform."[2] His vision included a commitment to a zero-emission fleet by 2040 and an anticipation of social trends accelerated by the pandemic, with cities rethinking their infrastructure and individuals' driving habits evolving.[3] Yet the company had also just laid off 6,700 employees—25% of its workforce—in May 2020,[4] and Khosrowshahi himself had announced that he would forgo his own base annual salary of $1 million.[5] It was clear that the leadership team was under pressure to guide Uber boldly into the future, but also that it needed to do so from a difficult current financial position and under very challenging market conditions.

Jaseem had joined the company three years earlier, after spending several years at Google in a product-development leadership role, a job she secured immediately following graduation from business school at the University of Southern California. A first-generation Iranian American, she had grown up in Los Angeles after her parents immigrated to the United States in the mid-1990s. The car culture of Southern California had intrigued Jaseem as a young woman, later fueling her interest in issues around transportation and mobility, which had motivated her undergraduate major in Urban Studies at University of California–Irvine. Despite her interesting work at Google and a promising career track there, Jaseem had jumped at the chance to join Uber in the fall of 2017: it was an opportunity to continue to work in an exciting, tech-rich environment, at a firm poised for explosive growth, while also reconnecting to some of her core interests in urban dynamics and personal mobility.

Jaseem joined Uber at a key inflection point: the company's former CEO, Travis Kalanick, who personified the firm's "bad boy" reputation, had stepped down the month before Jaseem joined. His departure had given Jaseem confidence in Uber's changing culture, and she had hoped that her presence in a leadership position would help facilitate the move away from some of the company's past internal problems, specifically the reputed behind-the-scenes culture of misogyny and discrimination. True to Jaseem's hopes, Uber's culture had improved under new CEO Khosrowshahi, but a host of other controversial concerns had arisen, challenging the relationship between the company and its various stakeholders. The firm's recent continued financial volatility, from the high of its IPO to the low of the recent staggering net loss, didn't ease matters. A constant sense of urgency pervaded the company.

Khosrowshahi had called a meeting for senior leaders the next day, and Jaseem needed to prepare a list of potential strategic action recommendations for the company to consider with an eye to better positioning itself to weather the uncertain times ahead. As the lead program manager of the product group, Jaseem would be presenting the group's best ideas to Uber's full top management team, but she and her staff had yet to settle on what those best ideas were. Jaseem knew it was going to be a long afternoon and evening, and she sighed again as she thought about Uber's past and contemplated its future.

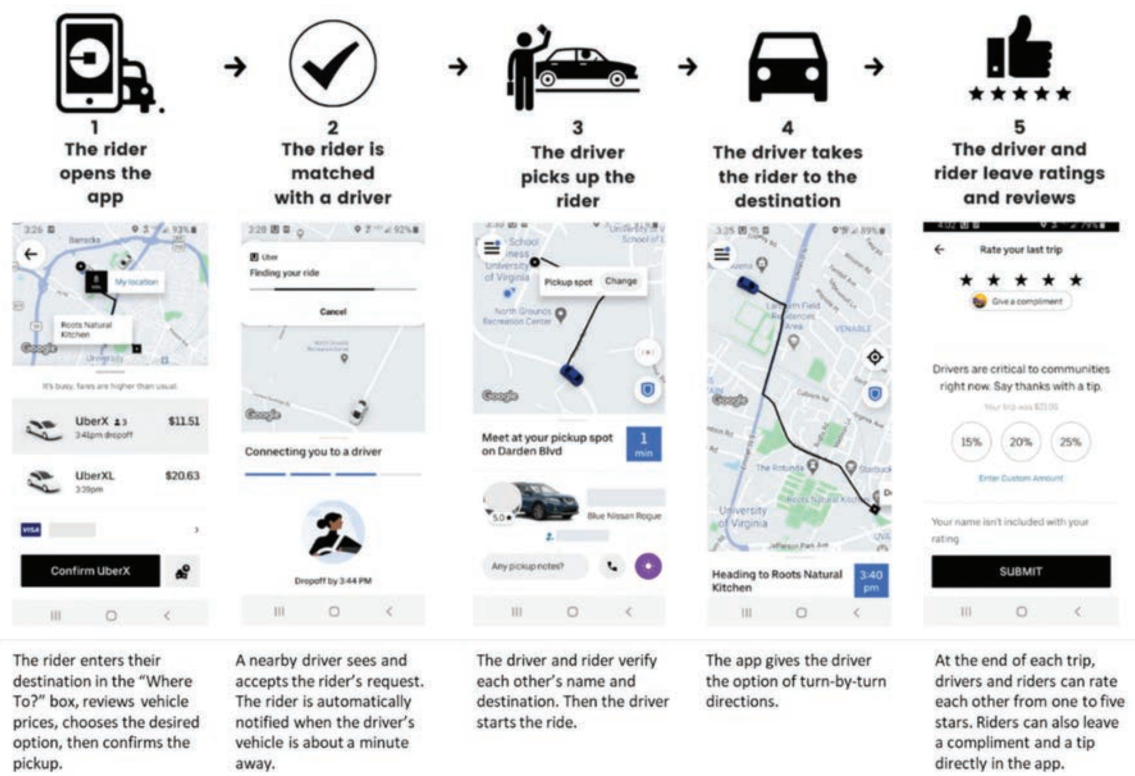
Revolutionizing Personal Transportation

The app-based ride-hailing company Uber helped spearhead a revolution in personal transportation, massively disrupting the existing transportation-for-hire industry around the world. Harnessing the "sharing economy" zeitgeist in much the same way that Airbnb had disrupted the hotel industry, Uber created a digital platform that connected people seeking rides with freelance "gig economy" workers willing to provide them. This offered the convenience of a smartphone app (as opposed to hoping a taxicab would physically drive by and hailing it by waving one's arms) while also automating the financial transaction itself, seamlessly collecting payment from the rider and paying the driver, all while earning a margin for the company. (See Exhibit 1 for a visualization of how the Uber app works.)

Despite its meteoric rise and ubiquity, Uber confronted a host of difficulties and challenges, both internal and external, in 2020. The company had grown wildly since its founding in 2009, but had attracted controversy practically from its inception, making for a rocky decade-plus journey. Yet Uber had experienced an extraordinarily rare level of rapid success, not only growing exponentially, but also truly revolutionizing on-demand mobility throughout the world. So deep was its impact on personal transportation, the company's name had become a household word, a proprietary eponym, a generic term for ride-hailing to a destination; "I'll Uber there" could mean one would take an Uber, a Lyft, or some other means of catching a ride. Nevertheless, this meteoric success had not come without a cost; the company faced a barrage of concerns from a variety of stakeholders. Driver discontent, regulatory pushback, globally uneven regulation and oversight, lawsuits about labor law violations from various states and cities, and scandal- and controversy-ridden leadership plagued Uber. On top of all that, after the company's IPO in May 2019, its stock price had faltered, and Uber continued to burn through cash.

As with many businesses and companies worldwide, the COVID-19 viral pandemic only exacerbated Uber's operational issues. Its 2020 Q1 bookings (1.6 billion), while down from 2019 Q4 (1.9 billion), were still up from the same quarter the previous year (1.5 billion in 2019 Q1); however, bookings from 2020 Q2—after COVID-19 lockdowns had begun—had fallen precipitously, to 737 million. Starting in March 2020, when the virus began to aggressively spread throughout the globe, ridership had dwindled substantially, anywhere from 50% to 85% in major US cities. In the second quarter of 2020, revenues had fallen 29% from the previous year, to $2.2 billion, a net quarterly loss of $1.8 billion. The company's Uber Eats delivery service, founded in 2015, was faring better, but overall, the company was still, as one analyst put it, "swimming in the red ink"[6] and struggling with an almost continuous stream of bad publicity from seemingly all angles. While the replacement of controversial cofounder Kalanick had calmed the public's anti-Uber sentiment slightly, the company still contended with a number of objections and concerns from riders, drivers, privacy advocates, regulating municipalities, and employees.

Exhibit 1 How Uber's Service Works



Source: Created by author and Eleanor Burton, Institute for Business in Society, University of Virginia Darden School of Business. Used with permission.

Everyone's Private Driver

The idea of creating a rideshare service that eventually became Uber was allegedly hatched in Paris in 2008, after Kalanick and Garrett Camp, two friends and entrepreneurs attending an annual tech conference, had trouble getting a cab on a snowy night. They ended up taking a limo, and Camp was shocked at the $800 cost of the ride. Back in San Francisco, Camp, remembering that snowy Paris evening, thought more about founding a timeshare limo service orderable through an app, and bought the domain name UberCab.com. His initial idea was born out of a question: What if you could summon a ride using your mobile phone? The concept evolved over time as Camp refined the process of matching riders with drivers; users were able to get an estimated fare as well as an estimated arrival time for the driver (including a map of the car's location as it approached). Cash or credit cards were not needed at the point of transaction; post-ride, the app would electronically apply the cost to a preset credit card. All these features brought new convenience to people seeking rides, whether as a replacement for car ownership or to address an in-the-moment need. Uber simplified the process of arranging for a ride.

Camp talked Kalanick, a UCLA dropout and founder of media search engine and file-sharing firms Scour and then Red Swoosh—which Kalanick had sold for $19 million in 2007—into joining him as "Chief Incubator" at this new venture, which they called Uber Cab. *Über* meant *above* in German, and the word embodied an approach to the fledgling company's value proposition that Kalanick and Camp considered essential. In 2009, they developed a smartphone app that, with a tap of a button, summoned a ride. Uber Cab, whose tagline was "Everyone's Private Driver," held a glitzy, invitation-only launch in San Francisco in June 2010 and incorporated as a business that July, but immediately received cease-and-desist orders from the San Francisco Municipal Transportation Agency as well as the California Public Utilities Commission. Despite the legal pushback Uber received from the beginning, the company continued operating and growing, raising $1.25 million in venture funding in October 2010, with Shawn Fanning, former Napster cofounder, as one of the early investors. See Exhibit 2 for Uber's 14 Core Principles, written by Kalanick in 2010 as a guide for Uber's strategy and culture.

Along with Kalanick, who became CEO in late 2010, some of the other early hires at the company included "a nuclear physicist, a computational neuroscientist, and a machinery expert who worked on predicting demand for private hire car drivers and where demand is highest."[7] In May 2011, Uber rolled out in New York City, where it met great resistance from the taxicab industry. Nevertheless, Uber continued to expand geographically, opening operations in Paris, Chicago, Seattle, and Boston. Later that year, thanks to its growth and management's promise of the technology's reach in other sectors, Uber completed a successful $37 million Series B round of fundraising. In February 2011, "Cab" was dropped from the company's name, in part to distance itself from the taxicab industry and to help position the company to better avoid the industry's accompanying regulations. The company was now Uber Technologies, Inc. In August 2014, UberPool was introduced, allowing riders to "pool" their rides and share the cost. In April 2015, Uber Eats launched in several large cities, including New York, Chicago, and Los Angeles, and the food-delivery service was an immediate hit. In September 2017, Uber rides surpassed taxi rides in New York City and, with the occasional fluctuation, continued that inverse trend through subsequent years.[8] (See Figure 1.)

Exhibit 2 Uber Core Values, as Written by Travis Kalanick, 2010

Customer obsession (Start with what is best for the customer.)

Make magic (Seek breakthroughs that will stand the test of time.)

Big bold bets (Take risks and plant seeds that are five to ten years out.)

Inside out (Find the gap between popular perception and reality.)

Champion's mind-set (Put everything you have on the field to overcome adversity and get Uber over the finish line.)

Optimistic leadership (Be inspiring.)

Superpumped (Ryan Graves's original Twitter proclamation after Kalanick replaced him as CEO; the world is a puzzle to be solved with enthusiasm.)

Be an owner, not a renter (Revolutions are won by true believers.)

Meritocracy and toe-stepping (The best idea always wins. Don't sacrifice truth for social cohesion and don't hesitate to challenge the boss.)

Let builders build (People must be empowered to build things.)

Always be hustlin' (Get more done with less, working longer, harder, and smarter, not just two out of three.)

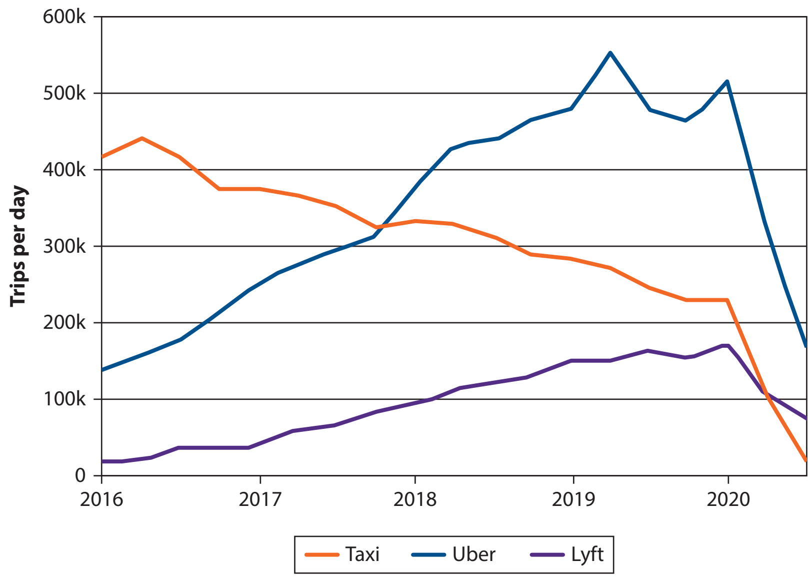
Celebrate cities (Everything we do is to make cities better.)

Be yourself (Each of us should be authentic.)

Principled confrontation (Sometimes the world and institutions need to change in order for the future to be ushered in.)

Source: Kris Dunn, "Bro-tastic vs. We Care: A Quick Review of Uber's Current and Past Corporate Values," *HR Capitalist* (blog), June 5, 2019, https://www.hrcapitalist.com/2019/06/brotastic-vs-we-care-a-quick-review-of-ubers-current-and-past-corporate-values.html (accessed Sept. 14, 2022).

Figure 1 NYC daily personal transportation trips, January 2016–June 2020.



Source: Todd W. Schneider, "Taxi, Uber, and Lyft Usage in New York City," *Todd W. Schneider* (blog), April 5, 2016, https://toddwschneider.com/posts/taxi-uber-lyft-usage-new-york-city (accessed Sept. 14, 2022).

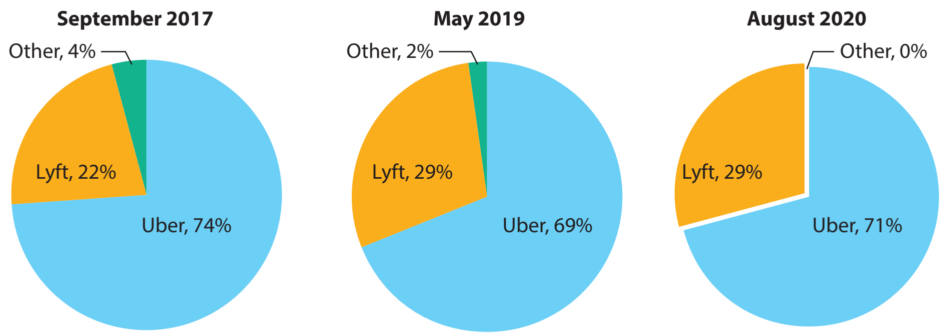
Despite experiencing setbacks and questions from regulators and the public along the way, Uber "bulldozed ahead of ride-hailing rivals through a mix of aggressive fundraising, dirty tricks and a take-no-prisoners attitude towards expansion in the United States and abroad."[9] The company was, as one *Fortune* writer described, "a maverick at birth" that "embraced rule-breaking as a business model, what with its catch-us-if-you-can flouting of local regulators."[10] Even in the face of stiff competition from Lyft, which had started in 2012 in San Francisco and cultivated a less aggressive, more polite image and presence, Uber dominated the domestic ridesharing market, with a fairly stable share of the ride-for-hire business consistently exceeding two-thirds (see Figure 2).

Whereas by 2020, Uber had only one primary competitor in the United States, internationally, the industry was much more fragmented and geographically differentiated. Many other global competitors had cropped up over the years, including Ola in India, DiDi Chuxing in China, Bolt (originally Taxify) in Europe, and Yandex Taxi—Uber's own affiliate—in Russia and the former Soviet Republics. Nevertheless, across all these markets, Uber maintained the largest—though less dominant—market leadership worldwide as well (see Figure 3).

International Expansion

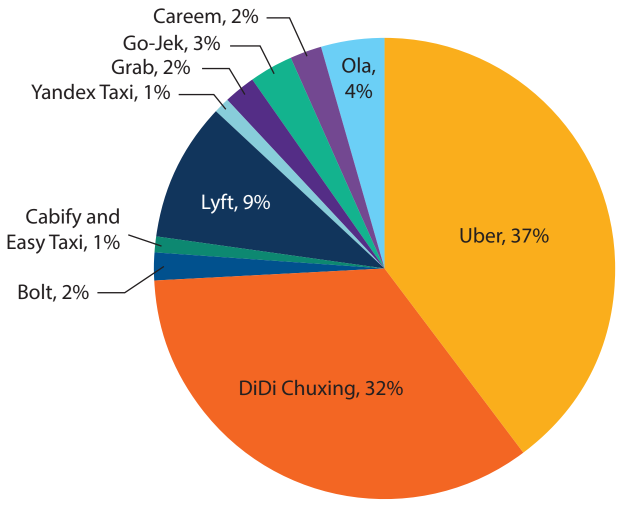
By late 2020, Uber operated in 85 different countries around the globe.[11] However, the company's international expansion did not come easy; like its initial experience in San Francisco, Uber's first international expansion, to

Figure 2 US ride-hailing market share, 2017–2020.



Data source: "Uber Revenue and Usage Statistics," Buildfire, https://buildfire.com/uber-statistics/#:~:text=Key%20Uber%20Statistics,Uber%20riders%20across%20the%20world.&text=The%20average%20Uber%20driver%20earns%20%24364%20per%20month (accessed Sept. 14, 2022).

Figure 3 Global ride-hailing market share, 2018.



Source: *Automotive Connected Mobility Overview Fisita World Summit - November 2019*. Strategy Analytics. (2020). https://www.fisita.com/documents/Roger_Lanctot_-_FISITA_World_Mobility_Summit_2019.pdf (accessed Sept. 14, 2022).

Paris in September 2011, also produced immediate resistance, with local authorities clamping down on the company and Parisian taxi drivers slashing the tires of the ride-sharing company's vehicles. The French protests would continue through the years, expanding into other areas of the country. It was not easy sailing anywhere on the globe, it seemed. In June 2014, English taxi drivers staged a protest against Uber in front of Buckingham Palace. That same summer, German taxi drivers protested at the Olympic Stadium in Berlin. They cited unfair competition, flouting of rules, and aggressive competitive tactics such as poaching drivers and inundating other systems with false ride requests.

The company's subsequent expansion efforts followed a rapid, locale-by-locale approach. Uber entered India and Africa in 2013, although it was banned in the New Delhi region after a passenger accused a driver of rape. There were many successes as well as some big setbacks, such as in China, which initially showed great promise but where, after establishing luxury car services in three of the biggest cities in 2014, Uber faced competitive pressure from the Chinese rival DiDi Chuxing. In order to operate there, Uber had to pay large driver and rider subsidies, amounting to an estimated $1 billion annually. Finally, in 2016, it pulled out of the country. And although it operated in Hong Kong in "a legal gray area,"[12] Uber persevered and made plans to move its Asia Pacific headquarters there. Uber operated briefly in Hungary, before mass protests and regulation forced the company to withdraw from the country for a time.

Uber also operated in Latin American countries, launching in Mexico in 2013; Colombia in 2013; Brazil, Peru, and Chile in 2014; and Argentina in 2016. Its operations in these countries were robust and profitable, but characterized by contentiousness and at times violence. There was push-back from both the taxi industry and the government, with authorities raiding Uber offices, destroying property, and often confiscating Uber cars in Argentina. In Mexico and Brazil, several Uber cars were torched and drivers attacked. Uber also had to contend once again with competition from DiDi Chuxing in Latin America. Uber drivers in the region had to learn some workaround techniques to avoid scrutiny and pushback, including the following: "Uber offices changing locations to avoid run-ins with governments, drivers concocting background stories with passengers about their relationship in case they are pulled over or questioned, drivers consistently insisting riders sit in the front passenger seat, drivers canceling trips in fear of taxis driving nearby, and drivers refusing to drive to the airport in fear of being discovered and fined."[13]

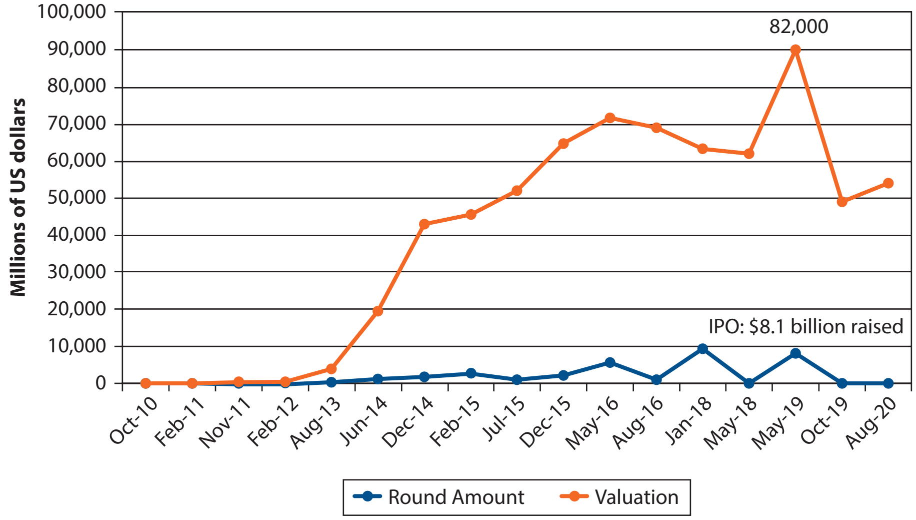
In late 2019, the Transport for London (TfL) agency revoked Uber's license, though the company was allowed to continue operations while it appealed this revocation. In September 2020, Uber won the appeal, with the judge affirming that the company "had taken the necessary steps to address regulators' concerns, including new safety measures to keep unauthorized and uninsured drivers from using its platform to carry passengers."[14] Its license to operate in London, Uber's biggest European market, was renewed for another 18 months.

Charting Uber's Performance

Through all of these growing pains, both domestic and international, Uber's rise had been truly remarkable (see Exhibit 3 to follow Uber's valuation over the years). By August 2015, Uber had achieved a $50 billion valuation, and that same year, it more than doubled its number of active drivers from 160,000 to 327,000.[15] Uber celebrated its billionth trip on Christmas Eve, 2015, in London, with a five-British-pound trip in a blue Honda Insight Hybrid.[16] (Lyft hit the billion-ride mark in September 2018). The intensity of competition between Uber and Lyft was fierce, with Kalanick and Uber not-so-stealthily trying to disrupt Lyft's funding efforts—Kalanick was upfront in a 2014 *Vanity Fair* interview about trying to decrease rival Lyft's capital options. Knowing that Lyft was about to fundraise, Kalanick said Uber approached these investors, telling them, "Just so you know, we're going to be fund-raising after this, so before you decide whether you want to invest in them, just make sure you know that we are going to be fund-raising immediately after."[17] Uber also targeted Lyft drivers with some "dicey tactics," such as "sending so-called brand ambassadors to order Lyft rides undercover and then persuade the drivers to defect to Uber."[18] Early on, Uber also reduced its fares to compete with Lyft, which infuriated many of its drivers, whose compensation was also reduced.

Uber sold equity shares to the public on the New York Stock Exchange (NYSE) in May 2019, with an initial share price of $45 and a $75.5 billion market capitalization. It was

Exhibit 3 Uber Valuation



Date	Round Amount (in millions)	Valuation (in millions)
Oct-10	1.6	5.4
Feb-11	11.0	60
Nov-11	37.0	330
Feb-12	48.8	346.5
Aug-13	258.0	3,700
Jun-14	1,200.0	18,200
Dec-14	1,800.0	41,200
Feb-15	2,800.0	42,800
Jul-15	1,000.0	51,000
Dec-15	2,100.0	62,500
May-16	5,600.0	66,000
Aug-16	1,000.0	68,000
Jan-18	9,300.0	54,000
May-18	–	62,000
May-19*	8,100.0	82,000
Oct-19	–	49,000
Aug-20	–	54,000

*Uber's IPO

Data source: Dana Olsen, "Uber by the Numbers: A Timeline of the Company's Funding and Valuation History," PitchBook, November 29, 2017, https://pitchbook.com/news/articles/uber-by-the-numbers-a-timeline-of-the-companys-funding-and-valuation-history (accessed Sept. 14, 2022).

the highest-value tech company IPO since Facebook's 2012 IPO and Alibaba's in 2014, and it joined other Silicon Valley "unicorns," such as Zoom and Slack, in going public that year. However, it was a rocky debut: the price fell more than 7% on Uber's first day of trading. Compared to most other technology company IPOs, it was a big disappointment. According to Renaissance Capital data, "only 10% of venture capital-backed US technology IPOs finished the first day in the red."[19] A month later, in June, Uber laid off a third of its marketing department (more than 400 employees) because of continued losses; there were additional layoffs (435 employees) from the engineering and product teams the following September.

Yet, in the broader industry, global demand for ridesharing continued to rise steadily, as users came to depend on the convenience of hailing a ride with a smartphone app; Figure 4 shows Uber's rising ride totals. In addition to the dramatically increasing number of rideshare rides, Exhibit 4 shows a steady increase in the number of active users of the underlying ridesharing apps, led by younger customers, as shown in Exhibit 5.

Because Uber's post-IPO stock performance did not rise in proportion to the increasing demand for instant mobility among consumers, investors were disappointed. Uber's stock initially hovered in the $40 price range, never getting higher than $50, and dropping into the $30 range by 2019. At that point, the onset of additional volatility introduced by the COVID-19 pandemic did little to calm investors' nerves; see Figure 5, which charts the company's post-IPO stock performance through all these fluctuations. Uber's key financial metrics in Exhibit 6 give a more detailed view of the firm's revenues, costs, cash flow, and market capitalization over a series of years; see Exhibit 7 for a comparable set of measures for primary ridesharing competitor Lyft.

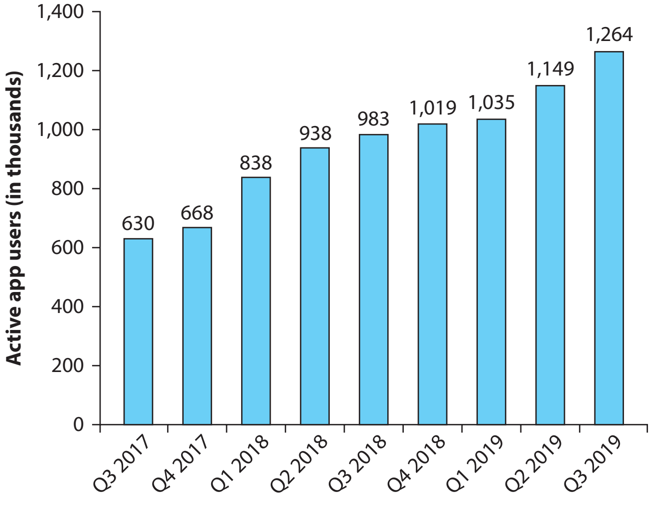
Figure 4 Uber global annual trips.

Year	Annual Ride Totals
2014	140 million
2016*	1.8 billion
2017	3.7 billion
2018	5.2 billion
2019	6.9 billion

*2015 figure not available

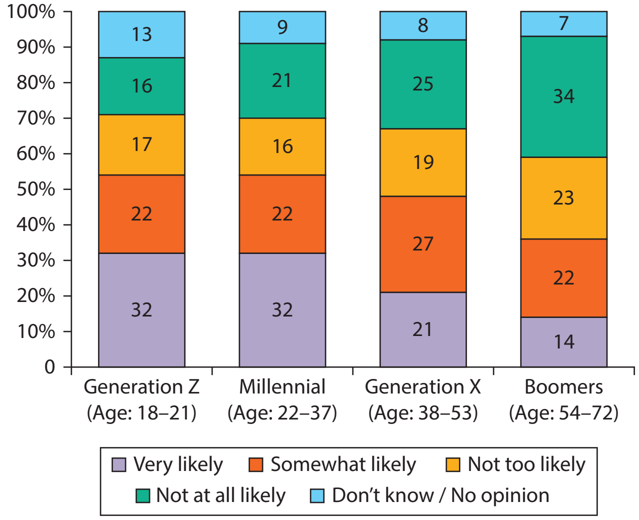
Data source: https://www.businessofapps.com/data/uber-statistics/.

Exhibit 4 Active App Users



Data source: Jon Moore and Nat Bullard, "BNEF Executive Factbook," BloombergNEF, April 22, 2020, https://data.bloomberglp.com/promo/sites/12/678001-BNEF_2020-04-22-ExecutiveFactbook.pdf?link=cta-text (accessed Sept. 14, 2022).

Exhibit 5 Likelihood of US Adults Using a Ride-Hailing App by Generation



Survey question: *"When thinking about transportation options, how likely are you to consider using each of the following: Ride-hailing apps (i.e., Uber, Lyft)?"*

Data source: Morning Consult, National Tracking Poll #180976, September 27–29, 2018, https://morningconsult.com/wp-content/uploads/2018/10/180976_crosstabs_RIDESHARE_v1_DK.pdf (accessed Sept. 14, 2022).

As Uber charted its course forward, the company worked to enhance its customer experience by introducing new features for riders. These included "quiet mode," which gave riders an in-app way to request minimal conversation,[20] and "discreet reporting," which allowed riders to bypass traditional direct-to-driver feedback mechanisms to report something that made them feel unsafe.[21] In addition, the company diversified into a number of different operations, branching out beyond its original core ride-for-hire smartphone application. "Everyone's Private Driver" was retired as the company's tagline, since Uber had begun to offer a variety of different services, including modified ride-for-hire offerings such as Uber Black (luxury vehicle hires in the spirit of Uber's founding idea), Uber Pool (carpool facilitation in a number of different urban markets), Uber Comfort (newer cars with extra legroom), and Uber Green (sustainable rides in electric vehicles). But perhaps Uber's most commonly recognized diversification was in the arena of food delivery, with its launch of Uber Eats in 2014. While Uber Eats certainly performed well initially, it exploded in the COVID-19 era of lockdowns and social distancing. Notably, in the second quarter of 2020, Uber Eats surpassed Uber's core ridesharing business; food delivery brought in revenue of $1.21 billion versus ride hailing at $790 million.[22] As CEO Khosrowshahi put it, the food-delivery business grew as big as the rides business had been when he joined the company: "We've essentially built a second Uber in three years."[23]

This business line promised significant growth potential. In a call with investors in August 2020, Khosrowshahi suggested that opening up the delivery service to prescriptions, home goods, and other consumer items presented additional opportunities for future revenue. The company had already

Figure 5 Uber post-IPO stock price performance.

Source: Yahoo! Finance; Uber annual report, 2019.

