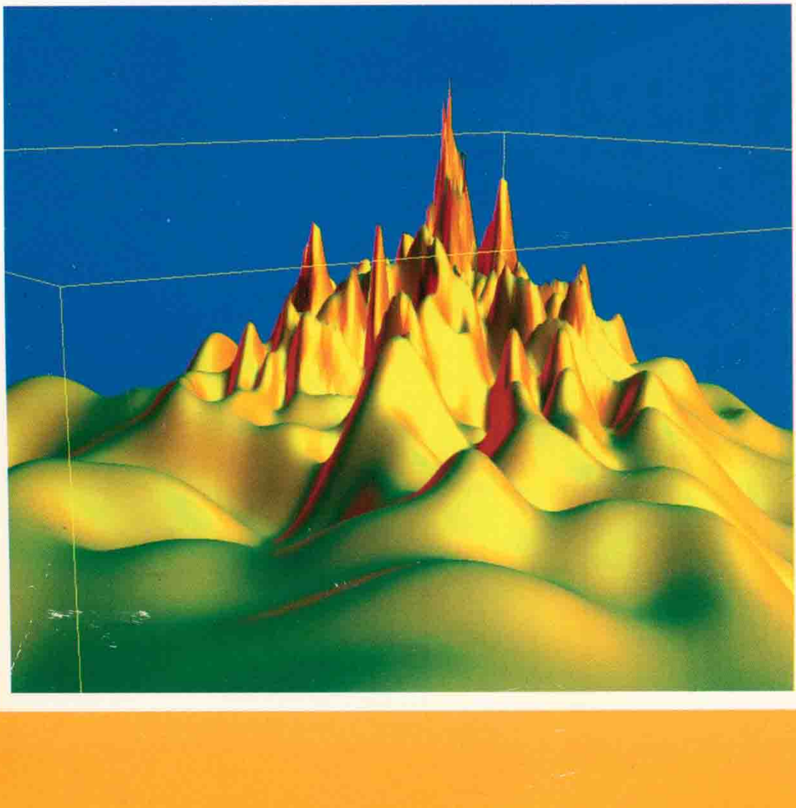
THIRD EDITION

STRATEGY *and the* BUSINESS LANDSCAPE

PANKAJ GHEMAWAT



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In Memory of Dr. C. R. Mitra,
Educator Extraordinaire

PREFACE

The third edition of *Strategy and the Business Landscape* has been thoroughly updated as well as expanded to include a new chapter on global strategy that is based on my last ten years of work on that topic. Most of the chapters have also been revised to include brief discussions of how economic downturns affect strategy. But this edition's similarities with the earlier ones greatly outweigh the differences. In particular, it continues to emphasize rigor, relevance and readability.

In terms of rigor, *Strategy and the Business Landscape* is based on contemporary research in the field of strategy and adopts a value-focused perspective that is consistent with recent work on value addition and appropriation. In addition to deriving some rigor from such microfoundations, this perspective helps tie together the discussions in the different chapters.

In terms of relevance, *Strategy and the Business Landscape* is squarely aimed at practitioners or practitioners-to-be, for whom it has been written as a short introduction to or refresher on strategy. That target readership has influenced decisions about how much detail to go into regarding academic research, and how much to draw on insights from business and consulting.

Readability is enhanced by the maintenance of a unified perspective throughout, richly detailed examples, including some featuring "inside" perspectives, and the fact that, despite the new chapter on global strategy, this book is still shorter than most trade books, let alone strategy textbooks.

The first edition of *Strategy and the Business Landscape* included a set of Harvard Business School cases that were meant to illustrate, deepen, and extend the concepts developed in the text. Given trends in case usage, affording users flexibility in this regard seemed a superior option for the second edition and continues to be so for the third edition. However, a suggested case map is included on the front inside cover of the text for reference.

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, Bruno Cassiman, David J. Collis, and Jan W. Rivkin (twice over). None of the three, however, should be presumed to have signed off on the entire end product.

I am also indebted to other current and former colleagues at Harvard Business School and at IESE Business School, Barcelona, for very helpful comments on one or more of the chapters in this book, particularly Bharat Anand, Adam Brandenburger, Estelle Cantillon, Ramon Casadesus-Masanell, Giovanni Gavetti, Tarun Khanna, Cynthia Montgomery, Felix Oberholzer-Gee, Gary Pisano, Joan Ricart I. Costa, Jordan Siegel, John Wells, and Dennis Yao. In addition, consultants at Booz Allen Hamilton, the Boston Consulting Group, Marakon/Trinsum, McKinsey & Company, and the Monitor Group all provided useful inputs.

