

chapter one

What Is Strategy and Why Is It Important?



Strategy means making clear-cut choices about how to compete.

—**Jack Welch**

Former CEO, General Electric

A strategy is a commitment to undertake one set of actions rather than another.

—**Sharon Oster**

Professor, Yale University

The process of developing superior strategies is part planning, part trial and error, until you hit upon something that works.

—**Costas Markides**

Professor, London Business School

Without a strategy the organization is like a ship without a rudder.

—**Joel Ross and Michael Kami**

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

In this opening chapter, we define the concept of strategy and describe its many facets. We shall indicate the kinds of actions that determine what a company's strategy is, why strategies are partly proactive and partly reactive, and why company strategies tend to evolve over time. We will look at what sets a winning strategy apart from ho-hum or flawed strategies and why the caliber of a company's strategy determines whether it will enjoy a competitive advantage or be burdened by competitive disadvantage. By the end of this chapter, you will have a pretty clear idea of why the tasks of crafting and executing strategy are core management functions and why excellent execution of an excellent strategy is the most reliable recipe for turning a company into a standout performer.

WHAT DO WE MEAN BY STRATEGY?

A company's **strategy** is management's action plan for running the business and conducting operations. The crafting of a strategy represents a managerial *commitment to pursue a particular set of actions* in growing the business, attracting and pleasing customers, competing successfully, conducting operations, and improving the company's financial and market performance. Thus a company's strategy is all about *how*—*how* management intends to grow the business, *how* it will build a loyal clientele and outcompete rivals, *how* each functional piece of the business (research and development,

Core Concept

A company's **strategy** consists of the competitive moves and business approaches that managers are employing to grow the business, attract and please customers, compete successfully, conduct operations, and achieve the targeted levels of organizational performance.

supply chain activities, production, sales and marketing, distribution, finance, and human resources) will be operated, *how* performance will be boosted. In choosing a strategy, management is in effect saying, "Among all the many different business approaches and ways of competing we could have chosen, we have decided to employ this particular combination of competitive and operating approaches in moving the company in the intended direction, strengthening its market position and competitiveness, and boosting performance." The strategic choices a company makes are seldom easy decisions, and some of them may turn out to be wrong—but that is not an excuse for not deciding on a concrete course of action.¹

In most industries companies have considerable freedom in choosing the *hows* of strategy.² Thus, some rivals strive to improve their performance and market standing by achieving lower costs than rivals, while others pursue product superiority or personalized customer service or the development of competencies and capabilities that rivals cannot match. Some target the high end of the market, while others go after the middle or low end; some opt for wide product lines, while others concentrate their energies on a narrow product lineup. Some competitors position themselves in only one part of the industry's chain of production/distribution activities (preferring to be just in manufacturing or wholesale distribution or retailing), while others are partially or fully integrated, with operations ranging from components production to manufacturing and assembly to wholesale distribution or retailing. Some competitors deliberately confine their operations to local or regional markets; others opt to compete nationally, internationally (several countries), or globally (all or most of the major country markets worldwide). Some companies decide to operate in only one industry, while others diversify broadly or narrowly, into related or unrelated industries, via acquisitions, joint ventures, strategic alliances, or internal start-ups.

At companies intent on gaining sales and market share at the expense of competitors, managers typically opt for offensive strategies, frequently launching fresh initiatives of one kind or another to make the company's product offering more distinctive and appealing to buyers. Companies already in a strong industry position are more prone to strategies that emphasize gradual gains in the marketplace, fortifying the company's market position, and defending against the latest maneuvering of rivals and other developments that threaten the company's well-being. Risk-averse companies often prefer conservative strategies, preferring to follow the successful moves of pioneering companies whose managers are more entrepreneurial and willing to take the risks of being first to make a bold and perhaps pivotal move that reshapes the contest among market rivals.

There is no shortage of opportunity to fashion a strategy that both tightly fits a company's own particular situation and is discernibly different from the strategies of rivals. In fact, a company's managers normally attempt to make strategic choices about the key building blocks of its strategy that differ from the choices made by competitors—not 100 percent different but at least different in several important respects. A strategy stands a better chance of succeeding when it is predicated on actions, business approaches, and competitive moves aimed at (1) appealing to buyers in ways that set a company apart from rivals and (2) carving out its own market position. Simply copying what successful companies in the industry are doing and trying to mimic their market position rarely works. Rather, there needs to be some distinctive "aha" element to the strategy that draws in customers and produces a competitive edge. Carbon-copy strategies among companies in the same industry are the exception rather than the rule.

For a concrete example of the actions and approaches that comprise strategy, see Illustration Capsule 1.1, which describes Comcast's strategy to revolutionize the cable TV business.



Illustration Capsule 1.1

Comcast's Strategy to Revolutionize the Cable Industry

In 2004–2005 cable TV giant Comcast put the finishing touches on a bold strategy to change the way people watched television and to grow its business by introducing Internet phone service. With revenues of \$18 billion and almost 22 million of the 74 million U.S. cable subscribers, Comcast became the industry leader in the U.S. market in 2002 when it acquired AT&T Broadband, along with its 13 million cable subscribers, for about \$50 billion. Comcast's strategy had the following elements:

