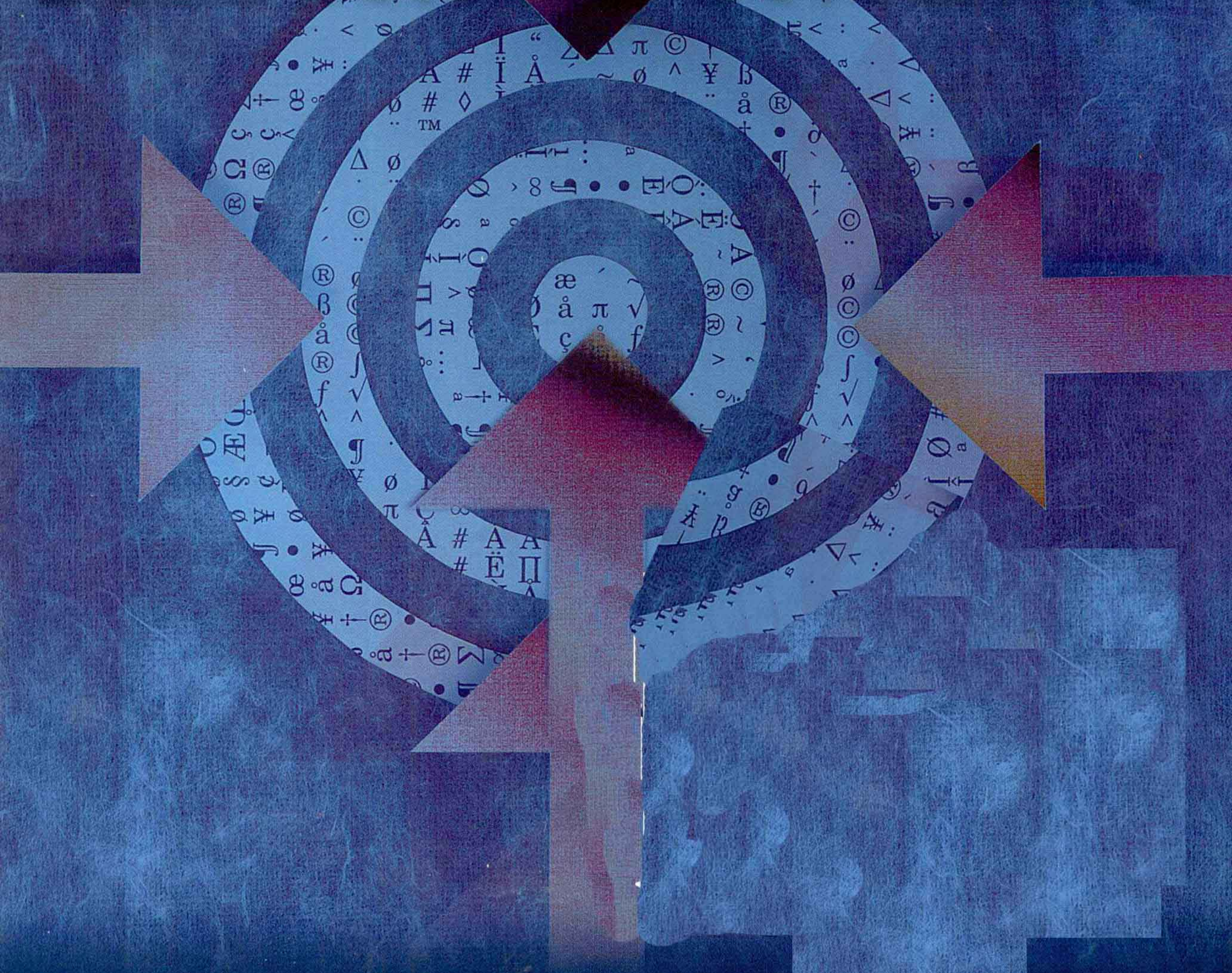
MODERN COMPETITIVE STRATEGY



Gordon Walker

Modern Competitive Strategy

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Gordon Walker is Professor and Chairman of the Strategy and Entrepreneurship Department at the Edwin L. Cox School of Business at Southern Methodist University. He received his BA from Yale University and an MBA and PhD from the Wharton School, University of Pennsylvania. Dr. Walker has previously taught at the Sloan School, MIT; the Wharton School, University of Pennsylvania; and Yale University. The author of numerous articles, he is on the editorial boards of *Administrative Science Quarterly* and *Strategic Organization.* He has received several grants from the National Science Foundation.

