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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*

P R E F A C E

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 microeconomics (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 colleagues 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 push-back—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.”

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STRATEGIC MANAGEMENT

B R I E F C O N T E N T S

1	INTRODUCTION	1
2	BUSINESS STRATEGY	19
3	COMPETITIVE ADVANTAGE	39
4	INTERNAL CONTEXT: ORGANIZATION DESIGN	65
5	ORGANIZATION AND COMPETITIVE ADVANTAGE	93
6	EXTERNAL CONTEXT: INDUSTRY ANALYSIS	119
7	THE SPECTRUM OF COMPETITION AND NICHE MARKETS	149
8	COMPETITION IN CONCENTRATED MARKETS	185
9	ENTRY AND THE ADVANTAGE OF INCUMBENCY	215
10	CREATING AND CAPTURING VALUE IN THE VALUE CHAIN	239
11	STRATEGIC MANAGEMENT IN A CHANGING ENVIRONMENT	271
12	STRATEGY IN MARKETS WITH DEMAND-SIDE INCREASING RETURNS	305
13	GLOBALIZATION AND STRATEGY	329
14	CORPORATE STRATEGY: MANAGING FOR VALUE IN A MULTIBUSINESS COMPANY	351
15	THE STRATEGY PROCESS	381
Appendix	APPLYING GAME THEORY TO STRATEGIC MANAGEMENT	405
Credits		427
Index		429

CONTENTS

1	INTRODUCTION	1
1.1	Strategic Management	1
1.2	The Role of Business Strategy	2
	Examples: Dell Computer and Compaq Computer	4
	The Dynamics of Business Strategy	6
	Strategic Planning versus Strategic Thinking	8
1.3	The Organization and Its Objectives	10
	Performance: Overarching Objectives	10
	Firms and Managers	12
1.4	Perspectives on the Impact of the General Manager	14
1.5	Organization of the Book	16
2	BUSINESS STRATEGY	19
2.1	Introduction	19
2.2	Describing Business Strategy	19
	Goals	20
	Scope	21
	Competitive Advantage	21
	Logic	22
2.3	Relationship of Strategy to Mission, Purpose, Values, and Vision	24
	Mission, Purpose, and Values	24
	Vision	27
2.4	The Strategy Statement	28
	Benefits of an Explicit Strategy Statement	29
	The Form and Use of the Strategy Statement	30
	An Example: Borders Books	31
2.5	Developing Strategy: The Strategy Process	33
	Strategy Identification	34
	Strategy Evaluation: Testing the Logic	35
	Strategy Process and Strategic Change	36
2.6	Summary	38
3	COMPETITIVE ADVANTAGE	39
3.1	Introduction	39

3.2	Value and Competitive Advantage	39
3.3	Two Main Routes to Competitive Advantage	41
	Position	43
	Capabilities	46
3.4	Sustainable Competitive Advantage	48
	Capability as Sustainable Competitive Advantage	49
	Position as Sustainable Competitive Advantage	50
3.5	The Relationship of Position to Capabilities	51
3.6	Position, Capabilities, and "The Resource-Based View of the Firm"	53
3.7	The Cost-Quality Frontier and Competitive Advantage	55
	Product Quality and Cost	56
	A Cost-Quality Framework	58
	Using the Cost-Quality Frontier to Illustrate Competitive Advantage: An Example	59
3.8	Summary	63
4	INTERNAL CONTEXT: ORGANIZATION DESIGN	65
4.1	Introduction	65
4.2	Organization Design and Competitive Advantage	65
4.3	Strategy and Organization at Southwest Airlines	67
	Southwest's Strategy and Performance	67
	Southwest's Organization	68
	Comparisons to Other Airlines	70
	Summary: Consistency and Alignment	71
4.4	The Challenge of Organization Design	71
	The Coordination Problem	72
	The Incentive Problem	73
4.5	Meeting the Challenge	75
	Architecture: Structure	76
	Architecture: Compensation and Rewards	82
	Routines	86
	Culture	88
4.6	ARC Analysis	89
4.7	Summary	90
5	ORGANIZATION AND COMPETITIVE ADVANTAGE	93
5.1	Introduction	93
5.2	Aligning Strategy and Organization	95
	Applying ARC Analysis to Assess Strategic Alignment: Southwest Airlines Revisited	97
	Other Examples: Sony, Apple Computer, and Silicon Graphics	101
5.3	Building and Creating Competitive Advantage	102

