Summary: strategic management

Topic 1: What is strategy?

What is strategy?

It raises allot of questions in terms of what is included in strategy
Often when asking executives what their strategy is they give a reply of 'gnomes'.
As an organization they do things, and they think about outcomes but how do we get there? Strategy is about connecting the dots.

Long-term Performance of Companies

Strategy is about the **long-term performance** of the companies.

Let's think about airlines. Ryanair performed really well relative to their peers. They grew over the 30 years to become the largest airline. Other players entered, Spanair however they went out of business after a few years.

Ryanair
In airlines, the capital gets stuck in the planes, which only make return when flying. Because of that, Ryanair makes everything possible to turn the plane around as fast as possible because it is when the plane is flying that they are making money. The important asset here is the plane, it only makes returns when it is flying. Also, Ryanair is interesting because they have low prices. Everything they did was optimizing the use of their planes and maximizing turnaround.

Some changes have been made since they first started their business: they used to operate in small airports such as Charleroi. In those secondary airports, traffic was low, so they were able to land and then take off almost right after because no one was in their way. It does not work that way in Brussels or in Frankfurt because there is way more airlines in those main airports.
In the beginning, they were not even giving seat assignment: it resulted in the planes filling faster (nowadays they do give seated assignments). Moreover, unlike Eurowings, they do not allow connecting flights, so they do not have to wait for the luggage to be transferred or for a late plane to arrive.

Ryanair has been performing very well for 20+ years now: despite the toughness of the airline industry, it is one of the most profitable airlines in the world and it has been really hard for other companies to replicate what Ryanair achieved. However, they have been facing trouble recently with their move to more primary airports and thus becoming dependent on others, putting a lot of pressure on people with their low-cost model. No matter how good their model is for money making, it is putting pressure on other elements of the business, such as the staff.

Spanair, Air Berlin & WOW Air
Spanair wanted to make Barcelona's airport an intercontinental flights hub but went out of business. They were aiming for business class services and VIP lounges (no frills airlines).

- Route policy? → everything to and from BCN (national, regional, and intercontinental)
- **No frills airlines but business class service + VIP lounges**
- Fleet
  - Airbus (2 makes)
  - Boeing (3 makes)
  - McDonnell-Douglas (2 makes)
  - Fokker (2 makes)

Many airlines try to enter the (low-cost) sector but most of them go out of business (Wow Air or Air Berlin). Only a few are actually profitable and none of them is nearly as profitable as Ryanair.

Brussels Airlines
In 2016, Brussels Airlines was becoming a low-cost airline. They decided to change things and let consumers choose; they can pay more for more services or be ok with lower service and pay less.

*De nieuwe commerciële strategie laat passagiers de keuze hoe ze willen reizen en voorziet ook in een expansie van het netwerk... Chief Commercial Officer Lars Redeligx: "**We combineren service én scherpe prijzen…"** Brussels Airlines Press Release 12/01/2016*

→ they combine service with good prices → what happened? Three years later Brussels airlines is removed from eurowings and becomes part of Lufthansa.

Kodak and Fujifilm
Different companies can react differently to a same difficult situation in a hostile environment. Kodak and Fujifilm were competitors until phones with digital cameras became popular. Kodak did not switch fast enough to the digital technology, even though they had the first digital camera, went bankrupt and ended up disappearing. Fujifilm did something different. They realized that films were not the future, but they had the capability of working with chemical products and especially antioxidants, which are used against skin ageing. They thus decided to move into the beauty care industry, where they have been quite successful in terms of anti-ageing creams.

- ⇨ **when you think about strategy long term is very critical. We talk about long term survival and doing well.**

Positioning within your Industry
Positioning matters!

Delhaize and colruyt
Delhaize and Colruyt have different positioning. Colruyt is focusing on low prices, as can be seen in all their commercials, while Delhaize is trying to get out of that by focusing on quality but not without trouble (it was merged with Albert Heijn so it has somewhat recovered). Delhaize is trying to differentiate and take up a new position in the market, but retailing is mainly about pricing.

Facebook and LinkedIn
LinkedIn and Facebook are both social medias networks. However, Facebook focuses on friends and family while LinkedIn focuses on the professional market. Although they are in the same business, they have very different positioning.

Xior
Xior focuses on student housing. It is very unique to focus on such a market, but it is the result of a strategic decision. Indeed, Xior saw the many potential advantages. Most real estate companies are not that focused. However, it is working well as they even started expanding abroad.

- ⇨ **We need to think about positioning within our industry.**

Choosing your Target Market
Ducati and Harley Davidson
Different people buy each of these brands. It has to do with marketing and market segmentation targeted at specific so-called typical customers.

Athenaeums and catholic schools
Both of these schools attract different people, even though both are state financed.

- ⇨ **Not only positioning within your industry but also different targets when thinking about strategy.**

Your Resources and Capabilities

Apple and Google

Apple **and** Google are **both** in the smartphone business. While Google makes money with advertising and out of searches, Apple makes money mainly through the App Store, earning 30% of each transaction, and to a lesser extent by selling hardware. They each look at the business from different angles but compete in the same environment.

What is apple good at? Design, visuals, interface.
What is Google good at? Does it make sense for them to go into this business? They make money with ads so why going into the phone business? Developing phones is smart because this is where people will search on the search engine.

What about Apple? They are good at creating a system. They provide a user experience to customers. They were the first to have point and click. User friendliness is part of Apple, and they created an ecosystem around it. Apple and Google entered the system for very different reasons.

You can see on the statistics (graph on ppt) that most phones had Android which uses Google and more than IOS which is Apple.

- *What does the company expect for its LT return?*
- *How does it position itself in the industry?*
- *How does the company make choices?*
- *What is the target market?*
- *What are the resources and capabilities of Apple going into smartphones?*
- *What are the resources and capabilities of Google going into smartphones?*

⇨ **Just to point out that thinking about resources and capabilities are important. We need to analyze this for different companies.**

Competition and Market Entry

Amazon go

Amazon created its *just-walk-out* technology, allowing customers to shop rapidly and pay through an app. In the ads, the focus is on the convenience and prices are never mentioned, unlike in Aldi or Colruyt's ads. It is a ≠ shopping experience but it will probably be more expensive. It raises societal questions about the need for less workers, as well as questions about privacy. Amazon has not been clear about the technology, but it seems that the system will be taking pictures of customers to know what they are putting in their bags. Big players are under pressure because of the arrival of such competitors (Jumbo, Deliveroo), leading to considerable changes in the business.

- How is Amazon Go competing?
- How are competitors competing?
- What is the future of supermarkets going to look like?

⇨ **All the supermarket players are really struggling. We need to think about how competition really interacts.**

Technology Convergence

Amazon VS Apple, Kindle VS iPad

Technology becomes really important. Amazon (biggest online store) just bought Whole Food (retailer) while Apple is going into the car business by developing software.

- How is technology driving and impacting strategy?
- What is AI going to do to the different players?
- How can AI be integrated in strategic thinking and strategy in general?

Irreversibility of Decisions

Boeing and Airbus
Airbus considered the future to be about bringing people to hubs, with big planes to fly between hubs, and then bring them to smaller locations, with smaller planes to fly from hubs to other areas.

→ *Strategic decision: A380*

Boeing considered the future to be about bringing people from point to point, with small, fast & efficient planes.

→ *Strategic decision: Dreamliner (Boeing 787)*

- ⇨ **Strategic decisions cannot be changed overnight: it is about commitments, even though that might restrict the company's movements in the future. Strategy has often to do with irreversibly decisions → it's hard to reverse decisions.**

Sustainability?

Madonna versus Spice Girls, versus Psy, versus Justin Bieber
Madonna is a businesswoman. She is still around after all these years because she succeeded in sustaining her business overtime by changing and evolving; unlike the Spice Girls, Psy, or Justin Bieber (who is still around, but for how long?).

- ⇨ **We need sustainable strategies.**

Non-Market Strategies

Uber
Uber went public while being a new player and has been involved in lots of fights and disagreements in many countries. Their mission has become a controversial topic, probably because regulations are a political matter. The taxis have used decades of political contributions and influence to restrict competition, reduce choice for consumers, and put a stranglehold on economic opportunity for drivers. Uber was quite aggressive moving into some areas. Could it have it done differently? Should Uber go head-to-head with the taxi business or be smarter in the way of tackling this issue? Uber had to think about political strategies because they had to deal with regulations.

Airbnb
Airbnb is a new player that has caused issues in cities like Barcelona, where every apartment has become up for tourist rental because it is more profitable, resulting in locals unable to afford living in the center anymore. Although Airbnb is seen as a threat in many places, it is also an opportunity to visit a city differently through a different experience.

- ⇨ **Nonmarket strategies is about how to interact with other players like regulators.**

Communities

Online gaming
On EVE, players have their own board and are invited to the board meetings of the company. Players are customers who can influence what happens to the game and have a say on strategic decisions of the company.

Nasa
The Nasa puts out problems they cannot solve themselves with a monetary reward, if someone was to come up with a solution. They decided to use their community of suppliers to resolve issues. However, it was a traumatic experience for them: as we know, the smartest people in the world already work for them, so if they can't solve them, who will?

Corporate Social Responsibility
Sustainability is a crucial and inevitable issue nowadays; and the public doesn't allow companies to make mistakes on this matter (VW & the diesel gate; BP & the pollution of the Gulf of Mexico, Siemens & the coal mine investment). But is it real and meant, or are companies pretending?

Unilever

Unilever has a lot of waste because they are using a lot of resources; which could be improved. Their excuse was that investors didn't allow them time because Unilever gives quarterly earnings. The CEO decided to give yearly guidance instead, and to implement *Unilever's sustainable living plan*. Stock prices went down, but Unilever recovered overtime. However, by doing this, it changed the type of people buying Unilever's stocks: from avid traders who wanted to make a lot of money to people willing to bet on the longer terms, with more time for Unilever to change its processes.

⇨ **Every decision has to fit the mission and has to be reflected by actions.**

Not Only Profitability
Museums, hospitals, … can also think about strategy. Their objectives will be different, but they will need to consider similar elements as for-profit organizations when designing their strategy.

Corporate Strategy

Kinepolis

Kinepolis bought MJR Grand; they have been expanding and acquiring. That is a ≠ type of strategy, called corporate strategy (M&As, …).

Leadership Communication Alignment
Example Elon musk: "So, in short, the master plan is:

1) Build sports car
2) Use that money to build an affordable car
3) Use that money to build an even more affordable car
4) While doing above, also provide zero emission electric power generation options"

Although he is not exactly correct because Tesla hasn't made money yet, he had a clear view on his direction. With his strong leadership, he was able to communicate well and give objectives to its employees so they could all be aligned.

The roles of strategy
- Strategy as Decision Support: it helps making decisions and coordinating decisions
- Strategy as a Coordinating Device: it provides directions
- Strategy as a Target

Strategy as Decision Support & Coordinating Device
Despite the uncertainty, strategic thinking should at least eliminate bad decisions and lead towards good ones. Moreover, strategy is useful to make sure everybody is on the same page.

What is a strategic decision?
Important decisions for direction of organizations? When we think about strategy it is about **interdependence**

- **Internal Coordination** with other decisions is necessary to achieve coherence (cross-section) and consistency (over time). Managers make decisions on a daily basis, so they need to understand the strategy of the company. Decisions need to add up so that the company can go in the desired direction.
    - This results in fits but also trade-offs: this is about coherence; strategy is also about knowing what to do.
    - A strategy is valuable if alignment or coordination is needed. However, the strategist might only be correct with a certain probability:

- A strategy is more valuable if it's more reliable (focus on more stable factors).
- A strategy is more valuable if decisions tend to be irreversible: when it is harder to reverse decisions:
    - An option to commit makes decisions more strategic (<u>size of the investment</u>, <u>timing of the decision</u> (at the perfect time)).

- **External Interdependence**: reaction from competitors or other players (complementors, suppliers, customers…) might arise and have positive or negative consequences.
    - Small number of players: With a small number of players, a company can influence the direction of the industry when player interact with each other.
    - Game Theory: a complete contingent plan of action – optimization of the company's decisions considering potential external reactions.
        - Interdependence with other organizations. What we do has an impact on others.

Below we see an example of interdepence and interdependent decisions.

Which decisions are strategic?

Definition: a decision is '**<u>strategic</u>**' if it is investigated or announced as part of the optimal strategy
The CEO develops the strategy, but he can't tell everybody what to do, he can only tell a few things → he sets out the strategy and other makes decisions that should be consistent with the strategy.

Companies make thousands of decisions every day but should focus on the one that is going to influence everything else. Indeed, in big organizations there is a lot of different players (marketing, finance). Each of them makes decisions but has only local information, about their part of the business, and maximizes the return from their individual decision. It is hard to know what others are doing and make sure everyone coordinates.

Example: imagine we have 3 departments. Marketing wants to sell customized products. Productions departments like standardized products because this is more cost efficient. Then we have our operations department.
→ difficult to reconcile customized products of the marketing department with the standardized product of the productions department
→ a strategy is needed to coordinate among the different departments

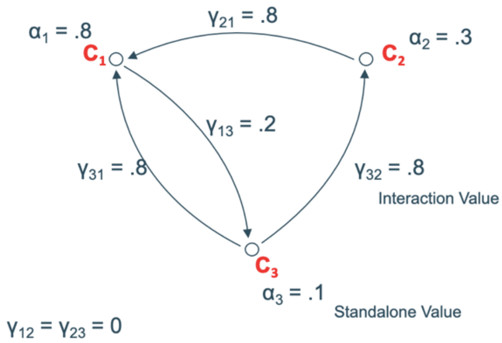
Different Players make decisions, have only "local" information, and maximize the return from their individual decision

- **Standalone Value** of a decision (A or B): α
    - there are many things an individual could decide to do butthere might be only one particular decision that is optimal from a standalone perspective
    - you do what is best for yourself
- **Interaction Value** of a decision: if decisions are complements, they need to be coordinated and select the same value as the other decision (A or B): γ
    - ***For example:*** *marketing could say we sell standardized products because there is value in coordinating = interaction value*
- The standalone decision is different from the interaction decision.
- Probability that random selection of a decision gets it right is zero, because there are so many decisions → investigation by strategist is costly.

Example: 3 Decisions; C1 (Product Development), C2 (Marketing), C3 (Operations).

- α_1 = 0,8 = the optimal decision (locally) for C1 (product development)
- If C2 (marketing) coordinates with C1 (product development): $\gamma 21$ = 0,8

Strategy = Set of decisions announced or investigated by strategist



Absent any investigation or announcement: Investigating the best decision will be costly. If there's no common strategy, all decisions will be standalone and locally optimal; because the departments don't know the decisions of the others. Then each participant will choose locally the optimal decision.

→ The payoff is going to be: 0,8 + 0,3 + 0,1 = 1,2

Now, if C2 says they're doing X (and the investigation shows that it is indeed the right decision), they will get 0,3 because it chose the optimal decision. However, the other departments can still choose: if C1 wants to coordinate, the interaction value is 0 or they can do whatever is good for them (take the standalone decision) and get 0,8. C3 can coordinate and get 0,8 (more than the standalone value).

→ The payoff is going to be: 0,8 + 0,8 + 0,3 = 1,9
→ The value of the announcement of this strategy is 0,7

The value of having a strategy is higher (1.9 > 1.2). We can even do better and investigate what's best for C1 (strategic choice), have C2 and C3 coordinate (with C1)(aligned choices) and see if it scores higher than 1,9:

→ The payoff is going to be: 0,8 + 0,8 + 0,8 = 2,4
→ This is the **optimal strategy** is to investigate and announce C1
→ Strategy is used as a coordinating device

Conclusion:

- Strategy is Valuable if there is alignment → coordination is needed.
- What if the Strategist is only correct with certain probability?
  - Reliability of Strategy: focus on more stable factors
  - Irreversibility (by itself) does not make a decision more strategic but makes strategy more valuable
  - Option to commit makes decision more strategic
- What if decisions interact with other players in the market?
  Not optimal because strategy only has value of there is coordination between <u>different departments</u>.

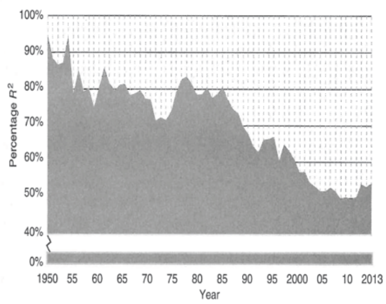
Strategy as a Target

The financials are less and less relevant to understand what the market value of the company is because of intangibles (brand name, R&D). A lot of the value lies within the strategy.

To be successful with a strategy, it's important to be different and creative.

Strategy and historical numbers

Adjusted R^2 of regression of Corporate market value on reported earnings and book value, 1950-2013



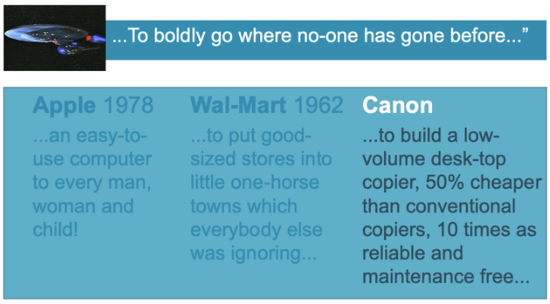
Book value and earning predict the market value of a company, but today it does not really predict the stock market value = end of accounting. The book argues that understanding the strategy of the company is critical to understand the stock value of the company. The link between strategy and finance becomes much more important.

Be different: strategy and vision

Be different in your strategic thinking. If everybody does the same thing you will be competing head-to-head so creative thinking is important.
In strategy there is some art in thinking differently in terms of what needs to be done.

Successful companies try to boldly go where no one has gone before. Acting differently starts with the vision.

Apple wanted easy to use computers for everyone. Another big computer CEO at the time didn't think there was a reason why people would need a computer at home. Both knew the business, but they had different visions, and therefore different strategies.



Walmart started to implement discount supermarkets in small cities. To do so, they had to figure out the whole distribution process systems. Now, Walmart is the biggest player in the industry, even though people didn't fear it at first.

Meta: Originally founded in 2004 as Facebook, Meta's mission is to give people the power to build community and bring the world closer together. Our products empower more than 3 billion people around the world to share ideas, offer support and make a difference.

Different companies will actually come from very different directions.

Coca cola company (2020)

Mission (Statement explaining why a company exists, "Purpose")
To Refresh the World
To Inspire Moments of Optimism
To Create Value and Make a Difference
Vision for Sustainable Growth (What leaders want the organization to become)
People: Being a great place to work where people are inspired to be the best they can be.
Portfolio: Bringing to the world a portfolio of beverage brands that anticipate and satisfy peoples'desires and needs.
Partners: Nurturing a winning network of partners and building mutual loyalty.
Planet: Being a responsible global citizen that makes a difference
Profit: Maximize long-term return to shareowners while being mindful of our overall responsibilities.
Productivity: Be a highly effective, lean and fast-moving organization.

Our Purpose
Refresh the world. Make a difference.

Our Vision
Our vision is to craft the brands and choice of drinks that people love, to refresh them in body & spirit. And done in ways that create a more sustainable business and better shared future that makes a difference in people's lives, communities and our planet.

→ They had a mission and a direction.
→ Purpose is important because it tells you where to go the same with vision
→ Strategy means vision

What is strategy? Definition

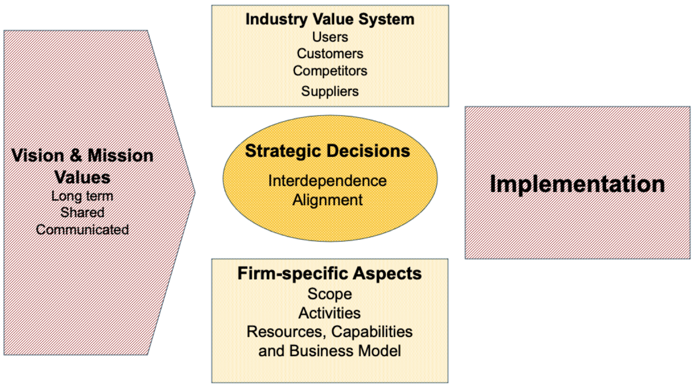
Source: classic reading What is a strategy

A **strategy** is the choice of a future for the organization and a way to reach that future. It is the framework that coordinates, unifies and integrates the company's decisions and actions and positions a business in an industry so as to generate superior financial returns over the long run. It is a smallest set of choices (announced or investigated by a strategist) to optimally guide – or force – other choices.

Strategies are always about the uncertain future – no one knows the right decisions to take now.

ChatGPT: A strategy is a plan or approach for achieving a specific goal or set of goals, especially in an organization or in business. It involves making choices about the allocation of resources such as time, money, and personnel, in order to achieve the desired outcome. Strategies help organizations to stay focused on their objectives and to make informed decisions that are in line with their long-term goals. Effective strategies are based on a thorough understanding of the organization's strengths and weaknesses, as well as its environment and competition. They also involve continuous monitoring, evaluation, and adaptation in response to changes in the environment and market.

Choice of a future



Strategy focuses on <u>interdependence</u> and <u>alignment</u> and is influenced by the environment (industry value system) as well as by firm-specific aspects. Strategic decisions are constrained by the vision, mission & values of the company. Execution (matter of leadership) and implementation are also crucial: a good strategy needs to be executed. A good strategy not implemented, or a bad strategy implemented both result in a negative outcome.

The **vision** is a concise statement that defines the mid- to long-term goals of the organization. The stretch goal in the vision statement should truly be a difficult reach for the company in its present position, challenging even well-performing organizations to be become much better.

The direction of the company is oftentimes indicated in the company's **mission**, a statement explaining why a company exists, its purpose. It gives directions for what the company wants to do and accomplish. Just as the vision, the purpose really restricts what the company can and should do. It restricts also strategic decision making.

The **values** of a company prescribe the attitude, behavior, and character of an organization. Value statements (lengthy) describe the desirable attitudes and behavior the company wants to promote and the forbidden conducts (bribery, harassment, conflicts of interest) employees should avoid.

As strategy is a framework that aims to integrate, all employees should be able to express the **strategy statement**, which resumes the strategy with simple words, for it to be comprehensive. It should include the objective, the scope (what? where? who? when? how?), the competitive advantage and how to develop it. That way, every worker knows where the company is headed. A secret strategy is never good as it results in employees not knowing what direction to take and thus cannot take good decisions.

<u>First dimension</u>: Operational effectiveness is not strategy

Companies must be flexible to respond rapidly to competition and market changes.

- They must benchmark continuously
- They must outsource aggressively
- They must nurture a few core competencies to stay ahead of rivals

⇨ Those beliefs are dangerous half-truths and leads more and more companies to **mutually destructive competition**

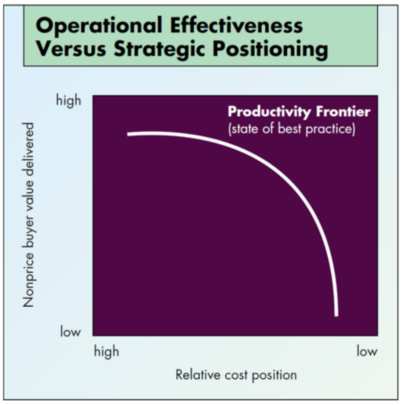
The problem is the failure to distinguish between operational effectiveness (OE) and strategy. OE and strategy are both essential to superior performance (= the primary goal of any enterprise), but they work in different ways.

A company can outperform rivals only if it can establish a difference that it can preserve.
It must deliver greater value to customers (allows to charge higher unit prices) or create comparable value at a lower cost (creates lower average unit costs) or both. *Cost* is generated by performing activities, and cost advantage arises from performing particular activities more efficiently than competitors. *Differentiation* arises from both the choice of activities and how they are performed. Activities, then, are the basic units of competitive advantage.

- **Operational effectiveness (OE)** means performing **similar** activities **better** than rivals perform them. It includes efficiency. It refers to practices that allow a company to better utilize its inputs by reducing defects in products or developing better products faster.
- **Strategic positioning** means performing **different** activities from rivals' or performing **similar** activities in **different** ways.

Differences in operational effectiveness among companies are pervasive and are important in creating profitability among competitors because they directly affect relative cost positions and levels of differentiation.

Imagine a *productivity frontier* = sum of all best practices at any given time/the maximum value that a company can create at a given cost, using the best technologies, skills, management techniques, and purchased inputs. When a company improves its operational effectiveness, it moves toward the frontier. Doing so may require capital investment, different personnel, or simply new ways of managing.



OE competition shifts the productivity frontier outward, as new technologies and management approaches are developed, and as new inputs become available → raising the bar for everyone. As companies move to the frontier, they can often improve on multiple dimensions of performance at the same time.

Constant improvement in OE is necessary to achieve superior profitability, but not sufficient.

- *First reason*: because of the rapid diffusion of best practices. Competitors can quickly imitate management techniques, new technologies, … The most generic solutions – those that can be used in multiple settings – diffuse the fastest. The more rivals outsource activities to efficient 3rd parties, the more generic those activities become.
  → *Such competition produces **absolute** improvement in OE, but it leads to **relative** improvement for no one.*
- *Second reason:* competitive convergence is more subtle and insidious. As rivals imitate each other's quality improvements, cycle times, supplier partnerships; strategies converge, and competition becomes a race on an identical path where no one can win.

⇨ **Operational effectiveness is not strategy.**

Second dimension: Strategy rests on unique activities

Competitive strategy is about being different. The essence of strategy is choosing to perform activities differently than rivals do. **Strategic positions** emerge from 3 sources, which are not mutually exclusive and often overlap:

- Variety-based positioning: based on product varieties rather than customer segments.
  - Producing a subset of an industry's products or services
  - Makes sense when a company can best produce particular products or services using distinctive sets of activities
- Need-based positioning: serving most or all the needs of a particular customer group.
  - It arises when there are groups of customers with differing needs, and when a tailored set of activities can serve those needs best.
  - A variant of needs-based positioning arises when the same customer has different needs on different occasions or for different types of transactions.
  - Differences in needs **will not** translate into meaningful positions unless the best set of activities to satisfy them *also* differs.
- Access-based positioning: segmenting customers who are accessible in different ways (rural or urban-based customers). Needs are similar, but the best way to reach them is different.
  - Access can be a function of customer geography or customer scale – or of anything that requires a different set of activities to reach customers in the best way.

    - Rural versus urban-based customers are one ex- ample of access driving differences in activities.

Positioning is not only about carving out a niche. A position emerging from any of the sources can be broad or narrow.

- Focused competitors thrive on groups of customers who are overserved (and hence overpriced) by more broadly targeted competitors, or underserved (and hence underpriced)
- A broadly targeted competitor serves a wide array of customers, performing a set of activities designed to meet their common needs.

⇨ **A strategy is the creation of a unique and valuable position to deliver a unique mix of value, involving a different set of activities.**

Third dimension: A sustainable strategic position requires trade-offs

Choosing a unique position is not enough to guarantee a sustainable advantage. A valuable position will attract **imitation by incumbents**, likely to copy it in 2 ways:

- A competitor can *reposition* itself to match the superior performer.
- *Straddling*: the straddler seeks to match the benefits of a successful position while maintaining its existing position.

A strategic position is not sustainable unless there are trade-offs with other positions. **Trade-offs** occur when activities are incompatible and arise for different reasons:

- Inconsistencies in image or reputation.
    - A company known for delivering one kind of value may lack credibility and confuse customers – or even undermine its reputation – if it delivers another kind of value or attempts to deliver two inconsistent things at the same time.
- Trade-offs arise from activities themselves.
    - Different positions (with their tailored activities) require different product configurations, different equipment, different employee behavior, different skills, and different management systems. Many trade-offs reflect inflexibilities in machinery, people, or systems.
- Trade-offs arise from limits on internal coordination and control.
    - By clearly choosing to compete in one way and not another, senior management makes organizational priorities clear.

Positioning trade-offs create the need for choice, purposefully limiting what a company offers and protect against repositioners and straddlers.

⇨ **Strategy is making trade-offs in competing**. The essence of strategy is choosing what not to do. Without trade-offs, there would be no need for choice and thus no need for strategy. Any good idea would be quickly imitated. Again, performance would once again depend wholly on OE. Trade-offs are essential to strategy. They create the need for choice and purposefully limit what a company offers

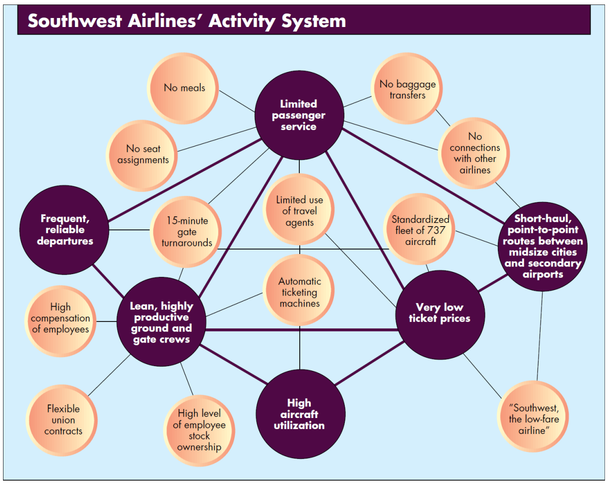
Fourth dimension: Fit drives competitive advantage and sustainability

Positioning choices determine which activities a company will perform and how it will configure individual activities and also how activities relate to one another. While OE is about achieving excellence in individual activities, or functions; **strategy is about combining activities**. Fit is important because discrete activities often affect one another. Fit locks out imitators by creating a chain that is as strong as its strongest link. Fit is important because discrete activities often affect one another. The most valuable fit is strategy-specific because it enhances a position's uniqueness and amplifies trade-offs. There are 3 types of fit:

- 1st order: **simple consistency** between each activity (function) and the overall strategy.
    - It ensures that the competitive advantages of activities accumulate and do not erode or cancel themselves out.
    - It makes the strategy easier to communicate to customers, employees, and shareholders, and improves implementation through single-mindedness in the corporation.
- 2nd order: **activities are reinforcing** one another.

- 3rd order: **optimization of effort** (coordination and information exchange across activities to eliminate redundancy and minimize wasted effort).
    - Product design choices can eliminate need for after-sale service or makes it possible for customers to perform activities themselves

In all three types of fit, the whole matters more than any individual part. Competitive advantage grows out of the entire system of activities. The fit among activities substantially **reduces cost** or **increases differentiation**. Beyond that, the competitive value of individual activities cannot be decoupled from the system or the strategy.



*Southwest's rapid gate turnaround, which allows frequent departures and greater use of aircraft, is essential to its high-convenience, low-cost positioning. But how does Southwest achieve it? Part of the answer lies in the company's well-paid gate and ground crews, whose productivity in turn- arounds is enhanced by flexible union rules. But the bigger part of the answer lies in how South- west performs other activities. With no meals, no seat assignment, and no interline baggage transfers, Southwest avoids having to perform activities that slow down other airlines. It selects airports and routes to avoid congestion that introduces delays. Southwest's strict limits on the type and length of routes make standardized aircraft possible: every aircraft Southwest turns is a Boeing 737. What is Southwest's core competence? Its key success factors? The correct answer is that everything matters. Southwest's strategy involves a **whole system** of activities, **not a collection of parts**. Its competitive advantage comes from the way its activities **fit and reinforce** one another.*

Fit and sustainability

Strategic fit among many activities is fundamental to competitive advantage and to the **sustainability** of that advantage. It is harder for a rival to match an array of interlocked activities. Positions built on systems of activities are far more sustainable than those built on individual activities.
- Strategic positions should have a horizon of at least a decade, not of a single planning cycle.
- The more a company's positioning rests on activity systems with second- and third-order fit, the more sustainable its advantage will be.
- Fit among a company's activities creates pressures and incentives to improve operational effectiveness, which makes imitation even harder.
- When activities complement one another, rivals will get little benefit from imitation unless they successfully match the whole system.

The most viable positions are those whose activity systems are incompatible because of trade- offs. Strategic positioning sets the trade-off rules that define how individual activities will be configured and integrated. Seeing strategy in terms of activity systems only makes it clearer why organizational structure, systems, and processes need to be strategy-specific. Tailoring organization to strategy, in turn, makes complementarities more achievable and contributes to sustainability.

Alternative Views of Strategy

The Implicit Strategy Model of the Past Decade	Sustainable Competitive Advantage
☐ One ideal competitive position in the industry	☐ Unique competitive position for the company
☐ Benchmarking of all activities and achieving best practice	☐ Activities tailored to strategy
☐ Aggressive outsourcing and partnering to gain efficiencies	☐ Clear trade-offs and choices vis-à-vis competitors
☐ Advantages rest on a few key success factors, critical resources, core competencies	☐ Competitive advantage arises from fit across activities
☐ Flexibility and rapid responses to all competitive and market changes	☐ Sustainability comes from the activity system, not the parts
	☐ Operational effectiveness a given

⇨ **Strategy is creating fit among a company's activities**. The success of a strategy depends on doing many things well – not just a few – and integrating among them. If there is no fit among activities, there is no distinctive strategy and little sustainability.

Rediscovering strategy

- **The failure to choose**: why do many companies fail to have a strategy?
  - A sound strategy is undermined by a misguided view of competition, by organizational failures, and, especially, by the desire to grow.
  - Caught up in the race for OE, many managers simply do not understand the need to have a strategy.
  - Unnerved by forecasts of *hypercompetition*, managers increase its likelihood by imitating everything about their competitors. Exhorted to think in terms of revolution, managers chase every new technology for its own sake.
  - Conventional wisdom within an industry is often strong, homogenizing competition.
  - Some managers mistake "customer focus" to mean they must serve all customer needs or respond to every request from distribution channels.
  - The desire to preserve flexibility.
- **The growth trap**: the desire to grow has perhaps the most perverse effect on strategy.
  - Trade-offs and limits appear to constrain growth → managers are tempted to take incremental steps that surpass those limits but blur a company's strategic position
  - compromises and inconsistencies in the pursuit of growth will erode the competitive advantage a company had with its original varieties or target customers.
  - Attempts to compete in several ways at once create confusion and undermine organizational motivation and focus
- **Profitable growth**: efforts to grow blur uniqueness create compromises, reduce fit, and ultimately undermine competitive advantage. What approaches to growth preserve and reinforce strategy?
  - concentrate on deepening a strategic position rather than broadening and compromising it (those could best contain the risk by creating stand-alone units, with their own brand name and tailored activities).
    - Deepening a position involves making the company's activities more distinctive, strengthening fit, and communicating the strategy better to those customers who should value it.
    - managers can ask themselves which activities, features, or forms of competition are feasible or less costly to them because of complementary activities that their company performs.
- **The role of leadership**: management's core is strategy: defining and communicating the company's unique position, making trade-offs and forging fit among activities. The operational agenda involves continual improvement where there are no trade-offs (change, flexibility, efforts to achieve best practices).
  - The leader must provide the discipline to decide which industry changes and customer needs the company will respond to, while avoiding organizational distractions and maintaining the company's distinctiveness.

  - The strategic agenda is the place for defining a unique position, making clear trade-offs, and tightening fit.
  - Strategic continuity doesn't imply a static view of competition. A company may have to change its strategy if there are major structural changes in its industry. A company's choice of a new position must be driven by the ability to find new trade-offs and leverage a new system of complementary activities into a sustainable advantage.

Classic reading: The origins of strategy (Ghemawat)

(Re)defining strategy is an ongoing effort. The historical perspective leads to changing conceptions of strategy. The term strategy goes way back and has long focus on military aspects.

- Early history: military concepts & considerations
- 1st Industrial Revolution: none of the firms had the power to influence market outcomes, and such small businesses did not require strategy.
- 2nd Industrial Revolution (19th century): adaptation of strategic terminology to a business context. It saw the emergence of strategy as a way to shape market forces and affect the competitive environment. A new type of firm has begun to emerge: the large, vertically

integrated company that invested heavily in manufacturing, marketing and in management hierarchies to coordinate those functions.

- WW2: vital stimulus to strategic thinking in business (it sharpened the problem of allocating scarce resources across the entire economy). Also the development of formal strategic thinking to guide management decisions. The learning curve also became an important tool for production-planning efforts in wartime. By consciously using formal planning, a company could exert some positive control over market forces.

It is good to question whether a firm's strategy matches its competitive environment. Every organization should have clearly defined purposes/goals which keeps it moving in a chosen direction and prevents its drifting in undesired directions. 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. Then came the **SWOT analysis**, a step forward in explicitly bringing competitive thinking to bear on questions of strategy. Later, 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.

It was argued that when companies fail, it usually means that the product failed 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.

The early 70s saw the rise of strategy consulting practices (BCG): it applied quantitative research to problems of business and corporate strategy to find meaningful quantitative relationships between a company and its chosen markets. Good strategy must be based on logic and not on experience derived from intuition. BCG developed its version of the learning curve: the **experience curve**, to try to explain price and competitive behavior in extremely fast-growing segments of certain industries. They wondered why a competitor outperformed another and if there were any basic rules for success. It appears that indeed there were basic rules for success: they relate to the impact of accumulated experience on competitors' costs, industry prices and the interrelation between the two.
It led them to a powerful oversimplification: the **growth-share matrix**, (used in portfolio planning). The relative potential of a diversified company's portfolio of BUs as areas for investment was compared by plotting them on the grid. BCG's basic strategy was to maintain a balance between cash cows (mature businesses) and stars (high share & high growth), while allocating some resources to fund question marks (potential stars) and selling of dogs. This means: since the producer with the largest stable market share eventually has the lowest costs and greatest profits, it becomes vital to have a dominant market share in as many products as possible. However, market share in slowly growing products can be gained only by reducing the share of competitors who are likely to fight back. In a rapidliy growing product market however a company can gain share by securing most of the growth.

Later, McKinsey developed the idea of SBUs (natural BUs). They came up with a nine-block matrix, which uses a dozen measures to screen for industry attractiveness and another dozen to screen for competitive position, although the weights attached to the measures were not specified.

Later, it was argued that the consequence of intensively pursuing a cost-minimization strategy (based on the experience curve) is a reduced ability to make innovative changes and to respond to those introduced by competitors. The experience curve also drew criticism for treating cost reductions as automatic rather than something to be managed, for assuming that most experiences could be kept proprietary, for mixing up different sources of cost reduction with different strategic implications, and for leading to impasses as multiple competitors pursued the same experience-based strategy.

In the late 70s, portfolio planning came under attack too. The strategic recommendations for an SBU were often too sensitive to the specific portfolio planning technique employed. Moreover, even if one could figure the "right" technique to employ, the mechanical determination of resource- allocation patterns on the basis of historical data was problematic, as was the implicit assumption that financial capital was the scarce resources on which top management had to focus.

The heavy dependence on package techniques has frequently resulted in nothing more than a tightening up, or fine tuning, of current initiatives within the traditionally configured businesses. What's more, technique-based strategies rarely beat existing competition and often left businesses vulnerable to unexpected thrusts from companies not previously considered competitors. Some sought to loosen the constraints imposed by mechanistic approaches by proposing that successful companies' strategies progress through 4 phases (financial planning (meet the annual budget); forecast-based planning (predict the future); externally oriented planning (think strategically); strategic management (create the future)) that involve grappling with increasing levels of dynamism, multidimensionality and uncertainty, and therefore become less responsive to routine quantitative analysis.

It was also argued that these new principles of management, despite their sophistication and widespread usefulness, encourage a preference for analytic detachment rather than the insight that comes from hands-on experience and short-term cost reduction rather than LT development of technological competitiveness. Portfolio planning was criticized as a tool that led managers to focus on minimizing financial risks rather than investing in new opportunities that required LT commitment of resources.

However, portfolio planning had a lasting influence on subsequent work on business strategy because it focused on the need for more careful analysis of the 2 basic dimensions of the portfolio planning grid (industry attractiveness and competitive position). Portfolio planning underscored their usefulness in analyzing the effects of competition on business performance. Specifically, a business' performance could be thought of as the sum of the average profitability of the industry in which it operated plus its competitive advantage relative to the average competitor within that industry. But the attraction of an explicitly competitive perspective, involving direct comparisons with reference competitors, had already overcome tradition hesitations based on the uniqueness of companies and the implied difficulties of comparing them.

Classic reading: Can you say what your strategy is? (Collis)

No matter how successful a company is, very few executives can summarize their company's strategy in a same simple way. Leaders assume that the apparently great strategies emerging from an annual budget or a strategic-planning process will ensure competitive success and they fail to understand the necessity of having a simple, clear & succinct strategy statement that everyone can internalize and use as a guide for making difficult choices. However, with a clear definition, formulation becomes easier because executives know what they are trying to create, and implementation becomes simpler because the strategy's essence can be readily communicated and internalized within the organization.

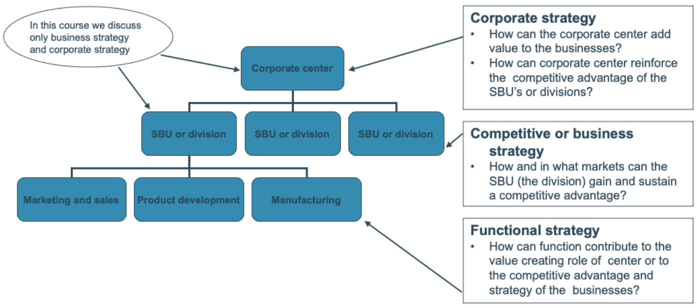
A good strategy statement includes objective (end point + time frame), scope (define off-limit boundaries), and competitive advantage (= the essence of the strategy. How are the objectives going to be reached your objectives? Why is the firm unique?). Defining these 3 elements requires trade-offs (growth/size >< profitability), which distinguish individual companies strategically.

- **Objective** (= ends): the form is usually wrong, companies confusing their statement of values/their mission with their strategic objective, which should be unique: ethical values (sustaining the environment, how employees should behave etc …) and ultimate purpose are not strategic objectives that can drive today's business decisions (doing things right >< the right thing to do). The strategic objective should be specific, measurable, time bound, and be a single goal (growth or profitability?). it is the single precise objective that will drive the business over the next five years.
- **Scope** (= domain): it encompasses 3 dimensions; customer or offering, geographic location, and vertical integration. This should make it obvious on which activities to focus on and which they should not do. It also encourages experimentation and initiative, while specifying where the firm will not go to ensure a focus on what the firm does well (boundaries).
- **Advantage** (= means): it is the most critical aspect of a strategy statement; clarity about what makes the firm distinctive is what most helps employees understand how they can contribute to successful execution of its strategy. A simple description should provide characterization that could not belong to any other firm. It consists of two parts:
    - a customer value proposition that explains why the targeted customer should buy your product above all the alternatives
    - a description of how internal activities must be aligned so that only your firm can deliver that value proposition. (see Porter)

Developing a strategy statement
The 1st step when crafting a strategy statement is to create a good strategy, carefully evaluating the industry landscape (customer segmentation, understanding their needs) and competitors' strategies. The creative part is finding the sweet spot of the company, where its capabilities meet with customer needs in a way that competitors cannot match, given the context (technology, regulation). It is best to develop a few plausible and very different strategic options. The process of developing the strategy and then crafting the statement that captures its essence should involve employees in all parts of the company and at all levels of the hierarchy. It should result in a brief statement with detailed annotations to elucidate possible nuances.

The rest here under was not discussed during the lecture

A strategy can be formulated for a business, several businesses or for a function



SBU= Strategic Business Unit, a unit of a company or a group that is responsible for its strategy in its markets and has and controls the resources and capabilities to implement such strategy.

A lot of bad strategy

- Strategy is not operational effectiveness
  (See also Porter, 1996)
- Strategy is not benchmarking
- Strategy is not Marketing
- Strategy not sufficiently integrated:
  - Financial planning
  - With functional strategies
  - With day-to-day operations
- SWOT analysis (Strengths, Weaknesses, Opportunities and Threats) is not strategy
- Failure to face the problem and make choices (trade-offs)
- Mistaking goals for strategy
  - 20/20 rule (growth and profit margin); 14% EBIT;
- Fuzzy and fluffy strategic objectives
  - Bank: “Our fundamental strategy is one of customer-centric intermediation”

“Strategy” used and Abused

- Many different definitions out there (and a lot of BS)
- There are no recipes. Only careful strategic analysis and thinking
- No generally accepted methodology for formulating strategy
  - Every consultant has own methodology
  - Some common frameworks exist, but no right answers
  - Some fads and “Guru’s”

Do you have a strategy?

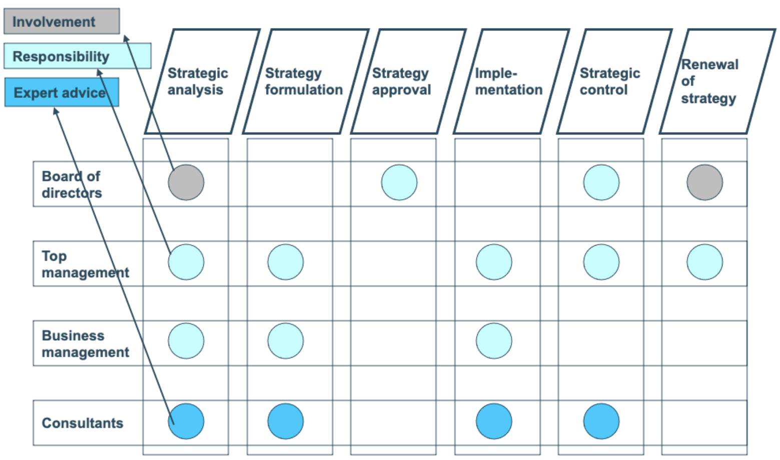
- Diagnosis about the nature of the challenge
- Guiding policy
  - Clear objectives:
    - Maximize enterprise value
    - Maximize number of people reached
    - Stay at the frontier of clinical cures
  - Where to compete and where not to compete: corporate strategy
  - How to compete: competitive strategy
- Coherent and consistent actions – patterns
- Persistence in results

When should a strategy be reviewed or changed?

- The results of the strategy are disappointing and that is not due to a slower development of the market or the technology.
- The existing resources and capabilities of the company are underutilized.
- Important changes are taking place in the market, the technology or at the competitors.
- The competitive advantage or strength is threatened.
- Substantial investments have to be made.
- Some opportunities arise and it is not certain that they fit the current strategy.
- **Top management** of the company is replaced by a new team.
- **Shareholders** impose different objectives on the firm.

Firm is taken over by strategic partner, PE investor or is listed on the public market

Who does what for strategic decision-making?



(see topic 10)

Topic 2: Value creation and value capture

Fundamental questions

Capital is invested in the business
We will think about what is the capital that is invested into this business and what is the business in terms of creating, capturing value and how is it sustained over time.

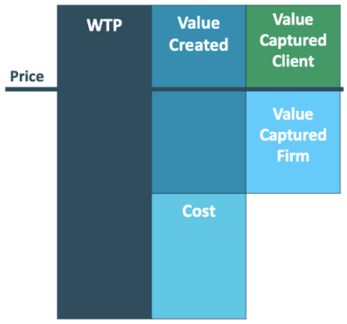
- Is value **created** by the business?
- Is value **captured** by the business (relative to the cost of capital invested)?
- Is value captured **sustained** by the business (relative to the capital invested)?

For that we need some concepts/definitions. Here when we think about a business, resources are being invested into the business. We want to think about what those resources generate and in particular resources that are typically not priced.

Is value created by the business?

A simple framework for value creating & value capture

- **Value Created**
  - willingness to pay (WTP) = cost (of providing good or service) + value created
  - costs of providing good or service
- **Value Captured**

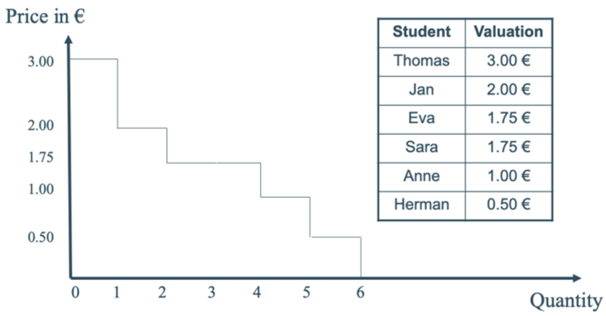


What goes into your WTP?
What goes into costs?
The value created in a particular transaction, is the difference between the maximum value of the willing to pay and the cost → the price is going to split the value created and the value captured.
Value created = value captured by the firm + value captured by the client = WTP – price

When we talk about that the business is creating value, we often talk about value captured however it is important to separate those elements when we think about strategy, we really want to know how much is being **captured** and how much is being **created**.

Willingness to pay & demand

We plot and list the different willingness to pay and we can form the demand curve.

