

# Strategic Management



LOGIC & ACTION

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*This book is dedicated to our first teachers*

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# Contents

1

## **DEFINING STRATEGY**

---

3

### **What Are the Characteristics of Effective Strategy?**

5

Strategy Communicates a Compelling Purpose or Vision to Others

6

Strategy Connects Organizational Strengths with  
Environmental Opportunities

8

Strategy Exploits Current Success While Exploring New Opportunities

12

Strategy Generates More Resources Than It Uses

12

Strategy Coordinates and Guides Activities

13

Strategy Responds to New Conditions over Time

13

### **How Are Strategists Influenced By Other Strategists?**

#### **How Do They Lead Others?**

14

Five Levels of Strategizing are important within the Organization

14

Stakeholders Influence Strategists across Organizational Boundaries

16

### **Why Are the Successes and Failures of Other Organizations Important?**

18

Performance Differences Shape Stakeholder Expectations

19

Performance Differences Offer Evidence from Strategic Experiments

20

### **Conclusions for the Strategist**

20

### **Key Concepts**

21

### **Questions for Further Reflection**

22

### **Notes**

25

2

## **DEVELOPING RESOURCES**

---

27

### **Which Firm Resources are Associated with Competitive Advantage?**

29

### **How Are Competitive Resources Created and Sustained?**

32

Branding

34

Supporting Activities

35

Investment	37
Position	38
Accumulation	41
Socialization	42
<b>What Risks Are Associated with Resource Accumulation?</b>	<b>43</b>
Uncertain Capacity to Accumulate Resources	43
Causal Ambiguity	44
Overcommitment	44
External Attribution	44
<b>How Is Resource Accumulation and Deployment Strategically Managed?</b>	<b>45</b>
Step 1: Attend to Necessary Resources	46
Step 2: Determine Competitive Advantage (If Any)	46
Step 3: Define Distinctive Competencies	46
Step 4: Decompose Distinctive Competencies to Focus Investment	46
Step 5: Look for Opportunities to Leverage Resources	47
Step 6: Plan for the Ongoing Renewal of Resources	47
Step 7: Watch Out for Competence-Destroying Change and Capitalize on Competence-Enhancing Change	47
<b>Conclusions for the Strategist</b>	<b>48</b>
<b>Key Concepts</b>	<b>48</b>
<b>Questions for Further Reflection</b>	<b>49</b>
<b>Notes</b>	<b>53</b>
<b>3 SERVING CUSTOMERS</b>	<b>57</b>
<b>Why Is the Customer Relationship Increasingly Critical?</b>	<b>59</b>
Customers Are Becoming More Sophisticated and Demanding	60
New Technology Allows New Forms of Customer Contact	62
Competitors Are Raising Expectations	63
Coproduction Is Increasing	64
<b>What Is a Service Mentality?</b>	<b>66</b>
Organizational Activities Matched to Customer Needs And Desires	66
Customers Seen from a Positive Perspective	68
Employees Who Understand That Their Success Comes from Service	69
A Climate That Supports and Reinforces Service	70

<b>What Are the Guidelines for a Customer-Based Business Model?</b>	<b>71</b>
Definition of the Business in Customer, Not Production, Terms	71
Clarity about the Needs to Be Satisfied	72
Choices about How Needs Will Be Satisfied	74
<b>How Do Companies Gather Data to Identify and Understand Their Customers?</b>	<b>75</b>
Analyze Customer Experiences	76
Map Customer Perceptions of the Market	77
Track Marketing Information	78
Anticipate the Consequences of Demographic Trends	79
Involve Customers in Design and Selection	80
Use Ethnography Techniques	80
<b>Can the Customer Connection Be Overemphasized?</b>	<b>81</b>
Service Levels Have to Fit Strategy	81
Some Customers Are Too Expensive to Serve	82
Today's Happy Customers Are Not Necessarily Tomorrow's Customers	83
<b>Conclusions for the Strategist</b>	<b>83</b>
<b>Key Concepts</b>	<b>83</b>
<b>Questions for Further Reflection</b>	<b>84</b>
<b>Notes</b>	<b>87</b>
<b>4 SEEKING OPPORTUNITY</b>	<b>91</b>
<b>What Signals the Capacity to Develop Opportunity?</b>	<b>93</b>
Characteristics of Individuals Who Recognize and Develop Opportunities	94
Teams That Develop Opportunities	97
Capabilities of Organizations That Develop Opportunities	97
<b>What Are the Processes of Opportunity Development?</b>	<b>99</b>
Recognizing Opportunities	100
Finding Resources	102
Managing Innovation	103
<b>What Are the Differences between Small Firm and Corporate Entrepreneurship?</b>	<b>106</b>
Small-Firm Entrepreneurship	107
Corporate Entrepreneurship	110
<b>Is Ambidexterity the Answer?</b>	<b>114</b>

Conclusions for the Strategist	116
Key Concepts	116
Questions for Further Reflection	118
Notes	120

## 5

## **COMPETING WITH RIVALS** 125

---

<b>What Distinguishes Competitive Environments?</b>	<b>127</b>
<b>What Affects Profit Potential in Different Environments?</b>	<b>129</b>
Rivals	131
Buyers	131
Suppliers	132
Substitutes	132
New Entrants	133
Complements	134
Strategic Groups	135
<b>How Do Macro Forces Affect the Evolution of Competitive Conditions?</b>	<b>136</b>
Demographic Environment	138
Sociocultural Environment	138
Technological Environment	138
Economic Environment	138
Political/Legal Environment	139
<b>How Do Asymmetries Help Explain Competitive Advantage?</b>	<b>140</b>
<b>What Are Generic Strategies for Achieving Competitive Advantage?</b>	<b>143</b>
Cost Leadership	144
Differentiation	145
Focus	146
Combination Strategies	147
<b>What Are the Characteristics of Hypercompetition?</b>	<b>147</b>
<b>When Do Competitors Collaborate?</b>	<b>149</b>
Spontaneous Collaboration	150
Formal Collaboration	151
Collaboration across Industries	152
<b>Conclusions for the Strategist</b>	<b>153</b>
<b>Key Concepts</b>	<b>153</b>

Questions for Further Reflection	154
Notes	158

## 6

## **SPECIFYING A BUSINESS MODEL** 163

---

<b>What Are Common Business Models?</b>	<b>165</b>
Subscription Model	166
Razor-and-Blades Model	167
Broker, Advertising, Community, and Other Models	168
First Mover, Second Mover, Reinventor	170
<b>How Can Value Chain Analysis Contribute to Strategic Change?</b>	<b>174</b>
Linking Value Chain Activities	177
Deconstructing the Value Chain	178
<b>How Can the Life Cycle Be Used as a Source of Business Model Ideas?</b>	<b>180</b>
Stage 1: Birth of a New Offering	181
Stage 2: Systems	182
Stage 3: Solutions	184
Stage 4: Relationships	184
<b>What Can Be Learned from Competitors, Customers, and Others?</b>	<b>186</b>
Franchise Model	186
Promising Practices	188
Open Innovation	189
<b>How Do Business Plans Differ from Business Models?</b>	<b>191</b>
<b>Conclusions for the Strategist</b>	<b>191</b>
<b>Key Terms</b>	<b>192</b>
<b>Questions for Further Reflection</b>	<b>193</b>
<b>Notes</b>	<b>197</b>

## 7

## **CONSIDERING CORPORATE STRATEGY** 201

---

<b>How Do Strategists Pursue Growth?</b>	<b>203</b>
<b>How Are Economic Transactions among Firms Facilitated?</b>	<b>207</b>
Spot Market Exchange	208
Long-Term Contracts	208

Alliances and Networks	209
Equity Joint Ventures	209
Transaction Cost Analysis	210
<b>Can Diversification Leverage Core Competence?</b>	<b>213</b>
Diversification and Core Competencies	216
Corporate Parenting	218
Why Managers Diversify beyond Current Competence	221
<b>When Is Learning an Outcome of Alliance?</b>	<b>222</b>
Barriers to Learning in an Alliance	224
Overcoming Barriers to Learning	225
<b>Conclusions for the Strategist</b>	<b>227</b>
<b>Key Concepts</b>	<b>228</b>
<b>Questions for Further Reflection</b>	<b>229</b>
<b>Notes</b>	<b>231</b>

## 8

**THINKING GLOBALLY** 235

<b>What Are the Advantages and Disadvantages of International Diversification?</b>	<b>237</b>
<b>How Can Competitive Advantage Be Increased through International Expansion?</b>	<b>238</b>
Exploit Economies of Scale	239
Exploit Economies of Scope	239
Exploit National Differences	239
<b>What Are Alternative Strategies for International Expansion?</b>	<b>244</b>
<b>What Are Alternative Entry Modes?</b>	<b>249</b>
Export	250
License	250
Franchise	251
Joint Venture	252
Wholly Owned Subsidiary	253
<b>What Are Significant Cross-Cultural Differences?</b>	<b>255</b>
<b>Conclusions for the Strategist</b>	<b>258</b>
<b>Key Concepts</b>	<b>258</b>
<b>Questions for Further Reflection</b>	<b>259</b>
<b>Notes</b>	<b>262</b>

## 9

**ACTING RESPONSIBLY** **265**

<b>What Is Sustainable Strategy?</b>	<b>267</b>
<b>How Are Standards for Corporate Governance Changing?</b>	<b>268</b>
Separation of Ownership and Managerial Control	270
More Diverse Boards of Directors	271
More Active Institutional Investors	273
Corporate Governance Reform in the United States: The Sarbanes-Oxley Act	275
<b>What Are Internal Forces for Social Responsibility?</b>	<b>278</b>
Business Ethics	279
Corporate Codes of Ethics	281
<b>What Intensifies Ethical Dilemmas?</b>	<b>283</b>
Multinational Operations	284
Multistakeholder Judgments	285
<b>Conclusions for the Strategist</b>	<b>288</b>
<b>Key Concepts</b>	<b>289</b>
<b>Questions for Further Reflection</b>	<b>289</b>
<b>Notes</b>	<b>293</b>

## 10

**ENSURING EXECUTION** **297**

<b>How Can Strategy Execution Support the Increasing Need for Flexibility?</b>	<b>299</b>
Focus on Strategic Flexibility	301
Align Organizational Activity with Emerging Strategy	303
Align People to Strategy and Strategy to People	305
Align Structure to Strategy	305
<b>How Is Strategic Planning Changing?</b>	<b>309</b>
Formality and Timing of Strategic Planning	310
Planning and the Resource Allocation Process	311
<b>How Is Individual and Unit Performance Improved?</b>	<b>312</b>
Financial Control Systems	312
The Balanced Scorecard	313
Linking Data, Decision Making, and Performance	315

<b>Conclusions for the Strategist</b>	<b>318</b>
<b>Key Concepts</b>	<b>318</b>
<b>Questions for Further Reflection</b>	<b>319</b>
<b>Notes</b>	<b>322</b>

<b>11</b>
-----------

<b>MANAGING KNOWLEDGE</b>	<b>325</b>
---------------------------	------------

---

<b>Why Is Knowledge an Increasingly Important Source of Sustainable Advantage?</b>	<b>327</b>
<b>What Are the Characteristics of Knowledge Needed by Companies?</b>	<b>330</b>
Private versus Public Knowledge	332
Explicit versus Tacit Knowledge	333
<b>How Do Strategists Manage and Use Knowledge?</b>	<b>334</b>
Knowledge Creation	336
Knowledge Storage	338
Knowledge Transfer	339
Knowledge Use	341
<b>How Do Organizational Systems Affect Knowledge Management?</b>	<b>343</b>
Corporate Culture and Values	343
Incentive Systems	344
Organizational Structure	345
Recruitment	346
<b>What Are the Most Important External Sources of Knowledge?</b>	<b>346</b>
Benchmarking	346
Contingent Employees	347
Strategic Alliances	348
Distributed Expertise	350
<b>Conclusions for the Strategist</b>	<b>351</b>
<b>Key Concepts</b>	<b>352</b>
<b>Questions for Further Reflection</b>	<b>354</b>
<b>Notes</b>	<b>357</b>

**12****PROVIDING LEADERSHIP 361**

<b>What Are Contemporary Definitions of Leadership?</b>	<b>363</b>
Discovering Mutual Meaning That Can Support Change When Necessary	364
The Responsibility of a Top Management Team and Other Leaders	365
<b>What Are the Most Important Activities of Strategic Leaders?</b>	<b>365</b>
Articulate and Execute a Vision	366
Establish a Supportive Culture	369
Invest in Human Capital	372
<b>How Are High-Performance Organizations Created and Maintained?</b>	<b>374</b>
Communicate High Expectations	374
Support Leaders throughout the Organization	377
Establish Leadership Systems	378
<b>Conclusions for the Strategist</b>	<b>379</b>
<b>Key Concepts</b>	<b>380</b>
<b>Questions for Further Reflection</b>	<b>381</b>
<b>Notes</b>	<b>385</b>

**13****PERSONAL STRATEGIZING 389**

<b>What Are the Trends Shaping Future Work?</b>	<b>390</b>
Growth Industries	390
Smaller, More Entrepreneurial Firms and More Entrepreneurial Workers	393
A Global Labor Market	394
<b>How Is the Employment Relationship Changing?</b>	<b>396</b>
The New Employment Contract	398
Compensation and Benefits	398
<b>What Are the Most Important Career-Planning Activities?</b>	<b>400</b>
Defining and Updating Your Career Strategy	401
Maximizing Career Options	402
Evaluating Employers	405
<b>Why Be Purposeful About Work/Life Balance?</b>	<b>406</b>
<b>Conclusions for the Strategist</b>	<b>409</b>
<b>Notes</b>	<b>410</b>
<b>INDEX</b>	<b>413</b>



# Introduction

Strategy is no longer the exclusive concern of generals. It is not something you wait to think about until you are the president of an organization. You need to understand strategic thinking as a graduate entering the workforce and as a mid-level manager. Corporations, small businesses, non-governmental organizations, and public agencies—organizations of all kinds—are facing new challenges. Many of these organizations rely on their employees to help strengthen current ways of doing things and invent new ones. In other words, strategy is not an academic exercise, it is a way of thinking that can help you find and keep a good job.

This is a relatively short text written to acquaint you with important, research-based principles underlying strategic management. A wide range of organizational examples are part of the text, and worksheets at the end of each chapter facilitate further analysis. You are also encouraged to assess organizations around you and interview others to learn more. However, we urge you to move quickly to action as the best way to learn about this important subject.

