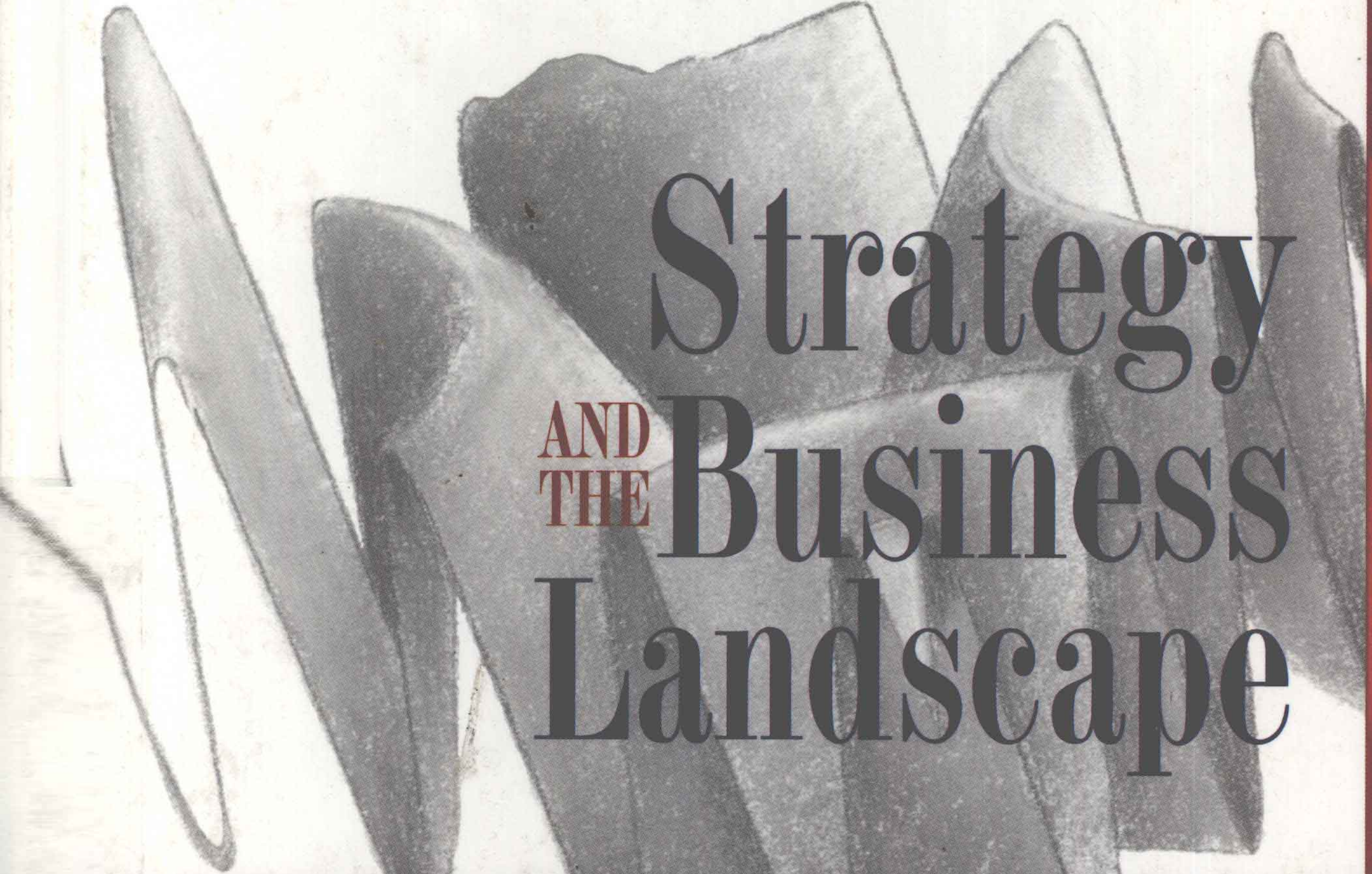
Pankaj Ghemawat



Strategy and the Business Landscape

TEXT AND CASES

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with

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Case material of the Harvard Graduate School of Business Administration is made possible by the cooperation of business firms and other organizations which may wish to remain anonymous by having names, quantities, and other identifying details disguised while maintaining basic relationships. Cases are prepared as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Preface

This book grew out of my experience, over the last four years, teaching and then running Harvard Business School's required first-year course on Competition and Strategy. My colleagues and I were dissatisfied with the available strategy textbooks and disinclined to assign a mish-mash of book chapters and articles instead. As a result, I, along with some of them, began to write conceptual notes for our students. These notes, which have since been revised several times, constitute the core of this book.