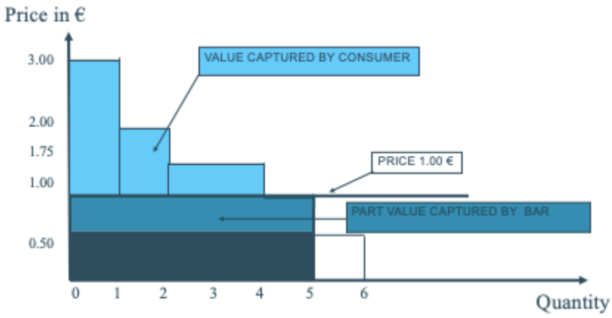


Student	Valuation
Thomas	3.00 €
Jan	2.00 €
Eva	1.75 €
Sara	1.75 €
Anne	1.00 €
Herman	0.50 €

WTP, prices and value captured

There is a cost.
Value captured by consumer depends on which consumer we have. When we think about strategy, we both think about creating and capturing value.

When we think strategically, we create value either by the willingness to pay side or cost side → increasing willingness or reduce costs. It could also be a combination.



How can I do better as a business in capturing more value?
- Price discrimination (marketing, which connects strategy on how to capture value): you try to capture more value for the people who value it more (example of someone of the students)

Drivers of value creation
When creating value, either WTP or costs can be increased.
- What affects WTP?
- What affects Costs?

When we think strategically, we will think about both sides. There are many things that affects costs but what does impact WTP? Behind the WTP is the demand curve.
Anything that shifts the demand curve will affect willingness to pay. But in which direction will depend. Factors that shift demand curve:
- Prices of substitutes
- Income
- …

What affects WTP?
The quantities demanded in a market depend on the price but also on other factors. If the demand curve shifts, it will affect the WTP. So, what shifts the demand curve?

The willingness to pay (WTP) depends on:

- *Income* (there is a shift in demand depending on the type of product).
  - Normal/luxury goods (+): income goes up, demand shifts out (motorcycle, PC).
  - Inferior goods (-): income goes up, demand shifts in (potatoes, bus rides).
- *Price of related goods*:
  - Substitutes (+): the demand for Mac increases if the PC's price increases.
  - Complements (-): the demand for Mac decreases if the price of software increases.
- *Others*: tastes, expectations, product innovation, financial condition, mental state, information about the estimated costs, budget constraints, quality, preferences, …

Estimation techniques for calculating the WTP include regression analysis, conjoint analysis or market surveys. The WTP to pay is easier to estimate for B2B transactions because it's easier to compare to competitors (big machines).
- Estimate based on historical data (Regression analysis)
  - Structural estimation demand (and supply)
  - Hedonic Pricing equations: price regressed on some parameters
- Estimate based on "survey" data for new products and services
  - Choice analysis (Conjoint analysis): ask some focus group what their preferences are
  - Indifference analysis: what makes you indifferent between different choices?

A demand curve can be created on the basis of the WTP and so anything that will shift in or out the demand curve will affect the WTP:

- Income can shift in or shift out (shift out = what we want) the demand curve
- Marketing is made to shift out the demand curve
- If a complement becomes cheaper, it shifts out the WTP
- If a substitute becomes cheaper, the WTP of the other product decreases because the alternative is more interesting.

⇨ The final price determines how much value is captured.

Determining WTP
The main drivers of the different WTP include productivity, extra production, cost of use and quality of the product (harder to assess).

	Husky	Major competitor
System	PET preform system producing 48 preforms per cycle, for production of 20 ounce soft drink bottle	PET preform system producing 48 preforms per cycle, for production of 20 ounce soft drink bottle
Cycle time	10,4 seconds	11,8 seconds
Average operating hours per day	22,3 hours	18,9 hours
Weight of preform		
Average	24,39 gm	24,42 gm
Standard deviation	0,16 gm	0,16 gm
Floor space occupied	343,1 square feet	351,8 square feet
Electricity consumption	Husky system uses 0,137 kWh less of electricity per kilogram of Preform produced. Cost of electricity: 8 cent/kWh	
Number of surface blemishes visible on perform body	~5-10	~50
Pressure required to burst bottle		
Average	~205 psi	~205 psi
Standard deviation	~ 5 psi	~ 20 psi
Approximate purchase price	$ 1,2 million	$ 1,0 million
Price of resin	$1,3 per kg	

How much MORE are you willing to pay for the Husky machine relative to a Competitor Machine?

WPT has a comparative element.
You need to think about the important drivers here:

- How many years the machines will be operating
- The production difference
- Maintenance costs: Husky is operating longer so maintenance costs are lower

Why do we need to know this?
We need to make a distinction of how much is actually charged and the willingness to pay.
Calculation for an injection molding machine:

	HUSKY	**COMPETITOR**
Production volume	48 preforms x 3600/10.4 cycles per hour x 22.3 hours x 365 days = **135 million preforms/year**	48 preforms x 3600/11.8 cycles per hour x 18.9 hours x 365 days = **101 million preforms/year**
→ Husky machine produces 34% more: Competitor's Machine costs $1M **Husky Machine could cost up to $1.34M and still leave the customer better off.**		
Overall savings with the Husky machine		
Electricity savings	$0.08 x 0.137kWh x (0.02439 kg x 135M preforms) = **$36.200**/year	
Resin savings (resin: not environmentally friendly!)	0.03 gram saving x $0.0013 x 135M preforms = **$5.300**/year	
Floor space savings	8.7 sqft x $60 (avg of $20 - $100) = **$522**	
→ Total yearly savings: **$42.000**		

<u>NPV of Husky Machine</u>

- Purchasing Price: $1.2M
- Production Volume Value: $1.34M
- Discount rate: 20% (this is only and example, you can assume another reasonable number)
- NPV of yearly savings (in perpetuity): $0.042M @ 20% = $0.210M

⇨ **NPV = $1.34M + $0.210M - $1.2M = $350.000**

<u>Willingness to Pay</u> of Husky Customer is $550K <u>higher</u> than for the average competitor's machine!

- We can actually get a number. But 200k more will be the purchase price.

As we didn't take the quality into account, it should be even more. Calculation like the one above can helpconvince customers. A piece of the actual price is captured by the customers, and the other by Husky.

What affects costs?

Reducing costs means increasing value creation. Costs are affected by **scale and scope economies** (vol.: indivisibilities, specialization & division of labor), **learning economies** (vol.: increased individual skills, improved organizational routines to make costs go down), **capacity utilization**: how well are the assets utilized? (vol.: ratio of fixed to variable costs, speed of capacity adjustment), **production techniques** (process innovation, reengineering of business processes), **product design** (standardization), **input costs** (LAs, ownership of low-cost inputs, bargaining power, non-union labor), and **residual efficiency** (motivation, culture, managerial efficiency, organizational slack).

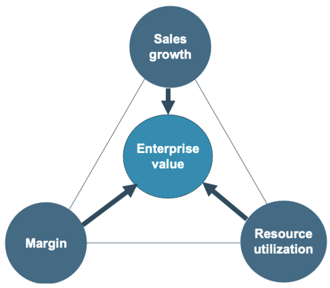
- ⇨ *Economies of scope*: spread a fixed cost over different products, by sharing resources, processes and skills, reducing the overall costs.
- ⇨ *Economies of scale*: reduce costs with increased production levels.

Is value captured by the business (relative to the capital invested)?

What is value captured? It's important that WPT ≠ price; the price is what is going to divide what is captured by customer and by company → see classic reading value based strategy!

Supplier will also have a willingness to supply, and they will get a certain price for their services. We only talked about customer. We can also look at value captured by the supplier.

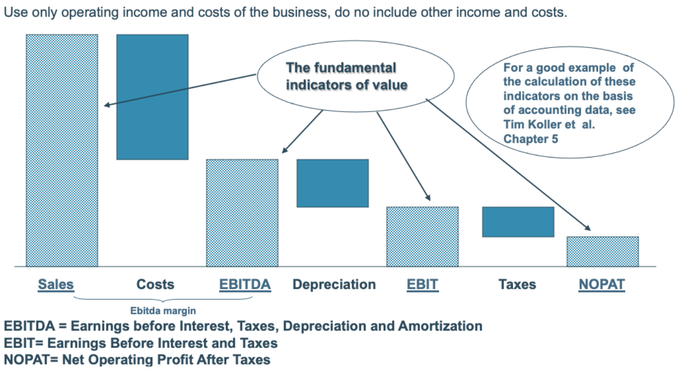
The Drivers of Capturing Value: measuring enterprise value



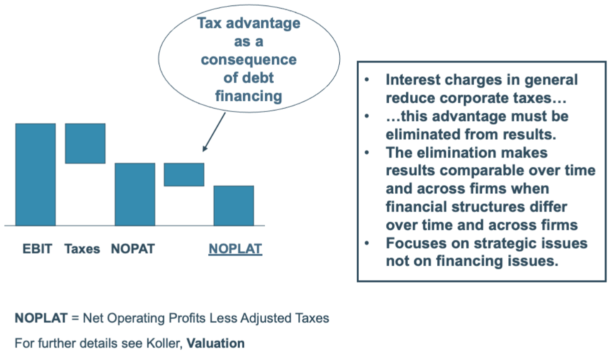
Enterprise value = part of value that is created that is captured by the business → 3 important levers that affects this value (margin, resources and growth).
We don't have to maximize enterprise value, it's all the capital that is in the business (not only shareholder value). We will look at what the business is generating and what it is capturing from that. The strategy will tell us how we use the different levers to affect enterprise value. If I make a strategic decision it has costs and benefits which I want to know, but you would also want to maximize enterprise value if you want to go public but if you are a family business for example you might think differently.

Capturing Value at a Moment in Time

(see classic readings at the end of the chapter)
Identify the fundamental metrics for measuring and evaluating the performance of the business:



From NOPAT to NOPLAT … and why that may be necessary, sometimes!

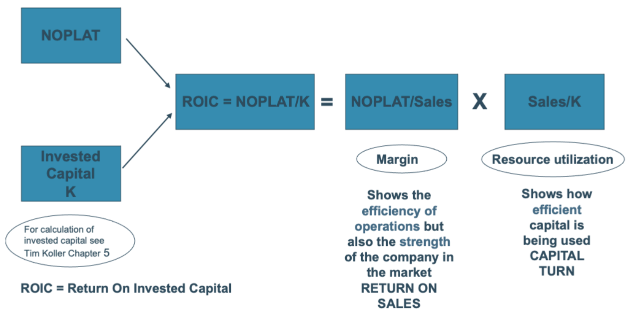


NOPAT can be improved because there might be some benefits in terms of how you finance your company. You might pay less taxes depending on how you finance your company. If you want to compare companies (as an analyst), we don't want to compare the financing but the strategy of the company, the operations and what they generate.

NOPAT measures the profitability, starting from sales (with resources paid). Using NOPLAT might sometimes be necessary, depending on how the business is financed (by shareholders (equity) or by banks (debt)). Some countries/regions might give advantages according to the financing mean chosen. NOPLAT can be used to make a comparison with no difference possible due to a certain tax regime.

Calculate the key variable for evaluating strategy: ROIC

Return on invested capital assesses a company's efficiency at allocating its capital to profitable investments (per € put in, what's left after resources are paid?). The ROIC ratio is an outcome measure and gives a sense of how well a company is using its money to generate returns.



ROIC: ratio between profits NOPLAT / K (Capital invested). It's a combination of two things, it's my return on sales and my sales over capital (=how many sales I am generating per euro invested into the business). The sales over resource utilization is the capital turn. Different businesses will use different levers in terms of strategy and you might see that in the margins they generate.

- Companies with **high ROIC** improve total returns to shareholders (TRS) more with growth than further improvements to ROIC.
- Companies with **medium ROIC** must focus on both TRS and ROIC.
- Companies with **low ROIC** improve TRS more with ROIC improvements, though growth is also important.

Looking at the overall variance in companies' ROIC, an important part will be explained by the industry environment and the positioning relative to the environment. Stable characteristics of the industry and a competitive position are driving returns.

Different companies focus on different parts of this equation. Ryanair scores very high on resource utilization (planes always flight), while Apple focuses on the margin (but still has an efficient resource utilization).

When analyzing a company, it has to be done for normal times, not when exceptional events happen.

Invested capital represents the cumulative amount the business has invested in its core operations; primarily property, plant, and equipment and working capital (Koller). It is everything that is used to run the business. You can get this by rethinking what is in your balance sheet:

Invested Capital = Fixed Assets (Property, plant & equipment)
+ Inventories
+ Trade receivables
- Current liabilities
=
Equity
+ Non-current liabilities
- Cash (it is on the books and not in the business, so we take it out it is not invested)
Why is that important? Return on invested capital is not the same as return on assets because some of these assets might not be used to run the business and you also might have some receivables.

$$\rightarrow ROIC = \frac{NOPAT}{Sales} \times \frac{Sales}{Inv.K} = \frac{NOPLAT}{Inv.K}$$

$$\rightarrow ROA = \frac{NOPAT}{Sales} \times \frac{Sales}{Total\ assets} = \frac{NOPAT}{Total\ assets}$$

Example BARCO (see slides)
Sales are declining:
When we think about strategy, we think about resources they are putting gin, the value they create with that and how much is captured. When something happens in a particular year this is something that does not interest us.

But margins increase:
ROCE = (Return after tax + added back restructuring costs on which you normally would pay taxes)/ Operating capital employed (incl. Goodwill)
Barco tells us how much capital is being employed, what is the capital that is being used to generate this result? Even though their sales has been going down;
Capital turn stayed similar, but their margin went up. We would have expected to play in the margin rather than on the capital turn (because Barco is more a premium player). If you are a low-cost player you would want a higher capital turn.

They actually wanted to clean up their company. These results get reflected into the share price.

Example Colruyt (see slides)

Fixed Assets	2733
Current Assets	1413

(Current Liabilities)	-1712
(Cash)	-163
Invested Capital	**2271**

Colruyt VS Delhaize

	Colruyt 2012-2013	**Colruyt 2011-2012**	**Delhaize 2012-2013**	**Delhaize 2011-2012**
Revenue	8311,6	7847,6	22737	21110
Cost of Goods Sold	6205,3	5839	17170	15749
Gross Margin	2106,3	2008,6	5567	5361
Selling, General and Administrative Expenses & Other	1406,5	1327,2	5177	4548
Operating Profit (EBITDA)	699,8	681,4	390	813
Depreciation	184,7	196,2	261	182
EBIT	515,1	485,2	129	631
Taxes	148,9	145,9	24	156
NOPAT	366,2	339,3	105	475
Invested Capital	1442,7	1466,6	3819	4424
ROIC	**25,3%**	**23,1%**	**2,75%**	**10,7%**
Total Assets	3443,30	3167,00	11936,00	12292,00
Return on Assets (NOPAT/total assets)	**10,64%**	**10,71%**	**0,88%**	**3,86%**

Delhaize did not very well in terms of ROIC. Colruyt has very high ROIC. If you look at return on assets the numbers look very different.

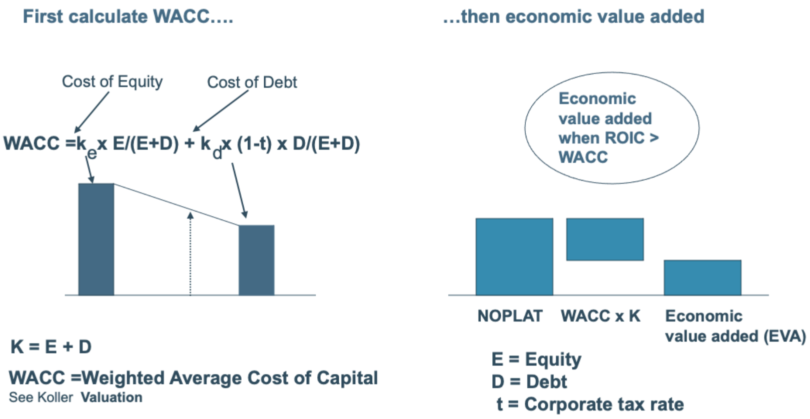
Colruyt vs Ahold Delhaize

	Colruyt 2018/19	Colruyt 2017/18	Ahold-D 2 018/19	Ahold-D 2017/18
Revenue	9434	9030	62791	62890
Cost of Goods Sold	6963	6681	45839	46121
Gross Margin	2471	2349	16952	16769
Selling, General and Administrative Expenses & Other	1986	1861	12647	12520
Operating Profit (EBITDA)	757	734	4305	4249
Depreciation	272	245	261	182
EBIT	485	488	2395	2225
Taxes	135	144	372	146
NOPAT	350	344	2023	2079
Invested Capital	2271	2063	20188	18985
ROIC	15,4%	16,7%	10,02%	10,95%
Total Assets	4146	4055	33331	33871
Return on Assets (NOPAT/total assets)	8,44%	8,48%	6,07%	6,14%

Colruyt and ahold today

Ahold did very well relative to Colruyt and Colruyt has been struggling.

Calculate the key variable for evaluating performance: economic profit or economic value added most
= important criteria for evaluating performance

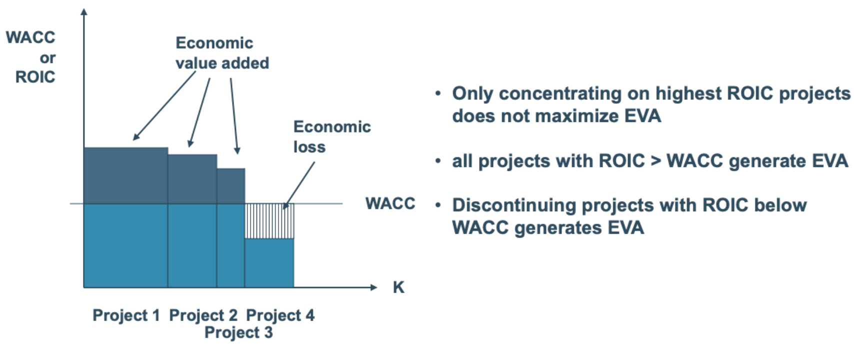


We want to understand what is happening and what decisions could be made from a strategic perspective. We talked about return on invested capital but what is the cost on invested capital? WACC is the price of capital and then we can calculate the economic value added. That is basically your profitability (NOPAT/NOPLAT) minis the cost of capital (WACC) times capital I am using. Comparing a company's ROIC with WACC reveals whether invested capital is being used effectively: this is the return on capital, what investors (banks and equity) are looking at.

⇨ *WACC = share of the cost of equity + share of the cost of debt*

How can economic value-added (EVA) grow?

Typically, companies are involved in different projects and that's how EVA can grow. We have ROIC and WACC. Some projects generate ROIC while other don't. To sustain, projects need to generate EVA. A company should focus rather on projects where *ROIC > WACC*, because that's when EVA is created.

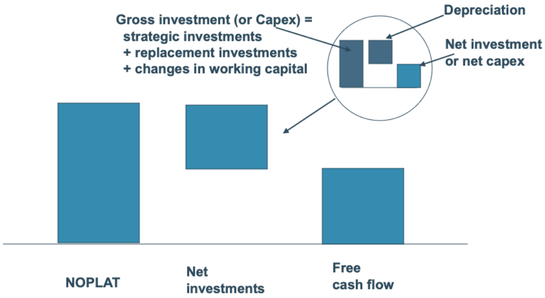


It's not true that I want to maximize my return on invested capital in order to improve my economic value added. I want to add different projects (even though they have different or lower ROIC) as long as I am above my WACC, and then I am creating economic value added and I capture value. In this example if I was doing project 4 it was better to discontinue the project because WACC is more than return.

Is value captured <u>sustained</u> by the business (relative to the capital invested) over time?

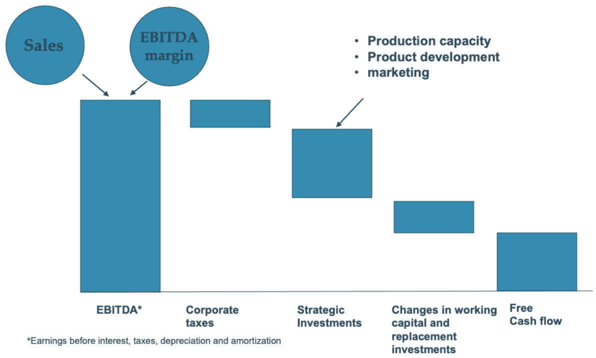
We want some kind of measure that corresponds to the long term view of businesses.

Determine free cash flow



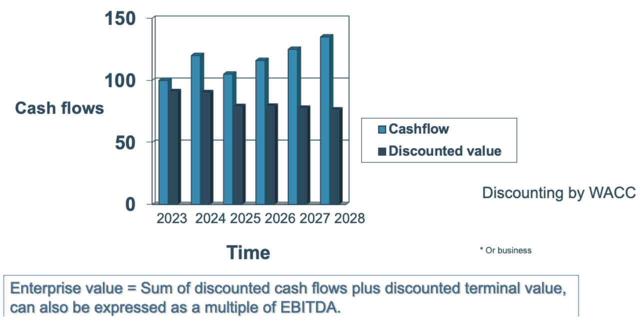
We need to define another concept which is more LT.
Net investment: capex – depreciation. NOPLAT – net investments = free cash flow. This is what the business is generating, the free cash flow.

Drivers of free cash flows



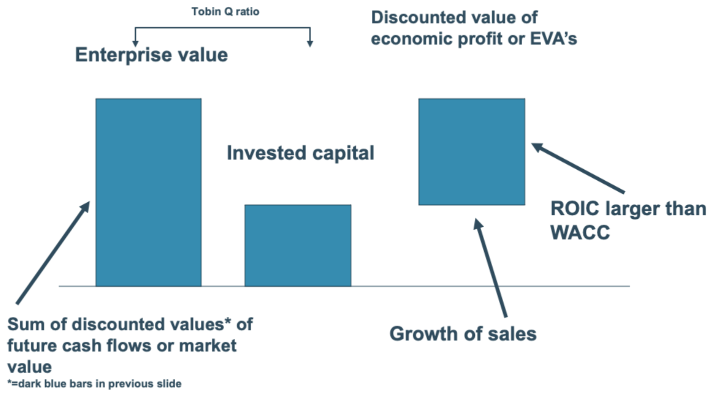
Put differently we have our EBITDA. What is driving this is the sales. EBITDA – corporate taxes – strategic investments – changes in NWC = free cash flow. This is easier to use to think over time about enterprise value.

Use future evolution of free cash flow to estimate enterprise value* and value of strategic plan:



A business runs many years, we have the time running, the cash flow and then depending on the year we will discount that. You will have as a result different years with the value you predict and then the terminal value.
When looking at a business overtime, FCF determines its enterprise value. Future evolution of FCF can help estimate enterprise value and the value of a strategic plan. The enterprise value is the sum of discounted CF + discounted terminal value (often expressed as a multiple of EBITDA).

Drivers of value capture: ROIC and growth



Enterprise value – invested capital = economic profit (or EVA). What we did before for one year, we do it now for different years.
Alternatively, we could have calculated the economic profit for each year then discounted it back and calculate the discounted value of EVA. What is driving this are expectations, growth of sales, *ROIC > WACC* (if not, value is destroyed).

Enterprise Value with Perpetuity Formula

$$ROIC = \frac{NOPLAT}{Invested\ Capital} = (1 - Tax\,rate)\frac{(Price - Cost)\,x\,Quantity}{Invested\ Capital}$$

$FCF = free\,cash\ flow$

$WACC = weighted\ average\,cost\ of\ capital$

$g = growth\,rate$

Economic profit

$$Enterprise\,Value = Invested\ Capital + \frac{Invested\ Capital\,x\,(ROIC - WACC)}{WACC - g}$$

Discounted cash flows

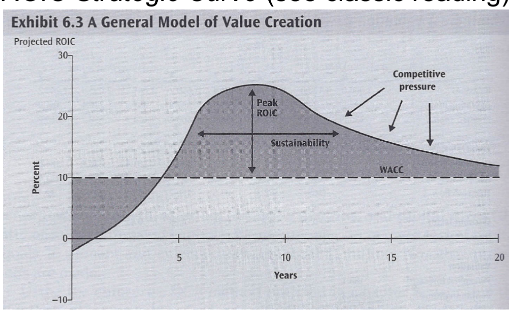
$$Enterprise\,Value = \frac{FCF}{WACC - g} = \frac{NOPLAT\left(1 - \frac{g}{ROIC}\right)}{WACC - g}$$

The question is what drives economic profit and enterprise value? That is what strategy is about here.

The margin between ROIC and WACC is driving enterprise value but again it might be the margin price minus cost. It can be the quantity over invested capital, or growth rate. These are the 3 levers that we can pull to affect our enterprise value and the strategy will decide which one I am using.

- **Profit** = (price – cost) x quantity
- **Margin** = price – cost
- **Resource utilization** = quantity/invested K
- g = annual growth rate of free cash flow in big businesses
- Enterprise value = what's invested + what's generated by that invested K

ROIC Strategic Curve (see classic reading)

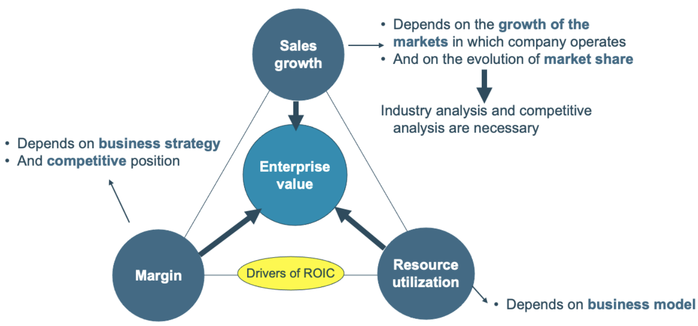


In reality it is not just a perpetuity. It would look like this figure. What typically happens is we might start with a negative ROIC. But hopefully at some point we turn positive in the sense that ROIC exceeds WACC. Then your business seems interesting and maybe competition comes in and ROIC goes down again. Strategy needs to think about this whole process over several years (LT).
In finance they call this the model of value creation, but this is not value creation this is value capturing: value measured over time (difference between price and cost).

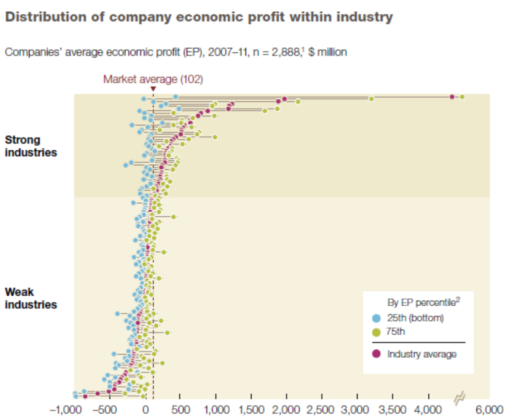
When does a strategy creates economic value?
A strategy creates economic value when *enterprise value* > *invested K*. This implies that the sum of discounted values of economic profit must be positive. It is only possible when in several periods *ROIC* > *WACC* (which is only possible when margins are larger, or the use of capital is more efficient) or when growth is realized in activities where *ROIC* > *WACC*. In strategy formulation, it is important to make sure that the creation of economic profit or EVA is sustain as long as possible.
= The key variables that must be shaped by strategy.

In formulating strategy, it is important to make sure that the creation of economic profit or EVA is sustained as long as possible.

The keys to capturing value

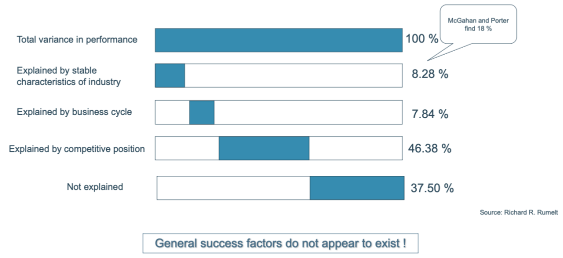


Strategy is the choice of which levers to pull and how (positioning relative to the competition, business model, environment).
Companies' economic profit are very different between industries but also within industries. While performance difference between various industries can easily be understood, performance differences between companies of a same industry are difficult to explain.
Some companies prefer to play on the margin, think about Ryanair.



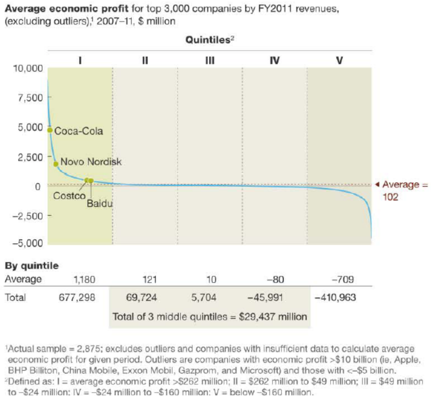
Here is a picture that list industries in terms of their profit. Interesting is that there is allot of variation, even **within** the same industry. There are firms doing well and not so well.

Performance differences between companies are difficult to explain:



So there is allot of variation. What explains this? The industry explains this (10% of the variance). m Stable characteristics of industry include business cycle or position (within industries) and explain only 8,28% of the variance in performance. So being in a bottom industry doesn't mean it's hopeless and being in a top industry doesn't mean it's going to be easy. Much has to do with the competition within the industry and how a firm position itself in its sector matters a lot. Most of the variation was explained by competition. This picture forms the basis for our framework.

Distribution of Economic Profit



Competitive position explains allot but this picture shows: we see here that there are few very high performers and very few very bad performers and allot of them are actually around zero. All of these companies are developing fantastic strategies but still they remain around zero. If you think about strategy you would think to move from the bad situation or the zero situation to the high performers.

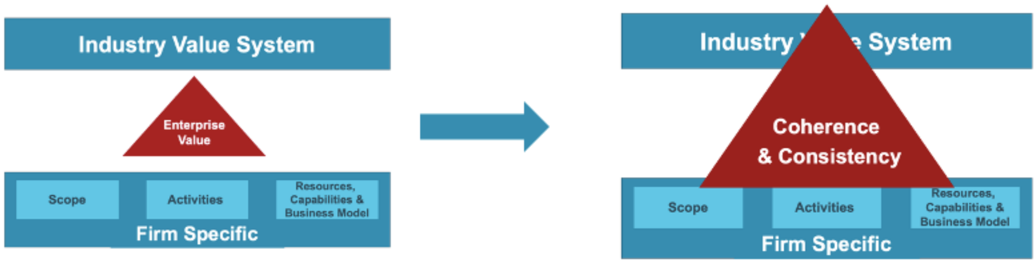
The Odds of Moving up after a Decade

		Ending Position On Power Curve		
		Bottom	Middle	Top
Starting Position On Power Curve	Top	15	26	59
	Middle	14	78	**8**
	Bottom	43	40	17

Source: Bradley, C., Hirt, M., & S. Smit (2018) "Strategy: Beyond the Hockey Stick"

Afterwards the study made this table. They say we start at the top, middle or bottom in this power curve. We are ending up, 10 years later somewhere in this table. What is the chance to end up in the top 20%? Only 8% ends up in the top. This is very depressing for executives. How do we move ourselves to the top? By thinking strategically, but differently than everyone does this.

Strategy and the Drivers of Enterprise Value



This is important!
We talked about what is the outcome that strategy will affect → enterprise value. So the enterprise value is affected by the environment (industry value system).
It depends on how we position ourselves relative to the environment. This whole picture together has to be **coherent** and **consistent**. We peel away the different boxes and in the end it's all about making connections.

Classic reading: Ch3 - Fundamental principles of value creation (Koller)

- **Discounted cash flow** (present value): forecasting of the future cash flow of a company and discounting it to the present at the same opportunity cost of capital discussed earlier.
- Economic profit and discounted cash flow are the same if you discount future economic profit at the same cost of capital
- Maximize the intrinsic value of the company (real market) and properly manage the expectations of the financial market (financial market).
- In the real market, value is created by earning a return on your invested capital greater than the opportunity cost of capital (e.g. in the stock market).
- The more is invested at returns above the cost of capital, the more value is created (growth creates more value as long as ROIC > cost of capital).
- Select strategies that maximize the present value of expected cash flows or economic profit.
- The value of a company's shares in the stock market is based on the market's expectations of future performance (which can deviate from intrinsic value if the market is less than fully informed about the company's true prospects).
- After an initial price is set, the return investors earn is driven by the future performance relative to expectations (expected earning on investment: 25%, actual earnings: 20% → the stock price will drop, even though the company is earning more than its cost of capital).

Key drivers of CF and thus value: the rate at which the company can grow its revenues and profits, and its ROIC (relative to the cost of capital).

- *Growth rate = return on new invest capital × investment rate*

Discounted cash flow

Intuition behind it is that what matters to investors is the cash flow generated by the business because this can be used for consumption or additional investment.
The DCF model accounts for the difference in value by factoring in the capital spending and other cash flows required to generate earnings. This can be used to value entire businesses.

Drivers of cash flow and value

When you have estimated the discounted cash flows, this is not enough to lead to insights about the performance or the competitive position of the company. Also short-term cash flows are not good performance measures.
There are two key drivers of cash flow and ultimately value:

- The rate at which the company can grow its revenues and profits
- Its return on invested capital (relative to the cost of capital) = ROIC

A company that earns higher profits per dollar invested will be worth more than a company that cannot generate the same level of returns. Similarly, a faster growing company will be worth more than a slower growing company if they both earn the same return on invested capital.
Link ROIC, growth an free cash flow: A greater return on invested capital results in more cash flow, given the same growth rate in operating profits.

Link growth, cash flow and value: As long as the return on new invested capital is greater than the cost of capital used to discount the cash flow (WACC), higher growth will generate greater value.
If this is not the case:
- If they are equal: additional growth neither creates nor destroys value
- If ROIC is less than (WACC): additional growth destroys value

The Zen of corporate finance

- **Net operating profit less adjusted taxes (NOPLAT)** represents the profits generated from the company's core operations after subtracting the income taxes related to the core operations.
- **Invested capital** represents the cumulative amount the business has invested in its core operations (property, plant, and equipment and working capital
- **Net investment** is the increase in invested capital from one year to the next:
  Net investment = Invested capital t+1 − Invested capital t
- **Free cash flow (FCF)**: CF generated by the core operations of the business after deducting investments in new capital (what is left after all is paid; in the bank or returned to shareholders): *FCF = NOPLAT − Net Investment*
- **Return on invested capital (ROIC)** is the return the company earns on each $ invested in the business. ROIC can be defined as the return on all capital or as the return on new or incremental capital. For now, we assume that both returns are the same.
- **Investment rate (IR)** is the portion of NOPLAT invested back into the business:

$$IR = \frac{\text{Net Investment}}{\text{NOPLAT}}$$

- **Weighted average cost of capital (WACC)** is the rate of return investors expect to earn from investing in the company and thus the appropriate discount rate for the FCF. It is the rate that a company is expected to pay to all its security holders to finance its assets.
- **Growth (g)** is the rate at which the company's NOPLAT and cash flow grow each year.

$$\text{Enterprise Value} = \text{Invested Capital} + \frac{\text{Invested Capital } x\,(ROIC - WACC)}{WACC - g}$$

This formula relates a company's value to the fundamental drivers of economic value: growth, ROIC and the cost of capital.

The economic profit model: the value of a company equals the amount of capital invested plus a premium equal to the present value of the value created each year. It measures the value created by a company in a single period.

Economic profit = Invested capital × (ROIC – WACC)
Present value of economic profit = EP/(WACC-g)

- It is a useful measure for understanding a company's performance in any single year ←→ DCF
- If a company earned exactly its WACC every period then the discounted value of the projected free cash flow should exactly equal its invested capital → company is worth what was originally invested
  - o A company is worth more or less than WASS only to the extent that it earns more or less than its WACC
- The premium or discount relative to invested capital must equal the present value of the company's future economic profit.

⇨ Value is driven by expected cash flows which in turn is driven by expected returns on capital and growth

Classic reading: Ch 5- Frameworks for valuation (Koller)

Model	Measure	Discount factor	Assessment
Enterprise discounted CF	FCF	WACC	Works best for projects, BUs, and companies that manage their capital structure to a target level
Economic profit = NOPLAT (invested K × WACC)	Economic profit	WACC	Explicitly highlights when a company creates value
Adjusted present value = enterprise value as if the company was all-equity financed + present value of the tax shield	FCF	Unlevered cost of equity	Highlights changing capital structure more easily than WACC-based models
Capital CF	Capital CF	Unlevered cost of equity	Compresses FCF and the interest tax shield in one number, making it difficult to compare performance among companies overtime
Equity CF	CF to equity	Levered cost of equity	Difficult to implement correctly because capital structure is embedded within CF – best used when valuing financial institutions

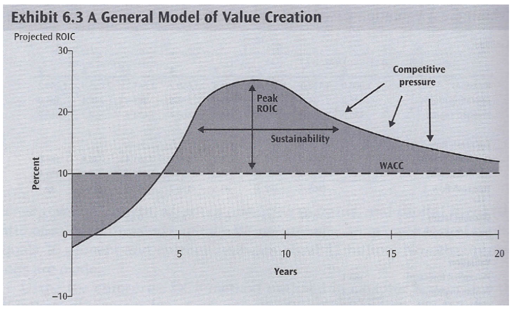
Classic reading: Ch6 - ROIC and growth (Koller)

A company's value depends on its ROIC and its ability to grow. By focusing on those, it can be measured how well the model's projections fit with the capabilities of the company and the competitive dynamics of the industry. Most models are rather complex. However, a simple model can capture the necessary flexibility. It is only smart to add detail, when it refines the accuracy of the key value drivers forecast.

A framework of value creation - the key value driver formula:

$$\text{Value} = \frac{\text{NOPLAT}_{t=1}\left(1 - \frac{g}{\text{ROIC}}\right)}{\text{WACC} - g}$$

The ability to create value can be measured in two dimensions: the level of peak ROIC and the sustainability of returns in excess of the cost of capital. The longer the *ROIC > WACC*, the greater the value creation.



In this example the peak ROIC occurs where the vertical arrow marks the spread between ROIC and cost of capital. The horizontal arrow represents sustainability; the longer the *ROIC > WACC*, the greater the value creation.

You also see competitive pressure. If it can no longer protect its competitive position, economic theory predicts its ROIC will regress to WACC such that enterprise value equals the book value of invested capital. To justify high future ROICs, you must identify at least one source of competitive advantage:

- *Price premium*: is the company a price taker or a price setter?
  - *Price taker must sell at market price*
  - *Price setter has control over the price it charges*

- *Cost competitiveness*: can the company sell products and services at a lower cost than the competition?
- *Capital efficiency*: even if profits per unit are small, a company can generate significant value by selling more products per $ of invested capital than its competition.

Sustainability is only present when a company can maintain its pricing power or a cost advantage. Only if the company maintains a barrier of imitation (from existing competition) or a barrier to entry sustainability will be guaranteed.

Not every company generates positive spreads. When ROIC < WACC, it should be asked:

- *How long will it take before the company starts creating value?*
- *How large will the initial investments (or losses) be?*

Any ROIC forecasted should be consistent with the company's core competencies, competitive advantage and industry economics. In a second step, the forecast should be benchmarked against actual long-run historical performance of other companies to check whether they are reasonable.

Empirical analysis on ROIC
ROIC by industry, size and growth: *industry* is an indication of varying competitive barriers to entry, *size* for economies of scale and *growth* for the intensity of competition. Industry membership can be an important predictor of performance. The ROIC of industries with identifiable sustainable advantages (patents and brands) tend to generate higher returns. ROIC increases consistently with revenues growth. However, growth does not cause the good performance. This is because firstly underlying factors both enable growth and ROIC. Secondly, companies with high ROICs have more incentives and greater opportunities to grow.
There is no clear relation between *size* and ROIC.

Return on invested capital decay rates
When a company generate ROICs greater than its cost of capital it invites competition.
- Mean reversion pattern: companies earning high returns tend to fall gradually over the next 15 years and companies earning low return tend to rise over time
  - Individual-company ROICs gradually regress toward medians over time however there is somewhat persistence
  - Continued persistence of superior performance beyond 10 years: a company's continuing value is highly dependent on long-run forecasts of ROIC and growth.

⇨ ROIC varies across companies and industries in a systematic fashion. For many companies, these differences are persistent, even in the face of ever more competitive markets.

Empirical analysis of corporate growth
- Real revenue growth is high and fluctuates more than ROIC and varies over time
- Growth decays very quickly: for the typical company, high growth is not sustainable (←→ ROIC is persistent)
  - Because of competition, size, saturation and growth itself
  - The typical firm cannot maintain supernormal revenue growth

Classic reading: value-based business strategy (Brandenburger)

What is the meaning of value in a business context?
*Value is **created** by a vertical chain extending from suppliers of resources to firms, through firms, to buyers of products and services from firms. The definition of value depends on suppliers, firms and buyers.*
*The question then becomes how much value can a player **capture**? Important here is the concept added value = value created by all the players in the vertical chain – value created by all the players except the one in question → "upper-bound" of the amount of value a player can capture. So one condition for value capturing is that the player has **positive added value** → How?*
- *The firm must enjoy a favorable asymmetry between itself and other firms*

Three important factors in this paper:
- *Emphasis on importance of firms' adopting external focus: towars buyers and suppliers they rely on*

- *Buyers and suppliers are treated symmetrically*
- *Cooperative game theory is used: notion of "free-form" interaction between players which is suited for a business context*

<u>Value creation</u>

Assume one player per stage

Vertical chain of activities: firm acquire resources from supplier → resources into product and services → sold to buyers

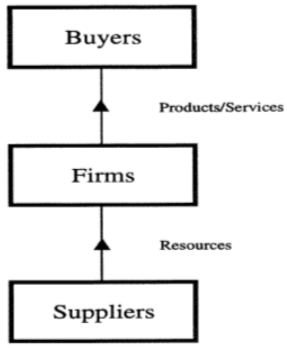


FIGURE 1

Value created = WTP – opportunity cost
- We go beyond the firm's actual outlays (costs) to the opportunity costs of its suppliers
- Actual price paid/received reflect the bargaining power between firm & buyer and firm & supplier
- Buyer & supplier have access to well-defined prices elsewhere in the economy

Assume many players

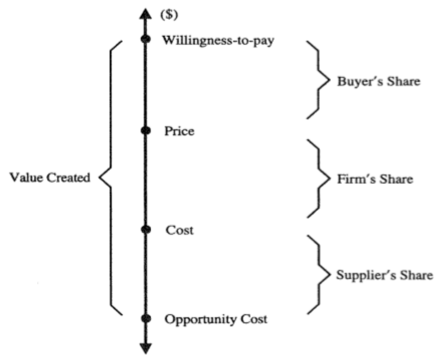
Firm has now competitors, multiple buyers and suppliers to consider.
The definition remains, but we extend the approach.
Example: Buyer considers two products: standard or premium product
→ but to define the buyer's WTP we have to know the price of the standard product first which in turn reflects the outcome of bargaining between players. So the definition of value creation cannot be separated from value appropriation (see below.) → what now?
The solution is to distinguish what happens inside and outside the game. The buyer's WTP for the premium product needs to be determined outside relative to alternative opportunities. The money the buyer paid for this product that amount is the point of indifference which could not be used for a standard product. So WTP does not depend on the bargaining outcome of the game. Similar analysis can be done for opportunity costs.

Now value creation is again calculated with WTP and opportunity costs but with an extra step: the calculation needs to be done for flows of resources from suppliers to firms and of products from firms to buyers.

<u>Value appropriation</u> (capturing)

Assume one player per stage

Bargaining between the players determines the division of value.



- The arrow represents the whole value created
- Value captured by buyer = buyer's WTP – price paid
- Value captured by firm = price received from buyer – cost of acquiring resources
- Value captured by supplier = cost of acquiring resources – opportunity cost

Assume many players

We add a new dimension to bargaining: bargaining is "many-on-many". Firms will try to play one supplier off against another etc …
This leads to a situation where each player captures an amount of value which is no greater than that player's "added value" (= value created by all players – value created by all other players except one in question). This added value places an upper bound on the amount of value each player can capture.
We make here the assumption of unrestricted bargaining = all favorable deals are identified and sought out by the players. Under this assumption, having a positive added value is a necessary (but not sufficient) condition for a player to appropriate a positive amount of value.

<u>Value-based strategies</u>

= ways to capture value
First of all, if a company does not have a positive added value yet, it has to achieve this. This can be done by being different from the competitors. It has to enjoy a favorable asymmetry between itself and other firms. (This can also happen on the supplier side)

- An asymmetry in WTP can arise because the firm finds a way to raise the WTP of buyers for its product
    - Or it may arise because buyers end up with a lower WTP for other firms' product
- An asymmetry can arise in opportunity cost because the firm finds a way to lower the opportunity cost of suppliers
    - Or it may arise because suppliers end up with a higher opportunity cost of providing these resources to other firms

  = four value-based strategy for the firm

1) Raising WTP of buyers (left above): this is the classic differentiation strategy
2) Lowering opportunity cost to suppliers (left down): reducing a supplier's cost of doing business with him. Or by human resource management.
3) Lowering WTP of buyers for other firms (top right): negative advertising, the creation of switching costs for buyers.
4) Raising the opportunity cost to suppliers of providing resources to other firms (right down):
   Influencing suppliers' perception of other firms, creating of switching.

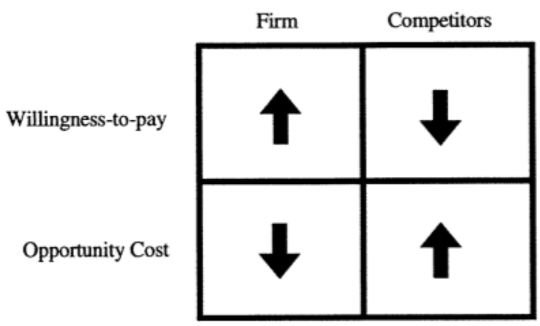


FIGURE 3

Note:

- We assumed maximal flows of resources (value creation with many players) and unrestricted bargaining (value capturing with many players). While these two seem distinct they are in fact intertwined. They are both expression of the single underlying of unrestricted bargaining.
- The assumption of unrestricted bargaining does not always hold: frictions in the marketplace can prevent bargaining such that some players will then be able to capture more value than their added values.

Now we start with topic 3, 4 and 5.

The Competitive Landscape (T3)
Building Competitive Advantage (T4)
Sustaining Competitive Advantage (T5)

<u>Developing a Sustainable Competitive Advantage</u>

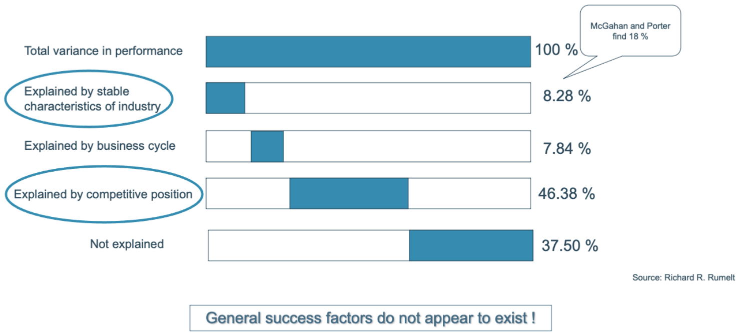
1. Understanding the Competitive Landscape (T3)
2. Define the Scope of your Business (T4)
3. Select the Activity set of your Business (T4)
4. Assemble the needed Resources and develop the key Capabilities (T4)
5. Set up the Business Model to link Value Creation and Value Capture and create a Virtuous Cycle (T4)
6. Understand the Sustainability of your Competitive Advantage (T5)
7. Test your Strategy (T5)

There are different steps we need to pass when we think about strategy.
We don't go step by step, but we actually need to iterate between them. But in order to cover those we will go through those steps in order. Think about strategy as a puzzle, different pieces coming together.

Topic 3: The competitive landscape

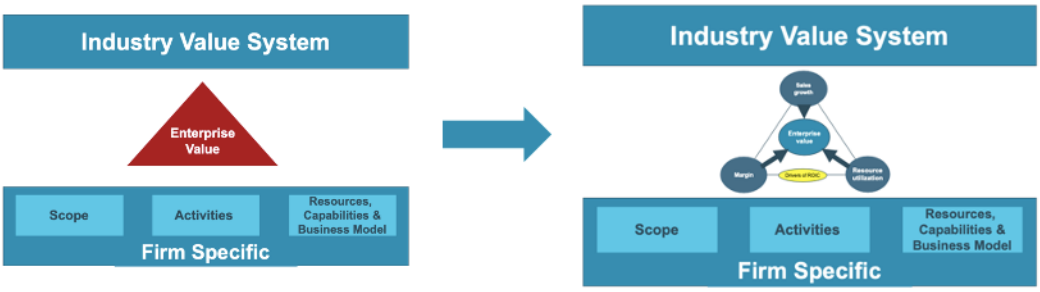
Understanding the competitive landscape

Performance differences between companies are difficult to explain



This is the variance in returns in businesses.
There are two important elements:
- Explained by the characteristics of the industry
- How are we positioned within that industry (topic 3 and 4)

Strategy and the Drivers of Enterprise Value



We talked about enterprise value last time. Now we will think about the competitive environment and the landscape.