The four of us are business professors, and we emphasize business strategy while recognizing that strategy is important for all organizations. We have used the material you will find here in at least a dozen countries to work with business undergraduates, MBAs, corporate executives, state employees, and not-for-profit managers.

Even with a focus on business strategy, it wasn't easy to condense the insights of a large field of research and practice into a few pages. An important complexity is that organizations increasingly work together to offer connected products/services/experiences that engage customers in the production process. Apple's iPod and iTunes offer a perfect example. Apple helped change the music industry with the iPod, creating opportunities for other companies to offer speaker systems and other complementary goods but also spurring competitors to offer alternatives. If music is important to you, if you chat about it online, offer opinions, share playlists with others, *you* are both enhancing and modifying these offerings.

Thirteen relatively brief chapters provide frameworks for understanding how to think and act strategically in this and other situations. Chapter 1 explains why explicitly defining (and redefining) strategy is important. Chapters 2, 3, and 4 suggest connections between the tasks of developing organizational capabilities, engaging customers and seeking entrepreneurial opportunities. Chapter 5 offers advice on analyzing competition and cooptation. Chapter 6 then emphasizes the

importance of a business model specifying how resources to sustain the organization will be gathered.

The next three chapters look at the external context affecting strategy. Even if the business is small or oriented toward a local market, it is likely that some suppliers, buyers, and other entities in its environment will be part of larger international entities. Chapter 7 therefore considers corporate strategy. Chapter 8 talks about why and how strategists pursue their initiatives in more than one country. Chapter 9 moves to governance and social responsibility, issues that are not only in the public eye but also concern actors within an organization.

Chapters 10, 11, and 12 consider how to unite strategic ideas found in previous chapters. Chapter 10 discusses the flexible execution of strategy. Chapter 11 focuses on managing knowledge. Chapter 12 considers leadership at various organizational levels, returning to the idea that *you* will be increasingly required to be a strategist.

Finally, Chapter 13 moves even closer to you, our reader. We describe some of the pressures on individual workers today and propose that individuals can use the strategic concepts found in this book for personal and career decisions. This is an important part of the book, not an aside. Every individual in a strategic situation is thinking at a personal level as well as a collective level, and it is important to remember that when making organizational decisions.



# Acknowledgments

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We think of the resulting volume as a 'travel guide' for those facing new situations. It is not the book with one compelling idea that you can pick up in an airport – these efforts can be inspiring, and often raise important issues, but a travel guide should cover more material and inform people with more varied agendas.

However, no book can tell you everything you need to know about strategizing in today's demanding circumstances. Much of that knowledge must be learned from experience. We try to give you a good start on an important and interesting journey, and we wish you well.

Anne Huff

Steve Floyd

Hugh Sherman

Siri Terjesen

### **Teaching Supplements**

An Instructor's Manual has been designed to facilitate convenient lesson planning and includes sample syllabi, chapter outlines, and in-depth teaching notes. Approximately 300 PowerPoint slides give instructors the ability to integrate classroom lectures with a visual statement of chapter material. A test bank consisting of 60 multiple choice, true/false, short answer, and essay questions of varying difficulty also is available for each chapter. These comprehensive resources can be found on the Instructor Companion Site at [www.wiley.com/college/huff](http://www.wiley.com/college/huff).

# Strategic Management

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- 1 DEFINING STRATEGY
  - 2 DEVELOPING RESOURCES
  - 3 SERVING CUSTOMERS
  - 4 SEEKING OPPORTUNITY
  - 5 COMPETING WITH RIVALS
  - 6 SPECIFYING A BUSINESS MODEL
  - 7 CONSIDERING CORPORATE STRATEGY
  - 8 THINKING GLOBALLY
  - 9 ACTING RESPONSIBLY
  - 10 ENSURING EXECUTION
  - 11 MANAGING KNOWLEDGE
  - 12 PROVIDING LEADERSHIP
  - 13 PERSONAL STRATEGIZING

# 1

## Defining Strategy



Everyone is a strategist. We all act, every day, to achieve desired results—trying to avoid being the person left clearing the dishes after dinner, seeking a desired job interview, or demonstrating for a worthy cause. This book focuses on business strategists, whose purpose is to create something of value to customers or clients and make enough money doing so to stay in operation. Their activities are similar to those we all use to achieve our individual desires. They collect resources and organize activities to achieve their objectives. They learn from failure as well as success. They observe and sometimes try to duplicate what others achieve. As the world changes, their strategies change.

Strategic “success” is in the eye of the beholder. Because our primary focus is on profit-making firms in this book, we will describe “above-industry-average profitability” as an important measure of success. It is a widely used comparative measure of ability, and one that very few firms manage to maintain over time. When other goals are added (to be socially responsible as well as profitable, for example), the strategist’s task becomes even more difficult.

.....

*The strategy field has developed a vocabulary that is essential for further discussion. This introduction focuses on the nature of strategy by answering three questions:*

What are the characteristics of effective strategy?

- Communicates a compelling purpose to others
- Connects organizational strengths with environmental opportunities
- Exploits current success while exploring new opportunities
- Generates more resources than it uses
- Coordinates and guides activities
- Responds to new conditions over time

How are strategists influenced by other strategists? How do they lead others?

- Five levels of strategizing are important within the organization
- Stakeholders influence strategists across organizational boundaries

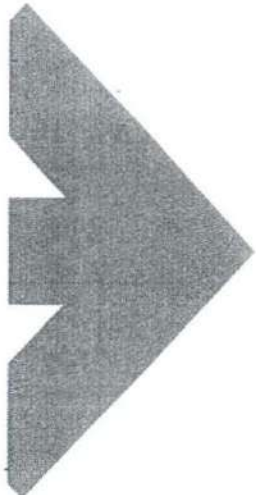
Why are the successes and failures of other organizations important?

- Performance differences shape stakeholder expectations
- Performance differences offer evidence from strategic experiments

We use examples to help clarify concepts and analytic frameworks throughout the book—our first is particularly interesting.

.....

## NAPSTER: AN IDEA THAT CHANGED THE WORLD



In the fall of 1998, Shawn Fanning, a computer science freshman at Northeastern University, began working on a program to help his roommate share MP3 music files. His first efforts were not very reliable, but they were enthusiastically received, and Shawn's friends began to send the program to other friends. The response was so positive that Shawn did not go back to his university in January. He continued to refine his revolutionary "peer-to-peer" file sharing system that allowed a user to find and download music from another user's computer. In May 1999, with an uncle, he founded Napster.com, a site that allowed registered users to share music files without charge.

The Internet was radically changed by Fanning's idea. A number of universities quickly blocked access to Napster and the similar sites that followed because student use started to dominate available bandwidth. Young users were not the only ones involved. One new website allowed individuals to share detailed needlepoint designs. Napster itself reported that many of its users were over 30.

However, the freely shared files frequently were the products of commercial enterprises, and Napster was quickly involved in heated discussions about copyright. On December 7, 1999, the company was sued by the Recording Industry Association of America (RIAA) and eighteen record companies. Various recording artists, including the well-known heavy metal band Metallica, supported the suit. Other musicians applauded Napster, arguing that the record industry was too controlling and that new music was more likely to find an audience on the web.

Fifteen months after its inception, more than 23 million Napster users were registered. At that point, in October 2000, BMG (the third-largest record company in the world) announced an alliance with the controversial company and proposed a monthly fee of \$4.95 for unlimited downloading. However, many file sharers resisted even a nominal charge, arguing in various ways that music should be a free resource. The model did not get off the ground, and a court ruling in the same month made Napster vicariously liable for its users' copyright infringements. Eight months later, founder Shawn Fanning and CEO Konrad Hilbers abruptly resigned and Napster was gone.

Napster left a legacy. New file-sharing services, using different technologies, continued to facilitate downloading. In response, the RIAA launched 261 music piracy suits against individuals in the fall of 2003, including a mother whose 12-year-old daughter had downloaded music. Gradually, additional legal actions were taken in the United Kingdom, Australia, and other countries, though downloads are more difficult to trace with new technology. A further move was the development of digital rights management (DRM) software that blocked copying.

Meanwhile, Roxio bought the Napster brand name and technology for \$5.3 million at a bankruptcy auction, and Napster2.0 emerged in 2004 under new ownership as a legal music-download service that now offers millions of songs for 99 cents each or a monthly subscription fee. By the beginning of 2008, Apple's slick iPod players and iTunes site were

estimated to dominate 80 percent of the music scene following the same pricing scheme, but the game is not over. The major music labels have dropped DRM, which facilitates many new partnerships. Most observers expect Amazon to counter Apple's dominance with "more flexible pricing" and a more varied set of partners offering downloads. Whatever happens next, the billions of music and video files that have already been electronically downloaded around the world are ample evidence that an 18-year-old student's invention revolutionized not just the Internet but an important aspect of contemporary life.<sup>1</sup>

Napster's story shows the power of a business idea that meets an unmet need. It would be ideal if a book on strategic management could offer a list of such promising ideas. In fact your job as a strategist is to identify opportunities, just as Shawn Fanning did. An increasing number of organizations are looking for employees who have this skill.

The record companies' strong response to Napster makes the second important point that strategists do not play on an empty stage. Beneficiaries of the status quo are likely to join forces when the current way of doing things is upset, particularly when the potential consequences are as far-reaching as publicly available file-sharing technology. Conflict significantly increases the resources needed to further innovate and win. In addition, radical departures from the status quo often generate heated discussions about what is fair and ethical, the subject of Chapter 9.

A considerable body of strategic management research and experience helps explain who is likely to succeed in evolving competitive dramas like the one Napster helped initiate. We present some highlights in this text in the hope that readers will apply them to situations of interest. A globalizing, increasingly interconnected world offers opportunities with significant rewards for generating the kind of response that Napster did.

Of course, globalization is not the only dynamic shaping strategy. While some companies are growing larger from sales around the world, customers also are paying more attention to local efforts, from farmers' markets to indie films. They also are monitoring a wider range of outcomes, such as environmental impacts. Our excitement about strategic management is fueled by the possibilities of this complex setting. We want you to have a more sophisticated understanding of the nature of strategy before we look at details.

## **WHAT ARE THE CHARACTERISTICS OF EFFECTIVE STRATEGY?**

When you think about your strategic choices, such as choosing a college, a major, or a job, you can probably identify a number of different objectives. It is likely that you are a logical and forceful actor about some aspects of these decisions, but also influenced by chance and the timing of events around you.

Determining organizational strategy is even more complex. We believe effective strategy has to do several things simultaneously:

1. Communicate a compelling purpose or vision to others
2. Connect organizational strengths with environmental opportunities
3. Exploit current success while exploring new opportunities
4. Generate more resources than it uses
5. Coordinate and guide activities
6. Respond to new conditions over time.

### Strategy Communicates a Compelling Purpose or Vision to Others

A basic definition of *strategy* is that it is a purposeful attempt to achieve an objective. Though it may take some time for a startup firm to come up with the details shown in Figure 1.1, a complete picture of strategy needs to include the following:

- What will be done—typically creating product(s), service(s), and/or experience(s)
- Who will do the work
- How (and often when and where) the work will be done
- Who will be offered the results
- Why customers or clients are expected to value and pay for what they receive.

**Strategy** defines a desired objective and communicates what will be done, by whom, how, for whom, and why the output is valuable.

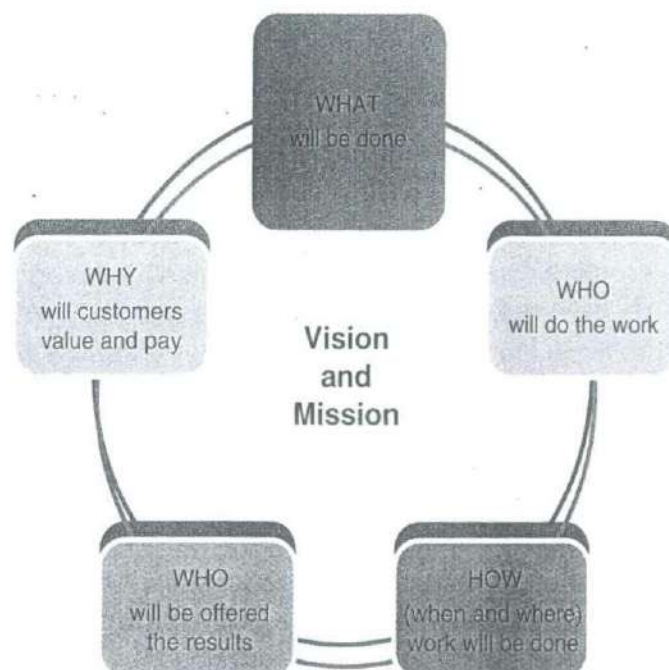


Figure 1.1 — A Visual Definition of Strategy

**Vision** statements provide a compelling image of what the company wants to become or do.

The dictionary definition of *vision* is “the ability to think about the future with imagination or wisdom.”<sup>2</sup> *Strategic* vision more specifically provides a compelling image of what the organization is doing and why. Consider this statement from Google.

### Never Settle for the Best

“The perfect search engine,” says Google co-founder Larry Page, “would understand exactly what you mean and give back exactly what you want.” Given the state of search technology today, that’s a far-reaching vision requiring research, development, and innovation to realize. Google is committed to blazing that trail. Though acknowledged as the world’s leading search technology company, Google’s goal is to provide a much higher level of service to all those who seek information, whether they’re at a desk in Boston, driving through Bonn, or strolling in Bangkok.<sup>3</sup>

The heart of this vision, in our minds, is providing “a much higher level of service to all those who seek information, whether they’re at a desk in Boston, driving through Bonn, or strolling in Bangkok.” It sets direction, but does not give employees and others very detailed information about what should be done, by whom, how, for whom, or why. A *mission* statement often provides this detail, and Google has one. Note that the following statement from Google’s website addresses individual searchers, but also provides information of interest to advertisers, current and potential employees, stockholders, and the media.

**Mission** statements are more explicit than vision statements about what will be done, by whom, how, for whom, and why.

#### *Google: Organizing the World’s Information*

Google’s mission is to organize the world’s information and make it universally accessible and useful.

As a first step to fulfilling that mission, Google’s founders Larry Page and Sergey Brin developed a new approach to online search that took root in a Stanford University dorm room and quickly spread to information seekers around the globe. Google is now widely recognized as the world’s largest search engine—an easy-to-use free service that usually returns relevant results in a fraction of a second.