Strategy and the Business Landscape has several distinguishing features.

First and perhaps most obviously, it begins with and maintains a historical perspective on the field of strategy. This approach offers several advantages. It avoids imposing an arbitrary definition of strategy on the reader. Tracking changing conceptions of strategy can also help identify patterns in what might otherwise seem to be just the random churn of ideas. Most ambitiously, an understanding of the history of the field may foster an ability to sort through the continual barrage of new ideas—some good and others bad—about strategy.

Second, this book tries to be contemporary as well as historically grounded. Thus Chapter 2 begins by reviewing early work on environmental analysis, particularly Michael Porter's influential "five forces" framework (which is standard practice), but goes on to discuss newer ways of thinking about the business landscape (which is not). Chapter 3 pursues a parallel line of development, starting with the early work on competitive positioning but culminating in the more recent conceptualizations of added value and rugged landscapes. Chapters 4 and 5 deal with dynamic issues—the sustainability of superior performance and the instrumental roles of capabilities and commitments—that most strategists have begun to address only since the mid-1980s.

Third, this book uses firm-centered, value-based logic to bridge some of the great debates about strategy. It addresses the debate about internal versus external focus by concentrating on the firm in relation to its environment, aided by the visual imagery of the business landscape. The debate about competition versus cooperation is channeled into the recognition that both kinds of relationships affect a firm's added value as well as its ability to sustain and appropriate some of that value over time. And the debate about the activity-system vs. resource-based views of the firm is dealt with at length in chapter 5 which emphasizes both the complementarity of these two perspectives on strategy and the way in which they need to be extended.

Fourth, this book tries to be practical as well as rigorous. Key concepts are laid out succinctly (but with suggestions for additional reading in the notes). They are illustrated with rich examples, often drawn from consulting work. In addition, the process of actually applying these concepts to real-world situations is discussed in some detail.

Fifth, *Strategy and the Business Landscape* contains a core set of Harvard Business School cases that further illustrate, deepen, and extend the concepts developed in Chapters 1 through 5. Both tried-and-tested favorites and more contemporary material that appears promising have been included. These cases should be treated as staples, to be supplemented with other cases as necessary. Working through a number of the cases is likely to be important to the internalization of strategy concepts.

Finally, this book focuses on business- rather than corporate-level strategy. While strategies at the corporate and business levels intersect to some extent significant differences are also apparent in many of the management issues raised. In addition, corporate strategy may have less immediate relevance to most of the M.B.A. students taking an introductory course on strategy. Having said that, there are obviously a number of good readings on corporate strategy that can be assigned in conjunction with this book for a course whose scope extends to corporate- as well as business-level issues.

It would have been impossible to prepare this book without aid and support from a number of different quarters. My most obvious debt is to my coauthors on the individual chapters in this book, David J. Collis, Gary P. Pisano, and Jan W. Rivkin. Each pushed the chapter in which he was involved to a new level. Each also provided copious feedback on some of the other chapters in this book, although none of the three should be presumed to agree entirely with the end-product. I would also like to thank the authors and supervisors of the cases included in this book.

I am also greatly indebted to the other colleagues with whom I have taught the Competition and Strategy course at Harvard, particularly the ones in the Spring 1998 Competition and Strategy teaching group. All of them have stimulated and sharpened my thinking about business strategy, and some of them have commented on earlier drafts of the chapters in this book. I am especially grateful to Adam Brandenburger, for developing and helping educate me about a number of the key ideas in this book, as well as for reading and commenting on a number of the draft chapters.

I owe another very important debt to our students in the Competition and Strategy course, who were an invaluable source of feedback on earlier versions of the chapters in this book. Their perspective on what worked and what didn't greatly helped reorganize and refine the exposition in this book.

In addition, I should thank a number of reviewers for their guidance:

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Finally, I am very grateful to the members of the team assembled by Addison Wesley Longman for their patient support of this project as I insisted on revising the chapters "one last time"; to my research associates, Bret Baird and Courtenay Sprague, who helped me push this work toward completion; to my exceptionally able assistant, Sharilyn Steketee, who made the process as painless as possible; and to my wife, Anuradha Mitra Ghemawat. Thank you all.