- *Continue to roll out high-speed Internet or broadband service to customers via cable modems.* With over 8 million customers that generated revenues approaching \$5 billion annually, Comcast was already America's number one provider of broadband service. It had recently upgraded its broadband service to allow download speeds of up to six megabits per second—considerably faster than the DSL-type broadband service available over telephone lines.
- *Continue to promote a relatively new video-on-demand service that allowed digital subscribers to watch TV programs whenever they wanted to watch them.* The service allowed customers to use their remotes to choose from a menu of thousands of programs, stored on Comcast's servers as they were first broadcast, and included networks shows, news, sports, and movies. Viewers with a Comcast DVR set-top box had the ability to pause, stop, restart, and save programs, without having to remember to record them when they were broadcast. Comcast had signed up over 10 million of its cable customers for digital service, and it was introducing enhanced digital and high-definition television (HDTV) service in additional geographic markets at a brisk pace.
- *Promote a video-on-demand service whereby digital customers with a set-top box could order and watch pay-per-view movies using a menu on their remote.* Comcast's technology enabled viewers to call up the programs they wanted with a few clicks of the remote. In 2005, Comcast had almost 4000 program choices and customers were viewing about 120 million videos per month.
- *Partner with Sony, MGM, and others to expand Comcast's library of movie offerings.* In 2004, Comcast agreed to develop new cable channels using MGM and Sony libraries, which had a combined 7,500 movies and 42,000 TV shows—it took about 300 movies to feed a 24-hour channel for a month.
- *Use Voice over Internet Protocol (VoIP) technology to offer subscribers Internet-based phone service at a fraction of the cost charged by other providers.* VoIP is an appealing low-cost technology widely seen as the most significant new communication technology since the invention of the telephone. Comcast was on track to make its Comcast Digital Voice (CDV) service available to 41 million homes by year-end 2006. CDV had many snazzy features, including call forwarding, caller ID, and conferencing, thus putting Comcast in position to go after the customers of traditional telephone companies.
- *Use its video-on-demand and CDV offerings to combat mounting competition from direct-to-home satellite TV providers.* Satellite TV providers such as EchoStar and DIRECTV had been using the attraction of lower monthly fees to steal customers away from cable TV providers. Comcast believed that the appeal of video-on-demand and low-cost CDV service would overcome its higher price. And satellite TV providers lacked the technological capability to provide either two-way communications connection to homes (necessary to offer video-on-demand) or reliable high-speed Internet access.
- *Employ a sales force (currently numbering about 3,200 people) to sell advertising to businesses that were shifting some of their advertising dollars from sponsoring network programs to sponsoring cable program.* Ad sales generated revenues of about \$1.6 billion, and Comcast had cable operations in 21 of the 25 largest markets in the United States.
- *Significantly improve Comcast's customer service.* Most cable subscribers were dissatisfied with the caliber of customer service offered by their local cable companies. Comcast management believed that service would be a big issue given the need to support video-on-demand, cable modems, HDTV, phone service, and the array of customer inquiries and problems such services entailed. In 2004, Comcast employed about 12,500 people to answer an expected volume of 200 million phone calls. Newly hired customer service personnel were given five weeks of classroom training, followed by three weeks of taking calls while a supervisor listened in—it cost Comcast about \$7 to handle each call. The company's goal was to answer 90 percent of calls within 30 seconds.

Sources: Information posted at www.comcast.com (accessed August 6, 2005); Marc Gunter, "Comcast Wants to Change the World, But Can It Learn to Answer the Phone?" *Fortune*, October 16, 2004, pp. 140–56; and Stephanie N. Mehta, "The Future Is on the Line," *Fortune*, July 26, 2004, pp. 121–30.

Strategy and the Quest for Competitive Advantage

The heart and soul of any strategy are the actions and moves in the marketplace that managers are taking to improve the company's financial performance, strengthen its long-term competitive position, and gain a competitive edge over rivals. A creative, distinctive strategy that sets a company apart from rivals and yields a competitive advantage is a company's most reliable ticket for earning above-average profits. Competing in the marketplace with a competitive advantage tends to be more profitable than competing with no advantage. And a company is almost certain to earn significantly higher profits when it enjoys a competitive advantage as opposed to when it is hamstrung by competitive disadvantage. Furthermore, if a company's competitive edge holds promise for being durable and sustainable (as opposed to just temporary), then so much the better for both the strategy and the company's future profitability. It's nice when a company's strategy produces at least a temporary competitive edge, but a

sustainable competitive advantage is plainly much better. What makes a competitive advantage sustainable as opposed to temporary are actions and elements in the strategy that cause an attractive number of buyers to have a *lasting preference* for a company's products or services as compared to the offerings of competitors. Competitive advantage is the key to above-average profitability and financial performance because strong buyer preferences for the company's product offering translate into higher sales volumes (Wal-Mart) and/or the ability to command a higher price (Häagen-Dazs), thus driving up earnings, return on investment, and other measures of financial performance.

Four of the most frequently used and dependable strategic approaches to setting a company apart from rivals, building strong customer loyalty, and winning a sustainable competitive advantage are:

1. *Striving to be the industry's low-cost provider, thereby aiming for a cost-based competitive advantage over rivals.* Wal-Mart and Southwest Airlines have earned strong market positions because of the low-cost advantages they have achieved over their rivals and their consequent ability to underprice competitors. Achieving lower costs than rivals can produce a durable competitive edge when rivals find it hard to match the low-cost leader's approach to driving costs out of the business. Despite years of trying, discounters like Kmart and Target have struck out trying to match Wal-Mart's frugal operating practices, super-efficient distribution systems, and its finely honed supply chain approaches that allow it to obtain merchandise from manufacturers at super-low prices.
2. *Outcompeting rivals based on such differentiating features as higher quality, wider product selection, added performance, value-added services, more attractive styling, technological superiority, or unusually good value for the money.* Successful adopters of differentiation strategies include Johnson & Johnson in baby products (product reliability), Harley-Davidson (bad-boy image and king-of-the-road styling), Chanel and Rolex (top-of-the-line prestige), Mercedes-Benz and BMW (engineering design and performance), L. L. Bean (good value), and Amazon.com (wide selection and convenience). Differentiation strategies can be powerful so long as a company is sufficiently innovative to thwart clever rivals in finding ways to copy or closely imitate the features of a successful differentiator's product offering.
3. *Focusing on a narrow market niche and winning a competitive edge by doing a better job than rivals of serving the special needs and tastes of buyers comprising*

Core Concept

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

the niche. Prominent companies that enjoy competitive success in a specialized market niche include eBay in online auctions, Jiffy Lube International in quick oil changes, McAfee in virus protection software, Starbucks in premium coffees and coffee drinks, Whole Foods Market in natural and organic foods, CNBC and The Weather Channel in cable TV.