When you visit [www.google.com](http://www.google.com) or one of the dozens of other Google domains, you’ll be able to find information in many different languages; check stock quotes, maps, and news headlines; lookup phonebook listings for every city in the United States; search billions of images and peruse the world’s largest archive of Usenet messages—more than 1 billion posts dating back to 1981.

We also provide ways to access all this information without making a special trip to the Google homepage. The Google Toolbar enables you to conduct a Google search from anywhere on the web. And for those times when you're away from your PC altogether, Google can be used from a number of wireless platforms including WAP and i-mode phones.

Google's utility and ease of use have made it one of the world's best known brands almost entirely through word of mouth from satisfied users. As a business, Google generates revenue by providing advertisers with the opportunity to deliver measurable, cost-effective online advertising that is relevant to the information displayed on any given page. This makes the advertising useful to you as well as to the advertiser placing it. We believe you should know when someone has paid to put a message in front of you, so we always distinguish ads from the search results or other content on a page. We don't sell placement in the search results themselves, or allow people to pay for a higher ranking there.<sup>4</sup>

Strategy is clearly a communication tool. Strategists must make sure that the right people know about the purpose of their organization and how it is being put into action. Aspects of this strategy must be clearly conveyed to salespeople, customers, managers, and other employees. In a typical business the board of directors, suppliers, partners, stockholders, and perhaps venture capitalists need to be informed as well. However, strategists in profit-making organizations such as Google are not the only ones who think about vision and mission. Individuals trying to realize personal objectives can think about strategy in this way. So can groups, non-profit organizations, networks, nation-states, and other entities.

Few actors need to know all components of strategy, and sometimes it is not a good idea to publicize details. When he was beginning to understand that his file sharing idea had promise, for example, Shawn Fanning benefited from the fact that the music establishment was not aware of his activities. As his purpose solidified, however, it was important that Napster attract an expanding group of users and employees. Eventually other groups had to understand what was being done, by whom, how, for whom, and why the outcome was valuable.

Napster is a wonderful example of how easy communicating a strategy can be. Fanning's vision was irresistible: share music without cost. Though illegal as initially formulated, the basic concept has had an amazing ripple effect. Strategists in other organizations often have to work harder to articulate purpose, but all successful strategists have to make their strategy compelling to others or they will not survive.

### **Strategy Connects Organizational Strengths with Environmental Opportunities**

To recognize, develop, and evaluate strategic alternatives, it is important to look at the match between the capabilities of an organization

and the environment where these capabilities might be used. Strategy connects a firm to individuals and other firms. They are all influenced by a broader environment of technological changes, economic realities, sociocultural values, and other forces. This macro context must be understood as the source of both strategic opportunities and threats to strategic success. A very general summary of this context is provided in Figure 1.2.

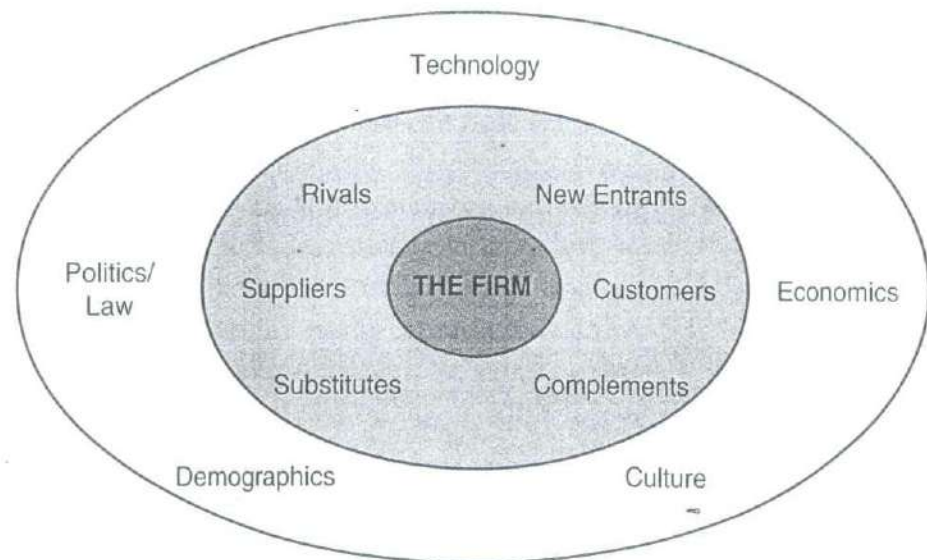


Figure 1.2 — An Overview of the Context of Business Strategy

This diagram appears again in Chapter 5, where it is discussed in more detail. At this point we merely emphasize that it is impossible to understand the sources of strategic ideas, or their outcome, without looking at the broader environment. Consider this example, from an interesting book called *Corporate Creativity*, by Professors Alan Robinson and Sam Stern.

#### *A New Line of Business for Japan Railways East*

When building a new high-speed line north of Tokyo, Japan Railways East was unexpectedly slowed by persistent flooding in a new tunnel. Specialists drew up plans to permanently divert the water, but the operation was stopped just in time, when a safety inspector suggested an alternative and much more strategic solution. Noting that workers had been drinking and enjoying the water, he proposed that the company bottle the water instead of draining it away.

In a relatively short period of time, Japan Railways East had vending machines on 1,000 rail platforms and was delivering bottled water to homes. Their advertising emphasized the long filtration that had

taken place in the mountains and also noted the healthy minerals that the water had absorbed. It was an unplanned and unanticipated development that became a highly profitable new business, and solved what had been seen as a costly engineering problem.<sup>5</sup>

Several contextual issues are important in this short story. Demographic growth north of Tokyo was the opportunity that triggered Japan Railways East's decision to build a new rail line. The success of the new bottled water venture was a response to sociocultural changes leading individuals around the world to drink more water and be more concerned about its quality.

It is helpful to be more systematic about how these and other factors intersect with company characteristics. A worksheet for *SWOT analysis* can be found at the end of this chapter, the first of a series of tools included with every chapter. SWOT summarizes the firm's strengths and weaknesses, along with *environmental* opportunities and threats. Thinking about organizational strengths and weaknesses helps strategists see themselves relative to their competitors. You might think Japan Railways East had no strengths for developing a bottled water business, relative to others already in the beverage business, for example, but don't forget that a captive market was waiting on railway platforms.

We hope you will take the time to apply SWOT to a situation you know. Research has shown that people learn more from activities that involve them directly. The worksheets found at the end of each chapter not only provide you with tools used in strategic analysis, but also give you a better understanding of the concepts we present and their value in action.

SWOT can be used in a static way that hides aspects of environmental change and new conditions within the firm. When used thoughtfully, it can summarize the evolution of strategy over time. It is particularly interesting to see how an apparent weakness in one setting might be changed into a strength by the introduction of a new strategy. This is a key issue facing many companies—such as Radio Shack.

Worksheet 1.1:  
SWOT  
Analysis—A  
Tool for  
Identifying  
Strategic Fit  
.....

### Staying in Tune with the Times at Radio Shack

Radio Shack moved from a retailing has-been in the United States to a force to be reckoned with in the electronics retail market in the 1990s. A major player in the 1980s as a vertically integrated manufacturing and retail enterprise, the company was blindsided by the rise of electronics superstores like Circuit City. Staffed by minimally trained sales clerks,

these competitors offered deeply discounted prices on products that were often stacked on warehouse-style selling floors.

Radio Shack originally attempted to follow this trend with its Incredible Universe and Computer City superstores, but abandoned that strategy in 1997, shuttering all 17 Incredible Universe locations and selling its 90 Computer City stores to CompUSA. Unable to compete with the superstore concept, Radio Shack's new president, Leonard Roberts, chose an alternative strategy that identified the company's 7,000 retail outlets as its competitive advantage. Rather than manufacture products, the chain shifted its strategy to offer exclusive distribution of name-brand electronic products, especially wireless telephones and related goods, and it re-emphasized service as a way to support this new approach.

The company did have help. In 1996, Sprint was looking for a retail base from which to sell its wireless service, and Radio Shack offered an exclusive distribution opportunity. Radio Shack persuaded Sprint to contribute tens of millions of dollars toward upgrading its stores, in addition to providing needed advertising. As a result of further focus under Roberts, Radio Shack began to sell more wireless phones than its competitors Best Buy, Circuit City, Sears, and Montgomery Ward combined.

Unfortunately, the road continued to be rocky. In 2005 the company began a controversial program to monitor sales associates called Fix 1500. Then, in 2006, CEO David Edmondson resigned when it was revealed that he had doctored his résumé. The next hire, Julian Day, brought turnaround experience from Safeway, Sears, and Kmart. Though stock prices rose by 60 percent as a result, he took some heat when a large number of workers were notified via e-mail that they would be laid off.

By 2008, the company had more than 6,000 outlets around the world, and an important source of revenue was nonbranded kiosks in Sam's Club stores. Though Radio Shack is sometimes criticized for an "old fashioned" name and store design, Hoover's predicts that U.S. personal consumption expenditures on electronic goods will "grow at an annual compounded rate of 6.5 percent between 2007 and 2012." That's not bad, but some observers continue to question whether the company's business model works in a world of one-stop low-cost providers like Wal-Mart.<sup>6</sup>

Radio Shack is one of many companies that have significantly changed strategic direction in recent years. Imagine the difference in a SWOT analysis before and after Roberts took over. He and his team saw new opportunities in the external environment, especially the need for emerging wireless manufacturers to have effective retail outlets. Once an alliance strategy with Sprint was identified, old threats (notably warehouse-style competitors) became less important, but new ones had to be addressed. Strengths were also redefined: 7,000 small retail outlets had seemed a weakness, but they became a strength in the strategy adopted

in the late 1990s, especially after the company's capacity for service delivery was improved. Yet five years later, store locations were less important as competitors across the industry began selling in convenient kiosks within larger retail locations.

### Strategy Exploits Current Success While Exploring New Opportunities

Professor Jim March from Stanford University suggests that companies can follow two very different strategic paths when searching for opportunities.<sup>7</sup> *Exploration* strategies (like Japan Railways East's bottled water venture) find new ways to create value based on unfamiliar resources. In the process, strategists stretch their organization's capabilities well beyond what they were in the past.

Radical innovation is not, however, the only strategic opportunity. Indeed, as many Internet businesses illustrate, exploration is highly risky. The alternative to exploration is *exploitation*—a strategy that creates value by rearranging and improving established offerings. For example, exploitation strategies might seek better contracts with existing buyers or suppliers, use better equipment that reduces operating costs, or develop training programs that motivate workers and help them become more efficient. Improvements do not happen without attention and new activity, but when these efforts are successful, the effect can be additional value around an existing set of resources and activities.

Because exploitation builds on what the firm already knows, it is often seen as less risky than exploration. Often this is an accurate assessment. An exploitation path can become a trap, however, when the environment changes.<sup>8</sup> In a dynamic environment, firms that merely do what they have done before quickly go out of business.

### Strategy Generates More Resources Than It Uses

Strategy is much more than words; we suggest you look especially at the way money and other resources are deployed. It is equally important that strategy *generate* substantial resources—not only income, but reputation, employee commitment, brand identity, and other intangibles.

The balance between using and creating resources is critical. There is almost inevitably an imbalance at startup. Ultimately, however, customers, clients, or perhaps some third party must sufficiently value the outputs of strategy to pay for their creation. Unfortunately, quite a few organizations fail because the cost of their activities continues to exceed returns.

A strategic statement of “what, by whom, how, for whom, and why is it valuable” is therefore almost always an impressive achievement. Clever strategists leverage what they have in various ways, especially by connecting with other organizations. “Necessity is the mother of invention” is as true of strategy as it is of research and development (R&D), and invention is often needed to make inputs and outputs balance.

**Exploration**  
strategies try to  
create new value  
from unfamiliar  
resources and  
activities.

**Exploitation**  
strategies try to  
create additional  
value using current  
resources and  
activities.

### Strategy Coordinates and Guides Activities

Organizations exist to accomplish what individuals do on their own. Strategy is a helpful statement that individuals should work together. But there are limits to be made explicit, even in very bureaucratic organization guide, rather than explicitly direct, activities within the organization and outside it.<sup>9</sup>

The word *guide* is critical. No statement can be detailed enough to tell many different people exactly what to do, especially when that statement is also supposed to be inspiring! Instead, strategy provides a general “recipe” that helps people make detailed decisions in their particular domain and coordinate with others. That logic is especially important in the unanticipated situations that inevitably arise.<sup>10</sup>

In other words, strategy should set off waves of compatible decisions that are important to achieving a given purpose. For example, after Fanning decided that his file-sharing concept was promising, he left college so that he could focus on programming, sought investor capital, incorporated, and moved to Silicon Valley. Strategic decisions in large companies can be traced in much more extensive progressions across functional specialties and geographic boundaries. Less strategic decisions are more contained and pertain to shorter periods of time.

### Strategy Responds to New Conditions over Time

Our description of strategy so far has been rather straightforward. Strategy helps people focus attention on some things and de-emphasize others. Clarity is critical for influencing different people, in different places, across time. When strategy coordinates understanding and action in this way, it is a remarkable achievement—because there are many reasons why promising ideas do not proceed as planned.<sup>11</sup>

For example, many actors inside the organization and outside are simultaneously pursuing their interests. Customer needs and desires change and new competitors spring up to meet them. Sooner or later, because of these and other circumstances, even a compelling strategy has to be revised. Furthermore individuals and organizations often identify successful activities after they happen. All this means that strategic decision making in an inevitably changing world is more an ongoing process of *strategizing* than a one-time process of defining “what, by whom, how, for whom, and why it is valuable.”<sup>12</sup>

Professor Henry Mintzberg, who teaches at McGill University, makes a useful distinction between *intended strategy* and *realized strategy*<sup>13</sup> that fits this idea very well.<sup>14</sup> Intended strategy is the plan before action begins; realized strategy reflects what is learned as events unfold. In our opinion, both kinds of strategy are useful. It is difficult to act, especially in groups of many individuals, without some kind of explicit statement of intention. That’s intended strategy. But some of these

**Strategizing**  
is the ongoing  
process of  
discovering  
purpose,  
creating and  
using resources,  
and guiding  
supporting  
activities.

**Intended  
strategy**  
is the set of ideas,  
usually made  
explicit, that the  
strategist uses to  
inspire and direct  
activities.

**Realized  
strategy**  
is illustrated by the  
pattern of actual  
behavior over time.

ideas will not achieve desired results and so they cease to be used, while new insights and experiments that were not thought of originally will be incorporated into strategy over time.