Boston
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CHAPTER 1

CHAPTER 2

CHAPTER 1

The Origins of Strategy

If we wish to increase the yield of grain in a certain field and on analysis it appears that the soil lacks potash, potash may be said to be the strategic (or limiting) factor.

—*Chester I. Barnard*

The term "strategy" . . . is intended to focus on the interdependence of the adversaries' decisions and on their expectations about each other's behavior.

—*Thomas C. Schelling*

Strategy can be defined as the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out those goals.

—*Alfred D. Chandler, Jr.*

This chapter reviews the history of strategic thinking about business through the mid-1970s. The historical perspective, which is maintained throughout this book, is attractive for at least three reasons:

- Despite thoughtful attempts over the decades to define "strategy" (see the quotes at the beginning of this chapter), a rash of manifestos continue to emerge that purport to redefine the term.[1] It would therefore be idiosyncratic to begin by tossing another definition onto that pile. Examining the history of strategic ideas and practice constitutes a less arbitrary approach to the study of strategy.
- The historical perspective organizes changing conceptions of strategy as envisioned or enacted by the participants in this field—academics, managers, and consultants—allowing us to identify patterns in what might otherwise seem to be the chaotic churn of ideas. Patterns of this sort are evident in all the chapters of this book: coevolution with the environment, the development and diffusion of particular strategic paradigms, paradigm shifts, the recycling of earlier ideas, and so on.
- Most ambitiously, the idea of path-dependence (one of the rallying cries of academic strategists since the mid-1980s) suggests that an understanding of

the history of ideas about strategy is essential for having a more informed sense of where they might go in the future. This point is developed further in the last chapter of this book.

In this chapter, we briefly discuss the origins of strategic ideas. We begin with some background, including military antecedents and then move on to discuss ideas about strategy that were developed and disseminated by academics and consultants in the 1960s and early 1970s. We conclude by reviewing the dissatisfaction with the state of the field that had developed by the second half of the 1970s. In particular, the underdevelopment of two basic components of popular techniques for portfolio planning—environmental attractiveness and competitive positioning—set the stage for much of the subsequent work on these topics that is discussed in Chapters 2 and 3, respectively. Chapters 4 and 5 address the other weakness of portfolio planning by emphasizing the dynamic dimension of strategic thinking.

BACKGROUND

"Strategy" is a term that can be traced back to the ancient Greeks, who used it to mean a chief magistrate or a military commander-in-chief. Over the next two millennia, refinements of the concept of strategy continued to focus on military interpretations. Carl von Clausewitz's attempted synthesis in the first half of the nineteenth century is a particularly notable example: He wrote that whereas "tactics . . . [involve] the use of armed forces in the engagement, strategy [is] the use of engagements for the object of the war."[2] The adaptation of strategic terminology to a business context, however, had to await the Second Industrial Revolution, which began in the second half of the nineteenth century but really took off only in the twentieth century.[3]

The First Industrial Revolution (which spanned the mid-1700s to the mid-1800s) had failed to induce much in the way of strategic thinking or behavior. This failure can be chalked up to the inference that, while this period was marked by intense competition among industrial firms, virtually all of those companies lacked the power to influence market outcomes to any significant extent. Because the First Industrial Revolution was largely driven by the development of international trade in a few commodities (especially cotton), most businesses tended to remain small and to employ as little fixed capital as possible. The chaotic markets of this era led economists such as Adam Smith to describe market forces as an "invisible hand" that remained largely beyond the control of individual firms. Like the "butchers, bakers, and candlestick makers" of the medieval guild system, the small industrial and merchant firms of the time required little or no strategy in any of the senses described in the quotes at the beginning of this chapter.

The Second Industrial Revolution, which began in the last half of the nineteenth century in the United States, saw the emergence of strategy as a way to shape market forces and affect the competitive environment. In the United States, the construction of key railroads after 1850 made it possible to build mass markets for the first time. Along with improved access to capital and credit, mass markets encouraged large-scale investment to exploit economies of scale in production and economies of scope in distribution. In some capital-intensive industries, Adam Smith's "invisible hand" came to be supplemented by what Alfred D. Chandler, Jr., a famous historian, has termed the "visible hand" of professional managers. By the late nineteenth century, a new type of firm began to emerge, first in the United States and then in Europe: the large, vertically integrated company that invested heavily in manufacturing and marketing, and in management hierarchies to coordinate those functions. Over time, the largest companies of this sort began to alter the competitive environment within their industries and even cross industry boundaries.[4]