Industry attractiveness

Industry attractiveness refers to the future average returns expected for firms operating in this industry

- Depends on:
  1. Long-term Trends: expectations about the obsolescence of <u>activities</u> linking buyers and suppliers and/or <u>core assets</u>
     Do: trend analysis, scenario planning,…
  2. Definition of Industry: Product-Technology Combination (Markets interact industries with customers)
  3. Drivers of Value Capture at Industry Level

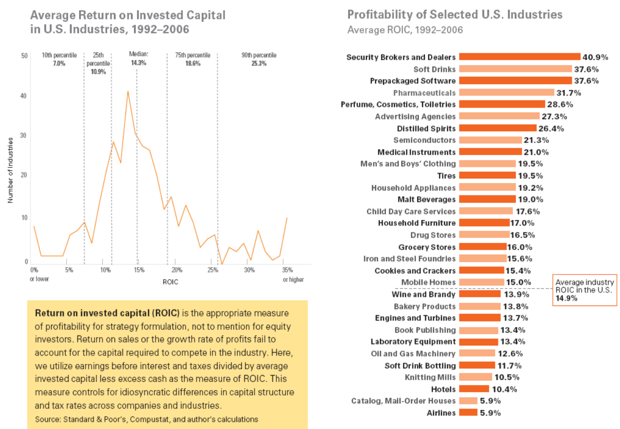
Example UBER: taxi business. Which assets link taxis to customers? Dispatch. Uber replaces dispatch. This refers to the average player in the industry. When we think about an industry, an environment, **what is the average player going to create and capture?**
That Will depend on different elements, typically we will also think about how that will evolve in the future.

<u>First element</u>: what we expect to happen in this environment. If you are a business, you are linking suppliers with customers. What is the value of your core assets in connecting these suppliers and these customers. Ex taxi business, core business was dispatch. But now with uber it takes away that dispatch so obviously this industry is in disarray. Fundamentally, in the long term what do we expect of the business in the long term? There are different ways to think about these long term trends. We are going to talk about industry.

Second element: But what is an industry? It is typically a product technology combination, when we think about a market you connect also customers. So, when we have a product technology combination looking at what is driving average value for that particular industry, if we look at our customers, our customers might source from that industry but they might also buy from another industry to satisfy a similar need. That is what we call **potential substitutes**. So, there is no perfect overlap between the industry and market necessary. These are dimensions we need to play with as we move along

Third element: what does an average player get from the industry → see readings

Average Returns across Industries



Show: soft drinks versus soft drink botteling versus grocery stores
Pharma - Semiconductors
Airlines – Hotels

We look at different industries and their average return on capital on a number of years. This is long term average return invested capital.
If you look at the different industries, you can see that for example airlines or hotels is not such an attractive business. So, **on average** a hotel or an airline does not do really well. Compared to the top; pharmaceuticals do on average very well.

What we are more interested in is different players within the same chain: coca cola and Pepsi cola → on top these are doing well. The one who are not doing so well relative to those two players in the bottom are a level down (for example the bottlers). We see different players within the same chain who have different returns. What we want to understand is why are the soft drink producers doing well and the bottlers not doing so well? If I am thinking about entering this business, where do I like to position myself? I need to think about my strategy. I will need to execute very well on this strategy to make money in this business. If you want to enter pharma this is not an easy business to enter. But on average if you are in you are likely to get a higher return. Those are the things we want to understand when we look at those business.

Return on invested capital (ROIC) is the appropriate measure of profitability for strategy formulation, not to mention for equity investors. Return on sales or the growth rate of profits fail to account for the capital required to compete in the industry. Here, we utilize earnings before interest and taxes divided by average invested capital less excess cash as the measure of ROIC. This measure controls for idiosyncratic differences in capital structure and tax rates across companies and industries.

CASE: Marijuana

Is the U.S. Legal Marijuana Industry an attractive Industry?

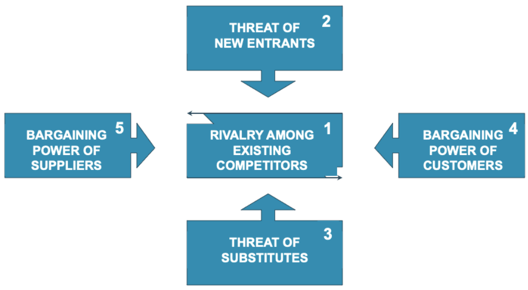
- For venture capital investors, how attractive is the US marijuana industry as an investment destination?
- Which parts of the industry offer the best prospects: growing, retail distribution, or infrastructure?
- Looking longer term (e.g. over a 10 or 12 year horizon), how do you think the US marijuana industry will develop? What will be the implications of this development for competition and profitability?

On average: what is the **average** value captured by a player within the industry. If we think about getting into this business, is it a good idea? Think about how you structure those questions.

What is the Average Value Captured by a Player in the Industry?

Porter's 5-forces Model

Porter based on Industrial Organization. All forces squeeze the margin.
Use Carbonated Soft Drinks as example:
- Little rivalry
- Entry is difficult
- Retailers are concentrating
- Suppliers irrelevant
- Bottler are tied to concentrate producer
- Regulation/Obesities is important threat
- Missing: Complements, Bottlers are intermediaries, and flow of product



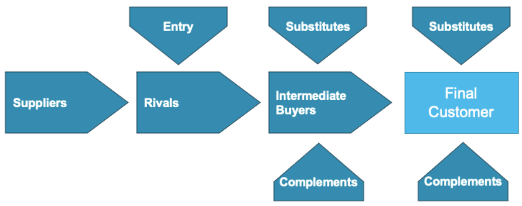
Competition for Profits (Value Capture) goes beyond established rivals.

But this is an old model: look at new model here below:

The industry value system

The industry value system is the analysis of the industry's environment in which it is operating.

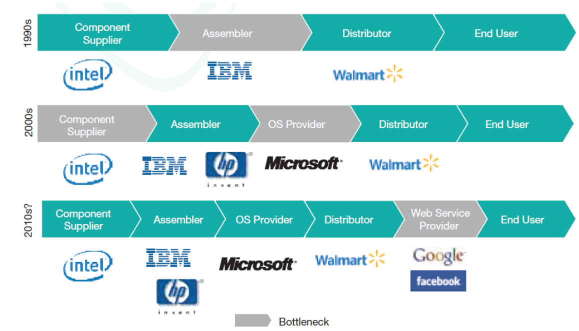
The dynamics and flow of the business matters… Need to get to the final user. What is the need of the final user?



<u>Substitutes and complements</u> at the end of the line because we talk about value creation: it's the difference between WTP and costs.
- The complements can increase the willingness to pay. Imagine that marihuana becomes more legalized than enforcement becomes less though. That might actually increase the illegal side because there are less enforcements so there might be more supply on the illegal side which would hurt the legal business. It goes about creating value.
- The cost side, all these regulations, are they increasing my cost? So, there will be less value created there. Competing with the illegal side is much more difficult because they don't have that part of the cost. So, they should be able to give a better offer to kind off compete.

Industry Architecture & Bottlenecks: Computing Industry: 1990 – Present
IBM had the power in the 90s as an assembler. Later, Intel and Microsoft become powerful, capturing the value (instead of the assemblers). Now, the power is shifting again (tech giants (Facebook, Google) = bottleneck). As the power in the industry changes overtime, it is an important dynamic to consider. To think strategically is to think dynamically.

In an industry with lots of rivals, it is not likely that margin will be an important lever for a company of that industry. Instead, it's better to focus on resource utilization.
In 2000 IBM opened a system and then Intel and Microsoft were capturing the value in this chain. Today there is google and Facebook (and all other apps and AI). When we look at this chain, value is created. What we really should think about when we think about average value, **which part of this chain is really <u>capturing</u> the value here?**



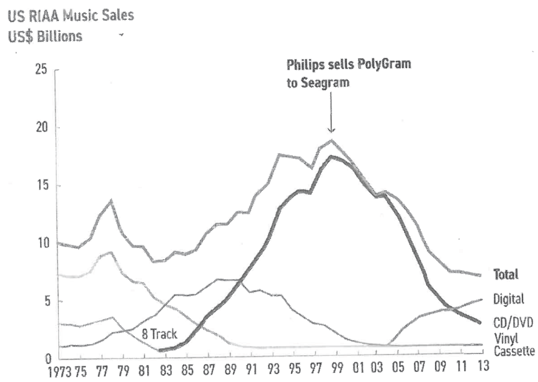
Source: Professor Michael G. Jacobides

We have different pieces; raw materials, cultivation, manufacturing, … the final user is capturing some value. Because that is the WPT minus the price paid to the retailer. Retailer also captures some value, manufacturers also, … today maybe retailers are capturing value, but manufactures are not really making money today. Cultivating is very competitive. The retailers → location is very important. It’s interesting to see where the value is captured. For tobacco and alcohol companies to enter, the value to enter will be on the manufacturing side.
Alcohol and tobacco they are not in cultivation at all. They do marketing and organize the distribution for their core business. Then they might sell to a retailer. In order for that to happened the manufacturing part needs to capture much more value. When would that happen?

Dynamics of Industries

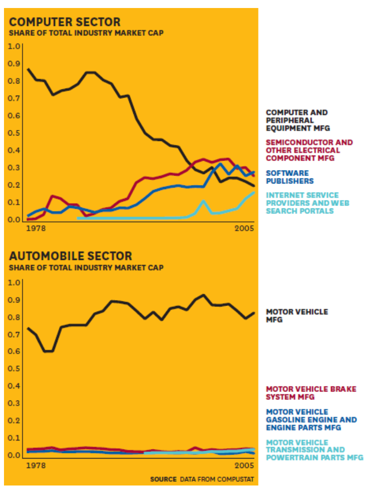
There is some dynamic here:
Phillips was in the music business. They sold off to Seagram right before the market for cd’s was about to collapse. It’s important to look at those dynamics because this could mean survival or death in the business. How did Phillips know about this? Because they were producers of cd-roms. And in the cd-rom business they were booming in sales and asking the manager how come are you selling all those cd-roms? Because people were putting music on it so they sensed that the business might collapse.

- ⇨ Although the average profitability was good before, things might happen so you might want to keep an eye out.



Interestingly, how is value distributed in these eco-systems… Look at market value of players in computers versus OEMs in automobiles…

Here in this example we have the computer industry. They looked at the market valuation of different groups of players. The assemblers, the semi conductors (Intel), Microsoft, Google, … it starts in the late 97s that most of the market value was with the assemblers. But what we see over time is that their power decreases so the average value over time goes down and that of Microsoft and Intel increases. The question is who is going to capture the value today? In the same study they had the automobile sector. They capture most of the value in the automobile sector.



Classic reading: Mapping the business landscape (Ghemawat Ch2)

Supply-demand analysis

The price paid is where the demand curve for a particular product of their WTP crosses the supply curve. Price-elasticity of demand: demand is said to be relatively price-elastic if changes in price induce relatively large changes in aggregate quantity demand.
→ the classic case of supply-demand had many restrictive assumption (as homogenous buyers etc…) and is insufficient and needs to be generalized.

The “five forces” framework

Others came with relaxed assumptions of supply-demand: oligopoly, monopoly, …
But more important was the development that the structure of some **industries** might allow firms to earn positive economic profits over long periods of time. An industry’s structure would determine the conduct of buyers and sellers, and by implication the industry’s performance in terms of profitability, efficiency and innovation.
Three basic types of entry barriers:

- Absolute cost advantage for an established firm (patents, …)
- Significant degree of product differentiation
- Economies of scale

→ but two main problems with this view: only focused on public policy and used a short list of variables to explain industry profitability

Then Porter’s five forces framework was developed.
It generalized the supply-demand analysis of individual markets in several respects.
The focus here is on business concern rather than public policy with the emphasis on extended competition for value rather than just competition among existing rivals. Rivalry is only **one of several forces** that determine industry attractiveness.

Force 1: The degree of rivalry
This influences the extent to which the value captured by an industry will be dissipated through direct competition.
Structural determinants of rivalry:

- *Number and relative size of competitors*
  The more concentrated the industry the more likely that competitors will recognize their mutual interdependence and so will restrain their rivalry. While if the industry includes many small players, one may think that its effects on others will go unnoticed and doing so will grab additional market share and disrupt the market.
- *The industry’s basic conditions*
  - Capital intensive industries for example, the level of capacity utilization directly influences firms’ incentive to engage in price competition.
  - More general: high fixed costs, excess capacity, slow growth and lack of product differentiation increase the degree of rivalry
- *Behavioral determinants*
  If competitors are diverse, face high exit barriers, or attach high strategic value to their positions in an industry, they are more likely to compete aggressively.

Force 2: The threat of entry
Average industry profitability is influenced by potential as well as existing competitors. The key concept here is entry barriers: they prevent firms to enter an industry whenever profits rise above zero. This exists when it’s difficult or not feasible for an outsider to replicate the incumbents’ positions.
Forms of entry barriers:

- Intrinsic physical or legal obstacles to entry
- Scale and the investment required to enter
- Not always exogenous: they can be contrived along these dimensions and many others
- …

Force 3: The threat of substitutes
This depends on the relative price-to-performance ratios of the different types of products or services to which customers can turn to satisfy the same basic need. This is also affects by switching costs: the costs in areas such as retraining, retooling, redesign… that are incurred when a customer switches to a different type of product or service.
You also need to look very broadly when analyzing this: all the different ways of performing similar functions for customers. For example: taking the plane for a meeting VS online meeting.
Consider also the possibilities available to suppliers.

Force 4: Buyer power
This influences the appropriation of the value created by an industry. Buyer power allows customers to squeeze industry margins by compelling competitors to either reduce prices or raise the level of service offered without compensating price increases.
A buyer is powerful if:
- There are few of them
- One purchases in large volumes
- They have good information about prices and product attributes
- They face few switching costs
- They can threaten to integrate backwards

Distinguish the *potential* buyer power from the buyer's *willingness or incentive* to use that power!
A buyer would or not have the incentive to use their power dependent on:
- The nature of cost from the perspective of the purchasing industry
- The perceived risk of failure associated with a product's use

Force 5: Supplier power
The analysis of supplier power focuses first on the relative size and concentration of suppliers relative to competitors and second on the degree of differentiation in the inputs supplied. The market is characterized by high supplier power when there is an ability to charge competitors different prices in line with the differences in the value created for each of them.

The value net and other generalizations
The value net framework brings new types of players into the analysis. It highlights the critical role that complementors (participants from whom customers buy complementary products or services to whom suppliers sell complementary resources) can play in influencing business success or failure.
Complementors are the mirror image of competitors which includes new entrants, substitutes and existing rivals.
On the demand side they increase buyers' WTP and on the supply side they decrease the price that suppliers require for their products.
→ cooperating with complementors to expand the size of the pie should be combined with some consideration of competing with them to claim slices of that pie. How to asses the bargaining power of complementors?
- *Relative concentration*: complementors are more likely to have the power to pursue their own agenda when they are concentrated relative to competitors and are less likely to be able to do so when they are relative to competitors and are less likely to be able to do so when they are relatively fragmented.
- *Relative buyer/supplier switching costs*: when the costs to buyers or suppliers of switching across complementors are greater than the costs of switching across competitors, that increases complementors' ability to pursue their own goals.
- *Relative complementor/competitor switching costs*: the ease with which complementors themselves can switch to working with different competitors versus the ease with which competitors can switch to working with different complementors. If complementors play a significant role in pulling through demand, their power is likely to expand.
- *Asymmetric integration threats*: complementors tend to have more power when they can threaten to invade complementors' turf more credibly than competitors can threaten to invade theirs.
- *Rate of growth of the pie*: from a behavioral perspective, competition with complementors to claim value is likely to be less intense when the size of the pie available to be divided among competitors and complementors is growing rapidly.

Each of the models discussed above included new players. The question is, can additional improvements in our ability to understand the business landscape be achieved by further broadening the types of players considered? This depends on the case being considered but is sometimes clearly affirmative.

The process of mapping business landscapes

How to link what we have discussed above with strategic thinking? This is what we do with mapping the business landscape.

<u>Step 1:</u> Gathering information
Mapping the business landscape requires allot of information.

<u>Step 2:</u> Drawing the boundaries
Which part of the business landscape will you focus on? This is the problem of industry definition. The challenge for the strategist is to decide how to draw boundaries.

- General-purpose industry classifications
- Take an inside-out approach: start with a business's served (and unserved) market.
  → horizontal scope

Vertical scope and geographic scope raise different analytical issued.

- Vertical issue: the key issue is how many vertically linked stages of the supplier-buyer chain to consider
- Geographical scope: the key issue is how broadly to define the business landscape in terms of physical locations covered. The degree of market integration is key to determine whether geographies should be looked at together or separately.

There is no perfect way in drawing boundaries. Instead focus on ensuring that the boundaries are clear and that there is consistency in the treatment of what is in versus out instead of looking for the right way of drawing boundaries.

<u>Step 3:</u> Identifying groups of players

- Groups of players need to be clearly and consistently labeled from the perspective of the business for which the analysis is being undertaken. Thus, in case discussions, rivals are sometimes confused with suppliers on the grounds that rivals are suppliers for their own buyers!
- It is often useful to distinguish *within* the groups of players listed above: to explicitly separate out and consider different strategic groups within the set of direct rivals, different buyer segments, and so on. The objective is to pick up variations in bargaining power (the subject of step 4) that more aggregated perspectives might obscure. For example, in airlines, it is useful to distinguish explicitly between labor, with substantial bargaining power, and other input suppliers who typically have much less leverage. Similarly, the bargaining power of different types of buyers of pharmaceuticals varies greatly.
- Finally, there is often a tendency, in mapping business landscapes, to focus on existing players. Deliberate attempts to counteract such biases by explicitly directing attention toward new or potential players may be necessary. Note that this ties in with the theme of thinking dynamically, which is the subject of step 5.

<u>Step 4:</u> Understanding group-level bargaining power
Now we can discuss the core objective of attempts to map the business landscape. It is useful to concentrate on groups or subgroups of players with particular potential to influence a business's payoffs, or groups that are outliers on important structural dimensions. Structural analysis of group-level can help identify which groups of players will get how much of the economic pie. This requires some modifications of the approaches discussed so far. They can't be thought of as value-maximizers but think through their interests and the amount of influence that they are likely to bring to bear in pursuing them.

<u>Step 5:</u> Thinking dynamically
We need to think about the business landscape as it will be rather than as it is or was = dynamic thinking. It is important in this step to distinguish between different time horizons, especially the short run and the long run.

In the short run we often see:

- Industry cycles: related to lags in commercialization of new generations of products or the installation of new
- Economy-wide business cycles: they are greatly in the extent of their impact on different parts of the economy

It is important to gauge the sensitivity of the industry you are interested in to these cycles.

The long-run cycle that has attracted the most attention is the product/industry life cycle. This hinges on the idea that opportunities for innovation are likely to be depleted as an industry matures.
Beside cycles, long-run trends are also important. Some trends emanate within an industry other outside it.

Step 6: Responding to/shaping the business landscape
Now we can turn to strategic action. There are many possible uses of landscape analysis:

- Anticipating long-run performance
- Identifying groups of players or forces that must be countered to achieve good performance
- Testing, decisions to enter, invest in, or exit from an industry
- Assessing the effects of a major change in the business landscape so as to be able to respond to it
- Identifying ways to shape the business landscape

But it is also important to respond or shape the business landscape.
Respond for example to a change in the industry. Shaping the industry is most obvious in fluid environments that are still taking form for example multimedia, but is also evident in older more mature contexts.

Porter: The five competitive forces that shape strategy

Competitive is often defined too narrowly: it goes beyond the rivalry among competitors and includes customers (and their bargaining power), suppliers (and their bargaining power), potential entrants and substitute products. These 5 forces define an industry's structure and shape the nature of competitive interaction within the industry: they help understand industry competition and profitability.

As different as industries might be, they have in common the underlying drivers of profitability. If the forces are intense (airlines, textiles), almost no company earns attractive ROIC. If not (software, soft drinks), many companies are profitable. It's the industry structure that drives competition and profitability, not its maturity or its products.

Understanding the competitive forces, and their underlying causes, reveals the roots of an industry's current profitability while providing a framework for anticipating and influencing competition (and profitability) over time.

Forces that shape competition

The importance of each of the 5 forces differs by industry: in the market for commercial aircraft, the threat of new entrants is not relevant while the bargaining power of the airlines is very important. The strongest competitive force determines the profitability of an industry and becomes the most important to strategy formulation.

Threat of entry: new entrants bring new capacity and desire to gain market shares by putting a pressure on prices and costs. It puts a cap on the profit potential of an industry. It is the threat of entry, not whether entry actually occurs, that holds down profitability. It depends on the entry barriers, which are advantages that incumbents have relative to new entrants. They source from:

- *Supply-side economies of scale*: production of larger volumes leads to lower costs per unit, spreading fixed costs over more units. The aspiring entrant can enter the industry on a large scale, dislodging entrenched competitors, or accept a cost disadvantage. So, this deters entry.
- *Demand-side benefits of scale/network effects*: when a buyer's WTP for a product increase with the number of other buyers (trust, valuation of being part of a network). This deters entry by limiting willingness of customers to buy from a newcomer and by reducing the price the newcomer can command until it builds up a large base of customers.

- *Customer switching costs*: fixed costs that buyers face when they change suppliers (retrain employees to use the new product, modify processes). The larger the switching costs, the harder it will be for an entrant to gain customers?
- *Capital requirements*: the need to invest large financial resources to compete can deter new entrants; for fixed assets, build inventories, …
    - *It is important not to overstate the degree to which capital requirements alone deter entry. If industry returns are attractive and are expected to remain so, and if capital markets are efficient, investors will provide entrants with the funds they need.*
- *Incumbency advantages independent of size*: cost or quality advantages not available to potential rivals, stemming from proprietary technology, preferential access to raw material sources, favorable geographic locations, …
- *Unequal access to distribution channels*: the new entrant must secure distribution of its products, via price breaks, promotions or intense selling efforts. The more limited the wholesale or retail channels are and the more that existing competitors have tied them up, the tougher entry into an industry will be.
- *Restrictive government policy*: it can hinder or aid new entry directly and amplify or nullify the other entry barriers (licensing requirements, restrictions on FDI).

<u>Expected retaliation</u>: How potential entrants believe incumbents may react (expected retaliation) will also influence their decision to enter or stay out of an industry. Newcomers are likely to fear expected retaliation if incumbents have previously responded vigorously to new entrants; if incumbents possess substantial resources to fight back (excess cash, borrowing power); if incumbents seem likely to cut prices because they are committed to retaining market share at all costs or because the industry has high fixed costs; if industry growth is slow so newcomers can gain volume only by taking it from incumbents.
An entry is easy if it is economically and regulatory feasible, if entrants can quickly catch up with incumbents (not a steep learning curve, undifferentiated products) and if retaliation by incumbents is difficult (costly, hard to target retaliation, no industry leader to lead).

An analysis of barriers to entry and expected retaliation is obviously crucial for any company contemplating entry into a new industry. The challenge is to find ways to surmount the entry barriers without nullifying, through heavy investment, the profitability of participating in the industry.

The power of suppliers: powerful suppliers capture more of the value by charging higher prices, limiting quality or services. Companies depend on a wide range of different supplier groups for inputs. A supplier group is powerful if:
- It is more concentrated than the industry it sells to (few suppliers and multiple buyers).
- It does not depend heavily on the industry for its revenues, because they serve many industries for example.
- Industry participants face switching costs in changing suppliers.
- Suppliers offer products that are differentiated.
- There is no substitute for what the supplier group provides.
- The supplier group can credibly threaten to integrate forward into the industry. If industry participants make too much money relative to suppliers, they will induce suppliers to enter the market.

The power of buyers: powerful customers can capture more value by forcing down prices, demanding better quality or more services, and playing industry participants off against one another, all at the expense of industry profitability. They are powerful if they have negotiating leverage relative to industry participants (intrinsic power), especially if they are price sensitive. A customer group has negotiating leverage if:
- There are few buyers, or each one purchases in large volumes relative to the size of a single vendor. The latter are powerful in industries with high fixed costs, because high fixed costs and low marginal costs amplify the pressure on rivals to keep capacity filled through discounting.
- The industry's products are standardized or undifferentiated (buyers can find the product elsewhere).
- Buyers face few switching costs in changing vendors.

- Buyers can credibly threaten to integrate backward and product the industry's product themselves if vendors are too profitable.
- Buyers have good information.

A buyer group is price sensitive if:
- The product it purchases from the industry represents a significant fraction of its cost structure or procurement (buyers will shop around and bargain).
- The buyer group earns low profits, is strapped for cash or is under pressure to trim its purchasing costs (thin margin).
- The industry's product barely affects the quality of the buyers' products or services.
- The industry's product has little effect on the buyer's other costs.
- Providers are not distinguished by something else other than their prices.

Most sources of buyer power apply equally to consumers and B2B customers. The major difference with consumers is that their needs can be more intangible and harder to quantify.
Intermediate customers, or customers who purchase the product but are not the end user (such as assemblers or distribution channels), can be analyzed the same way as other buyers, with one important addition. Intermediate customers gain significant bargaining power when they can influence the purchasing decisions of customers downstream

The threat of substitutes: a substitute (often unpredictable) performs the same or a similar function as an industry's product by different means. Substitutes are always present, but they are easy to overlook because they may appear to be very different from the industry's product. The products might be different, but they are tailored to the same customers' needs.

When the threat of substitutes is high, industry profitability suffers. Substitute products or services limit an industry's profit potential by placing a ceiling on prices and limiting demand. An industry must distance itself from substitute through product performance, marketing, … to not suffer in terms of profitability and growth potential. The threat of a substitute is high if:
- It offers an attractive price-performance trade-off to the industry's product. The better the value of the substitute, the more dangerous for the industry's profit potential.
- The buyer's cost of switching to the substitute is low.

Strategists should be alert to changes in other industries that may make them attractive substitutes when they were not before.

Rivalry among existing competitors: it includes many familiar forms such as price discounting, new product introductions, advertising campaigns or service improvements. High rivalry limits the profitability of an industry. The degree to which rivalry drives down an industry's profit potential depends on the *intensity* with which companies compete and on the *basis* on which they compete.
The rivalry is greatest if:
- Competitors are numerous or are roughly equal in size and power.
- Industry growth is slow, as it precipitates fights for market share.
- Exit barriers are high, keeping companies in the market even with low or negative returns.
- Rivals are highly committed to the business and have aspirations for leadership.
- Firms cannot read each other's signals well because of lack of familiarity with one another, diverse approaches to competing, or differing goals.
- Competitors can't maintain (price) discipline (immediate benefits of cutting prices are large, long-run costs of cutting process today are small, behavioral considerations)

The strength of rivalry reflects the intensity of competition and the basis of competition. The *dimensions* on which competition takes place, and whether rivals converge to compete on the *same dimensions*, have an influence on profitability. Rivalry gravitating around prices is destructive because price competition transfers profits from the industry to its customers. Sustained price competition trains customers to pay less attention to product features and services. Price competition is most liable to occur if:
- Rivals' products or services are nearly identical and switching costs are low.
- Fixed costs are high and marginal costs are low.

- Capacity must be expanded in large increments to be efficient.
- The product is perishable.
- There is excess capacity.
- Industry growth is slow.
- Buyers have access to information about products.

Competition on dimensions other than price (product features, support services, delivery time, brand image) is less likely to erode profitability because it improves customer value and can support higher prices. Rivalry focused on such dimensions can improve value relative to substitutes or raise the barriers facing new entrants.

When rivals compete on the *same dimensions*, they aim to meet the same needs, resulting in a zero-sum competition: one firm's gain is another's loss, driving down profitability. This can be avoided is companies take care to segment their markets, targeting their low-price offerings to different customers.

Factors, not forces

Industry structure determines the industry's long-run profit potential because it determines how the economic value created by the industry is divided (among customers, substitutes). By considering all five forces, a strategist keeps overall structure in mind instead of gravitating to any one element. In addition, the strategist’s attention remains focused on structural conditions rather than on fleeting factors. Following examples illustrate this (always keeping the five forces, and the impact on those in mind):

- **Industry growth rate**: assuming that fast-growing industries are always attractive is wrong. Growth does tend to mute rivalry because there are more opportunities for all competitors. However, fast growth can put suppliers in a powerful position and high growth with low entry barriers will draw in entrants. Powerful customers and attractive substitutes will not guarantee profitability.
- **Technology & innovation**: they are not by themselves enough to make an industry structurally attractive.
- **Government**: its involvement is neither good nor bad for industry profitability, but policies can affect the 5 forces, each one impacting the structure in a different way.
- **Complementary products & services**: they are used together with an industry's product, the customer benefit of 2 products combined is greater than each product alone. They can have a positive or negative influence on all 5 forces.

- Good industry analysis looks rigorously at the structural underpinnings of profitability. A first step is to understand the appropriate time horizon.
- The point of industry analysis is not to declare the industry attractive or unattractive but to understand the underpinnings of competition and the root causes of profitability.

- The strength of the competitive forces affects prices, costs, and the investment required to compete; thus the forces are directly tied to the income statements and balance sheets of industry participants.
- Finally, good industry analysis does not just list pluses and minuses but sees an industry in over- all, systemic terms

Changes in industry structure

Although industry structure is quite stable and profitability differences are persistent overtime, industry structure is constantly undergoing model adjustment and occasional abrupt changes, boosting or reducing profit potential.

Shifts in structure may emanate from outside an industry or from within. They can boost the industry’s profit potential or reduce it. They may be caused by changes in technology, changes in customer needs, or other events.

- **Shifting threat of new entry**: changes to any of the barriers can raise or lower the threat of new entry. Strategic decisions of leading competitors often have a major impact on the threat of entry (expiration of a patent, new technology).
- **Changing supplier or buyer power**: As the factors underlying the power of suppliers and buyers change with time, their clout rises or declines. Appliance industry (from specialty stores to Best Buy & Home Depot); flight tickets (from travel agents to internet).
- **Shifting threat of substitution**: advances in technology create new substitutes or shift price-performance comparisons. Trends in the availability or performance of complementary producers shift the threat of substitutes.
- **New bases of rivalry**: rivalry naturally intensifies over time. As industry matures, growth slows, and competitors become more alike. A trend toward intensifying price competition and other forms of rivalry is inevitable. M&A alter rivalry, introducing new capabilities and ways of competing. Technological innovation can reshape rivalry. In some industries, companies turn to mergers and consolidation not to improve cost and quality but to attempt to stop intense competition. Eliminating rivals is a risky strategy, however. The five competitive forces tell us that a profit windfall from removing today's competitors often attracts new competitors and backlash from customers and suppliers.

Implications for strategy

Understanding the forces that shape industry competition is the starting point for developing strategy. The 5 forces reveal *why* industry profitability is what is it. Only then can a company incorporate industry conditions into strategy.

- **Positioning the company**: strategy as building defenses against the competitive forces or as finding a position in the industry where the forces are weakest (to avoid some). In addition, the five forces allow companies to analyze entry and exit.
    - Exit is indicated when industry structure is poor or declining and the company has no prospects of a superior positioning
    - In considering entry into new industry, strategists can use the framework to sport an industry with a good future before this good future is reflected in the prices of acquisition candidate
- **Exploiting industry change**: opportunity to spot and claim promising new strategic positions. Structural changes (inevitable) open up new needs and ways to serve existing needs. Established leaders may overlook these or be constrained by past strategies from pursuing them. Smaller competitors in the industry can capitalize on such changes, or the void may well be filled by new entrants.
- **Shaping industry structure**: a firm can lead its industry toward new ways of competing. In reshaping structure, a company wants its competitors to follow so that the entire industry will be transformed. Industry leaders have a special responsibility for improving industry structure, it often requires resources that only large players possess. The innovator can benefit most by shifting competition where it excels. An industry's structure can be reshaped by:
    - redividing profitability in favor of incumbents (capturing more profits and keeping out potential entrants):
        - The starting point is to determine which force or forces are currently constraining industry profitability and address them.
        - Industry leaders have a special responsibility for improving industry structure as this requires resources only large players possess.
        - Is beneficial to the whole industry including the large leader
        - The dark side: ill-advised changes in competitive positioning and operating practices can *undermine* industry structure → strategists should ask whether they are setting in motion dynamics that will undermine industry structure in the long run
    - expanding the overall profit pool (increasing the overall pool of economic value generated by the industry).
        - The total pool of value available to competitors, suppliers, and buyers grows.
        - Expanding the overall profit pool creates win-win opportunities for multiple industry participants.

- It can also reduce the risk of destructive rivalry that arises when incumbents attempt to shift bargaining power or capture more market share.
- The most successful companies are those that expand the industry profit pool in ways that allow them to share disproportionately in the benefits

- **Defining the industry**: the five forces hold the key to defining the relevant industry in which a company competes. It will clarify the causes of profitability. A company needs a separate strategy for each distinct industry.

Competition & value

By understanding that competition extends well beyond existing rivals will help detect wider competitive threats. At the same time, thinking comprehensively about an industry's structure can uncover opportunities: differences in customers, suppliers, substitutes, potential entrants, and rivals that can become the basis for distinct strategies yielding superior performance. In a world of more open competition and relentless change, it is more important than ever to think structurally about competition.

Also important for investors: a deep thinking about competition is more powerful to achieve genuine investment success than the financial projections and trend extrapolation.

If both executives and investors looked at competition this way, capital markets would be a far more effective force for company success and economic prosperity. Executives and investors would both be focused on the same fundamentals that drive sustained profitability. The conversation between investors and executives would focus on the struc-ural, not the transient.

Topic 4: Building competitive advantage

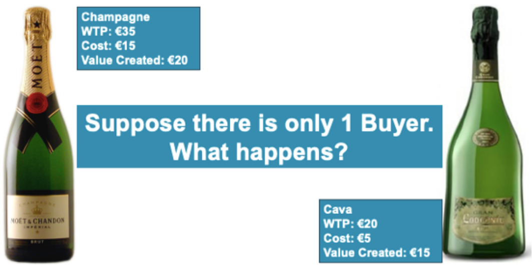
Defining Competitive Advantage

What is a competitive advantage?
A firm or a business is said to have created a **competitive advantage** over its rivals if it has driven a wider wedge between willingness to pay and costs than its competitors have achieved

The value created in the case of champagne is 20 (WTP – cost)
Value captured is 10 euro (WTP - price)

⇨ If you create more value than the alternative, you have a competitive advantage.

Suppose there is only 1 Buyer. What happens?



Champagne creates more value than cava so I can always give the same amount of value to the customer and keep more. But of course, my WTP for champagne is higher, its lower for cava. What matters is the difference in the value created. If I create more value, I capture more value. If we have different cost levels, we can pay around.
Here we have a **non-restrictive bargaining**, a bargaining of one buyer and two sellers and the buyer has an advantage.

Defining Added Value

Added Value of a player is the maximum value that can be created by all participants in the vertical chain minus the maximum value that would be created without that particular player. It restricts how valuable the competitive advantage is (added value = boundary condition).
How much value can 3 players create together? If one is out, how much can the others create?

Cooperative Game Theory
Think about it as a game. We have one buyer and two sellers. What is the value of all these players in this game? In this case we have one buyer, and 2 champagnes.
This comes from the cooperative game theory: typically, we talk about non cooperative game theory, but we have also cooperative game theory when we have non restricted bargaining. This has been used to launch this value-based strategy.
If we change the game and we add a second buyer, then the game is different.

Players:
- Moët & Chandon (champagne)
- Codorniu (cava)
- One buyer

Added value:
- Moët & Chandon: (35 – 15) – (20 – 5) = 5
  - The added value of having champagne in the game is 5.
- Codorniu: (35 – 15) – (35 – 15) = 0
  - Cava doesn't add value to the game because it is not the one who is going to be transacted.
- One buyer: (35 – 15) – 0 = 20
  - Obviously if there is not buyer in the game, there is not transaction.

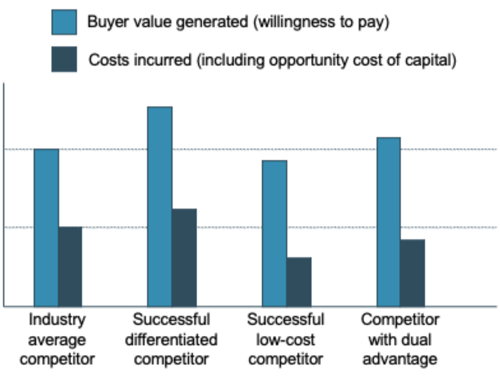
A cooperative game theory would be to make a **coalition** (3 players; coalition of 2). Cournot is a non-cooperative game theory.

Competitive Advantage & Added Value
A firm with a **<u>COMPETITIVE ADVANTAGE</u>** cannot capture more value than its **<u>ADDED VALUE</u>**

Look at the first example: the added value of champagne is 5. Champagne cannot capture more than 5. The important conclusion is that competitive advantage creates more value than the alternative. This is important because if we think about strategy we think about how can I create more value for particular customers than the alternative. If that is true for everybody than nobody will be buying cava. In Catalonia WTP for cava would be higher, then the demand for champagne and cava would be different if we go there.

Types of Competitive Advantage

Airlines: Lufthansa vs Ryanair vs Airberlin/Easyjet??
Dual advantage: Samsung—> yield, how many semi conducers are coming out of your silicon. If you have allot of high yield your costs Will go down. But what they were also good at is switching from one type of d ram to another. So, they could actually switch easily. They were good at both things. As a result, they had low cost but also tailored goods to their customers. Everybody wants to do that, but how come Samsung could they do it? Their production was located in south Korea, and all the employees and their families lived there on the location.



- The **average player** doesn't exist.
  - Before we talked about the average industry competitor, we looked at the average player in the industry. In reality there is no average player.
- **Successful differentiator**: higher WTP, more quality provided, more customized products, but also higher costs.
- **Successful low-cost competitor**: lower costs than the average of the industry but more standardized products, so a lower WTP.
- Competitor with **dual advantage**: the position everybody wants; with a high WTP and low costs. Firms trying to do that often get stuck in the middle, doing neither very bad nor very well (because they didn't make the trade-offs needed to perform well)

Classic reading: Creating a competitive advantage

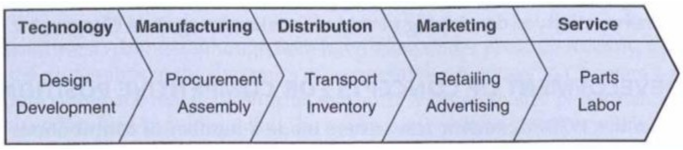
A firm is said to have a CA if it has driven a wider wedge between WTP and its costs than its competitors. A CA can boost profitability: while the industry a business is in has an impact on its performance, large differences in performance also appear **within industries** (the best performing airlines create economic value while the worst performing pharmaceutical firm destroy it, no matter the average returns of each industry). The structure within industries (strategic groups) helps explain part of these widespread and substantial performance differences. Within-industry differences in profitability are larger than differences in the averages across industries and may appear even larger during downturns. However, industry-level effects should not be ignored:

- Industry-level effects do account for a significant fraction of the performance variation on average.
- Industry-level effects may have a more persistent influence on business-level profitability than within-industry differences.
- Industry characteristics play a larger role in determining the room for positive departures from average profitability than their average effects suggest.
- Market leaders often confront important tensions between managing industry structure and improving their own **competitive position** within that structure

In order to understand within-industry differences in good times or bad, we must zoom in from the industry level to look at the landscapes within industries.

The development of concepts for competitive positioning

Activity analysis

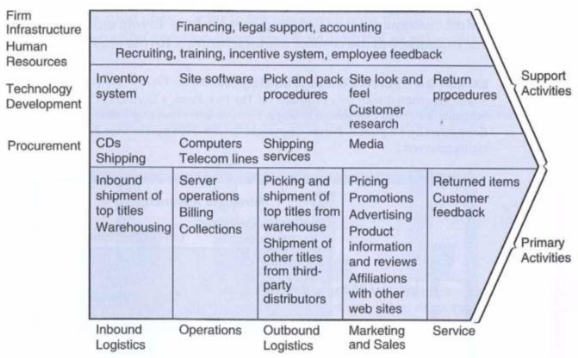


Cost analysis:

- Disaggregating businesses into their components (activity-based analysis and the identification of SBUs; economies of scale & scope, capacity utilization).
- Assessing how costs in a particular activity might be shared across businesses.
- Cost drivers: scale effects, economies of scope, …

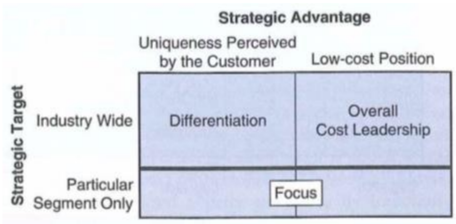
Differentiation analysis:

- Shift to customer analysis
- Focus on differentiated ways of competing: increase in price premium by improving customers' performance or reducing costs.
- Product differentiation: analyzing costs and differentiation **via the value chain**. Emphasis on the importance of regrouping functions into activities actually performed to produce, market, deliver and support products. CA cannot be understood by looking at a firm as a whole. Each activity contributes to the firms cost position and creates a basis for differentiation, this is explained and identified by the value chain.



Cost vs. differentiation

- Successful companies usually had to choose to compete either on the basis of low costs or by differentiating products through quality and performance characteristics. Porter popularized this idea in terms of the generic strategies of low cost and differentiation. He also identified a focus strategy that cut across the two basic generic strategies.
- Porter's generic strategies was appealing because it identifies the tension between cost and variation (low cost, differentiation, focus with a combination of both (= dual competitive advantage)).
  - A firm must often incur higher costs to deliver a product or service for which customers are willing to pay more.
- Also, because capabilities, organizational structure, reward system, corporate culture and leadership style, needed to make a low-cost strategy succeed, are contrary to those required for differentiation. For internal consistency, a firm might have to choose to compete either in one way or the other.
- Dual competitive advantage: those are rare which are typically based on operational differences across firms that are easily copied. But this is still a debate today…
- However, strategist have stopped being dogmatic about generic strategies and now embrace the idea that any analysis of competitive position must consider both relative cost and differentiation and recognize the tension between the two.
  - Positioning should be about driving the largest possible wedge between cost and differentiation



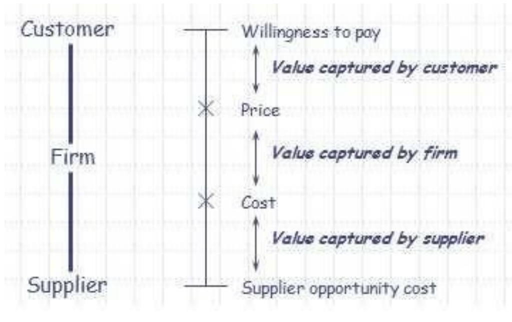
Added value *(see also Brandenburger and Stuart Value-based business strategy)*

Value is created by a business operating together with its customers and its suppliers: a firm does not create value in isolation.

- WTP: the most that a customer will pay for a firm's product (demand-side)
- Supplier opportunity cost: willingness to receive, the least that a supplier will accept for the resources required to make a product

⇨ The value created by a transaction is the difference between the customer's WTP and the opportunity cost of the resources.

The amount of value that a firm can claim cannot exceed its added value under unrestricted bargaining.



Added value
= total industry value created with the firm in the game – total value created without the firm
= value that would be lost to the industry if the firm disappeared

This concept also helps to tie together intra-industry analysis of competitive advantage and industry-level analysis of average profitability.

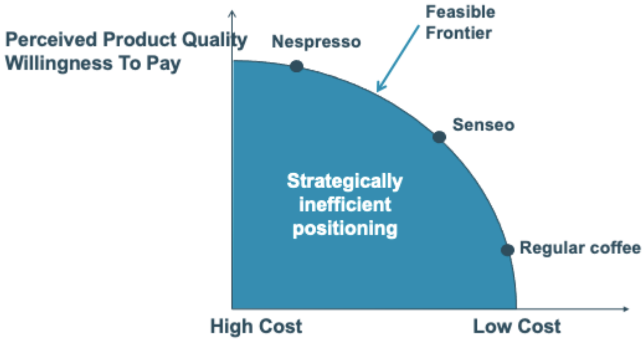
Key Questions for Strategy

- **Do we create value?**
    - Two broad routes to competitive advantage
        - **Cost advantage (Cost)**
        - **Differentiation advantage (WTP)**
    - Configuring activities for a low-cost position is different from how you configure activities to deliver superior customer benefits.
- **Do we capture value?**
- **Can we sustain this value?**

One issue; if we organize more on the WTP side we will have to organize differently than if we play on the cost side. That is why you have these two extremes because you need a very different structure if you choose one of them.

Choice between Strategic Positions

We have here two axes: cost and WTP
What we argue here is that first we choose a strategic position. This is on the feasible frontier. This is what we have with Nespresso, they have a high WTP, but they also have high costs. Regular coffee machine might have lower cost but also lower WTP. In the middle you can maybe find Senseo.



Resources are only used efficiently if firms are on the line and not in the middle! If you in the middle, that is not good that is *operational defective*. For same level of cost, you can have higher WTP or for same WTP you can have lower costs. So, in this blue are that is not good, but also that is not strategy, that is not using your resources effectively. So, you need to be more affective in using your resources, it kind off minimizes your costs but obviously a player here will have a different cost structure than a player at the level of Nespresso. You don't want to be in this blue area because you can do better.

⇨ **Strategy** is about the choice of this positioning.
Strategy is about the choices made: a firm can be a low-cost player, a luxury player or somewhere in the middle. People have preferences so there is a need to assess whether there is a market for a certain product/service, and choose a position on the frontier. It's all a matter of choice: how does it feed back into the costs? And into the WTP? And how much value is created compared to the alternative? That's where the competitive advantage comes in.

<u>Example Walmart</u>
Size and Scope of Wal-Mart

- World's largest firm in terms of sales revenue $550 billion worldwide
- World's largest private employer US and Mexico (more than 2.3 million employees, 600.000 international)
- Bigger than next 5 retailers combined: Home Depot, Kroger, Kmart + Sears, Costco and Target!
- Bigger than most economies, except for the 30 largest!
- Accounts for 15% of US Consumer goods imports from China.
- Serves more than 260 million customers per week. This year 7.2 billion people will go to a Wal-Mart store (World population 7 billion).
- Became largest grocery retailer in the US in only six years
- Accounts for 28% Playtex sales, 25% of Clorox, 21% of Revlon, 13% of Kimberley Clark's and 17% of Kelloggs.
- Have the nation's second largest computer (behind Pentagon) to support their logistics operations
- Broadcast more live television than any US broadcast network
- Generated $1.25 billion in sales on November 24, 2001 – the single biggest day for any retailer in history; $100 billion in 4th quarter 2007. Makes $35.000 profit/minute.

Comparative costs (1993)
Here is a comparison with an average competitor. Where are the differences?

There is a difference of 6% but we talk here about billions of dollars. 1% makes a big difference in retailers.
In terms of the COGS, Walmart surprisingly doesn't seem to have a competitive advantage. It also has higher costs for its goods and lower prices. Costs might seem lower %-wise but might actually be less in absolute value (due to the low prices offered).

	Wal*Mart	Competitor Average	Wal*Mart Advantage
Sales	100.0%	100.0%	-
Cost of Goods Sold			
FOB Purchase Prices	*69.7%*	*66.0%*	*(3.7%)*
Inbound Logistics	*3.7%*	*4.8%*	*1.1%*
Shrinkage	*1.7%*	*2.0%*	*0.3%*
Total COGS	75.1%	72.8%	(2.3%)
Operating Costs			
Advertising	*1.5%*	*2.1%*	*0.6%*
Rental	*3.0%*	*3.3%*	*0.3%*
Info Systems	*1.5%*	*1.3%*	*(0.2%)*
Regional offices	*0.0%*	*2.0%*	*2.0%*
Payroll and Other SG&A	*12.1%*	*15.9%*	*3.8%*
Total Operating Costs	18.1%	24.6%	6.5%
Income			
Other Income	0.7%	1.3%	(0.6%)
Operating Income	7.5%	3.9%	3.6%

We know that Walmart is like Colruyt in Belgium, they have a lower price base but when we make the comparison we start with total sales. The difference really comes from total operating cost (no advertising, cheap locations in rural areas). Walmart doesn't have regional offices, just HQ. Another big difference is that employees really understand what the strategy is and how to run the store (company culture), encouraging them in their job. In Walmart the people working there know exactly what needs to be done. This is difficult to copy. So, it’s a strategy and everybody in the company knows exactly what is going on.
But there is also a danger. Because it is a low cost player, they always wanted to lower their cost so this started to put pressure on the store managers, and the store managers started hiring illlegal immigrants to clean, … the enormous pressure started to make those managers do things they are not supposed to do. Then the ethics and norms of the company becomes really important.