The cumulative pattern of strategy can be difficult to follow. It takes time to understand new situations and assess the implication of many actions. Thus, strategists spend a great deal of time communicating strategy to those who must be involved. Clever observers (including competitors) often identify realized strategy more by looking at behavior than by examining verbal statements.

Figure 1.3 provides a summary of all six functions of strategy.

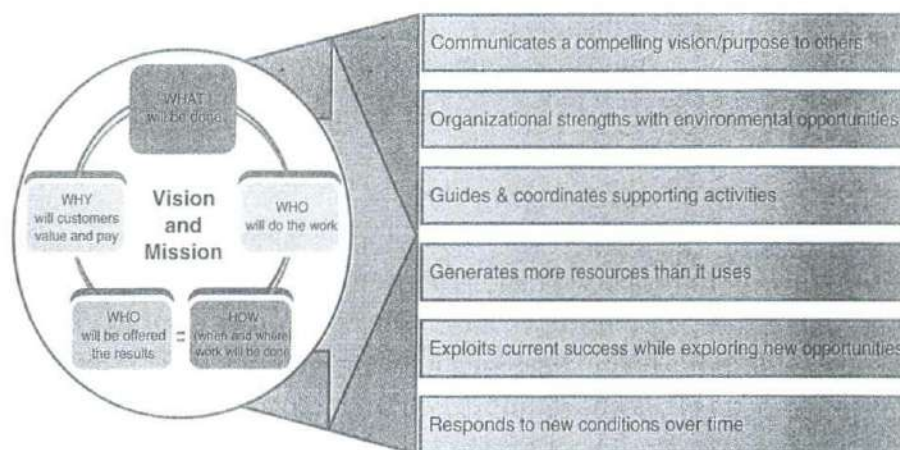


Figure 1.3 — Six Functions of Strategy

## HOW ARE STRATEGISTS INFLUENCED BY OTHER STRATEGISTS? HOW DO THEY LEAD OTHERS?

The definitions and examples offered so far show that strategy is a relatively complicated response to a changing environment. It therefore should not be surprising that strategy is rarely developed by just one individual—such as the president or chief executive officer (CEO) of a firm. First, one person can rarely come up with all the ideas needed to define what, by whom, how, for whom, and why. Second, and more important, many different individuals, interest groups, and organizations care about and expect to have a role in specifying a firm's strategic objectives and activities.

### Five Levels of Strategizing are Important within the Organization

Organizations vary in their formality and structure. Whatever form, structure provide channels of influence. Most organizations establish a hierarchy; a classic (simplistic and somewhat old-fashioned) example is shown in Figure 1.4. The arrows show that strategizing at any level within the organization will be affected by strategists both above and below.

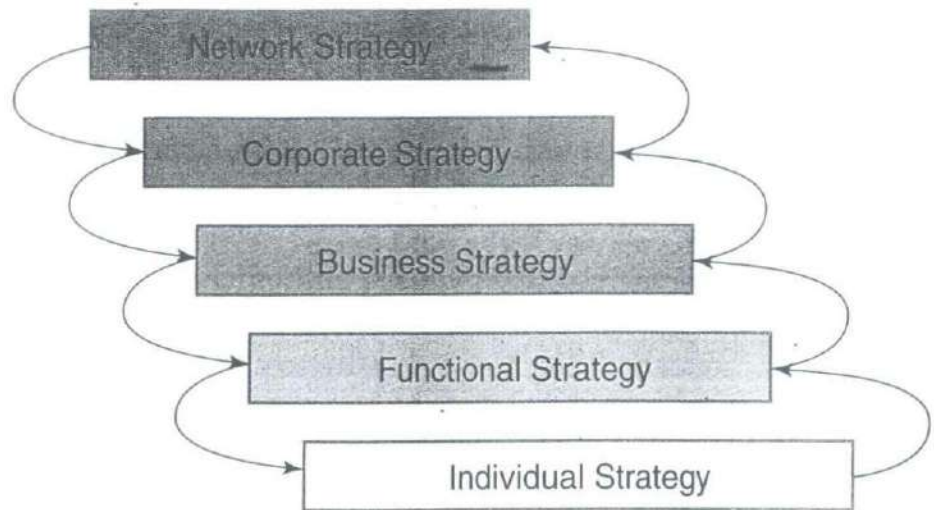


Figure 1.4 – Levels of Strategizing

**Network strategy** coordinates actions among allies that are not under the control of a single entity.

**Corporate strategy** makes broad domain and funding decisions for a portfolio of business units.

**Business strategy** defines what will be done, by whom, how, from whom and why to meet the goals of one organization, or one subunit of a diversified corporation.

*Network strategy* develops within a group of organizations to achieve an objective that no single organization could achieve (or chooses to achieve) alone. Sometimes network strategy is formal and strict (contracts between buyers and suppliers, for example) but in many other cases it is informal. In all kinds of networking arrangements, however, the basic definitions of strategy just offered are still relevant. One example of a network strategy is the partnership of aerospace companies to design and build the Boeing Dreamliner.

In contrast to network strategy, *corporate strategy* develops within a single organization. Typically, the two most important foci of strategy at the corporate level are specifying the industries within which the business divisions of the corporation will compete, and allocating corporate resources to these divisions. The downward influence of corporate strategy thus determines the types of competitors encountered by a business and the resources available to compete with them. The corporate strategists' upward influence affects alliances with other organizations. An example of a corporate strategy is General Electric's goal to be either number one or number two in all of the markets in which it competes.

*Business (or organizational) strategy* is generated within an independent business or within the division of a large corporation. Business strategy focuses on a single competitive arena or on a closely related set of arenas. Strategists at this level must influence the units that carry out strategy within their organization. Looking upward, business strategists are likely to influence external networks as well. For example, a business or organization strategist in Procter & Gamble's Duracell battery division focuses on how to compete in the battery industry, but that increasingly means connections with producers of goods that use batteries.

**Functional strategy** — supports business strategy in areas such as information technology, human relations, research and development, and marketing.

**Individual strategies** direct efforts by individuals, inside or outside the organization, to protect and enhance their own welfare.

*Functional or operating strategy* Functional strategists are coordinated by business-level strategy. In larger companies, functional units are likely to be established in information technology, human relations, finance, manufacturing, research and development, and marketing. These sub-units develop more detailed assessments of purpose and make more specific resource commitments than strategy at higher levels. Outsourcing can complicate the picture provided in Figure 1.4, as we will discuss in more detail in Chapter 5, but the basic interaction among strategic levels remains the same. An example of a functional strategy is a purchasing department's decision to implement an enterprise resource planning software package.

Finally, *individual strategy* potentially affects and is affected by all other strategic levels. The epilogue shows how the decisions of individuals can be analyzed using the frameworks we discuss in this book. A SWOT analysis, for example, can be highly relevant to personal career choices. You can also use SWOT analysis as a manager to predict how your employees might act in a new situation. Other important individual strategists (especially consumers) are outside the organization's formal boundaries, and their choices also affect the various levels of strategy.

### Stakeholders Influence Strategists across Organizational Boundaries

The overall conclusion to be drawn from the picture of interacting strategies shown in Figure 1.4 is that any given strategy will (and often should) be affected by strategy made in other parts of the organization. But this is not the only complication strategists face. Strategy is also the result of interactions with individuals and groups known as *stakeholders*. Some are likely to reinforce the organization's objectives, while others are likely to oppose its activities. They can be particularly influential when they form alliances that magnify their ability to influence the organization.

Figure 1.5 provides the strategists' view of the environment we sketched more generically in Figure 1.2. If the expectations of the community, owners/stockholders, special interest groups, customers, partners, employees, governments, and suppliers are not met, some actors are likely to put a great deal of effort into trying to influence strategic decisions. Think of parents and teachers who work together to raise funds for school activities as an example from the public sector. Their cooperation may fit with the strategic plans of the school system very well. Parents working with lawmakers to legislate testing or impose other policy mandates on schools could be less welcome.

**Stakeholders** are potentially affected by an organization's activities and thus may attempt to influence its strategy.

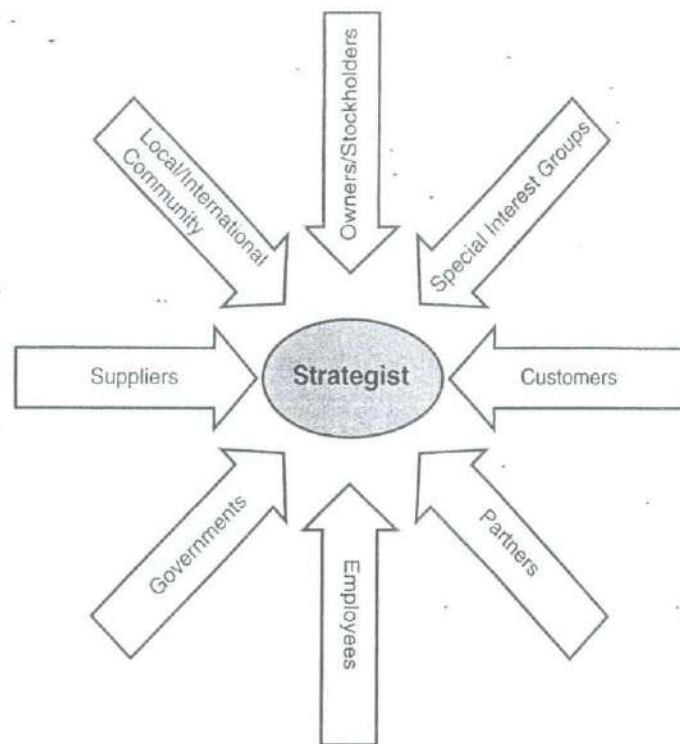


Figure 1.5 — Business-Level Stakeholders

Stakeholders vary in power and attentiveness, but even the possibility of positive or negative stakeholder activity affects the range of decisions strategists consider or execute. Whether they face an opportunity or a threat, stakeholders often affect how purpose is defined, how resources are gathered and used, and who benefits from this activity.

Each stakeholder is almost certain to see a given situation in a unique way because of their unique history and objectives. Further, not all actors have access to the same information or will attend to the same information. This complex, interactive, political environment makes it difficult to develop coherent strategy. A helpful starting point is to realize that every actor, inside and outside the organization, is trying to both make sense of the situation, and influence others to see the world in a way that fits the outcomes they prefer.

From the point of view of strategists at the business or organizational level, this tussle explains why coordinated action is important but also difficult. A classic problem for business level strategists, for example, involves reconciling inconsistent functional strategies that are likely to have incompatible objectives. The manufacturing unit typically wants to simplify product designs in order to smooth production, while the marketing department is likely to promote complex products to meet customer requests for new features. Business strategists try to address this kind of tension, but the welfare and strategic perspective of any one organizational group will never align perfectly with the needs of units established to achieve other purposes.

Sometimes inconsistencies are strategically useful. At the network level, for example, BMG kept its options open by maintaining participation in the RIAA lawsuit, even as strategists at the corporate level were working on a new business with Napster. Many strategists similarly explore new strategies with activities that are deliberately out of step with current strategy.<sup>15</sup> Fundamentally, however, strategy must limit the proliferation of inconsistent activities, because they make communication and coordinated activity so difficult.

Instead, strategists often try to create *synergies*.<sup>16</sup> They may, for example, build expertise in one functional unit by drawing on skills from other units. And strategists often rotate people through different job positions to promote understanding of the different pressures and contributions present in the business.

Worksheet 1.2 can be helpful for developing strategy in situations that involve many different types of strategists. It relies on the very simple principle of identifying similar and dissimilar interests and trying to create positive links that are strong enough to counter inevitable negatives.

At first, stakeholder analysis may seem overwhelming, given the large number of potential influences that could be identified. One approach is to limit the analysis to two groups: those that are the most active and those that seem most threatening. A broader base of analysis could be achieved in an organizational setting by dividing into work groups that focus on influential actors in different sectors in the environment. Stakeholder analysis would then identify the most important players for strategic consideration in each sector. The ultimate objective of stakeholder analysis, obviously, is to develop a compelling statement of strategy that will be acceptable to a large number of influential actors, while also inspiring and coordinating internal actions that are beneficial to the firm.

## WHY ARE THE SUCCESSES AND FAILURES OF OTHER ORGANIZATIONS IMPORTANT?

Conversation about strategy cannot go very far without considering the strategist's *rivals*. These are the firms that compete for the same customers with similar offerings, often following similar strategies.

Rivalry means that stakeholders can compare organizations. Obviously, if a competitor provides outcomes that are much more attractive to customers, the firm must adapt or go out of business. Even before these choices are clear, however, if sources of capital or other influential stakeholders find one organization's strategy less compelling than others, survival is jeopardized.

It may seem paradoxical at first, but this basic reality means that interacting with strong competitors can strengthen a firm's capabilities—a theme that is developed further in Chapter 5. In this first chapter we simply observe that the performance of competitors is a valuable measure of strategic success and a source of models for potential adaptation.

**Synergies**  
enable one  
resource to increase  
the impact of  
others.



Worksheet 1.2:  
Stakeholder  
Analysis—A Tool  
for Working with  
Other Influential  
Strategists

**Rivals**  
offer similar  
products, services,  
or experiences to  
similar clients or  
customers.

**Economic profit** is the level of return after all costs of the unit's activities have been subtracted from revenue.

**Competitive advantage** is revealed when a firm is more profitable than its rivals or exceeds them on other valued performance measures.

### Performance Differences Shape Stakeholder Expectations

Economic theory proposes that over time, *economic profits* in a competitive arena will come together around an average figure as firms imitate each other, assuming that monopoly is not allowed. But the field of strategy refutes this view. Wherever there is rivalry, competitors try to differentiate themselves from one another. Research shows that profits tend to increase for firms that improve on, rather than just imitate, successful strategy.

Earning a profit means more than recovering the costs required to create it. Economic profit means recovering all costs: the costs of capital (shareholders' expected returns and interest on loans) along with something to reinvest in the business or use for other purposes.

The average return in an industry approximates what shareholders, analysts, banks, and other important stakeholders demand. By definition, only a few firms will be able to exceed this standard. The few firms that excel enjoy what is called *competitive advantage*. We know that a firm has an advantage because it has successfully competed for an above-average share of the industry's profits. Companies that consistently earn such profits (and/or meet some other performance standard important to stakeholders) have found a way to sustain their advantage.