Exhibit 6 Uber Financial Data

	2019	2018	2017	2016
Total revenue	14,147	11,270	7,932	3,845
Gross profit	6,939	5,647	3,772	1,617
Selling, general, and administrative expenses	7,925	5,233	4,787	2,575
Research and development	4,836	1,505	1,201	864
Depreciation, amortization, and depletion	472	426	510	320
Other operating expense	2,302	1,516	1,354	881
Total operating expense	15,535	8,680	7,852	4,640
Operating income	−8,596	−3,033	−4,080	−3,023
Other income (expense)	488	4,889	−87	117
Income before tax	−8,433	1,312	−4,575	−3,218
Net income	−8,506	997	−4,033	−370
Basic earnings per share (EPS)	−6.81	–	−2.76	−0.25
Basic normalized EPS	−7.08	−1.82	−2.69	−2.25
EBITDA	−7,402	2,386	−3,586	−2,537
Total current assets	13,925	8,658	6,837	–
Property/plant/equipment—Net	3,325	1,641	1,192	–
Goodwill and other intangible assets	238	235	93	–
Total non-current assets	17,836	15,330	8,589	–
Total assets	31,761	23,988	15,426	–
Total current liabilities	5,639	4,259	3,847	–
Total non-current liabilities	11,250	27,114	20,136	–
Total liabilities	16,889	31,373	23,983	–
Total equity	14,872	−7,385	−8,557	–
Total common shares outstanding	1,716.7	1,697.6	1,677	–
Free cash flow	−4,909	−2,099	−2,247	−4,548
Market capitalization	51,055	–	–	–

Note: All financials are in millions of US dollars.

Source: Uber annual report, 2019; Hoovers; Yahoo! Finance.

Exhibit 7 Lyft Financial Data

	2019	2018	2017	2016
Total revenue	3,616	2,156.6	1,059.9	343.3
Gross profit	1,439.5	913.2	400.3	64.3
Selling, general, and administrative expenses	2,000.2	1,251.7	788.5	594.3
Research and development	1,505.6	300.8	136.6	64.7
Other operating expense	636.1	338.4	183.5	97.9
Total operating expense	4,142	1,890.9	1,108.6	756.9
Operating income	−2,702.5	−977.7	−708.3	−692.6
Other income (expense)	0.1	0.7	0.3	3.2
Income before tax	−2,599.9	−910.6	−687.7	−682.4
Net income	−2,602.2	−911.3	−688.3	−682.8
Basic earnings per share (EPS)	−11.44	−3.21	−2.89	−2.87
Basic normalized EPS	−11.44	−3.21	−2.89	−2.87
EBITDA	−2,594.1	−959	−705.7	−692.1
Total current assets	3,247.4	2,320.4	2,563.7	–
Property/plant/equipment—net	629.9	109.3	14.2	–
Goodwill and other intangible assets	241.6	269.8	4.3	–
Total non-current assets	2,444	1,439.6	453	–
Total assets	5,691.4	3,760	3,016.7	–
Total current liabilities	2,451.4	1,448.8	696.8	–
Total non-current liabilities	385.9	5,182.5	4,299.3	–
Total liabilities	2,837.3	6,631.3	4,996.2	–
Total equity	2,854.1	−2,871.3	−1,979.4	–
Total common shares outstanding	302.6	255	284.1	–
Free cash flow	−283.8	−351.5	−405.5	−496
Market capitalization	13,018	–	–	–

Note: All financials are in millions of US dollars.

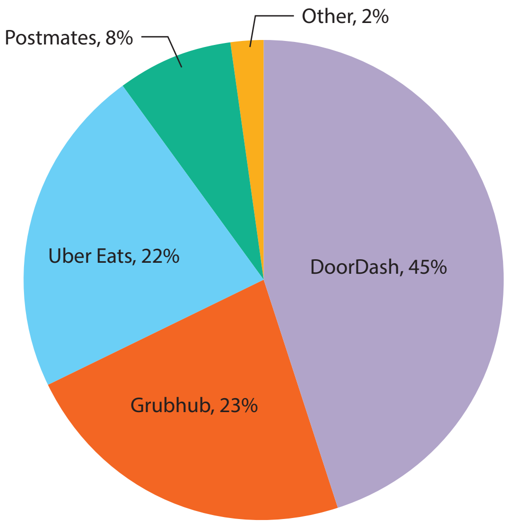
Data source: Lyft annual report, 2019; Hoovers; Yahoo! Finance.

tried and failed to acquire Grubhub the previous May; when that deal fell through because of antitrust concerns, Uber entered a deal to acquire Postmates, another delivery service, in an all-stock deal with a value of $2.65 billion. With the Postmates acquisition, Uber would control approximately 35% of the delivery market in the United States, making the company competitive with DoorDash and its 45% market share (see Figure 6).

However, observers pointed out that such expansion came at a cost; Uber was currently "swimming" in "red ink… Investors are still giving them the benefit of the doubt because of Uber Eats."[24] As a financing measure, on September 14, 2020, Uber announced that it planned to offer "$500 million of senior notes that mature in 2028, joining the many companies issuing record amounts of debt during the coronavirus pandemic."[25]

Beyond food and other deliveries, the company launched a number of other business lines. Uber Freight began in 2017 and became a separate business unit in 2018, matching freight shippers throughout the continental United States and Europe

Figure 6 Percentage of food-delivery sales, May 2020.



Source: Willem Roper, "Uber to Acquire Postmates for $2.65 Billion," July 7, 2020, https://www.statista.com/chart/22206/uber-acquires-postmates/ (accessed Sept. 14, 2022).

with appropriate transportation, similar to the way Uber traditionally matched drivers and riders. Uber Health launched in 2018, allowing health care facilities to arrange accessible transportation solutions for patients. Other initiatives, such as Uber Rush (Uber's attempt at on-demand urban courier services), were launched unsuccessfully and then shuttered. In 2015, to compete with Google's autonomous vehicle development, the company founded Uber ATG (Advanced Technologies Group), partnering with the National Robotics Engineering Center (NREC) at Carnegie Mellon University to develop its own technology, and later partnering with the University of Toronto and receiving additional investment from Toyota and Softbank. Uber's first self-driving car, a Ford Fusion, was piloted in 2016 in Pittsburgh, after which the company developed a fleet of Volvo self-driving cars, with operations based in Arizona. The Uber Elevate business unit included both the Uber Copter service between Manhattan and JFK International Airport in greater New York City, and the Uber Air initiative that envisioned a shared air-transportation ridesharing service at scale, with tentative plans to roll it out as soon as 2023. Uber Air identified initial launch markets of Dallas, Los Angeles, and Melbourne, and involved partnerships with original equipment manufacturer (OEM) aircraft manufacturers, skyport infrastructure partnerships, and airspace management information systems.

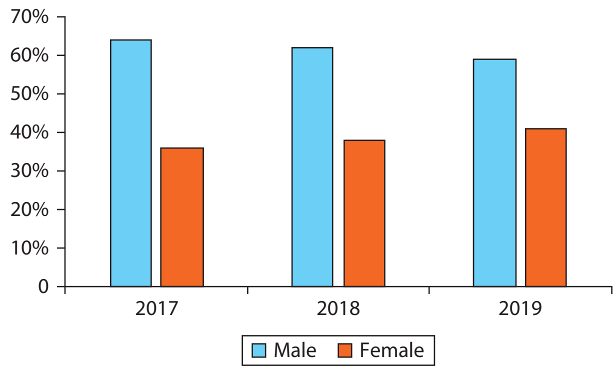
Driving for Uber

In its core business, the "gig" work that Uber provided was a hit with many drivers, who were unemployed, retired, looking for occasional extra pocket money, or just supplementing their income. These individuals could work as their schedules allowed, drove their own cars, and were responsible for their own insurance and vehicle maintenance.[26] As independent contractors, they received no benefits such as overtime, unemployment insurance, or health coverage provided. Drivers could set their own schedules, choosing to work when they wanted. Just as riders could leave comments and ratings for the driver on their app (along with any tip), drivers could also rate their riders. Bad ratings for drivers could affect their number of trips and even get them dismissed; bad ratings for passengers could mean they would have trouble getting future rides. Payments to drivers were set up electronically and flowed directly from the transactions with riders; Uber kept 20% of the electronically collected fares, with the rest going to the driver.

Since Uber's inception, its drivers had been predominantly male. In 2019, 59.1% of drivers were male and 40.9% were female, roughly mirroring the gender makeup of Uber's worldwide employees (see Exhibit 8). Among Uber's drivers, studies had shown a gender pay gap, with women drivers making approximately 7% less than men. This had nothing discernible to do with Uber's platform but potentially resulted from three primary factors: in general, men drove faster (by about 2.2%), allowing them to give more rides; male drivers were more comfortable going to riskier (and therefore sometimes more remunerative) locations, while female drivers usually avoided riskier neighborhoods for safety reasons; and men stayed on as Uber drivers longer than women, gaining greater experience in efficient and more lucrative driving strategies.[27] In the United States, almost 50% of drivers were white, followed by Asians, then African Americans (see Exhibit 9).

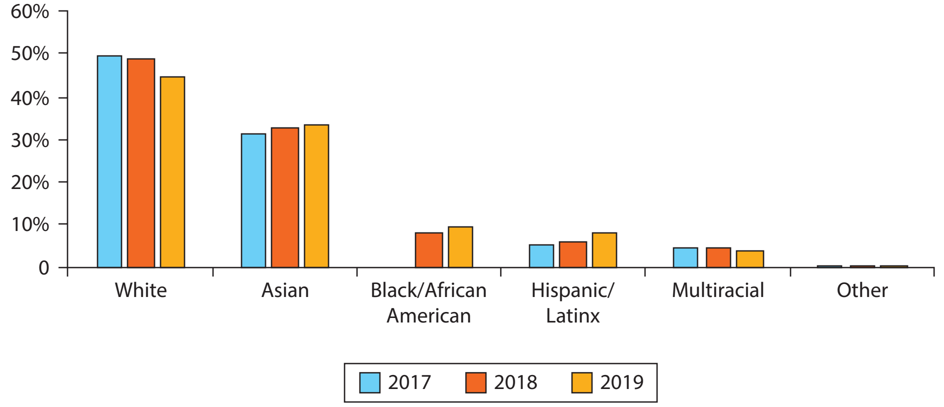
How much a driver could earn working for Uber depended on a number of factors, including the locale, the driver's experience, and the number and frequency of fares. Although Uber had once asserted, in 2014, that its drivers could make up to $90,000 a year,[28] this claim prompted a $20 million fine from the Federal Trade Commission (FTC) for being fraudulently misleading.[29] The reality was that, while the average driver's hourly earnings before taxes had risen to $19.73 by 2019,[30] their after-expenses net earnings hovered between $8.55 and $11.77, making it a "photo finish with fast food as the lowest-paid work in America."[31] Driver earning power also varied greatly between cities, with New York City drivers averaging, before expenses, $29.34 per trip;

Exhibit 8 Worldwide Uber Employees by Gender



Data source: Uber Diversity and Inclusion Report, 2019, 9.

Exhibit 9 US Uber Employees by Ethnicity



Data source: Uber Diversity and Inclusion Report, 2019, 15.

Chicago's average was $10.99; and Phoenix's was $14.36.[32] In general, maintenance, gas, and other driving expenses consumed a substantial portion of the driver's income; these realities of driver compensation caused substantial friction between drivers and the company, invoking public debates about living wage and reasonable pay. Indeed, Uber received pressure not only to pay drivers better, but also to go further and classify them as employees; the public commotion over driver exploitation had placed the company in the crosshairs of state and local government authorities.

For several years, many Uber drivers had protested their freelance-contract-worker status, seeking to become employees who received benefits and perks. Uber (and Lyft, which experienced similar pressure) held firm against these demands, but the outcry grew. In 2013, over 35,000 of the company's independent drivers filed a class-action lawsuit seeking full employment along with better wages and benefits. Although the lawsuit was settled out of court in 2016, with drivers still considered independent contractors, Uber did take steps to improve both pay and perks. In August 2020, Khosrowshahi acknowledged the "existential question" that had shadowed Uber for 10 years: "Do we treat drivers well?"[33] Citing surveys indicating that most Uber drivers valued their flexibility over a more traditional safety net, as well as the potential far-reaching consequences for Uber of moving to a full-time employee model—reduced service, employees, and efficiency—Khosrowshahi advocated for larger reforms to US employment law to avoid the binary choice of flexibility versus security. Some experts disputed this characterization, saying that being freelance worked for some of the drivers, but not all; for instance, gig-economy expert and sociologist Juliet Schor pointed out that "people who are using these platforms to supplement their income, rather than depending on them for an income" fared much better than drivers whose livelihood depended on driving for Uber.[34]

In the meantime, differential regulatory regimes had begun to address the issue in distinct ways. For instance, California had passed a bill, State Assembly Bill 5 (AB5), in January 2020. AB5 implemented a test to determine whether, under California law, a worker was an employee. The law, designed to provide benefits to gig workers, would force the ride-hailing companies to classify their drivers as employees "if it was shown that the drivers' jobs were part of the companies' core business, among other criteria."[35] In response, Uber and Lyft, which continued to operate in California despite being sued by the state in May, argued that they were not transportation companies, but merely tech platforms. At the same time, both firms began to consider a franchise operational structure, in which they would license their brands to operators of fleet vehicles, essentially creating independently operated franchises akin to a Federal Express model or Uber's operations in Germany and Spain. A San Francisco judge ruled in mid-August 2020 that the companies must immediately reclassify their workers as employees; Uber and Lyft appealed, warning that they would have to cease operations in California if their appeal was unsuccessful.[36] In late August, Uber and Lyft pledged financial support to California ballot initiative Proposition 22, which would exempt ridesharing and food-delivery companies from AB5 regulations, allowing drivers to continue to set their own schedules. Although Uber and Lyft suggested they would "offer a concession on minimum wage standards, health benefits and collective bargaining rights,"[37] the issue continued to be contentious, with one California assemblywoman, a sponsor of AB5, responding that "billionaires who say they can't pay minimum wages to their workers say they will spend tens of millions to avoid labor laws. Just pay your damn workers!"[38] The campaign to promote Proposition 22 had, by September 2020, cost gig-economy firms $181.4 million (paid by Uber, Lyft, DoorDash, and Instacart), making it the costliest ballot initiative in the state's history). The legal wrangling continued, lending credence to Khosrowshahi's assessment that the treatment of drivers remained Uber's existential issue.

Controversies and Challenges

As serious as the issue of driver treatment remained for Uber, it was far from the only friction point with the company's stakeholders. Whatever the company's future strategic choices were, it seemed clear Uber would need to consider a number of other contentious issues and controversies prompted by the firm's actions. A number of particular challenges stood out in Jaseem's mind.

Aggressive Market Entry and Operations

Early in its existence, Uber—which deliberately took a "don't ask for permission now; ask for forgiveness later" attitude in conducting business—found itself fighting different municipalities and industry incumbents over the company's legitimacy. At times, this involved a battle over public perception for social acceptance, while at others, it involved the firm's literal license to operate (as in London or California), with associated legal maneuvering.

Kalanick's Brashness

Considered by some to be "arrogant and over-confident," Kalanick, who had already made millions with two different start-ups before Uber, was a "renegade" with a brash, almost belligerent personality, who made it impossible for Uber to ever "get out of public scorn."[39] In 2014, Kalanick caused a stir when, in a *GQ* interview, he called the company "Boober," referring to Uber's popularity with women and claiming it helped Kalanick attract "women on demand."[40] Several years later, Kalanick faced backlash after a video of him arguing with an Uber driver went viral.[41] Kalanick later agreed that he needed to "grow up,"[42] although he countered all criticism with remarks such as, "Look, I'm a passionate entrepreneur. I'm like fire and brimstone sometimes," and "It's hard to be a disrupter and not be an asshole."[43] Although he stepped down as CEO in 2017, Kalanick remained on the Uber board until December 2019, and in many ways, the company continued to grapple with the early image Kalanick had set.

Privacy Concerns

Early on, at several of its launch parties in various cities, Uber unveiled what it called its "God View" tool, which allowed managers at the company to see all the Uber users in the area in real time. Usually this was anonymous—waiting riders were not identified, simply visible in shadow. However, in some instances, riders were identifiable, leading to broad concern and outcry over rider privacy, causing some customers to quit the service altogether. Some called it the "Creepy Stalker View."[44] In any case, the publicity of Uber's casual approach to privacy, with God View and other missteps, triggered a larger public conversation about the service's privacy practices and lack of vigilance.

Surge Pricing

During times of peak ridership, such as rush hour and holidays like New Year's Eve and Halloween, algorithm-determined fares spiked higher in what was called surge pricing. This pricing produced predictable complaints from customers, as fares could increase dramatically over the normal rate. Uber first came under scrutiny for surge pricing during New Year's Eve 2012 in New York City, when fares shot up as much as eight times the normal rates; later, in 2016, there was a class-action suit against the company, alleging that Uber's surge pricing had violated antitrust laws against price fixing. Uber's troubles deepened in July of that year when "a federal judge ruled that Uber 'engaged in fraudulent and arguably criminal conduct' when it used an investigative firm to conduct a background check" on the plaintiff who filed the original lawsuit.[45] In January 2017, after a federal executive order was signed banning travelers from several Muslim countries from entering the United States, protests were held at JFK International Airport. In support of the protest, taxis avoided the area, but Uber stepped into controversy by continuing to serve the area and even eliminated surge pricing there, a move that was interpreted by many as seeking to boost its business by taking advantage of the lack of taxis and the tumultuous situation. As a result, the hashtag "Delete Uber" went viral.[46]

Safe-Ride Fees

In April 2014, a $1.00 surcharge was added to each fare, allegedly to help cover benefits for drivers by funding "an industry-leading background check process, regular motor vehicle checks, driver safety education, development of safety features in the app, and insurance."[47] That turned out not to be the case. Employees who worked on the fee program later told an investigative reporter that the dollar per ride was pure profit for the company, bringing in over half a billion dollars over time—money that was never earmarked for safety improvement. Yet Uber used the fee to promote its service as the "safest." A class-action suit followed, and Uber was forced to pay $30 million—a small fraction, as the *New York Times* investigative report stated, of the "safe-ride fees" it had collected over the years.

Data Security

In 2016, in a second breach of data (following a previous one that had occurred in 2014), hackers were able to clandestinely access Uber's user data, stealing users' personal information and demanding money. As it was later revealed, then–Uber Chief Security Officer Joe Sullivan quietly worked with management to pay the hackers $100,000 as long as they signed a nondisclosure agreement. The 2014 hack had concerned Uber's leaders; the second hack horrified them, and Sullivan and others were determined that knowledge of the data breaches would not become public. Sullivan kept the information from both the FTC—which was investigating the earlier hack—and Uber employees, who were already working with the FTC on the earlier hack. The data breach was not disclosed until 2017, when Kalanick stepped down and Khosrowshahi became CEO. When he learned what had happened, Khosrowshahi fired Sullivan along with other Uber employees who had helped in the cover-up. Uber paid $148 million to settle with state attorneys general who had sued the company, as well as $1.2 million to British and Dutch regulators. In August 2020, Sullivan was charged with attempting to hide the hack from the FTC investigators.

Sexual Harassment and Reckless "Bad Boy" Culture

In February 2017, several former employees charged Uber with sexual harassment. A former company engineer, Susan Fowler, wrote a damning blog post about her experiences with Uber's sexist workplace culture.[48] In addition, that same month, there was a blistering *New York Times* report about Uber's "Hobbesian environment…in which workers are sometimes pitted against one another and where a blind eye is turned to infractions from top performers."[49] Alleged behavior included groping women, going after an employee with a baseball bat, unrestrained cocaine use, and use of homophobic slurs. Management responded by launching a high-profile independent inquiry to investigate the complaints about misogyny and recklessness in the work environment. The investigation confirmed Fowler's accounts, corroborating the ubiquitous sexism embedded in the company, and also documented a number of other aspects of the firm's "bad boy" internal culture. This eventually led not only to Kalanick's resignation as CEO, but also to the departure of 20 employees and new rules about workplace behavior.[50] In an attempt to alleviate the discord, Khosrowshahi, in November of that year, posted a new list of Uber's cultural norms, which included, among other things, "We do the right thing. Period."[51] See Exhibit 10 for Khosrowshahi's rewritten list, which dropped some of Kalanick's original values such as "Superpumped" and "Always be hustlin."

Sexual Assaults While Riding

In December 2019, Uber voluntarily released a report stating that it had received almost 6,000 reports of sexual assault in the United States in the previous two years. Roughly half the assaults had been committed by drivers and the other half by passengers. Uber said it released the report in the interest of "improving safety for Uber and the entire industry."[52] Lyft had its own issues with sexual assault reports, though they appeared to be far fewer. While there was no publicly available data, a CNN investigation determined that, between 2014 and 2018, 18 Lyft drivers (compared to 103 Uber drivers) had been accused of sexually assaulting passengers.[53] This issue raised concerns about safety among potential passengers, particularly women, and caused some female riders to avoid Uber in favor of Lyft.

Theft of Autonomous Vehicle Technology

In 2017, mere months after partnering with NREC at Carnegie Mellon University to develop self-driving technology, Uber—promising triple salaries and increased benefits—hired over 65 NREC engineers away to develop its own technology, located in a new 53,000-foot research center not even a mile away from NREC. This almost caused the well-regarded NREC to shut down. Two years later, Uber moved its autonomous vehicle division to the Vector Institute for Artificial Intelligence at the University of Toronto. In 2017, Waymo, an autonomous vehicle division spun off by Alphabet (Google), accused Uber of stealing some of its technology. A former Waymo engineer, Anthony Levandowski, was accused of downloading confidential files before leaving Waymo and starting a company that Uber planned to acquire. This turned into a multiyear legal battle, with Uber settling with Waymo in February 2018 and warning investors that it might have to pay Waymo to use the technology involving the laser navigational tool Lidar. Levandowski pleaded guilty in the spring of 2020, facing 30 years in prison.

Exhibit 10 Uber Cultural Norms, as Rewritten by Dara Khosrowshahi (November 2017)

We build globally, we live locally. We harness the power and scale of our global operations to deeply connect with the cities, communities, drivers and riders that we serve, every day.

We are customer obsessed. We work tirelessly to earn our customers' trust and business by solving their problems, maximizing their earnings or lowering their costs. We surprise and delight them. We make short-term sacrifices for a lifetime of loyalty.

We celebrate differences. We stand apart from the average. We ensure people of diverse backgrounds feel welcome. We encourage different opinions and approaches to be heard, and then we come together and build.

We do the right thing. Period.

We act like owners. We seek out problems and we solve them. We help each other and those who matter to us. We have a bias for action and accountability. We finish what we start and we build Uber to last. And when we make mistakes, we'll own up to them.

We persevere. We believe in the power of grit. We don't seek the easy path. We look for the toughest challenges and we push. Our collective resilience is our secret weapon.

We value ideas over hierarchy. We believe that the best ideas can come from anywhere, both inside and outside our company. Our job is to seek out those ideas, to shape and improve them through candid debate, and to take them from concept to action.

We make big bold bets. Sometimes we fail, but failure makes us smarter. We get back up, we make the next bet, and we go!

Source: Kris Dunn, "Bro-tastic vs. We Care: A Quick Review of Uber's Current and Past Corporate Values," *HR Capitalist* (blog), June 5, 2019, https://www.hrcapitalist.com/2019/06/brotastic-vs-we-care-a-quick-review-of-ubers-current-and-past-corporate-values.html (accessed Sept. 14, 2022).

Greyball Technology

In 2017, it was revealed that Uber had for years been using a software program called Greyball to elude authorities in cities where the company had been banned or was the target of law-enforcement officials. Data collected from the app allowed the company, with approval from its legal team, to identify and refuse rides to authorities trying to enforce local regulations on the company. This software had been used in cities such as Boston and Las Vegas, as well as in other countries. Undercover authorities would try to hail a ride using what they did not realize was a fake app that showed nonexistent Uber cars in the area. Alerted to these authorities by their apps, drivers could then cancel the rides—a practice that became known as Greyballing the authorities. The use of Greyball attracted a criminal probe from the US Department of Justice.

Congestion and Efficiency

Part of ride-hailing companies' value proposition was the reduction of congestion and air pollution in cities achieved by getting cars off the road, decreasing time spent in traffic, and offering faster, more economical rides. However, the reality was much more complicated. A 2018 government study concluded that "those convenient rides really are not so convenient after all when accounting for the extra time commuters were spending in traffic. The authors of the survey crunched the numbers and found that ride-sharing companies…were accountable for a 51% increase in commuters' time in 2016 when compared to 2010."[54] That same year, a different report from a New York–based consulting company revealed that mass transit was being hurt by the ride-hailing companies, with many people opting to take the quicker, albeit more expensive, alternative. Furthermore, the report also outlined how "deadheading"—the term for Uber and Lyft drivers spending passenger-less time on the road while waiting for calls on their app—was actually putting more cars on the road, not fewer.[55] In addition, certain neighborhoods and intersections tended to attract rideshare drivers awaiting new customers, imposing intangible costs associated with increased traffic and pollution on local residents that neither drivers, nor oblivious riders, nor the company itself ever had to bear.

Autonomous Vehicle Death

In March 2018, a driver in one of Uber's autonomous vehicles struck and killed a pedestrian who was walking her bike across a street in Tempe, Arizona. The first incidence of a pedestrian death caused by an autonomous vehicle, it raised the thorny ethical issue of who held responsibility for fatalities such as these. There were few laws of any type governing the liability for autonomous vehicle–involved accidents; while the National Transportation Safety Board attributed the crash primarily to human error, it also pinpointed what it called Uber's "inadequate safety culture."[56] Uber temporarily suspended its self-driving-car tests, although the company resumed operations the following year, with added restrictions including required lower speeds. Two years later, in September 2020, the driver was charged with negligent vehicular homicide; she had been watching a video right before the accident and had not braked until it was too late.

Racial Issues

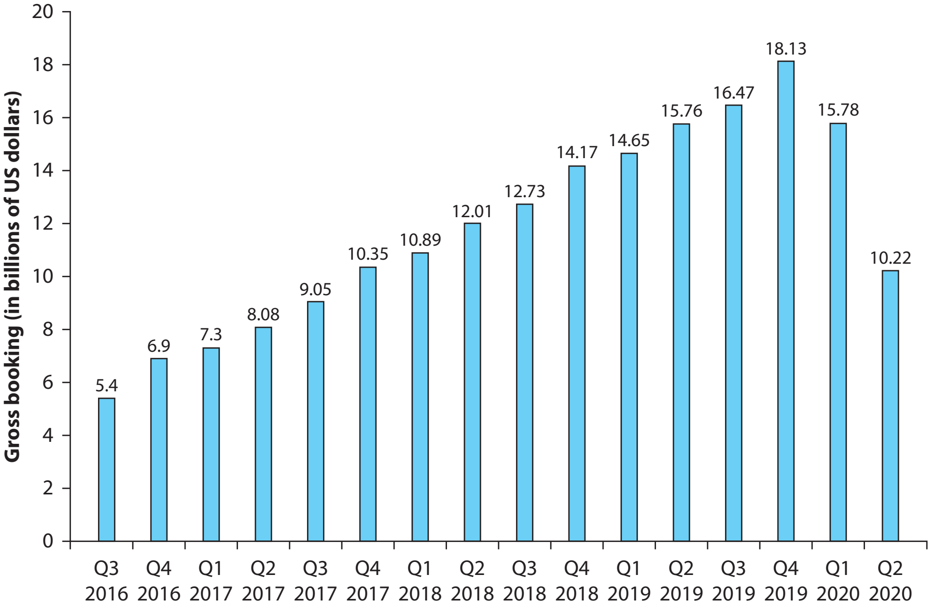
In the summer of 2020, after the killing of George Floyd by a police officer ignited widespread protests and calls for police reform and racial justice globally, Uber attempted to address the issue of racial inequality, outlining a series of initiatives and actions. These initiatives included the company committing to anti-racism education for drivers and riders alike, expanding internships and opportunities for people of color, and doubling the number of Black leaders employed at the company by 2025. Additionally, Uber put up billboards reading, "If you tolerate racism, delete Uber"; however, this awareness campaign engendered some public backlash. Whereas the message was meant to show company support for racial-justice efforts, critics described such public displays as hypocritical. Because California's Proposition 22 was viewed as harmful to drivers—many of whom were members of minority groups—who depended on ridesharing as their sole livelihood, Uber's public support of racial justice while simultaneously funding the California Proposition 22 campaign was seen as disingenuous. Other critics pointed out that both Uber and Lyft had been accused of price discrimination in predominantly nonwhite communities, adding to the controversy.[57]

Moving Forward in a COVID-19 World

As the 2020 COVID-19 pandemic unfolded and progressed, Uber, like many other companies, was hit hard financially (see Exhibit 11). Not only had Uber's loss of revenue deepened the impact of the company's various existing challenges by lowering demand for ridesharing, but it had also created a new problem: how to recover lost ridership in the face of individuals actively minimizing their own travel to avoid exposure to the deadly disease. The travel industry in general had been harmed by a collective fear of infection; in the face of second-quarter 2020 losses, airlines "parked 16,000 airliners" as "passenger volume dropped 90%," hotel occupancy hit an all-time record low, and business travel was projected to drop over 35% by the end of 2020.[58] In September 2020, as part of an effort to reassure potential customers regarding infectious disease precautions, Uber embedded a mask-verification protocol into its core app, requiring drivers to submit photos with masks in place and asking riders to verify mask wearing as well.

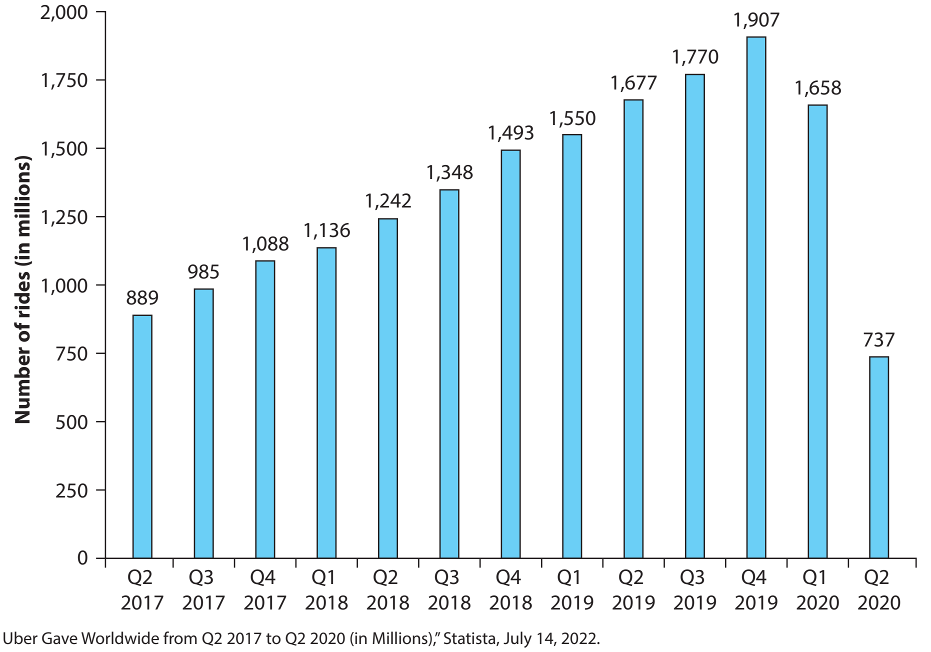
But Jaseem worried that these efforts might make little difference. A recent automotive industry survey revealed that 39% of Americans who previously relied on ridesharing planned to decrease or cease their use of those services altogether, even after economic activity returned to normal, and 49% planned to increase usage of their own personal vehicle.[59] Much as experts were suggesting that the collective shift toward working from home during the pandemic might have lasting effects on the commercial real estate industry even after the pandemic ended, Jaseem wondered what the lasting effects of 2020's massive dip in ridesharing

Exhibit 11 Uber Quarterly Gross Bookings Worldwide (Q3 2016 to Q2 2020)



Source: "Global Gross Booking Volume of Uber from Q3 2016 to Q2 2020 (in Billion U.S. Dollars)," Statista, July 12, 2022.