Dr. Walker has consulted and performed contract research for a number of organizations including Chaparral Steel, Sprint, Xerox, General Motors, Johnson & Johnson, Carlson Restaurants, Texas Instruments, The Associates, Halliburton, UICI, and EDS, as well as numerous smaller firms. His executive training programs include senior management seminars at Southern Methodist University, the Wharton School, Yale University, and INSEAD. He was named among the best Business Policy teachers in the United States in 1994 and 1998 by *Business Week* magazine and received the President's University Teaching Award in 1999 at SMU. He is listed in *Who's Who in America* and *Who's Who in the World.* Professor Walker was an infantry officer in the Marine Corps from 1967 to 1970 and was awarded the Bronze Star.

Preface

The genesis of this book lies in my experience as a strategy professor. Over the past 19 years, I have taught the core strategic management course in some very good MBA programs. When I began as an assistant professor, Michael Porter's book, *Competitive Strategy,* had recently been published, and I adopted it. The book brought the concepts and observations of industrial economists into the realm of business policy in a way that students and practitioners could comprehend and appreciate. At the time Porter's book was introduced, there was little research in strategic management, and his book presented the most rigorously developed set of frameworks available to academics teaching and doing research in strategy.

Over the past two decades, however, the strategy field has developed into a robust discipline with its own interests and research topics. Many of these topics build on the original synthesis of industrial economics in early strategy texts. However, many current ideas, concepts, and theories are only loosely related to traditional industry analysis. Practitioners, moreover, have continuously innovated to solve strategic problems in ways that the frameworks of industry analysis do not address. Its major points remain essential, but these points do not cover as much of the territory of strategy as they once did.

As the field developed, I moved more to teaching with readings, a shift that I believe has been fairly common for strategy courses in many business schools. But because many effective readings were (and are) written in practitioner journals, they were often oriented primarily toward application. This emphasis was beneficial for particular topics, but the course was often perceived as lacking sufficient theoretical content or coherence.

What was needed then was a book founded on disciplinary research which at the same time included the concepts and topics of strategy that have been developed over the past 20 years. Moreover, since I teach at all levels—undergraduate, MBA, and EMBA—the book had to be understandable by students who had never been in business and yet offer immediate practical benefits to line managers and executives. And it had to be readable and fit within the confines of a module or quarter (7 to 10 weeks) or a semester-long course.

This is the book I have tried to write. It is organized in five parts:

- Introduction.
- Building Competitive Advantage.
- Managing the Boundaries of the Firm.
- Expanding the Scope of the Firm.
- Governing the Firm.

Each part deals with a separate set of strategic issues as the firm grows from one to multiple lines of business.

Part I lays out the concept of strategy and argues that strategy is about achieving superior performance over time. Companies can accomplish this goal in ways that look very different across industries. But a single theme underlies these differences: The superior firm produces more value for the customer at a lower cost than competitors and defends the sources of this advantage—the firm's resources and capabilities—from imitation. This traditional but robust approach to defining competitive advantage pervades the book. The first chapter then outlines the origins of strategy as a discipline of inquiry drawing from a variety of fields, including industrial economics, evolutionary economics, and organizational sociology. And the distinction is made between strategy in a firm with a single business and one with multiple businesses, a central organizing theme in the book. The end of this chapter briefly describes the content that will follow in later chapters.

The chapters in Part II describe how successful firms build competitive advantage within the constraints of industry forces as they evolve over time, with a separate discussion of strategy execution within the organization. Part III focuses on how the firm executes its strategy by managing its boundaries through vertical integration and outsourcing and takes a separate look at partnerships. Part IV expands the scope of the firm to global markets and multiple businesses. Last, Part V outlines in detail the major issues of corporate governance, including its legal and institutional frameworks, and of strategic planning, the practical tool that brings the logic of strategy systematically to the whole organization.

I believe this approach has three main advantages:

1. It provides a relevant, discipline-based underpinning to the discussion of important strategy topics and allows the student to make connections among these topics as the course proceeds. By the end of the course, the student should see that many strategic problems can be understood as elaborations of a small number of theoretical frameworks. Thus, the course is an integrated experience.
2. It provides a clear way to understand the similarities and differences between single and multibusiness strategic issues. Identifying how a business can be improved as part of a larger multibusiness enterprise is a central management task. However, without linking single and multibusiness firms through common strategic frameworks, the task can be obscured.
3. The text covers a wide range of current strategy topics and links current theory to management practice. My experience with the frameworks in the book is that they are especially well suited for teaching cases, from any era currently in the case archives—Head Ski to Microsoft 2002. Also, when students read the business press, they will be able to see the applicability of what they're being taught.