Competitive advantage is difficult to sustain over time, because rival strategists are highly motivated to copy success.<sup>17</sup> Nonetheless, there are a few impressive winners. As an introduction, Table 1.1 looks at return on assets, one way to think about economic performance.<sup>18</sup>

TABLE 1.1 RETURN ON ASSETS (ROA) IN FOUR RELATED INDUSTRIES (5-YEAR AVERAGE AS OF MAY 11, 2007)

Industry	Industry Average	Company	Company Average
Retail (Department and Discount)	8.6	Kohl's	12.2
		JC Penney	9.0
		Wal-Mart	8.7
		Tuesday Morning	8.2
		Target	7.7
		Sears	5.1
		Dillard	4.3
		Saks	-0.2
Retail (Specialty)	8.6	Costco	6.1
Retail (Grocery)	8.2	Whole Foods	9.4
		Tesco	7.9
		Safeway	5.7
		Kroger	5.4
Retail (Drugs)	7.0	Walgreens	11.8
		Rite Aid	0.4

The differences shown have significant consequences. Luck and differences among competitive environments partially explain why some organizations consistently outperform others, but most observers think that strategy accounts for performance variances like the ones shown. Boards of directors support or question corporate strategists based on this kind of comparison. Advice from investment analysts is based on this measure and a few others. Potential employees consider them. Current employees may stay or look for other jobs based on persistent comparisons.

### **Performance Differences Offer Evidence from Strategic Experiments**

Laboratory scientists have confidence in their evidence because they can control the environment in which they experiment. Unfortunately for the strategist, the natural experiments that generate results like those shown in Table 1.1 are not as tidy. Still, comparative results like the ones shown are the only evidence of effective strategy available.

Wal-Mart may make more than companies such as Safeway and Kroger because along with groceries it also sells more expensive goods with higher margins. Surely there is more to it than this? Especially because Walgreens leads the group shown in Table 1.1? Most strategists spend a great deal of time thinking about comparisons like these. They try to make sense of them because they know their stakeholders are looking at similar figures as evidence about effective strategy. Strategists also need inputs to their own decision making.

Strategists consider the performance of their rivals in the hope of learning from their experience without the cost and time required to make their own experiments. Following the same logic, we offer many examples in this book. Although we know they will inevitably be a bit out of date by the time the publishing process is complete and you read them, the learning opportunities they offer should be taken seriously. If the questions they raise were easy to answer, strategic management would not be necessary, and the economists' expectation of regression to the mean would be borne out in fact. We know there are fascinating differences among organizational outcomes. This book provides frameworks for analyzing these results.

## **CONCLUSIONS FOR THE STRATEGIST**

Strategy isn't always necessary. Dishwashing and other household tasks often are completed without maneuvering. Jobs sometimes are offered and accepted with little analysis on either side. Contributions to worthy causes are sometimes made without seriously examining the provider's

operations. Entire organizations drift without participants seriously considering their purpose.

The authors of this book want something more. We want to live in reliably clean houses, find rewarding jobs, improve the world if we can, and influence what is done in the organizations where we work. That means we pay attention to strategy, and we hope that you, our reader, will too.

We have said that strategy establishes a desired objective and communicates what will be done, by whom, how, for whom, and why the output is valuable.

That seems straight forward, yet many strategies fail. The next five chapters help define a strategy that attracts enough resources for an organization to survive and prosper.

- Chapter 2 shows how **resources** can be developed and used to create competitive advantage.
- Chapter 3 describes how organizations create value for **customers** and provides ideas for drawing customers into the strategy process.
- Chapter 4 suggests that responding to **opportunity** brings needed energy and insight into the organization.
- Chapter 5 looks at **rivals** and the competitive environments they create.
- Chapter 6 discusses **business models**.

These are the basic building blocks of strategy. The chapters that follow add information about external and internal contexts that further affect the success of your efforts. Ideally you work, or will work, in an organization that actively seeks your inputs to strategy. Even if you do not, this book should be helpful for assessing the issues to which strategists around you are responding. We are confident that it won't be long before you identify your own contributions, and wish you well with this guide to strategizing.

### Key Concepts

**Strategy** defines and communicates what an entity creates, by whom, how, for whom, and why it is valuable. It must also be a compelling statement of purpose that ultimately generates more resources than it uses and coordinates supporting activities while being responsive to changing conditions. Strategy is often communicated in a relatively general **vision** statement that provides a compelling image of what the organization should be. A more explicit **mission** statement often supplies more detail about what will be done, by whom, how, for whom, and why.

Strategies are more likely to succeed if they respond to or create opportunities in the environment, while minimizing threats. Successful

**exploration** strategies create new value with unfamiliar resources and activities. Successful **exploitation** strategies develop additional value from current resources and activities. Both kinds of strategy require recognizing an opportunity to turn a new idea into a successful venture.

**Strategizing** describes the ongoing process of discovering purpose, creating and using resources, and guiding supporting activities as new information accumulates. Consistent with this idea, it is useful to distinguish **intended strategy**, the set of ideas that the strategist uses to inspire and direct activities, from **realized strategy**, which is illustrated best by the pattern of actual behavior over time.

Strategists work at many levels in organizations. Each level can be expected to influence strategies developed at other levels. **Network strategy** coordinates actions among allies that are not under the control of a single entity. **Corporate strategy** deals with the broad domain and funding decisions for a portfolio of business units. **Business strategy**, the focus of discussion in this book, identifies specific competitive advantage(s) that can generate profit and other desired outcomes at the business unit or product level. **Functional strategy** supports business strategy in areas such as information technology, human relations, research and development, and marketing. **Individual strategies** are efforts by individuals, inside or outside the organization, to protect and enhance their own welfare.

More broadly, **stakeholders** (which are likely to include suppliers, employees, partners, customers, special interest groups, owners/stockholders, local and perhaps international communities, and governments) are potentially influenced by organizational outcomes and thus may attempt to influence strategic activities. Strategy helps resolve differences of opinion among stakeholders. Ideally, the business strategist also finds **synergies** that enable one resource to increase the impact of others.

Strategists must pay attention to **rivals**, especially the firms that try to capture similar customers. Relative success is an important indicator of the viability of comparable strategies. **Economic profit**, the level of return after all costs of an organization's activities have been subtracted from revenue, is a particularly good performance indicator for profit making firms. **Competitive advantage** indicates that an organization is more profitable than its rivals or exceeds them on other measures valued by stakeholders.

### Questions for Further Reflection

1. Choose a time frame (from one year to a lifetime) and describe your personal career strategy. What do you want to do, who needs to be involved in helping you, how will you proceed, who will benefit, and why will your efforts be valuable?

2. Identify five organizations that you admire, perhaps because they make a product you use or pursue a cause that is important to you. Using statements by organizational leaders found on the web, assess how compelling the public statement of each company's strategy is to you. Choose the one that you find least compelling and restate it.
3. Outline the network of organizations involved in delivering a widely used product or service. (You could choose part of the automobile industry, but consider being more venturesome. What about fresh flowers? Or football?) Using Figure 1.2, suggest environmental changes that might impact this network over time. Choose one actor in the network and think about how that actor might make sense of the changes you anticipate. Then, outline the efforts that actor might make to change current network strategy if the change in the macro environment you anticipate actually occurs.

### WORKSHEET 1.1

#### SWOT Analysis—A Tool for Identifying Strategic Fit

In this activity, you use a worksheet to summarize the internal strengths and weaknesses of an organization you know (your employer, your school, your sports team, your church, etc.) in the context of environmental opportunities and threats.

SWOT analysis has long been used as a tool for strategic analysis. If the analysis is done only once, it can be deceptively static. Comparative analysis is often a better thinking tool.

**Step 1:** Specify the organization and a time frame, then fill in your strategy summary and the four SWOT quadrants for the organization you wish to analyze.

**Step 2:** Identify which of the four boxes you were most uncertain completing, and brainstorm alternative answers.

**Step 3:** Put the most likely of these alternatives on one or more additional worksheets, and reconsider the other four categories in light of this anchor.

**Step 4:** Assess current strategy, given the fit revealed by these scenarios.

#### ALTERNATIVES

- Explore the SWOT implications of the most threatening or the most attractive ideas entered into the first worksheet.
- Fill out additional worksheets for competitors and compare them with your organization's current (or future) SWOT position.

<b>SWOT Analysis</b> Worksheet 1.1	<b>Organization:</b> <b>Time Frame:</b>
<b>Analyst(s):</b> Black = current (date ____ ) Blue = anticipated (date ____ )	<b>Strategy Summary:</b>
<b>Strengths</b>	<b>Weaknesses</b>
<b>Opportunities</b>	<b>Threats</b>

## WORKSHEET 1.2

### Stakeholder Analysis—A Tool for Working with Other Influential Strategists

**Step 1:** Identify the most important groups and individuals that can affect the outcomes of an organization you know.

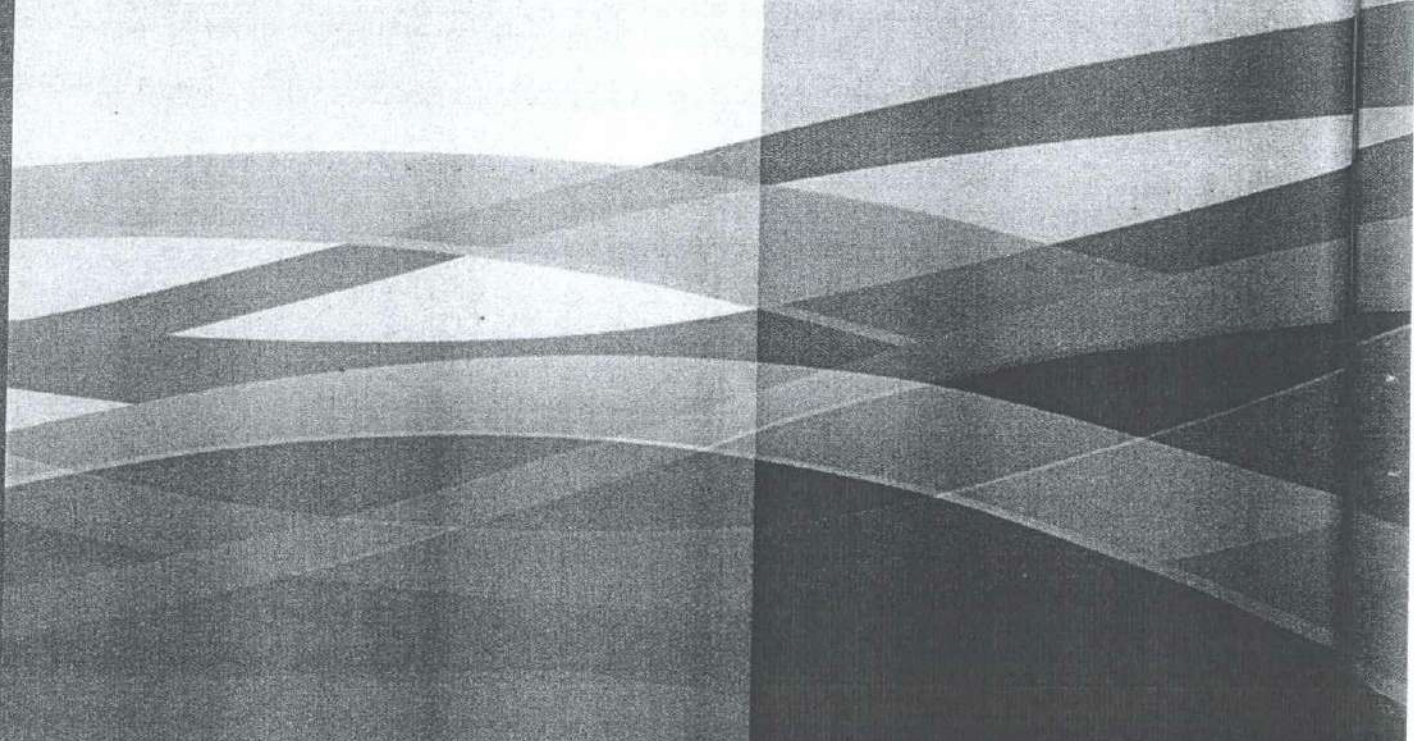
**Step 2:** Specify areas in which their interests are most likely to be supported and frustrated by current (or proposed) strategy.

**Step 3:** Brainstorm potential responses to these interests.

<b>Working with Strategists</b> Worksheet 1.2	<b>Organization:</b>
<b>Analyst(s):</b>	<b>Strategy Summary:</b>
<b>Areas in which interests are likely to be supported by current/proposed strategy</b>	<b>Potential Interactions with specific stakeholders:</b>
<b>Areas in which interests are likely to be frustrated by current/proposed strategy</b>	<b>Potential Interactions with specific stakeholders:</b>

## NOTES

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- <sup>2</sup>[http://www.askoxford.com/concise\\_oed/vision?view=uk](http://www.askoxford.com/concise_oed/vision?view=uk), accessed May 5, 2007.
- <sup>3</sup><http://www.google.com/corporate/tenthings.html>, accessed May 5, 2007.
- <sup>4</sup><http://www.google.com/corporate/>, accessed May 5, 2007.
- <sup>5</sup>Robinson, A., & Stern, S. 1998. *Corporate Creativity: How Innovation and Improvement Actually Happen*. San Francisco: Berrett-Koehler.
- <sup>6</sup>An overview of Radio Shack and its competitive landscape can be found at [http://www.hoovers.com/radioshack/-ID\\_\\_11441-/free-co-competition.xhtml](http://www.hoovers.com/radioshack/-ID__11441-/free-co-competition.xhtml), accessed January 21, 2008. For an update on Radio Shack, see press releases at <http://www.radioshack.com>. See also [http://topics.nytimes.com/top/news/business/companies/radioshack\\_corporation/index.html?query=SAM'S%20CLUB&field=org&match=exact](http://topics.nytimes.com/top/news/business/companies/radioshack_corporation/index.html?query=SAM'S%20CLUB&field=org&match=exact) and <http://en.wikipedia.org/wiki/RadioShack>, accessed April 15, 2007. A satirical perspective can be found in Even CEO Can't Figure Out How RadioShack Still in Business. *The Onion* (April 23, 2007), accessed January 21, 2008, at [http://www.theonion.com/content/news/even\\_ceo\\_cant\\_figure\\_out\\_how](http://www.theonion.com/content/news/even_ceo_cant_figure_out_how).
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- 1 DEFINING STRATEGY
  - 2 DEVELOPING RESOURCES
  - 3 SERVING CUSTOMERS
  - 4 SEEKING OPPORTUNITY
  - 5 COMPETING WITH RIVALS
  - 6 SPECIFYING A BUSINESS MODEL
  - 7 CONSIDERING CORPORATE STRATEGY
  - 8 THINKING GLOBALLY
  - 9 ACTING RESPONSIBLY
  - 10 ENSURING EXECUTION
  - 11 MANAGING KNOWLEDGE
  - 12 PROVIDING LEADERSHIP
  - 13 PERSONAL STRATEGIZING
- 

# 2

## Developing Resources



As individuals, we already know a lot about using resources. When we want something, we ask ourselves what is needed to achieve our goal. For example: “Do I have what it takes to become a competitive swimmer? Not just the skill, but the dedication, the coaches, and the travel money?” If resources are not at hand, we try to acquire them. Money is often important to achieving what we want, but everyday experience shows that money is not a substitute for the self-discipline, training, and commitment required to become a champion athlete. The objectives of organizational strategists similarly require financial resources, but also time, skill, and other inputs.