Uber Quarterly Number of Rides Worldwide (Q2 2017 to Q2 2020)



Source: "Number of Rides Uber Gave Worldwide from Q2 2017 to Q2 2020 (in Millions)," Statista, July 14, 2022.

might have on the industry going forward, and what it would mean for Uber.

As she reflected on the company's substantial challenges, Jaseem leafed through the latest annual report. It painted an unsettling portrait, even before the effects of COVID-19. The company, the report read, had incurred "significant losses since inception." Operating losses for the past several years were: $4.1 billion (2017); $3.0 billion (2018); and $8.6 billion (2019). At the end of 2019, the company had an accumulated deficit of $16.4 billion.[60] The way she saw it, the company was facing a triple whammy: challenging financials, various persistent stakeholder frictions, and the unpredictable effects of the significant current global health crisis.

What strategic choices should Uber make? What should Jaseem and her team recommend to Khosrowshahi and the rest of top management during tomorrow's strategy meeting?

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Case 19

Digital Transformation at *The Washington Post*: Innovating for the Next Generation

After joining *The Washington Post* (*The Post*) in 2014 as publisher and CEO, Fred Ryan worked with owner Jeff Bezos to bring about an extraordinary digital transformation at the global news organization.[1] As a result of Ryan and Bezos's efforts, *The Post* was on track to finish 2021 as a profitable and growing company, as it had been for the past six years. The turnaround had been nothing short of miraculous, leading *Fast Company* to recognize *The Post* as one of the "World's Most Innovative Companies" … "for bringing Amazonian ambition to news."[2]

Yet, despite all its success, *The Post* continued to face several significant business challenges, including new competitors, a growing number of channels through which readers consumed news, and rapidly changing consumer behavior. While *The Post* was transforming itself, the share of Americans using social media to access news had nearly doubled to 48%. Underscoring this trend, Gen Z individuals (those born after 1996) were far more likely than those in earlier generations to use social media and news aggregators instead of direct methods (e.g., https://www.washingtonpost.com/) to access news, hurting both subscriptions and ad revenues, and posing challenges to the future profitability of *The Post*.

On August 4, 2021, *The Post* announced the creation of Next Generation (Next Gen)—a new initiative to accelerate the acquisition of younger and more diverse audiences through new products, practices, and partnerships.[3] As part of the announcement, Ryan made the following statement:

> Over the past few years, *The Post* has boldly experimented in developing new ways to reach readers and expand our subscription base. We have delivered *The Washington Post* journalism to the broadest national and global audience in our history with many younger readers enjoying *Post* content on sites and in formats that didn't exist a few years ago, and we are eager to build upon this success and accelerate our progress.

To execute the Next Gen initiative, a cross-company task force was formed to develop *The Post*'s strategic roadmap for emerging audiences, which it would present to Ryan and his executive team. The future of the 143-year-old institution would depend on its ability to continue its organizational transformation and innovate for the next generation.

A Brief History of the American Newspaper Industry and *The Washington Post*

The first newspapers in the newly formed United States had been crucial to inspiring civic unrest across the Thirteen Colonies by spreading radical ideas on personal liberties. Their vast influence during the Revolutionary Period was plainly understood by the authors of the US Constitution when they designed the First Amendment to cement the role of newspapers as a bulwark of democracy, capable of holding the powerful to account. Historian and Continental Congress delegate David Ramsay observed, "In establishing American independence, the pen and the press had merit equal to that of the sword."[4]

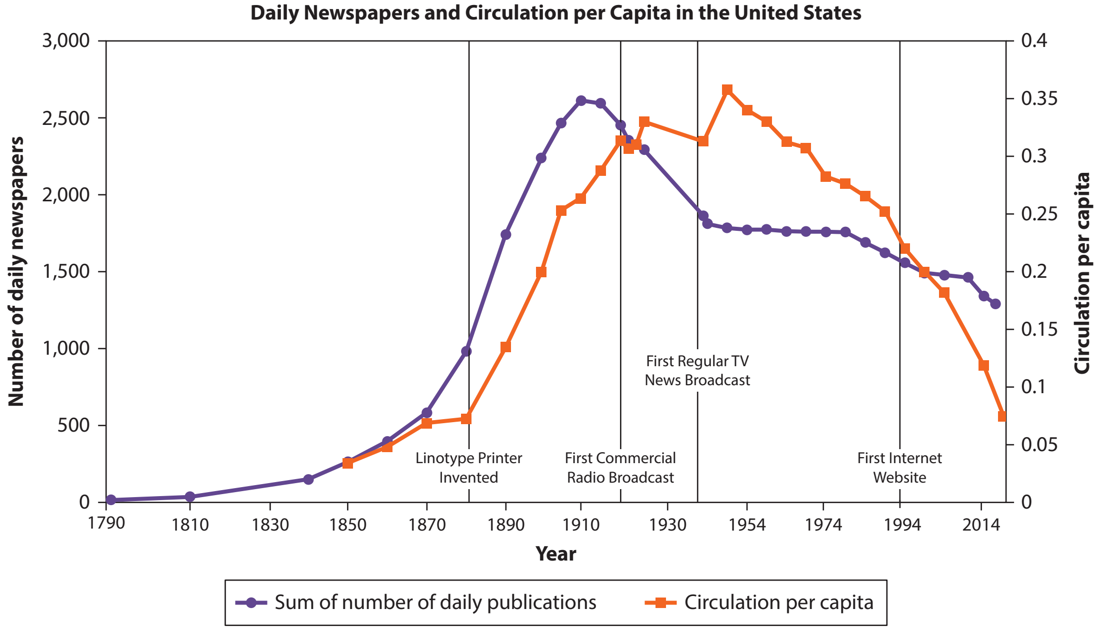
Despite the legal protections of the First Amendment, newspapers of the late 18th century struggled with a business model based on feeble circulation capacities (only several hundred readers per paper), content lag times ranging from weeks to months, and particularly high operating costs.[5] On the demand side, low literacy rates, a largely nonexistent middle class, and a highly rural agrarian society constrained expansion. These business pressures would linger for nearly a century before giving way to a period of enormous growth in the late 1800s for the newspaper industry[6] (Exhibit 1).

During this period of growth, Stilson Hutchins, founder of the *Saint Louis Times*, moved to Washington, DC, and began publishing at 914 Pennsylvania Avenue under the title of *The Washington Post* on Thursday, December 6, 1877.[7] The first published papers focused chiefly on government affairs and were circulated to around 10,000 readers, mainly residents of Washington, DC.

In the late 19th century, American newspapers, including *The Post*, continued to be constrained by two stubbornly high costs—printing and circulation (transportation). Several advancements during the era improved the viability of papers in less populated and more competitive environments: the telegraph (which decreased story lead times), railroad networks (which enabled wider circulation), and the Linotype printer (which decreased printing costs). Created by German immigrant Ottmar Mergenthaler in Baltimore, Maryland, the Linotype printer was said to have been described by Thomas Edison as the Eighth Wonder of the World.[8] When Mergenthaler unveiled his new machine in January 1883, Hutchins was an eager spectator. Of the first 102 machines produced

This field-based case was prepared by Ryan Nelson, Professor of Commerce, and Kevin Miner, Research Assistant. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

Exhibit 1 Daily Newspapers and Circulation per Capita in the United States, 1790–2020



Data sources: Dailies, 1790–1925: William A. Dill, "Growth of Newspapers in the United States," March 15, 1928, tables V and VI, https://kuscholarworks.ku.edu/bitstream/handle/1808/21361/dill_1928_3425151.pdf?sequence=1&isAllowed=y; Pew Research Center, "Newspaper Fact Sheet," June 29, 2021, https://www.pewresearch.org/journalism/fact-sheet/newspapers/; and Amy Watson, "Number of Daily Newspapers in the U.S. 1970–2018," June 10, 2021, https://www.statista.com/statistics/183408/number-of-us-daily-newspapers-since-1975 (all accessed Nov. 8, 2021). Chart adapted from Matthew Gentzkow, Edward L. Glaeser, and Claudia Goldin, "The Rise of the Fourth Estate: How Newspapers Became Informative and Why It Mattered," https://scholar.harvard.edu/files/goldin/files/the_rise_of_the_fourth_estate_how_newspapers_became_informative_and_why_it_mattered.pdf (accessed Nov. 8, 2021).

for commercial use, several went to *The Post*. The Linotype allowed *The Post* to swell production and develop longer and more complex segments (the first newspapers printed at *The Post* were limited to just four pages due to high costs). Aided by rising demand and technical innovation, many publishers reorganized themselves to focus on large commercial advertising deals and mass subscription revenues.

After *The Post* was hit hard by both scandal[9] and the Great Depression, Eugene Meyer bought the organization at a public bankruptcy auction for $825,000 in 1933. He returned *The Post* to financial stability and greatly improved its reputation among Washingtonians. Meyer gave the paper to his son-in-law, Philip Graham, who led the paper from 1946 to 1963. Upon his death, Katharine Meyer Graham became the first 20th century female publisher of a major American newspaper. She would inspire a new generation of journalism dedicated to truth and courage above all else. Despite personal threats from the White House, she oversaw *The Post*'s commitment to uncovering the secrets of the Watergate scandal, leading to President Richard Nixon's resignation, and also oversaw the publishing of the *Pentagon Papers*, which contributed to the end of the Vietnam War. In 1979, Katharine Meyer Graham passed the paper over to her son, Donald. Donald Graham led *The Post* for nearly three decades before handing the CEO and publisher titles over to his niece, Katharine Weymouth, in 2008. Amazon founder Jeff Bezos would buy *The Post* five years later, in 2013. As a clear representation of its mission and a historical connection to the first American newspapers, "Democracy Dies in Darkness" became the first official slogan of *The Post* in 2017, and appeared at the end of its first Super Bowl commercial in 2019.

The Washington Post's Digital Transformation Journey

For over a century, *The Post* was well positioned in the profitable Washington, DC, metro area; it held a dominant share of the market, produced unique content for devoted subscribers, and was financially supported by a robust combination of local advertising and subscription revenues. As a watchdog in the federal government's own backyard, *The Post* earned a reputation for hard-hitting investigative journalism that extended its brand around the world.

Unfortunately, industry disruption caused by the internet and the 2008 financial crisis proved disastrous for newspapers. After *The Washington Post* Company had faced six straight years of declining revenue,[10] Katharine Weymouth and Donald Graham made the difficult decision to personally approach Bezos and ask that he lead *The Post* into the digital age. Despite his initial reservations, Bezos agreed to buy *The Post* for $250 million, ending four generations of Graham family ownership and 42 years of public trading. In the deal, Nash Holdings LLC, Bezos's personal holding company, bought *The Post* as well as some related ventures.[11] Many industry analysts at the time believed that there were no easy fixes Bezos could use to return *The Post* to profitability.[12]

Bezos, determined to save the storied institution, brought in digitally savvy industry veteran Fred Ryan to serve as CEO and publisher. Following his service as chief of staff to President Ronald Reagan, Ryan had served as vice-chair of the television, cable, and internet company Allbritton Communications. While at Allbritton, Ryan cofounded *Politico*, a politically focused website and newspaper. Ryan reflected on his first meeting with Bezos:

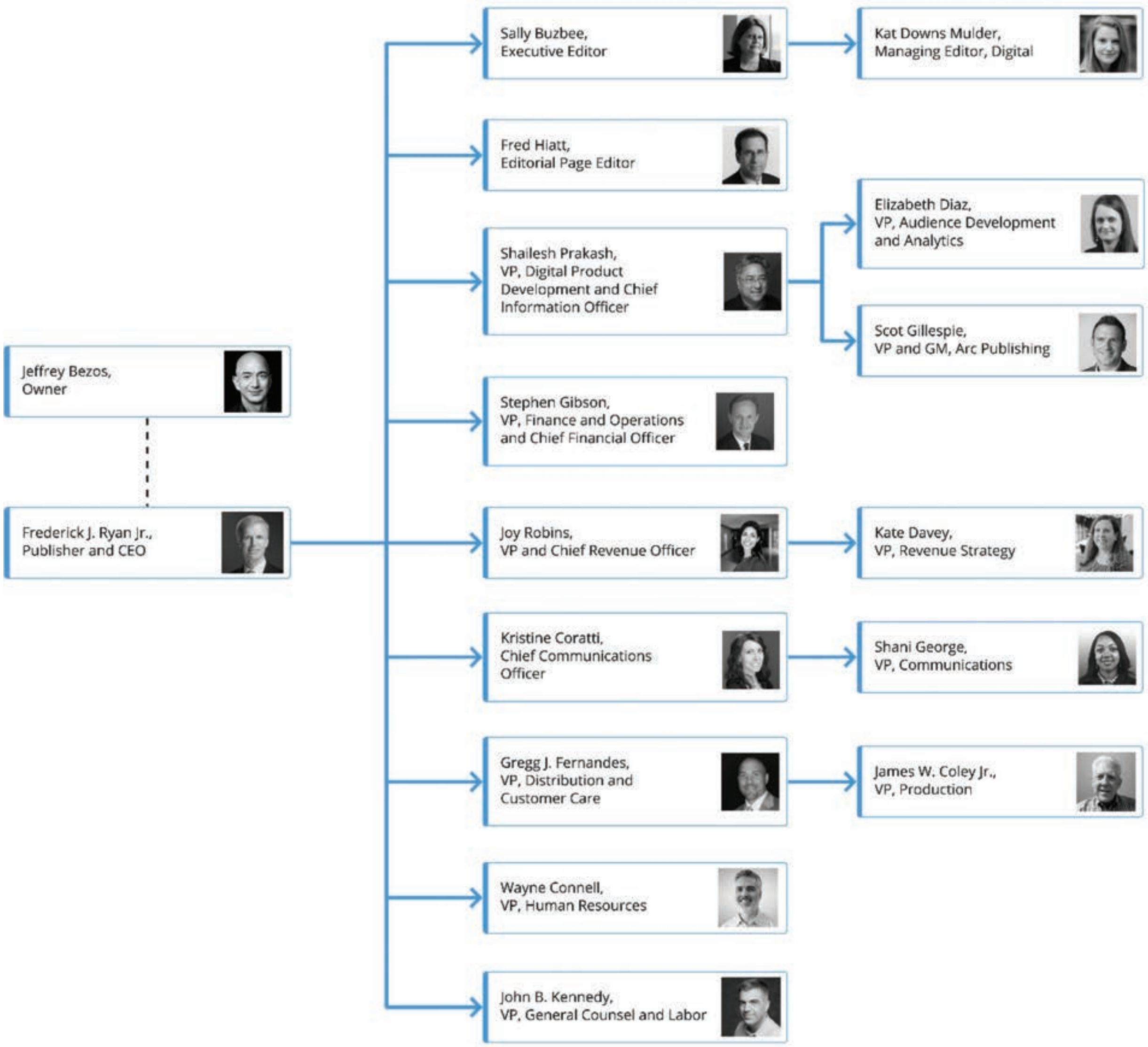
> In the very first meeting we had when we were talking about this job, I asked him, "Jeff, why did you buy *The Washington Post*?" He said, "I bought *The Washington Post* because I believe that a free, independent, and strong press is essential for the health of our democracy." And I thought, that's the right answer…the answer I was hoping for.[13]

Soon after joining *The Post*, Ryan worked with his executive team (Exhibit 2) to reinvent the organization's business and operating model to become much nimbler and risk tolerant. Ryan characterized it this way: "*The Post*, like many large, successful institutions, can become the proverbial battleship that is very slow to turn." Recognizing the role that culture played in organizational change, *The Post* redefined how employees were reviewed, placing an emphasis on three criteria, called catalysts, to convey that "something is happening": shaping ideas, taking ownership, and speed of execution. Ryan described the importance of the three catalysts:

> We continue to ensure that our speed of execution becomes an asset for us rather than a liability. When there is a competitive environment, we want to be able to execute faster than our competitors, so that we can do the deal, launch the product, and be the first.

It was clear that the three catalysts were designed to create an organizational culture that would help turn the

Exhibit 2 *The Washington Post* Executive Team



Source: Created by authors. Company photographs are used with permission.

organization in a new direction and be capable of making additional turns as demanded by the environment. Leveraging the three catalysts, several strategic initiatives helped steer the "battleship" in a new direction: developing a digital-product mindset, rebuilding the newsroom, redesigning core business processes, and achieving excellence in both technology and journalism.

Developing a Digital-Product Mindset

Prior to joining *The Post*, Ryan and Bezos had seen firsthand what a digital-product mindset could do to make an organization nimbler, more innovative, and ultimately more competitive. Ryan described the early work this way:

> It was important that we quickly build a digital mindset across the organization, particularly in the newsroom, where page A1 of the newspaper had traditionally been considered the most important item we produced. We were able to accelerate our growth by staying focused on our digital product and the ways we could extend the reach our journalism.

Fortunately, when they got to *The Post*, Ryan and Bezos discovered that Shailesh Prakash, *The Post*'s chief information officer (CIO), had created a solid foundation on which to build digital products. Before joining *The Post* in 2011, Prakash had held engineering leadership roles at Motorola, Sun Microsystems, Netscape, and Microsoft, and was responsible for product development and engineering for e-commerce operations at Sears. Prakash recalled his first days at *The Post*:

> There was a lot that needed fixing. Product development had slowed to almost a standstill and the newsroom had very little confidence in the systems they used to do their jobs and in IT's ability to ship digital products. I needed to roll up my sleeves and get into the trenches, and that is what I focused on initially. I also needed to move the organization from an IT mindset of babysitting systems into a product development mindset of building and inventing digital products.

Early on, Prakash encountered different levels of acceptance for his initiatives, with the organization falling into three groups: one group embraced the changes, saying "This is exactly what we need! We will finally make some progress"; another group that was very resistant, saying "Oh my God, this guy is going to tank the ship"; and "the big middle," whose members simply watched and waited to see what would happen. With top management's support, Prakash brought in new engineering talent and got some early wins on the board to help convince "the big middle" that *The Post* was headed in the right direction.

In the new model, engineers were empowered to be more hands-on, co-located to work directly with their internal partners in the newsroom and build, rather than buy, digital solutions. They were also expected to ship quickly and ship often. Kat Downs Mulder, managing editor for digital (and formerly head of product), described the changes this way: "I think it was good for us because we just so badly needed a metabolism shift toward more creation, more invention, and more embracing of new ideas and new technology."

One pivotal moment came during a change-requirement meeting when the project-management group presented a comprehensive spreadsheet with red, yellow, and green used to represent the status of stakeholder requests. At the end of the one-hour meeting with more than 60 participants, it was still not clear what was needed. After months of debate, it turned out that the changes that the newsroom wanted could be achieved with minimal engineering effort. Prakash described "a revelation in terms of how much the bureaucracy of constant debate had stifled both stakeholders and product developers." Regarding the massive spreadsheet for tracking requirements, he smiled and said, "It's great for status reports, but it's not good for productivity." Mulder agreed:

> What doesn't work is just having people execute on an assembly line. You need the team to be engaged with formulating the roadmap and prioritizing things; otherwise, you just end up doing the stuff on a list. It's outcomes, not outputs.

Prakash was adamant that this was the best way to work:

> Every day of the week, and twice on Sunday, I'd prefer a model where the engineers are directly engaged with their newsroom partners rather than having a layer of project managers in the middle who kind of, sort of think they know what's going on, while the actual doers are twiddling their thumbs saying, "I'm sorry, what am I supposed to do again? I'm waiting for the order. What should I do?"

To help put the product-development mindset into action, *The Post* adopted agile methodologies and scrum practices. The result was that teams ("squads") worked together more efficiently on the things that mattered. Over time, roughly a dozen different product teams were formed, each consisting of 5 to 10 members with the following roles: lead product manager, one or more designers (user experience [UX] designer, visual designer, or design technologist), one or more engineers (front end, back end, or hybrid), a scrum master (typically shared across multiple teams), and subject-matter experts as appropriate (e.g., analytics or A/B testing). Mulder added: "One of our goals is to give them more autonomy and give them more power to experiment."

At an organizational level, there were two main components to the product group: one focused on *reader revenue* (including purchasing a subscription, managing all the paywalls and registration, subscriber engagement, and retention), and one focused on the *core user experience* (including all manifestations of journalism on every platform, as well as the features that made it easy for readers to find what they were interested in consuming). Seamless product integration demanded that the two units worked closely together and quarterly alignment exercises were used to review the product organization's objectives and key results (OKRs).

Product vision was communicated from the top using a vision statement containing high-level objectives and how they would be measured (key results). Each product team would then set out to execute those objectives by drafting OKRs for the team, which were then reviewed for alignment with the company vision every two weeks. Periodically, multi-team communication meetings were held to track progress against objectives and get visibility into what the product organization was doing. In addition, product roadmap reviews occurred once a month with the executive team. Mulder explained:

> The tricky part is that you really want empowered teams, but there are higher-level business and financial decisions that depend on what the product teams are doing…and so there are moments in which it has to be escalated a level, and so forth…I do think that it's really important to facilitate prioritization in order for people to have a really clear understanding of why you're choosing to do certain things.

Although he didn't get involved in editorial content or the day-to-day business at *The Post*, every two weeks, Bezos met via phone with the leadership team to review process, product, and technical issues, such as subscription flow and load time for the website. Prakash highlighted some of the benefits of having Bezos as the owner of *The Post*:

> Here's a man who understands and believes in product development. He's always encouraged us to innovate and invent and not worry too much about having the full business plan figured out before we start building. He wants to see us constantly make our site faster, lower the cognitive dissonance of the news-reading experience…you name it, and Jeff pushes on it, and he's excited about it. My developers talk to him, my product managers talk to him, and my designers talk to him. We love the fact that he is a product guy.

The frequent engagement with Bezos also proved to be instrumental in recruiting and retaining hundreds of top technologists—many of whom would have otherwise taken jobs with technology companies like Facebook, Google, and Microsoft. Utilizing this talent, *The Post* released a variety of industry-leading products in the years leading up to 2021 (see representative examples in Exhibit 3).

Rebuilding the Newsroom

Staying above water during the downturn had required aggressive cost cutting that reduced newsroom staff by a third in the decade preceding 2012.[14] Ryan and his team had been determined to rebuild what was core to the business—the newsroom. To this end, they provided the tools and resources necessary for the news creators to grow with the rest of the business. As a point of reference for the speed with which *The Post* had hired, when Bezos bought *The Post* in 2013, the newsroom had 580 employees. In 2021, *The Post* was on track to add 150 new positions, which would expand the newsroom to 1,010 employees—the largest newsroom in the history of *The Post*. Many of these new roles emphasized a forward-looking approach to covering the news. Data scientists, graphic and data designers, and software engineers aided *The Post* in using data visualizations to communicate complex topics in simple and powerful ways. Ryan explained:

> *The Post*'s newsroom had been cut so deep before its sale that it had made a significant impact on the company's ability to attract readers and advertisers alike. It was a top priority to me to rebuild our core reporting centers like politics, national security, foreign policy, and investigative, and expand into areas like technology, climate, food, and travel. That strategy was proven to be the right one, with meteoric subscription growth and record advertising revenue.

The added human capital also supported *The Post*'s political journalism. The largest political news team ever assembled at *The Post* comprised additional journalists, engineers, and data scientists. The diverse team developed one-of-a-kind data visualizations and political models widely adopted by eager readers (e.g., complex voting models were successfully deployed during the 2020 US presidential election to much fanfare).

Utilizing the larger, modernized workforce, *The Post* widened its news content by adding new channels of content dissemination. To capitalize on a growing domestic interest in foreign affairs and capture digital audiences abroad, *The Post* invested in expanding its world content by adding foreign staff in 26 locations—the largest corps of foreign correspondents in *The Post*'s history. To approach new customers, *The Post* powered its apps with augmented-reality storytelling features and invested in audio storytelling and live news events, constructing three studios to air *The Post* journalists on channels like the Cable News Network (CNN) and MSNBC as well as produce original video content.

Redesigning Core Business Processes

There were two principal ways to monetize news, regardless of whether it was digital or printed: advertising and subscriptions. For most of *The Post*'s history and that of its competitors, advertising had played the leading role in the form of a multisided platform business model—bringing together their two distinct but interdependent groups of customers: advertisers and subscribers.[15] Yet, more recently, the internet put pressure on advertising revenues (Exhibit 4) because ad space became ubiquitous online (Exhibit 5). The extreme decline in print advertising happened without an equally offsetting rise in digital advertising for many companies, underscoring a grim industry situation.

Exhibit 3 *The Washington Post*'s Digital Product Launch Timeline, Representative Examples (2015–21)

Arc XP (Arc Publishing): Modern digital experience platform (DXP) that provides an end-to-end solution for media and entertainment organizations and enterprise businesses across industries

2016

Bandito: Real-time content testing tool
Carta: Newsletter delivery platform
Heliograf: Artificial intelligence system that helped *The Post* cover nationwide election races in 2016 and 2018
Breakfast: Improves the speed of breaking-news email alerts
Zeus Technology Platform: Media-monetization platform that levels the playing field for publishers and advertisers
Fuse: Consumer-first ad experience built for the high-speed mobile era
Re-engage: Aims to get distracted or inactive users to re-engage further with *The Post* content

2017

Own: Artificial intelligence (AI) that lets brands use their own content for ads and improves chances of ads being seen and read
Today's WorldView: Daily newsletter; first product created for an international audience

2018

Post Reports: First daily flagship podcast showcasing *The Post's* wide-ranging journalism
SwitchPlay: User-friendly video experience that seamlessly combines pre-roll and in-article video
Augmented Reality Experience: AR stories using Apple's latest AR Quicklook technology

2019

Feedbuilder: Tool that automatically builds multiple creative assets, scans all available content, and then utilizes proprietary personalization technology to align ad units with what users are reading at the time or read in their current visit
By the Way: Highly visual digital destination for travelers who want to experience cities around the world like a local
Zeus Performance: Industry-leading advertising framework and revenue technology stack
Zeus Insights: Context targeting with first-party data
Zeus Prime: Premium ad network

2020

Audio Stories: Audio versions of all stories available on mobile devices
Heliograph Elections: AI-powered audio updates for 2020 election results

2021

Zeus Video - improves the efficiency of advertising by reducing latency and driving viewability
Arc Commerce - equips brand marketers with the tools and capabilities to grow ecommerce

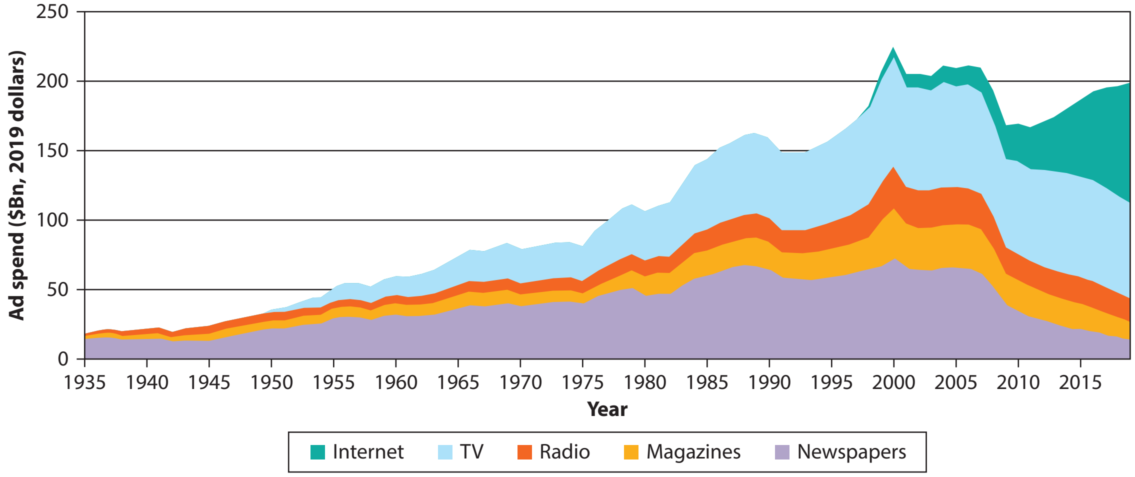
Data source: *The Washington Post* PR blog, 2015–2021, https://www.washingtonpost.com/pr/ (accessed Nov. 8, 2021).

To counteract industry trends, *The Post* attempted to differentiate its offering by promising advertisers an end-to-end collaborative partnership and best-in-class ad technology. Led by Joy Robins, chief revenue officer (CRO), teams at *The Post* provided advertising clients proprietary audience insights and research, helped brands connect with *The Post* readers, and hosted live virtual leadership masterclasses on topics like privacy, storytelling, and emerging platforms. For example, *The Post* went beyond basic ad transactions by forging *premium* relationships with companies like Rolex and AT&T that focused on issues of importance to their customers.

In addition, the Research, Experimentation, and Development (RED) team at *The Post* ideated, created, and patented ad technology that simultaneously benefited the marketer and reader. The team developed several revenue-generating products including Feed Builder, which scanned all available personal content information and then used proprietary personalization technology to align ads with what users were currently reading or viewing on the site. The tool was developed with thorough subscriber testing and feedback. *The Post*'s goal was to bring the most relevant ads to subscribers while boosting ad engagement for its partners.