These benefits can be palpable no matter what level the course. It can be gratifying to see undergraduates respond appropriately and enthusiastically to almost the same material that executive MBAs like for somewhat different reasons. The undergrads like the clarity, coherence, and consistency of the approach to strategy, while EMBAs can take much of the material and apply it directly to their work. Needless to say, regular MBAs can experience the material in both ways.

Several teaching supplements are available to adopters of this text: an instructor's manual including lecture notes, multiple-choice questions, and suggested cases for each chapter; a computerized test bank; and PowerPoint slides with key figures from the book and other lecture materials. Select supplements and additional resources are also available from the book website at www.mhhe.com/walker1e.

Many people have helped in preparing this book. Without their assistance, it could not have been written. Steve Postrel and Tammy Madsen have been remarkably helpful in commenting on the material. Their input has been critical for choosing and organizing content throughout the book. Bente Lowendahl and Andy Spicer gave me excellent comments on parts of the text. Dave Mauer was highly instrumental in ensuring that the nuance in the text was consistent with current thinking in finance. Roger Kerin and Ed Fox served in the same role for marketing. David Hoopes and Gary Moskowitz provided key feedback on separate sections. Glenn Carroll, Stanlislav Dobrev, and Ken Simons were generous in sharing their data, and all of my understanding of the money market fund industry I owe to my collaboration with Richard Makadok. Bruce Kogut has been a constant source of interesting and helpful commentary on various problems throughout the book's gestation. Chuck Armstrong of IBM, Raymond Herpers of Strategian, Greg Mutz of UICI, Barry Mike of Pizza Hut, Tommy Valenta of Chapparal Steel, and Heidi Ryback provided important feedback on the practical side of various chapters. Their encouraging and insightful comments were very important in shoring up my confidence in the book's applicability to management problems.

The following reviewers of the book over several years were enormously helpful in keeping my language and concepts straight:

Jaideep Anand
University of Michigan

Heather Elms
University of Florida

Michelle Gittelman
New York University

Bruce Kogut
INSEAD

Tammy L. Madsen
Santa Clara University, California

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Wharton School, University of Pennsylvania

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Virginia Tech

Gregory Theyel
Worcester Polytechnic Institute

Paul Tiffany
University of California, Berkeley

I don't think I have done justice to their excellent comments. But without them the task of steering this material through the shoals of the strategy field would have been impossible.

I am indebted to my students who allowed me to experiment with the book's concepts as they applied to a wide range of teaching cases. This experience was essential for helping me appreciate how the book's ideas worked in the classroom. In many cases, the linkages between the ideas and their range of applicability were not clear until the ideas were taught.

My publisher has provided invaluable assistance in putting this book together. My editors at McGraw-Hill/Irwin—John Biernat, Ryan Blankenship, and especially Laura Spell—have been constantly supportive of this project and remarkably patient about its development. Susanne Riedell, my project manager, has been consistently helpful as the book has progressed.

Finally, my family deserves the greatest thanks. They were very patient with me during the book's gestation and have forgiven the many times I have pulled away to write instead of play or participate in normal family life. It will take me some time to repay their kindness and generosity.

Gordon Walker

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Part 1

Introduction

Chapter 1

What Is Strategy?

The question at the heart of strategy is: Why do some firms outperform others over time? No two firms are the same, even in the same industry. They vary in size, products, people, location, organization, and history. In almost all industries this underlying variability among companies leads to significant differences in their performance. How can this be explained and the explanation used by managers to make better strategic decisions?

The road to success is by no means the same for all firms. Some, like Microsoft, rise to dominance because they develop an industry-wide standard (Windows, Microsoft Office) and partner with firms selling complementary products (Intel). Others, like Walmart and Nucor, become number one due to efficient practices that enable low prices. In turn, Dannon yogurt has neither the highest value nor the lowest cost but offers the best value-price combination. How should strategy be conceived to capture these differences?

An effective strategy gives a firm three benefits. First, it is a source of *economic gain.* Second, it provides a framework for *resource allocation.* And third, it guides the firm's decisions regarding *management and organization.*

1. Strategy matches the market position of the firm to its resources and capabilities. Market position entails both the amount and type of value offered to customers and the cost the firm incurs to produce that value. The more value customers receive at a lower cost to the firm, compared to its rivals, the more productive the firm. But the firm must also prevent the imitation of its value and cost drivers by competitors. Otherwise, it loses its advantage as rivals copy the sources of its strength. Since market dominance correlates with higher economic returns, strategy is a determinant of economic gain.