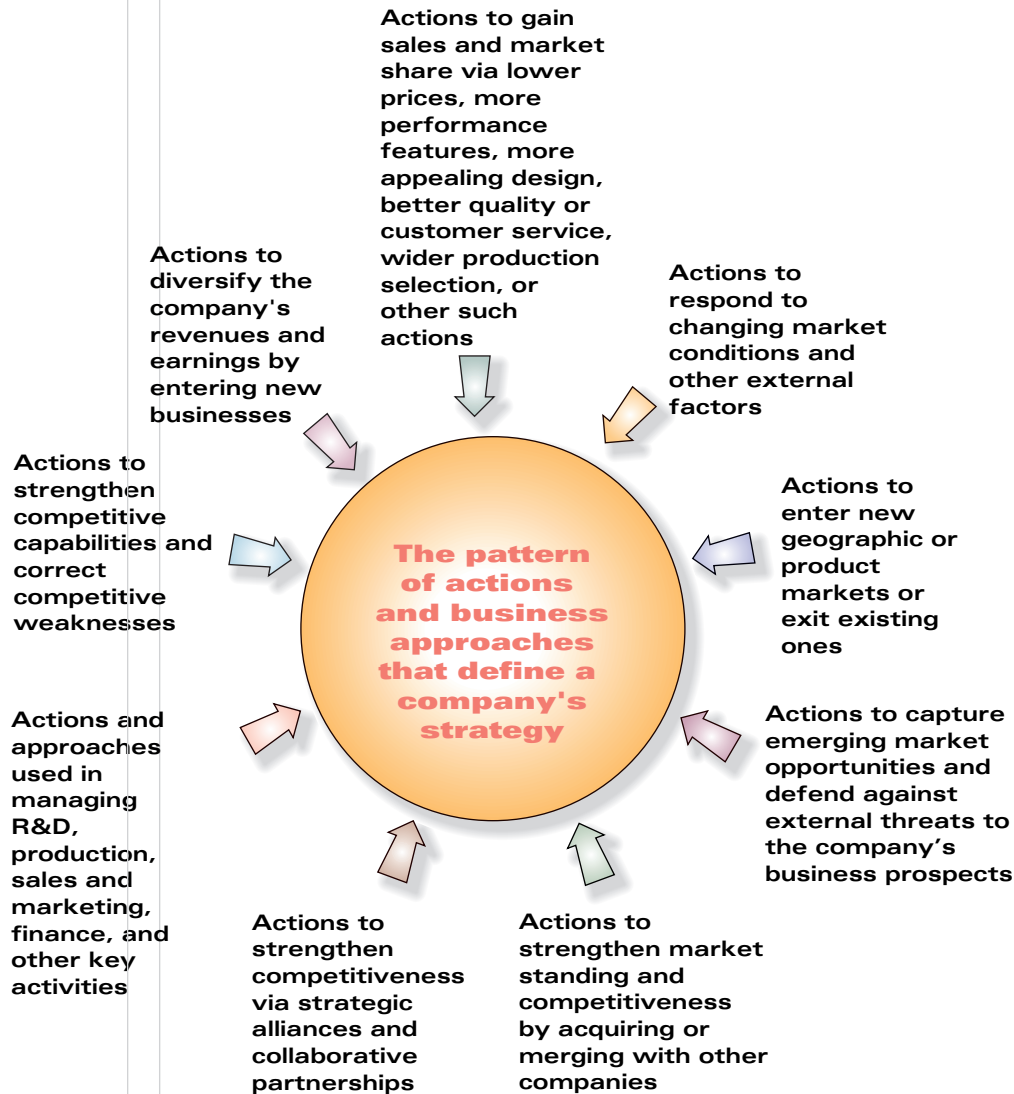
4. *Developing expertise and resource strengths that give the company competitive capabilities that rivals can't easily imitate or trump with capabilities of their own.* FedEx has superior capabilities in next-day delivery of small packages. Walt Disney has hard-to-beat capabilities in theme park management and family entertainment. Over the years, Toyota has developed a sophisticated production system that allows it to produce reliable, largely defect-free vehicles at low cost. IBM has wide-ranging expertise in helping corporate customers develop and install cutting-edge information systems. Ritz-Carlton and Four Seasons have uniquely strong capabilities in providing their hotel guests with an array of personalized services. Very often, winning a durable competitive edge over rivals hinges more on building competitively valuable expertise and capabilities than it does on having a distinctive product. Clever rivals can nearly always copy the attributes of a popular or innovative product, but for rivals to match experience, know-how, and specialized competitive capabilities that a company has developed and perfected over a long period of time is substantially harder to duplicate and takes much longer.

The tight connection between competitive advantage and profitability means that the quest for sustainable competitive advantage always ranks center stage in crafting a strategy. The key to successful strategy making is to come up with one or more differentiating strategy elements that act as a magnet to draw customers and yield a lasting competitive edge. Indeed, what separates a powerful strategy from a run-of-the-mill or ineffective one is management's ability to forge a series of moves, both in the marketplace and internally, that sets the company apart from its rivals, tilts the playing field in the company's favor by giving buyers reason to prefer its products or services, and produces a sustainable competitive advantage over rivals. The bigger and more sustainable the competitive advantage, the better the company's prospects for winning in the marketplace and earning superior long-term profits relative to its rivals. Without a strategy that leads to competitive advantage, a company risks being outcompeted by stronger rivals and/or locked in to mediocre financial performance. Hence, company managers deserve no gold stars for coming up with a ho-hum strategy that results in ho-hum financial performance and a ho-hum industry standing.