It is possible to use different resources to produce similar outcomes, just as swimmers with different genetic endowments will choose different coaches and use different practice routines. Like the athlete, the strategist must find a particularly effective bundle of resources and manage it over time to create sustainable competitive advantage.

.....

*This chapter answers the following questions:*

Which firm resources are associated with competitive advantage?

How are competitive resources created and sustained?

Branding

Supporting activities

Investment

Position

Accumulation

Socialization

What risks are associated with resource accumulation?

Uncertain capacity to accumulate resources

Causal ambiguity

Overcommitment

External attribution

How is resource accumulation and deployment strategically managed?

The basic ideas behind effectively collecting and managing resources are straight forward. (Anyone could outline a workout schedule for a competitive swimmer on paper.) But living up to this vision and developing the skills to win are an entirely different matter. The problems and rewards of accumulating and using competitive resources are magnified several times at the business level. Consider Disney, a company that enjoys a remarkable set of resources.

.....



## THE IDEAL STAR

If you were choosing a performer to play the leading role in your blockbuster movie—purely from a business standpoint—what criteria would you use? How about a performer who is one of the world's best-known personalities, who is always ready and willing on a moment's notice, who doesn't require a formal contract, who never complains about anything, who doesn't even have an agent, and . . . whose rates are far below what all other actors demand?

Walt Disney Studios has dozens of such performers—classic names such as Mickey Mouse and Snow White, along with more recent stars such as the Little Mermaid, Simba, and Buzz Lightyear. The company has successfully used these characters in film, television, videotape, the Internet, consumer products, and theme park attractions. Over time, the characters' appeal has led to the development of a “Disney brand” that creates strong loyalty among customers. In the media business, nine out of ten projects fail. Disney's ability to create unique animated characters allowed it to produce top-notch entertainment at a low cost, with remarkably few failures for many years.

However, in 1997 Disney's financial performance took a significant turn for the worse. Michael Eisner, the company's CEO and an important force behind the effective use of its decades-old assets, explained the problem as the result of a few big clunkers at the box office, including *Hercules* and *Mission to Mars*. Some analysts thought the problem was deeper than that, stating that Disney's cherished animated film characters and the strategy of creating wholesome, family entertainment no longer resonated with contemporary American (or international) values.

Perhaps confirming Mickey Mouse's fading appeal in a changing world, Regis Philbin and the show *Who Wants to Be a Millionaire?* appeared to be Eisner's lifeboat in late 1999. In eighteen months it earned almost \$1 billion for ABC and its parent, the Walt Disney Company. The stock market reacted favorably, but Regis and his show were not as unique or as durable as Donald Duck and Goofy. *Millionaire* was challenged by the CBS show *Survivor*, which was scheduled in the same time slot. On *Survivor*'s first airing, 2.5 million more people watched the desert island performance than Regis's big-money game, and a number of similar shows followed close behind.<sup>1</sup>

Disney celebrated its fiftieth anniversary in 2005. Under new CEO Bob Iger, the company has been doing very well in the last few years, and the star performer is studio entertainment.<sup>2</sup> Pixar Animation Studios, purchased at the beginning of 2006, set box office records with *Finding Nemo* and *Shrek 2*. Its *Pirates of the Caribbean* trilogy, enhanced by computer-generated imagery, broke numerous box office records.

Disney also made headlines as the first media partner joining Apple to sell TV shows and movies on iTunes. An additional sign of success is that the company continues to be chosen as one of the best places to work by U.S. graduates. All in all, it is easy to conclude that Disney has found a place in the hearts of many people—and that an impressive group of cartoon characters still has a role to play.<sup>3</sup>

## WHICH FIRM RESOURCES ARE ASSOCIATED WITH COMPETITIVE ADVANTAGE?

**Resources** are assets used to create and support offerings to customers or clients.

Disney illustrates one of the most enduring insights from strategy research: even the most ably supported advantage cannot be sustained forever. Some advantages can last over a significant period of time, however, and bring profit in many different ways. The strategist's job is to accumulate and utilize the *resources* that create these advantages. Differences in carrying out that job are a primary reason why some firms are more profitable than other firms in the same market.

The Resource Based Theory of the Firm<sup>4</sup> provides useful vocabulary for thinking about why success tends to be associated with distinctive patterns of resources. From this perspective, an organization is a bundle of resources capable of creating value for shareholders and other stakeholders. Strategists are constantly trying to enhance their organization's resource bundle as environmental and internal circumstances change. Both theory and empirical evidence suggest that those who are better at identifying (and creating) changes in the world around them, then adjusting their resource mix accordingly, are more likely to perform above the average for their industry.

**Tangible resources** have a physical reality—examples are buildings, machinery, and supplies.

Figure 2.1 provides a brief summary of this logic. At the bottom of the figure are two kinds of resources—the basic building blocks of competitive advantage: *tangible* (physical) *resources* and *intangible* (not directly visible) *resources*.

Most tangible resources are widely available and unlikely to create competitive advantage or meet performance demands of stakeholders by themselves. They are more likely to satisfy performance demands

**Intangible resources** are not directly visible—examples are knowledge and reputation.

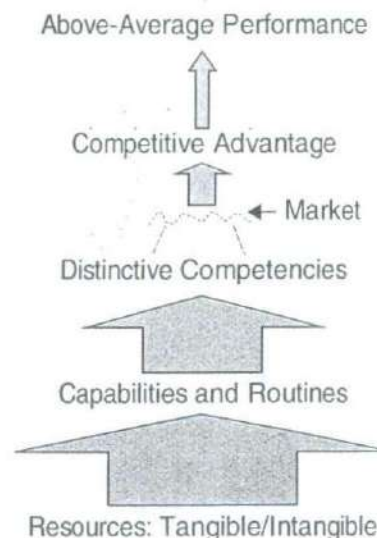


Figure 2.1 — Resource-Based Model of Performance

Capabilities are combinations of resources that create value.

Routines systematize the knowledge required to create and replicate capabilities needed by the organization.

Distinctive competencies are the organization's unique resources, capabilities, and routines.

when they are combined with intangible skills and knowledge to create *capabilities*. A simple example involves uniting an individual's hand-eye coordination with an automobile to end up with driving as a capability. The automobile without a driver provides little value; conversely, the ability to drive without an automobile is also of little use. The combination of the car (a tangible resource) and driving skill (an intangible resource) creates value.

Organizations collect, extend, and elaborate individual capabilities. The bundle of resources developed far exceeds the possibilities of individuals working on their own. Imagine being able to work with the talents that Walt Disney put together over the years—many of the best people wanted to work at his studio, and this must be seen as the foundation for his success.

*Routines* provide a way of systematizing the possibilities of the organization's bundle of resources. After all, Walt Disney couldn't live forever. Routines create "regular and predictable patterns of behavior in firms"<sup>5</sup> that persist over time, even as employees leave or enter the organization. Examples include procedures for ordering new inventory, advertising, accounting, and many other support activities as well as the procedures that directly create goods, services, and experiences. They are an important means of reproducing success, even though they can become disadvantageous if they persist when they no longer create value.<sup>6</sup>

*Distinctive competencies* are even more important for understanding profitability. Every organization has many resources, capabilities, and routines that are similar to those found in other organizations. Indeed, a large set of resources, capabilities, and routines are necessary to stay in business. Only a relatively small number of things that the organization does will be distinctive competencies. For example, Disney's signature style is a distinctive competency.

An important contribution of the resource base view was to put the spotlight on distinctive capabilities as a source of competitive advantage, as shown in Figure 2.1. As we said in Chapter 1, competitive advantage represents the ability of an organization to consistently outperform rivals in a given market. Enduring advantage is created by skillfully identifying distinctive competencies and combining them with other more widely available resources to attract and keep customers. The most widely used test of this relatively rare ability is economic profit that surpasses that of rivals—although other performance measures can also be important. Companies that consistently appear on lists of desirable workplaces, for example, have a competitive advantage.

The list of distinctive competences in a given organization is almost inevitably short because of the human will and ability to imitate. Humans (along with many other animals) have a remarkable tendency to modify their behavior after observing successful behavior by others, and sometimes this happens without conscious effort. In business settings, rivals

**Mimetic behavior** is activity that follows patterns observed in the behavior of others.

**Socially complex activities** arise from the interaction of individuals and other resources; they are difficult to understand, but result in more than the apparent sum of their parts.

deliberately match successful routines developed by other companies, and stakeholders often expect strategists to follow proven practices.<sup>7</sup>

This *mimetic behavior* is often strategic. Strategists can and should observe and learn from the skillful performance of others, and it makes sense to hire employees who have worked in companies with high performance. Strategists should also learn from customers, suppliers, distributors, and other intermediaries.

The firm with a distinctive advantage has to anticipate this mimetic process, which is one reason that no advantage can be expected to last forever. At the same time, the firm that copies should be cautious. Our globalizing, increasingly connected world tends to speed deterioration of advantage as firms follow each other's success. Only firms with less obvious and more difficult-to-understand resources, capabilities, and routines have a chance to elude the will to copy profitable strategies, at least for a time.

Research suggests that distinctive competencies based on *socially complex activities* are particularly important, and thus we will focus most of this chapter on this aspect of resource development. Socially complex activities exceed the understanding of any one individual, even those who participate in them. They consequently are difficult for outsiders to understand or replicate; even former employees will find replication difficult.

Although we have been speaking in terms of corporate or organizational strategy, the same resource-based logic is applicable at other levels of strategic decision making. For example, it makes sense for a functional department focused on information technology to think about whether it has, or can obtain, competitive advantages when compared with other IT providers because outsourcing functions that do not meet the competitive advantage test has become easier and easier. Organizations certainly make mistakes in outsourcing decisions, but the basic logic of using the best suppliers (internal or external) is hard to refute.

Resource-based logic can also be applied at an individual level. It makes sense for people to think about and strategically develop their own bundle of resources, capabilities, and distinctive competencies. Almost everyone will be in the labor market multiple times within his or her lifetime. Many people choose, or are forced by circumstances, to alter their objectives. Each time this happens, an opportunity arises to revisit one's distinctive competencies and ask: Do I have a competitive advantage?

Worksheet 2.1 can be used to analyze resources at all levels, from the individual to the network, along with further instructions for its use. We encourage you to learn the resource-based vocabulary by using this worksheet, because it has proven to be a particularly useful way of thinking about strategy.

**Worksheet 2.1:**  
A Tool for  
Analyzing  
Resources  
.....

## HOW ARE COMPETITIVE RESOURCES CREATED AND SUSTAINED?

One thing that makes strategy interesting is that different decision makers often come to entirely different conclusions about what combination of resources is most likely to bring them an advantage. Retail banking offers one example.

### Royal Bank of Scotland: The Counterintuitive Strategy

Consolidation within the banking industry around the world has been rather dramatic in the last few decades. This has been accomplished primarily by large banks buying up smaller, regional banks and incorporating them into their systems. The usual strategy has been to rename the purchased banks under a single corporate name. Banc One, Bank of America, Citigroup, and Barclays are among the acquirers that have used this strategy to create a “supermarket” of services under one highly recognizable brand. Banks following this approach view the “umbrella brand” as a highly valued resource and invest considerable effort in developing it.

Royal Bank of Scotland Group (RBS) PLC has developed a different strategy. More like a “shopping mall” than a supermarket, RBS offers a variety of products under multiple brands.<sup>8</sup> For purposes of efficiency, the bank consolidates back office operations, but it views the acquisition process as collecting brands rather than killing them. In doing so, it creates competition among its own branches. Yet the company is described as being “one of the UK bank sector’s star performers since taking over NatWest in 2000.”<sup>9</sup>

In theory, maintaining multiple brands is a costly and inefficient strategy. However, behind the scenes, RBS supports a massive centralized technology and purchasing infrastructure that creates economies of scale. The bank believes that the cost of maintaining separate brands is worth the advantage gained by leveraging the identities of former competitors. The results support this belief. In 2007 the company was ranked fifty-fourth in the Fortune Global 500.<sup>10</sup>

At the time we write this book, Royal Bank of Scotland’s strategy has proven to be profitable and sustainable. An interesting comparative study of bank performance by Accenture, the consulting firm, compared RBS to other prominent banks in a way that underscores our emphasis on distinctive competence:

Wells Fargo . . . sets the pace in distribution, Danske Bank [is a leader in] workforce superiority. Citibank’s back-office scope and flexibility is a major competitive advantage, while Royal Bank of Scotland excels

at risk management and multi-brand management. It is important to note that in each case, the decision to concentrate resources and investment on one area is not at the expense of the other performance drivers. In fact, just the opposite is true. These institutions became high performers as a result of a strategic focus on, and a commitment to, elevating to excellence in at least one key skill set, while clearly demonstrating a general level of competence across the board.<sup>11</sup>

Many combinations of resources are possible. We define Disney's distinctive competitive advantage as the ability to consistently market and produce family entertainment at a relatively low cost. Underlying this competitive advantage is a unique pool of resources, capabilities, and routines, including a large cast of animated characters, and the routinized capability to make them remarkably lifelike performers in appealing scripts. In other words, Disney has more than the necessary resources to be in its business, and consumers reward its distinctive capabilities with above-average box office returns.