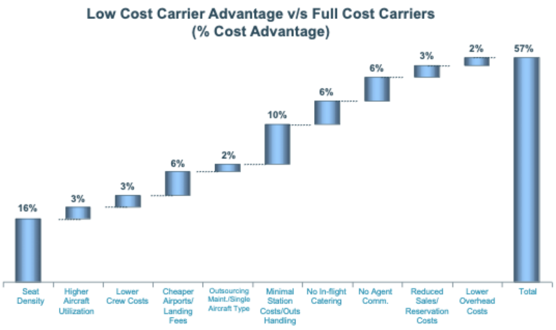
Your strategy is obviously conditioned by the values of the company!
As a CEO of the company you cannot tell everybody what to do but you can set the lines, and those have to be clear enough that everybody understands what needs to be done from their perspective.

<u>Example Airlines</u>
A low price is the most important factor for people when purchasing an airline ticket. Price is the key factor in the decision. Because the value captured depends on the WTP minus the price. However, it is hard to compare Lufthansa and Ryanair because they have very different positions but on average, a low-cost airline has *a 57% cost advantage*.

Low-Cost Carriers at 57% of Costs

Here the low-cost carriers came in and from where do these low costs come? A big part is from the number of seats. The more seats the more people they can fly.

- More seats
- Secondary airports
- Minimal handling
- No catering
- No agents (online)



Ryanair's efficiency, compared to Southwest's, is explained by more efficient and productive staff, better airports, better financing deals (Ryanair typically buys when the market is down), lower overall costs. Ryanair handles 10.050 passengers per employee while British Airways handles 758 passengers per employee (huge productivity gap resulting in strikes). Ryanair's prices might be the lowest, but value is captured where customers didn't expect it. With their low-cost model, they've been doing very well in terms of growth (= a lever for enterprise value).

The "Ryanair Formula"
Pax: passenger
Productivity gap: (10050-6293)/6293 = 60%
The result is the productivity: in Ryanair they handle 10 000 passengers per staff member. They are much more productive in using their staff and you see why their staff cost is much lower.

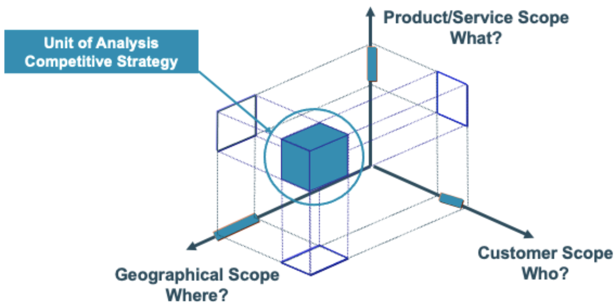
		Pax per Employee	Productivity gap
Low	Ryanair	10,050	-
Med	Easyjet	6,293	60%
	Germanwings	1,000	905%
High	Lufthansa	1,281	685%
	Alitalia	959	948%
	Iberia	978	928%
	British Airways	758	1,225%

Developing a Sustainable Competitive Advantage

1. *Understanding the Competitive Landscape (topic 3)*
2. ***Define the Scope of your Business (topic 4)***
3. ***Select the Activity set of your Business (topic 4)***
4. ***Assemble the needed Resources and develop the key Capabilities (topic 4)***
5. ***Set up the Business Model to link Value Creation and Value Capture and create a Virtuous Cycle (topic 4)***
6. *Understand the Sustainability of your Competitive Advantage (Topic 5)*
7. *Test your Strategy (topic 5)*

Define the scope of your business

This is the most important thing when you start thinking strategically.
What is the relevant unit to think strategically about? I am about to create a competitive advantage in a business but how do you define the business? How many businesses are you really in?



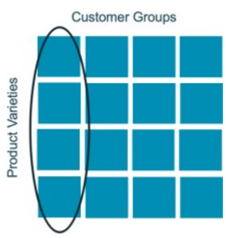
Three important dimensions:

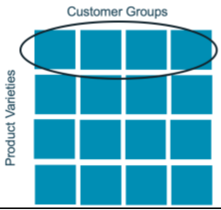
- What do you offer?
- Who are you offering them to?
- Where?

Then you start realizing that maybe you have to start differently if you start thinking strategically. Maybe your geographic scope needs to change, …

- Identify the market-, product- and customer segments the company intends to service or supply and the regions it wants to cover.
- In Flanders many businesses have chosen for a niche strategy (Barco, Picanol, LMS, Sioen,…)
- Niche strategies typically require a large degree of internationalization.
- Sometimes companies refer to their scope as their <u>*strategic territory*</u> or as the <u>*space*</u> in which they are competing.

Product & Customer Scope

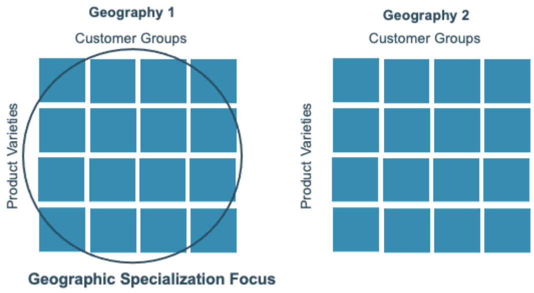
	**Customer specialization focus:** a variety of products for a particular type of customer group. *Philips Medical Systems: MRI, CT scanners, X-ray, etc. In medical imaging for Hospitals. But Siemens and GE Health doing the same.* → focus on a customer type but offer different products.

 	**Product specialization focus:** a particular product tailored to different customer segments (plastic caps). Molding machines: machine is standard, application depends on the mold and clamp power needed. → different customers but very similar products

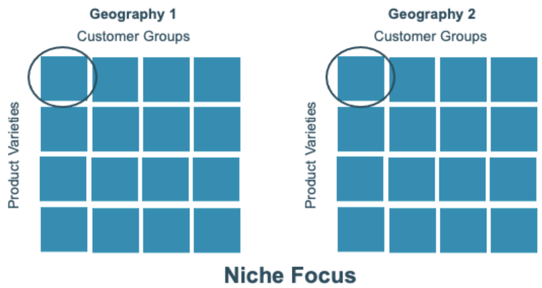
Product & Customer & Geographical Scope

Geography specialization focus (VW)

Automotive. Most cover many different segments.



Niche focus:
a very particular customer group with a very particular product (Barco)



To understand what type of product or service a company can offer to what type of customer, AI comes in handy because it allows for more accurate matches.
When too many competitors are entering a lucrative market, there is a big need for innovation. Companies should study the customers in depth to understand them and their needs, and thus to innovate. **A company should be consistent in the scope of its business.**

Example Barco: they are a world player and they really focus on cinemas and projections but across different geographies. You need to understand which business you are in. How do we do that?

Example: Dockers Khakis (pants)
Became really popular since in companies every Friday you could come casual. Dockers entered and offered these pants but then competition came so they had to come up with innovation. What kind of innovations can we come up with that might differentiate the dockers khakis with other players?
Innovations:

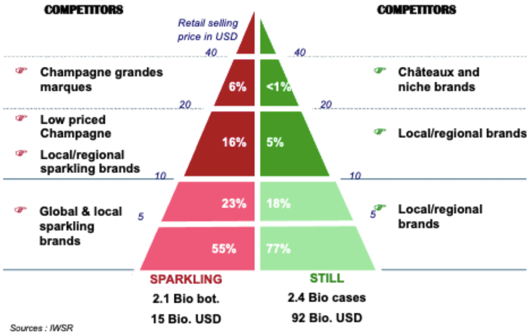
- Other type of fabric (stain resistant)
- Hidden oversized pockets
- Expandable waistband

How did they come up with these ideas? They go and follow customers, go live with customers and see how they use stuff. What they found out was that man that started to live on their own, they went into their appartements and found out that 60% of man don't have an iron. They also see that man buy pants that are too small (expandable waistband). These things they observed. The important point is that it is very important to think about who your customer is and what are you offering to your customer. There is where the competition lies because if you do better you actually grow. If you do worse, you lose customers. That is part of strategic thinking. Who is our customer and what product fits well?

<u>Example Ziemens</u>: they made high speed trains
Think about the customer, what do the final customers dislike about trains. They are worried whether they will be on time. How can we help the train being on time? They use productive maintenance. We make sure that we service the train on time. Ziemens provided an insurance; if the train is 15 min late you get your money back. Rethinking actually what really matters is the customer, to our customer that matters to them for the final customers so that is actually a step further in making that connection.

What is EW's Business Scope?

The wine business
Customers are restaurants
Products are "collections" of wines



Stage and wine were not a good business. They want their business to become profitable and to grow. They wanted a profit margin of 20% this wine business was not doing well, so they thought about whether to cut it or revamp it. LVMH was thinking about cutting it but the manager of the business, was thinking differently.

Firstly, they had to define what the scope of their business was. Their scope was buying different wineries around the globe. He was buying top wineries in different regions in the world. His reasoning was the following:
We have the champaign and the still wines. And these are the top chateaux. The problem is that it is limited. Max 10k cases per chateaux. Also, ground is limited so no option to grow the business.
They started thinking what do the customers want. What are you looking for with drinking wine? Often customers want to drink different types of wine. So, they bought different wineries to kind of offer a different collection of wines to different customers. But who is a different customer in this case? Who do I want to sell to? Do I sell to the final customer? The wine drinker? Where are the interesting margins in this business?
Restaurants → We offer them a collection for all the food they offer. So, he focused on the restaurant business, on this intermediate segment where he could grow the business. So, what am I offering, to whom am I offering, I am offering a collection. And for that I need to be geographically internationally spread because otherwise I cannot offer that collection.

➔ So, we see thinking carefully about the scope is important to make this business successful.

Select the activity set of your business - <u>Activity analysis</u>
Source: Ghemawat and Rivkin, Chapter 3

Activity analysis of competitive advantage
By analyzing a firm activity by activity, managers can:
- Understand why the firm does or does not have added value
- Spot opportunities to improve its added value
- Foresee likely shifts in added value

The goal is to drive a wedge between WTP and cost but often, a firm must incur higher costs to deliver a better product. A solution is to conduct an activity analysis to spot opportunities to widen the wedge.
- Use activities to analyze relative costs
- Use activities to analyze relative WTP
- Explore different strategic options and making choices

1. Catalog the firm's activities

The value chain

Company must be broken down in activities in order to identify the drivers of competitive advantage

The value chain encompasses the activities the firm has to perform to deliver a service or a product. Carrying out every activity obviously requires capabilities. The value chain is often confused with the **value system**, which is related to the industry (how are the firms connected to each other?).

Now we look at a business and the different activities that that business is developing.

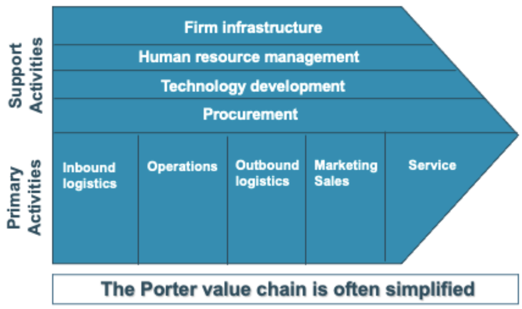
<u>Analyzing the Value Chain</u>

- Estimate the importance of the specific activity for the creation of a competitive advantage
- Identify the scale-scope-learning advantages in the separate activities
- Identify the interdependence or complementarity between activities
- Identify coordination needs across activities

When we think about competitive advantage, we need to make these connections again. How do we create value by using these activities? We need to think about the importance of each activity for our competitive advantage. Are there any scale, scope, learning advantages? That is going to affect my cost. Are there interdependencies between different activities that also could affect my cost?

The Porter Value Chain

Explain this better with example of how activities should help create value (cost &/or wtp)



<u>Unusual Features of Wal-Mart's Value Chain</u>

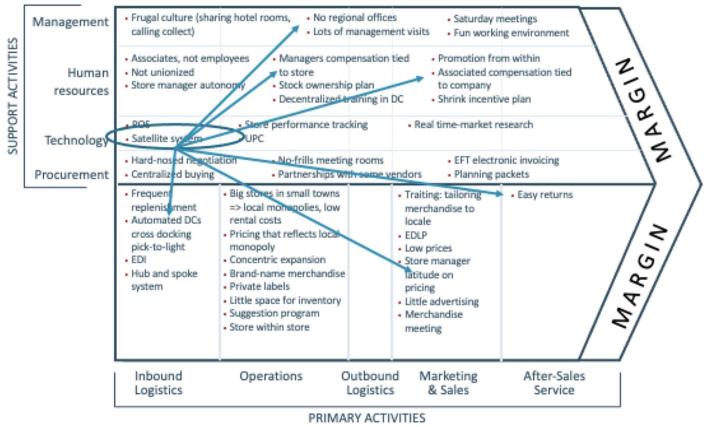
All Activities reinforce our Competitive Advantage and are Coherent with our scope?

As an example, we look at all the activities the retailing organization Walmart is doing. One important element, Walmart was the first company to have set up a satellite. They set up a satellite for all their data and to connect all the data from the different stores to really understand what was going on. How does that help us around the business? This actually affects allot of things we do and allot of our costs

- For example, the logistics. We have a cross dock, we actually can track the trucks very well and transport, Walmart was the first to do crossdocking (you have a warehouse, and you swap things from one thing to another). You need allot of data to do that efficiently.
- Another element was that Walmart did not have regional offices, that was about 2% of sales. Because they had a satellite system.
- Manager compensation: motivation? Tie bonuses to a detailed level to what managers are asking decisions on
- Easy returns: shrinkage, stuff that leave the store without being paid for. But with the tracking system they could know this. It makes it easy to return things because it tracks everything in different places. Also what it allows it to do is to give the store managers allot of freedom in pricing. So, the prices are not the same in different places.

Walmart was always on the forefront and are very early in everything but today with online shopping it's a different story.

The key point: all the activities reinforce your competitive advantage and are also coherent with your scope. Because if you think about who is the Walmart client, typically they would be in area with lower acquisitive power. They know who their customers are. The only way they can gain here the competitive advantage is by low cost because the WTP is everywhere the same.



Example Tesla: Creating Value and Complementary Activities

All Activities reinforce our Competitive Advantage and are Coherent with our scope

Why is tesla successful? They are doing several things right at the same time.

- They have technology, the platform is very simple, they have a good design.
- Excellent on marketing, they had a roadster, free advertising by racing the tesla against other cars. The tesla won because they had the shifts. It goes much faster. So, lots of viral marketing.
- They had to rethink manufacturing, distributions they don't have dealerships. You buy online.
- Also on the financing, tesla at one point was in trouble and needed refinancing. One of the concerns was what happens if I buy a tesla, and after 5 years the company stops existing? That is a problem. A tesla you don't know the resale value. The financing that tesla offered was including the resale value. Meaning that if you buy a tesla and you want to sell it, you can sell it back to tesla and they would pay the difference. That was necessary at the beginning to get people buying Tesla's. So, Tesla has been working on many different activities that reinforce each other and reinforce their competitive advantage.

Example Hilti: Big Moves and Complementary Activities

They sold power tools with focus larger construction companies.

- More working capital and risk management
- Leasing versus one-time invoice
- Compensation system sales
- Pricing and total cost of ownership

→

- From selling power tools to consulting…
- Sell to management versus sell to construction worker
- Educate the customer

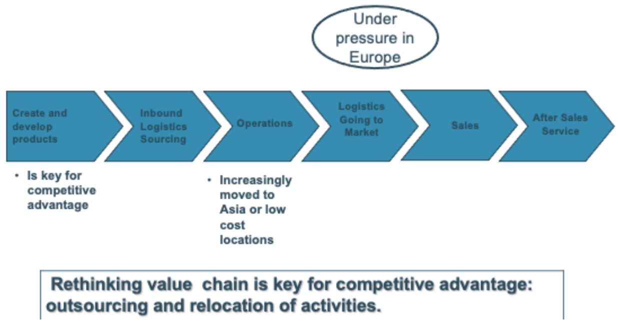
The company asked their biggest customer what they can do better: help them manage the tools etc. So, they thought about it and they implemented fleet management but almost after 20 years. So, when you make big strategic decision, it takes time. You have to convince people, you have to change the way you work.

When we think about fleet management, and instead of selling a power tool we are now going to manage the fleet of tools, what needs to change in terms of activities that you do?
Before Hilti sold its products to production site (and the construction workers). Now, it has shifted, and it is selling a service (fleet management) rather than a product (= selling to the management).
This shift impacted every level of the company and all the changes had to be done at the same time and to fit: design of the products (made easier to fix); quality of the products (↗); legal contracts (from selling to renting); finances (working capital, leasing/invoicing, total cost of ownership); distribution (selling to management instead of workers); marketing (educate the customers & sell a productivity increase); HR (different sellers or retrain the actual ones?); complementary (Hilti's own drills?); R&D.

All activities reinforce our competitive advantage and are coherent with our scope. They moved from just selling a power tool to selling a service. Competitors were really struggling in copying this. Today this is a revenue generator for Hilti.

The Value Chain is Changing

We have change happening in the value chain. You might have different **pressures:**



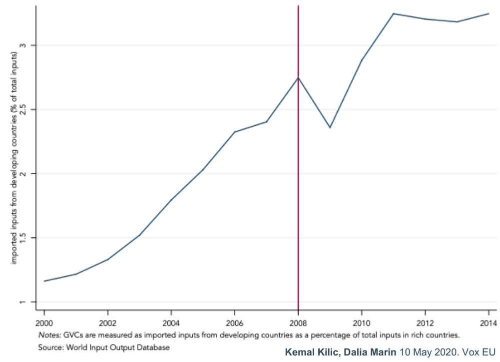
Relocation and outsourcing
When thinking about relocation, one must ask: Where should activities be located?

⇨ Criteria for choice: costs at location, logistics costs, access and proximity to market

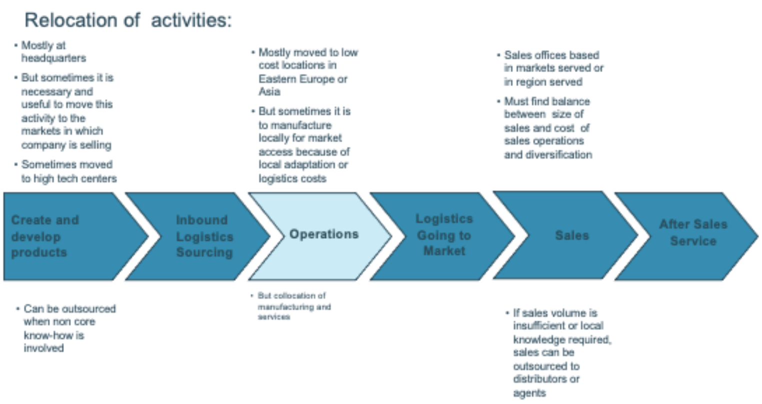
When thinking about outsourcing, one must ask: Is this creating value? Who should carry out activities, the company or 3rd parties?

⇨ Criteria for choice: strategic importance, economics of scale, labor contracts, experience

When we think about the global value chain there is this idea that there is more being outsourced to more developing countries. There was kind of an increase but today there seems to be a flattening out, so are we still outsourcing from cheaper area's? Where do we locate our different activities?



Global Value Chains



Typically, the creation, the R&D, we have to think about that in a particular case, organization → what is the best way of organizing different activities

Head and tail companies

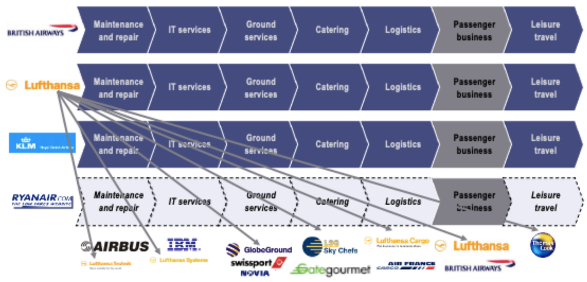
Some European companies outsource many activities and only focus on development and sales

Some European companies, or Apple and Nike, outsource many activities and only focus on development and sales (and the development and design of IP).

Example Airline industry

Lufthansa actually provides a lot of activities related to the passenger business. Ryanair is much more focused on the passenger business and outsource other activities.
→This goes back to the positioning of the company, how it creates value and captures it.

Think about how to organize these activities and how they affect your competitive advantage.



Example 3D Printing and the Value Chain…

Think maybe of automotive: print spare parts?
Or even digital printing, wallpaper business: print your wall decorations?

Example Electric Cars & Tesla

Crowd-sourced and 3D Printed
Think of what this means for the value chain. Manufacturing can be done distributed… small set-up close to customer, no more economies of scale?

With the rise of 3D printing, many companies are thinking about bringing the factories back to Europe after having delocalized them, to print at the location of the customers.
→ What if we start printing cars? How will that affect the value chain? On what activities could this have an impact? Is digitalization going to help restructure the value chain?

Example Crowdsourcing & Design

Crowdsourced DARPA Marine Assault Vehicle
Crowdsourcing: crowdsourced their marine assault vehicle. They had design studio's submit designs and the winner had 7500 dollar. If they had this designed by contractors this would have costed much more.

Value Chains (Pipelines) versus Platforms

Platforms also change the value chain

- Network Externalities and the rise of Platforms
  - Direct Network Externalities
    - Online gaming, Whatsapp
    - Everyone is one whatsapp so everyone uses it, it makes it more valuable
  - Indirect Network Externalities
    - Alibaba, eBay, Amazon, Uber, Airbnb
    - People like to shop where there is a lot of suppliers and suppliers like to offer their products where there is a lot of customers shopping

→Platforms usually need both these externalities.

- Combining Pipes & Platforms (Apple)
  Now companies are combining pipes and platforms; apple makes allot of money on the iPhone but it also has a platform where all the apps are. They combine both and this really drives their competitive advantage. Why are platforms interesting from that perspective? Often times platforms create matches between buyers and sellers. If there are more buyers, there is more stuff I am interested in. If there is a cost element, if there is more scale the cost might be lower. So, you have a dynamic aspect a high WTP and lower cost and dynamic effect of the platform that increases the value created.
- Strategy & Platforms
  - Better information creates better matches, better matches create more value (higher WTP and possibly lower Costs through scale): *That is where people have been thinking that if they create more value than the alternative they might win. Not quite, because it has to be <u>sustainable</u>.*
  - From resource control to resource orchestration where we control our resources
    For example: Uber doesn't own cars but wants more drivers and more clients, so it connects them (= orchestration) and create interaction).
  - From internal optimization to external interaction

There are some different elements, different questions we need to think about when thinking strategically. We need an ecosystem where many different players that needs to be connected.

2. Examine the costs associated with each activity, and use differences in costs to understand how and why costs differ from those of the competitors

Activities generate costs but also WTP so we will look at both of these elements.

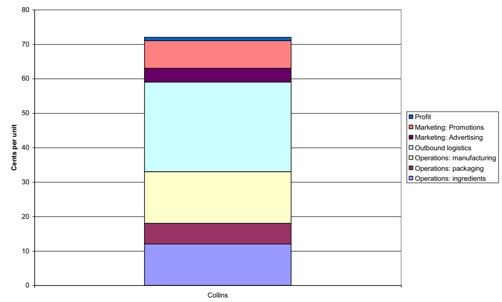
Comparative Cost Analysis is what we did above with the Walmart example. *(?? Is this the same as relative cost analysis??)*

<u>Example: The snack cake market</u>

- Between 2000 and 2005, Little Debbie grew its market share from 1% to nearly 20%
- At the same time, Hostess saw its dominant 45% share dwindle to 25%
- Hostess' managers were not happy about that…

Hostess' cost components

Comparative analysis: they looked at their own costs, they looked at the unit level. We see different elements of costs.



Identify cost drivers

Cost drivers are the factors that make the cost of an activity rise or fall. What we are really after is what is driving these costs and how can we affect them?

- Outbound logistics' cost influenced by:
  - Delivery costs depends on the number of stops truck driver has to make
  - Urban deliveries tend to be more expensive than suburban ones
  - Costs increase with product variety: a firm with a broad product line can make it difficult for drivers to restock shelves and remove out-of-date merchandise
  - Costs depend on the product: cakes with more preservatives can be delivered less frequently

Cost drivers are critical because they can allow to estimate competitors' cost position

- One (usually) cannot observe a competitor's costs directly, but can observe the **drivers** (e.g., share of sales in urban areas, breadth of product line, ingredients etc.)

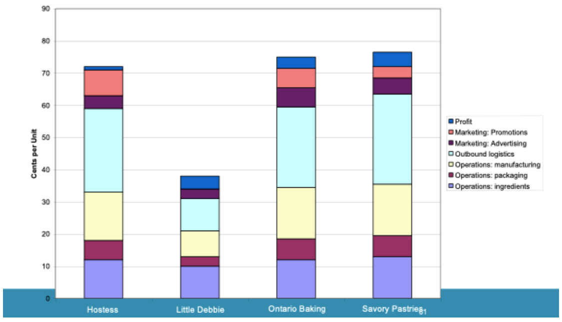
Cost drivers

- Related to firm size
    - Economies of scale / scope; capacity utilization
- Related to cumulative experience
    - Learning curve
- Independent of firm size / experience
    - Input prices, location, complexity, government policies, efficiency, agency costs, etc.

Important issues

- Focus on differences in individual activities, not just differences in total cost
  The focus should be on the big differences between the player: what are other doing that might have a competitive effect? It should also concentrate on differences in individual activities, not just differences in total cost
- Good cost analysis focuses on a subset of all firms' activities (which ones?)
  Effective cost analysis usually break out in greatest detail and pay most attention to cost categories that:
    - Pick up significant differences across competitors or strategic options
    - Correspond to technically separable activities
    - Are large enough to influence the overall cost position to a significant extent
- Activities that account for a thicker slice of costs deserve a deeper treatment in terms of cost drivers
- A driver should be modeled only if it is likely to vary across competitors or the strategic options that will be considered
- Sensitivity analysis is crucial: it identifies which assumptions really matter and therefore need to be honed. It also tells the analyst how much confidence to have in the results.

Relative cost analysis



Now we can compare **the total price of different players**. We immediately see the difference. We see that little Debbie is cheaper.

3. Analyze how each activity generates WTP and try to understand differences in WTP

Activities and WTP

- The activities of a firm do not just generate costs (hopefully): they also generate WTP
- Differences in activities account for differences in willingness to pay and subsequently for differences in added value and profitability
- WTP is difficult to calculate
- There is the need for a willingness to pay calculator: something that indicates how much customers would pay for any combination of activities. But this is lacking in firms for many reasons. But firms can use simplified methods to analyze relative WTP (We did this when we calculated WTP for the Husky machine relative to its competitors):
    1. Identify the *real* buyer (scope!)
    2. Understand what the buyer wants and is willing to pay for (and possible trade-offs)
    3. Assess how successful the firm and its competitors are at fulfilling needs
    4. Relate differences to activities

You compare that to competitors; how good are they in satisfying their needs and how good are we?

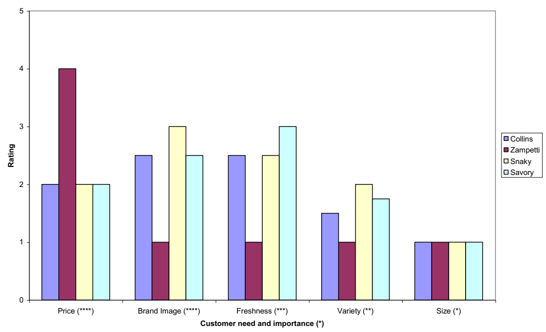
At this point managers should have a refined idea of how activities translate, through customer needs, into WTP. They should also understand how activities alter costs.

Customer needs and relative success

A major challenge in analyzing WTP is narrowing the list of customer needs into manageable roster. Buyers differ in what they want and how badly they want it. It is crucial to understand how customers value a certain offer.

- Horizontal differentiation: customers rank products differently
- Vertical differentiation: customers agree on which product is better but differ in how much they are willing to pay for the better product

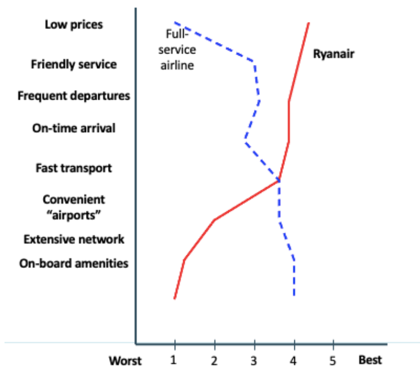
Price: purple bar is little Debbie → they have a low price
Brand image is not very known, and freshness is lower because they put more preservative in their cakes and so their outbound logistics looks differently. Obviously, the freshness is lower. The important thing is, how much do customers care about freshness versus how much do they care about the price? What is the value they capture? We have to look at **tradeoffs**.



To compare all these elements, the **value curve** is a useful representation: it is a simple tool for recording how a company performs relative to competition on the attributes that customers consider as they choose among rivals. It is truly a ranking of customer's perspective. Even successful companies rarely are (or try to be) superior on all attributes. Instead, they make strategic choices resulting in <u>trade-offs</u>.

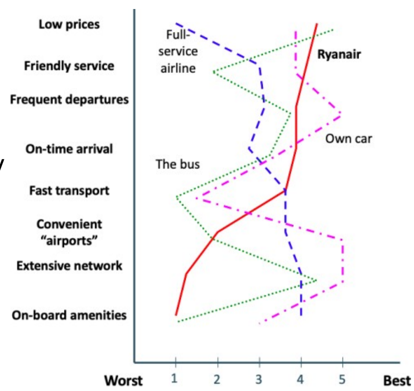
Ryanair's Value Curve

Scope is important here: who are you competing with? Bus and ferry or full service airlines?
When we think strategically, the important thing is **not** to be better at **everything**. Companies who are good at thinking strategically are good in making **tradeoffs**. Ryanair is making tradeoffs. You don't try to be better on everything.



More interestingly with who are you comparing to? Lufthansa is maybe not a good airline to compare with… I should compare to flexibus. Or I can score my own car.

So, the real question becomes again to look at the **scope**; who is my customer? Am I going after my flexibus customer or am I going after the Lufthansa customer? Actually, when Ryanair started, the first rout Ryanair did was Dublin – London because allot of people were doing this but by ferry.
It is more likely that a customer is looking at a flexibus and Ryanair than Ryanair and other airliners.



4. Consider changes in activities to widen the wedge between Costs and WTP

In this step we are trying to widen the gap between WTP and costs because more value created means more likely to have a competitive advantage. To this point, management team has researched how changes in activities will affect added value. The goal now is to find favorable options.

Explore options and make choices

- Understand what drives competitors (e.g., Little Debbie saw preservatives as a substitute for fast delivery etc.)
- When considering changes in activities, consider reactions (secondary airports, no animals in circus). What is hard for others to follow/imitate might give an advantage (and make the competitive advantage more sustainable overtime).
- Consider also buyers/suppliers value chains (DSD, complements, etc) to avoid to fixate on a few product characteristics and think too narrowly about benefits to buyers.
    - Supplier value chain: creating scale for your suppliers, e.g. Ducati.
    - Buyer value chain: robotics that Husky would add to the injection molding machine. DSD delivery by
- Consider unobserved customer segments (ferry users, flexibus)
- Adjust scope of the operations; change the range of customers the firm serves or products if offers within an industry
- Start with a set of options, articulate what each option implies for activities THEN analyze the impact of each alternative configuration of activities on the wedge between costs and WTP (reverse the process of activity analysis)

Drivers of willingness to pay and scope

Understand how each customer connects with the product: in Japan, a watermelon is a gift so it's more valuable than here and incurs a higher WTP. Moreover, considering the reduced spaces, smaller watermelons are better suited for sales in Japan. Watermelon is difficult to store. They let it grow in a box, so it has the form of a kubus. They came up with this idea because they have small fridges in Japan.

⇨ So again, scope has to do with where you live and where the ideas come up, and how you create value is again depending on the context.

Conclusion: in the final step of exploring options the management team must build a vision of the whole. → importance of internal consistency

Assemble the needed Resources and develop the key Capabilities

→ Understand how we think strategically about resources and capabilities

Resources & capabilities

- **Resources** are like “nouns”: things that firms “have”
- **Capabilities** are like “verbs”: things that firms “do”
    - Typically valuable across multiple products or markets
    - Embedded in Organizational Routines
        - That’s why we have now on boarding when starting a new job, to learn also how things are done in the organization
    - Tacit and cannot be reduced to simple algorithms or procedure guides
    - “capacity to perform a particular activity in a reliable and at least minimally satisfactory manner” (Helfat and Winter, 2011)

What are Samsung’s Resources and Capabilities?

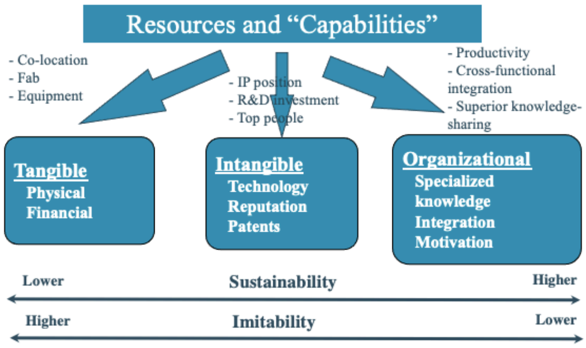
In DRAM? Design and production.

= Memory ship with dual advantage; increasing WTP compared to industry average AND reduce their cost relative to industry average

Virtuous Circle Reinforcing Capabilities

In terms of fully loaded costs Samsung did better but actually if we look at labor per chip there were more expenses. They generate high volume, lower cost but also higher yield ratio so they got more chips out of their silicone. And it allowed them to provide premium quality because they could tailor to different players in different customers, demanding customization of their chips.
What was important there was the delivery on time, they made sure their high-quality chips came on time to their customers

The 3 types of resources & capabilities are linked to how easy it is to copy.



- **Tangible** *(co-location, fab, equipment):* easy to copy (buildings, factories, money, …) so sustainability (in terms of protection your advantage) is relatively low. physical and financial. Today it might be difficult to gain competitive advantage financially because we are in a crunch.
- **Intangible** *(IP position (= the brand), R&D investment, top people)*: more difficult to imitate because it has to do with R&D and product development.
    - The importance of intangibles increases; both the manufacturing and the services sector are driven by the intangibles. What are intangibles? Innovation, patents, … but could also be brand, marketing, … think about 'Kom op tegen kanker' where they really had to build a brand. That makes the company very valuable, and the intangibles becomes more and more important to sustain a competitive advantage.
- **Organizational** *(productivity, cross-functional integration, superior knowledge sharing)*: very hard to copy because it takes a lot of time to develop a certain type of business.

Appraising <u>Resources</u>

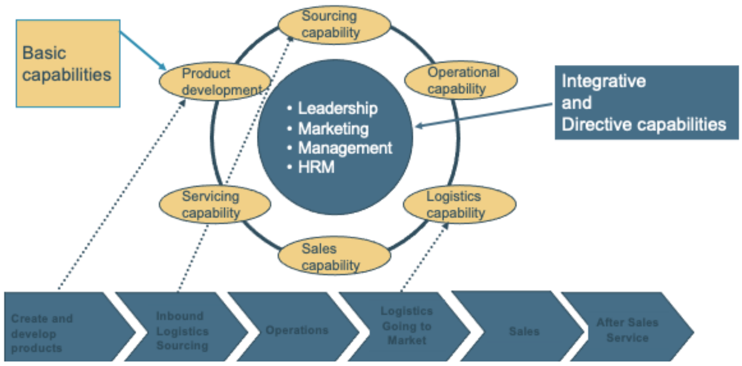
→ *Hard to copy capabilities for other companies when they try to copy the exemplar ones.*

RESOURCE		CHARACTERISTICS	INDICATORS
Tangible Resources	Financial	Borrowing capacity Internal funds generation	Debt/ Equity ratio Credit rating Net cash flow
	Physical	Plant and equipment: size, location, technology flexibility. Land and buildings. Raw materials.	Market value of fixed assets. Scale of plants Alternative uses for fixed assets
Intangible Resources	Technology	Patents, copyrights, know how R&D facilities. Technical and scientific employees	No. of patents owned Royalty income R&D expenditure R&D staff
	Reputation	Brands. Customer loyalty. Company reputation (with suppliers, customers, government)	Brand equity Customer retention Supplier loyalty
Human Resources		Training, experience, adaptability, commitment and loyalty of employees	Employee qualifications, pay rates, turnover.

FUNCTION	CAPABILITY	EXEMPLARS
Corporate Management	Financial management Strategic control Coordinating business units Managing acquisitions	ExxonMobil, GE IBM, Samsung BP, P&G Citigroup, Cisco
MIS	Speed and responsiveness through rapid information transfer	Wal-Mart, Dell Capital One
R&D	Research capability Development of innovative new products	Merck, IBM Apple, 3M
Manufacturing	Efficient volume manufacturing Continuous Improvement Flexibility	Briggs & Stratton Nucor, Harley-D Zara, Four Seasons
Design	Design Capability	Apple, Nokia
Marketing	Brand Management Quality reputation Responsiveness to market trends	P&G, LVMH Johnson & Johnson MTV, L'Oreal
Sales, Distribution & Service	Sales Responsiveness Efficiency and speed of distribution Customer Service	PepsiCo, Pfizer LL Bean, Dell Singapore Airlines Caterpillar

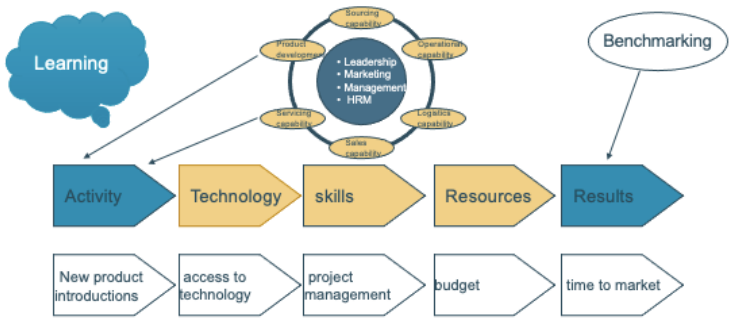
From activities to capabilities

Different value activities require different capabilities



In the Porterian view, activity choices are sufficient for competitive advantage… you make trade offs! Going a step further, capabilities are how you run activities. On the bottom we have our value chain with the different activities → to run these activities you need to be able to do something. To coordinate those activities, you need leadership and management.

Capabilities have five critical dimensions

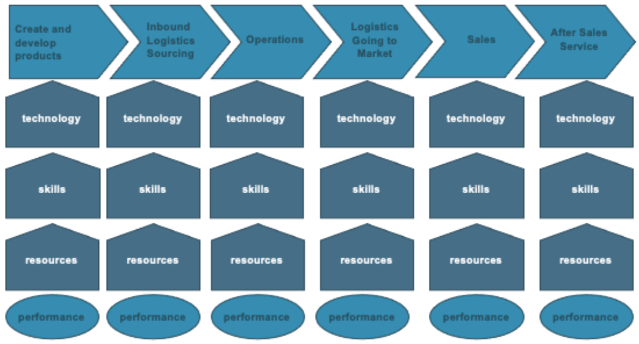


→ 5 elements that could be linked to capability.
When introducing a new product: we will have technology, some skills, some resources, and we will have some outcome. We can actually piece apart what elements of a capability.
But what is the difference between a skill and a capability?
Example of beatboxing. The first example had the technology and skills. The second one actually did something with it and that is much harder to copy.

→ *It is important to have a methodology to analyze the required capabilities for the competitive advantage that the company aspires to achieve.*
In an activity, the outcome of everything (technology, skills, resources) combined can be compared to other companies (benchmarking).

Capabilities and Activities

When talking about strategy, be truthful to the firm's values is really important (= innovation capability).



Patagonia example: Because they were thinking about the environment, they said we cannot have wet suits based on a certain fabric so they found some stone in Japan that can generate the same kind of material. Then they found out that this material actually works betters. They have developed this product development capability because of the value they had. It's hard to disconnect. They really looked for a very different way to develop their product and they developed their product development capability different from others in the industry.

Capabilities can be developed in many ways

How?

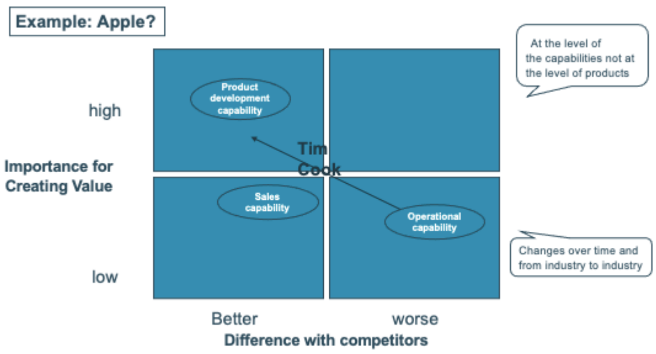
- By accident or luck (Madonna?)
- Systematic research (McDonalds, Patagonia)
- Experiences, learning by doing (Samsung)
- Leap-frogging investments in resources (Tesla electric vehicles, competing with normal engines, Mpesa)
- Innovative combination of skills, technologies and resources (Barco DLP, they are the leader in digital cinema. Why? They licensed the patent from Texas instruments)

Sources of ideas

- Contacts with customers (Hilti)
- Conditions at location (Walmart: selling cheap stuff in the middle of Arkansas, they had to build up ware houses, … this is a capability to do it in a low cost way)
- Transfer from related industries and markets (Apple)
- In-house experiences (Ryanair actually was at the verge of bankruptcy because they wanted to do things at a low cost but they did not have the capabilities for that. Then the father came and gave the money but replaced the CEO with someone else. The brothers were so focused on cash, generating cash but because of this fixation they almost went bankrupt. It's an experience they had that really triggered the company.)

Key or Core Capabilities. Distinctive Capabilities

Not all capabilities are equally important for generating a Competitive Advantage



Operational capability of Apple has become more important. Tim Cook was responsible for this. Apple actually designs the equipment that suppliers use to manufacture Apple products.

How to think more strategically about resources and capabilities? Two dimensions:

- How important is a capability for creating value?
- How different is it from competitors?

Think about Apple; they were known for product development and design. However, over time other players entered and they needed to think about how do we advance? Today Apple is the example were people go look and see how they run their supply chain efficiently.

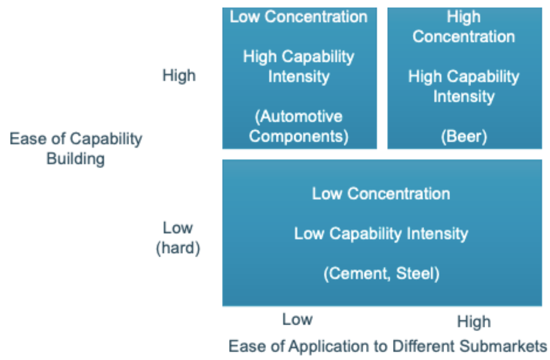
Competing in Level of Capabilities (Endogenous Sunk Costs)

Endogenous sunk costs are costs that we decide to grow over time because it makes sense.

→ The ease of capabilities: how easy is it to build a certain capability? Hard? Then firms are not going to invest a lot.

→ How easy can you apply it to different markets and submarkets?

When it is easy to build a capability than it really matters if you can apply it to different submarkets. For example, in beer, Abinbv are strong worldwide. They have both eases, so they invest more and more and it becomes very hard for others to follow.

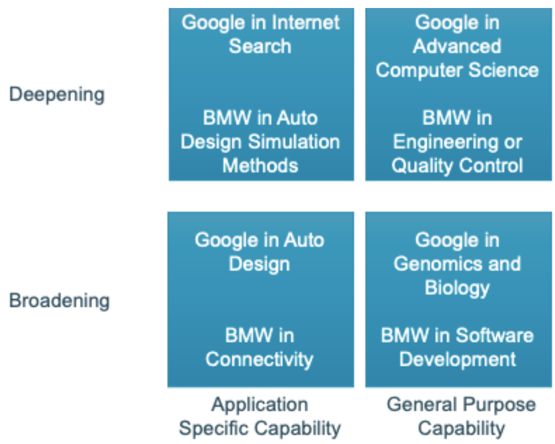


How much we invest is endogenous compared to the environment.
If you cannot apply your capability to different markets than you won't invest that much. You'll get low concentration high capability …. Ex automotive components it is very difficult to apply this to other industries and markets.

⇨ Endogenous sunk costs: as the market expands, few players are actually investing to try to capture more of it. How big the investment is depends on how much competition there is; how big the market is; and how is it to actually apply the capability developed to different submarkets (how to expand and leverage that?).

Competing in Type of Capabilities

EXTRA reading of Pisano
Application specific is like design simulations, internet search
On the x axis you have the characteristic of the capability.
On the y axis you have the characteristics of the company.
→ How good are you?

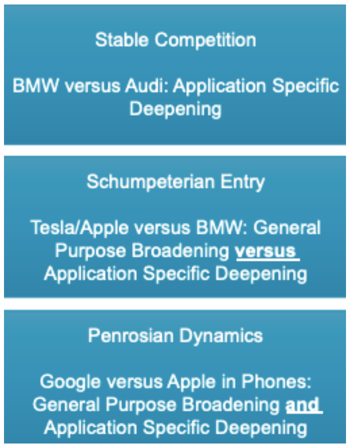


Let's think about the box with computer science. Google is already very good in that, and they keep investing, they **deepen** their capability in this area. BMW are very good at engineering and quality control, and they keep on investing and improving in those.
Box below: The broadening, Google can be interested in genomics.

→ You can broaden or deepen what you know.

- Capabilities can be deepening or broadening what is known.
- Capabilities can be related to a specific application or can be general

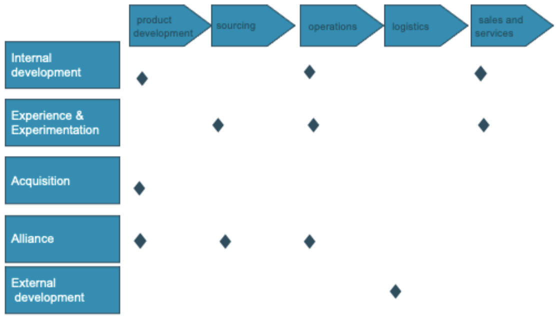
Competing in Capabilities



- If you have stable competition, companies are deepening their capabilities.
- When do you broaden? When you move into a different area.
- If you try something new; google vs apple in phones. Then you need broadening AND deepening capabilities.

It depends on the competitive environment: the firm should think ahead of time where it wants to be in the future and what capabilities need to be developed to achieve the goals and compete with other potential players. Capabilities development is a strategic move that takes time.

Strategically Developing Capabilities



In each of these activities we need to think about how we are building our competitive advantage based on these capabilities. Some needed to run the company and some to distinguish ourselves.

Classic reading: Competing on Resources

As recently as 10 years ago, we thought we knew most of what we needed to know about strategy. At the business unit level, the pace of global competition and technological change has left managers struggling to keep up. As markets move faster and faster, managers complain that strategic planning is too static and too slow. Strategy has also become deeply problematic at the corporate level. Many frameworks were developed but generated more and more confusion.

A framework that has the potential to cut through much of this confusion is the ***resource-based view of the firm*** **(RBV)**. The approach is grounded in economics, and it explains how a company's resources drive its performance in a dynamic competitive environment.
The RBV combines the *internal* analysis of phenomena within companies with the *external* analysis of the industry and the competitive environment (the central focus of earlier strategy approaches).
It builds on but does not replace these two approaches to strategy and combines both perspectives.
It derives its strength from its ability to explain in clear managerial terms:

- why some competitors are more profitable than others
- how to put the idea of core competence into practice,
- how to develop diversification strategies that make sense

The RBV sees companies as very different collections of physical and intangible assets and capabilities. No two companies are alike because no two companies have had the same set of experiences, acquired the same assets and skills, or built the same organizational cultures. These assets and capabilities determine how efficiently and effectively a company performs its functional activities. Following this logic, a company will be positioned to succeed if it has the best and most appropriate stocks of **resources** for its business and strategy. Valuable resources can be physical, intangible or an organizational capability.

⇨ **Competitive advantage**, whatever its source, ultimately can be attributed to the ownership of a **valuable resource** that enables the company to perform activities better or more cheaply than competitors.

Competitive valuable resources

Resources cannot be evaluated in isolation, because their value is determined in the interplay with market forces.