Identifying a Company's Strategy

The best indicators of a company's strategy are its actions in the marketplace and the statements of senior managers about the company's current business approaches, future plans, and efforts to strengthen its competitiveness and performance. Figure 1.1 shows what to look for in identifying the key elements of a company's strategy.

Once it is clear what to look for, the task of identifying a company's strategy is mainly one of researching information about the company's actions in the marketplace and business approaches. In the case of publicly owned enterprises, the strategy is often openly discussed by senior executives in the company's annual report and 10-K report, in press releases and company news (posted on the company's Web site), and in the information provided to investors at the company's Web site. To maintain the confidence of investors and Wall Street, most public companies have to be fairly open about their strategies. Company executives typically lay out key elements of their strategies in

Figure 1.1 Identifying a Company's Strategy—What to Look for

presentations to securities analysts (the accompanying PowerPoint slides are usually posted in the investor relations section of the company's Web site), and stories in the business media about the company often include aspects of the company's strategy. Hence, except for some about-to-be-launched moves and changes that remain under wraps and in the planning stage, there's usually nothing secret or undiscoverable about a company's present strategy.

Why a Company's Strategy Evolves over Time

Irrespective of where the strategy comes from—be it the product of top executives or the collaborative product of numerous company personnel—it is unlikely that the strategy, as originally conceived, will prove entirely suitable over time. Every company must be willing and ready to modify its strategy in response to changing market

conditions, advancing technology, the fresh moves of competitors, shifting buyer needs and preferences, emerging market opportunities, new ideas for improving the strategy, and mounting evidence that the strategy is not working well. Thus, *a company's strategy is always a work in progress.*

Most of the time a company's strategy evolves incrementally from management's ongoing efforts to fine-tune this or that piece of the strategy and to adjust certain strategy elements in response to unfolding events. But, on occasion, major strategy shifts are called for, such as when a strategy is clearly failing and the company faces a financial crisis, when market conditions or buyer preferences change significantly, or when important technological breakthroughs occur. In some industries, conditions change at a fairly slow pace, making it feasible for the major components of a good strategy to remain in place for long periods. But in industries where industry and competitive conditions change frequently and in sometimes dramatic ways, the life cycle of a given strategy is short. Industry environments characterized by *high-velocity change* require companies to rapidly adapt their strategies.³ For example, companies in industries with rapid-fire advances in technology—like medical equipment, electronics, and wireless devices—often find it essential to adjust one or more key elements of their strategies several times a year, sometimes even finding necessary to reinvent their approach to providing value to their customers. Companies in online retailing and the travel and resort industries find it necessary to adapt their strategies to accommodate sudden bursts of new spending or sharp drop-offs in demand, often updating their market prospects and financial projections every few months.

But regardless of whether a company's strategy changes gradually or swiftly, the important point is that a company's present strategy is always temporary and on trial, pending new ideas for improvement from management, changing industry and competitive conditions, and any other new developments that management believes warrant strategy adjustments. Thus, a company's strategy at any given point is fluid, representing the temporary outcome of an ongoing process that, on the one hand, involves reasoned and creative management efforts to craft an effective strategy and, on the other hand, involves ongoing responses to market change and constant experimentation and tinkering. Adapting to new conditions and constantly learning what is working well enough to continue and what needs to be improved is consequently a normal part of the strategy-making process and results in an evolving strategy.

A Company's Strategy Is Partly Proactive and Partly Reactive

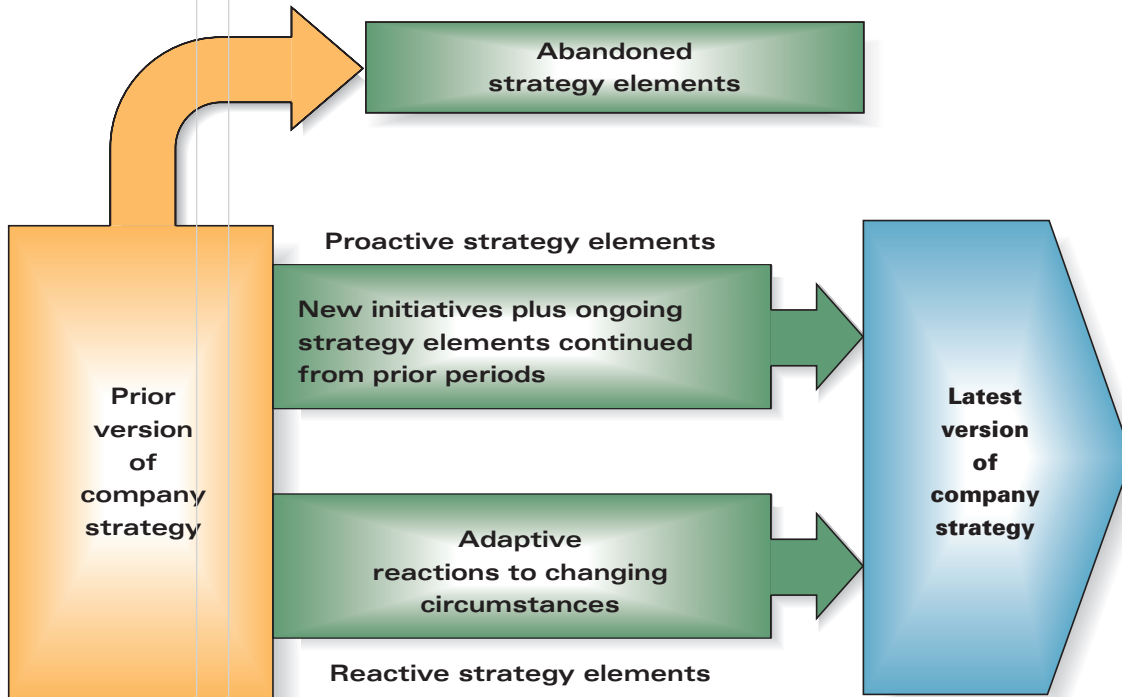
The evolving nature of a company's strategy means that the typical company strategy is a blend of (1) proactive actions to improve the company's financial performance and secure a competitive edge and (2) as-needed reactions to unanticipated developments and fresh market conditions (see Figure 1.2).⁴ The biggest portion of a company's current strategy flows from previously initiated actions and business approaches that are working well enough to merit continuation and newly launched initiatives aimed at boosting financial performance and edging out rivals. Typically, managers proactively modify this or that aspect of their strategy as new learning emerges about which pieces of the strategy are working well and which aren't, and as they hit upon new ideas for strategy improvement. This part of management's action plan for running the company is deliberate and proactive, standing as the current product of management's latest and best strategy ideas.