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Finally, a book such as this would have been infeasible without the work of all the scholars that underlies it, as well as all the students and practitioners whom I have interacted with and learned from about these topics in the course of 25 years of teaching and researching strategy. The brevity of this acknowledgment should not detract from how deeply it is felt.

Barcelona
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ABOUT THE AUTHOR

Pankaj Ghemawat received his bachelor's degree in Applied Mathematics (and was elected to Phi Beta Kappa) and his Ph.D. in Business Economics from Harvard University. After a stint at McKinsey & Company, he spent 25 years on the full-time faculty at Harvard Business School, where, in 1991, he was appointed the youngest full professor in the school's history. Since 2006, Ghemawat has been the Anselmo Rubiralta Professor of Global Strategy at IESE Business School in Barcelona.

Ghemawat's award-winning book, *Redefining Global Strategy*, was published in 2007 by Harvard Business School Press. His other books include *Commitment* and *Games Businesses Play*. Ghemawat is also one of the world's best-selling writers of teaching cases. He served as the editor of the Business Strategy department of *Management Science* from 2003 to 2009 and on the AACSB's Globalization of Management Education task force.

Ghemawat's recent honors include the McKinsey Award for the best article published in the *Harvard Business Review*, the IESE-Fundacion BBVA Economics for Management Prize, and the Irwin Award for the Educator of the Year from the Business Policy and Strategy Division of the Academy of Management. Ghemawat is a Fellow of the Strategic Management Society and the Academy of International Business.

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CONTENTS

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 maintained throughout this book is attractive for at least three reasons:

- Interest in defining and redefining **strategy** is an ongoing endeavor despite thoughtful attempts over the decades, some of which are cited above.[1] It would therefore be idiosyncratic to begin by tossing yet another definition onto the 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: co-evolution with the environment, the development and diffusion of particular strategic paradigms, paradigm shifts, the recycling of earlier ideas, to name a few.

- Most ambitiously, the idea of path-dependence (one of the rallying cries of academic strategists since the mid-1980s) suggests that understanding the history of ideas about strategy is essential to developing a more informed sense of where the field might go in the future.

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 the ideas about strategy, especially portfolio planning, 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 the two basic dimensions of portfolio planning grids—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, and revisited from the perspectives of corporate and global strategy in Chapters 6 and 7. 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 the word *strategos*, from which it is derived, to designate a chief magistrate or a military commander-in-chief. Over the next two millennia, refinements of the concept of strategy continued to focus on its military aspects. Carl von Clausewitz's attempted synthesis in the first half of the nineteenth century is an especially 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) failed to induce much in the way of strategic thinking or behavior. This failure can be attributed to the fact that while the period was marked by intense competition among industrial firms, virtually none of them had the power to influence market outcomes to any significant extent. Most businesses remained small and employed 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. Such firms required little or no strategy in any of the senses described in the quotations 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 to cross industry boundaries.[4]

The need for explicit strategic thinking was first articulated by high-level managers at these large companies. For example, Alfred P. 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] And in the 1930s, Chester I. Barnard, a senior executive with New Jersey Bell, argued that managers should pay very 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 in the military domain, because it sharpened the problem of allocating scarce resources across the entire economy. New operations research techniques (e.g., 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*[7], which solved the problem of zero-sum games (many military ones) and framed the issues surrounding non-zero-sum games (most business situations, as discussed further in these terms in Chapter 4). The concept of the **learning curve**, first noted in the military aircraft industry in the 1920s and 1930s as manufacturers realized that direct labor costs decreased by a constant percentage as the cumulative number of aircraft produced doubled, also became an important tool for production-planning efforts in wartime.

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 obtain 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."[8] 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, namely 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.[9]

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 the arrangements that would best protect legitimate competition among the four military services while still maintaining the needed integration of strategic and tactical planning. Many argued that the Army, Navy, Marine Corps, 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."[10] The concept of **distinctive competence** would turn out to have 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 R. Commons, an institutionalist, wrote in his 1934 book about the focus of business firms on strategic or limiting factors in a way that was picked up a few years later—the potash example and all—by Chester I. Barnard (see the first quotation at the beginning of this chapter).[11] Ronald H. 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 seventy-five years later and that garnered its author a Nobel Prize.[12] 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.[13] 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.[14] 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 had 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 one of the first to promote the idea that managers should be trained to think strategically rather than just act as functional administrators, although strategy itself was not explicitly invoked until the 1960s. In 1912, Harvard introduced a second-year course required in "Business Policy" that 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 were supposed to maintain a "balance in accord with the underlying policies of the business as a whole."[15]