The RBV links a company's internal capabilities (what it does well) and its external industry environment (what the market demands and what competitors offer).
For a resource to qualify as the basis for an effective strategy, it must pass a number of external market tests of its value:

1. **The test of inimitability: is the resource hard to copy?**
   Inimitability limits competition and lies at the heart of value creation.
   If a resource is inimitable then any profit stream it generates is more likely to be sustainable. However it does not last forever, competitors will find ways to copy most valuable resources. Managers can forestall them and sustain profits for a while by building their strategies around resources that have at least one of the following four characteristics:
   - *Physical uniqueness,* which almost by definition cannot be copied. A wonderful real estate location, mineral rights, or Merck's pharmaceutical patents simply cannot be imitated.
   - A greater number of resources cannot be imitated because of *path dependency.* These resources are unique and, therefore, scarce because of all that has happened along the path taken in their accumulation. As a result, competitors cannot go out and buy these resources instantaneously but they must be built over time.
   - *Causal ambiguity:* competitors are thwarted because it is impossible to disentangle either what the valuable resource is or how to re-create it.
     - Causally ambiguous resources are often organizational capabilities. These exist in a complex web of social interactions and may even depend critically on particular individuals.
   - *Economic deterrence:* occurs when a company preempts a competitor by making a sizable investment in an asset. The competitor could replicate the resource but, because of limited market potential, chooses not to.
     - This is most likely when strategies are built around large capital investments that are both scale sensitive and specific to a given market.

2. **The test of durability: How quickly does this resource depreciate?**
   The longer lasting a resource is, the more valuable it will be. Like inimitability, this test asks whether the resource can sustain competitive advantage over time. While some industries are stable for years, managers today recognize that most are so dynamic that the value of resources depreciates quickly.

3. **The test of appropriability: Who captures the value that the resource creates?**
   Not all profits from a resource automatically flow to the company that "owns" the resource. The value is always subject to bargaining among a host of players, including customers, distributors, suppliers, and employees.

4. **The test of substitutability: Can a unique resource be trumped by a different resource?**
   Since Porter's introduction of the five-forces framework, every strategist has been on the lookout for the potential impact of substitute products. The resource-based view pushes this critical question down a level to the resources that underpin a company's ability to deliver a good or service.

5. **The test of competitive superiority: Whose resource is really better?**
   Perhaps the greatest mistake managers make when evaluating their companies' resources is that they do not assess them relative to competitors'. Every company can identify one activity that it does relatively better than other activities and claim that as its core competence. Unfortunately, core competence should not be an internal assessment of which activity, of all its activities, the company performs best. It should be a harsh external assessment of what it does better than competitors, for which the term *distinctive competence* is more appropriate
   The way to avoid the generic statements of core competence is to disaggregate the

corporation's re-sources. The category *consumer marketing skills,* for example, is too broad. But it can be divided into subcategories such as effective brand management, which in turn can be divided into skills such as product-line extensions, cost- effective couponing, and so on.
Disaggregation is important not only for identifying truly distinctive resources but also for deriving actionable implications. Although disaggregation is the key to identifying competitively superior resources, sometimes the valuable resource is a combination of skills, none of which is superior by itself but which, when combined, make a better package.

The lesson for managers is that conclusions about critical resources should be based on objective data from the market. In our experience, managers often treat core competence as an exercise in intuition and skip the thorough research and detailed analysis needed to get the right answer.

Strategic Implications

Managers should build their strategies on resources that meet the five tests outlined above. The tests capture how market forces determine the value of resources. They force managers to look inward and outward at the same time.

However, most companies are not ideally positioned with competitively valuable resources. More likely, they have a mixed bag of resources – some good, some mediocre, and some outright liabilities.

Even those companies that have unusual assets or capabilities are not home free. Valuable resources must still be joined with other resources and embedded in a set of functional policies and activities that distinguish the company's position in the market.

In a world of continuous change, companies need to maintain pressure constantly at the frontiers. Managers must therefore continually invest in and upgrade their resources, however good those resources are today, and leverage them with effective strategies into attractive industries in which they can contribute to a competitive advantage.

Investing in resources.
Because all resources depreciate, an effective corporate strategy requires continual investment in order to maintain and build valuable resources.

The great contribution of the core competence notion is its recognition that, in corporations with a traditional divisional structure, investment in the corporation's resources often takes a backseat to optimizing current divisional profitability. Core competence, therefore, identifies the critical role that the corporate office has to play as the guardian of what are, in essence, the crown jewels of the corporation. In some instances, such guardianship might even require explicitly establishing a corporate officer in charge of nurturing the critical resources.

At the same time, investing in core competencies without examining the competitive dynamics that determine industry attractiveness is dangerous. By ignoring the marketplace, managers risk investing heavily in resources that will yield low returns.
Similarly, if competitors are ignored, the profits that could result from a successful resource-based strategy will dissipate in the struggle to acquire those resources. This is true not only for resources acquired on the market but also for those core competencies that many competitors are simultaneously trying to develop internally.

Upgrading resources.
What if a company has no unusually valuable resources? Unfortunately, that is a common experience when resources are evaluated against the standard of competitive superiority. Or what if a company's valuable resources have been imitated or substituted by competitors? In these cases companies must continually upgrade the number and quality of their resources and associated competitive positions in order to hold off the almost inevitable decay in their value.

Upgrading resources means moving beyond what the company is already good at, which can be accomplished in a number of ways:

- Adding new resources.
- Upgrading to alternative resources that are threatening the company's current capabilities.
- A company can upgrade its resources in order to move into a structurally more attractive industry.

Perhaps the most successful examples of upgrading resources are in companies that have added new competencies sequentially, often over extended periods of time.

Leveraging resources.
Corporate strategies must strive to leverage resources into all the markets in which those resources contribute to competitive advantage or to compete in new markets that improve the corporate resources. Or, preferably, both. Failure leads a company to be undervalued.

Good corporate strategy then requires continual reassessment of the company's scope. The question strategists must ask is; How far can the company's valuable resource be extended across markets?

The answer will vary widely because resources differ greatly in their specificity, from highly fungible resources (such as cash) to much more specialized resources (such as expertise in narrow scientific disciplines). Specialized resources often play a critical role in securing competitive advantage, but, because they are so specific, they lose value quickly when they are moved away from their original settings.

The RBV helps us understand why the track record of corporate diversification has been so poor and identifies three common and costly strategic errors companies make when they try to grow by leveraging resources:

- First, managers tend to overestimate the transferability of specific assets and capabilities. Because valuable resources are hard to imitate, the company itself may find it difficult to replicate them in new markets.
- Second, managers overestimate their ability to compete in highly profitable industries. Such industries are often attractive because entry barriers limit the number of competitors.
    - Entry barriers are really **resource barriers**: The reason competitors find it so hard to enter the business is that accumulating the necessary resources is difficult.
    - Many managers fail to see the connection between company-level resources and industry-level profits and convince themselves that they can vault the entry barrier, without considering which factors will ultimately determine success in the industry.
- The third mistake is to assume that leveraging generic resources, such as lean manufacturing, will be a major source of competitive advantage in a new market – regardless of the specific competitive dynamics of that market.

Despite the common pitfalls, the rewards for companies that leverage their resources appropriately are high

Conclusion
Whether a company is building a strategy based on core competencies, is developing a learning organization, or is in the middle of a transformation process, those concepts can all be interpreted as a mandate to build a unique set of re- sources and capabilities. However, this must be done with a sharp eye on the dynamic industry context and competitive situation, rigorously applying market tests to those resources. Strategy that blends two powerful sets of insights about capabilities and competition represents an enduring logic that transcends management fads.

Set up the Business Model to link Value Creation and Value Capture and create a Virtuous Cycle

Determine the Business Model

The Business Model indicates how value creation and competitive advantage are related to value capture. The Business Model is a dynamic expression of these relations. Developing the Business Model is becoming critical in many businesses:

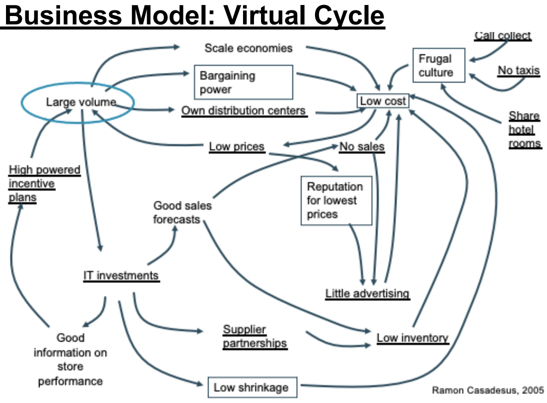
- 2 sided markets: newspapers and magazines with advertisers and subscribers; search engines as google with search and advertising
    - I create value for customers but how do I capture this value? Every business model of those newspapers is different: they think about creating value and capturing value.
- iPhone: in US telecom operators paying for data transfer
    - deal with ATT, they wanted a % of how much data is transferred through the iPhone. So, they made the iPhone cheaper but on the other hand they charged ATT for those data transfers. Thinking creatively of how we can capture part of this value!
- Music sales and concerts
- BIG idea company or Troc: intermediary

- The Business Model has implications for Margins, Capital Utilization, Working Capital and Capital Investments and Growth, i.e. Enterprise Value
    - The business model has an impact on different elements from Enterprise value

Think here about the Ducati Case!

- A Business Model consists of **Choices** that management has made.
    - Policy choices: how to operate?
    - Asset choices
    - Governance choices: who decides what & who get incentivized to do what?
- and **Consequences** of these choice
- Successful Business Models generate **virtuous cycles** or **feed-back loops** that are self-reinforcing
- However, the virtuous cycle might turn **vicious** if the whole dynamic stops.

<u>Example Walmart (Retail) Business Model: Virtual Cycle</u>



- Basic loop: large volume creates scale economies; this creates low costs.
- Important step: low-cost leads to low prices, leads to large volume this also gives better bargaining power …. A loop. If you have large volume, you can make big IT investments. If I make big IT investments, I have good sales forecasts then what I put into inventory gets sold, …. Then back into our cycle.
- IT investments → sales (things in stock that are not selling) → no sales → no need for advertising …

Allot of the things companies do we can put it into this model.

Innovation, Cost and Sustainability
Walmart says:
*"Today's new square or case-less milk jugs do not require crates or racks for shipping and storage. Instead, the newly designed milk gallon is self stacking because the spout is flatter and each gallon can rest on another during transport, as well as while on display. It's estimated trucks used for **shipping** from the processor to club can accommodate **9% more milk -- 4,704 gallons per truck or approximately 384 more jugs** -- without any metal racks.* In addition, the flat top and wider spout do not come in contact with other equipment during filling reducing the risk of possible contamination. At a time when the impact of food inflation appears on every grocery receipt, the new case-less jug also delivers a **cost savings of 10 to 20 cents**."*

<u>Example Ryanair "Business Model"</u>
Per Passenger Service and Ancillary Revenue and Costs (2019)
If Ryanair just would go with the flight, they would not be profitable, so it is critical for them to have other revenue sources. Their business model is going from creating value from the flight but also capturing the value in different ways.
How long can Ryanair keep on growing? They are exploring a wide range of options (standing room, free tickets with nothing else free). Right now, the flights are not even covering the costs. The extra are what they make money out of (luggage fees, …).

<u>Example Spotify</u>
What is Spotify's
1. Value System?
2. Business Model?

Spotify is playing in this whole field; value is created. But can Spotify capture some of that value? We need to think about the business model: the link between creating value and how you capture part of that.

Subscription version VS advertising supporting version.
The business model of Spotify: we try to move people from the free version to the paid version to capture some of that value. You need to be creative in how to capture value.

Will Spotify ever make money?
- What is the cost of sales? The license fee they have.
- Today, still not clear whether they will make money. It will be very hard. But it will survive because otherwise where would people get their music?

Over time everybody is streaming now. Who is capturing this value? Labels start to IPO. The money goes actually to the company who is owning the music. Think about the value system, different systems. Where does the value end up being captured

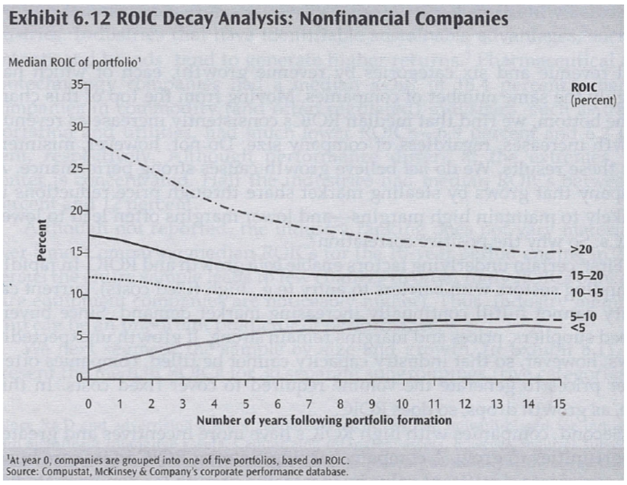
Developing a Sustainable Competitive Advantage
1. *Understanding the Competitive Landscape (topic 3)*
2. *Define the Scope of your Business (topic 4)*
3. *Select the Activity set of your Business (topic 4)*
4. *Assemble the needed Resources and develop the key Capabilities (topic 4)*
5. *Set up the Business Model to link Value Creation and Value Capture and create a Virtuous Cycle (topic 4)*
6. ***Understand the Sustainability of your Competitive Advantage***
7. ***Test your Strategy***

Topic 5: Sustaining competitive advantage

Understand the Sustainability of your Competitive Advantage

Are there any patterns in ROIC? Persistency? Above-average performance tends to subside toward the average much more rapidly than many managers assume.

They split all of the business of the different groups at time zero and the look at return on IC at time zero. Then they watch these groups over time. The question is, why is there a convergence? Ask Why this is happening? Competitive pressure → Imitation is a very important driver in this convergence. If you are on top today, you can expect over several years not be on top anymore. There are some extremes who stay on top but on average this is not the case.



Threats to Sustainability

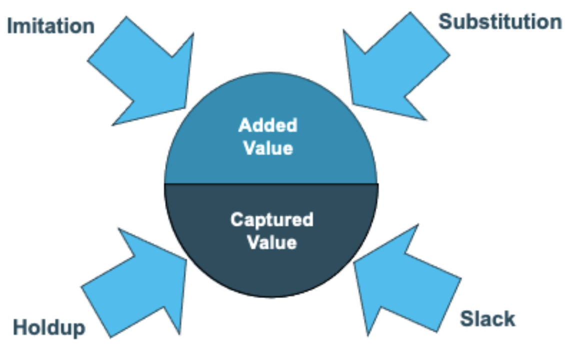
Classic reading: Chapter 5 Ghemawat

In classifying threats to sustainability, it is useful to split observed performance into two components: *industry-level performance effects* and *within-industry performance differentials*.

Superior performance that is sustained over the long term is due to stable i*ndustry-level effects*. Performance advantages over the competition tend to be less sustainable.

Commitments to durable and specialized resources (sticky resources) are generally needed to sustain *within-industry profit differences*. However, it is also important to look at the activities that a business performs because it is hard to value fixed inputs except in terms of the flows of services they generate. But for dynamic purposes, in our case understanding the determinants of sustainability, it is important to look at long-run factors. This involves shifting the focus from activities to underlying resources. In thinking whether resources will or will not sustain performance we need to distinguish between:

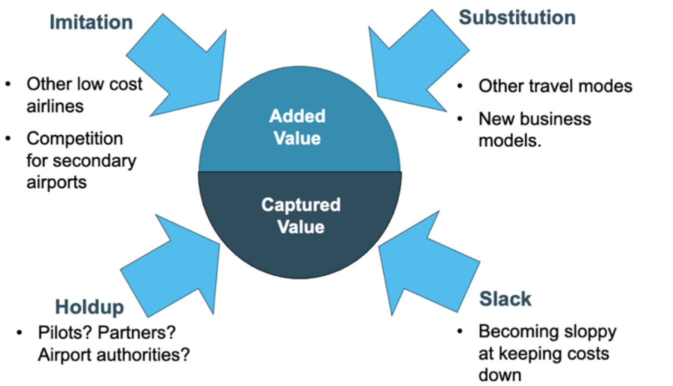
- Their **added or scarcity value** (related to competition): can be threatened by imitation and substitution
- Their **appropriability** (related to bargaining); can be threatened by slack and hold up → the sticky resources that underpin performance must continue to be *scarce* to sustain performance and the firm must be able to *appropriate* some of that sustainable scarcity or added value.



- Imitation: Rivalry & Entry → affects what we can capture from the value we create. Imitation of the resources underpins superior performance when the resources are no longer scarce which forms a **direct threat to the sustainability of added value**.
- Substitution → new ways of satisfying the same needs (we fly, or we take the bus = substitution). This is an **indirect threat to the sustainability of added value**, driven by displacement rather than duplication.
- Slack: is probably most important element (if you have an NGO). It is the **internal threat to the appropriation**, or value capture, that reflects a persistent tendency to dissipate potential economic surplus.
- Hold up: Buyers, Suppliers & Complementors. It is a **threat to the appropriation**, or capture, of sustainable added value that is often rooted in resource co-specialization.

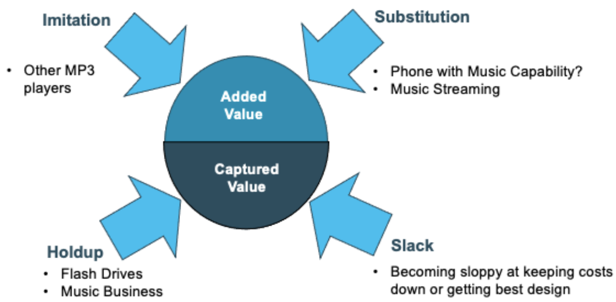
<u>Example: low-cost airlines</u>

- Imitation: Rivalry & Entry → important element was the secondary air pots: other Airlines had occupied these airports.
- Substitution: high speed trains for example, airline that went from Madrid to Barcelona lost allot of customers when a high speed train came from Madrid to Barcelona
- Hold up: Buyers, Suppliers & Complementors → when things go better in the airline business then you see strikes,…



<u>Example apple iPod</u>

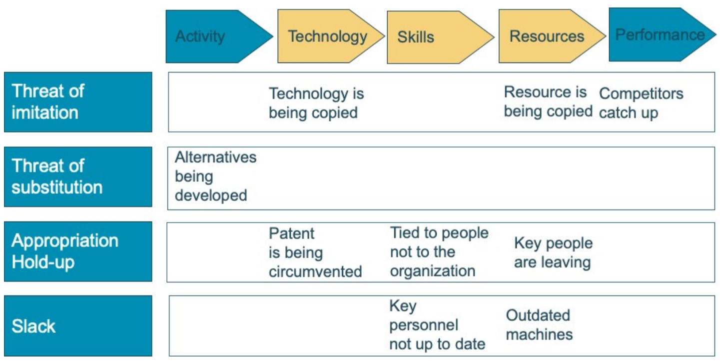
- Hold up: flash drives in iPod; it was new technology → what if there is not enough capacity of flash drives? Who will capture the value? → the manufacturers of flash drives. So, apple made a contract locking up 40% of the flash drive market.
- Imitation: trying to crowd the market with different versions. That's very different from what they did in computer industry where they only had one line.
- Substitution: iPhone



There are different ways to work against these treats (see below)

⇨ So, we see different elements that are threats to sustainability. If we want to sustain our business, we have to think about that ahead of time.

Evaluating the sustainability of a competitive advantage at capability level:



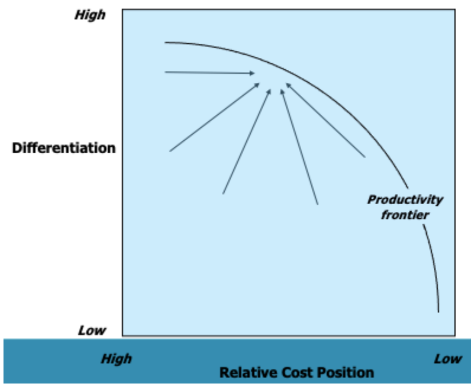
Bundling of capabilities increases sustainability because imitation becomes more difficult

Imitation: Apple vs Google disputes, Apple vs Samsung
Substitution: Store in the CLOUD vs Hard drive locally; hard copy (CD DVD) versus digital storage,
Appropriation: Steve Jobs gone, Consulting & Law Firms

If you get a case about sustaining competitive advantage, think about what you can do against that!

Imitation – Not being Different

Other companies will try to imitate what the top performers are doing, leading to many different players converging towards the same position in the industry, reducing monopoly opportunities. The threat of imitation has to be taken seriously even in contexts where barriers to imitation seem to be high.



- A gravitational tendency for firms to converge on a single position
    - Following the path of least resistance
    - Herd behavior
    - Risk aversion
- Leads to similar products, similar suppliers, full information
    - Closer to perfect competition

Barriers to imitation

- Economies of scale and scope → size economies
    - Scale economies: advantages of being large in a particular business at a particular point in time
    - Economies of learning by doing: advantages to being large in a particular business over time
    - Scope economies: advantages of being large across interrelated business
    - *If there are size economies a firm will be able to deter imitation by precommitting itself to exploiting them*
- Learning / private information
    - When superior information or knowledge can be kept private or that it is costly for imitators to tap into it, imitation will be limited
    - Privacy is most likely to be sustainable when information is tacit rather than specifiable an when no one party can carry it out of the organization
- Contracts and relationships / legal restrictions
    - Signing enforceable contracts or creating cultivating relationships that secure superior access to customers, suppliers or other important players.
- Network externalities / Switching costs
    - Creating switching costs that secure superior access to customers, suppliers or other important players.
- Threats of retaliation
    - For this threat to be credible it must be backed up by
        - the ability to retaliate this is facilitated by creating of a competitive advantage and by maintenance of resource reserves
        - the willingness to retaliate
    - the credibility is highest when it is payoff-maximizing for the retaliator
- Causal ambiguity/Social complexity/Complexity (hard to imitate/don't understand it fully)
    - This puts certain resources beyond the reach of systematic management and the challenges of achieving a cross-sectional fit or coherence across many choices
    - These complexities can explain barriers to imitation ex post but their implication for action ex ante are unclear
- Upgrading / Crowding the Market
    - Continuous upgrading of the organization's own added value → driving a wider wedge between customers' WTP and suppliers' opportunity costs over time

    - Upgrading makes a business a moving target in a way that compounds the difficulties or delays for potential imitators
    - Need to upgrade can be measured in the following way: track the rate at which an industry's real prices change over time → if the average prices decrease by more than a threshold rate it is a fast-cycle environment in which advantages tend to be short-lives rather than sustainable
- Imitation lags
    - Even if the barriers to imitation do not apply, imitation takes time.
    - Estimate of the average lead times in taking various types of actions will help underscore the importance of such lags.

Example Ryanair

- Grows fast and generates scale and scope
- Tie airport authorities to them by more favorable contracts
- Start price wars on particular routes
- Causal ambiguity: .9x.9x.9… for 20 activities 12% everything correct

Substitution

Substitution reduces the "demand" for what a firm uniquely provides by shifting the demand elsewhere

    - Due to changes in technology, customer needs, input prices, etc.
    - Provides higher WTP and / or lower costs to substantial segment of customer base
- Substitution threats can be subtle and unexpected *"Substitution is to imitation as bombardment is to forcing a door" (J. Schumpeter)*
    - Videoconferencing vs. Air Travel
    - On-line vs. Conventional Trading (Brick & Mortar)
    - Analog versus Digital Photography
    - Internal Combustion Engine versus Electric
    - Car sales versus car sharing
- For this reason, substitution is an especially effective way to attack dominant players
- Substitution is very difficult to predict.
- Substitution is sometimes a very good way to enter a business

Responses to substitution

- Do not respond
- Fight the threat
    - Incorporate their WTP benefits / cost reductions
    - Face up to your loss of uniqueness, and reduce price before the substitute gets a foothold
    - Further differentiate
    - Danger: threats may have fundamentally faster improvement dynamics
    - Defense can also be achieved by impairing the fundamentals of the competitors
- If you can't beat them, join them
    - Straddling: Responding to a substitution threat by establishing a foothold in both camps
        - Can be a transitional hedge or a log-term hedge
        - Can be balanced between the old and new or imbalanced
    - Or switching: it involves a wholesale shift to the substitute
    - Will you have a competitive advantage?
    - Will you <u>accelerate</u> undesirable cannibalization?
    - Will you face straddling problems?
        - Danger: excessive commitment to an old form of competition that may no longer be viable and an unwillingness to make though choices
- Take the money and run
- Migrating/harvesting
    - Migration: redeploying resources to uses that are less vulnerable to substitution threats or more attractive overall in light of them
    - Harvesting: a shift toward milking existing resources instead of building or even maintaining them

- Recombining
    - Recombining elements of existing ways of competing with some of the new possibilities implicit in substitution threats
- Leapfrogging
    - Trying to out substitute the substitution threat by looking for a performance improvement or value innovation that promises even better performance

Example Hub-and-Spoke airlines

- Fight with own low-cost airline
- Go “low cost”: cut service and amenities, drop prices, further differentiate. Only business class.
- Most straddlers lost a lot of money

Holdup

Others in the value chain/value system want their piece of the cake. Holdup diverts value to customers, suppliers, or complementors who have some bargaining leverage.

    - They have bargaining leverage because they have something you need and can’t get elsewhere (added value)
- Holdup is especially threatening when parties in a relationship have invested in assets that are specific to that relationship (so it’s hard to walk away): quasi-rent. For example:
    - An electric plant built at the mouth of a coal mine
    - Skills that are tailored to a particular employer

Responses to holdup

- Contractual arrangements
    - But contractual incompleteness limits this option
    - Completely comprehensive contracts enforceable at zero costs are impractical
- Multiple sourcing (make others *dispensabl*e)
    - But investments in relationship specific assets are important
- Vertical integration
- Tough negotiation
- Increasing (and using) bargaining power
    - It raises the risk of going too far in marginalizing suppliers to a point where the shrinkage in the size of the pie outweighs the increased share of the pier
- Build relationships / Trust
- Building mutual dependence
    - An example is interorganizational relationships where both sides build up their confidence in each other to the level where they are both willing to invest in a profit stream that would materialize only if they continued to work together.
        - This can only be self-sustaining if each player allocates sufficient large share of the gains from cooperation

Also important is that the broader context in which a business operates can create a different type of hold up threat: one reflecting unilateral expropriation rather than bargaining based on resource dependence or co-specialization.

Holdup is a systematic threat to the appropriability of added value that tend to be based on resource dependence or co-specialization. Strategic responses to holdup vary in the extent to which they emphasize competition versus cooperation.

Slack

A company may think it is doing fine because it is at the top but could crumble out of the blue because it was not paying attention. Slack: extent to which the value appropriated by a firm falls short of the amount potentially available: X-inefficiency = inefficiencies that can be improved. Slackis persistent suboptimization by a business that dissipates appropriable added value or even reduces added value over time

- Slack is hard to identify…but slack is thought to be large…
- Slack tends to be worse under certain conditions
    - Forgiving competitive environments
    - Settings in which managers must have wide discretion over productive processes

- Some slack are even needed to attract customers or for experimentation with new strategies and innovative projects

Responses to slack

- Monitoring of performance
    - The goal is to catch inappropriate behavior before it occurs or to decrease its attractiveness by increasing the probability of detection
    - Benchmarking
    - Time-motion studies
    - Outsiders on Boards
- Managerial incentives
    - Reward good behavior by rewarding good performance
    - Works well when the behavior of an individual is connected to the performance outcomes that are actually observed
    - In the past, on average, top executives got roughly $3.25 for each $1,000 of shareholder value created (Jensen & Murphy, 1990)
- Commitments to return cash to shareholders
    - E.g., dividends
- Appeals to a higher calling, a sense of mission (Culture)
    - Supplementing economic rewards or punishments with appeals to norms, values, a sense of mission, …
    - People in an organization are motivated by more than just rewards
- Generating information
    - The difficulty of measuring slack increases the importance of generating information about it
    - Benchmarking against direct competitors or best-in-class is useful
    - Simulation, experimentation or direct investigation
    - But we will have impacted information: one party if better informed than the other
- Bonding resources
    - It is a top-down approach
    - Agency cost of free cash flow: managers can pursue investments that destroy shareholder value when there is too much free cash flow available → increase the amount of debt to reduce the amount of free cash flow (with risk that company might be overloaded with debt)
- Changing governance
    - Top-down approach
    - Creating small but well-informed boards of directors, restricting the ability of CEOs to dominate those boards, requiring board members and top managers to own firm equity, …
- Mobilizing for change
    - Forcing change at the top (but is not sufficient method)

Example Apple iPod and sustainability

- Against **Imitation**:
    - New versions of iPod
    - Crowding the market (nano, shuffle, iPod, iPod (xGB), iPod video,…)
    - Continuous upgrading of applications
- Against **Substitution**:
    - Develop iPhone
- Against **Hold-up**:
    - Lock up 40% flash memory
    - Keep music business in check through DRM
- Against **Slack**:
    - High powered incentives management and employees
    - Exciting work environment
    - Secrecy and expectation in new product development

Monitoring targets incentives (ik weet niet of dit leerstof is)

Table 1

The Management Practice Dimensions

Categories	*Score from 1–5 based on:*
1) Introduction of modern manufacturing techniques	What aspects of manufacturing have been formally introduced, including just-in-time delivery from suppliers, autonomation, flexible manpower, support systems, attitudes, and behavior?
2) Rationale for introduction of modern manufacturing techniques	Were modern manufacturing techniques adopted just because others were using them, or are they linked to meeting business objectives like reducing costs and improving quality?
3) Process problem documentation	Are process improvements made only when problems arise, or are they actively sought out for continuous improvement as part of a normal business process?
4) Performance tracking	Is tracking ad hoc and incomplete, or is performance continually tracked and communicated to all staff?
5) Performance review	Is performance reviewed infrequently and only on a success/failure scale, or is performance reviewed continually with an expectation of continuous improvement?
6) Performance dialogue	In review/performance conversations, to what extent is the purpose, data, agenda, and follow-up steps (like coaching) clear to all parties?
7) Consequence management	To what extent does failure to achieve agreed objectives carry consequences, which can include retraining or reassignment to other jobs?
8) Target balance	Are the goals exclusively financial, or is there a balance of financial and nonfinancial targets?
9) Target interconnection	Are goals based on accounting value, or are they based on shareholder value in a way that works through business units and ultimately is connected to individual performance expectations?
10) Target time horizon	Does top management focus mainly on the short term, or does it visualize short-term targets as a "staircase" toward the main focus on long-term goals?
11) Targets are stretching	Are goals too easy to achieve, especially for some "sacred cows" areas of the firm, or are goals demanding but attainable for all parts of the firm?
12) Performance clarity	Are performance measures ill-defined, poorly understood, and private, or are they well-defined, clearly communicated, and made public?
13) Managing human capital	To what extent are senior managers evaluated and held accountable for attracting, retaining, and developing talent throughout the organization?
14) Rewarding high performance	To what extent are people in the firm rewarded equally irrespective of performance level, or are rewards related to performance and effort?
15) Removing poor performers	Are poor performers rarely removed, or are they retrained and/or moved into different roles or out of the company as soon as the weakness is identified?
16) Promoting high performers	Are people promoted mainly on the basis of tenure, or does the firm actively identify, develop, and promote its top performers?
17) Attracting human capital	Do competitors offer stronger reasons for talented people to join their companies, or does a firm provide a wide range of reasons to encourage talented people to join?
18) Retaining human capital	Does the firm do relatively little to retain top talent or do whatever it takes to retain top talent when they look likely to leave?

Note: The full set of questions that are asked to score each dimension are included in Bloom and Van Reenen (2006).

Test your Strategy

1. *Internal* consistency – coherence
2. *External* consistency – coherence
3. *Dynamic* consistency

Internal consistency – coherence

Do the elements of the strategy fit well with each other? Are there <u>complementarities</u> between the different elements of the strategy?

- Does your *scope* match your activities, your resources and capabilities?
- Do your *activities* all reinforce your competitive advantage?
- Are you developing *resources and capabilities* that fit and reinforce your competitive advantage?

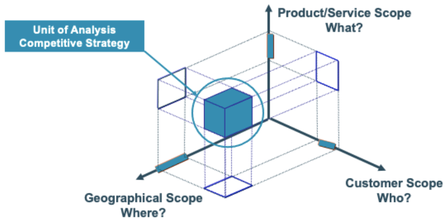
Scope Consistent

- Green yard Foods: frozen, local produce, price conscious customer
- Lunch Gardens: not you as a customer!
- Ryanair Scope:
  - Tourists
  - Price conscious, point-to-point flights,
  - Secondary airports
- Walmart Scope:
  - price conscious, low-middle income buyer
  - range of products
  - suburbs and smaller towns
- Ryanair Activities: all focus on Low Costs
- Walmart Activities: all focus on Low Costs

  → Both companies have a low-cost strategy consistent with scope.

  →Resources and Capabilities all focused on Low Costs.

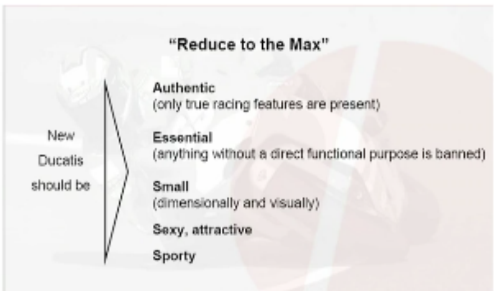
Defining Scope of a Business (recap)



The value chain

Company must be broken down in activities in order to identify the drivers of competitive advantage

Think about the ducati case:



External consistency – coherence

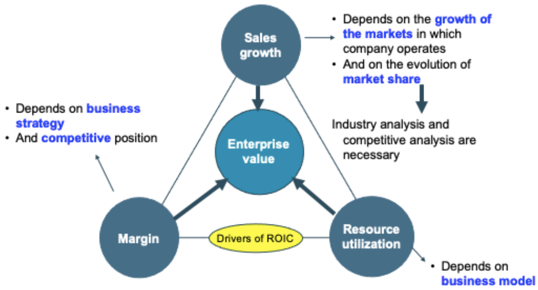
- Does the strategy neutralize the threats posed by the external environment? Does it take advantage of the opportunities?
- Objective:
  - Neutralize the pressures on value capture of rivals, potential entrants, substitutes, buyers and suppliers
    - Very competitive industry (retailing and airlines)
    - Size/Monopoly neutralizes several factors.
    - Neutralize Supplier power.
  - Take advantage of opportunities provided by complementors
    - Hard for entrants and substitutes to get footing if you are constantly reducing costs.

Dynamic consistency

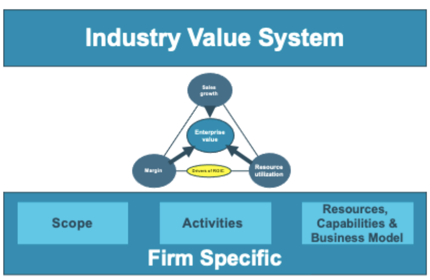
- Is the strategy set up to help sustain competitive advantage over time?
- Objective: Neutralize the threats to sustainability of competitive advantage
  - Imitation
  - Substitution
  - Hold up
  - Slack

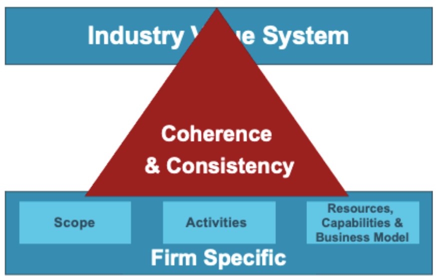
Topic 6: Putting it all together

The keys to capturing value



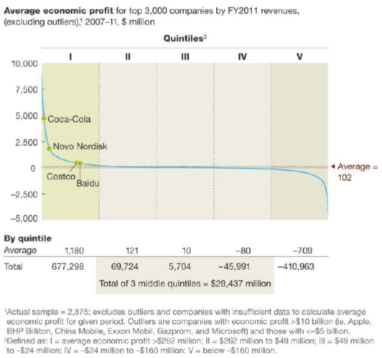
Strategy and the Drivers of Enterprise Value





→ If you get a case think about these different elements. But the left one is static → think about coherence and consistency

Distribution of Economic Profit



The Odds of Moving up after a Decade

		Ending Position On Power Curve		
		Bottom	Middle	Top
Starting Position On Power Curve	Top	15	26	59
	Middle	14	78	8
	Bottom	43	40	17

Classic reading: Have you tested your strategy lately

Strategy is a way of thinking, not a procedural exercise or a set of frameworks. To stimulate that thinking and the dialogue that goes along with it, we will discuss a set of tests aimed at helping executives assess the strength of their strategies.

We focused on testing the strategy itself rather than the frameworks, tools, and approaches that generate strategies because:

- companies develop strategy in many different ways, often idiosyncratic to their organizations, people, and markets
- many strategies emerge over time rather than from a process of deliberate formulation

Test 1: Will your strategy beat the market?

All companies operate in markets surrounded by customers, suppliers, competitors, substitutes, and potential entrants, all seeking to advance their own positions. That process drives **economic surplus** (the gap between the return a company earns and its cost of capital) toward zero.

For a company to beat the market by capturing and retaining an economic surplus, there must be an **imperfection** that stops or at least slows the working of the market. An imperfection controlled by a company is a **competitive advantage**.

- These are scarce and fleeting because markets drive reversion to mean performance.
- The best companies are emulated by those in the middle, and the worst exit or undergo significant reform.
- Each player responds to and learns from the actions of others → best practice becomes commonplace rather than a market-beating strategy.

⇨ Good strategies emphasize difference—versus your direct competitors, versus potential substitutes, and versus potential entrants.

The evolution of markets is path dependent (its current state at any one time is the sum product of all previous events, including a great many random ones) → the winners of today are often the accidents of history.

To beat the market advantages, have to be robust and responsive in the face of onrushing market forces.

Test 2: Does your strategy tap a true source of advantage?

Know your competitive advantage! Competitive advantage stems from two sources of scarcity: positional advantages and special capabilities.

- **Positional advantages** are rooted in structurally attractive markets.
    - Such advantages favor incumbents: they create an asymmetry between those inside and those outside high walls.
    - Also, understanding the relationship among structure, conduct, and performance is a critical part of the quest for positional advantage.
- **Special capabilities** are scarce resources whose possession confers unique benefits.
    - "Privileged, tradable assets": they can be bought and sold.
    - "Distinctive competencies": consists of things a company does particularly well, such as innovating or managing stakeholders. These capabilities can be just as powerful in creating advantage but cannot be easily traded.
    - Such a capability must be critical to a company's profits and exist in abundance within it while being scarce outside. As such, special capabilities tend to be specific in nature and few in number.
    - Companies mistake size for scale advantage or overestimating their ability to leverage capabilities across markets. Companies should test any claimed capability advantage vigorously before pinning their hopes on it.

→ When companies bundle together activities that collectively create advantage, it becomes more difficult for competitors to identify and replicate its exact source.

→ Don't forget to take a dynamic view. What can erode positional advantage? Which special capabilities are becoming vulnerable? There is every reason to believe that competitors will exploit points of vulnerability.

Test 3: Is your strategy granular about where to compete?

The need to beat the market begs the question of *which market*. The unit of analysis used in determining strategy significantly influences resource allocation and thus the likelihood of success: dividing the same businesses in different ways leads to strikingly different capital allocations.

What is the right level of granularity? Push within reason for the finest possible objective segmentation of the market.

Defining and understanding these segments correctly is one of the most practical things a company can do to improve its strategy. Management at one large bank attributed fast growth and share gains to measurably superior customer perceptions and satisfaction.

In fact, 80 percent of the variance in revenue growth is explained by choices about where to compete, leaving only 20 percent explained by choices about how to compete. Unfortunately, this is the exact opposite of the allocation of time and effort in a typical strategy-development process. Companies should be shifting their attention greatly toward the "where" and should strive to outposition competitors by regularly reallocating resources as opportunities shift within and between segments.

Test 4: Does your strategy put you ahead of trends?

The emergence of new trends is the norm. But many strategies place too much weight on the continuation of the status quo because they extrapolate from the past three to five years, a time frame too brief to capture the true violence of market forces.

Most trends emerge fairly slowly—so slowly that companies generally fail to respond until a trend hits profits. Managers typically delay action, held back by sunk costs, an unwillingness to cannibalize a legacy business, or an attachment to yesterday's formula for success. For companies that get ahead of the curve, major market transitions are an opportunity to rethink their commitments in areas ranging from technology to distribution and to tailor their strategies to the new environment.

Strategists must take trend analysis seriously. To see which trends really matter, assess their potential impact on the financial position of your company and articulate the decisions you would make differently if that outcome were certain.

Test 5: Does your strategy rest on privileged insights?

Data today can be cheap, accessible, and easily assembled into detailed analyses that leave executives with the comfortable feeling of possessing an informed strategy. But much of this is noise and most of it is widely available to rivals. Furthermore, routinely analyzing readily available data diverts attention from where insight-creating advantage lies: in the weak signals buried in the noise.

Developing proprietary insights isn't easy. In fact, this is the element of good strategy where most companies stumble. A search for problems can help you get started. Create a short list of questions whose answers would have major implications for the company's strategy. In doing so, don't forget to examine the assumptions, explicit and implicit, behind an established business model.

Another key is to collect new data through field observations or research rather than to recycle the same industry reports everyone else uses. Similarly, seeking novel ways to analyze the data can generate powerful new insights.

Many strategic breakthroughs have their root in a simple but profound customer insight: companies that go out of their way to experience the world from the customer's perspective routinely develop better strategies.

Test 6: Does your strategy embrace uncertainty?
A central challenge of strategy is that we have to make choices now, but the payoffs occur in a future environment we cannot fully know or control. A critical step in embracing uncertainty is to try to characterize exactly what variety of it you face → four levels of uncertainty.

1. Level one offers a reasonably clear view of the future: a range of outcomes tight enough to support a firm decision.
2. At level two, there are a number of identifiable outcomes for which a company should prepare.
3. At level three, the possible outcomes are represented not by a set of points but by a range that can be understood as a probability distribution.
4. Level four features total ambiguity, where even the distribution of outcomes is unknown.

Rigorously understanding the uncertainty you face starts with listing the variables that would influence a strategic decision and prioritizing them according to their impact. Focus early analysis on removing as much uncertainty as you can and using the underlying economics at work to highlight outcomes that are either mutually reinforcing or unlikely because they would undermine one another in the market. Then apply tools such as scenario analysis to the remaining, irreducible uncertainty, which should be at the heart of your strategy.

Test 7: Does your strategy balance commitment and flexibility?
Commitment and flexibility exist in inverse proportion to each other: the greater the commitment you make, the less flexibility remains. This tension is **one of the core challenges** of strategy.

Strategy can be expressed as making the right trade-offs over time between commitment and flexibility. Making such trade-offs effectively requires an understanding of which decisions involve commitment. Strategic decisions are those that involve commitment through hard-to-reverse investments in long-lasting, company-specific assets. Commitment is the only path to **sustainable competitive advantage**.

In a world of uncertainty, strategy is about not just where and how to compete but also when. Committing too early can be a leap in the dark but being too late is also dangerous.

Flexibility is the essential ingredient that allows companies to make commitments when the risk/return trade-off seems most advantageous.

A market-beating strategy will focus on just a few crucial, high-commitment choices to be made now, while leaving flexibility for other such choices to be made over time. In practice, this approach means building your strategy as a portfolio comprising three things: big bets, or committed positions aimed at gaining significant competitive advantage; no-regrets moves, which will pay off whatever happens; and real options, or actions that involve relatively low costs now but can be elevated to a higher level of commitment as changing conditions warrant.

Test 8: Is your strategy contaminated by bias?
It's possible to believe honestly that you have a market-beating strategy when, in fact, you don't. Sometimes, that's because forces beyond your control change. But in other cases, the cause is unintentional fuzzy thinking.

Behavioral economists have identified many characteristics of the brain that are often strengths in our broader, personal environment but that can work against us in the world of business decision making. *Examples: overoptimism, anchoring, loss aversion, the confirmation bias, herding, and the champion bias.*

Strategy is especially prone to faulty logic because it relies on extrapolating ways to win in the future from a complex set of factors observed today → two big inference problems: attribution error and survivorship bias.

- *Attribution error is the false attribution of success to observed factors; it is strategy by hindsight and assumes that replicating the actions of another company will lead to similar results.*

- *Survivorship bias refers to an analysis based on a surviving population, without consideration of those who did not live to tell their tale: this approach skews our view of what caused success and presents no insights into what might cause failure*

Developing multiple hypotheses and potential solutions to choose among is one way to “de-bias” decision making. The decision-making process can also be de-biased by, for example, specifying objective decision criteria in advance and examining the possibility of being wrong.

Test 9: Is there conviction to act on your strategy?

This test and the one that follows aren’t strictly about the strategy itself but about the investment you’ve made in implementing it. Many good strategies fall short in implementation because of an absence of conviction in the organization, particularly among the top team, where just one or two non-believers can strangle strategic change at birth.

Where a change of strategy is needed, that is usually because changes in the external environment have rendered obsolete the assumptions underlying a company’s earlier strategy. To move ahead with implementation, you need a process that openly questions the old assumptions and allows managers to develop a new set of beliefs in tune with the new situation.

CEOs and boards must make sure that the whole team actually shares the new beliefs that support the strategy. This requirement means taking decision makers on a journey of discovery by creating experiences that will help them viscerally grasp mismatches that may exist between what the new strategy requires and the actions and behavior that have brought them success for many years.

Test 10: Have you translated your strategy into an action plan?

In implementing any new strategy, it’s imperative to define clearly what you are moving *from* and where you are moving *to* with respect to your company’s business model, organization, and capabilities. Develop a detailed view of the shifts required to make the move, and ensure that processes and mechanisms, for which individual executives must be accountable, are in place to effect the changes → this is an action plan.

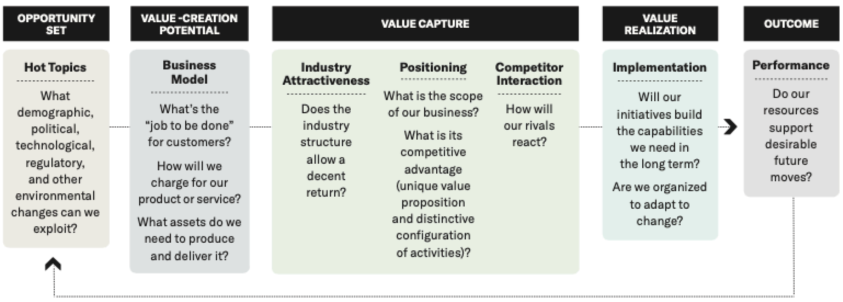
Finally, don’t forget to make sure your ongoing resource allocation processes are aligned with your strategy.

Classic reading: Why do so many strategies fail?

In today’s volatile and uncertain world, corporations that have dominated their markets for decades can be blindsided by upstarts with radical new business models, miss the boat on emerging technologies, or be outflanked by competitors that are more adept at shaping consumer preferences.

All too often those failures occur because the CEOs’ approach to strategy isn’t **holistic**. At many innovative new businesses, CEOs excel at identifying ways to <u>*generate*</u> value but don’t analyze what it would take to <u>*capture*</u> a sufficient portion of that value.

Leaders of traditional corporations tend to make different mistakes. These leaders either ignore some components of the **complete strategy landscape** or don’t recognize the interdependencies among them.



Today a **complete strategy** has to encompass carefully coordinated choices about the business model with the highest potential to create value, the competitive position that captures as much of that value as possible, and the implementation processes that adapt constantly to the changing environment while building the capabilities needed to realize value over the long term. CEOs must develop an approach that integrates *all* those elements. To do that, they have to take the following actions:

Identify opportunities. This involves continually taking stock of what's happening in the outside world. These changes and trends open up possibilities for firms to exploit.

Define the best way to tap a given opportunity. To translate an opportunity into strategy, CEOs need to develop a business model that maximizes the potential value of their offering. The model should:

- describe the "job to be done" for customers, which affects their willingness to pay for the product or service and the size of its possible market
- spell out the configuration of the assets that will be used to produce and deliver the offering and the monetization method
- suggest how the value produced might be distributed among the players pursuing it and key aspects of possible strategies

Figure out how to capture the value generated in the near term. This requires designing a strong competitive position. To do that the CEO has to assess three things:

- *Industry's attractiveness:* Regardless of the value created, an industry will be attractive only if its structure allows participants to earn decent returns.
- *Competitive positioning:* Identifying a unique value proposition for a defined customer group and a distinctive configuration of activities is still the way to build an advantage that allows you to outperform the industry's average rate of return
- *Competitive interaction:* To assess the sustainability of any advantage, you must predict how interactions among rivals will play out.

