GARTH SALONER
ANDREA SHEPARD
JOEL PODOLNY

STRATEGIC MANAGEMENT

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To

Marlene, Amber, Romy, and Kim
Diane, Anna, and Colin
Tamara, Aaron, and Asa
for this book and so much more

PREFACE

We have each taught the Strategic Management MBA core course at Stanford University's Graduate School of Business at various times over the past decade. Like many strategic management courses, ours is case-based, but we typically end our classes with a lecture summarizing the teaching points of the day. Over the years those lessons evolved from single slides to lengthy class notes. At some point we decided it would be easy and fruitful to pull this material together into a book. We were wrong about the former; we hope we were right about the latter.

We have written this book for current and future general managers who have or will have overall responsibility for a business. These managers have what can be the most rewarding of managerial jobs: to craft a strategy that will guide their business, to build an organization that can achieve their strategic goals, and to make the fundamental strategic decisions to navigate a changing world. *The essential ability for this job is a well-developed capability for strategic thinking*. We have tried to provide a set of frameworks, tools, and concepts to build this capability. We have drawn from research in the disciplines that surround and support strategic management with an inevitable emphasis on our own disciplinary backgrounds: theoretical and empirical microcoeconomics (especially industrial organization) and organization theory. While these disciplines have guided our writing, our steadfast focus has been on strategic management. Our goal has been to provide insights into organizations and strategy that will help general managers make strategic thinking in their firms pervasive, effective, and rewarding.

In writing a book about strategy from the perspective of the disciplines we have tried to achieve several things:

- We have tried to meld the various approaches rather than to pit them against one another. Consequently economic and organizational ideas are presented side-by-side.
- We have tried to focus on insights and concepts without bringing the full formal machinery of the related research to bear. As a result, we have written a book that is frugal in its use of footnotes to the literature, trusting that instructors will recognize and expand upon the underlying research as they see fit.
- Finally, we have chosen our material based on what we think is important for strategic thinking and have not, therefore, provided complete coverage of underlying disciplinary topics.

A number of colleagues have taught the course with us over the years and have contributed to our thinking. These collegues are Bill Barnett, Thomas Hellmann, Rebecca Henderson (on leave from MIT), Fiona Scott Morton, Kevin Murdock, and Ezra Zuckerman. Undoubtedly many of their ideas have found their way into the text.

Fiona and Rebecca also generously read and provided feedback on many of the chapters as we went along. Special thanks are due to Robert Burgelman who developed the predecessor course from which our course and book inherit a number of ideas and to Julio Rotemberg who helped develop some of the basic themes in the book. Thousands of Stanford MBA, Sloan, and executive education students have patiently endured many rough drafts of this material. Their feedback—and sometimes pushback—have molded and improved the book.

The course and book were developed during the decade in which Mike Spence presided as Dean of the Stanford GSB. His commitment to the strategy area was absolute, and his support for our efforts was unwavering. A number of other colleagues at the Stanford GSB and elsewhere have been influential in our thinking about this material and have helped us in various ways. We are grateful to David Baron, Jim Baron, Severin Borenstein, Tim Bresnahan, Mike Hannan, Paul Joskow, Jeffrey Pfeffer, David Kreps, Peter Reiss, John Roberts, Nancy Rose, Bob Wilson, and Mark Wolfson. We are also thankful to other colleagues who have read draft chapters or "beta tested" them in their own classrooms, including Judy Chevalier, Luis Garicano, Rob Gertner, Marvin Lieberman, and Peter Zemsky.

We have had the privilege of working with many outstanding general managers. These interactions have greatly influenced our understanding of what general managers need to know. We are especially grateful to managers and fellow board members at all the companies with whom we have worked. Special thanks are due to Peter Johnson, Chairman of QRS, for his wisdom over several years.

Our publisher, John Wiley & Sons, also solicited feedback from many reviewers to whom we are grateful. Some have been mentioned above and some have chosen to remain anonymous. We thank them all, including Duncan Angwin, Brian Boyd, Mason Carpenter, Kenneth Corts, James Davis, Derrick D'Souza, Arthur Francis, Philip Gibbs, Ari Ginsberg, Bruce Kogut, Julia Porter Liebeskind, John McGee, Mark Meckler, William Mitchell, Peter Moran, Atul Nerkar, John Prescott, Michael D. Ryall, Anju Seth, Richard A. Spinello, John Stanbury, Rod White, and Robert Wiseman.

The editors and staff at John Wiley have been wonderful partners. Joe Heider began working with us on this project before we had even decided to do it! Brent Gordon patiently managed the editorial process, Gerald Lombardi improved every sentence, and Johnna Barto ably managed development. At Stanford, Sandra Berg poured hours into correcting draft after draft, and Linda Bethel provided assistance with the illustrations.