Explorers and Exploiters	103
Interdependence and Tight-Coupling	106
Organizational Slack	109
Central Direction	110
The ARC of Explorers and Exploiters	111
5.4 Combining Exploration and Exploitation	114
5.5 Costs of Organizational Change	117
5.6 Summary	117
6 EXTERNAL CONTEXT: INDUSTRY ANALYSIS	119
6.1 Introduction	119
6.2 The Effects of Industry Characteristics on Firm Performance	120
6.3 Organizing Industry Analysis	123
6.4 A Framework for Industry Analysis	127
Value Creation: Potential Industry Earnings (PIE)	129
Determinants of PIE	130
An Example of Value Creation: Lobster PIE	133
Capturing Value: Dividing PIE	136
Competition	136
Entry and Incumbency Advantage	138
An Example of the Effects of Competition and Entry	139
Vertical Power: Buyer or Supplier Power	140
Dividing the Lobster PIE	142
6.5 Industry Definition	144
Industry Definition Based on "Close" Substitutes	145
Industry Definitions for Systems of Complementary Products	146
6.6 Summary	147
7 THE SPECTRUM OF COMPETITION AND NICHE MARKETS	149
7.1 Introduction	149
7.2 The Spectrum of Competition	150
Structure and Behavior	153
7.3 Niche Markets and Product Differentiation	154
Building, Defending, and Exploiting a Market Niche: Benetton and the Gap	155
7.4 Consumer Preferences and Product Differentiation	157
Preferences and Products	157
Horizontal and Vertical Product Differentiation	161
7.5 Differentiation and Competition	162
Niches and Neighbors	163
Differentiation Softens Competition	165
Price Competition and Market Share	168

7.6	Product Positioning	170
7.7	Summary	172
Appendix	Monopoly, Competition, and Niche Markets	172
	Monopoly	173
	Perfect Competition	176
	Niche Markets	178
8	COMPETITION IN CONCENTRATED MARKETS	185
8.1	Introduction	185
8.2	Oligopoly: The Elements of Strategic Interaction	186
	Differences in Actions	189
	Timing	197
	Players	199
	Information	200
	Repetition	202
	Summary	208
8.3	Dominant Firms	209
8.4	Antitrust	211
	Collusion and Antitrust	211
8.5	Summary	213
9	ENTRY AND THE ADVANTAGE OF INCUMBENCY	215
9.1	Introduction	215
9.2	Types of Incumbency Advantage	217
	Scale Advantages	217
	Incumbency Advantage from Cumulative Investment	222
	Incumbency Advantage from Consumer Loyalty	226
	Incumbency Advantage from Switching Costs and Demand-Side Increasing Returns	227
	Incumbency Advantage from Sunk Costs	228
	Firm Scope	229
9.3	Entry Barriers at Work	231
9.4	Strategically Creating Incumbency Advantage	232
	Packing the Product Space	232
	Blocking Entry through Contract or Vertical Integration	235
	Signaling to Prevent Entry	235
	Entry Barriers and Antitrust	236
9.5	Summary	237
10	CREATING AND CAPTURING VALUE IN THE VALUE CHAIN	239
10.1	Introduction	239
10.2	Value Creation and Value Capture	239

10.3	The Value Chain and Buyer or Supply Power	242
10.4	Capturing Value	244
	Value Capture without Buyer or Supplier Power	245
	Value Capture by a Single Powerful Supplier (or Buyer)	247
	Value Capture When Buyers and Suppliers Are Powerful	249
	Reducing Power in Other Segments	254
10.5	Creating Value	255
	Opportunities for Creating Value: The Coordination Problem	257
	Contracting to Create Value: The Incentive Problem	260
10.6	Summary	263
Appendix	Price Discrimination	264