Core Concept

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

A company's strategy is shaped partly by management analysis and choice and partly by the necessity of adapting and learning by doing.

Figure 1.2 A Company's Strategy Is a Blend of Proactive Initiatives and Reactive Adjustments



But managers must always be willing to supplement or modify all the proactive strategy elements with as-needed reactions to unanticipated developments. Inevitably, there will be occasions when market and competitive conditions take an unexpected turn that calls for some kind of strategic reaction or adjustment. Hence, a portion of a company's strategy is always developed on the fly, coming as a response to fresh strategic maneuvers on the part of rival firms, unexpected shifts in customer requirements and expectations, fast-changing technological developments, newly appearing market opportunities, a changing political or economic climate, or other unanticipated happenings in the surrounding environment. These adaptive strategy adjustments form the reactive strategy elements.

As shown in Figure 1.2, a company's strategy evolves from one version to the next as managers abandon obsolete or ineffective strategy elements, settle upon a set of *proactive/intended strategy elements*, and then adapt the strategy as new circumstances unfold, thus giving rise to *reactive/adaptive strategy elements*. A company's strategy thus tends to be a *combination* of proactive and reactive elements. In the process, some strategy elements end up being abandoned because they have become obsolete or ineffective.

STRATEGY AND ETHICS: PASSING THE TEST OF MORAL SCRUTINY

In choosing from among strategic alternatives, company managers are well advised to embrace actions that are aboveboard and can pass the test of moral scrutiny. Just

keeping a company's strategic actions within the bounds of what is legal does not mean the strategy is ethical. Ethical and moral standards are not governed by what is legal. Rather, they involve issues of both right versus wrong and *duty*—what one *should* do. A strategy is ethical only if (1) it does not entail actions and behaviors that cross the line from “should do” to “should not do” (because such actions are unsavory, unconscionable, or injurious to other people or unnecessarily harmful to the environment) and (2) it allows management to fulfill its ethical duties to all stakeholders—owners/shareholders, employees, customers, suppliers, the communities in which it operates, and society at large.

Admittedly, it is not always easy to categorize a given strategic behavior as definitely ethical or definitely unethical. Many strategic actions fall in a gray zone in between, and whether they are deemed ethical or unethical hinges on how clearly the boundaries are defined. For example, is it ethical for advertisers of alcoholic products to place ads in media having an audience of as much as 50 percent underage viewers? (In 2003, growing concerns about underage drinking prompted some beer and distilled spirits companies to agree to place ads in media with an audience at least 70 percent adult, up from a standard of 50 percent adult.) Is it ethical for an apparel retailer attempting to keep prices attractively low to source clothing from foreign manufacturers who pay substandard wages, use child labor, or subject workers to unsafe working conditions? Many people would say no, but some might argue that a company is not unethical simply because it does not police the business practices of its suppliers. Is it ethical for the makers of athletic uniforms, shoes, and other sports equipment to pay coaches large sums of money to induce them to use the manufacturer's products in their sport? (The compensation contracts of many college coaches include substantial payments from sportswear and sports equipment manufacturers, and the teams subsequently end up wearing the uniforms and using the products of those manufacturers.) Is it ethical for manufacturers of life-saving drugs to charge higher prices in some countries than they charge in others? (This is a fairly common practice that has recently come under scrutiny because it raises the costs of health care for consumers who are charged higher prices.) Is it ethical for a company to turn a blind eye to the damage its operations do to the environment even though its operations are in compliance with current environmental regulations—especially if it has the know-how and the means to alleviate some of the environmental impacts by making relatively inexpensive changes in its operating practices?

Senior executives with strong ethical convictions are generally proactive in linking strategic action and ethics: They forbid the pursuit of ethically questionable business opportunities and insist that all aspects of company strategy reflect high ethical standards.⁵ They make it clear that all company personnel are expected to act with integrity, and they put organizational checks and balances into place to monitor behavior, enforce ethical codes of conduct, and provide guidance to employees regarding any gray areas. Their commitment to conducting the company's business in an ethical manner is genuine, not hypocritical.