The Post's approach to digital subscriptions evolved through a process of experiment-test-learn-adapt. Like other newspapers, *The Post* had entered the digital world with free content underwritten by print subscriptions and advertising. Paywalls emerged when that model failed (Exhibit 6). First, *The Post* had a 20-story paywall, then it reduced the limit to 10 stories, and then 5. Later, with the help of technology, *The Post* transitioned to *dynamic paywalls*. Using this approach, if a reader viewed George Will's column repeatedly over a specified period, it would

Exhibit 4 US Ad Spend, 1935–2019



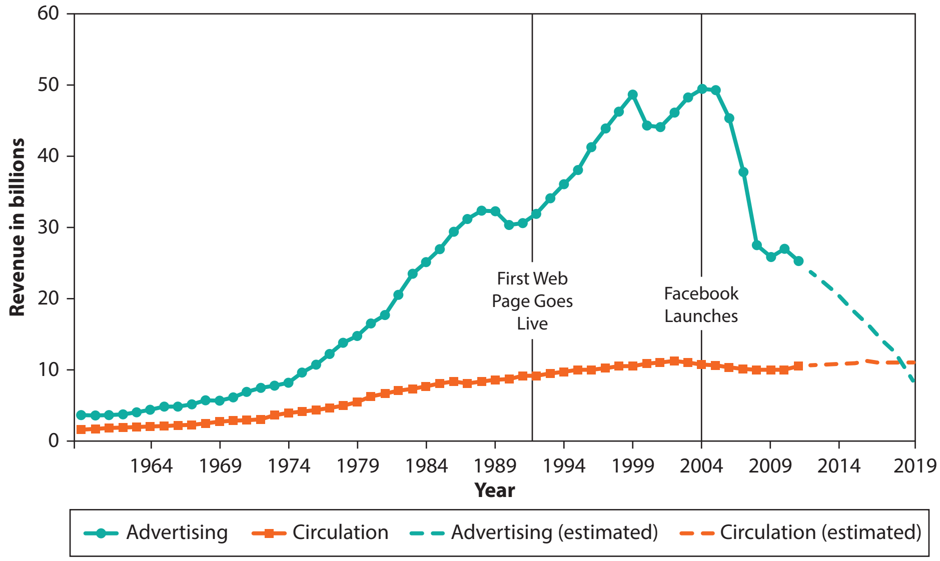
Data source: Benedict Evans, "News by the Ton: 75 Years of US Advertising," *Benedict Evans* (blog), June 15, 2020, https://www.ben-evans.com/benedictevans/2020/6/14/75-years-of-us-advertising (accessed Nov. 8, 2021). Used with permission.

suggest that the reader saw utility that they may be willing to pay for, and an offer to subscribe would follow. Regardless of the method, powerful storytelling presented in engaging ways and utility for the reader drove subscriptions. Ryan explained it this way: "It's this idea of commitment to utility. Making something that someone sees value in, and then you have to get the price right, and that's something we are constantly experimenting with."

As a positive sign that its experiments were leading *The Post* in the right direction, the organization recorded 111.6 million unique visitors to its website in January 2021 (3 million more than the *New York Times* for the same month) (Exhibit 7). Later that year, The Post reported the second-highest number of paying digital news subscribers in the world, at 3 million (Exhibit 8).

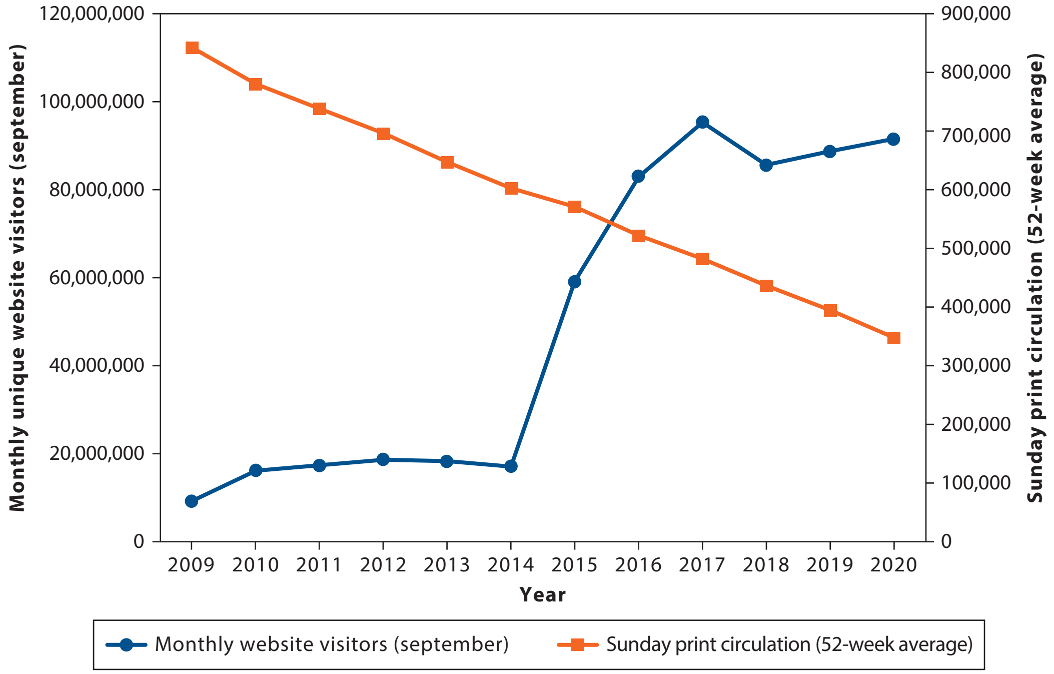
The Post credited much of this incredible success to a unique partnership between its engineering and marketing personnel. The combined team leveraged a culture of testing and experimentation—at any given time, *The Post* was running about half a dozen experiments—designed to create an outstanding user experience. In a 2020 survey, 23% of US consumers listed website/app experience as a reason to subscribe to online news, 30% listed simple payment systems, 32% listed good deal or trial offers, and 50% listed convenient digital news packaging (Exhibits 9 and 10).[16]

Exhibit 5 Advertising and Circulation Revenue of Public US Newspapers (Combined), 1956–2019



Data source: Pew Research Center, "Newspaper Fact Sheet," June 29, 2021, https://www.pewresearch.org/journalism/fact-sheet/newspapers/ (accessed Nov. 8, 2021).

Exhibit 6 *The Washington Post*'s Print and Digital Readership, 2009–2020



Data source: The Alliance for Audited Media, Annual Audit Reports, 2010–2020.

In 2021, *The Post* offered three types of subscriptions plans:

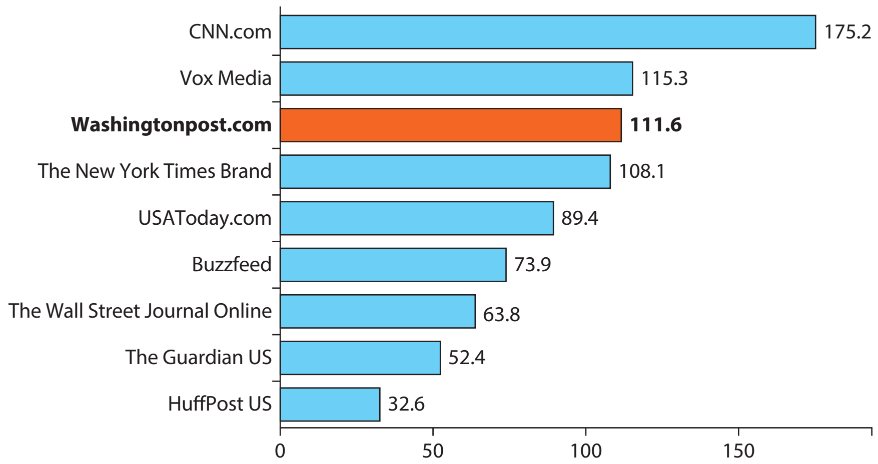
All-Access Digital: Unlimited web and app access (normally $100 per year, or $10 every four weeks, but the promotional price was $40 per year, or $4 every four weeks)

Premium Digital: Unlimited web and app access, bonus subscription to share, unlimited e-book downloads written by *Post* journalists (normally $150 per year, or $15 every four weeks)

Academic: Unlimited access for college students, faculty, and staff as well as active K–12 teachers (normally $10 every four weeks, but the promotional price was $1 every four weeks)

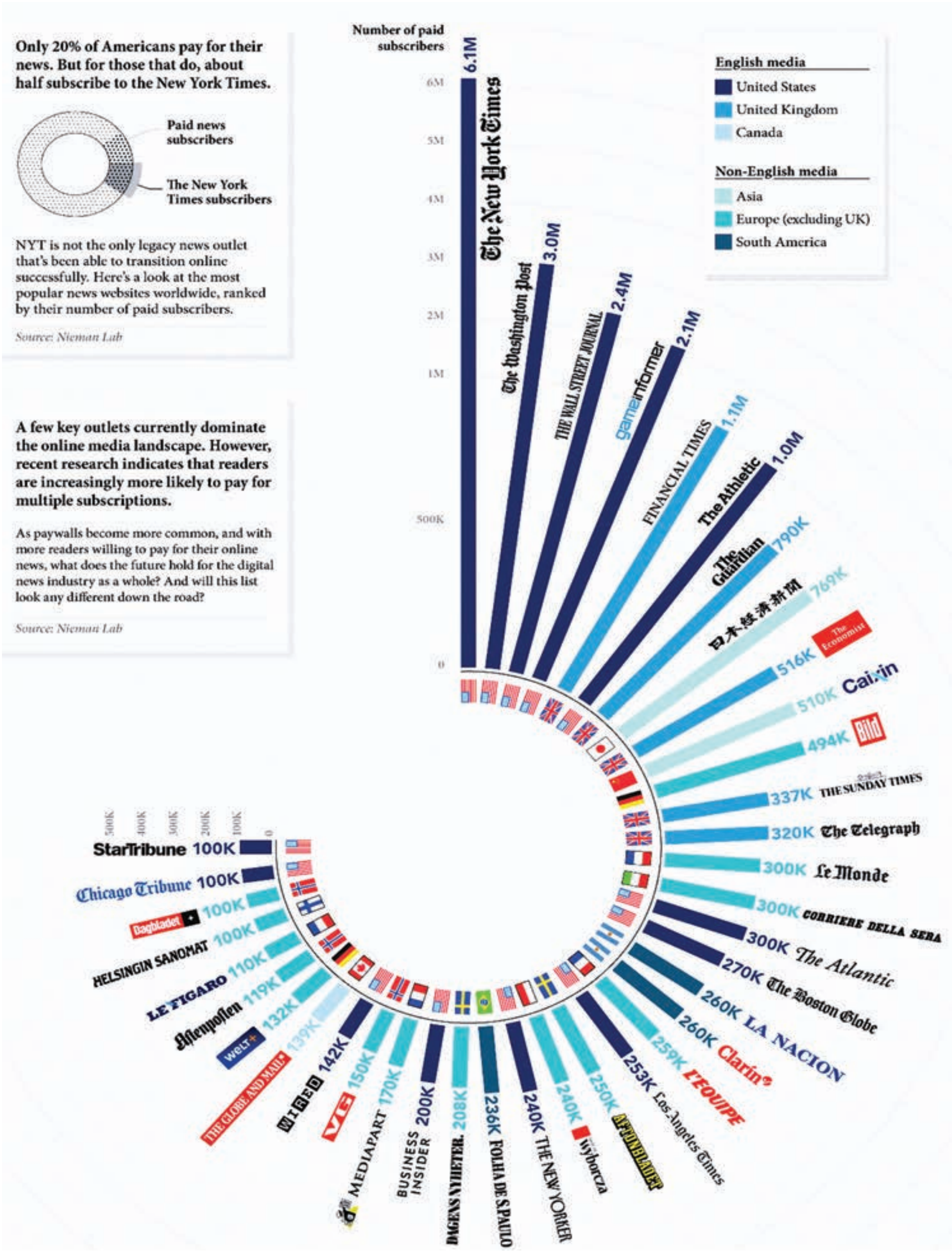
Furthermore, *The Post* experimented on a wide variety of platforms. For example, it was an early Facebook Journalism

Exhibit 7 Total Digital Population, Unique Visitors (in Millions), January 2021



Source: Company document, used with permission.

Exhibit 8 The Most Popular Paid Subscription News Websites, 2021



Source: Carmen Ang and Raul Amoros, "Ranked: The Most Popular Paid Subscription News Websites," Visual Capitalist, April 26, 2021, https://www.visualcapitalist.com/ranked-the-most-popular-paid-subscription-news-websites/ (accessed Nov. 17, 2021). Used with permission.

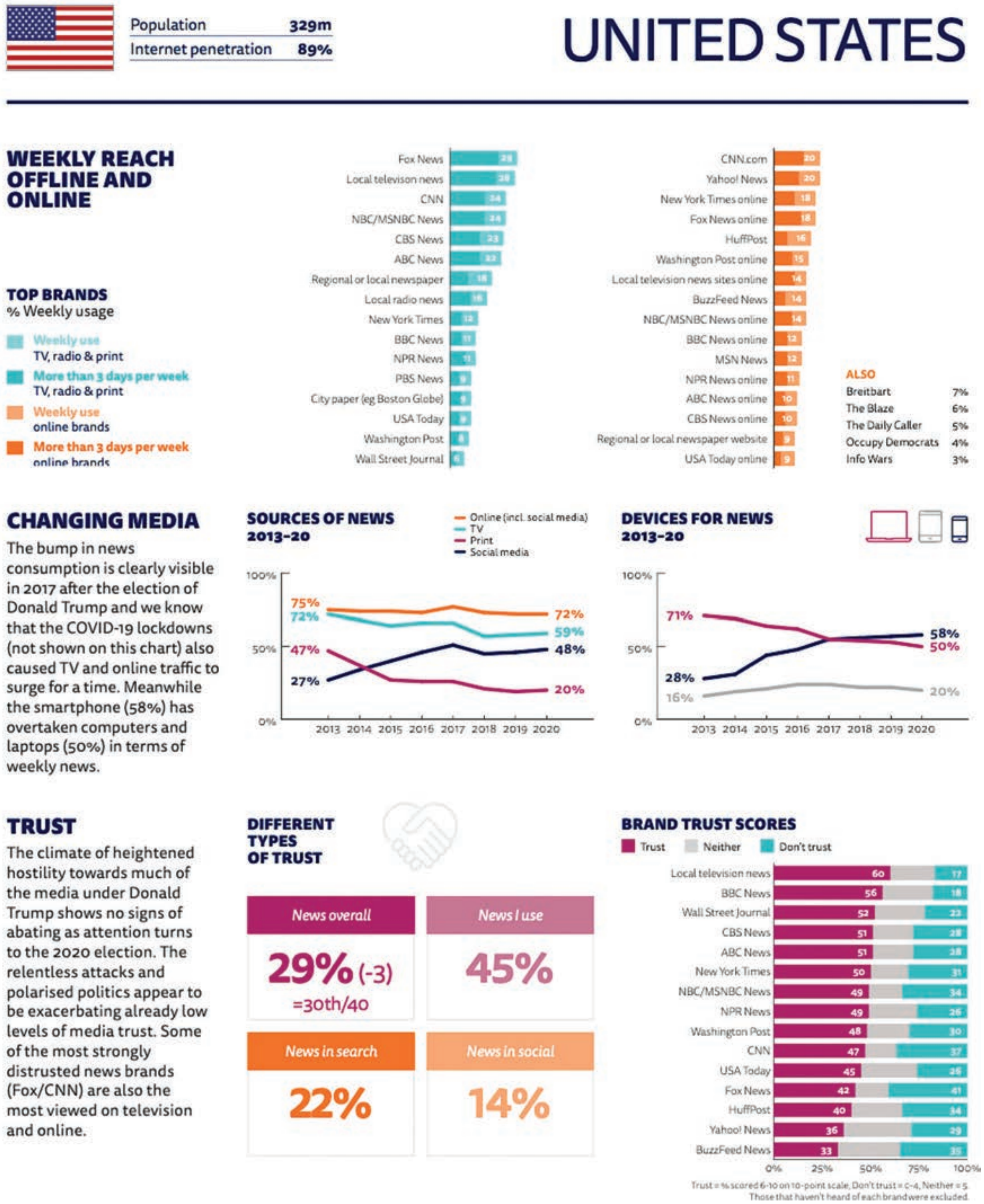
Project partner and closely collaborated on subscription strategy, data analysis, and news credibility on the platform; *The Post* became Snapchat's first editorial partner to provide breaking news; it was the first publisher to announce breaking news on Alexa-enabled devices, and published the *Daily 202*, *Retropod*, and *Post Reports* podcasts on the platform; it created custom, media-rich content on Apple News; and it launched on Google Home, providing daily political analysis, and was the first national publisher to test Subscribe with Google on it its site.

Achieving Excellence in Technology and Journalism

As a by-product of investing in its core business and processes, as well as embracing a digital-product mindset, *The Post* became as much a tech company as it was a media company—achieving excellence in technology as well as journalism. About this, Ryan said:

> We talk about this intersection of journalism and technology; today, you have to be excellent in both.

Exhibit 9 Digital News Country and Market Data, United States



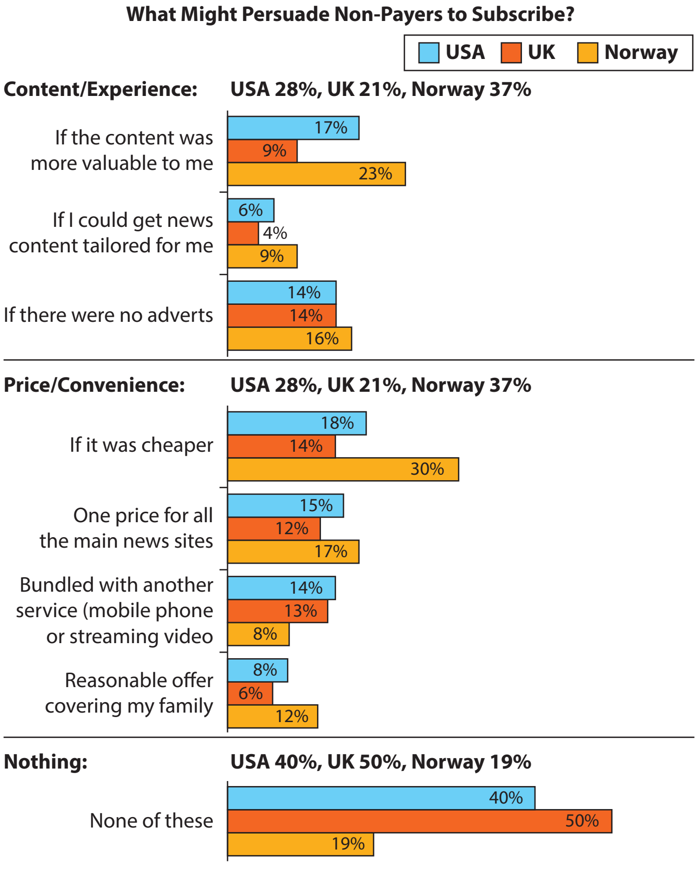
Source: Nic Newman, Richard Fletcher, Anne Schulz, Simge Andı, and Rasmus Kleis Nielsen, "Digital News Report 2020," Reuters Institute, 2020; used with permission.

If the journalism is not excellent, it doesn't matter how good the technology is; and if the journalism is fantastic, but the technology is not getting it out, you're out of luck. So, we hired and expanded our engineering team.

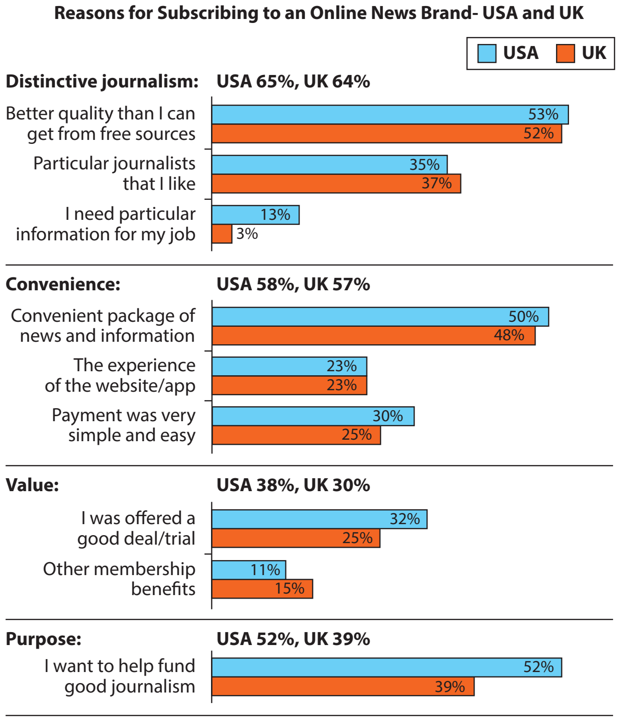
As noted by Ryan, achieving engineering excellence meant hiring talented engineers, developing them through technical training programs, and compensating them at commensurate rates. In addition, with Bezos's encouragement, *The Post* cultivated a culture of experimentation and rapid innovation, all with both the newsroom and the reader experience in mind; linked to a technology strategy that emphasized build versus buy, omnichannel with a strong emphasis on mobile, and the early adoption of emerging technologies.

The strategic intersection of journalism and technology produced another form of digital transformation at

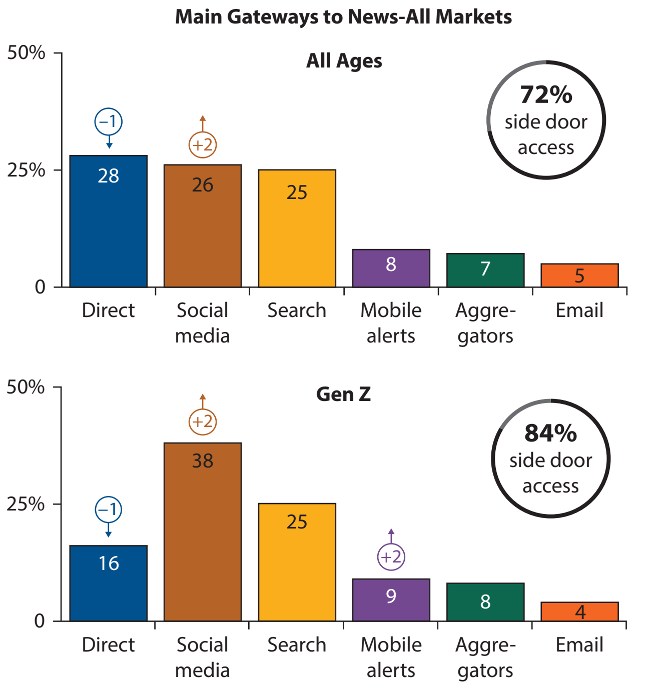
Exhibit 10 Global Digital News Survey Results, 2020



PAY1d. Which of the following, if any, would most encourage you to pay for online news access?
Base: All who do not have access to paid news: USA = 3269, UK = 3907, Norway = 1104.



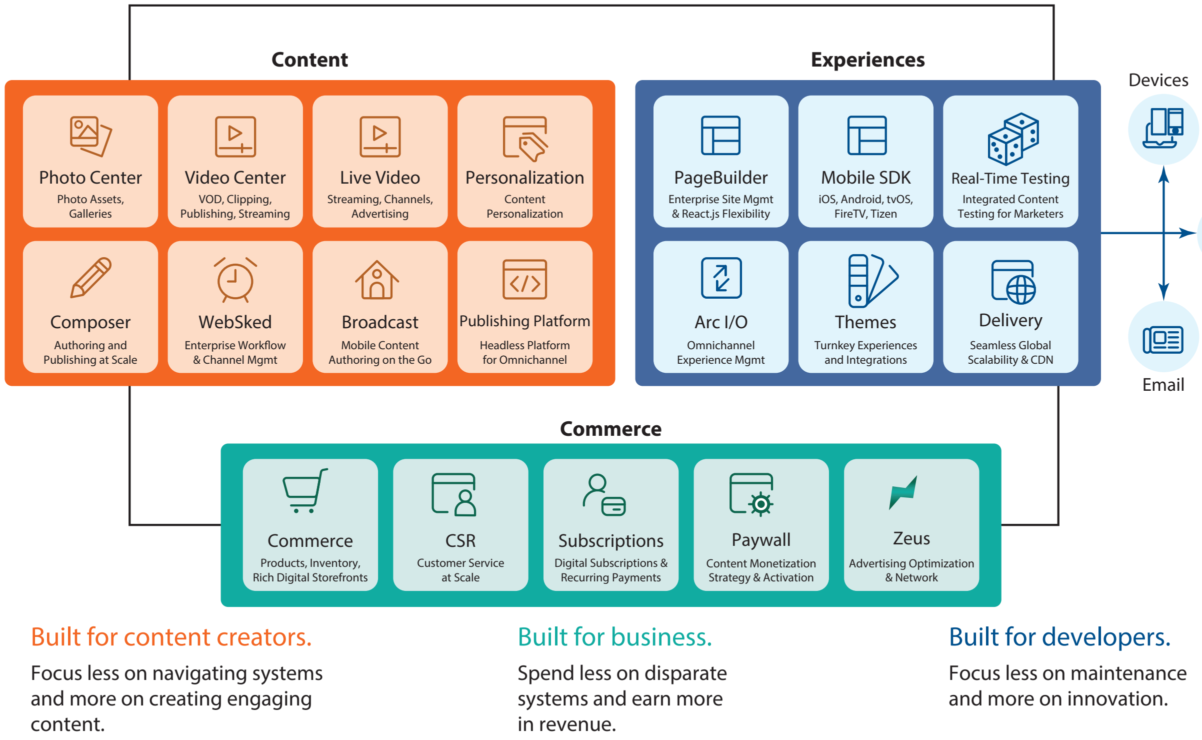
PAY5a. What are the main reasons for paying for online access?
Base: All that pay to access a single news brand: USA = 412, UK = 185.



Q10a. Which of these was the MAIN way in which you came across news in the last week?
Base: All/18–24s that came across online news in the last week: All markets = 74181/9083.

Source: Nic Newman, Richard Fletcher, Anne Schulz, Simge Andı, and Rasmus Kleis Nielsen, "Digital News Report 2020," Reuters Institute, 2020; used with permission.

Exhibit 11 Arc XP Service Map



Source: Company document, used with permission.

The Post—one typically only seen in "digital native" companies based on the West Coast. Just as Amazon leveraged its engineering excellence to take advantage of cloud computing when it created Amazon Web Services (AWS), *The Post* followed the same playbook to build a technology platform that became known as Arc XP (Arc because it spanned the arc of a publisher's needs and XP for "experience platform"). *Fast Company* wrote of Arc XP: "The newspaper created a platform to tackle its own challenges. Then, with Amazon-like spirit, it realized there was a business in helping other publishers do the same."[17] Prakash remembered an off-site meeting in which management discussed forming a "blue ocean strategy"[18] by focusing on an adjacency that *The Post* could develop so that it could win, as opposed to going head-to-head with the competition in its existing space. In this case, as Prakash said, "To build technology for *The Post* and then 'Arc-ify' it for other publishers."

Following that meeting, Prakash gained support to test the idea first with a group of college newspapers, offering for them to use it for free. As a proof of concept, a small team of engineers ran experiments to see if it could do multi-tenant systems, how to size the hardware and at what cost, what kind of complications would occur if it integrated video, and so on. These experiments allowed the team to learn a great deal about a variety of relevant use cases and the feedback was overwhelmingly positive.

As depicted in Exhibit 11, Arc XP evolved into a software-as-a-service (SaaS) business used to manage content, omnichannel experiences, and commerce (e.g., subscriptions and ad monetization). Its SaaS products were designed to increase efficiency and productivity by streamlining workflow, allowing newsrooms to focus less on navigating systems and more on producing content while growing readership. Given that the templates built for *The Post* went into the suite of Arc XP products, clients were not just buying a more efficient software solution—they were essentially getting a subscription to the roadmap of *The Post*. Scot Gillespie, VP and general manager of Arc Publishing, put it this way: "If it works here, most likely it's going to work for other large newsrooms." Prakash added: "And there are benefits both ways, [for example] sites that are heavy users of video have helped our own video platform evolve."

Arc XP's first paying customers were *Willamette Week* in September 2015 and then the *Alaska Dispatch News* the following month. Its next big break came when the *Toronto Globe and Mail* decided that it "[wasn't] looking for a shrink-wrapped product that would void the warranty if they tinkered with it"—it was more interested in partnering with *The Post* to build a modern digital experience platform (DXP). Arc XP quickly amassed an impressive list of national and international clients, powering sites across five continents, including a large number of brand-name publications and broadcasters such as the *LA Times*, *Chicago Tribune*, *New York Daily News*, *Philadelphia Enquirer*, and *Boston Globe* in the United States, and numerous international clients including *El País* (in Spain), *Le Parisien* (in France), *New Zealand*

Herald, and *Infobae* (in Argentina; *Infobae* was the largest Spanish-language news source in the world). By 2021, virtually every large publisher in the world was either on or considering Arc XP.

Utilizing the same multi-tenant platform, Arc XP was beginning to be used across several other verticals, such as broadcasting and e-commerce facilitation for clients who wanted to engage more with their customers. After all, these clients had the same basic problem as publishers: the video system, blogging system, planning system, and distribution system were all built by different vendors—an amalgamation of black boxes, creating a nightmare for the engineers who needed to make all the black boxes work together. Arc XP gave these sites that wanted to do both content and commerce a loosely coupled stack that worked well together. In 2021, Arc XP announced that the Golden State Warriors planned to use Arc XP not only to do the content and marketing of the team's site but also to sell seats in team suites. Other enterprise clients included BP, Avalon Bay, and Morningstar.

By 2021, Arc XP had become an extremely successful business, powering more than 1,500 sites for hundreds of clients in over 25 countries, generating over 1.5 billion unique visitors to the platform per month, tens of billions of page views per month, and on track to yield $100 million in annual revenue for *The Post*. Going forward, Arc Commerce was projected to triple Arc XP's revenue in three years.

In order to fuel this tremendous growth, *The Post* had built a staff of more than 250 engineers in the first five years after Bezos bought the organization, and planned to add 150 hires in the two years after 2021. The pace of hiring created an internal debate about whether this collection of talented engineers was being used properly in the service of either a perceived competitor or an adjacent industry (like broadcast) when the newsroom had plenty of needs of its own. Open questions included: Is Arc XP operating in enough of an adjacency? Is Arc XP on path, or off path? From Prakash's viewpoint, "We need to figure out the ultimate steady state for Arc…and today, I'm glad somebody like Fred is at the helm, because he trusts and he believes in it."

Notwithstanding the internal debate over the future of Arc XP as a "business within a business," the value of the platform to internal customers was undeniable. Arc XP represented a tremendous resource to *The Post*, enabling digital capabilities that few other news-media organizations could match. The newsroom used Arc XP to create content for all demographic segments of the market, while product teams used the platform to build digital products across a variety of devices and channels, as well as e-commerce solutions like digital subscriptions, dynamic paywalls, and ad optimization. Arc XP was a major step forward in *The Post*'s digital transformation journey.

The Transformation Journey Continued—Innovating for the Next Generation

When discussing *The Post*'s progress as a company, Ryan was often asked by his colleagues, "Are we there yet? Are we out of the woods?" Ryan's response was always simple and to the point: "The woods are endless; we will never be out because the woods are growing. As soon as we get to the edge, new trees keep growing!"

It was clear that the Next Gen task force was formed with this viewpoint in mind, and there were a lot of questions that it needed to answer while developing its strategic roadmap for emerging audiences:

- With reference to the digital subscription funnel (Exhibit 12), what would it take for younger audiences to engage with and eventually subscribe to *The Post*?
- Did younger audiences value what *The Post* had always been known for—objective, fact-based reporting?
- What about younger audiences' willingness to pay for quality journalism—and more broadly, how could *The Post* best monetize this segment of the market?
- When, where, and in what format did younger audiences prefer to consume news?
- Could *The Post* leverage the power of Arc XP to rapidly develop and test one or more new digital products geared to younger and more diverse audiences? If so, which ones?