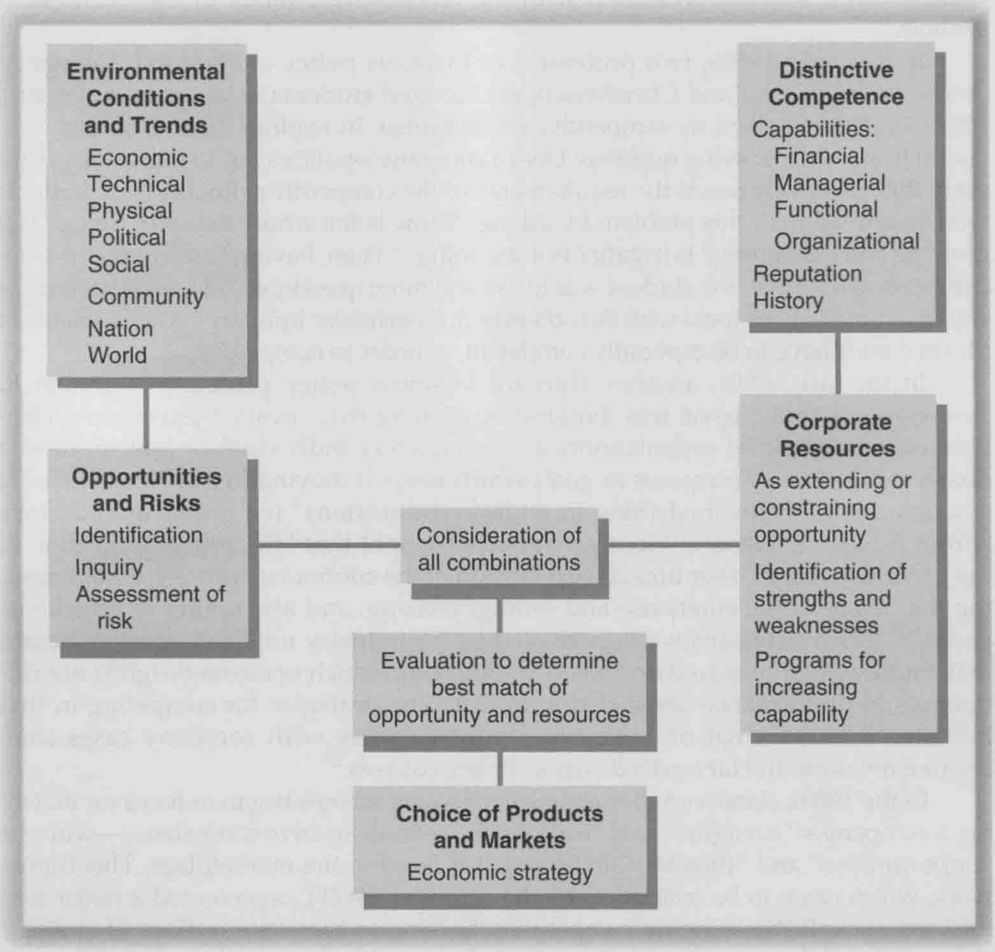
In the early 1950s, two professors of business policy at Harvard, George A. Smith, Jr., and C. Roland Christensen, encouraged students to question whether a firm's strategy matched its competitive environment. In reading cases, students were taught to ask the following question: Does a company's policies "fit together into a program that effectively meets the requirements of the competitive situation?"[16] 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?"[17]

In the late 1950s, another Harvard business policy professor, Kenneth R. 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 P. 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."[18] His conclusions were motivated by an industry note and company cases that Andrews had prepared on Swiss watchmakers, which uncovered significant differences in performance associated with different strategies for competing in that industry.[19] This format of combining industry notes with company cases soon became the norm in Harvard's Business Policy courses.[20]

In the 1960s, classroom discussions in business schools began 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 marketplace. This framework, which came to be referred to by the acronym **SWOT**, represented a major step forward in explicitly bringing competitive thinking to bear on questions of strategy. Kenneth R. 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).[21]

In 1963, a business policy conference was held at Harvard that helped diffuse the SWOT concept in both academia and management practice. The conference was well attended, but the ensuing popularity of SWOT—which is still used by many firms in the twenty-first century—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).[22] 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."[23]

EXHIBIT 1.1 Andrew's Strategy Framework.



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."[24]

Another leading strategist, H. 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"—its commitment to