Instances of corporate malfeasance, ethical lapses, and fraudulent accounting practices at Enron, WorldCom, Tyco, Adelphia, HealthSouth, and other companies leave no room to doubt the damage to a company's reputation and business that can result from ethical misconduct, corporate misdeeds, and even criminal behavior on the part of company personnel. Aside from just the embarrassment and black marks that accompany headline exposure of a company's unethical practices, the hard fact is that many customers and many suppliers are wary of doing business with a company that engages in sleazy practices or that turns a blind eye to illegal or unethical behavior

Core Concept

A strategy cannot be considered ethical just because it involves actions that are legal. To meet the standard of being ethical, a strategy must entail actions that can pass moral scrutiny and that are aboveboard in the sense of not being shady, unconscionable, or injurious to others or unnecessarily harmful to the environment.

on the part of employees. They are turned off by unethical strategies or behavior and, rather than become victims or get burned themselves, wary customers will quickly take their business elsewhere and wary suppliers will tread carefully. Moreover, employees with character and integrity do not want to work for a company whose strategies are shady or whose executives lack character and integrity. There's little lasting benefit to unethical strategies and behavior, and the downside risks can be substantial. Besides, such actions are plain wrong.

THE RELATIONSHIP BETWEEN A COMPANY'S STRATEGY AND ITS BUSINESS MODEL

Core Concept

A company's **business model** explains the rationale for why its business approach and strategy will be a moneymaker. Absent the ability to deliver good profitability, the strategy is not viable and the survival of the business is in doubt.

Closely related to the concept of strategy is the concept of a company's **business model**. While the word *model* conjures up images of ivory-tower ideas that may be loosely connected to the real world, such images do not apply here. A company's business model is management's story line for how the strategy will be a moneymaker. The story line sets forth the key components of the enterprise's business approach, indicates how revenues will be generated, and makes a case for why the strategy can deliver value to customers in a profitable manner.⁶ A company's business model thus explains why its business approach and strategy will generate ample revenues to cover costs and capture a profit.

The nitty-gritty issue surrounding a company's business model is whether the chosen strategy makes good business sense. Why is there convincing reason to believe that the strategy is capable of producing a profit? How will the business generate its revenues? Will those revenues be sufficient to cover operating costs? Will customers see enough value in what the business does for them to pay a profitable price? The concept of a company's business model is, consequently, more narrowly focused than the concept of a company's business strategy. A company's strategy *relates broadly to its competitive initiatives and action plan for running the business* (but it may or may not lead to profitability). However, a company's business model zeros in on *the principal business components by which the business will generate revenues sufficient to cover costs and produce attractive profits and return on investment*. Absent the ability to deliver good profits, the strategy is not viable, the business model is flawed, and the business itself will fail.

Companies that have been in business for a while and are making acceptable profits have a proven business model—because there is hard evidence that their strategies are capable of profitability. Companies that are in a start-up mode or that are losing money have questionable business models; their strategies have yet to produce good bottom-line results, putting their story line about how they intend to make money and their viability as business enterprises in doubt.

Magazines and newspapers employ a business model based on generating sufficient subscriptions and advertising to cover the costs of delivering their products to readers. Cable TV companies, cell-phone providers, record clubs, satellite radio companies, and Internet service providers also employ a subscription-based business model. The business model of network TV and radio broadcasters entails providing free programming to audiences but charging advertising fees based on audience size. McDonald's invented the business model for fast food—economical quick-service meals at clean, convenient locations. Wal-Mart has perfected the business model for

big-box discount retailing—a model also used by Home Depot, Costco, and Target. Gillette’s business model in razor blades involves selling a “master product”—the razor—at an attractively low price and then making money on repeat purchases—the razor blades. Printer manufacturers like Hewlett-Packard, Lexmark, and Epson pursue much the same business model as Gillette—selling printers at a low (virtually break-even) price and making large profit margins on the repeat purchases of printer supplies, especially ink cartridges. Companies like Dell and Avon employ a direct sales business model that helps keep prices low by cutting out the costs of reaching consumers through distributors and retail dealers. Illustration Capsule 1.2 discusses the contrasting business models of Microsoft and Red Hat Linux.

WHAT MAKES A STRATEGY A WINNER?

Three questions can be used to test the merits of one strategy versus another and distinguish a winning strategy from a so-so or flawed strategy:

1. *How well does the strategy fit the company’s situation?* To qualify as a winner, a strategy has to be well matched to industry and competitive conditions, a company’s best market opportunities, and other aspects of the enterprise’s external environment. At the same time, it has to be tailored to the company’s resource strengths and weaknesses, competencies, and competitive capabilities. Unless a strategy exhibits tight fit with both the external and internal aspects of a company’s overall situation, it is likely to produce less than the best possible business results.
2. *Is the strategy helping the company achieve a sustainable competitive advantage?* Winning strategies enable a company to achieve a competitive advantage that is durable. The bigger and more durable the competitive edge that a strategy helps build, the more powerful and appealing it is.
3. *Is the strategy resulting in better company performance?* A good strategy boosts company performance. Two kinds of performance improvements tell the most about the caliber of a company’s strategy: (a) gains in profitability and financial strength, and (b) gains in the company’s competitive strength and market standing.

Once a company commits to a particular strategy and enough time elapses to assess how well it fits the situation and whether it is actually delivering competitive advantage and better performance, then one can determine what grade to assign that strategy. Strategies that come up short on one or more of the above questions are plainly less appealing than strategies that pass all three test questions with flying colors.

Managers can also use the same questions to pick and choose among alternative strategic actions. A company evaluating which of several strategic options to employ can evaluate how well each option measures up against each of the three questions. The strategic option with the highest prospective passing scores on all three questions can be regarded as the best or most attractive strategic alternative.

Other criteria for judging the merits of a particular strategy include internal consistency and unity among all the pieces of strategy, the degree of risk the strategy poses as compared to alternative strategies, and the degree to which it is flexible and adaptable to changing circumstances. These criteria are relevant and merit consideration, but they seldom override the importance of the three test questions posed above.

Core Concept

A winning strategy must fit the enterprise’s external and internal situation, build sustainable competitive advantage, and improve company performance.