The need for explicitly strategic thinking was first articulated by high-level managers at these large companies. For example, Alfred Sloan, the chief executive of General Motors from 1923 to 1946, devised a successful strategy based on the perceived strengths and weaknesses of his company's critical competitor, the Ford Motor Company, and wrote it up after he retired.[5] In the 1930s, Chester Barnard, a senior executive with New Jersey Bell, argued that managers should pay especially close attention to "strategic factors" which depend on "personal or organizational action."[6]

World War II supplied a vital stimulus to strategic thinking in business as well as military domains, because it sharpened the problem of allocating scarce resources across the entire economy. New operations research techniques (for example, linear programming) were devised, which paved the way for the use of quantitative analysis in formal strategic planning. In 1944, John von Neumann and Oskar Morgenstern published their classic work, *The Theory of Games and Economic Behavior,* which solved the problem of zero-sum games (mostly military ones, from an aggregate perspective) and framed the issues surrounding non-zero-sum games (mostly business situations, which are discussed further in these terms in Chapter 4). Also, the concept of "learning curves" became an increasingly important tool for planning. The learning curve was first discovered in the military aircraft industry in the 1920s and 1930s, where manufacturers noticed that direct labor costs tended to decrease by a constant percentage as the cumulative quantity of aircraft produced doubled. Such learning effects figured prominently in wartime production planning efforts.

Wartime experiences encouraged not only the development of new tools and techniques, but also, in the view of some observers, the use of formal strategic thinking to guide management decisions. Peter Drucker, writing about this period, argued that "management is not just passive, adaptive behavior; it means taking action to make the desired results come to pass." He noted that economic theory had long treated markets as impersonal forces, beyond the control of individual entrepreneurs and organizations. In the age of large corporations, however, managing "implies responsibility for attempting to shape the economic environment, for planning, initiating and carrying through changes in that economic environment, for constantly pushing back the limitations of economic circumstances on the enterprise's freedom of action."[7] This insight became the key rationale for business strategy—that is, by consciously using formal planning, a company could exert some positive control over market forces.

These insights into the nature of strategy seemed, however, to lie fallow through the 1950s. In the United States, rationing or outright bans on production during World War II combined with high levels of private savings to create excess demand for many products. The Korean War provided a further boost in demand. Europe and Japan experienced even more severe postwar dislocations, which induced greater governmental control of what Lenin had called the "commanding heights" of an economy: its key industries and enterprises. Similar increases in governmental control, as opposed to reliance on market forces, were observed in poorer countries, including many of the new ones that emerged as colonialism unwound itself.[8]

A more direct bridge to the development of strategic concepts for business applications was provided by interservice competition in the U.S. military after World War II. During this period, American military leaders began debating which arrangements would best protect legitimate competition among military services while still maintaining the needed integration of strategic and tactical planning. Many argued that the Army, Navy, Marines, and Air Force would be more efficient if they were unified into a single organization. As the debate raged, Philip Selznick, a sociologist, noted that the Navy Department "emerged as the defender of subtle institutional values and tried many times to formulate the distinctive characteristics of the various services." In essence, "Navy spokesmen attempted to distinguish between the Army as a 'manpower' organization and the Navy as a finely adjusted system of technical, engineering skills—a 'machine-centered' organization. Faced with what it perceived as a mortal threat, the Navy became highly self-conscious about its distinctive competence."[9] The concept of "distinctive competence" had great resonance for strategic management, as we will see.

ACADEMIC UNDERPINNINGS

Eminent economists produced some of the earliest academic writings about strategy. For example, John Commons, an institutionalist, wrote in his 1934 book about business firms' focus on *strategic* or limiting factors in a way that was picked up a few years later—potash example and all—by Chester Barnard (see the first quote in the beginning of this chapter).[10] Ronald Coase, who might be called the first organizational economist, published a provocative article in 1937 that asked why firms exist—an article that continues to be cited six decades later, and garnered its author a Nobel Prize.[11] Joseph Schumpeter, a technologist, discussed in his 1942 book the idea that business strategy encompassed much more than the price-setting contemplated in orthodox microeconomics.[12] And a book published in 1959 by Edith Penrose explicitly related the growth of business firms to the resources under their control and the administrative framework used to coordinate their use.[13] Overall, however, economists had much less direct impact on the early evolution of academic thinking about business strategy than did academics located in business schools.