Uncovering the answers to these questions was critical if *The Post* was to survive another century as one of the world's most respected news-media organizations. Ryan and his executive team looked forward to constantly evolving and innovating for the next generation.

Exhibit 12 *The Washington Post*'s Digital Subscription Funnel

	Key Performance Indicators
Attract	• Off-platform interactions (social media views, comments, and so on) • Total unique visitors to owned and operated platforms
Activate	• Average number of page views • Newsletter sign-ups • App downloads
Convert	• Subscriptions starts
Retain	• Daily active users • Terminations • Churn rate

Source: Created by authors.

Notes

1. This is a field-based case. All information and quotations, unless otherwise noted, derive from interviews with company representatives.
2. "*The Washington Post*," *Fast Company*, https://www.fastcompany.com/company/the-washington-post (accessed Nov. 8, 2021).
3. "The *Washington Post* to Launch 'Next Generation' Initiative," *The Washington Post*, August 4, 2021, https://www.washingtonpost.com/pr/2021/08/04/washington-post-launch-next-generation-initiative/ (accessed Nov. 8, 2021).
4. David Ramsay, "The Advantages & Disadvantages of the American Revolution and Its Influence on the Minds & Morals of the Citizens," from David Ramsay, *The History of the American Revolution* (1789).
5. Todd Andrlik, "Reporting the Revolutionary War," George Washington's Mount Vernon, https://www.mountvernon.org/george-washington/the-revolutionary-war/reporting-the-revolutionary-war-an-interview-with-todd-andrlik/ (accessed Nov. 8, 2021).
6. In 1870, there were approximately 500 US daily newspapers circulating one paper per day for every 20 people in the country; 50 years later, in 1920, nearly 2,500 daily newspapers were printing enough copies per day for 1 out of every 4 people. See Matthew Gentzkow, Edward L. Glaeser, and Claudia Goldin, "The Rise of the Fourth Estate: How Newspapers Became Informative and Why It Mattered," https://scholar.harvard.edu/files/goldin/files/the_rise_of_the_fourth_estate_how_newspapers_became_informative_and_why_it_mattered.pdf (accessed Nov. 8, 2021).
7. "*Washington Post* Company History," *The Washington Post*, https://www.washingtonpost.com/company-history/ (accessed Nov. 8, 2021).
8. John Hendel, "Celebrating Linotype, 125 Years since Its Debut," *Atlantic*, https://www.theatlantic.com/technology/archive/2011/05/celebrating-linotype-125-years-since-its-debut/238968/ (accessed Nov. 8, 2021).
9. In the early 1920s, Edward McLean, the publisher of *The Post* at the time, became involved in the Teapot Dome Scandal after lying to Congressional investigators in an attempt to cover up the criminal actions of the Secretary of the Interior, Albert Fall.
10. In the period between 2004 and 2014, US paid daily circulation of the *Post* was down 33% and between 2005 and 2014, advertising revenue was down 60 percent. Source: *Getting to Nimble: How to transform your company into a digital leader*, by Peter A. High (2021).
11. The purchase deal included the *Express*, *Gazette* newspapers and Southern Maryland newspapers, *El Tiempo Latino*, and specialty publications, *New Homes Guide* and *Apartment Showcase*. The deal did not include the subsidiary that owns local television affiliates and the education company Kaplan, which were considered to be cash cow businesses at the time.
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15. Such platforms were of value to one group of customers *only* if the other group(s) of customers were also present. The platform created value by facilitating interactions among the different groups. See Alexander Osterwalder and Yves Pigneur, *Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers* (Hoboken, NJ: John Wiley & Sons, 2010).
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Case 20

Driving Waymo's Fully Autonomous Future

There isn't a chance to build, develop, deploy and introduce this technology again. You have to do it right the first time. You have to build public trust, you have to gain acceptance, you have to make sure the regulatory landscape is ripe and right for it. Then you launch what we believe will be a very successful service, and then you can scale from there.

—Tekedra Mawakana, Waymo Co-CEO[1]

On an early morning in July 2021, Tekedra Mawakana walked into Waymo's headquarters in downtown Mountain View, California. Scanning the office floor, Mawakana noticed mostly empty desks—Waymo employees had just begun returning to in-person work from the COVID-19 pandemic.[2] It was her third full month on the job as co-CEO.

Mawakana was named co-CEO alongside Dmitri Dolgov in April 2021. She previously served three years as Waymo's chief operations officer (COO), and Dolgov was chief technology officer (CTO) and a longtime engineering leader at Waymo. A pioneering company in the autonomous vehicle (AV) space, Waymo was a subsidiary of Alphabet Inc. (Alphabet), a holding company and parent to Google.

Waymo had debuted several notable AV innovations, including fully autonomous driving software; a commercial ride-hailing service in metro Phoenix, Arizona; partnerships with well-respected car manufacturers like Daimler AG, Nissan-Renault, Jaguar Land Rover, and Volvo; and an autonomous trucking and last-mile delivery pilot service in test markets in three US states. All together, these varied initiatives put Waymo in a market-leading position in the race to automate driving.

As a graduate of Columbia Law School, Mawakana had senior leadership experience in regulated industries well before her tenure at Waymo. She had served in vice president of public policy and deputy general counsel roles at eBay, Yahoo!, and AOL. Her promotion to chief executive at Waymo was groundbreaking on several fronts; Mawakana became Waymo's first black and first female CEO. She was both a rising star and an outlier in Silicon Valley, where technology companies had struggled to increase diversity and representation at their highest ranks.

Mawakana assumed leadership of Waymo during a critical time. A series of recent crashes and fatalities involving Tesla's Autopilot system prompted US safety officials to conduct sweeping investigations into the AV industry. Meanwhile, the COVID-19 pandemic forced Waymo to suspend its burgeoning ride-hailing operations in Phoenix and to shift the whole company to remote work. Waymo also faced increasing competition from upstarts and established players across its vast footprint in AV software, services, and partnerships.

Mawakana had the experience to lead Waymo into a more regulated and more competitive future. But she faced a number of critical decisions that required resolution. Above all else, in which direction should Mawakana steer Waymo?

Company History

In 2005, Sebastian Thrun, director of Stanford University's Artificial Intelligence Laboratory, won a Grand Challenge from the Pentagon's Defense Advanced Research Projects Agency (DARPA) by successfully leading a team to deploy and navigate an AV through the Nevada desert. Thrun and his Stanford team were quickly recruited by Google to spearhead the technology giant's efforts to build a self-driving car within its secretive "moonshot" division, known as Google X. Two years later, Chris Urmson and a Carnegie Mellon team won the Grand Challenge, this time hosted in an urban setting in Southern California. The win highlighted the rapid progress of AVs in navigating increasingly complex environments. Urmson would lead Google X's self-driving-car project following Thrun's departure in 2014.

At Google, the self-driving-car project team focused on leveraging the company's proprietary technologies, such as Google Maps and Street View, to develop vehicles capable of navigating any terrain, traffic, routes, and weather without human intervention. In its first year, the team tested a fleet of adapted Toyota Prius cars outfitted with driverless kits in the San Francisco Bay Area. By 2012, Google announced that its self-driving-car project had logged more than 300,000 highway miles without any human assistance.[3]

In late 2015, Google recruited automotive-industry veteran John Krafcik as its newest project chief. A Stanford mechanical-engineering grad with an MBA from the MIT Sloan School of Management, Krafcik knew the car industry inside and out. He had completed stints at Ford, Hyundai, and TrueCar, a car price comparison website. That same year, Google completed the first fully autonomous ride on public

This public-sourced case was prepared by **Jack McDermott** (MBA/MEd '21) and **Michael Lenox**, **Tayloe Murphy** Professor of Business Administration. Although the data and protagonist are real, the situation is fictionalized, and Tekedra Mawakana's thoughts and actions in this case are either based on publicly available information or were created by the authors for pedagogical reasons. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation roads in Austin, Texas, garnering national media attention in the process because the supervising driver on board was blind.[4]

In 2016, Google's parent company, Alphabet, spun out its self-driving-car division to form Waymo as an independent, wholly owned subsidiary. The name represented a "new *way* forward for *mobility*." Waymo's mission was "to make it safe and easy for people and things to get where they're going."[5] The newly formed company had its sights set on moving anything to anywhere with full autonomy.

Waymo introduced its first commercial ride-hailing pilot in Phoenix in 2017. The city was selected for its dry and consistent weather, wide streets, gradual terrain, grid-like layout, and business-friendly regulations. Early beta users could request a ride from Waymo's mobile app, just like requesting an Uber or Lyft. A Chrysler Pacifica minivan would arrive using a fully autonomous driving system supervised by a "concierge" driver who sat in the front seat to monitor key safety systems and answer riders' questions. Waymo's ride-hailing service enabled its fleet to quickly test new algorithms under real-world conditions. The rides also helped Waymo in building public support for its autonomous endeavors, knowing that government officials were actively discussing how to regulate the novel industry.

In 2018, Waymo revealed an autonomous trucking project based in Atlanta, Georgia. The foray into commercial trucking brought together Waymo's existing autonomous driver system with additional support from Google Cloud's logistics technology to intelligently allocate loads and manage shipping routes. After the announcement, Morgan Stanley valued Waymo at $175 billion based on expectations that roughly $90 billion would come from the company's trucking and last-mile delivery services by 2040.[6]

Autonomous Vehicles

Often referred to as self-driving cars, AVs had advanced from science fiction to real-word use over several decades. Each successive development in automated driving systems—from adaptive cruise control to forward collision warnings—brought the auto industry closer to a future of fully autonomous vehicles. The question was no longer *if* AVs would occupy roads and highways, but *how*, *when*, and *who* would realize the full value of mass-market AVs.

By 2021, autonomous technologies were impacting consumers' lives in numerous ways, even if few people had taken a ride in an AV. Automated systems used advanced sensors and artificial intelligence (AI) to complete tasks like picking items from the shelves of an Amazon warehouse and assisting surgeons in procedures that required intricate movements. AVs were finding commercial applications in areas such as agricultural (autonomous tractors) and retail (small autonomous delivery vehicles).

As for automobiles, customer attitudes about car ownership and use were changing rapidly. A growing population of younger, more urban consumers were likely to say that mobility is more important than car ownership.[7] Technology-enabled ride-hailing services such as Uber and Lyft had grown into multi-billion-dollar businesses. In 2014, American commuters spent nearly seven billion hours in traffic. AVs held the potential to free up this time. AVs also promised to connect millions of Americans living with disabilities or those living in communities underserved by public transportation to improved mobility.[8]

AVs further promised to save lives and make roads safer for drivers, pedestrians, and cyclists. More than 35,000 lives were lost per year in the United States as a result of auto accidents, and 94% of serious car crashes were due to human error. While the number of vehicles on American roads had steadily increased in recent years, vehicle fatalities had either decreased or remained at consistent levels (Exhibit 1). Proponents of AVs believed they could lead to an accident-free world.[9] In 2020, Waymo reported only 21 driver "disengagements" where the driver felt it necessary to take control of the vehicle.[10] Last, advocates for combating climate change viewed AVs as an important driver of electric vehicle adoption and a step toward decarbonizing the transportation industry.[11]

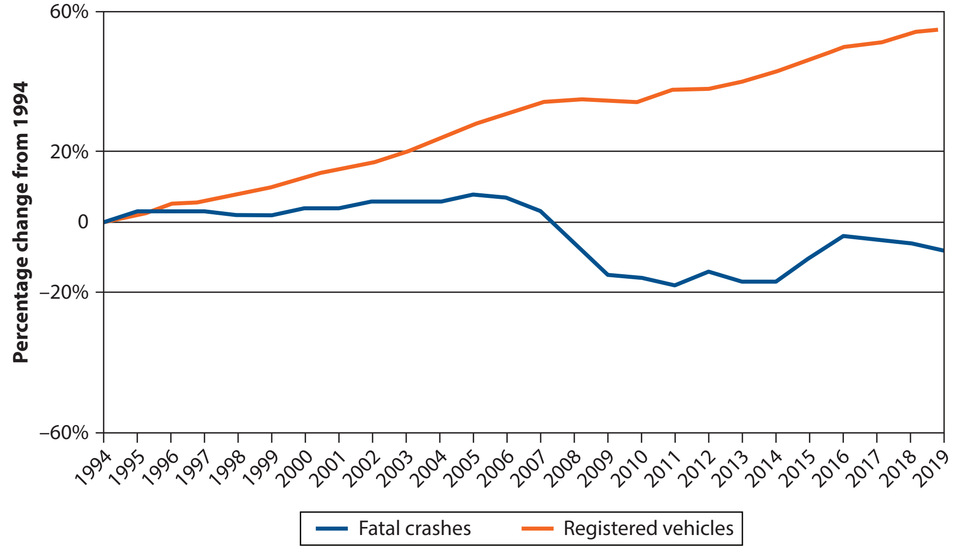
Yet critics raised concerns about the readiness of American streets and highway infrastructure to safely support AVs. Some critics warned against the use of personal and real-time location data used as inputs for AV algorithms. Others questioned whether AVs would *worsen* traffic delays, as people would adjust their behavior and increasingly opt for always-ready transit available with one tap. Some argued that AVs would contribute to increased inequality in access to modern transit and could promote urban sprawl and gentrification, as commuters moved ever farther away from city and town centers.[12]

Technology

Autonomous driving systems were categorized from Level 0 to Level 5 (Exhibit 2). Level 0 systems included common driver-assistance features like blind-spot detection and rear backup sensors, alerting drivers who remained in full control of the vehicle. Level 1 and 2 systems included driver-assistance features where the system could take control of steering, acceleration, and breaking. Such features were becoming more common on the road. McKinsey predicted that by 2030, 45% of new global car sales could reach Level 3, where the system was fully driving the vehicle, but a driver was still required to take control when prompted.[13] Waymo's technology placed its AVs at Level 4, where the car was fully autonomous and did not require a driver, but had safety features such as remote assistance and geofencing to limit operation. Level 5 represented fully "driverless" automation where an AV navigated and responded to changes in its driving environment without human intervention.

Autonomous driving systems used dozens of advanced sensors to enable the AV to steer, brake, and react to surrounding objects. Three core technologies allowed the system to form a three-dimensional model of a vehicle's driving

Exhibit 1 US Vehicle Fatalities (Indexed), 1994–2019



Data source: National Highway Traffic Safety Administration, "FARS Data Tables," https://www-fars.nhtsa.dot.gov/Main/index.aspx (accessed Dec. 6, 2021).

environment: cameras, lidar, and radar. Additional technologies, such as global positioning systems (GPS), microphones, gyroscopes, and inertial-measurement sensors offered further detail about the vehicle's environment.[14] With input from these sensors, AVs navigated their physical environments by continuously adjusting course, guided by AI and geospatial algorithms that had been trained on large data sets of real-world and simulated driving situations.

Vehicle cameras included high-definition, long-range, and peripheral lenses. At Waymo, AVs were equipped with

Exhibit 2 SEA International Levels of Driving Automation

	SAE LEVEL 0™	SAE LEVEL 1™	SAE LEVEL 2™	SAE LEVEL 3™	SAE LEVEL 4™	SAE LEVEL 5™
What does the human in the driver's seat have to do?	You are driving whenever these driver support features are engaged - even if your feet are off the pedals and you are not steering			You are not driving when these automated driving features are engaged - even if you are seated in "the driver's seat"		
	You must constantly supervise these support features; you must steer, brake or accelerate as needed to maintain safety			When the feature requests, you must drive	These automated driving features will not require you to take over driving	
	These are driver support features			These are automated driving features		
What do these features do?	These features are limited to providing warnings and momentary assistance	These features provide steering OR brake/ acceleration support to the driver	These features provide steering AND brake/ acceleration support to the driver	These features can drive the vehicle under limited conditions and will not operate unless all required conditions are met		This feature can drive the vehicle under all conditions
Example Features	• automatic emergency braking • blind spot warning • lane departure warning	• lane centering OR • adaptive cruise control	• lane centering AND • adaptive cruise control at the same time	• traffic jam chauffeur	• local driverless taxi • pedals/ steering wheel may or may not be installed	• same as level 4 but feature can drive everywhere in all conditions

Source: SAE International from SAE J3016 *Taxonomy and Definitions for Terms Related to Driving Automation Systems for On-Road Motor Vehicles* 021-April 30, 2021, https://saemobilus.sae.org/content/J3016_202104/; https://www.sae.org/binaries/content/assets/cm/content/blog/sae-j3016-visual-chart_5.3.21.pdf (accessed Dec. 23, 2021).

29 cameras integrated together to form a 360-degree view of the driving environment. Waymo reported that its cameras could see a stop sign from 500 meters away.[15] When autonomous driving systems detected an object, cameras collected image data so that computer vision algorithms could identify each object and direct the vehicle to respond as needed. Cameras also captured invaluable images that, when synced with internal computing data, could recreate any incident or driving scenario to continuously improve its machine-learning systems or to provide accident documentation. Cameras had several limitations, primarily their potential to be obstructed by common weather conditions like rain, fog, or snow.

To complement cameras, many AVs included "light detection and ranging" sensors, better known as lidar. Lidar was an advanced technology that used pulsed lasers to create three-dimensional models of real-world shapes and objects.[16] Developed by NASA in the 1990s, lidar was capable of sending millions of pulses per second to map nearby cars, people, and other objects during the day and in the dark of night. Lidar provided AVs with near and wide detection sensors, which let AVs sense their immediate proximity in tight urban parking spaces and to spot highway debris from 300 meters away.

Waymo unveiled its fifth-generation Waymo Driver system in 2020. It included four perimeter lidar sensors and a roof-mounted wide sensor to provide a 360-degree view around every vehicle. Tesla and its CEO, Elon Musk, were skeptical of lidar, criticizing its cost and its limited ability to differentiate between harmful and harmless objects. Lidar could sense an object obstructing the road but could not distinguish an air-filled balloon from a rock. Yet lidar was becoming increasingly common on AVs, as its cost decreased from approximately $75,000 per unit down to $7,500 in the years leading up to 2021.[17]

If cameras provided an image and lidar made out the shape of an object, radar gave AV algorithms a sense of an object's speed and direction. Radar could detect whether objects were moving, barely moving, or at rest in relation to an AV. Developed in the 1930s to detect ships, aircraft, and weather formations, radar transmitted radio waves that returned with precise velocity and location information even in poor-visibility settings where cameras could fail. As of 2021, radar systems could reach hundreds of meters ahead of a vehicle and could fit in compact devices mounted to a vehicle's body.[18]

To train AI algorithms for automated driving systems, developers used simulations to improve the accuracy and reliability of their automated driving models. Simulated environments provided millions of unique combinations of different streets, traffic, weather conditions, and external events—for example, a child chasing a ball into a road or a bicyclist slowly rolling through a stop sign—that would prove difficult for real-world sensors to experience with frequent occurrences. Testing on public roads often required human supervision, permits, hardware maintenance, and updates, all representing constraints not found in simulated environments. Simulations were widely used in other industries, such as aerospace and defense, that required extreme testing in highly unique physical settings.

At Waymo, engineering leaders chose to invest heavily in simulation to train Waymo Driver's AI. The company initially developed a proprietary simulation software, "CarCraft," followed by a more robust virtual environment, "Simulation-City," that gave Waymo's systems enough real-world fidelity to be valuable for AV perception and decision-making.[19] Whereas Waymo's vehicles logged just over 20 million miles on real-world streets by 2020, they simulated more than 15 billion miles by this time.[20] Waymo's simulations also benefited from access to Alphabet's leading technical infrastructure and teams of AI and machine-learning engineers.[21]

Regulation

Opening roads to AVs faced several regulatory hurdles. Pittsburgh, Pennsylvania, welcomed Uber's driverless car experiments in 2016. Only a year later, residents soured on Uber's presence, citing the few, if any, jobs created and increased fees for Uber's AV ride-hailing service, which had been pitched as "free" during initial public meetings.[22] Uber was also active in testing its self-driving capabilities in metro Phoenix. Pilot tests there resulted in the first recorded fatality involving a driverless vehicle in 2018, after an Uber car operating in self-driving mode struck and killed a 53-year-old woman who was crossing the street. An Uber safety driver was onboard at the time, but was watching television on her smartphone when the accident occurred.[23] Uber suspended its tests in Arizona and California following the fatal crash.

After these events, Waymo faced increasing reports of harassment for its AVs in Arizona, including having rocks thrown at the vehicles and several being chased and forced to turn off the road. One man was arrested after pointing a handgun at a test driver inside a Waymo Chrysler Pacifica minivan.[24]

The rise of AVs introduced a number of ethical concerns. If algorithms programmed by software developers could predict risks on the road, then how would AVs respond when faced with certain crash scenarios that threatened the lives of pedestrians and passengers? One Mercedes-Benz executive sparked controversy after suggesting in a 2016 *Car and Driver* magazine that the luxury automaker's AVs would always prioritize the lives of passengers first: "If you know you can save at least one person, at least save that one. Save the one in the car," Christopher von Hugo said. "If all you know for sure is that one death can be prevented, then that's your first priority."[25]

Also of concern was the loss of livery and truck-driving jobs. AV trucking upstarts raced to replace truck drivers with autonomous driving systems. Many experts predicted that fully driverless trucks would be the first AVs to experience mass adoption, perhaps by 2027.[26] Because of this, reports predicted that America's 3.5 million commercial truck drivers were at significant risk of economic displacement and total job loss. Trucking was the most common occupation in 29 US states.

By 2021, federal, state, and municipal agencies worked to balance innovation while establishing clear guidelines for public safety. The National Highway Traffic Safety Administration (NHTSA) attempted to formulate a guiding framework for the deployment of AVs, including updates to federal motor vehicle standards that required exemptions for companies testing on public roads.[27] Yet there was little agreement among agencies on these policies, as the National Transportation Safety Board (NTSB) openly criticized the NHTSA for its hands-off approach to safety following several of Tesla's high-speed-crash incidents.

Automakers and technology companies spent millions of dollars on government lobbying each year. In 2019, Waymo spent more than $600,000 lobbying in Washington.[28] Some states, most notably Arizona and California, acted quickly to spur innovation that accelerated companies' testing and access to public roads. Waymo launched its first ride-hailing pilot in Arizona after Governor Doug Doucey signed an executive order in 2015.[29] The order mandated that AVs follow all existing traffic laws observed by human drivers, but didn't establish new standards for the introduction of AVs in the years ahead.

By 2021, most states and federal agencies maintained a "wait and see" approach to granting open road access to AVs. Senators John Thune, Republican from South Dakota, and Gary Peters, Democrat of Michigan, cosponsored a 2017 bill that sought to set federal guidelines for AVs, ease limits for on-road testing, and allocate more than $100 billion in funding for American-made innovation in the AV space. Four years later, the bill had yet to advance beyond initial hearings and introductory floor votes in Congress. Senator Thune put the limited progress bluntly: "The U.S. regulatory framework has got to catch up with private sector innovation in order for these technologies to advance."[30]

Competition

In the AV space, start-ups and big tech companies challenged century-old auto companies from Detroit to Berlin to Tokyo. Companies formed partnerships with leading universities, such as Carnegie Mellon University's Transportation Research Center and Stanford University's Dynamic Design Lab. As Silicon Valley blitzed its way into the auto industry, traditional car manufacturers did not sit by idly. For most of the 2010s, major car manufacturers spun up self-driving divisions and actively invested in AV systems of their own. By 2021, Level 1 and Level 2 driver-assist features like adaptive cruise control, lane centering, and rear parking and blind-spot alerts came standard with most new luxury vehicles.

However, many auto manufacturers lacked the AI, software, and advanced sensor-hardware-development capabilities needed to compete in the race to Level 4 or Level 5 autonomy. Across the industry, traditional carmakers like Volvo, Nissan, and Jaguar initially invested in AV projects of their own, only to partner with Waymo or other technology companies as technical difficulties and costs mounted. Hyundai, Nissan, and Kia engaged in talks with Apple to partner on the design and production of an electric AV, yet a final deal was never reached.[31]

Many experts predicted that long-haul trucking, not ride-hailing or consumer automotive, would be the first sector disrupted by AVs. Class 8 tractor trailers often traveled hundreds of miles without making so much as a turn on interstate highways. With longer, straighter routes, freight lines and shippers could realize greater efficiencies and cost savings with autonomous trucks. McKinsey & Company estimated that autonomous trucking could cut operating costs 45%, resulting in annual savings of $85 billion to $125 billion for the US trucking industry.[32]

By 2021, AV trucking start-ups like Otto, Ike, TuSimple, and Embark descended on America's trucking market. TuSimple, a Chinese–American joint venture, became an early mover by partnering with UPS and the US Postal Service. Amazon chose Embark as its pilot partner to move goods between warehouses. Aurora inked partnerships with Volvo and Paccar, which combined to manufacture more than 50% of all class 8 trucks sold in the United States. Meanwhile, Waymo committed to adapting its Waymo Driver technology for the class-8 trucking market with Waymo Via. Daimler and Peterbilt Trucks both signed on with Waymo for pilots in Texas.[33]

Meanwhile, a number of companies were making significant investments to lead in the AV consumer automotive space. They included an interest mix of start-ups, established auto makers, and large technology companies.

GM Cruise

In March 2016, General Motors (GM) announced it had acquired Cruise, a self-driving-car start-up based in San Francisco. Cruise was Waymo's biggest competitor in the commercial AV space, and it formed the core of GM's AV division. Cruise had spent years developing AV kits that enabled self-driving capabilities on third-party cars. The company had successfully tested its AVs on millions of miles of public roads, including in its home cities of San Francisco and Detroit. By 2021, Cruise had logged more than 2 million miles driven in San Francisco, compared to only 83,000 by Waymo.[34] Beyond leveraging GM's assets, Cruise formed partnerships with top car manufacturers and tech companies, including Honda and Microsoft.

In January 2020, GM unveiled Cruise Origin, designed as an AV at Level 4 to Level 5 and intended for use in ride-hailing services. California regulators awarded Cruise the first permit for testing passenger rides *without* a safety driver on public streets in June 2021, allowing Cruise to begin pilot services in California at no charge to passengers.[35] Unlike Waymo's and Cruise's original kits that were built to retrofit traditional cars for self-driving uses, Cruise Origin was an all-electric, purpose-built AV that had no manual steering wheel for passengers. The vehicle's interior layout was designed as a shuttle to serve the fast-growing ride-hailing market. With a $5 billion line of credit from GM, Cruise announced its plans to mass produce Cruise Origin by 2023.

Tesla

Since 2008, Tesla had disrupted traditional car manufacturers with fully electric vehicles. Tesla's luxury cars included many advanced technological features, including an "Autopilot" mode. Autopilot represented Level 2 driver-assistance autonomy, still requiring human intervention. In 2021, Tesla delivered 185,000 vehicles in the first quarter—twice as many as the same quarter a year prior—which all came standard with Autopilot. Musk, Tesla's controversial cofounder and CEO, had announced the company's intention to have "full self-driving" (Level 5) cars on the road by the end of 2021.[36]

However, Tesla faced intense scrutiny after several fatal crashes during which its Autopilot system was activated. These crashes included an August 2019 incident where a 15-year-old boy was killed after a Tesla Model 3 sedan rear-ended the pickup truck he was traveling in on a California freeway. Data from the vehicle's computer indicated that neither the Autopilot system nor the driver slowed the car from 60 miles per hour until just before impact. The NHTSA had launched more than a dozen investigations into Tesla's Autopilot crashes by 2021.[37]

While Musk predicted that fully self-driving cars would be ready in 2021 and tweeted about the near-term possibilities of playing video games in a Tesla driven by Autopilot,[38] internal emails to California regulators revealed that Tesla was "firmly rooted" in Level 2 driver-assist autonomy in March 2021.[39]

Audi

Audi had developed Level 3 systems and tested its self-driving TTS Coupe over 12 miles of rugged terrain to the summit of Colorado's Pikes Peak as far back as 2010. By 2018, Audi sold the most advanced vehicle in mass production with Level 2 AV capabilities. The Audi A8 let drivers to go entirely hands free up to 37 miles per hour while the vehicle controlled itself.[40] Audi formed partnerships with Aurora, an AV software start-up founded by Chris Urmson—previously the director at Google X—and Nvidia, a Silicon Valley chipmaker. Audi had set its sights on innovating its own version of premium driverless cars.

Ford

Ford had made headway on AV development by hiring several former Google X employees and partnered with Chinese tech giant Baidu to incorporate its autonomous driving system in Ford vehicles.[41] Ford committed $1 billion over five years to accelerate its AV capabilities with Argo AI, an AV software developer that had more than 700 employers in the United States and Germany.[42] Ford also invested in Rivian, an electric vehicle company, and committed itself to delivering a purpose-built AV car in 2021. At the same time, Ford CEO Jim Hackett expressed doubt, saying the company had "overestimated the arrival of autonomous vehicles."[43]

Uber and Lyft

By 2021, the US ride-hailing market had grown into a duopoly. Uber and Lyft combined to own 99% of annual consumer spending on shared rides, and even as rideshare volume grew, both companies' losses mounted (Exhibit 3).[44] Both companies invested in AV technologies for several years, but reconsidered their respective courses of action in 2020 and 2021. The COVID-19 pandemic had decimated the ride-hailing industry: daily ridership levels had dropped 45% overall and as much as 70% to 90% in some cities. Reports found that business travel for ride-hailing would not be expected to return to pre-pandemic levels until 2023.[45]

Lyft exited from its AV-development efforts in April 2021 by selling a division appropriately-named "Level 5" to Toyota for $550 million in cash.[46] A year earlier, Uber had made a similar move, selling its AV technology to Aurora, a start-up founded by former Google X CTO Urmson. Exiting from AV research and development signaled that Uber and Lyft were content with waiting to leverage capabilities created by other firms. For now, Uber and Lyft focused on reaching profitability—both companies had yet to turn a profit by 2021—and regaining ridership following the pandemic.

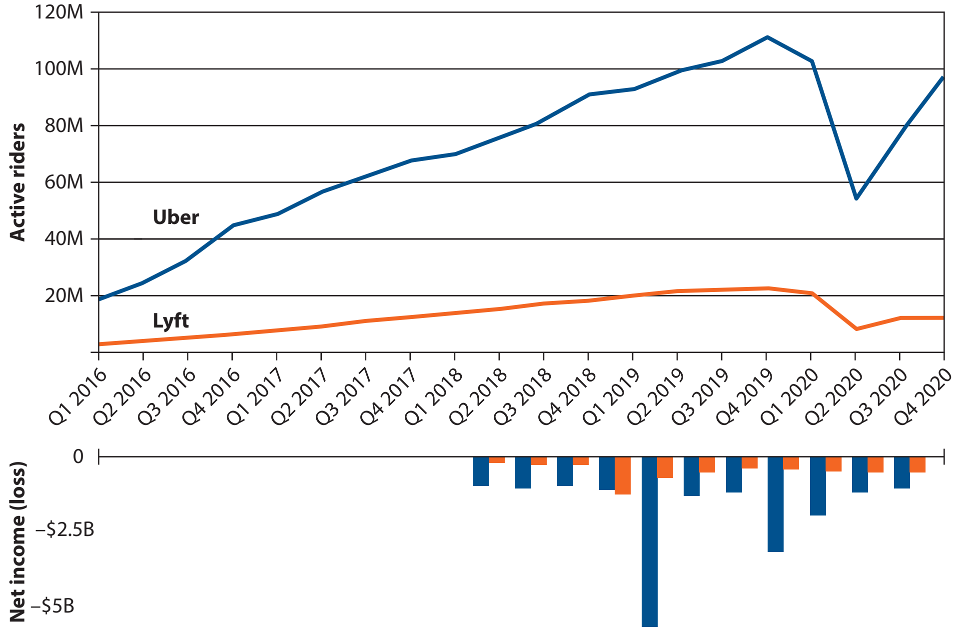
Amazon Zoox

In March 2019, Amazon appeared to unveil drones that delivered packages to customers' homes by air. A viral social media video showing a giant blimp deploying miniature drones into the air gained millions of views.[47] While the video proved to be fake—it had been created by a hobbyist animator—Amazon already held numerous patents for drone-based delivery services dating as far back as 2016.[48] The message was clear: Amazon was preparing to enter the AV race, and its services would soon be arriving at a doorstep near you.