Illustration Capsule 1.2

Microsoft and Red Hat: Two Contrasting Business Models

The strategies of rival companies are often predicated on strikingly different business models. Consider, for example, the business models for Microsoft and Red Hat in operating system software for personal computers (PCs).

Microsoft's business model for making money from its Windows operating system products is based on the following revenue-cost-profit economics:

- Employ a cadre of highly skilled programmers to develop proprietary code; keep the source code hidden so as to keep the inner workings of the software proprietary.
- Sell the resulting operating system and software package to PC makers and to PC users at relatively attractive prices (around \$75 to PC makers and about \$100 at retail to PC users); strive to maintain a 90 percent or more market share of the 150 million PCs sold annually worldwide.
- Strive for big-volume sales. Most of Microsoft's costs arise on the front end in developing the software and are thus fixed; the variable costs of producing and packaging the CDs provided to users are only a couple of dollars per copy—once the break-even volume is reached, Microsoft's revenues from additional sales are almost pure profit.
- Provide a modest level of technical support to users at no cost.
- Keep rejuvenating revenues by periodically introducing next-generation software versions with features that will induce PC users to upgrade the operating system on previously purchased PCs to the new version.

Red Hat, a company formed to market its own version of the Linux open-source operating system, employs a business model based on sharply different revenue-cost-profit economics:

- Rely on the collaborative efforts of volunteer programmers from all over the world who contribute bits and pieces of code to improve and polish the Linux system. The global community of thousands of programmers who work on Linux in their spare time do what they do because they love it, because they are fervent believers that all software should be free (as in free speech), and in some cases because they are anti-Microsoft and want to have a part in undoing what they see as a Microsoft monopoly.

- Collect and test enhancements and new applications submitted by the open-source community of volunteer programmers. Linux's originator, Linus Torvalds, and a team of 300-plus Red Hat engineers and software developers evaluate which incoming submissions merit inclusion in new releases of Linux—the evaluation and integration of new submissions are Red Hat's only up-front product development costs.
- Market the upgraded and tested family of Red Hat products to large enterprises and charge them a subscription fee that includes 24/7 support within one hour in seven languages. Provide subscribers with updated versions of Linux every 12–18 months to maintain the subscriber base.
- Make the source code open and available to all users, allowing them to create a customized version of Linux.
- Capitalize on the specialized expertise required to use Linux in multiserver, multiprocessor applications by providing fees-based training, consulting, software customization, and client-directed engineering to Linux users. Red Hat offers Linux certification training programs at all skill levels at more than 60 global locations—Red Hat certification in the use of Linux is considered the best in the world.

Microsoft's business model—sell proprietary code software and give service away free—is a proven money-maker that generates billions in profits annually. In contrast, the jury is still out on Red Hat's business model of selling subscriptions to open-source software to large corporations and deriving substantial revenues from the sales of technical support (included in the subscription cost), training, consulting, software customization, and engineering to generate revenues sufficient to cover costs and yield a profit. Red Hat posted losses of \$140 million on revenues of \$79 million in fiscal year 2002 and losses of \$6.6 million on revenues of \$91 million in fiscal year 2003, but it earned \$14 million on revenues of \$126 million in fiscal 2004. The profits came from a shift in Red Hat's business model that involved putting considerably more emphasis on getting large corporations to purchase subscriptions to the latest Linux updates. In 2005, about 75 percent of Red Hat's revenues came from large enterprise subscriptions, compared to about 53 percent in 2003.

WHY ARE CRAFTING AND EXECUTING STRATEGY IMPORTANT?

Crafting and executing strategy are top-priority managerial tasks for two very big reasons. First, there is a compelling need for managers to *proactively shape*, or *craft*, how the company's business will be conducted. A clear and reasoned strategy is management's prescription for doing business, its road map to competitive advantage, its game plan for pleasing customers and improving financial performance. Winning in the marketplace requires a well-conceived, opportunistic strategy, usually one characterized by strategic offensives to outinnovate and outmaneuver rivals and secure sustainable competitive advantage, then using this market edge to achieve superior financial performance. A powerful strategy that delivers a home run in the marketplace can propel a firm from a trailing position into a leading one, clearing the way for its products/services to become the industry standard. High-achieving enterprises are nearly always the product of astute, creative, proactive strategy making that sets a company apart from its rivals. Companies don't get to the top of the industry rankings or stay there with imitative strategies or with strategies built around timid actions to try to do better. And only a handful of companies can boast of strategies that hit home runs in the marketplace due to lucky breaks or the good fortune of having stumbled into the right market at the right time with the right product. There can be little argument that a company's strategy matters—and matters a lot.

Second, a *strategy-focused enterprise* is more likely to be a strong bottom-line performer than a company whose management views strategy as secondary and puts its priorities elsewhere. There's no escaping the fact that the quality of managerial strategy making and strategy execution has a highly positive impact on revenue growth, earnings, and return on investment. A company that lacks clear-cut direction, has vague or undemanding performance targets, has a muddled or flawed strategy, or can't seem to execute its strategy competently is a company whose financial performance is probably suffering, whose business is at long-term risk, and whose management is sorely lacking. In contrast, when crafting and executing a winning strategy drive management's whole approach to operating the enterprise, the odds are much greater that the initiatives and activities of different divisions, departments, managers, and work groups will be unified into a *coordinated, cohesive effort*. Mobilizing the full complement of company resources in a total team effort behind good execution of the chosen strategy and achievement of the targeted performance allows a company to operate at full power. The chief executive officer of one successful company put it well when he said:

In the main, our competitors are acquainted with the same fundamental concepts and techniques and approaches that we follow, and they are as free to pursue them as we are. More often than not, the difference between their level of success and ours lies in the relative thoroughness and self-discipline with which we and they develop and execute our strategies for the future.