Realize value over time. To keep capturing value, a firm needs to constantly adapt how it implements its strategy— adjusting its activities and building new capabilities as the external environment changes.
Build a foundation for long-term success. The firm's strategic choices and its interaction with competitors ultimately determine its financial performance and, critically, the resources it has to build assets and capabilities that support future moves.

⇨ Developing strategy across the complete landscape **isn't a linear process;** it should be continuous and iterative.

The Incumbent's mistake
CEOs of established companies often pay too much attention to defining how their firms will capture value and too little to new ways to create value and how firms' activities and capabilities need to evolve over time. One reason is that approaches focusing on capture (like the five forces) have been very successful in long-established and stable industries and as a result have become ingrained in the strategy process.

Discovering and exploiting new business models to satisfy previously unmet, unexpressed, or even unknown customer needs is where the action has been in recent years. The good news for leaders of incumbent companies is that if they take a holistic perspective on strategy, they may discover that those business models present attractive opportunities because they create more value.

No incumbent should respond to every new business model. Instead, a firm must develop a strategic approach to identifying the value-creation potential of models and then determine whether to pursue any new ones by predicting the outcome of competition among alternative models.

The entrepreneur's mistake

In their excitement to exploit new opportunities they spotted before anyone else, many entrepreneurs fail to see that the more value their business model creates, the more competition they're likely to face.

When a firm is pursuing a successful new business model against intense competition, it's vital to apply the three value-capture frameworks in the middle of the landscape—industry attractiveness, competitive positioning, and competitive interaction.
To capture sufficient value, a firm has to be in an industry with an attractive structure and possess a sustainable competitive advantage. If you simply cannot achieve operational efficiencies, you are condemned to fail, regardless of how exciting your business model is.

Implementation: the key to realizing value over time

Identifying a viable business model and a distinctive competitive position that captures value today doesn't ensure success when companies confront ever-changing opportunities. To realize value over the long term, firms have to balance agility and control, by giving project teams the authority to experiment with new configurations while consistently investing in the capabilities needed for the future.

The challenge for established companies often is not designing a completely new competitive position but supporting entrepreneurial activity that drives incremental but continual improvement.

It's in developing plans to realign the firm's activities that strategy plays out every day—not in its initial grand design. These adaptations are fundamentally strategic because they cut across functions inside the firm and require systemic change.

Conversely, entrepreneurs can fail by too frequently adjusting their product-market fit in response to the latest consumer test, which undermines their ability to build the organizational capabilities required for long-term success.

The solution for both established and young companies is a strategic approach that champions experimentation within bounds clearly established by the CEO. Each exploratory project should have a clear, objective process, a timetable, metrics, milestones that trigger cutoff decisions, and after-action reviews.

- Control is maintained first through adherence to a well-articulated and well-communicated "classic" strategy that clarifies how the firm will outperform competitors pursuing the same business model.
    - Hidden in this part of the strategy landscape is a source of competitive advantage that capitalizes on the interdependency of its elements. Strategic adaptation must become an ongoing, iterative process of hypothesis, experimentation, learning, and action.
- The second control mechanism lies in selection of the tactical projects pursued: the CEO must be able to see through the fog of immediate pressures and identify and support a limited number of long-term initiatives that will guide the individual experiments. Typically, these become "corporate" initiatives → broad themes that govern the sequence, selection, and design of multiple projects.
    - These broad initiatives should be manageable in number so that each can be adequately funded, monitored, and continually promoted.
    - They cannot change regularly

These higher-level strategic programs must be owned and championed by the CEO. Only the firm's top leader has the perspective and authority to ensure there's enough investment in building the capabilities they'll require.

It is the outcome of these "must-win" battles that determines long-run success. Though these broad themes or initiatives are not corporate strategies—as they are often mistakenly called—their pursuit is an essential part of a complete strategy.

The need for integration across the landscape

The **most important lesson** is that to craft a resilient strategy, companies of all sizes must integrate all the elements of the complete strategy landscape. While not disregarding how critical competitive positioning is to value capture, an effective strategy process must begin with a creative and open-ended discussion of the value potential of alternative business models and finish with an approach to execution that guides ongoing experimentation and operational adaptation while investing in underlying capabilities.

Strategy has always been about aligning the organization behind a clear direction. Today it must be broadened to become an integrated set of choices about the business model, competitive positioning, and capabilities required for long-term success. By managing the complete strategy landscape, CEOs of young ventures will greatly increase the odds that their firms won't crash and burn, and leaders of established companies will ensure that they continually renew themselves.

Guest lectures – LPQ, Kom op tegen kanker & BNP Paribas

Bekijk ppt samen met deze notities voor elke gastles

Le Pain Quotidien

Established by a Michelin star chef in BE.
Vegan products were on shelves from 2004. No canned soft drinks. No smoking allowed well before the ban in EU. 2007-2017 development of owned and franchised stores. Around 12% a year growth.

- ➢ Until this day → le pain quotidien founder still has a creative role in the company and steers direction in which they go.
- ➢ In 2017 we saw signals of a slow-down. The company missed the boat-focused on opening new stores while missing out product development. Wage increases also hit hard-as a high-end company they did not efficiently managed labor costs.
- ➢ PQ kinda missed the boat for loyalty customers → focused more on development of stores in different countries.
    - ○ kinda forgot about product development
    - ○ didn't focus on customer development and loyalty → market is developing though
    - ○ PQ did not take this as a focus point → instead looked at different stores around the world.
- ➢ productivity in the restaurant was not the best.
    - ○ did not manage the leases of their stores very well (UK and USA) → rent increases were too high and not good.
    - ○ CEO was with the company for a little too long → goals and strategy were not aligned.
    - ○ (2017) Also there was a change of CEO (new CEO from BK) who had a p.o.v. that aligned more with fast-food business (changed the whole management team as well). Many of the best store managers were replaced which made store management problematic. He also changed the supply chain closing down the production and contacting with a wholesale company who would deliver products to stores. With these changes EBITDA dropped from EUR 10 M to EUR-15M in 1.5 years.
        - ■ came the new CEO from Burger King, **BUT:** did not manage the people → only looked at cost management.
            - ● did it way too fast and not in the right way → on paper looks good what he did, **BUT:** in reality: was way too quick **>>>** first have to learn from the people before you can start making changes and get the best out of them.
            - ● management in stores decreased **>>> NO** longer had higher up support → so they quit.
        - ■ **TOO FAST INTEGRATION** (same with production process)
- ➢ CEO changed a lot without management behind him → caused all his implementations to fail.
    - ○ Each manager has its own area of expertise to help you with management of PQ.
- ➢ (2020) Management came up with a recovery plan to sell the company. Company was over-leveraged Net debt/EBITDA increased from 3 to 10 by 2018. Management team was also spread across different countries this became a challenge during Covid in terms of bringing the team together to discuss. March 2020-filed chapter 11 (restructuring) while UK and US branches went bankrupt.

- ➢ So the debt of PQ was way too high and equity was also way too high → had to change something or PQ would go bankrupt.
    - The company was overleveraged.
    - Even if they wanted to save the company and sell it → trust between management and shareholders was completely lost.
        - management was very spread out → does **NOT** work especially when they constantly have to work together and discuss business.
- ➢ Global transformation
    - Use OGSM system
        - objective
        - goals
        - strategies
        - management
- ➢ (2020)PE: New management team (including the guest speaker CEO). They went for a transformation and leverage optimization (2026 vision-PE usually stays 5 years and sells out). Global transformation scheme for every department. This exercise is done each year.
    - They all have the same goal → very good system to get your team aligned.
    - helps achieve what you want → is an exercise that is done every year to ensure every department remains aligned.
    - need to ensure that every aspect of every branch in every country is aligned → otherwise you cannot succeed as a global company **>>> BRAND DNA:**
        - can have some things different, **BUT:** majority needs to be similar across borders.
        - got to find out what is important to the brand + is necessary in each country.
            - brand DNA redefined: define what is important (e.g.: fresh baked bread, local products etc.)
            - new logo
            - brand standards: defining store outlook for each type
            - loyalty/marketing plan-loyalty card
            - consumer insight: who are the clients? Why do they come to LPQ? this is different for each country
    - brand needed to transform to one cohesive company.
        - logo needed to be streamlined + be more universal.
        - same with the photography, tone of voice and publicity of the company.
        - food information included
    - **SEE PWP SLIDE ABOUT DIGITAL CAMPAIGN**.
    - she mostly reads info from powerpoint
- ➢ clients in different countries have different needs → need to adapt to each country to client support (very recent like week ago recent)

F&B:

- identification of focus products (bakery, hot snacks, coffee)
- menu standardization (e.g.: avocado toast in same format everywhere)
- pricing: went from cost pricing to value pricing (what are people willing to pay for the product).
- also price changes based on stores (e.g. more expensive in airports)

PEOPLE:

- emphasis in employee quality and culture
- teach employees: why do we exist/who are we/what do we do/how do we do it
- trying to reduce employee turnover rate

EXPANSION:

- Grow franchisees
- Launch new markets and expand into new cities
- deepen the relationship with existing franchisees
- during covid a few market expansion and retention of existing franchisees

IT&SECURITY-ECOMMERCE:

- Security of data

- Company standard systems

EFFICIENCY:
- 2023 plan: order and pay at the table

Guest lecture Kom op tegen kanker

How 'Stand up to Cancer' stand up to cancer

The power of ideas → With ideas we can move forward

Can we combine the creativity of communication? Can we combine it towards a more value-oriented world in social profit? → both result and value oriented → they achieved this

Stand up to cancer – HISTORY
- founded in 1989 by Kathy Lindekens
- 100% independent, no grants, 80 employees, 500 care volunteers, thousands of campaigners
- chairman Jean-Jacques Cassiman, campaign leader: Frank Deboosere, CEO: Marc Michils
- corporate governance: maximum transparency, patients, care volunteers and campaigners in board

KOTK is not financially supported by the government: they have to do campaigns to raise money.

Corporate governance: what is at stake with a social brand is the credibility → you have to be very transparent in what you do with the money. Allot of communication efforts is about what we do with the money and what do we support.
It also means that in the way we work we absolutely invite cancer patients and volunteers in participating in what we do. It is a bottom-up organization where patients, volunteers and campaigners have an important voice in what we decide.

Stand up to cancer includes 1000s of volunteers who support this organization.

The challenge: how combine profit and social profit? How combine results and values-oriented philosophy? We had to move from more result to value-oriented approach: what is the target group? What do you want to reach with this approach?

Combine results and values
- From passive (gifts) to active marketing (create products/events): passive with just gifts without creating connections to active with events where people could participate –> more experience-oriented.
- From compassion to respect, optimism and humor: as an organization we have to bring in optimism and hope, it's also about compassion but also at the same time optimism and hope.
- From adult-children to adult-adult relationship between Stand up to Cancer and volunteers/cancer patients (participation): the relationship between the organization, volunteers and patients is not adult-children, we invite them to participate and have a adult-adult conversation. We listen to their opinion, also to look at which kind of research we have to do.
- From output (number of activities) to impact (survival rate, better life during/after cancer): this was new for people of stand up to cancer. The question what is the impact of what we are doing?

Building a social profit brand
1) The organizing idea: what is the big idea of the company? What is the emotion that gets us moving?
2) Mobilize people: how do we get value together?
3) Credibility: explain what you do with the money and make sure you are a credible brand
4) Bottom up: let all the stakeholders participate
5) Thinking and doing you need a strategy to think, but in certain moments in time you just have to just do.

The essential difference between emotion and reason is that emotion, leads to action, while reason leads to conclusions

1) The organizing idea

If you want to move things forward, you have to do it by getting in touch with the right <u>emotions</u> to make people move. You need also a reason, …

A real strong brand is strong on respect ratio, … then you have a landmark.

Encourages creativity	Fuels every child's imagination	Cultivates and celebrates the art of writing	Sees through the eyes of a baby	We live to deliver

You have to talk with your consumers to really understand what this is about.

The tagline of this organization: "one day we will beat cancer".
→ this is their dream.
"One day we will beat cancer, help us make it sooner".

This emotion, the why from our organization, it is not enough you have to fill it in and really explain what you are doing to get there. What we do in reality, is we are doing allot of things in the field of prevention, fighting, caring cancer patients and mobilizing people. It's not so easy to find and to get to the real essence of what you are doing.

2) Mobilise people

The 1000km emotionally

- Healthy mix of sport, fundraising, entertainment, experience
- 'doing something' much stronger than a gift
- good feeling: give > receive
- big solidarity event, no matter age, origin, social class
- makes Stand up to Cancer local nearby, human
- ... and is a big moneymaker

It's a platform where people can support cancer patients. It's not only about fundraising but about sport, entertainment, … its much stronger than a gift. This is active, this is experience. Its about solidarity. It's about human stories. The human factor is really important.

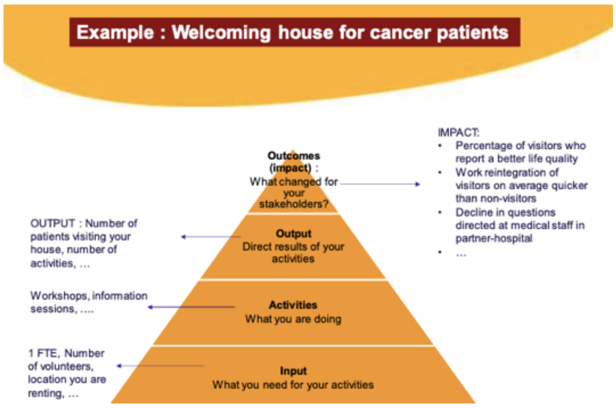
In those campaigns we tell personal stories, and these stories gets the money together. They also bring in some rational elements.

3) Credibility

Research: we communicate allot about the research we do, we are funding.
Influencing policy: every time they have an opportunity to show what they are doing with their research they do it. Also important is to see what they are doing to influence policy. Go to ministers and present what should be done for cancer patients. So influencing that cancer patients are better of in this society and supported by the government.
→ Files: cancerafter-care, working after cancer, bad news conversations, breast reconstruction costs, pain, care givers, financial problems, ...

From output to impact

If we can show the impact and really demonstrate the impact than that means that we are moving forward. Trying to clearly set the objectives of this project and then see if we are realizing the impact and objective we have been defining before.



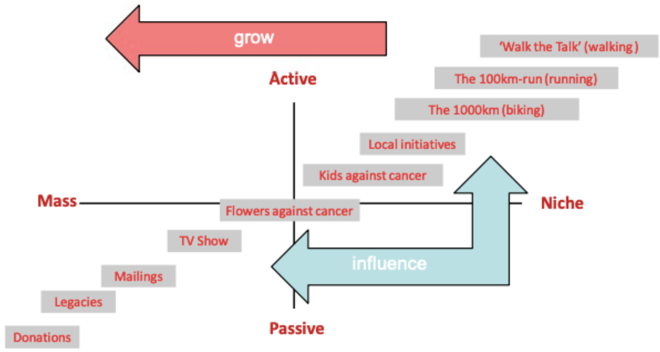
4) Bottom up

It’s the process: listen to the needs, listen to the patients, move research…

5) Thinking and doing

We are what we do.

Be creative in the fundraising, it’s a way of thinking we use. You can have very passive solidarity like giving a gift or donation, but it is even better if you have products where people are very active in the event. We start with a small group, a small event.



Guest lecture BNP Paribas Fortis
Zie zeker document op Toledo over BNP.

Basic thing in baking is to provide a solution for customers

3 things when you think about strategy
- Customer
- Environment: it changes very quickly
- Yourself as a company

→ Based on that you define your three-year strategy.

Environment
- **Inflation**: in Belgium it is indexed for employee etc. so it's a potential handicap to go further in the Belgian market
    - When inflation rises, we have increase of base rate
    - Negative interest rates before: credit was very cheap, allot of investment. Now we live in new environment where money becomes tightened → so decision making in a new way
- **Price electricity**: if you are a company which depends on electricity you will see that the costs will go up allot
    - The message: price will be 100 euro per megabyte/hour
    - As a company you will have to work in a new equilbirum where one of your base costs is this electricity
    - A full question mark that also drives investments in future and also renewables
    - Heavy decision for investments going forward
    - The Belgian market is very well based in Europe
        - We use nuclear energy
        - We have quite some renewable energy
        - Is a big advantage: green deal of European Commission → they have defined a price for carbon. The price for carbon will increase up to certain moment and then it will be interesting to invest in other domains because it will be too expensive.
        - If you have a carbon intensive electricity production you will have a competitive negative impact in the future
- **Growth**: inflation was expected to lead to a recession. The recession did not happen and will not happen despite the difficult economic environment.

→ outside environment

Inside environment:
- Customers; are they paying back their loans etc …
- We have to see whether internal data is confirming what we see in the market
- We live in an environment that can move ahead and can take advantage compared to other companies

Moving forward

Two things are key:

- The environment is important to support resilience and agility: we want to ensure resilience and strengthen agility
- Future: energy and electricity will play an important role so we need to invest in the future

To do so we have strategic plans with two elements:

- Our people: investing in knowledge, … banking remains a people business, human interaction becomes more digitalized
- Technology: clear decision about investing in this. We choose to invest in technology that gives value.

Strategy

'Together' is an element which includes not just us in the company but also our people, stakeholders, society, …
A better society is something important in whatever business you are. We need to invest in projects that lead to a better society.
You want to act as a **trusted financial companion**: trust is what we deal in.
Companion is linked together; we don't want to be on the outside we want to develop and provide solutions for a company. A client can be a young student, a big corporate, …

Three key themes: theme of growth, sustainability and accessibility:

GROWTH

What is very important is to look at your customer, your market, and yourself. If you are a company which existed for many years or even a company who just started for three months you know what your strengths are and what you realize.
In growth, the platform we have is we are a franchise for the market.

We have three domains in which we want develop in. Important to keep in mind what you can and can't do: the market share of BNP is 20-30% → you have size so you can make investments, choices, …
In each strategy you define your need to look at a growth path. That is based on the strengths you have.

1) **Transaction banking**
In your cash management and development this is something that is quite interesting. When you have liquidity, you need to have cash management. The bigger the activity, the more complex your cash management. Is important in corporate banking it's a worldwide activity.
There are multiple elements and brought into one approach → transaction banking: you propose a solution for factoring, fixed income, … just by combining existing elements and seeing that these elements serve the same needs you can offer a new offering
    - Factoring: huge increase in BE
        - Selling your bills was typically done by SMEs
        - But now BNP has proposed a 100% digital solution
        - Almost half of the full growth that has been realized from a new segment that was developed by using this new technology. On one hand you have growth and by investing in the same activity you have into new customer segment you opened a new market.
        - You really have a way to develop solutions which is a need for customer which allows you to fulfill the need of the customers
    - Fixed income: you use your trading room to execute contracts. Mostly for large companies but SMEs also have this need, but less access so propose a digital solution again opening up new customer segment

2) **Insurance**
BNP is very good at insurance for retail customers

However, in the segment of SMEs there was a rising need on insurance. People that use BNP for banking activities went through a broker for insurance activities.
→ You start from a need and based from that need you develop a solution.
This is where we invest in people, bankers, …

3) Starters segment
= largest segment in Belgium
This is a segment where we have to come up with solutions. Digital solution where as an entrepreneur you can start your banking activity.
If you look at the growth in that segment is the digital channel

ACCESSIBILITY

- From the platform that you start from, you need to look at you customer base.
  We have 800 000 customers who are **not digitally active**. So not only being digital is important but also inclusion of people that are not digitally active.

→ Focusing on strength we have developing what we need to do about strength …

- We are also active in micro-loans.

→ This also requires you to look at the customer segment in a different way.

Net promotor score (NPS): this is important because customers give feedback, also on things that are not going well.
Strategy is not just about ensuring that you can increase the strength, you need to have a plan to provide solutions.
Through the NPS we discovered that the SME segment has more difficulties. Two weaknesses:

- Accessibility and especially non digital
- Price perception: people perceive us as an expensive bank
  - BNP offers allot of features so high price: they provide products which from an internal point of view is the best offering but from an external point of view it is the most expensive product

→ To tackle accessibility, we reinvent our offering: hello banking, Nickel (if you only want to make a payment and a card with cash, you can open a card allows to complement needs)

→ By proposing different solution you allow customers to choose remote or digital model.

→ We need to continue to invest in digital; the key element you have here is that you need to propose digital solutions that proposes solutions for the customer

SUSTAINABILITY

Sustainability is key. We talk about ESG; Ecology, Social, Governance.
Governance is most difficult to explain, example; Silicon Valley bank issue of governance.

Invest in the future: invest in renewable energy
It's not about only investing in this but also ensuring people that they can live in a sustainable way.

→ BE is the frontrunner when it comes to sustainable investment.
European efficient mortgage label = energy efficient mortgage is a mortgage you give to ensure that a house is already carbon neutral.

Sustainable business entrepreneurs → very important. Many companies have questions about it, you need to assist companies. We have developed sustainable business competence centers where there are engineers etc. that are looking into project of companies to help and guide them for a sustainable transition.

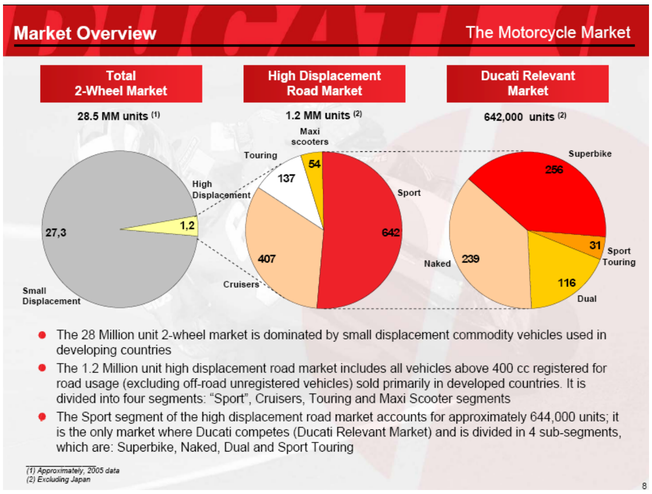
One of the things we need to do from a **regulation perspective** is know whether customers wants to do a sustainable investment → survey among customers: 80% said yes. Even in an environment where sustainability becomes more and more important, we still have customers that said no and said something about revenue being more important.

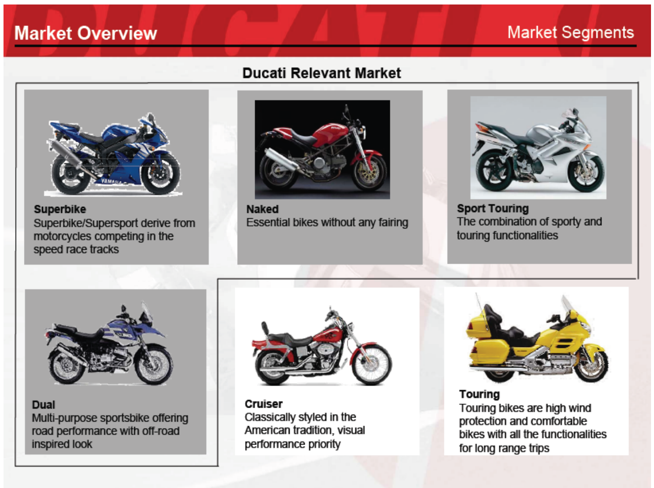
Electric cars: if all cars in the future become electrified the electricity grid will completely fail so not only making investment in those vehicles but also make sure **the whole system is adapted** for these systems → not just investing in electrification but also service for charging the cars. Also, about mobility as a service.

Conclusion
You have a long-term vision, you translate this into a strategic plan.
The two keys element: NPS and ??
Also, satisfaction of employees.

Case: Ducati – Value creation, Value capture and sustainability

Ducati → two-wheel market

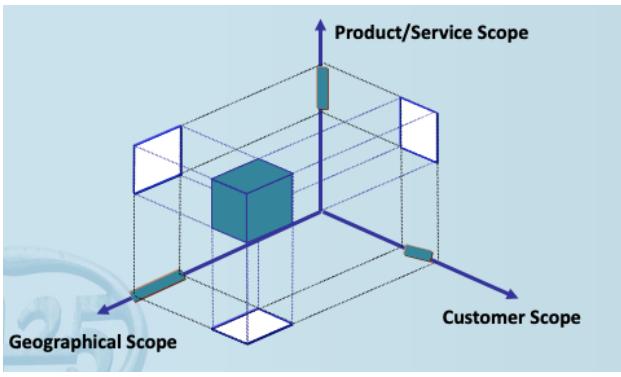




The biggest segment: sports segment -> has superbikes

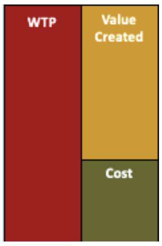
- When Federico Minoli came in as the new CEO how did he create value between 1996 and 2001? How was this different from before?
- How did Federico Minoli capture part of this value created for Ducati?
- What happened between 2001 and 2006 that made this strategy less sustainable? Which problem do you consider more important and what would you do about it?
- Suppose you fixed the immediate issues, think about possible strategic options for Ducati. What would you do next? Why?

What is Ducati's (business) scope?



- More high-end spectrum of motorcycles → owners cost **in**sensitive and more caring about quality → high income
- Accessory → selling adrenaline of the sport
- Geographic: EU and North-America
- We don't have customers but **fans**
- Selling of Ducati: sports and racing, adrenaline, experience, culture of racing (museum of Ducati) → does this make sense if we think about the scope? Is it consistent?
    - Yes, it we look at the type of customers they are after
    - Geographically? The Ducati comes after the Car, it's a transportation means for people who can afford it as a second way of transportation, so it makes sense looking at the countries they focus on.

How does Ducati create value?



A Simple Framework for Value Creation & Value Capture

- ***Value Created***
    - *willingness to pay*
    - *costs of providing good or service*

The value chain
Company must be broken down in activities in order to identify the drivers of competitive advantage

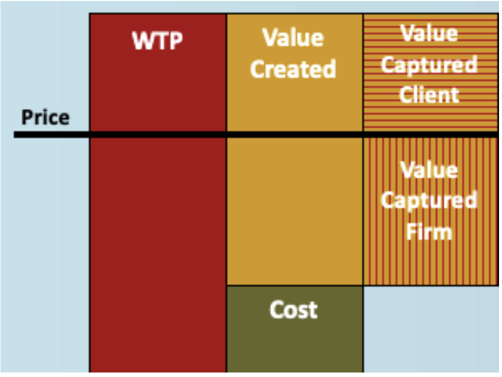
New strategy:
- 'World of Ducati' → customers are fans → higher WTP for the brand name Ducati.
- Creation of a museum instead of enlarging the production capacity → emphasizing that Ducati is more than a brand, it's an experience, a community
- Also, by segmenting the type of customers by the type of motorcycles → it captures more of the WTP but how does it CREATE value? You might create WTP for other customers…

Professor: what is value creation?
- Willingness to pay minus cost = VALUE CREATED
- After we create value, we want to CAPTURE it
  → try to distinguish both
    - Often, we only think about how we capture it but we have also to think about how we created it

So how is Ducati CREATING value? We have discussed the world of Ducati, museum, …what else?
- R&D creates new models, and the new models create WTP
- For every activity you should think about how this creates value for us? How does this create WTP?
- Outsourcing which lowers the cost but → Italy in the middle region → locally → so is that low cost? No! because there are other areas where you would have lower costs, like the south of Italy → so how does outsourcing here creates value? WTP increases since they can deliver higher quality. So, we are not talking lower cost but higher WTP. Could we talk here lower cost? By specializing your suppliers → scale of economies → it could be that we are lowering our costs through scale.
    - This is what he means by connecting the activities and looking at how it ACTUALLY CREATES value
- So, they create value through both sides: a bit of lowering costs but more increasing WTP through R&D, new models and performance.
- What is the worst thing that could happen to Ducati? That they lose races, so they have to keep investing in R&D.

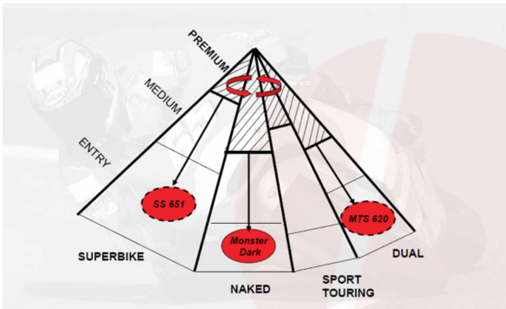
How does Ducati capture value?

Value captured:



- The access in every country to bring the product to customers → how access? What is Ducati doing to capture these customers? How do you make people buy your product? What is behind Ducati is a Private Equity company. A PE want to increase enterprise value and then sell off the company. So how did they capture value? How did they create a return on investment?

Ducati acquisition model



- NPV of the customer with the entry-level model and afterwards they upgrade to a higher model. They capture a customer base that upgrade with them over time. In this sense value creation and capturing is difficult to disentangle. With an entry model they attract customers who were firstly not interested so you create WTP (CREATION) but at the same time there is also value CAPTURING → think about the price: customer is capturing WTP minus price.
- Accessories: you can discriminate between customers
  - Most Ducati's offer the first accessory is the exhaust (noise) every new model has a higher noise
  - The extra's, the accessories are important in capturing value
- What does Ducati NOT do to capture value? Reduce costs and increasing the price. Exibit 5:

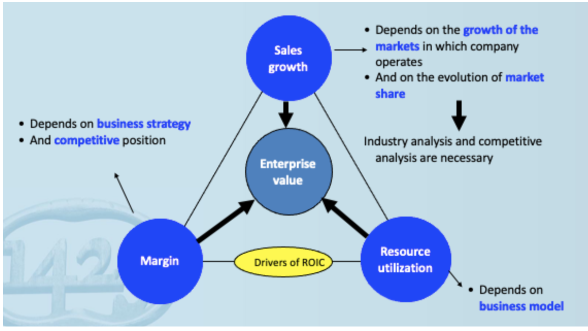
Exhibit 5

Ducati's Price Premiums vs. Competitors' Comparable Products

Year	Hyper-Sport	Super-Sport	Sport-Touring	Naked	Dual
1997	31.0%	8.0%	30.0%	13.3%	
2001	31.4%	7.2%	20.4%	13.0%	
2006 E	33.9%	8.0%	20.0%	28.4%	-11.6%

Ducati has a premium compared to other players but does Minolli change the premium? Not really. He is not really increasing the price. So, what happens by not increasing the price? The value for the customer gets bigger. We do allot of investments to increase WTP on the customer side, but we are not really increasing the price so how do we capture value? **Volume** goes up! Volume should also be thinking about. We make a more attractive product and as a result we sell more.

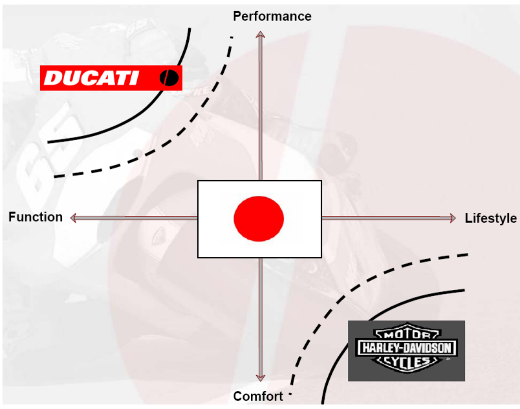
When we talked about value captured, we talked about enterprise value. The margin is not really affected, but what happens is that the sales grow and the FUTURE sales grow. What happens then to the enterprise value? It increases. Also thinking about resource utilization, it was sales per euro capital invested → either increase sales or reduce capital invested in the company. How does Minolli reduces then the capital invested in the company? By outsourcing. So outsourcing was value capturing because it shifts the capital invested in the company to the suppliers.



Unfortunately: there was a downturn. Minolli comes in creates and captures value, but the profit doesn't go up as much.

What problems does Ducati face? What would you do about them? Which problem is really strategic?

- **Product discontinuity**: change look of one model and the look before that was more popular. The customers don't like change. What do you do to fix this problem? Go back to the original. But here we have to think about the process, how do we design the model over time and customer? It is a process issue.
- **Competition**: Japanese companies who sell very cheap entry level models. Ducati is losing future business. It is a big problem because it reduces the enterprise value. Now the whole idea of how they capture value is undercut by the Japanese. This problem is very **strategic**.
  - How do they represent their market? Ducati is a niche player.



What options does Ducati have to grow?

What would you do? What are your growth options?

- New geographical locations: BRIC region. India? But the WTP is not high, and it difficult to ride a Ducati in India. India not a good idea. → NO
- Convincing other motorcycles companies in the EU to work together. How do you compete here with the Japanese? Can you compete here on costs? You could improve your costs this way, but this is not your strategic move to compete on costs with the Japanese→ NO
- Focus on women segment since it is a growing segment. Target a segment in women that have a high WTP. Ducati has an advantage to target the female market. The models of Ducati have a L shaped engine, they take less space and it is lighter so it makes it easier for the female segment. The women segment is growing for everybody, so it is also interesting for Ducati (so it's not interesting for only other parties) + they have an advantage. → YES
- Alternative is to compete more with the extremes, go to the cruiser market. (Davidson)
  - Do we have an advantage in the cruiser market? We have to develop one, these costs allot of money, they are in trouble, so it is difficult. And Davidson is a very big player.

- I would have to increase the price allot to compensate. Are people willing to pay that?
- We need other growth options → NO

- Buy an existing company (for example already in cruiser section): what is the advantage of doing that for <u>Ducati</u>? (When we think strategically you should always ask this question). Think about an advantage for Ducati and not something that everyone could have an advantage in.
- Sell their engines to other categories of products like boats, jetski, … then the brand will be recognized by those customers. But again, have to make allot of investments … → NO

What is important here is we generate options, and we go back to the scope:

- Geographically could I offer the same product to same customers elsewhere? Yes, in Brazil for example.
- Customer: women segment, same product to different customer
- Product: more difficult here.

The scope dimension is a critical decision and it also helps to generate options that make more or less sense. Also are we generating more or less dimensions.

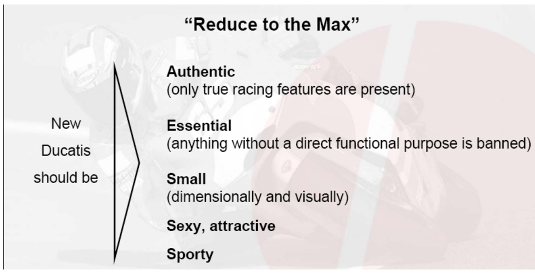
How do we decide? What is Ducati's competitive advantage?

*A firm or a business is said to have created a **<u>competitive advantage</u>** over its rivals if it has driven a wider wedge between willingness to pay and costs than its competitors have achieved*

Competitive advantage of Ducati:
CEO1: character of Ducati which in part is done by design but also the elements that distinguish Ducati. It is really in increasing WTP but it lies in these intangibles, the experience, that drives really the WTP.
CEO2: says the product in R&D drives the WTP.

We see that both CEOs disagree → is good because then you generate ideas

→ Define what a Ducati is:



Ducati was bought by Audi.

We need to tell a **consistent** story of what you do (scope definition cube), how you do it (value chain), and how it leads to **competitive advantage** (industry average competitor, competitor with dual advantage, … Both CEO's had a different opinion on what drives this. We need to decide, which one?

- Intangibles?
- Stick closely to what Ducati is all about, push geographically, focus on women, etc …
  → important to know what the competitive advantage is to know how to operate here

What happened?

After they turned around the company, sales really dropped after the financial crisis and they never recovered. People can't buy them anymore because you can only ride them on the highway. So, they needed new idea.

"More than Red": new strategy for Ducati. They have more variety; they all have to be sporty. We go back in time, because if you understand what happened in 2006 you understand Ducati today. Strategies take a long time to develop.

Italy is still biggest market → yes, they can grow geographically but Italy is still the biggest market.

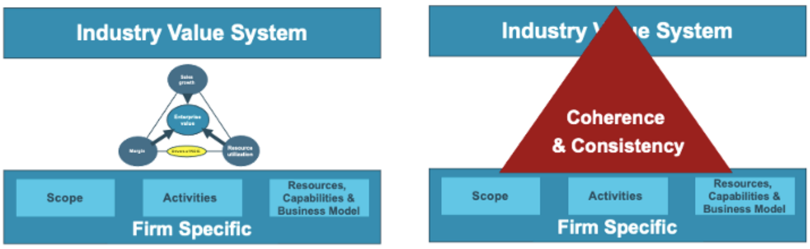
Latest results

- Deliveries have increased to a total of 61.562 motorcycles sold in 2022 (+3.6% compared to 2021 and their best sales ever).
- The Multistrada V4 was the best-selling bike in 2022 with 10,716 units, followed by the Scrambler 880 family with 6,880 and the Monster with 7,971.
- In Italy bike sales totaled 9578 8,707 (+10%, main market); in US: 8,441; in China: 4,901 motorcycles sold (+21%)
- Ducati introduced the DesertX (modeled on the 1990s bike that participated in the Dakar race and they launched the V21L prototype, which foresees the bike that will race in the MotoE championship from 2023.
- Ducati won the Moto GP Constructors World Championship in 2021.
- Ducati sales revenue are around €1 Billion

Key questions for strategy

Do we create value?
Do we capture value?
Can we sustain this value?

Strategy and the Drivers of Enterprise Value



Case Roland Berger

Question 1: What are the options for TransportCo to grow its revenue? What growth strategy fo you prefer?

- Expand the market broader then only the CIS region
- Stop focussing on real estate

We looked at three axes: See ppt

We pick the geographic expansion because main focus is now on Russia but should more focus on business units and try to capture clients there.
Offering more services: go to a 4PL revenue model → requires allot of ? resources which they don't have at the moment

Macro-screening of countries

Step 1: How would you prioritize geographies? Which screening criteria would you use to access these geographies?

Criteria:

- Legislation
- Which countries are easily accessible?
- Access to talent
- Infrastructure
- Financial factors

RB: (ppt)

1. Market and competition

2. Institutional
3. Fit with expertise

The next step is to prioritize the different geographies

Step 2: Based on the three different views, which regions would you prioritize?
→ *using extra information on Toledo*

You should also look at your clients.
GCC: local management is interesting
We try to narrow down the clusters.
Kasachstan: close related to Russia, similar environment. Even though its smaller then Saudi arabia, its also important to look at other factors → trade off between feasibility and attractiveness

Take away: its not only about attractiveness but also trying to capture market share.

Q3: Market entry strategy

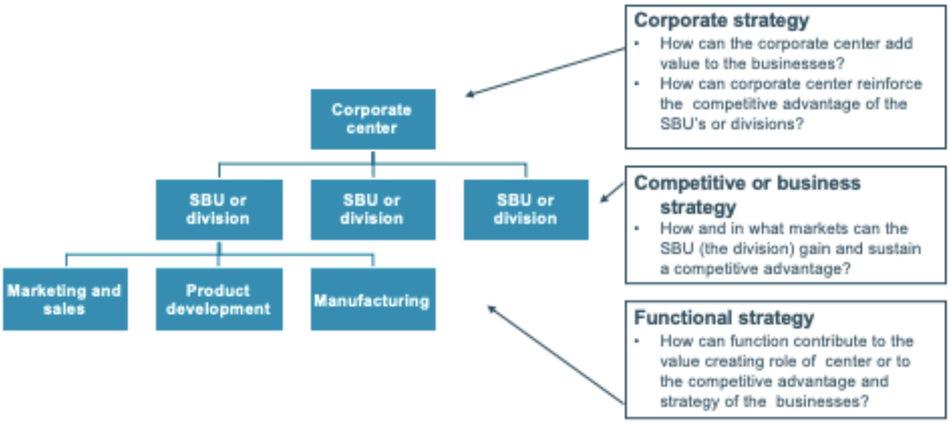
In a big market which is not growing fast, competitors have taken their market share,
Let's go for warehousing, since in the end forwarding market was from china and Russia and the client prefers western countries.

Theory part

See slides

Topic 7: Corporate strategy

A strategy can be formulated for a business, several businesses or for a function:



SBU = Strategic Business Unit, a unit of a company or a group that is responsible for its strategy in its markets and has and controls the resources and capabilities to implement such strategy.

We looked at a particular unit, and its competitive advantage or strategy. How to create comp advantage? But once you have this strategy you have to translate it into a functional area (marketing, finance,…) the strategy has to be consistent with that. But we won't talk about this.

We go to the corporate level: should we be in these different businesses at the same time, does it make sense? How do we create corporate advantage?

Defining Competitive Advantage: A firm or a business is said to have created a <u>**COMPETITIVE ADVANTAGE**</u> over its rivals if it has driven a wider wedge between willingness to pay and costs than its competitors have achieved

Defining Corporate or Parental Advantage: A company is said to have created a <u>**CORPORATE or PARENTAL ADVANTAGE**</u> if it has driven a wedge between the break-up value of its businesses and the enterprise value

Let's take the business with different businesses; we shop the business in pieces. If we sum al these values, it forms the break-up value. Now that we have all these businesses together, are they worth more or less? Are they valued more or less? If they are valued more there is corporate advantage, if they worth less there is no advantage.

Some companies such as Greenyard have been successful at bringing different businesses together. They built up their success with the mergers of 4 different businesses: it is now a global player in fruits and vegetables, active in all segments (fresh, frozen, prepared and horticulture).

Disney bought Pixar because it was lacking new technology compared to Pixar. Their animated feature films are still kept as independent units but each benefit from one another because they have very different ways of doing things.

Audi (VW group) acquired Ducati. The synergy between the two is not on the supplier side, as their suppliers are very ≠, nor on the distribution side. Their only connection is about technology.

Maersk is a premium conglomerate because they have different types of businesses within the same company (oil, drilling, shipping services, terminals, …). Now they got rid of some of these, to concentrate on transport and logistics and to try to provide an integrated service.

Corporate strategy

- **Step 1:** Building your Portfolio of Businesses and Defining your model for Corporate Advantage
- **Step 2:** Designing your Group and Organizing for Corporate Advantage

We don't talk about one business but a portfolio of business (step 1). Then think about how to organize it. (Step 2)

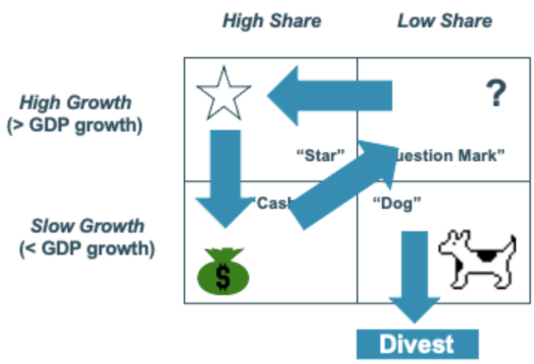
Step 1: Building your Portfolio of Businesses and Defining your model for Corporate Advantage

Brief History of Portfolio Management

Many ideas came from consulting
One important finding is by BCG:

- **Learning Curve**: cumulative output doubles, costs drop by 20% (BCG)
    - From that people started to think strategically and anticipate this.
    - Strategic pricing (anticipate an increase in demand): People drop prices today, double the output and as a result costs drop faster.
    - Go for share, be #1 or #2 (GE & Jack Welch)
- **Growth/Share Matrix** (BCG) or **Industry Attractiveness/Competitive Advantage** (McKinsey)
    - Invest in Stars
    - Milk Cows
    - Divest Dogs
    - Decide on: ?

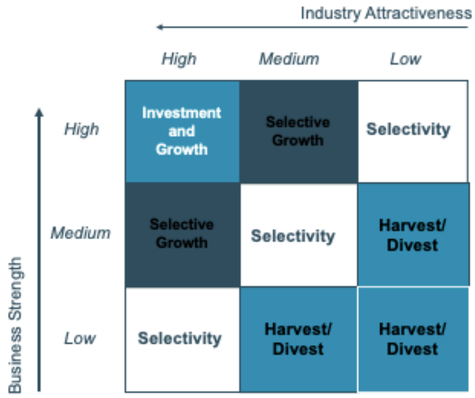
→ BCG's Growth-Share Matrix



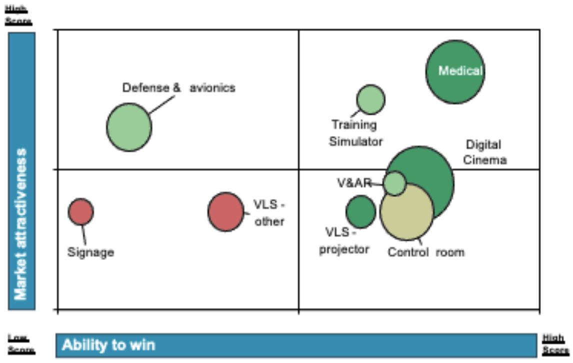
High growth or low growth?
- High growth: it grows faster than GDP

High or low market share?
- Based on where you are in the quadrant there is a different way to handle the business
- Dogs are being divested
- Slow growth & high market share → generating allot of cash
- High share & high growth: star
- Low share & high growth: what to do with that?
    - This is where the learning curve comes in: I can take the cash that I am generating for my cash cows and I am using that to finance my question marks. Then I am dropping price, so more is produced to respond to the higher demand. Then I grow my business into a star because the price comes down and market share improves. Over time the business matures, the stars become cash cows. Meanwhile, get rid of things that don't work (dogs). Cash has to be moved around to grow businesses, that is the cycle of how to manage a portfolio.

→ The Industry Attractiveness-Business Strength Matrix (McKinsey)



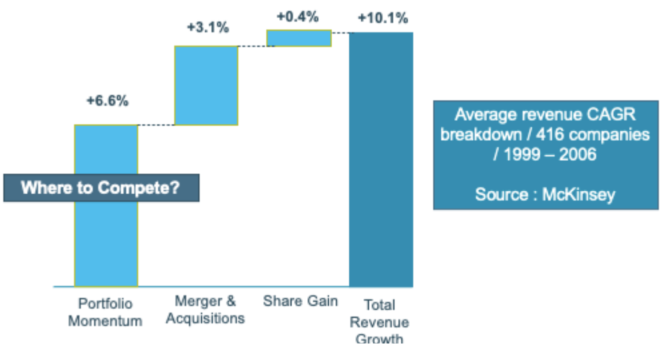
The first step in redefining Barco was an in-depth analysis of the current activities



Barco guest lecture of a few years ago:
They had a more sophisticated matrix

- **Problems** Growth/Share Matrix (BCG) or Industry Attractiveness/Competitive Advantage (McKinsey)
    - No Strategy: the BCG matrix was actually cash management
    - Oversimplification: using historical data, basically finance/cash driven
    - Actual positioning depends on measurement techniques (market definition)
    - Assumed independence between businesses: the most important problem! Does that make sense?
    - No (potential) competition

Growth by Large Companies



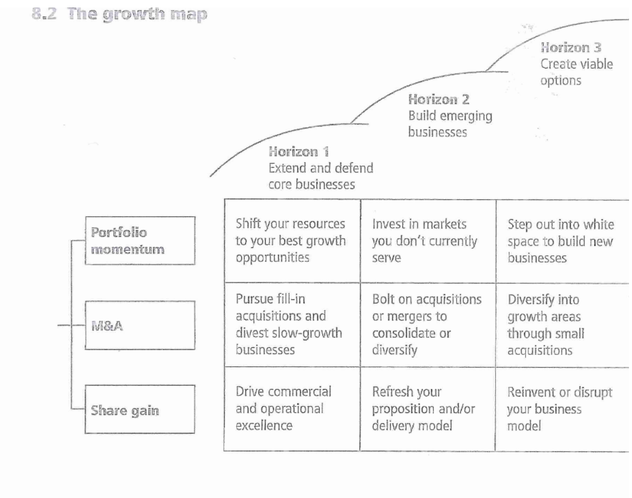
When we think more sophisticated about growth, the McKinsey had some interesting ideas about growth and which business to grow in.

On average, top line growth was 10% for these companies. Where does this growth come from? It comes from three areas:

- Market **Share Gain**: I increase my market share but it doesn't give top line growth.
- M&As: buy top line growth but top line growth is not really being driven by this competition.
- **Portfolio momentum**: the biggest part of these companies was portfolio momentum: being at the right place at the right time and understand where to compete. It is important to think strategically about where you want to grow. The study showed that it is maybe better to go to other places.
    - For example in the Munich area, we show that those areas are growing faster, as fast as China. Maybe it is better to go there? Instead of going to China where everyone goes.