11 STRATEGIC MANAGEMENT IN A CHANGING ENVIRONMENT 271

11.1	Introduction	271
11.2	The Evolution of the U.S. Automobile Industry	272
11.3	Change and Competitive Advantage	274
11.4	Industry Life Cycle	277
	Emergence	278
	Growth	283
	Maturity and Decline	284
11.5	The Evolution of Industry Organization	287
	Horizontal vs. Vertical Organization	287
	Organizational Implications of Industry Structure	292
11.6	Managing Strategic Change	294
	Overcoming the Barriers to Strategic Change	294
	Managing Under Uncertainty: Scenario Analysis	301
	Strategic Change: An Example	302
11.7	Summary	304

12 STRATEGY IN MARKETS WITH DEMAND-SIDE INCREASING RETURNS 305

12.1	Introduction	305
12.2	Sources of Demand-Side Increasing Returns (DSIR)	306
	Compatibility Benefits	306
	Network Benefits	308
12.3	Competition in Markets with Demand-Side Increasing Returns	311
	Installed Base and Tipping	311
	Competitive Strategies for Building DSIR	315
12.4	Systems of Components	317
	System Compatibility	317
	Leveraging Market Position	318

12.5	Technology Adoption	321
12.6	Managing the Adoption Process	323
	Marketing to Create Momentum	324
	Leveraging Reputation	324
	Committing to "Open" Standards	325
	Winning Over An Influential Buyer	325
	Advance Sign-Ups	325
	Winks at Pirates	325
	Leasing	326
	Price Commitments	326
12.7	Standards-Setting Processes	326
12.8	Summary	328
13	GLOBALIZATION AND STRATEGY	329
13.1	Introduction	329
13.2	Implications for Managers	330
13.3	Strategic Gains from Globalization	332
13.4	Globalization of Industries and Economies	334
13.5	Strategic Challenges	335
	The Challenge of Local Responsiveness	336
	The Challenge of Global Efficiency	340
	The Challenge of Learning	341
13.6	Organizing to Meet the Challenge	344
	Federated vs. Centralized	344
	Building the Middle Ground	345
	The Regional Organization	346
	Locational Advantage	346
	The Transnational Corporation	348
13.7	Summary	349
14	CORPORATE STRATEGY: MANAGING FOR VALUE IN A MULTIBUSINESS COMPANY	351
14.1	Introduction	351
14.2	A Framework for Corporate Strategy	352
	Managing Strategic Spillovers	354
	A Framework for Corporate Strategy	356
14.3	Does Corporate Add Value?	358
	The Performance of Diversified Firms	359
14.4	Strategic Spillovers and Competitive Advantage	361
	Identifying and Managing Spillovers	362
	Sources of Spillovers	363
14.5	Levers: Resource Allocation and Organization Design	366
	Resource Allocation	367

Organization Design	371
Corporate Direction	377
14.6 Summary	379

15 THE STRATEGY PROCESS	381
15.1 Introduction	381
15.2 Some Principles of the Strategy Process	382
15.3 Business Strategy Process	383
Strategy Identification	384
Strategy Evaluation	385
Developing and Evaluating Strategic Options	387
Selecting and Communicating the Strategy	388
Strategy Process in a Rapidly Changing Environment	389
15.4 Strategic Plans	390
15.5 The Evolution of Strategy	393
Autonomous and Intentional Strategic Changes	395
15.6 Corporate Strategic Processes	397
Corporate Strategy Processes for Strategically Independent Businesses	397
Corporate Strategy for Strategically Interdependent Businesses	401
The Role of General Managers	402
15.7 Concluding Remarks	403

APPENDIX APPLYING GAME THEORY TO STRATEGIC MANAGEMENT 405

A.1 Introduction	405
A.2 A Famous Example: The Prisoners' Dilemma	406
A.3 Nash Equilibrium and Duopoly	410
A.4 The Effect of Repetition	414
A.5 Credibility, Commitment, and Flexibility	416
The Value of Flexibility: Real Options	417
Commitment and Credibility	418
A.6 Strategic Behavior in the Presence of Asymmetric Information	422
A.7 Summary	425

CREDITS	427
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INDEX	429
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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.