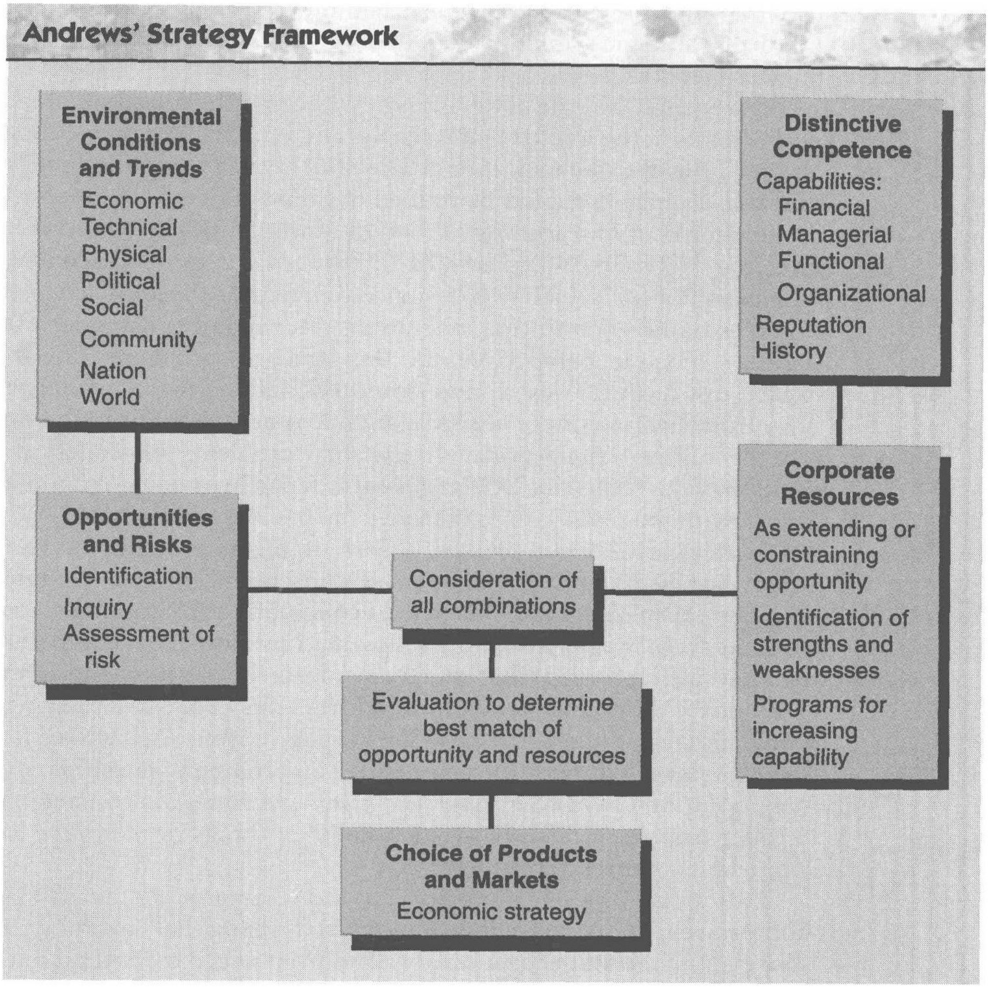
The Second Industrial Revolution witnessed the founding of many elite business schools in the United States, beginning with the Wharton School in 1881. The Harvard Business School, founded in 1908, was among the first to promote the idea that managers should be trained to think strategically rather than just acting as functional administrators, although strategy itself wasn't explicitly invoked until the 1960s. In 1912, Harvard introduced a required second-year course in "Business Policy," which was designed to integrate the knowledge gained in functional areas like accounting, operations, and finance. The goal was to give students a broader perspective on the strategic problems faced by corporate executives. A course description from 1917 claimed that "an analysis of any business problem shows not only its relation to other problems in the same group, but also the intimate connection of groups. Few problems in business are purely intradepartmental." Also, the policies of each department must maintain a "balance in accord with the underlying policies of the business as a whole." [14]