Resource-based theory has developed some indicators of the resources most likely to generate this kind of market advantage, using terms that are not often found in common conversation. That is not a bad idea from a strategic point of view, because strategists who master them may make it a bit harder for competitors to understand and copy their success. Resources are competitive resources because they have the following characteristics:

1. *Rare*: A resource that is widely available will not be distinctive.
2. *Nontradable*: A resource cannot be available for purchase in an open market; otherwise it will not remain rare over time.
3. *Nonsubstitutable*: If another resource can be substituted, the original resource loses its uniqueness.
4. *Inimitable*: The more difficult or costly it is to imitate a resource, the more likely it is to remain unique.
5. *Flexible*: A resource that can be adapted to new situations is much more likely to contribute to sustained advantage in a changing world.<sup>12</sup>
6. *Nonappropriable*: The profits generated by the resource must not be captured (appropriated) by others.<sup>13</sup>

A resource that meets one or more of these criteria may lead to a competitive advantage. The first four criteria are factors that preserve the unique, distinctive character of the resource. The fifth criterion listed, flexibility, is important in today's economy because rapid change is possible and often desired. There is considerable variance in the capacity of firms to ride the waves of change. Those that succeed often do so because

they use resources, capabilities, and routines that can be adapted to different contexts and different times.

The sixth criterion, appropriability, assesses whether the firm or some other competitor realizes the value or profit from the resource. Appropriability should not be a serious issue for a firm that combines relatively rare, nontradable, nonsubstitutable resources in unique ways. But that is not always the case.

Who really earns the economic profit from Disney's consumer products? Disney does not manufacture a thing. Instead, it licenses other companies to do the manufacturing. Although Disney does not realize all the revenue from the toys, clothing, and so on that bear its name, the above-average royalty charged to manufacturers means that Disney—not the manufacturer—appropriates most of the profit from its unique brand name.

It is not easy to unravel how competitive advantage is generated with competitive resources that meet at least some of these criteria. The attempt often draws strategists into very specific functional-level activities. Attention to detail is worth it, however, in order to understand more about how firms differ, and why some are more profitable than others. In this chapter we highlight six aspects of creating sustainable advantage:

- Branding
- Supporting activities
- Investment
- Position
- Accumulation
- Socialization

### Branding

A registered brand such as Disney's is obviously rare and nontradable, and in some markets, brand appears to be the single most important resource in determining market share. However, the value of this resource, and all others, depends on context. Table 2.1 estimates the percentage of customers loyal to a single brand across various products.

In the top categories, developing and managing brands is an obvious strategic priority. But why are brands in some markets so much more successful than others? And why are branding activities so different across companies, or even within the same company at different points in time? It is necessary to think about what lies *behind* brand name and other resources.

Strategists initiate different activities to create and maintain brand identity. They ask: What resources are at my disposal? What skills can I use or develop to create brand awareness? How can these be combined into more complex capabilities? What routines can I put into place to sustain my brand over time? Most important: How can I establish a brand image in the minds of my customers?

TABLE 2.1 THE VALUE OF BRAND AS A RESOURCE

Product	Percentage of Users Loyal to One Brand
Cigarettes	71
Mayonnaise	65
Toothpaste	61
Coffee	58
Headache remedies	56
Film	56
Laundry detergent	48
Beer	48
Automobiles	47
Shampoo	44
Soft drinks	44
Underwear	36
Television	35
Batteries	29
Athletic shoes	27
Garbage bags	23

Source: C. Schewe & A. Hiam, *The Portable MBA in Marketing* (New York: Wiley, 1998).

It is impossible to provide a recipe book for answering these questions, and they merge into the domain of marketing. From a strategic perspective, competitive resources, skills, and capabilities are unique to each company and meaningful only if customers feel other companies cannot match them. But these are not the only sources of advantage. Research also highlights the potential advantage of activities, investment, position, accumulation, and culture.

### Supporting Activities

Specific people must do specific things to create a competitive resource. Think about your personal resources and capabilities. If you are a competitive swimmer, part of your performance has to do with certain genetic assets, such as strong lungs and broad shoulders. In addition, however, your ability has almost certainly developed from hundreds of hours of practice, coupled with specialized weight training and discipline in diet. Those who coach athletes (who are certainly strategists) try to make sure these activities take place regularly.

The idea that strategy is about creating and integrating activities around a common purpose is as old as the field itself.<sup>14</sup> We outline an

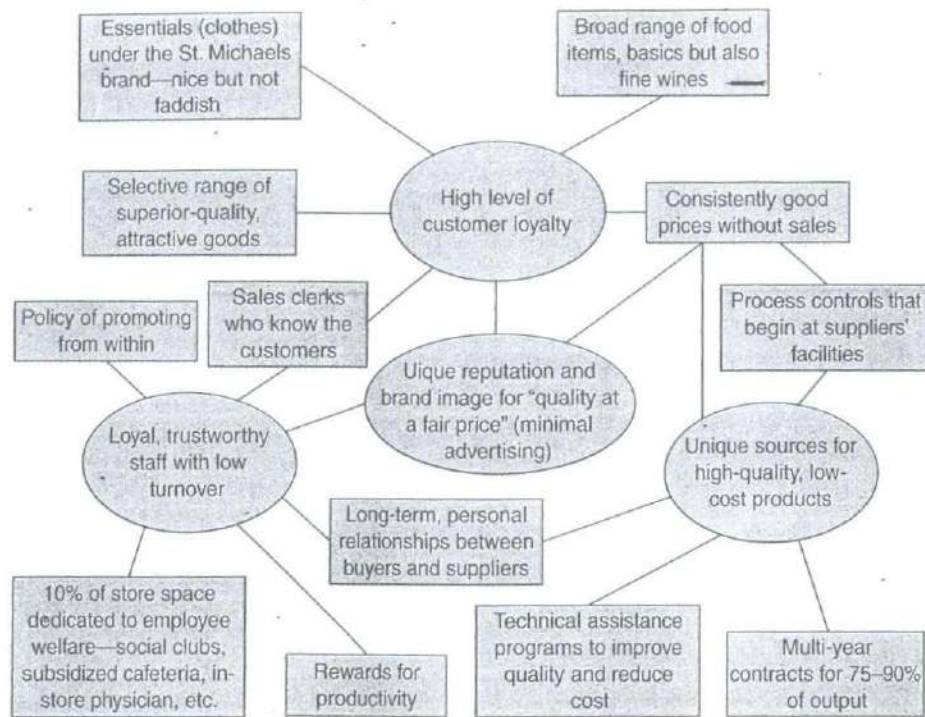


Figure 2.2 — Marks & Spencer's Activity System

Source: Analysis based on A. Montgomery, Marks & Spencer Ltd. (A). Harvard Business School Case No. 391089.

example in Figure 2.2. This set of interactions describes Marks & Spencer, a department store chain headquartered in the United Kingdom that long enjoyed a remarkable brand name and loyal customers, based on offering high-quality, relatively low-cost products.

### Marks & Spencer: Unadvertised Advantage

BBC News describes Marks & Spencer as “the granddad of British consumer brands, spending most of the 20th century building up a reputation as the UK’s most admired business.”<sup>15</sup> The firm had not only a brand name for “quality at a fair price” and strong customer loyalty, but also very loyal employees. Typically, retailers face high turnover among employees, intense competition from rivals, and cost pressures from large brand-name manufacturers. Lord Marks of Broughton, chairman of Marks & Spencer from 1916 to 1964, articulated five principles that helped his company avoid these problems. One of his principles was to foster good relations with suppliers, staff, and customers.

Marks & Spencer concentrated on store-branded merchandise and built strong relationships with a network of suppliers to provide good-quality products at fair prices. The company sold only British-made goods and was the sole customer for many of these firms. They invested in technical assistance programs to help suppliers overcome cost or quality problems long before forging strong relationships with suppliers was fashionable.

Other strategic decisions led to a series of unique investments in employee relationships, including 10 percent of store space dedicated to amenities such as employee social clubs and in-house medical care. These commitments helped reduce turnover among employees to exceptionally low levels. The firm created an environment where people knew each other well and it reinforced warm social relationships, not only among staff, but also with customers and suppliers. This, in turn, led to trust, reduced the costs of monitoring employees and suppliers, and solidified customer loyalty.<sup>16</sup>

The customers, of course, were key. Marks & Spencer's St. Michael brand had a very strong reputation for fair value for money. The goods were available in stores across the United Kingdom, and returns were accepted even without a receipt. The company's reputation was so strong that it did not feel the need to advertise on television. At the end of the 1997/1998 fiscal year, it had a turnover of more than £8 billion, with pretax profits of £1.17 billion.<sup>17</sup>

If you have traveled in the United Kingdom, you may know that 1998 was a high point for the company, and the performance picture rapidly deteriorated thereafter. However, before updating the story we want to make two important points about the system that Marks & Spencer was able to assemble. First, it is the interconnections among activities that produce advantage. The ovals in Figure 2.2 show competitive advantages that result from combinations of very specific activities. One activity in and of itself may not have much significance, but in combination they produce a valuable resource.

Second, the choices that produced these activities must be different from the choices made by rivals if they are to yield competitive advantage. Other retailers in the United Kingdom, for example, emphasized manufacturer brands, and few provided employees with the kinds of perks found at Marks & Spencer. Many rivals offered broader, more fashionable lines of merchandise. It would have been natural for Marks & Spencer managers to broaden their product line to include trendier clothing and otherwise emulate strategies that seem to be succeeding in the marketplace. However, strategy is about doing things differently. That worked for a long time at Marks & Spencer,<sup>18</sup> though the formula shown in Figure 2.2 ultimately did stop providing an advantage.

### Investment

Activity requires investment, and competitive advantage typically requires considerable investment. An important thing to learn from the success of companies such as Disney, Royal Bank of Scotland, and Marks & Spencer is that strategy is about saying no to many possible investments so that resources can be concentrated on creating and sustaining competitive advantage in well-specified ways.

Resource flows support current activity.

Resource stocks accumulate from investments over time to support competitive advantage.

One of the metaphors often used to describe the process of managing investment in resources is filling a bathtub. The gush of water as it fills the tub can be seen as the flow of investments needed to create resources. At Marks & Spencer, *resource flows* include the company's investments in employee rewards.

The level of water in the bathtub represents the *resource stocks* that have accumulated from past investments, such as Marks & Spencer's high level of employee loyalty.<sup>19</sup> The resource stock underlies current competitive advantage. The resource flows determine whether an advantage will be sustained or whether, perhaps, a new competitive advantage can be developed.

Notice that the flow decisions—investments in resources—are very fine-grained. Unlike grand corporate strategies (the decision to spend millions on an acquisition, for example), flow decisions involve multiple investments in technical and administrative systems and other specific activities. The detailed decisions required to amass these resources are made by middle- and operating-level personnel, and in recent years analysts have come to see that they are critical to strategy.<sup>20</sup> At the same time, broad themes guide flow decisions; top-level managers, such as Lord Marks, typically develop these themes.

Breaking resources down into their component activities and the investments that support them helps maintain strategic consistency and focus across a wide range of more tactical investment activities. A tool for doing so can be found in Worksheet 2.2.

Worksheet 2.2:  
Activity  
Map—A Tool  
for Connecting  
Strategic  
Investments

### Position

Activity and investment take place in a specific time and place, and both time and place make a difference. Let's go back to your hypothetical swimming talents. If swimming is important to you, living in California might be considered a plus, because you could swim year round and there are many able coaches and many competitive swim teams to join. Serious athletes sometimes move to take advantage of this relatively unique environment and see their skills improve as a result.

On the other hand, you have to be very good indeed to win a regional meet in California. The same skill might take you further in a less competitive environment. Indeed, you might have a greater chance of becoming an Olympic athlete if you swim in a country where very few young people have the privilege of competitive training.

The choice (if you are driven to be a winner, and have the capacity to move) would seem to be obvious. But, as often happens in strategy, it is not that simple. You had better hurry no matter where you move. Better-trained, younger athletes are breaking today's records, and more and more countries are sending winners. The general point, of course, is that today's business strategists face increasingly competitive conditions and thus have more complicated choices to make.

We defer a more complete discussion until later chapters that focus first on entrepreneurship (in Chapter 4) and then on rivalry more generally (in Chapter 5). At this point we will only observe the following:

- Where activity and investment take place makes a difference.
- When activity and investment take place makes a difference.
- Some choices are much more likely to succeed than others.

A basic trade-off involves trying to improve skills and abilities by facing particularly demanding competitive environments, an expensive and risky position, versus increasing the returns from current capabilities by seeking more sheltered environments. Table 2.2 illustrates this trade-off between deploying and accumulating resources.

**TABLE 2.2 DIFFERENCES BETWEEN RESOURCE DEPLOYMENT AND ACCUMULATION**

	Deploying Resources	Accumulating Resources
Focus	Apply what we already know	Learn what we need to know
Time frame	Short to immediate term	Varies, but may be very long term
Expected results	Efficient execution of plan	Trying new things leads to both success and failure
Norms of behavior	Consistency and conformity	Divergence and creativity
Core assumption	Success is determined by the efficiency and effectiveness of resource allocation processes	Success is determined by the discovery and integration of new skills and ability

These differences became an important trade-off for Marks & Spencer as strategists used its accumulated resources to diversify. As it happened, an exploratory strategy moved the firm into international environments that were unexpectedly competitive. After the fact, Marks & Spencer strategists were judged to have made poor decisions at home as well, because they took their eyes off increasingly aggressive new entrants. In a remarkably short time they lost the esteemed position the company had long enjoyed.

### The Fall of Marks & Spencer, 1998–2003

By 2003, Marks & Spencer had suffered a five-year decline in sales. The perception of the company slipped with remarkable speed from “assured quality” to “dowdy.” The firm’s collapse was a great shock to many, and a number of changes in positioning seemed responsible.

**Diversification.** In the 1990s, Marks & Spencer expanded throughout Europe, Canada, and the United States. Although the company enjoyed a strong reputation abroad, the firm encountered different retailing concepts that it failed to dominate with its operating strategy. After six years, strategists at Marks & Spencer reversed the diversification strategy. The company closed thirty-eight continental European stores, cut 4,000 jobs, eliminated its U.K. catalog business, and sold off its U.S. interests in Brooks Brothers. These measures resulted in a charge as high as \$450 million.

**Merchandising.** The core business suffered during the period of diversification. Long recognized as one of the leaders in combining stylish fashion and food, Marks & Spencer slowly lost its trendsetting position in apparel. Department layouts and displays looked tired and outdated. New strategies, such as a lingerie joint venture with Agent Provocateur, flopped. The firm failed to achieve critical mass in new product areas such as mobile phones and digital media.