Back on the ground, Amazon made headlines again in 2020 by acquiring Zoox, a Bay Area–based AV ride-hailing start-up).[49] Reports stated that Amazon paid approximately $1.2 billion to acquire Zoox, a lower price than expected for an AV company that had been valued at $3.2 billion in 2018.[50] The move represented Amazon's biggest foray into the AV space after years spent testing air-delivery drones and sidewalk-delivery bots, and investing in Aurora and partnering with Embark, the AV trucking company. At the time of acquisition, Zoox already held approval for testing its ride-hailing pilot service with a safety driver in major cities, including San Francisco and Las Vegas.

Unlike the Chrysler Pacifica minivans used by Waymo, Zoox built its AVs from the ground up by drawing design inspiration from a horse-drawn carriage. The futuristic-looking vehicles featured sliding glass doors, four-wheel steering that rotated to turn at any angle, and no definitive front or back. Four passengers could sit face-to-face as the vehicle traveled toward its destination in whichever direction was optimal.[51] Zoox vehicles were also fully electric, producing

Exhibit 3 Uber versus Lyft: Global Ridership and Net Income Data



Data sources: Brian Dean, "Lyft 2021 User and Revenue Stats," Backlinko, March 29, 2021, https://backlinko.com/lyft-users; Brian Dean, "Uber Statistics 2021: How Many People Ride with Uber?," Backlinko, March 23, 2021, https://backlinko.com/uber-users; "Lyft Net Income 2017–2021," Macrotrends, https://www.macrotrends.net/stocks/charts/LYFT/lyft/net-income; "Uber Technologies Net Income 2017–2021," Macrotrends, https://www.macrotrends.net/stocks/charts/UBER/uber-technologies/net-income (all accessed Dec. 6, 2021).

zero emissions while driving up to 16 continuous hours on a single battery charge.[52] Developing the AV software and vehicles themselves was a costly endeavor, but one that Amazon, with $21.3 billion in 2020 net income, was willing to embrace.[53]

Nuro

Nuro, an autonomous delivery start-up, was the first delivery service to receive a testing permit in California. Launched in 2016 by several former Google and Waymo engineers, Nuro joined Waymo and Cruise as the only companies permitted to test AVs on public roads at the time. While its small, windowless robots moved slowly, Nuro was quick to announce last-mile delivery pilots with FedEx and Domino's in Houston, Texas, and same-day grocery-delivery services with Kroger in Scottsdale, Arizona.[54]

Internationally, Chinese AV delivery services JD.com, Meituan, and Neolix received green lights for testing in pilot zones in Beijing.[55] These services featured a fleet of robotic minivans, like Nuro's, which navigated busy sidewalks and bike lanes on college campuses, in office parks, and around residential buildings. Through mobile apps, Chinese consumers could order items and request immediate delivery. Other vehicles behaved like mobile vending machines, letting consumers scan a QR code to purchase ice cream or snacks.

For years, the cost of delivery was prohibitively expensive for many local retailers and restaurants. The rise of AV delivery services like Nuro and Amazon "Prime Air"—the official name of Amazon's drone-based delivery service, which received federal approval for testing in August 2020—promised to move goods faster and cheaper than human couriers.[56] KPMG found that the cost for delivering small packages via AVs could be as little as 4 to 7 cents per mile. The report predicted by 2040 nearly one million delivery bots would be operating on US streets.[57]

Waymo Today

Waymo was organized into three core business lines: Waymo Driver, Waymo One, and Waymo Via. The company employed approximately 2,300 workers from its headquarters in Mountain View, California, to its field offices in Seattle, Austin, and Phoenix. Waymo had raised more than $6 billion in funding since March 2020—including $2.5 billion raised in June 2021—to maintain its three business units and continue forward on the road to a driverless future.[58]

Waymo Driver

Waymo Driver was the company's proprietary technology system, enabling autonomous mobility in partner vehicles. Waymo touted the system as the "World's Most Experienced Driver," a combination of hardware, software, and computing that combined to drive AVs.[59] Waymo Driver worked by equipping third-party vehicles, such as the Jaguar I-PACE crossover SUV or Chrysler Pacifica minivans, with specially designed hardware and sensors. The total cost of a vehicle outfitted with Waymo Driver was cited to be between $130,000 and $150,000 in 2021.[60]

Waymo Driver incorporated long-range and peripheral high-definition cameras, lidar sensors, GPS data, and radar. Taken together, these mounted devices provided real-time data that allowed Waymo's algorithms and computing systems to make instantaneous adjustments as to a vehicle's acceleration, breaking, and steering. Between 2009 and 2021, Waymo reported that its Waymo Driver technology had driven 20 million miles safely on public roads.[61]

Waymo One

Waymo One was the company's AV ride-hailing service, which was limited to operating in metro Phoenix. Since 2020, the service had been available through the Waymo app and was integrated with search results on Google Maps. Waymo One's fleet consisted of roughly 400 hybrid Chrysler Pacifica minivans, most of which were staffed by an onboard safety concierge. The ride-hailing service had yet to turn a profit.[62] Waymo signaled tentative plans to expand Waymo One's service into new cities such as San Francisco, but provided no specific timetable for its expansion.[63]

Waymo Via

Waymo Via was the company's autonomous trucking and delivery line for transporting goods. In 2019, Waymo announced it would pilot a version of the Waymo Driver technology adapted for class-8 tractor-trailer trucks and local delivery vans. Waymo initially launched trucking pilots between Google data centers in Atlanta before forging a partnership with J.B. Hunt in 2021. Jointly becoming North America's fifth-largest commercial trucking fleet, Waymo and J.B. Hunt ran tests on Interstate 45 shipping lanes across Texas. Trained safety operators remained on board for any necessary interventions and for docking once the vehicle arrived at each destination.[64]

Waymo Via announced its expansion with local delivery services. The company extended its partnership with Daimler AG to outfit Ram ProMaster vans for last-mile delivery services. Waymo also launched pilots to deliver UPS packages on existing Waymo One routes in Phoenix. Cruise followed with a strategic investment from Walmart, which included a delivery pilot of its own for Walmart goods in Scottsdale, Arizona. By 2021, Waymo, Cruise, and Nuro all ran AV delivery pilots within a few neighboring cities in and around Phoenix.[65]

The Autonomous Road Ahead

Since its earliest days as a secretive "moonshot" project within Google, Waymo was a leader in the increasingly crowded and competitive AV space. Many analysts predicted that Waymo could be eyeing an initial public offering (IPO) in 2022, but for now Mawakana had to drive the company toward a viable and defensible growth strategy. The company was a part of Alphabet's "Other Bets" division, which collectively lost more than $3.8 billion in 2020.[66]

Waymo's valuation once reached as high as $200 billion. After its most recent fundraising, this figure was reported to be closer to $30 billion in 2021. This 85% decline indicated that investors had cooled after years-long delays in go-to-market plans that were increasingly common in the AV space.[67] While Waymo was an early mover in AVs, the company's future remained unclear, with increased regulation, competition, and concerns of continued delays across its threefold business lines.

Tekedra Mawakana was now tasked with leading Waymo and its 2,300 employees on a pursuit that included a ride-hailing service, software development and partnerships, and trucking and last-mile delivery services. It was hard enough to get autonomous mobility right in one context, she thought, as Waymo continued pursuing research and development on AV technologies across several fronts.

Mawakana knew that the road to an autonomous driving future had taken longer—and cost far more—than most had expected. Analysts now predicted that companies pursuing AVs would be required to invest another $6 billion to $10 billion just to maintain pace over the next few years.[68] Mawakana recognized the need to fend off competitors and select strategic priorities intentionally if Waymo was to deliver financial returns to Alphabet and benefits to safer, more efficient transportation. It was time for Mawakana to steer Waymo on its own new way forward.

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Case 21

Wellington Brewery: Growth Decision in a Crowded Beer Market

In late June 2019, Brent Davies was considering various strategic options for the future of his company. Davies was the president of Wellington Brewery, a well-established craft brewery located in Guelph, Ontario, Canada. Wellington Brewery had recently completed a successful expansion of its operations. The expansion had taken place during a period of explosive growth in Canada's craft brewery industry. As part of the expansion project, the company had increased the size of its premises by 1,700 square metres (18,300 square feet). It had also upgraded its facilities with new state-of-the-art equipment for brewing, canning, and water treatment. The expansion process had successfully transitioned Wellington Brewery from a small company to a medium-sized operation. Within only a few years, the craft brewery's operations had expanded significantly.

Among its greatest assets, Wellington Brewery acknowledged its employees, cutting-edge equipment, and product quality and consistency. In fact, the brewery sought to create consistently handcrafted beer products with every batch, and never took shortcuts in the brewing process. The recently upgraded equipment significantly increased the company's efficiency in the beer-canning process and improved quality control of the product. These enhancements clearly supported Wellington Brewery's overall goal of expansion across the entire Ontario market. The brewery already performed exceptionally well locally. The next step was to continue expanding beyond its own community and throughout the province.

Wellington Brewery faced strong competition from other craft breweries in the province, but also from giant multinational "macrobreweries." However, the company boasted a competitive advantage over macrobreweries simply due to its smaller scale, which allowed the craft brewery to offer more expensive and exquisite ingredients in its beer, such as interesting fruits and carefully chosen additives, to brew a selection of unique-tasting, small-batch craft beers.

After completing its recent expansion project, Wellington Brewery faced the challenges of an unpredictable and oversaturated market. Ontario's craft brewery industry was characterized by unexpected growth, shifting consumer preferences, and intense competition for shelf space at limited retail outlets. Davies urgently needed to plan his company's continuing expansion and ensure that Wellington Brewery remained relevant and financially strong during challenging times.

Industry Background

The Beer Industry in Canada

In 2018, the global beer market was worth CA$895 billion[1] and was expected to continue growing.[2] Of the estimated 25,000–30,000 breweries around the world, most produced less than 1,000 hectolitres (hl) per year.[3] Beer was Canada's most popular alcoholic beverage. In 2018, Canadian beer sales reached $20.2 billion, and were forecasted to reach $22.1 billion by 2023.[4] The Canadian beer market was dominated by two multinational companies—Molson Coors Beverage Company and Labatt Brewing Company Limited (owned by Anheuser-Busch InBev). These two industry giants controlled 50 per cent of the Canadian market, while the myriad of much smaller craft breweries together accounted for only approximately a 9 per cent share. Between 2016 and 2018, Canada saw a 30 per cent increase in the launch of new breweries, reaching a total of 901 companies in the industry. Despite this increase, however, beer consumption in Canada remained relatively flat over the previous decade and dropped by 0.7 per cent during 2019.[5] This trend was attributed to various factors, including an increasingly health-conscious consumer base; lower drinking rates among younger customers; and growing cider, wine, and spirits industries.[6] Non-alcoholic beer also saw tremendous growth in 2018, with a 31 per cent growth in total volume.[7]

The beer industry was unpredictable for various reasons: consumption seasonality, explosive growth, changing consumer preferences (e.g., products being made sustainably), aggressive innovation from smaller breweries, and uncertain Canadian and provincial regulations. Until 2015, only the government-owned Liquor Control Board of Ontario (LCBO)[8] and The Beer Store (TBS) were authorized to sell alcoholic beverages. In 2019, TBS accounted for 63 per cent of total beer sales in the province, which was a decrease from 66 per cent in 2018. TBS traditionally sold mainstream beer brands, in packages of 24 bottles, whereas the LCBO offered over 28,000 alcoholic beverage products, including beer, in individual cans or small packs. The LCBO also acted as wholesaler to approximately 450 grocery stores in the province. In 2019, the LCBO's sales of beer, wine, and cider to grocery stores grew by 60.8 per cent for a total of $246.7 million. That same year, grocery store sales represented 80 per cent of its market share gain by volume. The LCBO's e-commerce channel was also steadily growing by 72 per cent year-over-year, reaching $19.5 million in 2019.[9] The price of alcohol was regulated and consistent throughout the province, regardless of the specific retailer.[10] The LCBO reported directly to Canada's Minister of Finance and provided $6.39 billion in revenue. In 2019, the LCBO transferred $2.37 billion in dividends to the Ontario Government.[11]

For convenience, beer distribution channels in Canada were classified into two categories: on-premises and off-premises. On-premises locations, which allowed consumers to drink beer directly, included bars and restaurants. Off-premises locations, which allowed consumers to purchase beer but not to directly consume it, included the LCBO, TBS, grocery stores, and e-commerce outlets. In 2018, the LCBO and TBS were the most popular off-premises beer distribution channels, generating $5.0 billion in sales. On-premises locations such as bars and restaurants generated $9.0 billion in beer sales.[12]

Craft Beer

The craft brewing industry, a sub-sector of the overall beer industry, offered premium beverage products. From 2014 to 2018, the Canadian craft beer industry experienced significant growth, almost doubling in revenue from $1.0 billion to $1.9 billion.[13] Although a comprehensive definition for the terms "craft brewery" or "microbrewery" was not officially established, microbreweries were understood to represent companies that produced less than 50,000 hl annually.[14] The federal government typically licensed craft breweries that produced 400,000 hl or less per year and were independently owned and operated.[15] For example, Brick Brewing Co. Limited (renamed Waterloo Brewing Ltd. in 2019) in Kitchener, Ontario, was a certified craft brewery.[16] Most craft breweries in Canada produced 5,000 hl or less per year.[17] Companies that produced over 400,000 hl, such as the two multinational beer companies that dominated Canada's beer industry, were categorized as "macrobreweries." In contrast, the Canadian craft brewing industry was highly fragmented, with hundreds of small breweries typically focused on serving local communities, although some of the larger craft breweries catered to the entire province. Ontario was home to 315 breweries, but only two-thirds of them sold their beer in retail outlets such as the LCBO, TBS, or grocery stores.[18]

Craft beer consumers, whose tastes changed rapidly, were mainly interested in the experience, locality, and the variety of products that craft breweries offered. In contrast to macrobrewery customers, these consumers also tended to have less brand loyalty and to prefer ale to lager.[19] Sales of ale, the most consumed craft beer, grew from $905.2 million in 2014 to $1.7 billion in 2018.[20] Emerging and alternative trends in the industry included canned nitrogenated beer[21] and non-alcoholic beer.

Despite environmental uncertainty and regulatory constraints affecting the entire industry, the Canadian craft beer industry continued to grow. Reasons for growth included changing demographics, consumer preferences for unique products and new experiences, and overall support from vital retail partners.[22] Specifically in Canada, the growth of the craft beer industry was influenced by the country's generally favourable demographic, social, political, economic, and environmental characteristics (see Exhibit 1).

Exhibit 1 Doing Business in Canada

Canada was a North American country that shared its southern border with the United States. The country's demographics were diverse. In 2019, it had a population of over 37 million people, of which almost 90 per cent were either immigrants or descendants of immigrants. Canada's population included over 100 indigenous tribes comprising approximately 250,000 indigenous Canadians. Canada was democratic country with a parliamentary system in a constitutional monarchy. As Canada was a member of the British Commonwealth, its reigning monarch was Queen Elizabeth II, although her role in terms of Canada was limited. Canada was organized as a federation, with 10 provinces and three territories, and three government levels: federal, provincial or territorial, and municipal. Canada had maintained strong political stability and was considered one of the safest countries in the world.

Canada was a good place to do business. It featured a growing global trade network that provided Canadians with access to global market opportunities. Specifically, Canada had 14 free trade agreements in place with 51 countries, giving it preferential access to international markets. The Liberal Party of Canada, led by Prime Minister Justin Trudeau, had been in power since October 2015, during which time several major regulatory laws and changes had taken place that impacted the food and beverages industry. Specific to the beer industry, policies governing alcohol availability were set and enforced by provincial liquor control or licensing boards. In all jurisdictions except the province of Alberta, these same provincial boards were responsible for the sale of alcohol through their own network of retail stores. Regulations regarding the sales of beer had been revised to allow beer sales in grocery stores and convenience stores in Ontario, starting in late 2015. Alcohol sale regulations varied widely across all Canadian provinces and territories, with Ontario having the most complex system. Therefore, doing business in multiple jurisdictions was usually limited to larger businesses and smaller craft breweries tended to sell their products only within their own province.

(*Continued*)

Exhibit 1 (cont.) Uber Core Values, as Written by Travis Kalanick, 2010

Canada was one of the top trading nations in the world. Canada's gross domestic product was expected to increase by 1.8 per cent in 2020 and 1.9 per cent in 2021, consisting of only minor improvements from the 2019 gain of 1.7 per cent. Healthy labour markets and modest increases in consumer spending were likely to benefit Canada's economy.

Labour laws and regulatory changes continued to have an impact on Canada's workforce. The government intended to modernize federal labour standards to benefit Canadian workers and assist employers. Existing and upcoming changes included improving eligibility for entitlements, helping with work–life balance, providing fair treatment and compensation for unpredictable (e.g., short-term, contract, seasonal) work, ensuring sufficient notice and compensation when jobs are terminated, and improving the administration of labour standards.

Business investments in Canada had trended downward in recent years, and Canada's trade sector would continue to be impacted by minimal global growth. In contrast, interest rates were not expected to change in 2020, as global economic conditions stabilized.

As one of Canada's key provinces, Ontario produced 37 per cent of the national gross domestic product and featured distinctive exports, manufacturing expertise, resources, and innovation trends. Ontario was known for its manufacturing industries, including medical devices, biotechnology, pharmaceuticals, and information and communications technologies. Additionally, the province was home to more than half of Canada's best farmland. It featured more than 50,000 farms that produced almost 25 per cent of all farm revenue in Canada.

Many of Canada's manufacturing sectors were shifting toward Industry 4.0 digitalization, automation, and data exchange in manufacturing technologies and business systems to drive innovation. It was becoming increasingly affordable for companies to make the digital shift, as consumers become more technology-savvy than ever.

Canadians were increasingly relying on mobile devices for everyday living—especially shopping. Increasingly, consumers relied on mobile payments, navigating the Internet on a smart phone, and numerous other mobile platform services. Software-as-a-service technology and data warehouse management solutions provided companies with new sources of data and analysis for higher efficiency and trend monitoring. Artificial intelligence and data analytics were key drivers of digital transformation and automation for businesses, both internally and throughout the supply chain.

Several cultural trends were likely to impact future Canadian businesses. First, millennials (people born between 1980 to 2000) were at the forefront of the consumer revolution and were often characterized as being frugal, shrewd, and lacking in brand loyalty. They were most likely to use smart phones, social networking, and online shopping. Increasingly, Canadians were seeking personalized and immediate interaction with instant access to information and goods, such as Amazon.com Inc.'s promise of next-day delivery on many of its products. Canadians were also exercising more, consuming more natural and organic products, and choosing products based on dietary restrictions.

Canada was North America's largest country by area, with vast natural open spaces. Despite some environmental concerns such as pollution of natural regions and rapidly changing weather patterns, numerous tourists chose Canada for its natural landscape and scenery. Climate change, clean fuels, carbon tax strategy, air quality, environmental testing, and renewable energy developments were among its environmental concerns. Businesses in Canada increasingly sought green options to become more environmentally sustainable with initiatives such as reducing single-use plastics, improved waste diversion, sustainable food initiatives, use of nuclear power, and electric transportation.

Source: e-Visa, "General Information about Canada," e-Visa.ie, accessed July 14, 2020, https://e-visa.ie/canada/general; Government of Canada, "Spotlight on Market Diversification," November 20, 2019, accessed July 13, 2020, www.tradecommissioner.gc.ca/guides/spotlight-pleins_feux/spotlight-diversification-pleins-feux-diversification.aspx?lang=eng&utm_source=business&utm_medium=slideshow-en; Government of Canada, "Prime Minister Justin Trudeau," June 9, 2013, accessed October 20, 2020, https://pm.gc.ca/en/prime-minister-justin-trudeau; "Beer Sales Guide to the Provinces and Territories," CBC News, April 16, 2015, accessed December 15, 2020, www.cbc.ca/news/business/beer-sales-guide-to-the-provinces-and-territories-1.3036387; Conference Board of Canada, "Canadian Outlook Summary: Winter 2020," December 17, 2019, accessed July 14, 2020, www.conferenceboard.ca/e-library/abstract.aspx?did=10543; Government of Canada, Employment and Social Development Canada, "Labour Program: Changes to the Canada Labour Code and Other Acts to Better Protect Workplaces," November 7, 2018, accessed July 17, 2020, www.canada.ca/en/employment-social-development/programs/laws-regulations/labour/current-future-legislative.html; Government of Ontario, "About Ontario," June 5, 2013, accessed July 14, 2020, www.ontario.ca/page/about-ontario; Tetra Pak, *INDUSTRY 4.0—Opening a Door to New Opportunities for the Food and Beverage Industry*, 3, accessed January 3, 29021, www.tetrapak.com/content/dam/tetrapak/publicweb/us/en/automation/tetra-pak-industry4-whitepaper.pdf; PwC, *Industry 4.0: Building the Digital Enterprise, Industrial Manufacturing Key Findings*, 5, accessed January 3, 2021, www.pwc.com/gx/en/industries/industrial-manufacturing/publications/assets/pwc-building-digital-enterprise.pdf; Business Development Bank of Canada, "5 Consumer Trends that Will Transform Your Business," 2017, accessed July 14, 2020, www.bdc.ca/en/articles-tools/marketing-sales-export/marketing/pages/5-consumer-trends-watch-out-for-2017.aspx; ECO Canada, "Environmental Trends 2020," blog, January 31, 2020, accessed July 16, 2020, www.eco.ca/blog/environmental-trends-2020.

Brent Davies, Wellington Brewery's President

Wellington Brewery earned $10 million in revenues in 2019.[23] It was one of Canada's oldest and largest independently owned craft breweries.[24] The brewery was initially known for its darker craft beers, which were offered throughout Canada's most populated province, Ontario. Davies started working at Wellington Brewery in 1995 but left the company in 2000 to pursue a career in the chemical industry. However, in 2010, Davies returned to Wellington Brewery as partner and vice-president, with responsibilities in the company's sales and marketing divisions. In 2016, Davies was appointed president. At the time, he owned 60 per cent of the brewery and held 90 per cent voting rights. The remaining control of the company was spread among small investors with limited voting rights.

In addition to his close affinity with the business, Davies had a passion for beer and a deep understanding of consumer choices. During his interactions with customers at the LCBO stores, he would often ask people why they chose a specific product. He was proud of Wellington Brewery's award-winning beers and sought to expand people's palette with high-quality tasting products. As the brewery expanded, Davies knew that upcoming decisions were critical. He believed that any decisions about the business strategy and long-term vision would need to respect, yet help evolve, the company's culture.

Company Background

Wellington Brewery's expansion in 2015–16 increased the organization's annual brewing capacity from 24,000 hl to 80,000 hl. In addition to state-of-the-art brewing equipment upgrades, the company purchased a second building to make room for offices and inventory, a new canning line to increase efficiency, and an enterprise resource planning (ERP) system. The company also installed a complete water treatment system to improve the longevity of the equipment and to reduce water usage and waste.

As of 2019, the brewery employed 45 staff, including full-time and part-time positions, depending on the seasonality of the business. Wellington Brewery's respect and pride in its employees was reflected by the company's impressive retention rate. For example, the brewery's vice-presidents of finance, sales, and brewing had been with the company for an average of 16 years. Its experienced staff helped Wellington Brewery master the challenging product submission process through the LCBO, as Davies explained:

> Because we've been around so long, we know the process to plan timing-wise. We got it so our last couple brands—our product launches—we were early to market and we had things well in advance to LCBO. We got approvals through, and we got it out there.

Long-tenured employees contributed to corporate memory, provided stability within the business, facilitated creativity, and readily provided their expertise. However, Davies was aware that long-time employees could also be more resistant to change and more heavily relied upon, rather than establishing more automated processes. Wellington Brewery's top management team described the company culture as "very family and community-oriented." This type of culture worked well as long as the company remained relatively small. However, with the expansion of the brewery and additional staff added to the team, Davies acknowledged the need for a more balanced approach between focusing on maintaining a "family" feel and integrating more structured roles into the business. Davies noted that "when you're small, everybody's doing everything. But now, the thing is, you can't. You can't do everything. You can't have those pressures all the time."

Some members of the top management team were responsible for multiple managerial roles, which reduced their ability to take on additional tasks or projects. The brewery had to start implementing its new inventory management system, but it was difficult to find the right time and the right person to manage the project, which incurred delays. That person would likely to be selected from among the busiest people in the company. Stress and confusion arose in reporting lines due to multiple roles held by some employees. Davies felt that a revised organizational structure was needed to support growth plans, formalize processes, clarify roles and responsibilities, and reduce employee workload.

Community

The community was a crucial element of the craft brewing industry. Craft beers were locally handcrafted, authentic products. Wellington Brewery maintained its connection to the community through engagements in local events, charitable work, and donations to local causes. Davies felt that "those decisions kind of become stand-in for a lot of things I think are really important, and in broader relationship building." Some initiatives included collaborations with local organizations, such as donations to Pride support groups based on the sale of a specific beer brand or hiring local artists to design beer coasters. Despite its goal to expand across the entire province, Wellington Brewery was eager to retain the local brand feel and connections it had established within its community.

A craft brewery's community was dependent on location, size, and strategy. Some regions and communities were more receptive than others to craft beer. In fact, the number of Canadian beer drinkers that consumed craft products ranged widely from 26 per cent to 50 per cent of the population, depending on the geographical location.[25] Therefore, craft breweries needed to decide whether to focus their efforts on competing in a popular craft beer market or instead tap into a smaller market and build up the brand by educating new craft beer consumers. In Ontario's highly competitive Toronto market, for example, a craft brewery's community could vary from the entire city, to a geographical portion such as east Toronto or the downtown core, or even a specific neighbourhood such as The Danforth or Etobicoke. A brewery could focus on specific stores within a small area to sell its products to a targeted consumer group. Alternatively, it could instead cater to a much broader range of consumers. For example, Waterloo Brewing Ltd. chose to expand its market share by acquiring province-wide distribution rights for several major beer brands including Laker, Seagram Coolers, and LandShark.[26]

Smaller breweries looking for growth needed to be more creative due to their limited access to capital. An alternative to acquisition was to develop long-term sustainable relationships with retailers outside the community. To achieve this, craft breweries could leverage their existing connections with local LCBO stores and licensees to help them expand. Other options included sponsoring events and sports teams outside their city and developing innovative methods for bringing people from outside the community to the brewery.

The craft brewery industry was generally collaborative. Companies often relied on each other during times of need and shared their knowledge at professional events. These practices helped produce resourceful teams and promoted rapid pivoting when information was needed. For example, when Wellington Brewery's equipment was experiencing rapid degradation due to the city's hard water, the company's vice-president of brewing and another employee leveraged their expertise to build a network of contacts who worked in wastewater management and water treatment services. Using this knowledge, the company was able to assess the problem and procure a new water system. One employee outlined his experience:

> It all ties back into [the fact that] we always try to get people out in the community to try and learn to make better beers. The [brewery] would put me out in trade shows to connect with people and network. So, if any of these things come up, I know who to contact.

Product Focus

Wellington Brewery was customarily known as an English-style craft brewery, with ale as its featured beer type. In the past several years, its product line focused on three core brands and an assortment of experimental small-batch and seasonal beers. The company's high-volume production brands—a traditional ale, an India pale ale, and a lager—were aimed at a wide consumer base and required different brewing strategies than its low-volume production brands, which were usually experimental beers aimed at consumers seeking a novel beer-drinking experience. Therefore, the two different product lines required the company to attract two different customer segments, which also divided Wellington Brewery staff members.

A senior executive felt that staff members were conflicted between "putting out products that sell versus products that are innovative." Davies agreed that producing award-winning experimental beers would build "street cred" (short for "street credibility" or acceptability among fashionable beer consumers) and thus draw more customers to the brewery. However, he also recognized that although lager was not Wellington Brewery's choice of beer type, it represented the largest beer market segment and could be an important source of revenue for the company. Because traditional ale products had always been associated with Wellington Brewery's identity, adding a lager to the product mix would require a significant shift in business culture.

Competitors

Wellington Brewery viewed the two international macrobreweries, Molson Coors Beverage Company and Anheuser-Busch InBev, as major competitors in Canada's overall brewing industry. Wellington Brewery's mainstream beers were intended to increase sales and faced direct competition for shelf space from the two brewery giants. However, over the previous three years, the overall craft brewery segment had helped flatten Canadian sales volumes of the two multinational breweries, which reflected a consumer trend away from traditional beer consumption.[27]

Wellington Brewery saw all other craft breweries as collaborators, but it nonetheless competed against local and nearby craft breweries. For example, Guelph's innovative small-batch craft brewery was home to Royal City Brewery and Fixed Gear Brewing, while in nearby Waterloo, the mid-sized multi-branded brewery Waterloo Brewing Ltd. had earned annual revenue of $53.7 million in 2019.[28] Guelph was also home to Sleeman Breweries (owned by Sapporo Breweries), a large traditional brewery that sold both domestic and imported beer products.

The Production of Beer

Beer had been produced in Canada since 1646. Key ingredients in the production of beer included malts (i.e., converted grains, often barley), hops (i.e., flowers of the hop plant), and yeast. Specific temperatures and times depended on the beer's recipe. Yeasts were re-added throughout the process to produce sugars, some of which transformed into alcohol.[29] The company's brewmaster would create recipes for traditional beer (e.g., lager or ale) or experimental beer (e.g., sour fruit beer) by using a variety of additives and customizations. Compared with both smaller craft breweries and larger traditional breweries, Wellington Brewery's advantage was its ability to produce large amounts of experimental beer, although some ingredients and additives proved challenging to scale for high volumes.