Our greatest debt is to our parents, partners, and children for their love and support. For all the times this book took precedence over more important things, the dedication comes from the bottom of our hearts. At last we can say with certainty—and no small measure of relief—that the answer to the persistent question "When *will* the book be finished?" is "Now."

Garth Saloner
Andrea Shepard
Joel Podolny

Stanford, California

STRATEGIC MANAGEMENT

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CHAPTER 1

INTRODUCTION

1.1 STRATEGIC MANAGEMENT

Some firms experience meteoric growth, achieving industry leadership, while others falter, stagnate, or fail. Some firms seem to seize every opportunity, while others seem always to move too late or not at all. Consider, for example, the performance of Coca-Cola relative to its contemporaries. One dollar invested in the Coca-Cola Company at its initial public offering in 1919 would have been worth over $200,000 in 2000, while a dollar invested in a portfolio of representative large U.S. stocks over the same period would have been worth less than $4200![1] Moreover, for every successful company started when Coca-Cola was founded, many more have long gone out of business.

A manager who is keenly aware of this tremendous range of firm performance naturally looks for some pattern that distinguishes success from failure. However, a review of the history of successful firms suggests a broad range of ways to achieve superior performance. Some firms have succeeded by innovating, and others by eschewing innovation in favor of operational efficiency. Some successful firms have sought to grow as quickly as possible, while others have pursued modest growth. Some dominate their market, while others prosper by concentrating on a small market segment.

Variation in firm performance and in the strategies successful firms pursue is not surprising given the vast differences in the industries in which firm participate, the regulatory environments they face, and the human, financial, and physical assets they can bring to bear. But the variation is perplexing for a manager who must navigate the firm's external environment in a way that makes the most of the firm's assets. Strategic management is fundamentally about helping the manager in that quest. It is about developing a set of tools and conceptual maps for uncovering the systematic relationships between the choices the manager makes and the performance the firm realizes.

[1] *Source: Stocks, Bonds, Bills, and Inflation: 1997 Yearbook* (Chicago: Ibbotson Associates, 1997) and authors' calculations.

Having a set of tools and frameworks is essential because a manager faces a bewildering array of choices every day. This array includes deciding which products or services to pursue, which investments to make, which human resource management policies to implement, and which organizational structures to adopt. Furthermore, in an organization of even modest size, strategic choices are made by multiple decision makers and implemented by many employees in different functional areas and geographies.

There is the danger, then, that the course the firm takes will be determined by the buffeting it receives from its competitive environment and by the aggregation of uncoordinated decisions made by independent actors within the firm. Its performance will be haphazard, opportunities will be lost, and threats will loom uncountered. The alternative is for the firm's managers to develop a common, overall sense of what they want the business to achieve and to formulate a strategy that they believe will enable it to achieve those goals. Developing and implementing a strategy that allows managers to exercise more control over the firm's direction and to chart a course that enhances the firm's performance are the objectives of strategic management.

1.2 THE ROLE OF BUSINESS STRATEGY

Firm performance depends both on the actions the firm takes and on the context in which those actions are taken. By "action" we mean the acquisition and deployment of the firm's assets. Each firm has some existing set of assets including know-how, business processes, plant and equipment, brand equity, formal and informal organizational structure, financial resources, and so forth. Action consists of deploying existing assets and acquiring new ones. Although many of these decisions are routine and incremental, some asset acquisition and deployment decisions can profoundly affect the firm.[2] For example, in an attempt to improve its performance in the small car segment of the automobile industry, General Motors (GM) decided in the early 1980s to invest more than a *billion* dollars in a new, small car division it named "Saturn." Saturn represented a sharp break with the product development, manufacturing, distribution, and human resources management processes common to GM's other divisions. The shift represented by Saturn was embodied in significant redeployment of GM's human resources, a change in its fundamental business practices, and a major investment of its financial assets in a new plant.

Although the firm chooses the actions it takes, factors that are immutable, at least in the short run, also affect its performance. These factors represent the "context" in which the firm acts. As our discussion of "action" suggests, some of these factors are internal. The firm's *internal context* consists of the assets it owns and the way it is organized.[3] Other factors are external to the firm. The firm's *external environment* includes

[2] This perspective is consistent with the focus of Pankaj Ghemawat who describes the firm's major resource *commitments* as its major strategic assets. (*Source:* Pankaj Ghemawat, *Commitment: The Dynamics of Strategy*, New York: Free Press, 1991.)

[3] It is tempting to include the way the firm is organized as an asset rather than as a separate feature of its internal context. Instead we choose to preserve organization as a separate category to highlight the complex and important role it plays in affecting firm performance. Because organization determines the way people interact, the activities they choose to pursue, and the policies and routines the firm employs to get things done, we believe that the organizational attributes of the firm deserve separate mention.