Good Strategy + Good Strategy Execution = Good Management

Crafting and executing strategy are core management functions. Among all the things managers do, nothing affects a company's ultimate success or failure more fundamentally than how well its management team charts the company's direction, develops

Core Concept

Excellent execution of an excellent strategy is the best test of managerial excellence—and the most reliable recipe for turning companies into standout performers.

competitively effective strategic moves and business approaches, and pursues what needs to be done internally to produce good day-in, day-out strategy execution and operating excellence. Indeed, *good strategy and good strategy execution are the most trustworthy signs of good management*. Managers don't deserve a gold star for designing a potentially brilliant strategy but failing to put the organizational means in place to carry it out in high-caliber fashion—weak implementation and execution undermine the strategy's potential and pave the way for shortfalls in customer satisfaction and company performance. Competent execution of a mediocre strategy scarcely merits

enthusiastic applause for management's efforts either. The rationale for using the twin standards of good strategy making and good strategy execution to determine whether a company is well managed is therefore compelling: *The better conceived a company's strategy and the more competently it is executed, the more likely that the company will be a standout performer in the marketplace.*

Throughout the text chapters to come and the accompanying case collection, the spotlight is trained on the foremost question in running a business enterprise: What must managers do, and do well, to make a company a winner in the marketplace? The answer that emerges, and that becomes the message of this book, is that doing a good job of managing inherently requires good strategic thinking and good management of the strategy-making, strategy-executing process.

The mission of this book is to provide a solid overview of what every business student and aspiring manager needs to know about crafting and executing strategy. This requires exploring what good strategic thinking entails; presenting the core concepts and tools of strategic analysis; describing the ins and outs of crafting and executing strategy; and, through the cases, helping you build your skills both in diagnosing how well the strategy-making, strategy-executing task is being performed in actual companies and in prescribing actions for how the companies in question can improve their approaches to crafting and executing their strategies. At the very least, we hope to convince you that capabilities in crafting and executing strategy are basic to managing successfully and merit a place in a manager's tool kit.

As you tackle the following pages, ponder the following observation by the essayist and poet Ralph Waldo Emerson: "Commerce is a game of skill which many people play, but which few play well." If the content of this book helps you become a more savvy player and equips you to succeed in business, then your journey through these pages will indeed be time well spent.

Key Points

The tasks of crafting and executing company strategies are the heart and soul of managing a business enterprise and winning in the marketplace. A company's strategy is the game plan management is using to stake out a market position, conduct its operations, attract and please customers, compete successfully, and achieve organizational objectives. The central thrust of a company's strategy is undertaking moves to build and strengthen the company's long-term competitive position and financial performance and, ideally, gain a competitive advantage over rivals that then becomes a company's ticket to above-average profitability. A company's strategy typically evolves and reforms over time, emerging from a blend of (1) proactive and purposeful actions on the part of company managers and (2) as-needed reactions to unanticipated developments and fresh market conditions.

Closely related to the concept of strategy is the concept of a company's business model. A company's business model is management's story line for how and why

the company's product offerings and competitive approaches will generate a revenue stream and have an associated cost structure that produces attractive earnings and return on investment—in effect, a company's business model sets forth the economic logic for making money in a particular business, given the company's current strategy.

A winning strategy fits the circumstances of a company's external situation and its internal resource strengths and competitive capabilities, builds competitive advantage, and boosts company performance.

Crafting and executing strategy are core management functions. Whether a company wins or loses in the marketplace is directly attributable to the caliber of a company's strategy and the proficiency with which the strategy is executed.

Exercises

1. Go to Red Hat's Web site (www.redhat.com) and check whether the company's recent financial reports indicate that its business model is working. Is the company sufficiently profitable to validate its business model and strategy? Is its revenue stream from selling training, consulting, and engineering services growing or declining as a percentage of total revenues? Does your review of the company's recent financial performance suggest that its business model and strategy are changing? Read the company's latest statement about its business model and about why it is pursuing the subscription approach (as compared to Microsoft's approach of selling copies of its operating software directly to PC manufacturers and individuals).
2. From your perspective as a cable or satellite service consumer, does Comcast's strategy as described in Illustration Capsule 1.1 seem to be well matched to industry and competitive conditions? Does the strategy seem to be keyed to maintaining a cost advantage, offering differentiating features, serving the unique needs of a niche, or developing resource strengths and competitive capabilities rivals can't imitate or trump (or a mixture of these)? Do you think Comcast's strategy has evolved in recent years? Why or why not? What is there about Comcast's strategy that can lead to sustainable competitive advantage?
3. On December 15, 2003, Levi Strauss & Company announced it would close its two last remaining apparel plants in the United States to finalize its transition from a clothing manufacturer to a marketing, sales, and design company. Beginning in 2004, all Levi's apparel would be produced by contract manufacturers located in low-wage countries. As recently as 1990, Levi Strauss had produced 90 percent of its apparel in company-owned plants in the United States employing over 20,000 production workers. With every plant closing, Levi Strauss & Company provided severance and job retraining packages to affected workers and cash payments to small communities where its plants were located. However, the economies of many small communities have yet to recover and some employees have found it difficult to match their previous levels of compensation and benefits.

Review Levi Strauss & Company's discussion of its Global Sourcing and Operating Guidelines at www.levistrauss.com/responsibility/conduct. Does the company's strategy fulfill the company's ethical duties to all stakeholders—owners/shareholders, employees, customers, suppliers, the communities in which it operates, and society at large? Does Levi Strauss's strategy to outsource all of its manufacturing operations to low-wage countries pass the moral scrutiny test? Is it ethical for a company to close plants employing over 20,000 workers? Why or why not?