2. Strategy provides the business with a framework for resource allocation. Given finite resources, businesses are forced to make choices between alternative investments, which imply different ways of competing. Clearly defining the business's strategy helps to prioritize these opportunities so that consistent, self-reinforcing programs can be built and maintained.
3. Strategic thinking guides the firm's management and organization. An understanding of the company's strategy at all levels of the organization can create a focal point for decision making, which can be especially useful in ambiguous or uncertain situations. Without such an understanding, the organization's structure, through which conflicts are resolved, can seem arbitrary and tied to personalities rather than an economic rationale.

As new challenges emerge over time, a firm's strategy shifts to meet them. To compete successfully, a firm must repeatedly change its size and shape by adding or eliminating products and activities and people. Unlike sports, there is no championship that caps the season, and unlike war there is no final battle. There is no fixed schedule of play, except as defined by law and government regulation. Rivalry among for-profit firms has no moment of rest or stopping point.

The job of creating an organization's strategy over time falls to senior managers. They are responsible for tying together policies, products, and projects into a whole that leads to the achievement of the organization's economic objectives. At the same time, the strategy must be able to be communicated both within the organization and to outside interests such as investment analysts and shareholders.

What Determines Firm Profitability?

Three general factors—macroeconomic forces, industry factors, and the firm's market position—influence profitability in varying degrees, depending on the firm's industry and sector. But in the end, competitive advantage derives primarily from the firm's ability to build and defend resources and capabilities that are more productive than those of competitors. These tangible and intangible innovations are the clearest path to long-term performance gains.

Global and national economies clearly have an effect on profits. When global markets are growing, firms in many industries make more money simply because the demand for their products is strong and the products can be sold at higher prices. In contrast, when global markets are stagnant, there are fewer customers for each firm, prices drop to attract them, and profits fall. Comparable scenarios for national markets follow the same logic.

Industry conditions also have an obvious influence on an organization's profitability. At any moment in time some industries are growing quickly while others are stagnant. Likewise, the customers of firms in one industry will buy all they can produce while firms in another industry struggle to sell their products. In one industry, organizations fight each other fiercely for a share of the market, yet in other industries firms live and let live. Further, some industries are relatively cheap to enter and so are overrun with competition, driving profits down; at the same time the cost of entering other industries is

Companies with Strong Market Positions Over Time

Examples of companies with consistently high performance:

- Southwest Airlines, under the leadership of first Lamar Muse and Rollin King and then Herb Kelleher, developed a strategy of cost leadership that has led to consistent profitability even when other airlines have lost money. The consistency of Southwest's low costs is impressive as the airline has grown. This cost trend suggests that the firm has managed to maintain at least constant returns to scale in its operations, starting with a very low cost structure compared to its competitors.
- Intel Corporation, first run by Robert Noyce, Gordon Moore, and Andy Grove and now by Craig Barrett, has built a formidable market position in microprocessors and a strong competence in efficient manufacturing to keep prices low. Intel has aggressively extended its capabilities into other semiconductor markets and established one of the premier corporate venture capital units to tap start-up innovations that are complementary to Intel's technologies. Like all semiconductor firms, the company's performance is sensitive to a strong cyclical pattern of demand, which in late 2002 is in a trough.
- Nokia is the world leader in mobile phones and is consistently profitable, even when demand slackens. Nokia's phones are neither the cheapest nor the most expensive. But because the company can produce phones that offer customers a relatively high value at a relatively low price, and these phones can be produced at an even lower cost, the company has significant economic returns, even when demand is flat or growing slowly.
- IBM originated as an office machine company in the early 1900s and introduced its first computer products in 1952. In the 1990s, IBM changed its emphasis from hardware and software to services, growing this business to dominance in the world market. This switch represents another step in a long sequence of successful product and technological changes that have kept IBM in the forefront of its industry.
- General Electric is one of the most successful diversified firms in the United States and possibly the world. Over its long history it has managed to build profitable businesses in a range of industries and sustain their growth through cheap capital, careful planning, strong financial reporting, and a series of highly effective top-down initiatives that increase value to the customer and lower costs. GE is an example of a multibusiness firm that adds value to its business units, increasing their competitiveness as part of the corporation.

prohibitive. Moreover, these industry conditions change over time, depending on technological innovation and shifts in customer tastes. Each of these factors affects the level of firm performance by increasing or decreasing current profit margins and the opportunities for profitable investments.

Third, economic performance is determined by how the firm is positioned in its market and how well the firm defends itself from competition. Without a successful market position, there is no competitive advantage. Successful positioning is based on the firm's resources and capabilities, which determine key value and cost drivers. A superior position is achieved when higher value to the customer, through better quality or stronger technology, for