In the early 1950s, two professors of Business Policy at Harvard, George Albert Smith, Jr., and C. Roland Christensen, encouraged students to question whether a firm's strategy matched its competitive environment. In reading cases, students were taught to ask the following question: Do a company's policies "fit together into a program that effectively meets the requirements of the competitive situation?" [15] Students were told to address this problem by asking, "How is the whole industry doing? Is it growing and expanding? Is it static? Is it declining?" Then, having "sized up" the competitive environment, the student was to ask still more questions: "On what basis must any one company compete with the others in this particular industry? At what kinds of things does it have to be especially competent, in order to compete?" [16]

In the late 1950s, another Harvard Business Policy professor, Kenneth Andrews, expanded upon this thinking by arguing that "every business organization, every subunit of organization, and even every individual [ought to] have a clearly defined set of purposes or goals which keeps it moving in a *deliberately chosen direction* and prevents its drifting in undesired directions" (emphasis added). Like Alfred Sloan at General Motors, Andrews thought that "the primary function of the general manager, over time, is supervision of the continuous process of determining the nature of the enterprise and setting, revising and attempting to achieve its goals." [17] His conclusions were motivated by an industry note and company cases that Andrews prepared on Swiss watchmakers, which uncovered significant differences in performance associated with different strategies for competing in that industry.[18] This format of combining industry notes with company cases soon became the norm in Harvard's Business Policy course.[19]

In the 1960s, classroom discussions in business schools came to focus on matching a company's "strengths" and "weaknesses"—its distinctive competence—with the "opportunities" and "threats" (or risks) that it faced in the

EXHIBIT 1.1



marketplace. This framework, which came to be referred to by the acronym SWOT, represented a major step forward in bringing explicitly competitive thinking to bear on questions of strategy. Kenneth Andrews combined these elements in a way that emphasized that competencies or resources had to match environmental needs to have value (see Exhibit 1.1).[20]

In 1963, a business policy conference was held at Harvard that helped diffuse the SWOT concept in both academia and management practice. Attendance at the conference was heavy, but the ensuing popularity of SWOT—which was still used by many firms in the 1990s, including Wal*Mart—did not bring closure to the problem of actually defining a firm's distinctive competence. To solve this problem, strategists had to decide which aspects of the firm were "enduring and unchanging over relatively long periods of time" and which were "necessarily more responsive to changes in the marketplace and the pressures of other environmental forces." This distinction was crucial because "the *strategic* decision is concerned with the long-term development of the enterprise" (emphasis added).[21] When strategy choices were analyzed from a long-range perspective, the idea of "distinctive competence" took on added importance because most long-run investments involved greater risks. Thus, if the opportunities a firm was pursuing appeared "to outrun [its] present distinctive competence," then the strategist had to consider a firm's "willingness to gamble that the latter can be built up to the required level."[22]

The debate over a firm's "willingness to gamble" on its distinctive competence in its pursuit of an opportunity continued throughout the 1960s, fueled by a booming stock market and corporate strategies that were heavily geared toward growth and diversification. In a classic 1960 article that anticipated this debate, titled "Marketing Myopia," Theodore Levitt had been sharply critical of any firm that focused too narrowly on delivering a specific product, presumably exploiting its distinctive competence, rather than consciously serving the customer. Levitt argued that when companies fail, "it usually means that the product fails to adapt to the constantly changing patterns of consumer needs and tastes, to new and modified marketing institutions and practices, or to product developments in complementary industries."[23]

Another leading strategist, Igor Ansoff, disagreed with this position, arguing that Levitt asked companies to take unnecessary risks by investing in new products that might not match the firm's distinctive competence. Ansoff suggested that a company should first ask whether a new product had a "common thread" with its existing products. He defined the common thread as a firm's "mission" or its commitment to exploit an existing need in the market as a whole.[24] According to Ansoff, "sometimes the customer is erroneously identified as the common thread of a firm's business. In reality a given type of customer will frequently have a range of unrelated product missions or needs."[25] To enable a firm to maintain its strategic focus, Ansoff suggested four categories for defining the common thread in its business/corporate strategy, as depicted in Exhibit 1.2.[26] Ansoff and others also worked to translate the logic built into the SWOT framework into complex flowcharts of concrete questions that needed to be answered in the development of strategies.[27]

In the 1960s, diversification and technological changes increased the complexity of the strategic situations that many companies faced, and their need for more sophisticated measures that could be used to evaluate and compare many different types of businesses. Because academics at business schools remained strongly wedded to the idea that strategies could be analyzed only on a case-by-case basis that accounted for the unique characteristics of every business, corporations turned elsewhere to satisfy their craving for standardized approaches to strategy