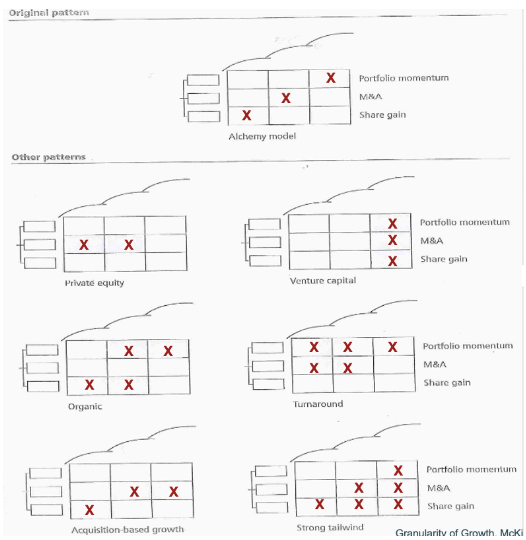
  → Granularity of growth

Growth Map: Horizons



Growth happens but we must be careful about timing → think about different horizons
All the ways of growing (portfolio, M&A, share gain) can be used for each horizon. Firms need to think about how they are going to grow and what their horizon is (but obviously it depends on the sector – software and gardening do not move at the same pace). The horizons and the timing will depend largely on the type of business.

Growth Map Patterns

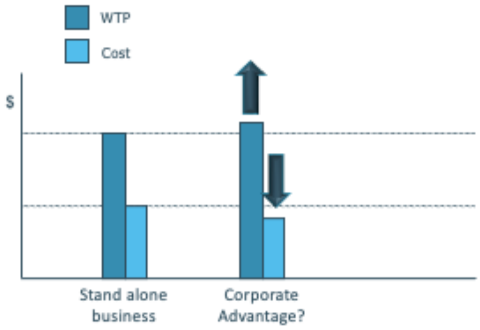


Different companies might grow in different ways...
Depending on your organization, you might be mixing and matching different types of growth.

People constantly question “What's next?”. How to stop having to think of what's next and develop something that doesn't need to rely on others? For example, Apple is never first, but they're good at gathering the different technologies available on the market. They're good at making their products easy to use but rely on others.

Corporate Strategy and Competitive Advantage

Corporate advantage is realized at the business-unit level, where individual businesses use the benefits of corporate affiliation to outperform their rivals in a particular industry



Does it make sense for an organization to add a business to its portfolio? Well... How does it actually create value for the business? Does it create WTP for an existing business or does it create costs for the business? So, if we add another business to the firm we need to ask how does the corporation add value to the businesses, and the existing businesses? Very similar as comp advantage.

Value Based Portfolio Management

In any discussion of corporate strategy managers should focus on the corporate strategy’s impact on individual business units. Competition occurs at the level of the individual business unit in a particular industry. Corporate strategy fails to the extent that it aids or undermines business units as they strive to win in their specific markets.
We need to think about two tests when we think about creating and capturing value in a portfolio.

“Better off” Test: are we better off having these two businesses together or separately? What is the corporate added value? An expansion in horizontal scope must enable a corporation’s business units to create and capture more value together than they could as separate single-business entities unrelated to one another. here are different reasons:

- ***Industry attractiveness***: by putting these businesses together you might mitigate the negative pressures of value creation and capturing. It can improve the structure of the industries in which a company competes.
    - By putting different businesses together, one mitigates the 5 forces that might affect value capture (rivalry, entry barriers, buyer power, supplier power, substitutes)
        - Microsoft: OS – SW, operating system and developing software → makes them powerful relative to the assemblers, the one putting the computers together or PepsiCo: dinks and Frito Lays
    - Migrate out of structurally poor industry into a more attractive setting (Apple)
    - But be careful: this can only be the case when management have better foresight than other potential entrants about what industries will be attractive in the future

- ***Competitive Advantage***: *how will you create synergies? How is putting these two businesses together going to reduce costs? Does it create scale and scope economies? Learning over time? Or will it have effects on WTP and potentially pricing.*
  Here scope is used to improve a company’s position *within* its industry → driving a wedge between the costs it incurs and the WTP among buyers.
    - Cost Effects: shared cost economies (Scale & Scope) - “synergies”

    - Shared cost economies are the multi business version of economies of scale within a single business
    - Their significance must be assess through analyzing cost structures of individual businesses activity by activity, sizing up the fraction of total costs that can be shared across the businesses and estimating how sensitive those shared cost elements are to total size. However, the savings can be offset by
        - Diseconomies of size or scope
        - Cost of conflict, compromise and coordination that reflect heterogeneity in requirements, foals and beliefs across businesses
- Willingness-to-Pay and Pricing Effects: the revenue benefits of broad scope come from increases in WTP for a combined offering and improvements in a company's ability to price in a way that extracts WTP. WTP effects include:
    - One-stop shopping (Amazon → one vendor for sales, service and other support)
    - Umbrella branding (*Virgin* – higher WTP because the *Virgin* brand is trusted, whatever industry they're active in)
    - Cross-promotion (Banking+Insurance, new media
    - However, potential limits: conflict, compromise and coordination; cognitive conflicts (when the scope expansion threatens to blur a company's external (or internal) message; reputational risks; mixed motives

→ Be Explicit! Tell an explicit story about why you think these businesses are better off together

It is good maybe to have A and B together, but does that mean you need to own them?

"Best Alternative" Test – Natural Owner: Am I the best owner for the two businesses together? We need to think harder about different issues, and how complex the relationship is. Example is Pixar and Nemo. The question here is can a corporation that owns its business units accomplish its ends better than the same business units coordinated in some other way?

The concept of **transaction costs** can help us understand which transactions tend to take place within a corporation instead of across firm boundaries. The relationship between two business units can be thought of as a set of transactions. Governing a transaction involves costs. Some transactions are straightforward and comparing these costs across forms of governance is easy. Other types of transaction costs are more subtle.

One particular type of cost is the **opportunistic behavior** (when parties enter into a relationship each might worry that the other will exploit opportunities to take unfair advantage of the relationship = threat of **hold up**). A way to overcome this behavior is to write contracts that lay out what each party can and must do. When contracts work well, companies are more likely to find it cost effective to complete transactions through arrangements that involve other parties. However, if it don't then companies are likely to prefer broad-scope and in-house deals. The following are impediments to contracting efficiency:

- Complexity and contractual incompleteness: difficult to write contract that cover long-term relationships in highly uncertain settings
- Unclear property rights: property rights are much harder to define and as a result contracting over intangibles is much more difficult
- Poor enforcement of contracts and property rights (developed economies vs emerging economies)
- Relationship-specific or co-specialized assets: **Hold up**. If transactors have to make up-front investments whose value is specific to their relationship the effects of contracting hazards might be amplified.
- Example: Coca-Cola and Bottler
  → these examples show why transactions costs of alternative arrangements might be high and why common ownership might be attractive

⇨ Both tests need to be satisfied to be safe and say that It make sense to have business together.

⇨ Those tests can help bring the discipline of business-level strategy to bear on issues of corporate strategy

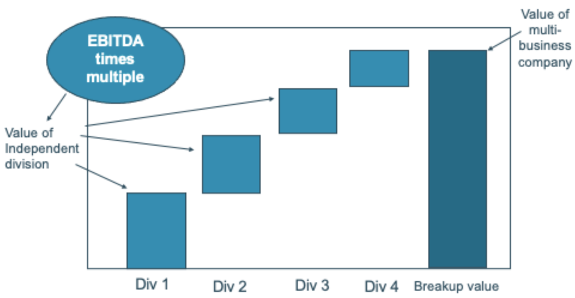
Value Adding or Subtracting

Companies usually try to add value but end up oftentimes subtracting value instead because they don't have a clear idea of how to grow.

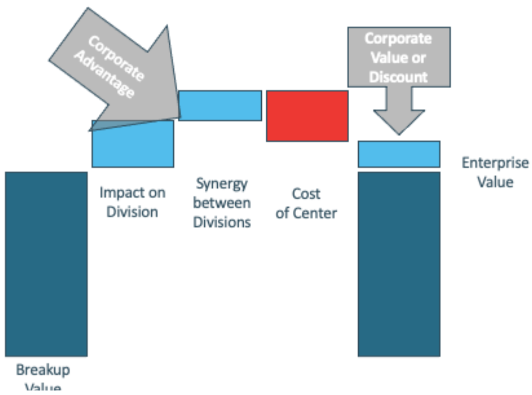
Vertical: from the corporate into the businesses:
- Corporate offices: Move management into different businesses
- Policies and standards: might be difficult and costly and might make sense to do business with very similar rules and regulations

Horizontal: between business A and business B → are there things that might make sense?
- Many companies have key customer accounts
- Banking and insurance example

Value Based Portfolio Management



Does it create value and capture it? Think about the stand-alone value and enterprise value. We have four divisions: we can look at the value and capture the value of each division.
Sometimes they look at multiples like EBITDA
If we sum up division 1, 2, 3 and 4 we get the breakup value of the organization.



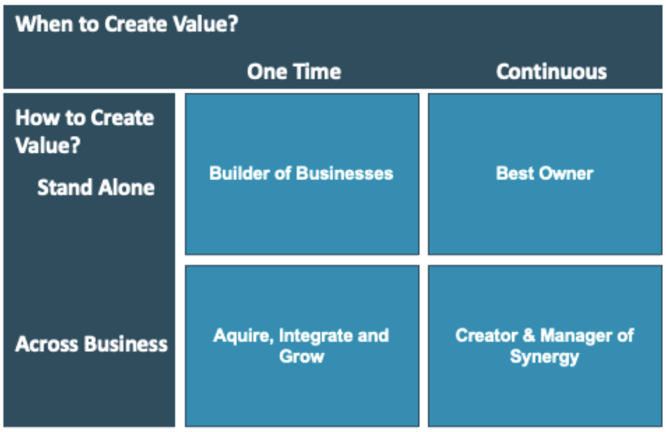
Then compare this value to enterprise value: if we put these business together what is impact on division (vertical) and what's the potential synergy between the division (horizontal)?

Then we have a cost: the center does not bring any revenue. That is why many managers don't like headquarters.
You need a good story. What is left is a plus or minus: a plus is corporate advantage.

Diversification discount: if everything is split up, each division would be worth more than what they're worth today together on the stock market.

Remember: a company is said to have created a **corporate or parental advantage** if it has driven a wedge between the break-up value of its businesses and the enterprise value

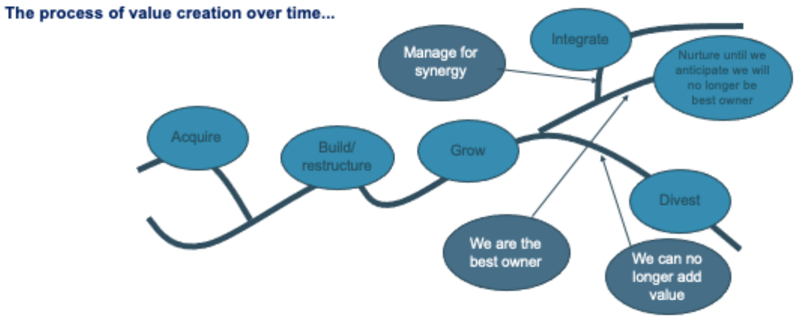
This will also depend on creating value within the value and capturing the value otherwise you will not have corporate or parental advantage. There is **Not one Size Fit All Corporate Strategy.** Different types of businesses will have different types of corporate strategy. Competitive strategy is much simpler than corporate strategy, it is morecompany-specific, depending on what the company has, where it wants to go and what bets it is making. Nonetheless some structure can be provided:



Different ways to think about corporations and how they create value.
→ Two dimensions: when (time) and how
→ It could be continuous
→ Stand Alone or across businesses

- **Builder of businesses**: buy a business; create value for it then sell it off (private equity companies (Ducati)).
- **Acquire, integrate, and grow**: but still connect something between the businesses (distribution channel between all of LVMH's businesses = their only mutual point).
- **Best owner**: You continue to create value over time. You are the best owner of that particular business because you keep creating value over time. Barco (display technology, projection technology and collaboration technology just have in common image processing (healthcare business, entertainment business, … each run independently)).
- **Creator & manager of synergy**: create value across businesses all the time so you are the creator and manager of synergies. (Disney owns the figures (Mickey, …) and with them they produce movies, manufactures merchandises,…, they have hotels, parks, … They continuously link all of those (media networks, parks & resorts, studio entertainment, consumer products, interactive media, …), yet every business doesn't have to be that way.

Building businesses is the essence of corporate strategy



Many theories of corporate strategy are too static, they do not show how the corporate strategy will create value over time.

Over time this might change, you might grow, divest, … companies have very different trajectories. Every time there is a story, and the management making the story needs a good story about why and how it makes the company better off, in terms of these businesses being together and why you are the natural owner of this business.

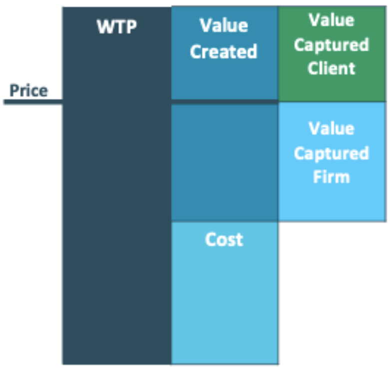
Case: DEME Corporate Strategy

- Why merge Dredging International and Baggerwerken Decloedt & Zoon in 1991?
- Should DEME develop the “Dredging+” strategy? Why? Why not?
- Should DEME enter Offshore Wind? Why? Why not?

DEME Corporate Strategy
Why merge Dredging International and Baggerwerken Decloedt & Zoon in 1991?

Why does the merge create such a (positive) jump in revenue?

Value Creation, Value Capture and Competitive Advantage



What is value creation? WTP – costs
One company has demand and the other company has vessels, so they use resources more efficiently which reduces the costs → this is not enough, try to be explicit in terms of **how** it creates value!

How is putting these companies together helping us? We create value but also capturing value but how?

Consolidation is happening in this business: more bargaining power is created → Yes, but what happens in the picture? What am I missing? **The price**. By consolidating, I increase my bargaining power so increase the price. There is on the one hand a capacity utilization, we use it better which improves efficiency and results in more **creation** of value. On the other hand, as a result of consolidation it takes pressure away from the price and I **capture** more value.

The most important strategic decision DEME made is buying ships. If I am doing better I can make more profits and buy better ships, what happens then to the picture? I might have less costs because of increased efficiency, I am affecting my WTP. Access certain high WTP products. I come to a different dynamics because of the decisions I made and I get a positive dynamic.

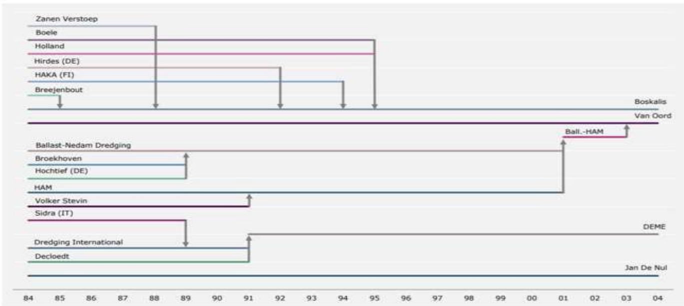
Key for success

- Combination of the well-filled order book at Dredging International with the idle capacity of Decloedt's vessel fleet. Return on Invested Capital.
- Decloedt's excellent position in Australia.

… into perspective:

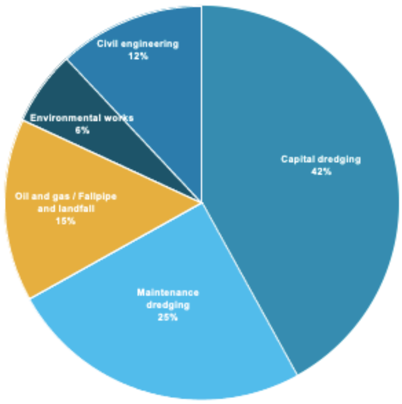
- This success should be put into perspective of the overall recovery from the **crisis of the 1980s**.
- The world market collapsed in 1982, with the **Iranian Revolution** decimating orders from the Gulf States, a giant **debt crisis** in the third World, and a **recession** in the West.
- Dredging International's turnover fell back from 178 million EUR in 1981 to 122 million in 1983 (-31%).
- The **crisis** also lasted unusually long; it took until after the first Gulf War in 1991 for recovery.

M&A's in the European dredging industry



Dredging+

Activity Portfolio, 1991



→ Not only dredging new and existing projects

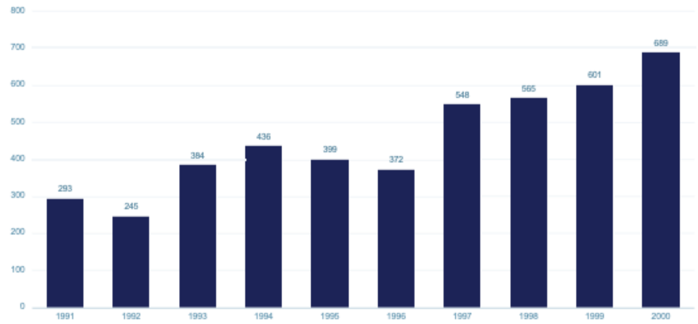
Diversification Strategy: Dregding+

Redefining DEME's scope by including activities in adjacent markets where the core business of dredging was essential, e.g.,:

- salvage and wreck removal;
- bituminous materials for shore, bottom and coastal protection;
- treatment of contaminated sludges and dredged silt;
- extracting raw materials (e.g., grint);
- …

What is the scope of DEME?

Impact on DEME: turnover between 1991-2000 (in mio EUR)



We see that DEME is growing in these different businesses

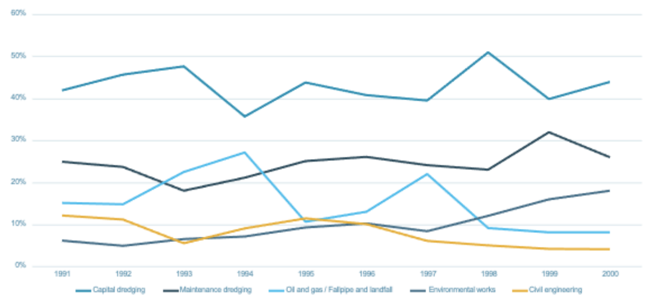
Should DEME develop the “Dredging+” strategy? Why? Why not?

Does this make sense? How does that make sense? Think about the **two tests**: does it make sense to add under the umbrella DEME those new activities? Always be **specific** how does X or Y create value, capture value?

By offering different activities it makes it less complex for the customer and therefore, increase WTP. It creates value = test 1 → it makes sense do have these different businesses together

Do I have to own those? (Test 2)
We see how they created this capability. It makes sense to own because they are the better owner, the better alternative.

Activity portfolio of DEME, 1990-2000



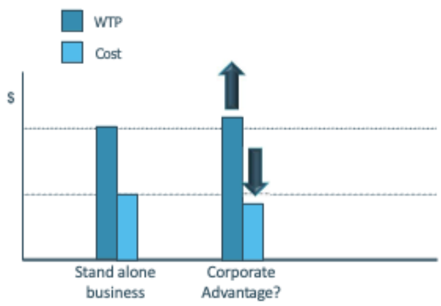
Business Model Innovation

- Definition: a business model describes the rationale of how an organization creates and captures value.
- BM evolution over time at DEME:

They changed their business model. They go from being a subcontractor to doing other stuff. They capture some of the margins, but it might just be shifting.

Corporate Strategy and Competitive Advantage

Corporate advantage is realized at the business-unit level, where individual businesses use the benefits of corporate affiliation to outperform their rivals in a particular industry



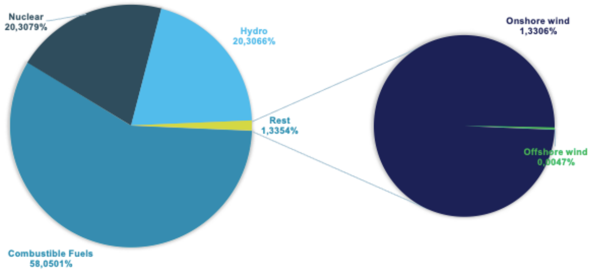
Implementation of *dredging+*

1. DEME developed a portfolio of complementary activities that supported the core activity of dredging and *could* compensate the cyclical nature of the dredging activities.
2. The portfolio of adjacent activities enabled DEME to reposition its scope in the existing value chain, which was instrumental to explore new business models (climbing up the value ladder from sub-contractor towards EPCI solutions provider).
3. DEME extended their internal organization, which became structured to tender and execute complex – high risk – contracts.

→ They developed a portfolio of complementary activities.

Offshore Wind

Installed electricity capacity in Europe, 1999



→ This business was a very small part in the market

Primary Demand of Renewable Energy Forms

% Share of Renewables in Gross Inland Consumption of EU

	1995	2010	2020	2030
Hydro	1.8	1.7	1.8	1.9
Biomass and Waste	3.2	3.4	3.5	3.8
Other (wind, solar, geothermal)	0.2	0.6	0.9	1.2
Total Renewables	5.3	5.7	6.2	6.8
in Mtoe	72.1	88.2	99.7	108.4

Source: PRIMES

→ The growth expectations were very low and again these are very long term investments

Should DEME enter Offshore Wind? Why? Why not?

Do we have an **advantage** here?
That was not an obvious choice at that point in time. What are they **leveraging**?

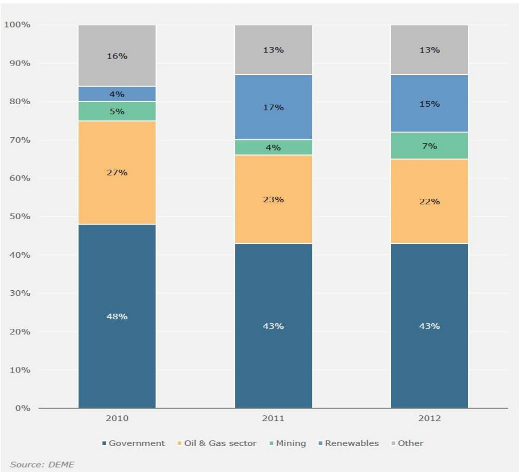
DEME is a solution provider. They provide <u>total solutions</u>. They are the first player to capture allot of the margins. That is how DEME becomes very important in these businesses of offshore wind.

Why DEME and why not somebody else? DEME might be good as a solution provider, but part of that solution is having these ships. There is strong competition and DEME is known as an early mover.

Important problem to sustain competitive advantage: **imitation**. How fast can others imitate this? They also need to think about new ships. When do they buy new ships? When do they get an ROI on those ships?

DEME Customers
We can look at who are the customers for DEME?

DEME's customers (2010 – 2012)



The government is an important customer. It is often times governments that are contracting for these offshore winds. They created this capability which takes time to develop. This is kind of an advantage. The case does not go much in depth.

DEME entering the offshore wind industry

They did Dredging+, they had this other subsidiary which focused more on offshore. They created two other subsidiaries exactly to work with the federal government and then powerC which is the total solution provider.

- Aligned with the *Dredging+* philosophy, via subsidiary HSS towards offshore marine foundation activities.
- In 1999: First explicit mention in the annual report over the year 2000: establishment of two companies:
    - C-Power (joint-venture): submission of proposals to the Federal Government of Belgium seeking approval to establish and operate a wind farm on the Wenduine Bank;
    - Power@Sea: DEME's concession specialist, concentrating the group's expertise in special disciplines required by such projects

Offshore wind in Europe

- EU public policies have given priority to build offshore wind farms in the North Sea region, with especially the southern part having an excellent wind regime and shallow water (Cruciani, 2018).

- EU as the world leader in offshore wind, accounting for 84% of the global cumulated installed offshore wind capacity per 2018.
- EU's 'Renewable Energy Directive' 2018: new binding renewable energy target of 32%.

→ Demand of offshore wind grew allot so they were **in the right place at the right time** (Today, others have caught up as well)

Quid DEME?

- Offshore wind: first explicit mentioned in the annual report over the year 2000:
    - Main contractor of a series of important European offshore wind farm projects (e.g., UK and Sweden).
    - Establishment of C-Power and Power@Sea
    - Senior management establishing Techno@Green to participate in C-Power
    - 2004: permits to start the construction in Belgium (Wenduinebank)
- 2007: start construction of C-Power

1. **Bundling internal capabilities**
    - Positioning as an EPCI(M) turnkey (total solutions) contractor:
        - Contracting phase: expertise in risk assessment and tendering
        - Offshore executing phase: internal organizational capabilities & technical leadership
    - Combining marine activities of several subsidiaries (DEME, 2001):
        - HSS, for foundations
        - Tideway, for soil protection and cable-laying
        - Scaldis, for offshore assembly
        - Dredging International, for maritime expertise and trenching for cables
    - Acquiring complementary offshore expertise:
        - A2Sea: a Danish wind turbine installation specialist, 2017
        - G-tech (majority share of 72.5%): a geotechnical investigation company, 2017
        - Cathie Associates: a leading offshore geoscience and geotechnical engineering consultancy, 2018

    DEME had a position as a total solutions provider. It combined different marine activities to do that, and it acquired some. They filled the gaps by doing that, but they also had to develop the market before anybody else was there and that meant allot of relations with the governments and other players.

2. **Developing the market**

    - EU public policies & directives regarding to renewable energy targets and offshore wind
    - DEME's First mover advantages from the past and the participation of senior management in the C-Power project (via Techno@Green) intensified the mutual trust with their shareholders to invest 'patient' capital (heralding an era of low (i.e., $5-10) oil prices)
    - Financial participation in wind farm projects (via joint ventures in concessions) to foster the development of the market
    - Spreading project risks among different partners, with intended dilution (i.e., from 33% down to 8%) during later investment rounds by attracting additional project partners in the consortium.
    - Temporary guaranteed prices for electricity produced by the offshore wind farms

Summary

- Capital dredging activities have become considerably less important for DEME's turnover, especially since 2014 (from a share of 55% in 2014 towards 23% in 2018, a drawback of 814 million EUR in 4 years).
- It was also the period that marine works (including offshore wind activities) became the fastest growing activity of DEME (Ackermans & van Haaren, 2018; Wittemans, 2014)

Step 2: Designing your Group and Organizing for Corporate Advantage

→ How to structure your different business and activities

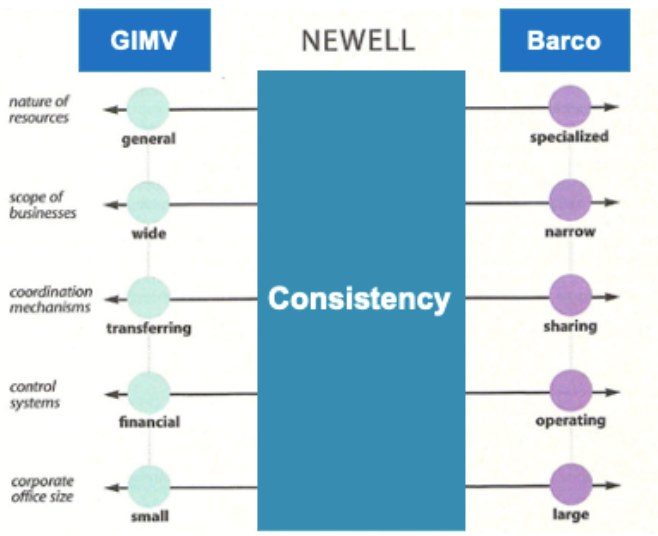
Classic reading: Creating corporate advantage (Collis)

The essence of corporate advantage is the way a company creates value through the configuration and coordination of its multi business activities.

Choices along the resource continuum
An outstanding corporate strategy is a constructed system of interdependent parts, it actively directs executives' decisions about the resources the corporation will develop, the businesses the corporation will compete in, and the organization that will make it all come to life. Also, all these elements are aligned with one another.

The alignment is driven by the nature of the firm's resources: its special assets, skills and capabilities. They can vary on a **continuum** from highly specialized to very general. This continuum is important because a corporation's location on this continuum constrains the set of businesses it should compete in and limits its choices about the design of its organization.

One common mistake is that managers often think that they are getting the alignment of their corporate strategy right when in fact they are not. They mistakenly enter the business based on similarities in products rather than similarities in the resources that contribute to competitive advantage in each business.



The authors of this reading use three examples of corporations that have an interesting corporate strategy. To make it a bit more up to date and closer to use we need to change to Barco which had a different corporate strategy and GIMV. These companies will organize themselves differently.

Both companies have a corporate strategy, but they are very different. What matters across these dimensions is consistency. A firm's corporate strategy really gets reflected in its organization (do board members specialize in a part of the business or in a world region?).

- *GIMV*: general skills that can be applied in different types of businesses; thus, a much wider scope that allows them to invest in a wide range of businesses.
- *Barco*: specialized technology company.

Nature of resources: GIMV: If we think about the nature of resources; as a PE they can invest in different types of businesses so the resources they have is very general.

The type of resources they command is much more specialized which means that the **scope of the businesses** can be very wide, they can invest in businesses in healthcare or smart cities, … in the case of Barco that's much narrower. They actually have divisions that is much more focused on information processing. How do we know whether the right balance of resources and businesses is adopted? When a firm's corporate capabilities enhance the competitiveness of every business it owns. This need for fit between resources and businesses constrains the set of businesses in which a company should operate but increases the likelihood that a multi business strategy will actually create value.

A great corporate strategy begins with a vision of how a company's resources will differentiate it from competitors across multiple businesses. Also important is how to achieve that vision. Which kind of coordination and. Control must the company employ in order to effectively deploy its resources?

For Barco and GIMV they both require very different **coordination mechanisms**. You can either share resources or transfer resources to capture synergies.
Transferring resources examples: moving managers across business units, annual management meetings, …
Sharing knowledge: using advanced data-management systems to capture the need of customers or using a sales force.
GIMV think more about transferring knowledge, … Barco is much more sharing knowledge.

Knowing whether to transfer or share resources is largely a question of what kind of resource you are trying to leverage.

You also need very different types of **control systems**. Without the appropriate control systems, the corporate center can lose is ability to determine strategic direction and influence performance in the individual businesses. Corporations have the choice between two types of control systems: operating or financial. Understanding which one fits a company's particular resources and businesses is critical to creating corporate advantage.

- Financial control holds managers accountable for a limited number of objective output measures (most appropriate in mature, stable industries)
- Operating control recognizes that all sorts of evens outside managers' influence may affect their performance (most appropriate for fast-moving industries with high levels of uncertainty)

In the case of GIMV the type of control systems are very financial, you follow the financial parameters, you invest as a private equity investor. In the case of Barco there might be some financial control mechanisms, but there is also clear operating control in for example distribution sales tech, … they are more closely operating control.

Lastly the **size of corporate office**: in GIMV you need people that control the financial parameters of a wide set of organizations, but you can have small corporate offices. In Barco the coordination is much more hands on, their corporate office will be much larger. It connects again to this principle we have been talking about in strategy where we need to think about the different elements and connect the dots. They are both organized differently but the way they are organized is consistent.

Important lessons:

- Corporate strategy is guided by a vision of how a firm as a whole will create value.
- Corporate strategy is a system of interdependent parts. Its success depends not only on the quality of the individual elements but also on how the elements reinforce one another.
- Corporate strategy must be consistent with and capitalize on opportunities outside the company.
- The benefits of corporate membership must be greater than the costs.
- There is no one fits all approach to corporate strategy

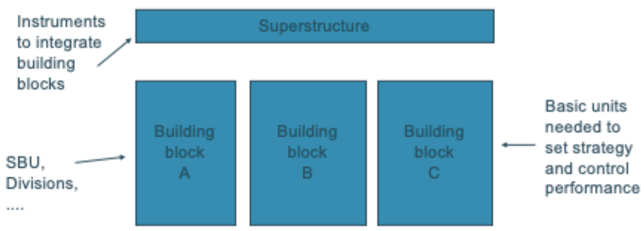
Corporate Strategy & Structure

At the same time this step is related to who you put in the top prior seats → leaders of an organization: when a new CEO comes in, it thinks about the strategy it wants to develop and as a result it makes the organization changes necessary which is reflected into the people and the new people coming in. What is clear in this example is that allot of the outgoing people, functions are related to regional divisions. The incoming people and titles are related more to different products in this example. Those titles reflect how the CEO wants to run the corporate strategy, what is important and where the focus should lie.
We see a clear shift from a more regional organizational structure to a more product related organizational structure.

Bekaert (changes 2019 – 2020)

- Oswald Schmid (2021) Matthew Taylor, Chief Executive Officer
- Yves Kerstens (2021) Jun Liao, Executive Vice President North Asia CEO Specialty Business & COO
- Curd Vandekerckhove Divisional CEO Bridon-Bekaert Ropes Group
- Arnaud Lesschaeve Divisional CEO Rubber Reinforcement Platform
- Stijn Vanneste, Executive Vice President Europe, South Asia and South East Asia Divisional CEO Steel Wire Solutions
- Taoufiq Boussaid Frank Vromant, Chief Financial Officer Americas Regional Operations Europe, North America and South Asia
- Yves Kerstens (2021) Oswald Schmid Operations Officer
- Kerstin Artenberg (2021) Rajita D'Souza, Chief Human Resource Officer
- Piet Van Riet Executive Vice President Industrial & Specialty Products Platform, Marketing, Customer Excellence and Group Business Development
- Geert Vanhaver, Chief Technology & Engineering Officer
- Juan Carlos Alonso is Chief Strategy Officer

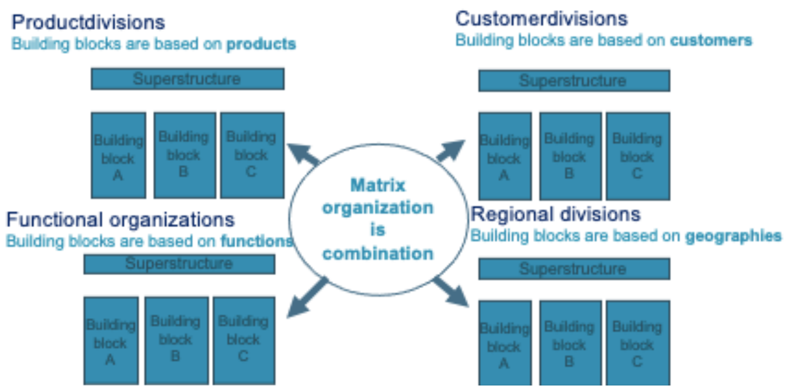
Building blocks and superstructure



Specialization versus Coordination
Trade off

When we think about corporates, there are different strategic business units.
A, B and C are business units with each their focus and leaders. Then you have a **superstructure** where you kind off have headquarters. The main focus of division A will be its own focus etc… the different ways we can think of that and how to coordinate is where your **corporate strategy** comes in.

Different building blocks are possible and can be based on….



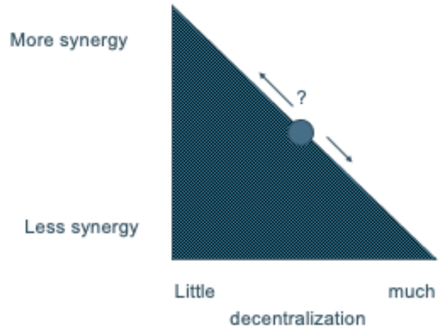
Different corporate strategies will lead to different organizational structures. Structure follows strategy?

Here you see four possible ways of organizing. In the case of Beakart you had those building blocks. The superstructure will try to coordinate between these different businesses.

- Product divisions…
- You can also organize along customer lines…
- Regional divisions: the main focus could be on developing the region and coordinate the products across the different regions.
- The functional organization where we have manufacturing, sales, marketing, … the leader will try to optimize these functions but the corporation needs to coordinate across functions

A key challenge for a multi-business group

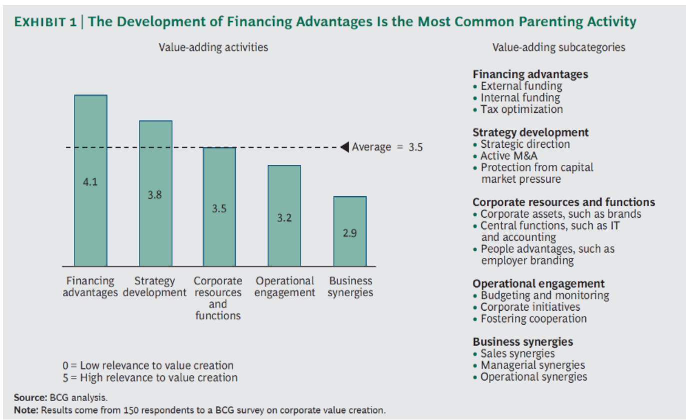
When we think about corporate strategy, we think about being a stand-alone organization or having different businesses within the same corporation and coordinating between these different businesses and creating these synergies.



There is this **tradeoff**: if we decentralize more it will be harder to create these synergies, if we decentralize less we might create more synergies but this decentralization might hurt the incentives to focus on their business. So corporate strategy has really this important tension between decentralization on the one hand and trying to create these synergies on the other hand.
Synergies are kind off the 'dirty word' in strategy, they are very difficult to realize and often times claimed.

Synergies?

Which synergies actually work?



- The highest scoring activity is **financial advantages**: better access to funding, … internal funding maybe…. There might be information asymmetries. Having different business together might have some advantages.
- **Strategy development**: M&A, for that you need a typical structure, and that structure has to be leveraged to different businesses.
- **Corporate resources and functions**: Leverage training, costs, … move managers from one business to another
- **Operational**: the value or the relevance that companies give to this is much lower and that indicates that it is nice to claim all these costs savings you can do by having a corporate strategy and putting these different businesses together → it's nice to claim all these advantages but many times it is difficult to realize these advantages. You need a really good story. The leaders of these businesses will be focused on their business.

Some conclusions

- There is not one success formula for corporate strategy. Value can be created in several way.
    - It is organization specific, and every organization needs to tell a story about how they will create value. This gap can happen in several ways, but the baseline, the principle stays the same; if we put businesses together we should ask ourselves, how does this allow us to create more value than the alternative of not being together. And do we really have to be under the same corporation?
- Synergy is often talked about but is difficult to implement (“dirty word”)
    - theoretical benefits are not easy to capture in practice
    - modern organizational structures make capturing of synergies more difficult

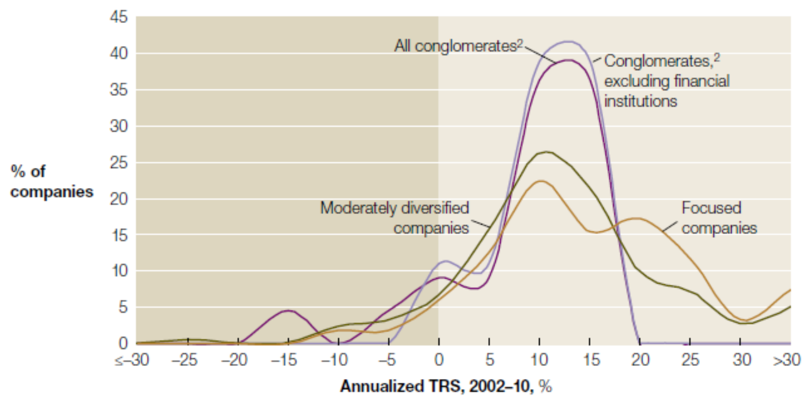
Topic 8: Diversification Strategy

Diversification strategy is an interesting application of corporate strategy
Diversification is something about which corporations often talk about (often in finance).

Diversification Discount
Median Total Return to Shareholders (2002-2010)

- Focused Company: 11.8%
- Conglomerate: 7.5%

Distribution of S&P 500 companies by total returns to shareholders (TRS), n =461[1]



[1]Includes companies in 2010 S&P 500 that were also publicly listed on Dec 31, 2002.
[2]Defined as any company with 3 or more business units that do not have common customers, distribution systems, manufacturing facilities, or technologies.

This is a study done by McKinsey.
In this case, they looked at the S&P 500 companies. They looked at total returns to shareholders and different types of companies:

- Focused companies: companies that are focused on particular business in a particular industry
- Conglomerates: organizations that are in different businesses that have very little relation

If you look at average returns of those two, the focused companies seems to generate on average higher returns. The idea is that it’s not good idea for a company to be in different businesses that have very little relation. An investor could do better by investing in different focused businesses that combine the same portfolio activities.
The diversification discount shows that there is little reason to bring businesses that are every different under the same organization except that obviously, if you have an interesting corporate strategy so what is then the story? What is the advantage to bring these different businesses together?

If the answer is **not better off** being under the same organization and little parental value, then these should maybe be under different organizations.

Emerging markets

- South Korea: 80% top 50 companies by revenue are conglomerates with average growth rate of 11%
- India: 90% top 50 companies by revenue are conglomerates with growth rate of 23%

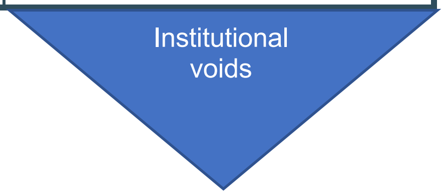
Is focus the right advice for emerging markets' groups?
What's different?

- Product market, capital market, labor market, government regulation, contract enforcement

Most of the top 50 companies in South Korea are actually conglomerates with very high average growth rate and better financial performance than focused companies.
In emerging markets there are allot of differences maybe these groups in emerging markets can take care of some of these issues and provide value, and create value by having these businesses under the same organization.

Institutions and strategy

<u>Dimension</u>	**USA**	**India**
Capital mkt	**Equity-focused, mkt for corporate control**	**Underdeveloped, weak monitoring**
Labor mkt	**Many BSs, consulting**	**Few BSs, little training**
Product mkt	**Liability laws, info, activists**	**Little info, few activists**
Government regulation	**Low, low corruption**	**High, corruption diffused**
Contract enforcement	**Predictable**	**Highly unpredictable**



If you compare US VS India:
In the US they can get external funding on the capital market, in India it is much more difficult. Same with labor market. In India, there is different training in organization, there is less people that have been trained in business schools. Organizations do that themselves and they move people within the same organization. These large groups actually provide an internal labor market.

Similarly, when we think about the labor market and reputation. You can have different organizations who develop different products. If the laws are not very well enforced than maybe creating reputation by having the product or the same organization creates value.

Similarity for government regulation and contract enforcement: there might be reasons for why a group can do better than a focused company in this environment.

→ This has turned to **institutional voids**: if you have this, than a group can actually cover that institutional void and having a conglomerate might make allot of sense compared to having such a group in the US where that group will create less value given that these institutions are well developed.

Martin and Sayrak (2003) What is the Puzzle?
(He said not really exam material)

- What is the puzzle? Whether or not corporate diversification creates value or destroys value. There are different theories and they come from different areas and fields in businesses
- Why diversify?
    - Agency theory: Managers like to diversify because they like the power and prestige of having an organization, they might secure their own position. Allot of their wealth is invested within the corporation they are at. Obviously, these are not good reasons for investors to invest in companies who diversify into conglomerates. Agency theory predicts that diversification is not a good idea, and you would create a diversification discount. Diversified companies will trade at a lower rate than similar
        - Increase compensation, power, prestige
        - Make position in firm more secure due to manager-specific skills
        - Reduce risk personal investment portfolio
    - Resource based firm
        - Excess capacity in resources and capabilities transferable across industries (economies of scope)
        - Diversifying can help firms reduce their excess capacity. You can realize certain economies by bringing different businesses together.
    - Market power
        - Sustain predatory pricing from one business to another: : I can sustain predatory behavior in one business by leveraging returns from another business. We can subsidize one business from another business! In competition with other players that do not have the ability to subsidize their businesses.
        - Multi-market contact: I can retaliate in different businesses where competition tries to attack me. Then I can retaliate in another division of the business where the competition does not have a huge stake.
        - Reciprocal buying to squeeze out small firms

As you can see there are different stories of why firms might diversify. In the end whether or not this creates value is an empirical question.

- Empirics 1: diversification destroys shareholder value
    - Resource misallocation: agency and inefficiency
    - Test? Diversified versus focused firms
    - They compared focused with conglomerates, and focused performed better
- Empirics 2: diversification does not destroy shareholder value
    - Diversified and focused companies are different
    - Test? Before and after diversification
    - By comparing diversified firms with focused firms, these firms might actually be different. We actually want to compare the same firm that at the beginning might be focused and then become diversified and then see how this firm does over time. So diversified firms and focused firms are different types of companies. Focused firms will stay focused and diversified firms have different reasons why it might have an advantage of doing that, the real test is looking at the company before and after diversification whether or not they do better. What they found is that actually in some cases, diversification might not destroy shareholder value but these are not reasons why they have a good strategy they need a story.
- Empirics 3: diversification creates shareholder value
    - Diversified companies are better
    - Test? Measurement error in Business segment data
    - Future? Better measures of corporate diversification capturing relatedness
    - Actually diversification does create shareholder value, but the way we have been measuring and comparing was maybe not with the best data. We have been comparing firms in the same industries but these classifications are pre recourse in terms of they measure industry and compare firms. So, when we use better measures, which is harder for larger samples, studies have found that diversified companies seem to do better. As a result, there might be allot of measurement there.

Topic 9: Governance & Corporate Social Responsibility

Shareholder Value Perspective

"The Social Responsibility of Business is to Increase its Profits."
- **Friedman, (1970)**

…it may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill… or have other worthwhile effects.

→ The context was very different when Friedman wrote this.
The most famous quote is the left one but the right one shows that he thinks about long term consequences of firms etc but always in the shareholder perspective.

Businessmen believe that they are defending free enterprise when they claim that business is not concerned only with profit but also with promoting desirable social ends, that it has a social conscience and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution, … They are in fact preaching socialism.

The discussions of the social responsibilities of business are loose and lack of rigor: only people can have responsibilities, businesses can't. Presumably, businessmen (corporate executives) are the responsible ones. In a free enterprise, they are employees of the business owners and have direct responsibilities (to their employers) to conduct the business in accordance with their desires – usually to make as much money as possible while conforming to the basic rules of the society. In the case of a hospital or a school, the objective will lean towards the rendering of certain services rather than solely making a profit

The corporate executive is also a person with other personal responsibilities (to his family, his conscience, his country, to refuse to work for certain corporations, …). They are the social responsibilities of this individual, in which he is acting as a principal, spending his own money, time and energy; not the money of his employers or the time and energy he has contracted to devote to their purposes.

To say that the corporate executive has a social responsibility in his capacity as businessman, it must mean that he is to act in some way that is not in the interest of his employers (not raise a price to contribute to the social objective of preventing inflation, …), or that he has to make expenditures beyond the amount that is in the best interests of the corporation. In either case, he would be spending someone's else money for a general social interest. If his decisions reduce returns to stockholders, he is spending their money. If his actions raise the price to customers, he is spending their money. In the shareholders' perspective managers should only do things that increase their utility of the shareholders.

He is thus imposing taxes on the one hand and deciding how the tax proceeds will be spent on the other. It raises political questions on the levels of principle and consequences. Usually, taxes are imposed so far as possible in accordance with the preferences and desires of the public. The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for social purposes. He becomes in effect a public employee, even though he remains an employee of a private enterprise. So, he should be elected through a political process. This is the reason why the doctrine of social responsibility involves the acceptance of the socialist view that political mechanisms (not market ones) are the appropriate way to determine the allocation of scarce resources to alternative uses. Everyone can do good, but only at their own expense.

On the grounds of consequences, can the corporate executive in fact discharge his social responsibilities? He is presumably an expert in running his company, but not on inflation for example.

Can he get away with spending his stockholders', customers' or employees' money? They could desert him for others, less scrupulous in exercising their social responsibilities.
In many cases, there is a strong temptation to rationalize actions, such as charity giving as an exercise of social responsibility. Nowadays, with the widespread aversion to capitalism, profits, the soulless corporation, …, this is one way for a corporation to generate goodwill as a by-product of expenditures that are entirely justified in its own self-interest.

Whether blameworthy or not, the use of the mask of social responsibility, and the nonsense spoken in its name by influential businessmen, does clearly harm the foundations of a free society. Some are capable of being farsighted in matters internal to their businesses and shortsighted in matters outside their businesses but that affect the possible survival of businesses in general. The shortsightedness is exemplified in their speeches on social responsibility. This may gain them kudos in the short run, but it helps to strengthen the already too prevalent view that the pursuit of profit is wicked and immoral and must be curbed and controlled by external forces.

In a free society, there is only one social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game; that is, engages in open and free competition without deception or fraud.

Value for whom?

- *Shareholder Perspective*: The firm exists to maximize the wealth of its owners (the social responsibility of business is to increase its profits)
- *Stakeholder Perspective*: The firm is a coalition of interest groups - it seeks to balance their different objectives

Important to distinguish creation and capturing because if we think that creating value equates capturing than we might not see interesting opportunities.

When we talked about value creation we were not only talking about the firm.