The addition of new canning and brewing equipment enabled Wellington Brewery to significantly increase its efficiency. The company went from producing 20 hl per large batch in six hours to 40 hl per large batch in only two and a half hours. The new equipment also helped increase malt-processing efficiency and reduce water waste. Brewed beer sat in tanks for approximately two to four weeks until it was ready for packaging. In recent years, cans had become the predominant packaging choice over glass bottles. The shift to cans provided a more environmental option and resulted in a better-tasting product. Cans could block ultraviolet light more effectively than bottles, which helped limit product spoilage.[30]

Wellington Brewery employed a pilot system to experiment with different combinations of ingredients. Its low-volume capability allowed the company to produce single products, or "one-offs," and later scale up to large volumes. Wellington Brewery was thus able to quickly react to consumer trends and release new products each week in the company's brewhouse. These frequent releases provided an opportunity to experiment, gauge customer reactions, and collect customer preference data at a relatively low cost.

Impact of Regulatory Changes

Both provincial and federal governments regulated the sale of alcohol in Ontario. An annual excise tax was based on the beer's alcohol percentage and production volume.[31] In 2018 and 2019, Canada's alcoholic beverage industry faced various challenges, and some opportunities, due to legislation changes. Legalization of cannabis in Canada went into effect in October 2018, and cannabis-infused beverages were allowed to be sold starting in December 2019.[32] These legislative initiatives provided opportunities for craft breweries to enter the new cannabis-infused beverage market. In addition, the sale of beer in grocery stores, which had started in December 2015,[33] had reached an Ontario government goal of enabling 450 grocery stores in the province to sell beer. This new market segment provided access to a new retail option for many breweries across Ontario.[34] In 2016, the sale of alcohol was made available by mail directly to consumers,[35] which opened a new opportunity for many breweries to set up an e-commerce platform. Discussions had also begun on the topic of making the sale of alcohol available in Ontario's numerous convenience stores, although no decisions had yet been made on this potential new distribution outlet.

Wellington Brewery's management team had not yet expressed an interest in the cannabis-infused beverage market. However, grocery store sales provided high margins, and e-commerce was an especially promising sales vehicle for the upcoming Christmas holiday season, so the company decided to enter both of these markets. Discussions by Ontario's regulators on the prospect of allowing beer sales in the province's convenience stores were still in early stages and remained unpredictable. Wellington Brewery was also licensed for the sale of cider, but had yet to decide whether or not to diversify into this segment, which could be an important consideration if a drop in beer sales occurred. However, the company was comfortable remaining focused on beer production at this stage. As Davies noted, the company had "historically done beer very well and still [saw] lots of room to grow."

Wellington Brewery's Sales Mix and Distribution

Wellington Brewery generated revenues from both on-premises sales channels, such as the company's onsite brewhouse or licensees (e.g., bars and restaurants), and off-premises sales channels, such as retailers. The brewhouse was the company's most profitable revenue source but represented only a small portion of total revenues, whereas off-premises retailer sales channels such as the LCBO and e-commerce, generated greater revenue amounts that were fundamental to the company's growth. Another important revenue channel was contract brewing, which referred to Wellington Brewery offering its brewing premises and expertise to other breweries that did not have their own facilities. The breakdown of Wellington Brewery's sales mix consisted of approximately 25 per cent LCBO, 30 per cent licensees, 25 per cent contract brewing, 10 per cent TBS, and 10 per cent brewhouse revenue.

Although macrobreweries typically sold their product in standard cases of 24 beers through TBS, craft brewery sales consisted mainly of low-number packs or single-unit sales. Therefore, the craft brewery segment's relationship with TBS was increasingly becoming insignificant. In contrast, the craft brewery segment's relationship with the LCBO, licensees, contract brewing, and e-commerce was critical (see Exhibit 2).

The LCBO

The LCBO dominated retail distribution in Ontario. Getting a product onto the retailer's shelves was challenging for craft breweries. The LCBO used a web-based product submission process called the New Item Submission System (NISS).[36] This process required a new product to pass through a series of stages, ranging from setting price parameters to product tasting, which lasted at least six weeks. Several factors affected a craft brewery's ability to be accepted and remain active in the LCBO stores. After a product was accepted, its shelf space was reviewed weekly. The LCBO preferred stocking beer products in cans of 473 millilitres and required a minimum of 20 litres of the product to be sold in each store within a specific period. Each year, a random sample from every product listed on the LCBO was sent to its quality assurance department for analysis of alcohol content and packaging.[37] If a product's alcohol content was found to be over its advertised level by as little as 0.5 per cent, the entire listing could be removed from the shelves. Therefore, Wellington Brewery made consistency a critical aspect of its business.

Before completing the NISS process, a craft brewery needed to establish a relationship with LCBO's head office and individual store managers. Dedicated brewery sales teams participated in ongoing relationship-building efforts and presented their new products. This process was labour-intensive and competitive. Shelf space at the LCBO stores was limited, and macrobreweries occupied a considerable amount of the available space. Davies was aware that new-product applications to the LCBO were required for both core and seasonal brands. The LCBO maintained an updated product-need item list through the NISS to guide new-product submissions.[38] As Davies explained, "the better a product's performance ratio, the better chance it had at getting a subsequent product in, or in scoring a seasonal listing."

Wellington Brewery modified its tactics over time to maintain a positive relationship with the LCBO. For example, the company decided to adopt the LCBO's preferred format of 473-millilitre cans for its beer. As well, the company used its own distribution service, rather than a third party, to better leverage opportunities to build rapport and connections with buyers. Among other strategies, Wellington Brewery offered tasting notes and comparable products to the LCBO store managers and ensured quality and consistency through lab testing before submission of its products. The LCBO also offered companies monthly in-store marketing opportunities, such as product sampling services and end-of-aisle

Exhibit 2 Wellington Brewery's Sales Channels

Criteria	The LCBO	Licensees	E-commerce	The Beer Store	On-Site (Brewhouse)	Contract Brewing
Description	Government-regulated retail outlets offering wine, beer, and spirits	Restaurants and bars	Online distribution	Government-regulated retail outlets offering beer	Selling at own brick-and-mortar store	Producing beer for other companies
Market potential	Provincial	Provincial	Provincial	Provincial	Local	N/A
Percentage of revenues	25%	30%	Negligible	10%	10%	25%
Profit margin	High	Low	Low	High	High	Medium
Ease of access to market	Difficult	Difficult	Easy	Difficult	Easy	Medium
Customer insights	DigThisData online platform analytics	Delivery and sales representatives	Shopify online platform analytics	DigThisData online platform analytics	Personal contact and TouchBistro point-of-sale system	N/A
Brand recognition	High	High	Low	Medium	Medium	None
Dedicated sales team	Yes	Yes	N/A	Yes	N/A	N/A
Opportunities for growth	High	Medium	Low	Low	Low	Low

Note: N/A = not applicable.
Source: Company files.

placement. However, the cost of these promotions was usually too high for craft breweries such as Wellington Brewery, and was therefore used mainly by macrobreweries.

Licensees

According to Davies, retail sales channels tended to provide higher margins for the brewery than licensee sales channels, such as bars and restaurants. However, licensees also served a critical purpose of promoting a local presence and collecting valuable information about consumer trends, product sales, and competitors. Therefore, Wellington Brewery opted for a relatively high portion of its product distribution through licensees, compared with most of its competitors. Its sales mix was set at approximately 60 per cent retail and 40 per cent licensees, compared with the sales mix of most competitors at 80 per cent retail and 20 per cent licensees.

However, securing permanent beer brand placement on-tap at a licensee, such as a bar or restaurant, was becoming increasingly difficult. As Davies explained, macrobreweries tended to offer financial incentives to licensees to gain on-tap brand placement, which craft breweries were unable to afford. As well, with licensees frequently rotating their beer taps and adding new product lines, the required amount of beer from each brewery could drop significantly. Therefore, although Davies delivered beer kegs to licensees in person to build connections and gather information, he was also working diligently to grow Wellington Brewery's retail presence, especially through the LCBO. The aim was to gradually reduce the company's dependence on licensees and contract brewing. To achieve this goal, the business needed to find ways to make its core brands self-sustainable by generating consistent and long-term revenue through higher-margin retail channels, while reducing reliance on lower-margin revenue streams.

Contract Brewing

Contract brewing provided a crucial revenue source for many breweries, despite its low margins. Wellington Brewery provided its production facility and expertise, at a cost, to breweries that did not have their own brewing premises, which helped counter lower-than-expected sales of its own product. However, contract brewing did introduce various challenges. The process was labour-intensive and tended to require extensive mentoring, especially for less established contract breweries. There was also a potential impact on Wellington Brewery's financial situation if a contract brewery was unable to pay for the services rendered.

From a list of up to eight contract brewery prospects, Wellington Brewery narrowed its focus on only a couple of well-paying partners, which provided both significant benefits and potential risks. For example, despite a favourable working relationship with one major contract partner, Wellington Brewery suffered a revenue shortfall when the contract brewery's production was unexpectedly reduced to 60 per cent of its 2019 forecast, as a Wellington Brewery senior executive explained:

> We were actually able to negotiate a really good rate. Because they are so big, their beer is cheaper to make per litre than some of our other contracts in the past, and we actually didn't have to eat too much on the margin to get this huge sum of volume. The problem is, it leaves us very much exposed. [If] they don't get their forecast right, it has huge implications for your financial forecasting, and that's basically what happened.

E-Commerce

The introduction of e-commerce as a new off-premises retail option was both beneficial and challenging for craft breweries. Difficulties included regulated mandatory shipping through Canada Post, standard shipping fees added to orders (as opposed to being built into the selling price), the cost of packaging, and the labour-intensive processing of online orders, which required different packaging and shipping processes than the company's usual format. Wellington Brewery initially chose to use Shopify Inc. (Shopify) as its e-commerce platform and engaged in benchmark research to generate ideas for the packaging, processing, and shipping of beer. The brewery was still looking for ways to improve the end consumer's online ordering experience when customers purchased Wellington Brewery products. For example, through Shopify's data analytics services, Wellington Brewery identified a recurring issue with dropped online shopping carts during the checkout phase. The company assessed the problem and addressed the issue by finding a mutually beneficial revenue and costs solution involving shipping and processing fees, which was passed onto the consumer.

Manual Processes and Insights From Data

Wellington Brewery conducted various manual processes to support routine tasks and operations. The manual processes included tracking inventory on paper and then physically verifying the amounts, forecasting sales using Microsoft Excel, recording licensee payments using Excel and telephone calls, recording production amounts on paper and in Excel, and extracting sales data from the brewhouse point-of-sales system (TouchBistro) and inputting it into Excel. Wellington Brewery deemed these manual processes suitable and efficient because new beer recipes were frequently created and modified, which was convenient for its current legacy systems to create in-depth reports. Additionally, manual processes enabled interaction and promoted data analysis. However, with the organization's expansion and growth, automated processes would inevitably become critical to improve overall efficiency.

Davies was hoping to improve the manual processes by leveraging digital technology to increase efficiency, save time, and produce additional data. In recent years, Wellington Brewery had started using data for sales-based tracking and to identify comparable products for submission to the LCBO. For example, the company was using the DigThisData platform, a business software-as-a-service application for alcohol vendors, to regularly monitor LCBO and TBS data. The software provided performance, competition, and product data with a two-week delay. Wellington Brewery used the data to better position its products and improve sales forecasting. Wellington Brewery also used Ekos, an ERP system designed for the craft brewery industry that involved complex implementation and time-consuming project management. However, Davies was not sure the Ekos ERP system was the most suitable choice for the company's needs.

Marketing Data

Wellington Brewery collected marketing data through its own monthly newsletter to customers, analytic data provided by the Shopify platform, and Google Analytics. The company's marketing department also remained abreast of new trends by monitoring secondary research data such as Beer Canada reports, US market reports, international trends, and relevant social media activity. The objective was to continue expanding strategically across the province and build the brand's reputation. Monthly campaign budgets were determined on an ad hoc basis, depending on current needs. Davies hoped to find creative ways to communicate Wellington Brewery's history and value proposition across the province, without sacrificing its strong local presence.

Conclusion

Wellington Brewery's business strategy was fluid. The company was proactive in assessing risk and in finding ways to improve cash flow. The major recent expansion had been successful, but it had required Wellington Brewery to incur considerable costs. The highest priority at this point was to recuperate those investment expenses. Davies was prepared to use all available information to devise a strategic path forward for his company.

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Case 22

WeWork: But Does the Corporate Governance Work?

It was September 2019.[1] Mark Schwartz, SoftBank officer and board member of the We Company (WeWork), entered the start-up's lower-Manhattan office for the most important board meeting of his two-year tenure. Schwartz had been put on the board after SoftBank had invested $4.4 billion in the company in 2017. Investors had been enamored with WeWork, a multi-billion-dollar "unicorn" apparently revolutionizing the collaborative office space market. The company was part tech company, part real estate play, and even part cult, some said.[2] Schwartz had been feeling uneasy about certain things related to WeWork's strategic direction for a while, but on this day, he knew he needed to speak up. Since the IPO prospectus had been filed a month earlier, in August, investors had griped about transparency, governance, and especially disclosures around flamboyant CEO Adam Neumann, the supposed cult leader of WeWork.

The company spent money like crazy, and Neumann seemed unfocused and slightly erratic. He also had a habit of overpromising. Schwartz knew that to take the company public the oversight of the company had to improve. The board had to evolve. In the past, he hadn't spoken out, and things had seemingly worked out quite well for WeWork's investors. Just nine months earlier, a financing round had valued the company at $47 billion. But the public market disagreed. The reported IPO valuation was between $8 billion and $10 billion—a number far less than what the company had raised since 2010 from investors like Masayoshi Son, whose SoftBank had invested $10 billion in the company.

Schwartz knew his performance before the board that day needed to be a balancing act. On the one hand, he didn't want to dismantle what had been successful. WeWork had been known as America's most valuable start-up just a few months earlier. But on the other hand, fiscal discipline, lapses in governance oversight, and perhaps even fraud needed to be plainly discussed. And what about the charismatic young CEO? Was Neumann ready to lead a public company? And most pressing—could WeWork do an IPO at all? The company needed money. Schwartz knew that the time to offer proper board-level oversight had come. The company's survival depended on it. But what should he say? Schwartz rose to speak to the six other board members, including Neumann. "I've stayed silent too long," he began.

WeWork's Early Days

The company had started innocently enough. Neumann and his friend Miguel McKelvey first gained success after the Great Recession by starting a small property leasing business in Brooklyn. In 2010, they opened an office in SoHo and a grander vision began to take shape. The founders created a collaborative coworking space that could be leased to entrepreneurs on a short-term basis. WeWork offices were beautifully designed and furnished with a simple yet elevated aesthetic, each tailored to its particular location.[3] The spaces offered an array of shared desks, furnished private offices, and meeting rooms that could be rented on a flexible basis (down to the minute, by the day, or for months at a time) without the need for a long-term lease, and featured technological infrastructure such as high-speed Wi-Fi and access to printers and office supplies. WeWork spaces also offered extensive amenities to foster collaboration and community, with complimentary refreshments in fully stocked kitchens, stylish common areas and lounges, and professional and social events such as happy hours and lunch-and-learns.[4] Some locations featured espresso bars with baristas, screening rooms, golf simulators, swimming pools, and wellness clubs.[5] The company described its business model as "space-as-a-service" and sought to take advantage of growth in globalization, urbanization, independent work, and the sharing economy.[6] WeWork started by catering to freelancers, start-ups, and small businesses in New York and San Francisco, and then expanded across the United States and internationally, eventually adding enterprise clients and memberships that allowed access to any location in WeWork's growing network of spaces.

Neumann showed his skill at fundraising early on. He spoke to investors enthusiastically about the changing workforce and about how his "We"-branded business would offer office rentals, housing, banking, and business services. Office rentals weren't a particularly new idea—companies like Regus had been offering business lounges, conferencing facilities, and shared office space since 1989. But Neumann captivated investors, customers, and employees with his enthusiastic optimism. He offered sermons about community and mission. Much later, in the company's IPO document, he wrote, "Our mission is to elevate the world's consciousness." Everyone ate it up, including Silicon Valley.

In 2012, Neumann caught the attention of a partner at famed venture capital (VC) firm Benchmark Capital. They didn't love the business, but they loved Neumann. And they were impressed by the business model of leasing long term and charging higher short-term rates to tenants. Early-stage tech investors used to investing in years of negative cash flow were heartened that WeWork promised the ability to quickly

This public-sourced case was prepared by J. Yo-Jud Cheng, Assistant Professor of Business Administration, and Stephen E. Maiden (MBA '01), Case Researcher. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. Mark Schwartz's thoughts and actions in this case are either based on publicly available information or were created by the authors for pedagogical reasons.

generate profits. Soon, the money began to flow. 2011 to 2014 featured a flurry of deals at escalating valuations. DAG Ventures was first to invest $1 million. MassMutual, Benchmark, and Fidelity invested at an $80 million valuation. JPMorgan Chase & Co. (JPMorgan), Harvard, and others invested at a valuation of $1.3 billion. T. Rowe Price invested at $4.6 billion. Then Fidelity contributed to another round of funding at $9.8 billion. One venture capitalist commented about Neumann, "He was the most charismatic pitchman I ever saw."[7]

Neumann was known to be a little bit crazy, but crazy was almost applauded by investors. In one instance in 2015, Neumann invited John Zhao to a party while Zhao's China-based Hony Capital Ltd. was considering investing in a round that would push WeWork's valuation over $16 billion. On the rooftop of the 27-story Wall St. building, Neumann led a round of tequila shots and then picked up a fire extinguisher and sprayed everyone (including Zhao) with white foam. Did the wild behavior scuttle the deal? Hardly. The deal closed and Zhao joined WeWork's board in 2016. Later Zhao's son got a job at WeWork. While all investors believed in the vision and optimism of Neumann, none committed more than SoftBank and its leader, Masayoshi Son.

Neumann Meets Masayoshi Son

SoftBank was originally founded in 1981 by 24-year-old Son as a software distributor. When SoftBank went public in 1994 with a valuation of $3 billion, it was Japan's largest publisher of computer and technology magazines and producer of trade shows. Over the years, SoftBank became a holding company and began to make investments. The most successful investment was $20 million placed into Jack Ma's Alibaba in 2000, which grew to $60 billion when Alibaba went public in 2014. Son had decided to invest in Ma within minutes of meeting him because of the "sparkles in his eyes." In 2017, Son launched the massive $100 billion Vision Fund to make tech, energy, and financial investments. Nearly half the capital in the Vision Fund came from Mohammad bin Salman, the crown prince of Saudi Arabia, buttressed by money from high-profile backers such as Apple, Qualcomm, UAE-based Mubadala Investment Company, Saudi Arabia's PID public fund, Foxconn, and Foxconn-owned Sharp.[8]

It was at a January 2016 investor event called Startup India where Son first saw Neumann speak onstage. This was the same year that Ma and his wife Cathy invested approximately $25 million in WeWork. WeWork had a $12 billion valuation at the time, but fewer than 75 locations, none of which were in India. On stage, Neumann said at one point, "I'm surprised [by] the amount of talk I heard about valuation and raising money and bubbles and building big companies. That is not the goal. The goal is finding something that you truly love. Make sure it has intention behind it. Make sure it's going to make the world a better place." That evening, Neumann joined Son for dinner.

Son initially played coy and passed on several funding rounds, but in December 2016, Son asked for a tour of WeWork's New York headquarters. When Son arrived, he told Neumann that he only had 12 minutes. Neumann raced to show what he could and then Son asked Neumann to accompany him in his car so they could talk. Son took out an iPad and wrote out the terms for a $4.4 billion investment in WeWork. He drew two lines at the bottom, signed one, then asked the 37-year-old Neumann to sign the other. Later Neumann recalled, "When Masa chose to invest in me for the first time, he only met me for 28 minutes."[9] Son's investment was announced in August 2017. The goal was to accelerate WeWork's growth; to grow as quickly as possible. As fast as Alibaba.

With pressure from Son, Neumann doubled his growth plans, straining the bounds of the organization. Opening a new location involved a complicated set of steps: negotiating a lease, getting permits, designing the space, constructing the project, tailoring the layout, marketing to the individual market, and finding tenants. In the frenzy to grow, mistakes were made. When his lieutenants urged Neumann to slow down, he berated them as "B players" and stripped their job titles. Neumann did not want to let down Son, who had become a mentor and friend. "Masa is a Jedi," commented Neumann, "and as a Jedi, he has a lot of superpowers."[10]

Growth Forever

By 2018, WeWork had become New York's largest private landlord.[11] WeWork was opening a new location practically every day and adding hundreds of employees each month, compensated partially in stock (see **Exhibit 1** for WeWork's locations over time).[12] Son told Neumann not to be proud of WeWork's lean sales staff, but to aim to have 10,000 salespeople (when the entire company had fewer than 10,000 employees). Once SoftBank invested, it seemed like no other investors were needed. Son cheered the growth despite some misgivings from his internal SoftBank analysts, who hadn't even wanted to invest in a real estate play in the first place.

Exhibit 1 WeWork Locations, Cities, and Memberships

	2010	2012	2014	2016	2018	Q2 2019
Locations	2	7	23	111	425	528
Cities	1	3	8	34	100	111
Memberships	450	4,000	15,000	87,000	401,000	527,000

Data sources: The We Company SEC Form S-1, 2019, https://www.sec.gov/Archives/edgar/data/1533523/000119312519220499/d781982ds1.htm; "WeWork: Deal History," PitchBook, https://my.pitchbook.com/profile/62181-28/company/profile#deal-history/118473-40T (both accessed Feb. 22, 2021).

With increasing valuations and seemingly endless money, WeWork went on a buying spree, acquiring 17 companies, including tech start-ups to manage construction projects and help marketing. Not all the investments seemed synergistic. WeWork bought event-planning site Meetup.com, search-engine-optimization company Conductor, and the Flatiron Academy coding school. After surfing with big-wave legend Laird Hamilton in Hawaii, Neumann decided to use company funds to invest $32 million in Laird Superfood. Despite members' questions around the disparate acquisition strategy, the board approved expenditures of more than $500 million in two years on tech-related companies. Neumann began to expand the vision for WeWork still further, reimagining education, fitness, social gatherings, sports, and leisure. He envisioned verticals WeWork, WeLive, WeLove, WeCongregate, WePlay, and WeGrow.

The company's growth was staggering. For the first seven years, the company doubled revenues annually. The fundraising was staggering too. It took a lot of money to fund that kind of growth. Since its founding, WeWork had raised $10.7 billion in nine separate funding rounds (**Exhibit 2**).[13] But questions began to arise for those paying attention. Neumann had a habit of overpromising and underdelivering—or worse. A fall 2014 investor pitch he made showed a projection of a $2.4 million operating profit for the year. But at year-end, just three months later, the company notched an operating loss of $88 million on $74 million of revenue. In 2015, Neumann told the *Wall Street Journal* that WeWork was profitable and didn't need additional funding pre-IPO. That year, the company made $187 million in revenue but lost $233 million. By the time of the fall 2019 board meeting, WeWork had had only one profitable year in its history, when it made $1.7 million in 2012 (see **Exhibit 3** for WeWork's financial performance).

Some investors wondered about WeWork's path to profitability. Was there one? When Benchmark first invested, Bruce Dunlevie, the VC firm's representative on WeWork's board, admitted to a partner that he wasn't sure the company would ever become profitable.[14] The business model was simple enough. Rent office space, divide it up, and sublease at a higher per-unit cost. For years, WeWork had bled cash chasing growth, but there were questions about whether the model could be profitable even at a single location.[15] It was also a model that could be copied. And it was. Big landlords began to launch their own coworking efforts around the world.[16] Other coworking entrepreneurs saw WeWork entering markets and opened their own location just a few blocks away, then undercut WeWork on price.[17] In 2017, China's UrWork raised $58 million from Alibaba's Ant Financial unit and other investors, essentially copying WeWork's model.[18] What did that mean for future pricing power? Would there be enough demand to keep occupancy rates high? Did WeWork have a sustainable competitive advantage?

Neumann Tightens His Grip

Neumann was becoming fabulously wealthy on paper ($3 billion by 2015), but raising money diluted the founders' financial ownership. It also diluted control. Neumann, who had cultivated an image of new-age enlightened leader, did not always seem to practice what he preached. In one meeting, an executive recalled that Neumann spoke openly about his goal to make WeWork into a "monopoly."[19] When it was mentioned that monopolies were illegal and implied unfair business practices, Neumann shrugged and said in the future he'd call it something else. When it came to company control, Neumann's worst impulses were on display.

Exhibit 2 Equity Funding Rounds (amounts in millions of US dollars)

Date	Round	Key Investor(s)	Amount	Pre-Money Valuation
10/25/11	First VC	DAG Ventures	$1	N/A
7/1/12	Series A	MassMutual, Benchmark, Fidelity	$17	$80
5/29/13	Series B	Undisclosed	$40	$400
2/1/14	Series C	JPMorgan Chase & Co., Harvard, Benchmark, Mort Zuckerman	$150	$1,343
12/16/14	Series D	T. Rowe, Wellington, Goldman Sachs	$355	$4,645
7/1/15	Series E	Fidelity	$434	$9,800
10/12/16	Series F	Legend Holdings, JANVEST Capital, Hony Capital	$690	$16,210
8/24/17	Series G	SoftBank	$3,000	$19,500
1/8/19	Corp Fin	SoftBank	$6,000	$47,000*
			$10,687	**post-money*

Data source: "WeWork: Deal History," PitchBook, https://my.pitchbook.com/profile/62181-28/company/profile#deal-history/118473-40T (accessed Feb. 22, 2021).

Exhibit 3 Consolidated Results of Operations (amounts in thousands of US dollars)

	Year Ended December 31,			Six Months Ended June 30,	
	2016	2017	2018	2018	2019
Revenue	$436,099	$886,004	$1,821,751	$763,771	$1,535,420
Expenses:					
Location operating expenses	$433,167	$814,782	$1,521,129	$635,968	$1,232,941
Other operating expenses	—	$1,677	$106,788	$42,024	$81,189
Pre-opening location expenses	$115,749	$131,324	$357,831	$156,983	$255,133
Sales and marketing expenses	$43,428	$143,424	$378,729	$139,889	$320,046
Growth and new market development expenses	$35,731	$109,719	$477,273	$174,091	$369,727
General and administrative expenses	$115,346	$454,020	$357,486	$155,257	$389,910
Depreciation and amortization	$88,952	$162,892	$313,514	$137,418	$255,924
Total expenses	$832,373	$1,817,838	$3,512,750	$1,441,630	$2,904,870
Loss from operations	$(396,274)	$(931,834)	$(1,690,999)	$(677,859)	$(1,369,450)
Interest and other income (expense), net	$(33,400)	$(7,387)	$(237,270)	$(46,406)	$469,915
Pre-tax loss	$(429,674)	$(939,221)	$(1,928,269)	$(724,265)	$(899,535)
Income tax benefit (provision)	$(16)	$5,727	$850	$1,373	$(5,117)
Net loss	$(429,690)	$(933,494)	$(1,927,419)	$(722,892)	$(904,652)
Net loss attributable to noncontrolling interests	—	$49,500	$316,627	$94,762	$214,976
Net loss attributable to WeWork Companies Inc.	$(429,690)	$(883,994)	$(1,610,792)	$(628,130)	$(689,676)

Data source: The We Company SEC Form S-1, 2019, https://www.sec.gov/Archives/edgar/data/1533523/000119312519220499/d781982ds1.htm; (accessed Feb. 22, 2021).

By 2014, Neumann was getting so much investor interest that he declared he'd only work with investors willing to give him a majority of voting control over the company's board.[20] When T. Rowe Price invested in two of WeWork's funding rounds, Neumann restructured the stock so that his shares had 10 times the voting control of normal shares, giving him long-term voting control. In the same deal, an entity he controlled sold $40 million of stock, and he sold an additional $80 million in 2015.

While most went along with these changes, Benchmark's Dunlevie resisted temporarily, warning Neumann that absolute power corrupts absolutely. Early-stage investors did not like seeing the founder pull money out before they did in an IPO, and Dunlevie had a history of walking away from a guaranteed payday over a principle (in a partnership with Toys"R"Us earlier in his Benchmark career, Dunlevie walked away from a big potential payout after middle management subverted his ideas). Later, Dunlevie's daughter was hired by WeWork. By 2017, Benchmark partners were concerned enough by Neumann's actions that they flew to see him in Manhattan. Dunlevie, despite his pushback, was more deferential to Neumann than other Benchmark partners who worried that Neumann was acting like Travis Kalanick, the wild CEO of Uber (another Benchmark investment), and needed to be reined in. They voiced their concerns to Neumann, but nothing meaningful changed. T. Rowe Price also became alarmed. "We saw the valuation rise and the corporate governance erode," said co-head of global equity at T. Rowe Price. When SoftBank invested, T. Rowe Price sold as much of its investment as possible to Son's firm.

A Captive Board

Like most other venture-backed private companies, WeWork's board started small and then grew over time with the addition of investors. It was typical for outside investors to negotiate a board seat as a contingency in the term sheet for an investment (alternatively, some investors negotiated for a seat as a board observer who could participate in board discussions but did not have formal voting rights). Over time, the board added VC representatives such as Benchmark's Dunlevie and Hony Capital's Zhao. Later, Son appointed two top SoftBank lieutenants—SoftBank vice chair Ron Fisher and Schwartz, a former Goldman Sachs partner—to sit on the board. Like public company directors, directors of private companies were also bound by fiduciary duties. For directors who also represented their VC firms, these duties could at times create conflicts because of their obligations both to the company in which they invested and to their VC fund.

Directors of private companies were often more deeply involved than public company directors in day-to-day company operations. For several years, Schwartz was a regular in the WeWork office, working out of a small room near Neumann and other top executives.[21] But Neumann's voting stock also meant that he could pack the board and replace dissenters. He had always favored hiring friends and family. His wife Rebekah was hired as WeWork's chief brand officer, despite misgivings from the board. This meant that functionally, WeWork's board operated more like an advisory board than a typical corporate board with strong oversight. For instance, the board signed off on Neumann's use of $13 million of WeWork's funds to invest in a company that made artificial wave pools,[22] and let Neumann conduct an expensive renovation of its corporate headquarters, adding a sauna and ice bath in his office. Neumann paid three times the normal price the company paid for renovations to get prime real estate in San Francisco, cutting through the floor to make room for a staircase and adding a fitness club.

While Dunlevie had pushed back against some of Neumann's most brazen moves, he never pushed too hard. One of Dunlevie's colleagues at Benchmark scoffed at the idea that he should have stepped down from the board, explaining that Benchmark had "invested when WeWork was worth, like, eighty million dollars, and now it's worth fifteen *billion*, and we should walk away? Or, even worse, complain?"[23]

Neumann regularly missed board meetings throughout 2018, sending a delegate instead. At the meetings, directors discussed the pace of growth among other issues. A top WeWork executive who participated in board meetings said, "If you review the minutes of our board meetings, you would see that never has there been a board vote that wasn't unanimous. There was never a budget plan, or a growth plan, that wasn't approved unanimously. If board members had concerns, they never once officially said them."[24]

Neumann's Leadership

The six-foot-five, long-haired Adam Neumann was charismatic, frenetic, and full of platitudes like, "If you are open-minded and you let the universe come in, you never know where things might go,"[25] and "Success is not just making money. Success is happiness. Success is fulfillment; it's the ability to give."[26] Top employees were told to attend weekly sessions with a guru. Recreational drug use and sex among staff members at the headquarters was commonplace, and condoms routinely were found in stairwells. Neumann smoked marijuana at the office.[27] While many investors appreciated Neumann's enlightened style of leadership, they seemed most impressed by his track record of doubling WeWork's revenues and its valuation every year.