"Purpose"

- Purpose is not a mere tagline or marketing campaign; it is a **company's fundamental reason for being** – what it does every day to create value for its stakeholders.
- Purpose is not the sole pursuit of profits but the animating force for achieving them. Profits are in no way inconsistent with purpose – in fact, **profits and purpose are inextricably linked**.
- Profits are essential if a company is to effectively serve all of its stakeholders over time – not only shareholders, but also employees, customers, and communities. Similarly, when a company truly understands and expresses its purpose, it functions with the **focus and strategic discipline that drive long-term profitability**. Purpose unifies management, employees, and communities. It **drives ethical behavior** and creates an essential check on actions that go against the best interests of stakeholders. Purpose guides culture, provides a framework for consistent decision-making, and, ultimately, helps sustain long-term financial returns for the shareholders of your company.
- Companies that fulfill their purpose and responsibilities to stakeholders reap rewards over the long-term. Companies that ignore them stumble and fail. This dynamic is becoming increasingly apparent as the public holds companies to more exacting standards. And it will continue to accelerate as millennials – who today represent 35 percent of the workforce – express **new expectations of the companies** they work for, buy from, and invest in.

Examples

Patagonia's stated goals
Patagonia owner: the way of organizing his business

- Cause no unnecessary harm
- Be profitable: "it's ok to be eccentric as long as you are rich otherwise you are just crazy"
- Achieve growth "The company was targeting a 10% annual growth for the next five years"

→ Patagonia was a business which tried to make profits, but it had a strong purpose in causing no unnecessary harm
→ It's important to understand purpose if you want to understand the company

Van de Velde

Making Women Stronger
Mission: Shaping the bodies and minds of women

Why important? Because every time we talk about strategy somebody will come up with the idea of making lingerie for men. But this purpose makes very clear that this is not part of the activities of van de Velde.

Colruyt

Create sustainable added value together through value-driven craftsmanship in retail.

- **Together.** Only together with our colleagues, suppliers, business partners, investors and customers can we make a positive difference.
- **Added value**. Creating social added value gives our work meaning, generates satisfaction and makes us wiser. Those are the true, lasting 'rewards'. Money, on the other hand, is merely a resource that we invest to realise our common dream.
- **Sustainable creation**. Every day, we start with a blank page. We gaze in amazement at the world to see what is possible, conscious of our strengths and limitations. And we don't waste energy needlessly from ourselves, our environment or nature.
- **Value-driven**. Our values form a common frame of reference that determines how we behave and cooperate with one another. They ensure that we act coherently and consistently, in everything we do.
- **Craftsmanship**. Living craftsmanship is a source of joy and pride. Our company's success is determined by the skills, attitudes and knowledge of our employees and their teams.
- **In retail**. Our craft is still retail, even though, over time, our entrepreneurship and creative drive have spawned many other initiatives.

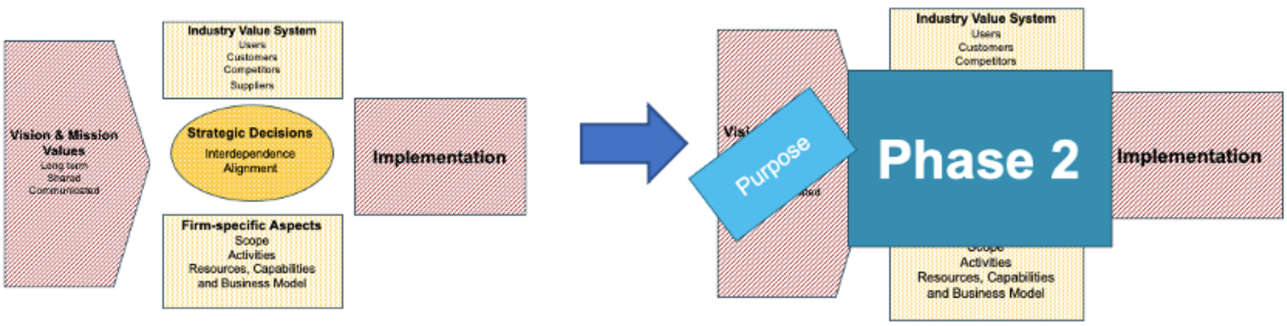
This is very instructive because we start to understand where Colruyt goes and how they translate that into their strategy.

Let's compare this with Delhaize: conflict with employees and its owners.
You see in their vision and purpose that they don't talk about their people.

→ Same business, but have very different purpose. Which leads to very different strategy and outcome. We will not argue that one is better than the other and that has consequences of how they developed their strategy, and behaved, …

→ Purpose has become more and more important to understand.

What is Strategy? Choice of a Future



We saw this in the first class. We focused on the middle part: phase 2.
Obviously there is a stage before which is also important, long term step that impacts strategy.
→ Purpose summarizes that first step.

Classic reading: Creating Shared Value

Capitalism is under siege, diminished trust in business is causing political leaders to set policies that sap economic growth. Business is caught in a vicious circle. The purpose of the corporations must be redefined around creating **shared value**; a concept which focuses on the connections between societal and economic progress and could unleash the next wave of global growth.

Companies are being blamed for all society problems and perceived to be prospering at the expense of the broader community. The issue lies within companies: they are trapped in an outdated approach to value creation, optimizing short-term financial performance while ignoring customer needs. Companies think that simply shifting activities to locations with lower wages is a sustainable solution to competitive challenges. They ignore the depletion of natural resources vital to their businesses and the economic distress of the communities in which they produce and sell. They must take the lead in bringing business and society back together.

The solution lies in the **principle of shared value**, which involves creating economic value that also creates value for society by addressing its needs and challenges. Shared value is all the policies and practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in which it operates. It will require new skills and knowledge: appreciation of societal needs, understanding of the bases of a company productivity, collaboration across profit/non-profit boundaries. Shared value is a way to achieve economic success. Companies can create shared value opportunities:

- By reconceiving products and markets: he demand for products and services that meet societal needs is rapidly growing. Companies need to offer products and services that create social societal benefits (healthier food, environmentally friendly products). This way shared value is created.
- By redefining productivity in the value chain: A company's value chain inevitably affects and is affected by numerous societal issues. Opportunities to create shared value arise because societal problems can create economic costs in the firm's value chain. The synergy increases when firms approach societal issues from a shared value perspective and invent new ways of operating to address them. A deeper understanding of productivity and a growing awareness of the fallacy of short-term cost reductions are giving rise to new approaches.
- By building supportive industry clusters at the company's locations: The success of every company is affected by the supporting companies and infrastructure around it. Productivity and innovation are strongly influenced by "clusters," or geographic concentrations of firms, related businesses, suppliers, service providers, and logistical infrastructure in a particular field. Clusters also include: academic programs, schools, clean water, …They play a crucial role in driving productivity, innovation and competitiveness. Firms create shared value by building clusters to improve company productivity while addressing gaps or failures in the framework conditions surrounding the cluster. An example is the creation of open and transparent market which allows a company to secure reliable suppliers, give suppliers better incentive for quality and gives purchasing power to citizens.

Each of these is part of the virtuous circle of shared value; improving value in one area gives rise to opportunities in the others. The three avenues for creating shared value are mutually reinforcing. Enhancing the cluster, for ex- ample, will enable more local procurement and less dispersed supply chains. New products and services that meet social needs or serve overlooked markets will require new value chain choices in areas such as production, marketing, and distribution. And new value chain configurations will create demand for equipment and technology that save energy, con- serve resources, and support employees.

Capitalism can help meet human needs, improve efficiency, create jobs and build wealth. But a narrow conception of capitalism has prevented business from harnessing its full potential to meet society's broader challenges and opportunities have been overlooked. The concept of shared value resets the boundaries of capitalism. The purpose of companies must be redefined as creating shared value, not just profit; this will drive the next wave of innovation and productivity growth in the global economy, as well as reshaping capitalism and offering benefits to society. Learn how to create shared value is the best way to legitimize business again; because the idea that to provide societal benefits, companies must temper their economic success, has been largely legitimized (moving beyond trade-offs). By better connecting companies' success with societal improvement, it opens up many ways to serve new needs, gain efficiency, create differentiation, and expand markets. We need a more sophisticated form of capitalism, one imbued with a social purpose. But that purpose should arise not out of charity but out of a deeper understanding of competition and economic value creation. This next evolution in the capitalist model recognizes new and better ways to develop products, serve markets, and build productive enterprises. So the concept of shared value is not in contrast with capitalism.

The ability to create shared value applies to advanced economies and developing countries, though the specific opportunities will differ. The opportunities will also differ markedly across industries and companies, but every company has them. Their range and scope are really broad.

Adding a constraint to a firm that is already maximizing profits will supposedly raise costs and reduce profits. The concept of shared value, in contrast, recognizes that societal needs, not just conventional economic needs, define markets. It also recognizes that social harms or weaknesses frequently create internal costs for firms (wasted energy, raw materials, costly accidents, training to compensate for inadequacies in education) but addressing societal harms and constraints does not necessarily raise costs for firms; because they can innovate (new technologies, operating methods, management approaches) and increase their productivity and expand their markets.

Shared value is not about personal values, nor about sharing the value already created by firms (redistribution approach – fair trade). It is about expanding the total pool of economic (productivity) and social value.

The roots of shared value: A business needs a successful community, not only to create demand for its products but also to provide critical public assets and a supportive environment. A community needs successful businesses to provide jobs and wealth creation opportunities for its citizens. This interdependence means that public policies that undermine the productivity and competitiveness of businesses are self-defeating, especially in a global economy where facilities and jobs can easily move elsewhere.
The old view of capitalism permeated management thinking for two decades and resulted in commoditization, little true innovation, price competition, slow growth and no clear competitive advantage.

Strategy theory holds that to be successful, a company must create a distinctive value proposition that meets the needs of a chosen set of customers. The firm gains competitive advantage from how it configures the value chain, or the set of activities involved in creating, producing, selling, delivering, and supporting its products or services. However, companies have overlooked opportunities to meet fundamental societal needs and misunderstood how societal harms and weaknesses affect value chains.

The concept of shared value blurs the line between for-profit and nonprofit organizations. New kinds of hybrid enterprises are rapidly appearing. This is a strong sign that creating value is possible.

Shared value is defining a whole new set of best practices that all companies must embrace. It will also become an integral part of strategy. The essence of strategy is choosing a unique positioning and a distinctive value chain to deliver on it. Shared value opens up many new needs to meet, new products to offer, new customers to serve, and new ways to configure the value chain. And the competitive ad- vantages that arise from creating shared value will often be more sustainable than conventional cost and quality improvements. The cycle of imitation and zero-sum competition can be broken.

Corporate social responsibility	**Creating shared value**
Value: doing good	Value: economic & societal benefits relative to cost
Citizenship, philanthropy, sustainability	Joint company and community value creation

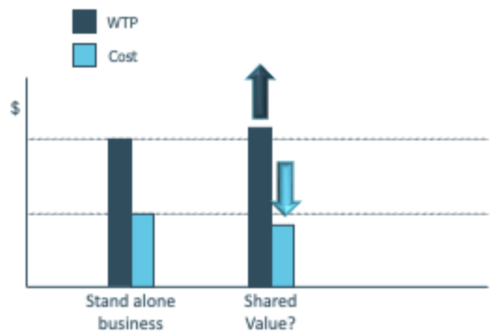
Discretionary or in response to external pressure	Integral to competing
Separated from profit maximization	Integral to profit maximization
Agenda is determined by external reporting and personal preferences	Agenda is company specific and internally generated
Impact limited by corporate footprint and CSR budget	Realigns the entire company budget
Example: fair trade purchasing	Example: transforming procurement to increase quality and yield

Creating shared value represents a new approach to managing that cuts across disciplines. Because of the traditional division between economic and social concerns, people in the public and private sectors have often followed very different educational and career paths. As a result, few managers have the understanding of social and environmental issues required to move beyond today's CSR approaches, and few social sector leaders have the managerial training and entrepreneurial mindset needed to design and implement shared value models. Most business schools still teach the narrow view of capitalism, even though more and more of their graduates are drawn to social entrepreneurship and a greater sense of purpose.

Not all societal problems can be solved through shared value solutions. But shared value offers corporations the opportunity to utilize their skills, resources, and management capability to lead social progress in ways that even the best-intentioned governmental and social sector organizations can rarely match. In the process, businesses can earn the respect of society again.

Types of Competitive Advantage

The concept of shared value fits very well when we think about creating competitive advantage, creating more value than the alternative. We think here about how we create value and each stakeholder, will capture some of that value. It is a starting point.



Value can be created either on the WTP side or on the cost side. But companies should think about doing business differently and be creative. There are still opportunities that lie within:

- *Products*: create new products for new markets and create value that a business can capture.
- *Value chains & supply chains*: lean supply chain could improve social performances. Potential mechanisms include:
    - Labor relations: try to keep better trained workers.
    - Management processes: complementarity between improved management systems and complying with labor, health and environmental standards.
      → Lean manufacturing actually improved labor relations.
- *Circular economy & local business*: collection fees to recycle, recycling old clothes, …
- *Clusters*: they can generate positive externalities for the environment they're in and create a lot of value for different sectors.

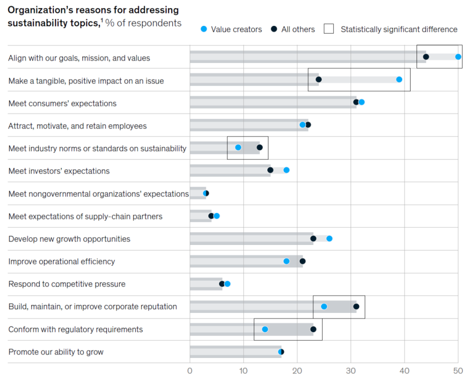
<u>Connect to today reading</u>: How is value created with ESG?
We try to make these connections on a more macro level: how do they create value in society?

A strong environmental, social, and governance (ESG) proposition links to value creation in five essential ways.

	Strong ESG proposition (examples)	**Weak ESG proposition** (examples)
Top-line growth	Attract B2B and B2C customers with more sustainable products Achieve better access to resources through stronger community and government relations	Lose customers through poor sustainability practices (eg, human rights, supply chain) or a perception of unsustainable/unsafe products Lose access to resources (including from operational shutdowns) as a result of poor community and labor relations
Cost reductions	Lower energy consumption Reduce water intake	Generate unnecessary waste and pay correspondingly higher waste-disposal costs Expend more in packaging costs
Regulatory and legal interventions	Achieve greater strategic freedom through deregulation Earn subsidies and government support	Suffer restrictions on advertising and point of sale Incur fines, penalties, and enforcement actions
Productivity uplift	Boost employee motivation Attract talent through greater social credibility	Deal with "social stigma," which restricts talent pool Lose talent as a result of weak purpose
Investment and asset optimization	Enhance investment returns by better allocating capital for the long term (eg, more sustainable plant and equipment) Avoid investments that may not pay off because of longer-term environmental issues	Suffer stranded assets as a result of premature write-downs Fall behind competitors that have invested to be less "energy hungry"

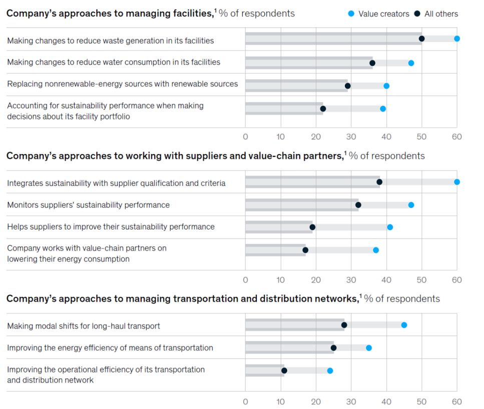
In another article, companies that were creating value, organizations that are value creators, are much more active in creating sustainability and aligning this with their goals and missions and their own values in the organizations making them tangible and a positive impact on these issues. Dealing and meeting the industry norms, standards and sustainability.

Companies creating value with sustainability are more likely than others to address the issue for reasons related to their organizational purpose.



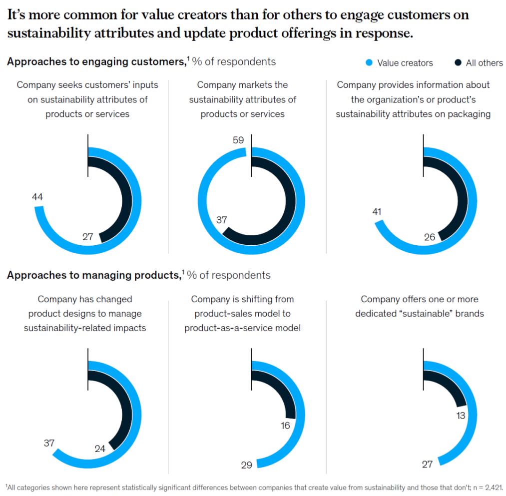
[1]All 13 topics that were presented as answer choices. Responses with "don't know," "other," and "not applicable" are not shown here. Total n = 2,475.

We see that firms that are doing well economically they are also very active on issues of sustainability. They translate that on different levels: on the one hand supply side, working with suppliers, distribution networks and at the same time very active on customer and product side.



[1]All categories shown here represent statistically significant differences between companies that create value from sustainability and those that don't; n = 2,421.

Again, these issues of ESG environment, social and government issues go through all the activities of the organization, they need to be embedded and those companies seem to do better than other organizations → there is a potential win win situation



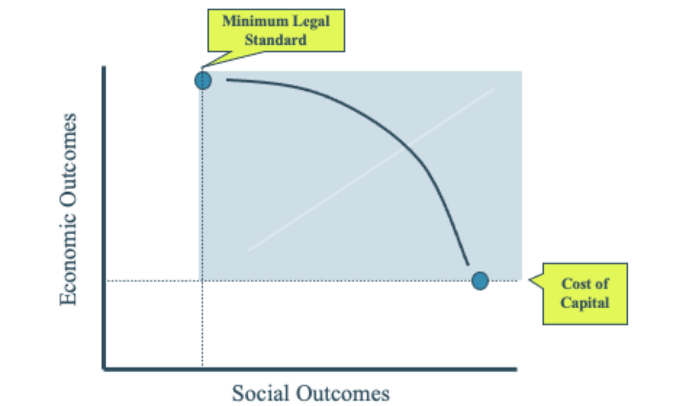
These issues go from linking with supplier, to developing new products to engaging with your own employees so it really touches the whole organization, and these companies seem also to do better on economics parameters

How do we deal with this? There are many different issues coming at us at the same time. The UN has put those into 17 different categories. As an organization, and if we think about strategy, how do we deal with all those potential opportunities of creating value and potentially capturing value and how do we deal with all those constraints.

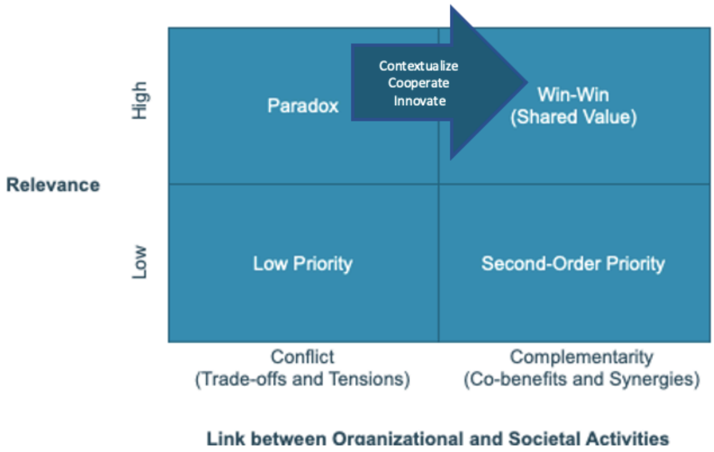
The Role of the Firm: Economic and Social Performance

Before capturing value, value needs to be created! There's often a tradeoff between social outcomes and economic outcomes. However, by thinking of business differently and thinking of the costs, it is possible to achieve both.

- When I think about strategy from a pure economics perspective: on the one hand we can think about economic outcomes Then I need a return which is higher than my cost of capital.
- At the same time there are some legal minimum requirements. There are some laws that I have to abide by. There are social outcomes.
- The playing field is this area above two dotted lines. I want to play in these different areas.



The question is, is there a win win? Meaning that social and economic outcomes are positively correlated. Or typically, there are tradeoffs because resources are limited and if I am at the frontier and I want to increase social outcomes I want a tradeoff in economic outcomes. Firms might locate some of the extremes. Others might choose lower economic outcomes in order to survive. But in many cases we might be in the middle space below the frontier and then we can improve both economic and social outcomes an create some win win situation which will solve some (and not all) of the problems.



- **Social relevance**: could be high or low
- **Organizational activities**: how are these social activities related to organizational activities? Complementary or in conflict?

They classify different projects in these different quadrants.
- If they are highly relevant and they are complementary to organizational activities, then we can create a **win win** and we believe that this is actually where the shared value is located. Here we can do things by improving the business and at the same time social outcomes.
- Some activities might have high social relevance but might create tension or tradeoffs that's where we have a **paradox**. It's much harder to advance then. In the win win situation, allot can be done.

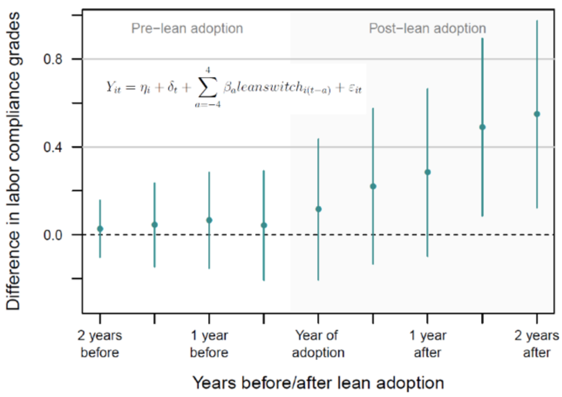
This article posits that the way to advance in this area, and to make it more concrete and have actions and execution is by **contextualizing** first, putting it in the environment of the business, think about stakeholders etc. Then think about innovating.

Examples

Contextualize: Geographically
Geographically: Empesa → transfer money through your telephone.
They found a way to transfer money in Africa where people mostly don't have bank accounts which is a very useful concept and maybe not here in Europe.
It creates allot of social value for people in Africa.

Contextualize by Industry: Nike and Lean Manufacturing

What they observed is that not only they improved their manufacturing skills but at the same time they improved labor compliance so these suppliers were abiding more regulations and laws..
By introducing this, they increase efficiency of production and at the same time they improved the compliance with the labor issues.



Contextualize by Industry: Supply Chains
- Lean supply chain improves social performance?
- Potential mechanisms

- Labor relations: try to keep better and better trained workers
- Management processes: complementarity between improved management systems and complying with labor, health and environmental standards

It might be that if you train your workers better you might do a better effort to keep them OR
There might be some complementarity → Again contextualizing

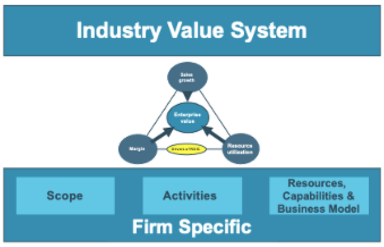
Contextualize, Cooperate and Innovate
Circular Economy: Mattresses and Dow Chemicals?

Dow chemicals: making raw materials for matrasses
The problem is that millions of matrasses get thrown away: they developed a reverse engineering were they collected these matrasses and collected the raw materials from those.
The real problem is how do we get these matrasses back to us? The distribution, the logistics to get these matrasses back is an important problem where they needed collaboration and partners.
The hard part was the logistics of these matrasses. So, you really need to think broadly, how do we make sure that many players in the chain are collaborating

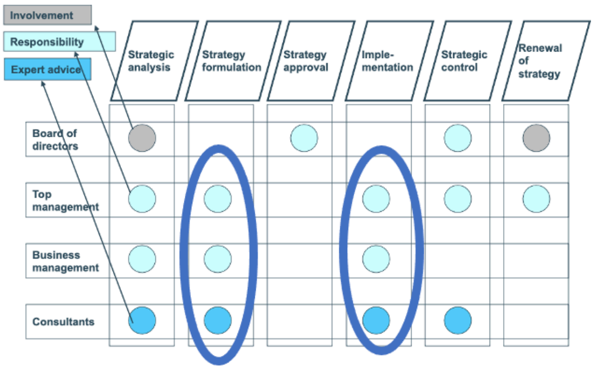
We need to find ways to create value for stakeholders but at the same time we need to allow different players to capture some of this value. How do we organize that? That's why the professor think it's interesting to look at the strategy framework we have developed on value creation and value capture. Connect that to purpose of organization and embed it in the purpose and other objectives (like for example one of those sustainable goals).

Topic 10: Strategy process

Strategy and the Drivers of Enterprise Value

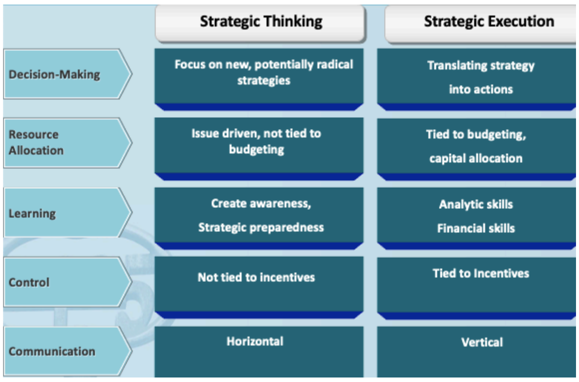


Who does what for strategic decision-making?



In terms of strategic decision making and the different elements, from analysis and renewal. We talked allot about strategy formulation, but we also need to think about executing. You can see who is really involved in formulation vs execution. It's the top management or business unit management. It's really an integral part of the organization.

Formulation and Execution



Strategic thinking and strategic execution → is not the same!
When we think about strategic thinking it's really about focusing on new ideas, new directions
Execution is about translation: how do I translate where I want go to my people. If I cannot translate this then it will not happen.

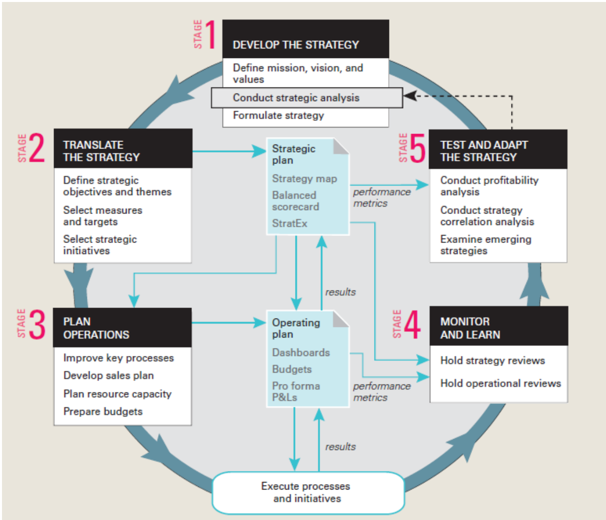
- Resource allocation: thinking is thinking it's not driven by allocation but once you start executing, we have to determine how much we spend on capital expenditures etc… without means you cannot realize your ambition.
  - If you have ambition you have to make sure you have the means to do that. This might be developing the ambition.
- Control: if we **think** strategically, it's not tied to incentives but once you start **executing** you have to put the right incentives in place. Otherwise, it won't happen. Developing strategy is not tied to incentives.

When thinking about strategy its more horizontal we want input from everybody in the organization. Everyone has a say. But once we decide, its commanding control is vertical.
It all has to come together but execution and development are different part of the strategy process.

As an executive you have to make decisions everyday but if those decisions do not add up with where you want to go then there is not much reason to think strategically.
When we think about strategy, we think about having the strategy in the back of your mind and being able to make decisions that are consistent with the strategy all the time. If you can't do that there is no point in having a strategy. If you can't communicate that to your people, there is no point in having a strategy.

The Management System (classic reading)

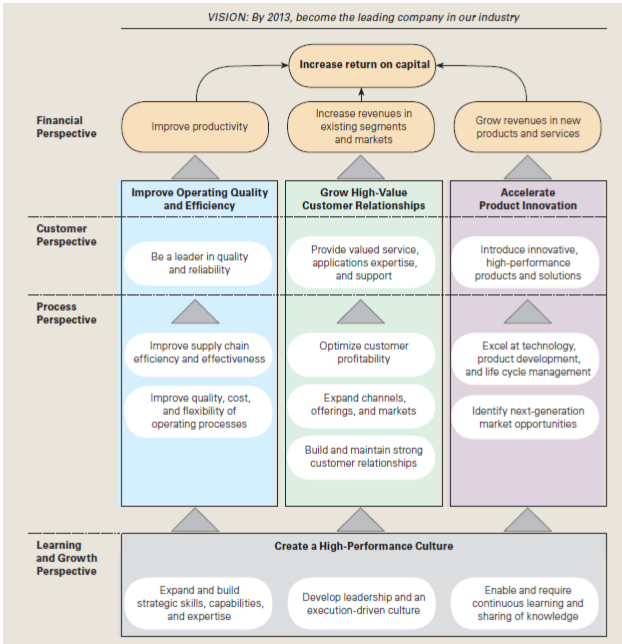
We developed a strategy, but then we need to translate this into specific objectives.
→ *How are we going to realize enterprise value?*
KPIs are important. We have to set some high level KPIs, it's not only about how much money you have in X years but maybe how many new customers? … also, we have our day-to-day business: this year, ST what are we doing? You need to connect LT with ST. We need to make that consistent. LT objectives are in strategic plan and ST is an operating plan. You have objectives. You need to develop some measures that you track.
You need to learn; you have some outcomes. Are we expecting what is happening? Maybe not... We need to test and adapt. You need some flexibility; you need to connect to the operations otherwise nothing will happen.



The **management system** is the integrated set of processes and tools that a company uses to develop its strategy, translate it into operational actions, and monitor and improve the effectiveness of both. The failure to balance the tensions between strategy and operations is pervasive. By creating a closed-loop management system, companies can avoid such shortfalls.
The loop comprises five stages:

1. Strategy **development** involves applying tools, processes, and concepts such as mission, vision, and value statements; SWOT analysis; shareholder value management; competitive positioning; and core competencies to formulate a *strategy statement*. This step should explore following questions:
    - What business are we in and why? (Mission, vision and values)
    - What are the key issues we face in our business? (Strategic analysis of the company's internal and external situation, SWOT)
    - How can we best compete? (tackle the strategy formulation itself, the statement describing the strategy and how the company wants to achieve it)
2. The *strategy statement* is then **translated** into specific objectives and initiatives, using other tools and processes, including strategy maps and balanced scorecards.
    - Strategy map: tool for visualization of the strategy as a chain of cause-and-effect relationships among strategic objectives.
    - Balance scorecard: maps the performance metrics and targets for each strategic objective
3. **Plan operations**: strategy **implementation** links strategy to operations with a third set of tools and processes, including quality and process management, reengineering, process dashboards, rolling forecasts, activity-based costing, resource capacity planning, and dynamic budgeting.

    - This stage starts with setting priorities for process improvement projects (align near-term process improvements with LT strategic priorities) followed by preparing a detailed sales plan (deconstruction of overall sales target into quantity, mix, …), resource capacity plan (identify required resources to implement strategic plan) and operating & capital budgets (financial means for acquiring the needed resources).
4. **Monitor and learn**: as implementation progresses, managers continually **review** internal operational data and external data on competitors and the business environment.
    - Review the performance of operating departments and business functions
    - Review balance scorecard performance indicators and initiatives to assess progress and identify barriers to strategy execution
5. **Test and adapt the strategy**: Finally, managers periodically **assess** the strategy, updating it when they learn that the assumptions underlying it are obsolete or faulty, which starts another loop around the system.
    - Cost and profitability reports: understand current economics of existing strategy
    - Statistical analyses: estimate correlations among strategy performance numbers
    - Emergent strategies: consider new strategies



The reading gives an example:
This generic strategy map illustrates how a corporate strategy can be sliced into four themes, each with its own cause-and-effect relationships. Real-life maps will be more complex but will still have the desirable property of making strategy much easier to understand and manage. The strategic themes provide a common structure that unit managers can use to develop their own maps within the big picture and a governance structure that assigns accountability for actions.

They tried to develop the different initiatives for this company. They have like different initiatives. That is going to affect the returns. This fits perfectly with what we have been discussing in our framework.
→Increase ROI: what are our levers? One is margin, one is resource utilization, and one is sales growth. They think about different levers affecting the outcome. That is what we are working towards.
→ We also have our initiatives. Which products for which customers? This is about scope, what products or services are we offering to customers in different area's? Which activities are we developing in order to actually realize that? Is that consistent?

Managers have always found it hard to balance near-term operational concerns with long-term strategic priorities. But such a balancing act comes with the job; it is an inherent tension that managers cannot avoid and must continually address. At the same time, a company can have the best strategy in the world, but it will get nowhere if managers cannot translate that strategy into operational plans and then execute the plans and achieve the performance targets.
The closed-loop management system enables executives to manage both strategy and operations, and to balance the tensions between them.

This is just to show you that we can translate allot of what is out there in the business literature in a simple framework we developed in class, everybody will have a different name, but it all comes back to the same issues in terms of how do you position yourself relative to your environment, and scope activities, resources and capabilities. Tell a consistent story, how does that affect the outcomes you want to affect? That is what strategy is about.
→ common sense: it's really about this how do we put these things together?

Top management team

- The CEO matters! (Bertrand and Schoar, 2003)
  - How do we know that leadership matters?
    They looked at a CEO of a company, which moves from company to company. Empirically we can follow them and see whether there is an effect on their leadership. They do find important CEO effects, and the CEOs affect significant things.
    - Significant effect of CEO changes on investment policies, dividend policy, cash management, number of acquisitions, R&D and advertising, SG&A.

Top management team & strategy

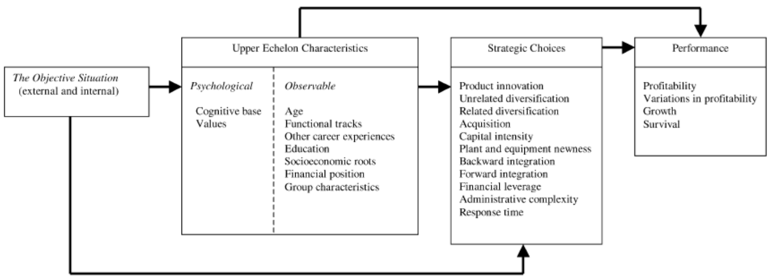


Figure 1. Hambrick and Mason's (1984) upper echelons perspective of organizations.

There is long literature on CEO effects and their effect on performance.
There might be biases, and observable characteristics. Today there is allot of research on potential biases that CEOs might have.

Challenges in dealing with Execution

In strategic decision making there might be biases. And also important is the network. The biases might affect your execution ability. You might make the wrong decisions in environments.

Biases in Decision Making

- **Overconfidence & Overoptimism**
  - Overestimating our skill relative to others, taking credit for past outcomes, and neglect the role of chance. Overestimate the likelihood of positive events.
  - A survey by the Institute of Advanced Motorists (IAM) has revealed that nearly two-thirds of newly qualified male drivers think they are more skilful than the average person behind the wheel (Green Flag, 2011).
  - Even in the hospital after an accident, drivers overestimate their driving abilities (Preston & Harris, 1965).
- *How to counter?*
  - Test strategies under a much wider range of scenarios
    - We need different scenarios: we need to push people into the direction of thinking less optimistically. This might also mean building some pessimistic scenarios or building some flexibility because things might not work as expected and you might need to change. We see for example in the entrepreneurship literature, that entrepreneurs are typically overoptimistic but the ones that survive is the one who pivot.
  - Add 20-25% more downside to the most pessimistic scenario.
  - Build more flexibility and options into your strategy to allow the company to scale up or retrench as uncertainties are resolved (learn-to-burn rate).

- **Confirmation bias & Groupthink**
  - Overweighting of evidence consistent with a favored belief, or the failure to search impartially for evidence: defend a (bad) argument whatever it takes.

- Striving for consensus at the cost of a realistic appraisal of alternative courses of action
- We look for arguments and then we look for things that confirm our arguments but if you think more scientifically you might want to think about a counter example but it's not in our nature to do. We look for confirmation while we need to look for the counter example. Also, we like to have consensus but when you make strategic decisions, you cannot make everybody happy.

- *How to counter?*
  - Create a culture of challenge: the worst thing is having yes man in your team. You need people that challenge the decisions.
  - Strong checks and balances with independent review
  - Establish a challenger team
  - Do a "pre-mortem" analysis: we make an acquisition for example and there are some risks → write a memo of why this is going to fail before we do this acquisition then at least the issues that might be risky and give us trouble we can analyze them.

- **Loss aversion (Prospect Theory)**
  - Tendency to feel losses more acutely than gains of the same amount, making us more risk averse than a rational calculation would suggest.
  - We don't like negative outcomes. We can win or lose. We hate losing more than winning the same amount. That is loss aversion.
  - This makes people more conservative: we don't like to make certain decision because what if things go wrong?

- *How to counter?*
  - Establish stretch targets that are impossible to achieve through "business as usual."
  - Zero-based (or clean-sheet) budgeting: you don't worry about the losses because you just reevaluate every year what you need and try to cut out the loss side.

- **Status quo bias**
  - Preference for the status quo in the absence of pressure to change it
  - Preference for even allocations
  - This might be the worst thing to do. We don't like change. It's difficult to change organizations. We also have some preference for allocations to divide resources evenly

- *How to counter?*
  - Adopt a radical view of all portfolio decisions. View all businesses as "up for sale".
    - We should look at each business separately, how much do they need, how much to develop?
  - Subject status quo to a risk analysis as rigorous as any change options.
    - To avoid status quo, you need to do risk analysis for the status quo. If we don't do anything, what are the risk? What do they need to do and where do they need to go?

- **Sunk-cost fallacy: "throwing good money after bad"**
  - Paying attention to historical costs that are not recoverable when considering future courses of action
  - We throw good money after bad money: "We already put so much money in this project we can't stop now"

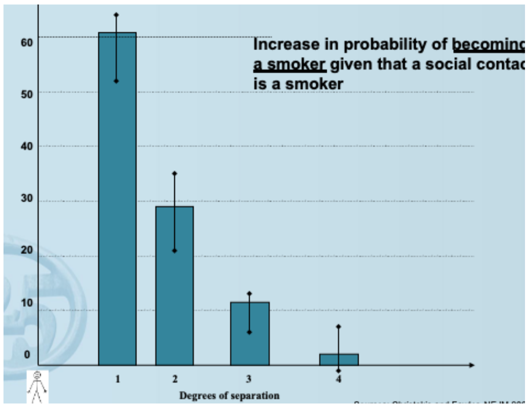
- *How to counter?*
  - Full rigor investment analysis to ***incremental*** investments, only looking at incremental prospective costs and revenues.
    - Incremental analysis: what you spend in the past does not matter, not looking at what you already spend but look at the future.
  - Be prepared to kill strategic experiments early
  - Use "gated funding" for strategic investments

- That's why companies put in staged gate processes, staged gates means that you have a funnel, you have different gates, those are hurdles that you have to make. A technical hurdle. The third hurdle is can we make money out of this. This really forces the business to rethink every time towards the future.

➔ These biases form also a problem in strategic decision making and it affects the costs.
➔ The second issue is networks and how networks can help execute your strategy.

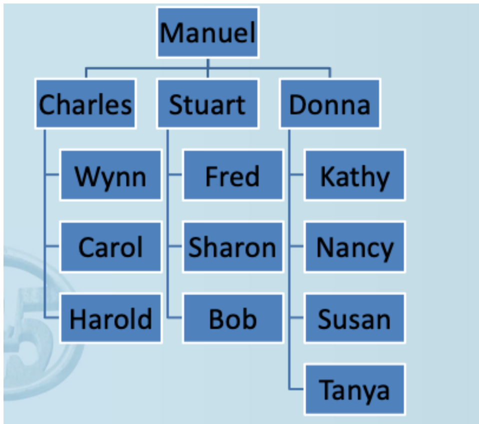
Importance of the network

How do we build a network? We have degrees of separation: two degrees means it's a friend of a friend, … Medical study on the probability of becoming a smoker if somebody in your network is a smoker. If your friend for example is a smoker you have 60% chance of becoming a smoker. …



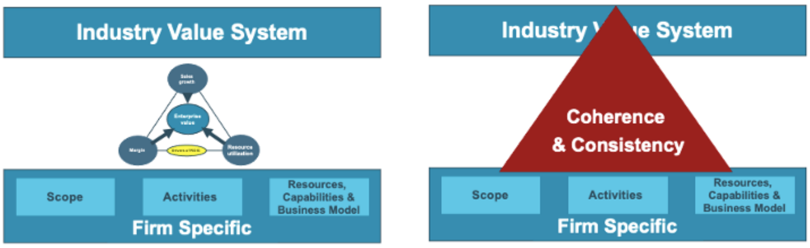
In organizations, there is a formal network (the person on top has the power) and an informal network, actually showing who really has the power because it constitutes the advice network and has nothing to do with hierarchy, but rather about knowledge and experience. Having the power means having the ability to get things done.

Auditor Unit in Large Aircraft Manufacturer
This is an example in the business environment.
The researchers ask Manuel, who has the power? Power means the ability to get things done.
If you don't have that in the organization, you cannot get things done. Who has it in the organization?
It's difficult to understand who has the power although the first reaction might have been that the power is with Manuel. How do we find out who has the power?
They have to figure out the network, the **formal structure**.
But we need to also know the **informal structure**. In network studies they also look at the **advice network**.



They ask everybody who do you go to for advice. Then they mapped that, and you get the informal network. Who seems to have power here is Nancy. She is in this pool, and she has power because she has been in the organization for a very long time and when Manuel sees this picture he realizes that he also goes to her.
It has nothing to do with hierarchy you need to understand the environment you are in.
We need to find how people respond to certain impulses.
You really need to understand not only the formal network but also the informal network and leverage that in the direction you want to move the organization. If you just go in blunt it's unlikely you will be successful.

Strategy and the Drivers of Enterprise Value



This brings all the elements together. In the middle you have an outcome that is affected by strategy. Again, it's not to maximize enterprise value but to at least see where enterprise value has an effect. We talked about the environment and the levers.
There are different elements an organization needs to think about when developing a strategy. The key issue is that we need to put all the pieces of the puzzle together and it needs to be a coherent and consistent story.

- Coherent means at one point in time all the elements connect well together.
- Consistency is more over time these connections seem to be making sense.

Developing a Sustainable Competitive Advantage

1. Understanding the Competitive Landscape
2. Define the Scope of your Business
3. Select the Activity set of your Business
4. Assemble the needed Resources and develop the key Capabilities
5. Set up the Business Model to link Value Creation and Value Capture and create a Virtuous Cycle
6. Understand the Sustainability of your Competitive Advantage
7. Test your Strategy

When thinking about this we thought about developing a sustainable competitive advantage in different steps. These steps are kind of an iterative process when we think about how these elements link together and the final step is to test your strategy.
When you think about and see different frameworks of strategy consultants, all these frameworks will have the same questions embedded but with particular flavor with that particular consultant organization.

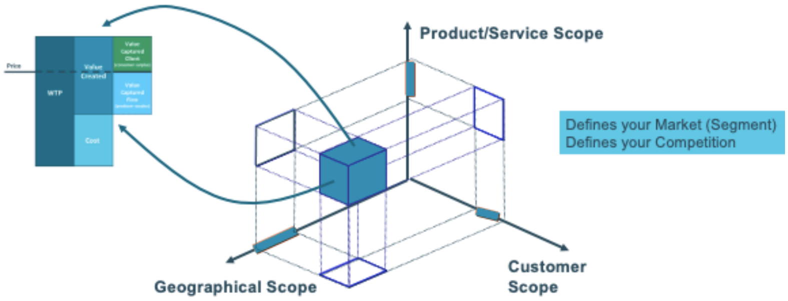
Test your Strategy
See ppt for link with guest lecture LPQ

When we talk about tests of consistency-coherence there are three of them:

1. ***Internal* consistency – coherence**
   - Do the elements of the strategy fit well with each other? Are there complementarities between the different elements of the strategy?
     - Does your *scope* match your activities, your resources and capabilities?
     - Do your *activities* all reinforce your competitive advantage?
     - Are you developing *resources and capabilities* that fit and reinforce your competitive advantage?

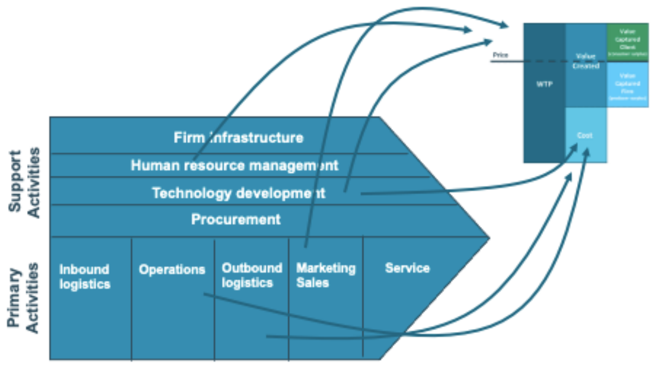
   What we want to do is make these connections. In making these connections think about the scope:

Defining Scope of a Business: Where you Play



Is most impotent issue to think about: what is our strategy referring to? What products/services? How is this creating value? More than alternative?
Make the connection explicit between how is creates and capture value!
It defines our markets, where we compete and who our actual competitors are.

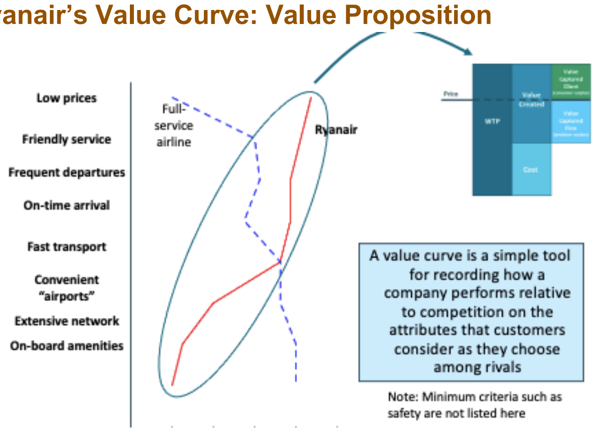
The Porter Value Chain



The Porter value chain is often simplified

We perform different activities to realize our strategy and competitive advantage. How are these activities EXPLICITLY allowing us to create value and to create more value than the alternative? What matters is creating more value than the alternative.

Ryanair's Value Curve: Value Proposition



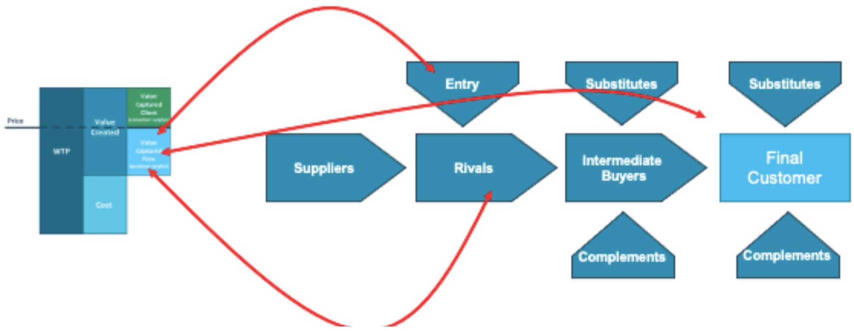
We have a value curve with different drives and WTP. What was critical was not to do everything better than others but choose on which elements we would leverage.

2. *External* consistency – coherence

- Does the strategy neutralize the threats posed by the external environment? Does it take advantage of the opportunities?
- Objective:
    - Neutralize the pressures on value capture of rivals, potential entrants, substitutes, buyers and suppliers
    - Take advantage of opportunities provided by complementors

We mean: does the strategy neutralize several of the threats posed in terms of allowing us to capture value on average? How does this allow us to create value in this environment?

The Industry Value System

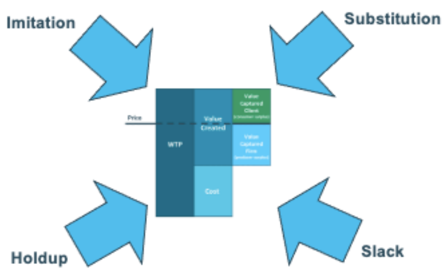


How does entry, rivalry, buyer power allow us to capture value?
The complements are a corner point of substitute and is actually an element of value creation. Well priced complements will actually help us create value. Substitutes will maybe reduce value creating since it reduces WTP. Place your strategy, and how it creates value and competitive advantage.

3. *Dynamic* consistency

- Is the strategy set up to help sustain competitive advantage over time?
- Objective: Neutralize the threats to sustainability of competitive advantage
    - Imitation
    - Substitution
    - Hold up
    - Slack

Threats to Sustainability



Telling the story more explicitly. Making an argument on strategy is very important.