During the time WeWork was valued at $5 billion, Neumann had flown private. But in 2018, he wanted an upgrade. Despite board of director and investor concerns, Neumann used $63 million to purchase a brand-new Gulfstream G650ER that had 16 seats and two lavatories—one for the crew. In more recent years, the board allowed Neumann to personally buy stakes in buildings that he would then lease back to WeWork. Related party transactions like this were frowned upon by Wall Street, and had to be plainly disclosed in SEC filings by publicly traded companies because of the possibility of a conflict of interest.

Eventually Schwartz, Dunlevie, and Langman pushed Neumann in board meetings to commit to a timeline for an IPO. Some of the board members reasoned that an IPO would bring public market oversight to a situation they had trouble reining in. But that same year, Son dangled a potential further $20 billion investment, including the buyout of existing investors. Son wanted a majority stake in the company.

Pressure Builds for an IPO

In December 2018, SoftBank's stock plunged—primarily due to market issues—and Son decided that the potential $20 billion investment could only be $2 billion. Over breakfast in Hawaii, Son and Neumann agreed that the new round would be raised at a $47 billion valuation, with $1 billion used to buy shares from previous investors, allowing some on the board to sell. Executives and board members like Schwartz knew the $6 billion on the balance sheet at the beginning of 2019 wouldn't last. In January 2019, Neumann told CNBC that the new funding from SoftBank (which brought its total investment in WeWork to $10 billion) was "above and beyond what we need to fund the company for the next four to five years." But the math didn't work. While he had always put off an IPO due to the intrusive scrutiny of public market investors and analysts, Neumann began to have a change of heart.

Investment banks acted as both enabler and seductress, wooed by the potential fees of a major IPO. JPMorgan and Goldman Sachs were both investors. Neumann referred to JPMorgan's CEO Jamie Dimon as his personal banker and had a $500 million personal credit line from JPMorgan and other banks.[28] Goldman Sachs bankers urged growth in pitchbooks and showed a slide with WeWork's path to a trillion-dollar market capitalization. Time and again, JPMorgan, Dimon, and other bankers championed Neumann's business model as they battled for the coveted IPO assignment that could bring prestige and yield millions in fees.

Stock exchanges, lured by the cachet and revenues that would come with a blockbuster public listing, also angled to get in on the action. With his listing decision on the line, Neumann invited the leaders of the New York Stock Exchange (NYSE) and NASDAQ to one of his Hamptons homes to solicit their support for one of his pet causes: environmental sustainability. NYSE President Stacey Cunningham offered to eliminate single-use plastic products in its cafeteria; NASDAQ CEO Adena Friedman offered to create a new stock market index, the "We 50," committed to sustainability.[29] Neumann went with NASDAQ.

Due to the structure of VC funds, investors were motivated to grow and scale a company over a constrained time period, with the end goal of exiting their investment through a sale or IPO.[30] The potential windfall offered by an IPO generated a strong incentive to see the public offering through. Although the board (shown at the time of the IPO in **Exhibit 4**) noted weaknesses in the company's operations and leadership, momentum for an IPO was growing, and pressure was mounting to clear any obstacles that stood in the way (directors' stock holdings are shown in **Exhibit 5**).

Exhibit 4 August 2019 Pre-IPO WeWork Board of Directors

Name	Role	Professional Experience	Notable Other Boards
Adam Neumann	Chairman of the Board	• CEO of WeWork	
Bruce Dunlevie	Director since 2012 (designated by Benchmark, Series A)	• Founding Partner of Benchmark Capital	• ServiceSource International • One Medical Group • Marin Software
Ronald D. Fisher	Director since 2017 (designated by SoftBank, Series G)	• Vice Chairman of SoftBank • CEO of Phoenix Technologies	• T-Mobile • Arm Holdings • Brightstar Global Group Inc.
Lewis Frankfort	Director since 2014	• Chairman of Flywheel Sports • Chairman and CEO of Coach	• Recycle Track Systems Inc. • Columbia Business School
Steven Langman	Director since 2012	• Managing Director of Rhone Capital • Chairman of ARK	• CSM Bakery Solutions Ltd. • Hudson's Bay Company
Mark Schwartz	Director since 2017	• Officer at SoftBank • Head of Asia-Pacific Region of Goldman Sachs • CEO of Soros Fund	• SoftBank • Harvard Business School • Paytm
John Zhao	Director since 2016 (designated by Hony Capital, Series F)	• CEO of Hony Capital	• Lenovo • China Glass Holdings

Data source: The We Company SEC Form S-1, 2019, https://www.sec.gov/Archives/edgar/data/1533523/000119312519220499/d781982ds1.htm; Eddie Small, "Behind the Curtain of WeWork's All-Male Board of Directors," Real Deal, August 23, 2019, https://therealdeal.com/national/2019/08/23/behind-the-curtain-of-weworks-all-male-board-of-directors/ (both accessed Feb. 22, 2021).

Exhibit 5 Pre-IPO Stockholdings

Greater than 5% stockholders:	Shares of Class A Common Stock	Shares of Class B Common Stock	Shares of Class C Common Stock
WE Holdings LLC	2,428,730	111,848,498	—
Benchmark entities	32,645,314	—	—
JPMorgan Chase & Co. entities	18,542,307	—	—
SoftBank entities	113,988,653	—	—
Directors and named executive officers:			
Adam Neumann (cofounder, CEO)	2,428,730	112,507,371	1,062,578
Artie Minson (co-president, CFO)	—	[less than 1%]	—
Jen Berrent (co-president, Chief Legal Officer)	[less than 1%]	[less than 1%]	—
Bruce Dunlevie (non-employee director)	32,645,314	—	—
Ron Fisher (non-employee director)	—	—	—
Lew Frankfort (non-employee director)	[less than 1%]	[less than 1%]	—
Steven Langman (non-employee director)	[less than 1%]	—	—
Mark Schwartz (non-employee director)	—	—	—
John Zhao (non-employee director)	—	—	—
All directors and executive officers, as a group	36,431,010	114,821,543	1,062,578

Notes: Class B common stock and Class C common stock had 20 votes per share, whereas Class A common stock had one vote per share. Adam Neumann and Miguel McKelvey were the managing members of WE Holdings LLC. Adam Neumann had sole voting power over all the shares held by WE Holdings LLC.

Data source: The We Company SEC Form S-1, 2019, https://www.sec.gov/Archives/edgar/data/1533523/000119312519220499/d781982ds1.htm (accessed Feb. 22, 2021).

After turning it over in his mind, Neumann soon became enthusiastic about the prospect of going public. He had been granted substantial stock options that could only be exercised following an IPO.[31] Just that year, Pinterest ($12.7 billion valuation), Zoom ($9.2 billion), CrowdStrike ($6.7 billion), and especially Uber ($82.4 billion) had all raised large sums of money at significant valuations. Success seemed inevitable. Executives and employees, paid heavily in equity, also saw dollar signs. No one wanted to stand in the way with a looming payday on the horizon.

A Company on the Brink

The first bad sign to investors was the July roadshow meeting. Neumann spoke to analysts but did not give any real numbers. He compared the company to Amazon with its nearly $1 trillion valuation, hoping the IPO value of $65 billion for WeWork would seem like a relative bargain. Meanwhile, a *Wall Street Journal* article crowed about Neumann cashing out at least $700 million via sales and loans.[32] Analysts wondered: If the founder was selling, why should we invest? Then investors learned that early investor Benchmark had not increased its initial investment in subsequent rounds, despite Benchmark partner Dunlevie sitting on the WeWork board. What did Benchmark see?

In the lead-up to a potential IPO, it was typical for boards to formalize governance policies and procedures as they prepared to comply with SEC and listing exchange requirements for public companies. Although newly public firms were granted a transition period to meet certain governance requirements following an IPO, many firms adopted these requirements well in advance to instill confidence with prospective investors.

On August 14, 2019, WeWork filed its IPO prospectus (also referred to as the "S-1" or "registration statement"). This represented one of the major milestones in the path toward an eventual IPO, and was the first time the public would gain access to details about the company's business plan, operations, and properties; audited financial statements; data on current shareholders' equity and executive compensation; and a list of independent directors. The reaction was swift and ugly. Analysts saw massive losses ($900 million in the first half of 2019) and $47 billion in lease obligations. They wondered why Neumann was to be paid $5.9 million in stock for the rights to the word "we" in the rebranded We Company name.

Neumann's huge voting power also raised eyebrows. In a public offering, companies could establish distinct classes of shares that conferred different voting rights. WeWork's offering included Class A shares, which provided one vote per share, as well as Class B and Class C shares (nearly all owned or controlled by Neumann) that provided 20 votes per share. The Class C shares were created through a complex restructuring that bestowed Neumann and other executives more favorable tax treatment on future profits than for other shareholders. In effect, Neumann would control more than 50% of the shareholder voting power, thus maintaining the control he had amassed as the company scaled, and limiting the ability of future shareholders to vote on issues such as director elections and the approval of mergers and acquisitions.[33]

Although single-class share structures were most common in public offerings, dual-class structures were becoming increasingly prevalent (used in 28% of IPOs in 2017 and 19% of IPOs in 2018),[34] particularly among founder-led tech companies. Even so, the 20 votes per share afforded to Neumann far exceeded the voting rights offered by most other firms' dual-class shares. The concentration of voting power also allowed WeWork to qualify as a "controlled company" under NASDAQ rules, thus exempting it from requirements that mandated a majority of independent board directors and that the audit and compensation committees be composed solely of independent directors.

External observers questioned why it was written in the prospectus that Neumann's wife Rebekah (who he called his "thought partner") would be placed at the helm of a committee with two board members to pick her husband's successor should something happen to him within 10 years of the IPO. Key executives only learned of this days before the prospectus was released (see **Exhibit 6** for excerpts from the prospectus). While there were no federal requirements in the United States around board diversity for public companies, it was common for boards to add directors from underrepresented groups as they prepared for an IPO (because the majority of start-up founders and VC investors were men, the boards of private, venture-backed firms typically had little gender diversity).[35] Pundits noted that the company boasted about its culture of inclusivity yet maintained an all-male board. They also wondered whether Neumann was fit to lead a publicly traded company. Although many founder-led companies like Facebook and Google performed well after going public,[36] leadership transitions were common: the founder was replaced by a new CEO in nearly half (47%) of IPOs.[37]

Saving the Sinking Ship

By the end of August, WeWork's valuation was expected to be less than half the $47 billion used in SoftBank's January financing. A few weeks later, WeWork's board of directors gathered for what was sure to be a long meeting. Schwartz had the attention of the entire board because the numbers were clear. WeWork would run out of money in a few months, the second week of November. Neumann seemed open to doing whatever was necessary to save the company. What needed to be done to salvage the IPO and regain the trust of investors? Schwartz rose to speak. There were many issues he wanted to address.

Exhibit 6 Excerpts from Prospectus (Form S-1)

Relationships and Transactions with Adam Neumann, our Co-Founder and Chief Executive Officer

Adam has served as the Company's Chief Executive Officer and Chairman of the Company's board of directors since our inception. From the day he co-founded WeWork, Adam has set the Company's vision, strategic direction and execution priorities. Adam is a unique leader who has proven he can simultaneously wear the hats of visionary, operator and innovator, while thriving as a community and culture creator. Given his deep involvement in all aspects of the growth of our company, Adam's personal dealings have evolved across a number of direct and indirect transactions and relationships with the Company. As we make the transition to a public company, we aim to provide clarity and transparency on the history of these relationships and transactions, as well as the background to the strategic governance decisions that have been made by Adam and the Company. …

Voting Controls

Adam controls a majority of the Company's voting power, principally as a result of his beneficial ownership of our high-vote stock. Since our high-vote stock carries twenty votes per share, Adam will have the ability to control the outcome of matters submitted to the Company's stockholders for approval, including the election of the Company's directors. As a founder-led company, we believe that this voting structure aligns our interests in creating shareholder value. Adam is, however, committed to relinquishing control at a time when he no longer maintains a significant economic interest in The We Company and the share ownership of Adam and certain of his permitted transferees represents less than 5% of the aggregate number of then-outstanding shares of our capital stock, at which time all of the outstanding high-vote stock would convert to having one vote per share.

Succession Planning

As part of our transition to a public company, our board of directors has spent significant time planning for the transition from a privately controlled company to a public company and put considerable thought into succession planning. In particular, in connection with this offering we are taking measures to provide clarity as to how unexpected transitions in our leadership might occur.

In the event that Adam is permanently disabled or deceased during the ten-year period commencing upon the completion of this offering, a committee will be formed for the sole purpose of selecting a new Chief Executive Officer. The composition of this committee will be as follows:

- **Bruce Dunlevie and Steven Langman, who are currently members of our board of directors and members of our compensation and nominating committee, to the extent they are then serving as our directors, will serve on this selection committee with Rebekah Neumann (with the size of the committee fixed at two or three, as applicable); and**
- **if neither Bruce nor Steven is then serving as one of our directors, Rebekah will choose one or two board members who are serving at the time to serve on this selection committee with Rebekah.**

Personal Loans

Adam currently has a line of credit of up to $500 million with UBS AG, Stamford Branch, JPMorgan Chase Bank, N.A. and Credit Suisse AG, New York Branch, of which approximately $380 million principal amount was outstanding as of July 31, 2019. The line of credit is secured by a pledge of approximately shares of our Class B common stock beneficially owned by Adam. In addition, JPMorgan Chase Bank, N.A. has made loans and extended credit to Adam totaling $97.5 million across a variety of lending products, including mortgages secured by personal property. None of these other lending products are secured by a pledge of any of Adam's shares of capital stock in the Company.

Source: The We Company SEC Form S-1, 2019, https://www.sec.gov/Archives/edgar/data/1533523/000119312519220499/d781982ds1.htm (accessed Feb. 22, 2021).

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Glossary

A

Above-average returns are returns in excess of what an investor expects to earn from other investments with a similar amount of risk.

An **acquisition** is a strategy through which one firm buys most or all a company's shares with the intent of making the acquired firm a subsidiary business within its portfolio.

Activist investors hold a significant, but not controlling, interest in the firm's stock. They use their positions to gain board seats and make shareholder proposals regarding what the firm can do to enhance shareholder returns.

Agency costs are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent.

An **agency relationship** exists when one or more persons (the principal or principals) hire another person or persons (the agent or agents) as decision-making specialists to perform a service.

Average returns are returns equal to those an investor expects to earn from other investments with a similar amount of risk.

B

The **balanced scorecard** is a tool firms use to determine if they are achieving an appropriate balance when using strategic and financial controls as a means of positively influencing performance**.**

A **board of directors** is a group of elected individuals who oversee managers to ensure that the corporation operates in ways that will best serve stakeholders' interests.

A **business ecosystem** is a complex network of interconnected organizations—suppliers, customers, government agencies, technology suppliers, financiers, and other stakeholders—whose competitive and cooperative efforts are associated with the satisfaction of a particular value proposition (e.g., product or service).

A **business model** describes what a firm does to create, deliver, and capture value for its stakeholders

A **business-level cooperative strategy** is a strategy through which firms combine some of their resources to create a competitive advantage by competing in one or more product markets.

A **business-level strategy** is an integrated and coordinated set of commitments and actions the firm uses to gain a competitive advantage by exploiting core competencies in a specific product market.

Business model innovation occurs when a firm determines that its current business model is outdated, and successfully replaces it with a newer one.

C

A **capability** is the capacity for a set of resources to perform a task or an activity in an integrative manner.

A **combination structure** is a structure drawing characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure.

A firm has a **competitive advantage** when, by implementing a chosen strategy, it creates superior value for customers, and when competitors are not able to imitate the value the firm's products create or find it too expensive to attempt imitation.

Competitors are firms operating in the same market, offering similar products, and targeting similar customers.

How companies gather and interpret information about their competitors is called **competitor analysis**.

Competitor intelligence is the set of data and information the firm gathers to better understand and anticipate competitors' objectives, strategies, assumptions, and capabilities.

A **competitive action** is a strategic or tactical action the firm takes to build or defend its competitive advantages or improve its market position.

Competitive behavior is the set of competitive actions and responses a firm takes to build or defend its competitive advantages and improve its market position.

Competitive dynamics is the complete set of competitive actions and responses taken by all firms competing within a market.

competitive form is a multidivisional structure characterized by complete independence among the firm's divisions that compete for corporate resources.

A **competitive response** is a strategic or tactical action the firm takes to counter the effects of a competitor's competitive action.

Competitive rivalry describes competitive actions and responses among firms as they maneuver for an advantageous market position.

Complementary strategic alliances are business-level alliances in which firms share some of their resources in complementary ways to create a competitive advantage.

Complementors are companies or networks of companies that sell complementary goods or services that are compatible with the focal firm's goods or services.

cooperative strategy is a means by which firms collaborate to achieve a shared objective.

Coopetition involves simultaneous cooperation and competition among firms at the same stage of the value chain in the same industry.

Core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals.

Corporate entrepreneurship is the application of entrepreneurship within an established firm.

Corporate governance is the set of mechanisms used to manage the relationships among stakeholders and to determine and control the strategic direction and performance of organizations.

Corporate relatedness provides opportunities for transferring corporate-level competencies across businesses of the firm.

corporate-level cooperative strategy is a strategy through which a firm collaborates with one or more companies to expand its operations.

Corporate-level core competencies are complex sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience, and expertise.

corporate-level strategy specifies actions a firm takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets.

The **cost leadership strategy** is an integrated set of actions taken to produce products with features that are acceptable to customers at the lowest cost, relative to that of competitors.

Costly-to-imitate capabilities are capabilities that other firms cannot easily develop.

A **cross-border strategic alliance** is a strategy in which firms with headquarters in different countries decide to combine some of their resources to create a competitive advantage.

D

The **demographic segment** is concerned with a population's size, age structure, geographic distribution, ethnic mix, and income distribution.

Determining strategic direction involves specifying the vision and the strategy to achieve the vision.

The **differentiation strategy** is an integrated set of actions taken to produce products (at an acceptable cost) that customers perceive as being different in ways that are important to them.

A **digital platform** is an Internet-based location for exchanges of information, goods, or services to occur between producers, consumers, and other members of the platform community.

A **digital strategy** uses digital technology to help a firm understand its customers and their needs with greater clarity as a foundation for developing innovations that create more value for those customers.

A **diversifying strategic alliance** is a strategy in which firms share some of their resources to engage in product and/or geographic diversification.

Downscoping refers to divestiture, spin-off, or some other means of eliminating businesses that are unrelated to a firm's core businesses.

Downsizing is a reduction in the number of a firm's employees and, sometimes, in the number of its operating units.

Due diligence is a process through which a potential acquirer evaluates a target firm for acquisition.

E

The **economic environment** refers to the nature and direction of the economy in which a firm competes or may compete.

Economies of scope are economic factors that lead to cost savings through successfully sharing resources and capabilities or transferring one or more corporate-level core competencies that were developed in one of a firm's businesses to another of its businesses.

entrepreneurial mindset values uncertainty in markets and continuously seeks to identify opportunities in those markets to pursue through innovation.

Entrepreneurial opportunities are conditions in which new goods or services can satisfy a need in the market.

Entrepreneurs are individuals, acting independently or as part of an organization, who perceive an entrepreneurial opportunity and then take risks to develop an innovation and exploit it.

Entrepreneurship is the process by which individuals, teams, or organizations identify and pursue entrepreneurial opportunities without being immediately constrained by the resources they currently control.

An **equity strategic alliance** is an alliance in which a firm purchases equity in another firm, which means that it is now a partial owner of that firm.

Executive compensation is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses, and long-term incentives such as stock awards and options.

An **external managerial labor market** is the collection of managerial career opportunities and the qualified people who are external to the organization in which the opportunities exist.

F

Fast-cycle markets are markets in which competitors can imitate the focal firm's capabilities that contribute to its competitive advantages and where that imitation is often rapid and inexpensive.

Financial capital refers to all the financial assets a firm possesses.

Financial controls are largely objective criteria used to measure the firm's performance against previously established quantitative standards.

Financial economies are cost savings realized through improved allocations of financial resources based on investments inside or outside the firm.

A **first mover** is a firm that takes an initial competitive action to build or defend its competitive advantages or to improve its market position.

The **focus strategy** is an integrated set of actions taken to produce products that serve the needs of a particular segment of customers.

Franchising is a strategy in which a firm (the franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources with its partners (the franchisees).

A **functional structure** consists of a chief executive officer and a limited corporate staff, with functional line managers in dominant organizational areas such as production, accounting, marketing, R&D, engineering, and human resources.

G

The **general environment** is composed of dimensions in the broader society that influence an industry and the firms within it.

A **global economy** is one in which goods, services, people, skills, and ideas move with limited barriers across geographic borders.

A **global mind-set** is the ability to analyze, understand, and manage an internal organization in ways that are not dependent on the assumptions of a single country, culture, or context.

The **global segment** includes relevant new global markets and their critical cultural and institutional characteristics, existing markets that are changing, and important international political events.

A **global strategy** is an international strategy in which a firm's home office determines the strategies that business units are to use in each country or region.

A **global supply chain** is a network of firms that spans multiple countries with the purpose of supplying goods and services.

A **global value chain** refers to the processes through which a firm receives raw materials, uses them to *add value* through manufacturing a product that provides greater utility for the consumer, and sells the product to another firm or the ultimate consumer of the product, in a global setting.

Globalization is the increasing economic interdependence among countries and their organizations as reflected in the flow of products, financial capital, and knowledge across country borders.

A **greenfield venture** is an entry mode through which a firm invests directly in another country or market by establishing a new wholly owned subsidiary.

H

A **heterogeneous top management team** is composed of individuals with different functional backgrounds, experience, and education.

A **horizontal acquisition** is an acquisition of a company competing in the same industry as the acquiring firm.

Human capital refers to the knowledge and skills of a firm's entire workforce.

Hypercompetition is a condition where competitors engage in intense rivalry, markets change quickly and often, and entry barriers are low.

I

Imitation is the adoption of a similar innovation by different firms.

An **industry** is a group of firms producing products that are close substitutes.

The **industry environment** is the set of factors that directly influences a firm and its competitive actions and responses: the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes, and the intensity of rivalry among competing firms.

Innovation is a process used to create a commercial product from an invention.

Institutional owners are financial institutions, such as mutual funds and pension funds, that control large-block shareholder positions.

Intangible resources are assets that are rooted deeply in the firm's history, accumulate over time, and are relatively difficult for competitors to analyze and imitate.

The **integrated cost leadership/differentiation strategy** finds a firm engaging simultaneously in primary value-chain activities and support functions to achieve a low-cost position with some product differentiation.

An **internal managerial labor market** consists of a firm's opportunities for managerial positions and the qualified employees within it.

An **international diversification strategy** is a strategy through which a firm expands the production and/or sales of its goods and/or services across the borders of global regions and countries into a potentially large number of geographic locations or markets.

International entrepreneurship is a process in which firms creatively discover and exploit opportunities that are outside their domestic markets.

An **international strategy** is a strategy through which a firm produces and/or sells its goods and/or services outside the country in which its headquarters office is located.

Invention is the act of creating or developing a new product or process.

J

A **joint venture** is a strategic alliance in which two or more firms create a legally independent company to share some of their resources to create a competitive advantage.

L

Large-block shareholders typically own at least 5 percent of a company's issued shares.

A **late mover** is a firm that responds to a competitive action a significant amount of time after the first mover's action and the second mover's response.

leveraged buyout (LBO) is a restructuring strategy whereby another company is purchased using a significant amount of debt to pay for the acquisition.

M

Managerial opportunism is the seeking of self-interest with guile (i.e., cunning or deceit).

Market commonality is concerned with the number of markets with which the firm and a competitor are jointly involved and the degree of importance of the individual markets to each.

A **market for corporate** control is an external governance mechanism that is active when a firm's internal governance mechanisms fail.

Market power exists when a firm is able to sell its products above the existing competitive price level or to reduce the costs of its primary and support activities below the cost levels of competitors, or both.

Market segmentation is the process of dividing customers into groups based on their needs.

A **mission** specifies the businesses in which the firm intends to compete and the customers it intends to serve.

A **merger** is a strategy through which two firms agree to integrate their operations on a relatively coequal basis.

A **multidivisional structure** consists of a corporate office and operating divisions, each operating division representing a separate business or profit center in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers.

A **multidomestic strategy** is an international strategy in which strategic and operating decisions are decentralized to the business units within individual countries or regions, allowing each unit the opportunity to tailor products to the local market.

Multipoint competition occurs when firms compete against each other in several product or geographic markets.

N

Nascent markets are often new markets but can also be existing markets that are experiencing significant technical, regulatory, or institutional shifts that fundamentally disrupt market order.

network cooperative strategy is a strategy by which several firms agree to form multiple partnerships to achieve shared objectives.

nonequity strategic alliance is an alliance in which two or more firms develop a contractual relationship to share some of their resources in pursuit of a mutually beneficial project.

Non-market strategies focus on altering a firm's institutional environment as a part of its competitive strategy.

Nonsubstitutable capabilities are capabilities that do not have strategic equivalents.

O

Operational relatedness provides opportunities to share resources among the operational activities of the firm.

An **opportunity** is a condition in the general environment that, if exploited effectively, helps a company reach strategic competitiveness.

Organizational capital refers to intangible resources the firm possesses that distinguish it from other firms and thus provide the potential to lead to a sustainable competitive advantage.

Organizational controls guide the use of strategy, indicate how to compare actual results with expected results, and suggest corrective actions to take when the difference is unacceptable.

Organizational structure specifies the firm's formal reporting relationships, procedures, controls, and authority and decision-making processes.

Outsourcing is the purchase of a value-creating activity or a support function activity from an external supplier.

Ownership concentration is defined by the number of large-block shareholders and the total percentage of the firm's shares they own.

P

The political/legal segment is the arena in which organizations and interest groups compete for attention, resources, and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and various local governmental agencies.

Primary stakeholders are directly involved in the value creating processes of the firm.

Protectionism involves actions taken by a government to protect its economy from adverse influences due to foreign trade

Q

Quality exists when the firm's products meet or exceed customers' expectations.

R

Rare capabilities are capabilities that few, if any, competitors possess.

Resources are inputs into a firm's production process, such as capital equipment, the skills of individual employees, patents, finances, and talented managers.

A **related acquisition** occurs when a firm acquires another firm in a highly related industry.

Resource similarity is the extent to which the firm's tangible and intangible resources compare favorably to a competitor's in terms of type and amount.

Restructuring is a strategy through which a firm changes its set of businesses or its financial structure.

Risk is an investor's uncertainty about the economic gains or losses that will result from a particular investment.

S

A second mover is a firm that responds to the first mover's competitive action, typically through imitation.

Secondary stakeholders can both influence and are influenced by what the firm does, but they do not contribute directly to the value the firm creates.

Shareholder activism refers to actions shareholders take with the intent of influencing corporate policy and practice.

simple structure is an organizational form in which the owner-manager makes all major decisions and monitors all activities, while the staff serves as an extension of the manager's supervisory authority.

Slow-cycle markets are markets in which competitors lack the ability to imitate the focal firm's competitive advantages that commonly last for long periods, and where imitation would be costly.

Social capital involves relationships inside and outside the firm that help in efforts to complete tasks that create value for stakeholders.

The sociocultural segment is concerned with a society's attitudes and cultural values.

Stakeholders are individuals, groups, and organizations that can both influence and are affected by the objectives, actions, and outcomes of a firm.

Standard-cycle markets are markets in which some competitors may be able to imitate the focal firm's competitive advantages and where that imitation is moderately costly.

A **strategic action** (or a **strategic response)** is a market-based move that involves a significant commitment of organizational resources and is difficult to implement and reverse.

A **strategic alliance** is a cooperative strategy in which firms combine some of their resources to create a competitive advantage.

A **strategic business unit (SBU) form** is a multidivisional structure consisting of three levels: corporate headquarters, strategic business units (SBUs), and SBU divisions.

Strategic change is change resulting from selecting and implementing a firm's strategies.

Firms achieve **strategic competitiveness** by successfully formulating and implementing a value creating strategy.

Strategic controls are largely subjective criteria intended to verify that the firm is using appropriate strategies for the conditions in the external environment and the company's competitive advantages.

Strategic entrepreneurship involves taking entrepreneurial actions using a strategic perspective.

Strategic flexibility is a set of capabilities firms use to respond to various demands and opportunities existing in today's dynamic and uncertain competitive environment.

A set of firms emphasizing similar strategic dimensions and using a similar strategy is called a **strategic group.**

Strategic human capital allows a firm to develop capabilities through matching the knowledge, skills, and abilities of their employees to particular strategic objectives.

Strategic leadership is the ability to anticipate, envision, maintain flexibility, and empower others to create strategic change as necessary.

The **strategic management process** is the full set of commitments, decisions, and actions required for a firm to achieve strategic competitiveness and earn above-average returns.

A **strategy** is an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage.

The sustainable physical environment segment refers to potential and actual changes in the physical environment as well as business practices that are intended to positively respond to those changes in order to create a sustainable environment.

Support functions include the activities or tasks the firm completes in order to support the work being done to produce, sell, distribute, and service the products the firm is producing.

Sustainability means that a firm should not deplete or destroy natural elements upon which it depends for survival.

synergistic strategic alliance is a strategy in which firms share some of their resources to create economies of scope.

Synergy exists when the value created by business units working together exceeds the value that those same units create working independently.

T

A **tactical action** or a (**tactical response)** is a market-based move firms take to fine-tune a strategy; these actions and responses involve fewer resources and are relatively easy to implement and reverse.

takeover is a special type of acquisition where the target firm does not solicit the acquiring firm's bid.

Tangible resources are assets that can be observed and quantified.

The **technological segment** includes the institutions and activities involved in creating new knowledge and translating that knowledge into new outputs, products, processes, and materials.

A **threat** is a condition in the general environment that may hinder a company's efforts to achieve strategic competitiveness.

A **top management team** (TMT) is composed of the individuals responsible for making certain the firm uses the strategic management process, especially to select and implement strategies.

Total quality management (TQM) involves the implementation of appropriate tools/techniques to provide products and services to customers with best quality.

transnational strategy is an international strategy through which the firm seeks to achieve both global efficiency and local responsiveness.

V

Valuable capabilities allow the firm to exploit opportunities or neutralize threats in its external environment.

Value is measured by a product's performance characteristics and by its attributes for which customers are willing to pay.

Value chain activities are activities or tasks the firm completes in order to produce products and then sell, distribute, and service those products in ways that create value for customers.

In a **value creation system**, each part of a system depends on other parts of the system to create value. If one part of the system is not functioning properly, it can hold back creation of value in the entire system.

vertical acquisition refers to a firm acquiring a supplier or distributor of one or more of its products.

Vertical integration exists when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration).

Vision is a picture of what the firm wants to be and, in broad terms, what it wants to ultimately achieve.

W

The **worldwide geographic area structure** emphasizes national interests and facilitates the firm's efforts to satisfy local differences.

In the **worldwide product divisional structure**, decision-making authority is centralized in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units.

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