**Competition.** Other apparel retailers, such as The Gap, Next, H&M, and Topshop, hit the High Streets with more contemporary and trendy assortments targeted to younger audiences. Instead of being a leader, by 2000 Marks & Spencer was forced to be a follower.

**Advertising.** Various advertising campaigns flopped and reaffirmed the public's view that the retailer was out of touch.

**Management.** Problems with uncoordinated management practices and problems started to appear in the interfaces between top management, middle management, and front-line employees. Instead of acting together, the three groups were moving apart. Trust levels were falling, morale was fading, and people were becoming cynical and negative in their thinking and responses.<sup>21</sup> The closure of the Paris branch ended up in a legal wrangle. Longtime suppliers in the United Kingdom were dropped in favor of cheaper overseas suppliers; however, Marks & Spencer had not secured its supply lines before becoming reliant on overseas manufacturers. Empty clothing racks, especially in the key winter season, simply advertised to the market that the company had lost its way.

Clearly the retailing environment had become more challenging. The media and many other onlookers spent a great deal of time analyzing the firm's situation. As is often the case, many strategies could be recommended, but it is hard to find consensus about *how* strategists should regain the success they once enjoyed. Stuart Rose, appointed CEO in 2004, led a turnaround that included high-profile advertising and was knighted at the end of 2007 for his success in helping revitalize a major British institution.<sup>24</sup> A press release in 2005 indicated that "the outlook remains challenging, with tough economic and competitive conditions

expected to continue. We are focused on delivering better quality, value and styling across all our product ranges, as well as improving service levels and store environment. We have made good progress, however, there remains much to do."<sup>22</sup> Strategies emphasized in other publications include the following:

- Refocusing on customers in three areas: product, service, and store environment
- Renegotiating supplier agreements and reorganizing buying teams
- Speeding delivery of high-quality product to stores
- Reducing stock commitments by more than 35 percent to increase flexibility
- Reducing clutter to make stores easier to shop
- Strengthening the Marks & Spencer brand with the launch of Your M&S
- Completing the sale of M&S Money to HSBC; acquiring per una (a brand of children's clothing); closing the Lifestore project; and returning £2.3 billion to shareholders
- Opening 31 Simply Food stores
- Emphasizing corporate social responsibility, including the use of fair trade products
- Implementing "green store" modernization plans<sup>23</sup>

### Accumulation

We have already noted how long it takes to collect sufficient stock of some resources, particularly some kinds of intangible assets and technical capabilities. Table 2.3 provides some interesting evidence about how long a company should expect to work before developing some of the most valuable assets.

TABLE 2.3 AVERAGE REPLACEMENT PERIOD OF SELECTED INTANGIBLE RESOURCES

Intangible Resource	Replacement Period (Years)
Company reputation	10.8
Product reputation	6.0
Employee know-how	4.6
Networks	3.4
Supplier know-how	3.1
Databases	2.1
Distributor know-how	1.6

The necessity of commitment may seem obvious from this evidence, but considerable subtlety is involved. Amazon faced a particularly difficult situation in its first years of operation as it tried to manage inventory.

### Amazon's Stockpile

After hitting a high of \$107 per share in December 1999, Amazon's stock lost more than half its market value by mid-2000. At that point, an analyst at a leading Wall Street investment bank issued a stinging financial analysis—essentially saying that the company was draining cash at a rate that threatened its survival. One of the biggest problems, according to the analyst, involved resources.

In its first few years, Amazon's managers accumulated talented programmers and marketing skill. As the product line expanded from books to other goods, warehouses and distribution centers were built all over the United States and ultimately around the world. But strategists failed to accumulate necessary inventory management skills and systems. As a result, they lacked the capability to estimate the amount and kind of inventory to order, and unsold inventory does not generate cash. Sales grew 170 percent in 1999, but inventory swelled by 650 percent! Basically, this new economy company was struggling because it lacked an old-economy competence.<sup>25</sup>

It took some time, but Amazon acquired key old-economy competence and significantly expanded its initial strategy—based on its previous weakness. *Business Week* reported that the company was “morphing into a tech company . . . as much Microsoft . . . as Wal-Mart.” After intense concentration on information technology, Amazon's distribution centers were reported to be able to handle triple the volume that they could in 1999, at half the cost. In fact, Amazon began managing the e-commerce business of other retailers.<sup>26</sup> At the heart of this success is a supply-chain management system that *Information Week* described as the most sophisticated in the world.<sup>27</sup>

### Socialization

One more point about the accumulation of resources is important: new employees are hired because they possess needed personal skills, but their contribution to the organization's competitive position cannot be assumed. They may arrive knowing how to carry out an assigned job in a general way, but they do not know how to work in a way that fits their employer's particular competencies. Nor is it possible to just give them detailed instruction, because even the simplest job cannot be totally described. Conditions vary; things happen that have never happened before; socially complex routines are not fully understood and so cannot be formally taught.

**Socialization**  
(formal and  
informal) results  
in newcomers  
understanding  
“how we do things  
here.”

The *socialization* of employees and other actors helps them understand why resources are valuable and how they are accumulated. Employees have to learn how things are done in a new job, how to solve the problems that inevitably arise, what kinds of new solutions are likely to be appreciated, and how they can best coordinate their activities with others. They do that by receiving formal instruction, but also by paying attention to people around them and having people pay attention to them. Employees make inferences from what they hear and see and compare their ideas with others. Stories are told and interpreted; activities are physically demonstrated.

Ideally, employees come to identify with the work of the organization and invest effort and creativity that goes beyond their job description. But whether or not this occurs, whether or not their experience in the organization is positive, their work continues to be shaped by the social setting. Understanding how this inevitable socialization occurs and influencing it in a positive direction is critical to the accumulation of competitive resources.

## WHAT RISKS ARE ASSOCIATED WITH RESOURCE ACCUMULATION?

Both Marks & Spencer's diversification difficulties and Amazon's problems with distribution illustrate why it is important to understand the sources of strategic risk. *Strategic risk* comes from uncertainty about the availability of resources as well as the cause-and-effect relationships of a desired strategy.

**Strategic risk**  
is an estimate of  
the uncertainty  
about outcomes  
associated with  
every activity.

Think of the career path you have chosen. If you have spent the last several years honing your business skills, it's not likely that you're going to become a competitive swimmer. Prior decisions about what you wanted to do with your life now constrain the options realistically available to you. After founder Jeff Bezos spent several years building Amazon around a business model that assumed physical presence wasn't necessary, it wasn't easy—some thought it was impossible—to accumulate a different set of capabilities in time to meet the competitive challenge of more traditional retailers. Each strategic choice involved risk. Theorists highlight four contributing factors: uncertain capacity to accumulate assets, causal ambiguity, over commitment, and external attribution.

### Uncertain Capacity to Accumulate Resources

Our examples illustrate how complex the resource picture can become. Limited availability of key resources and difficulties evaluating resource quality are problematic. In addition, a single distinctive competence is likely to involve coordination across many activities located in several functional departments (procurement, marketing, customer

service, warehousing, shipping), dozens of specific activities, and hundreds (if not thousands) of individual people. Limited capital, lack of experience, problems with communication, and lack of motivation make organizing these activities difficult.

### Causal Ambiguity

Accumulation can be problematic, but strategists often face the greater difficulty of not knowing in advance precisely which skills, systems, people, and activities are going to be critical as markets evolve (the topic of Chapter 6). It may be easy to see after the fact which pieces are missing, but in real time that insight is much more difficult to achieve. Resource-based theorists assert that most competitive resources are socially complex and have *causal ambiguity*. Even within the firm, strategists are unlikely to fully understand whatever magic they currently enjoy. To the extent that they do not, strategists are unable to deliberately support or replicate success.

The basic point is that risk cannot be avoided; complexities and ambiguities surround all resource investment decisions. That is good news, in a way. Uncertainty and risk protect competitive advantage from imitation. After all, if managers inside the firm could precisely articulate all the ingredients of distinctive competence, then why couldn't their rivals do the same thing? The very complexities of resource accumulation are what help isolate successful firms from their competition.<sup>28</sup>

### Overcommitment

Another significant risk is associated with exploiting the current stock of resources. Many organizations become almost blindly committed to their present course of action, even when changing circumstances encourage them to learn new things.<sup>29</sup> Managerial psychology plays a significant role. Those responsible for deploying a set of resources in support of a known, successful strategy are not likely to value someone else's idea to try something radically new. Why tinker with success? Current customers seem happy. Unfortunately, a focus on producing efficiency distracts managers from seeing the potential of learning or understanding how a new idea might contribute to a new capability. This myopia is efficient in the short run, but in the long run increases strategic risk.

### External Attribution

The final problem of resource accumulation that we will mention is also associated with how managers think. Research suggests that when things go well, people attribute success to their own efforts. When things do not go well, almost all of us tend to focus on external sources of the problem.<sup>30</sup> The competitor that can rise above this human tendency has a promising future. Consider the following comparison.

**Causal ambiguity** refers to the lack of readily apparent connection between a firm's activities and its competitive success.

### Strategy and the Weather

After World War II, the trucking industry became a major carrier of goods in the United States, considerably diminishing the railroads' share of the business. Two well-known firms, the Rock Island Railroad and the Chicago and Northwestern Railway (C&NW), were affected by this downturn, but they differed in the way they interpreted it. In letters to shareholders and speeches to analysts, Rock Island emphasized the impact of more favorable federal regulation of the trucking industry and noted a variety of unfortunate circumstances, including several years of unusually bad weather, that slowed business in various sectors of the economy. It spoke of declining traffic as a "temporary economic adjustment, which will be of comparatively short duration."

Strategists at the C&NW had a different interpretation of the same environment. They thought the railroad's declining share of traffic was likely to be permanent and signaled the need for internal change. Several different issues were seen as problematic, especially high wage/revenue ratios. But steps were taken in almost every phase of the business, from maintenance to finance, that strengthened the company's competitive position. It took at least six years to "unlearn" past ways of doing things and put new practices into place, but the company survived, while parts of Rock Island were ultimately acquired by a stronger railroad and the rest of the company was liquidated.<sup>31</sup>

In this and many other cases, a big part of the risk in strategic decisions results from how strategists perceive the circumstances around them. What is even more interesting about the railroad story, however, is that different managerial perceptions can create different business environments. C&NW saw the environment as somewhat controllable, and on this basis, it developed a strategy that created a more controllable environment. Rock Island saw the world as virtually uncontrollable, and on this basis, it did not act.

## HOW IS RESOURCE ACCUMULATION AND DEPLOYMENT STRATEGICALLY MANAGED?

Although luck may play a role in the resource endowments available to a given company at a point in time, it is the strategists' job to capitalize on luck, and when possible strategists must transcend it by managing the current resource base and developing new competencies over time. The following steps are suggested as an extended exercise to conclude our discussion of competitive advantage. They oversimplify the strategic thinking that occurs in most organizations, but highlight key aspects of formulating a resource-based strategy.

**Step 1: Attend to Necessary Resources**

There are many choices in how a given product or service might be produced, and successful competitors often find unexpected means of doing so. Although there are very few absolutely necessary resources, as a practical matter most companies use many similar ones, and a firm that lacks a particular resource, or an acceptable substitute, can be in trouble. That is the lesson of Amazon and its early difficulties with distribution.

**Step 2: Determine Competitive Advantage (If Any)**

Start with the question: Does the firm have a competitive advantage? The first clue lies in economic profit or some other widely valued performance measure. Remember that economic profit means above-average returns. If there is no current advantage, then focus the analysis on the intended or potential advantage of the organization. Remember also, as Marks & Spencer's story reminds us, that a historical advantage may no longer be creating value for your organization.

**Step 3: Define Distinctive Competencies**

The next step in the analysis of competitive advantage involves linking high performance with more specific firm attributes. It is not enough to talk in generalities about "what we do especially well." Value is relative. For example, a company that feels it provides exceptional service may find, when customers are closely questioned, that its service levels are really not that different from their competitors'. Strategists must beware of the tendency to overestimate their own prowess; too often improvements across the industry are interpreted as a company gain. Identifying distinctive competence involves external comparisons.

**Step 4: Decompose Distinctive Competencies to Focus Investment**

Once a list of distinctive competencies has been developed, each one should be broken down into its constituent parts. Activity system analysis (Worksheet 2.2) or some equivalent is helpful in this regard. For example, the activity system in Figure 2.2 highlights customer loyalty, trustworthy staff, and strong supplier relationships as the result of distinctive competencies Marks & Spencer enjoyed until the late 1990s. Once competencies like these are identified it is important for managers to understand the relationship between stocks (resources) and flows (investments to create resource). Without such an analysis, it would be easy to lose track of the investments that support an important capability or routine.

### Step 5: Look for Opportunities to Leverage Resources

Once one understands the relationships between a set of resources and distinctive competence, two logical questions arise: Can deployment of the resource be profitably expanded within this arena (an exploitation strategy)? Are there new arenas in which current and new resources could profitably be deployed (an exploration strategy)?

### Step 6: Plan for the Ongoing Renewal of Resources

Many things can diminish the value of a particular resource. For example, sustaining a successful retail operation requires an ongoing series of investments in human resources, typically including above-average compensation and employee benefit programs. If other companies begin to match or exceed a retailer's employment package, talented salespeople are more easily attracted away.

### Step 7: Watch Out for Competence-Destroying Change and Capitalize on Competence-Enhancing Change

Competence-destroying change in the environment reduces or extinguishes the value of past asset stocks.

Anyone who watches a company's fortunes over time recognizes that a major jolt sometimes comes along—a jolt that undercuts the value of a resource to the point at which no amount of incremental improvement restores advantage. These *competence-destroying changes* often involve new technology, significant regulation or deregulation, or the emergence of new competitors. For example, since the web made the process of arranging airline, hotel, and car rental reservations so easy, many large corporations have terminated their contracts with outside travel agents and trained people in-house to make travel arrangements. The fact that these activities no longer need to be outsourced has been a major blow to travel agencies.

Web-based technology is destroying the value of many competitive resources of the past. These changes are spreading across industries, including financial services (where intermediaries are the target), entertainment (where broadcast networks are suffering), and industrial production (where buying on the web destroys distributors' bargaining power). The Internet may be one of the biggest competence-destroying changes ever observed; it certainly affects strategy at all levels of analysis. We will continue to consider these changes because they are particularly relevant to today's strategist.

Competence-enhancing changes in the environment increase the value of resource stocks.

However, it is important to remember that some changes in the competitive environment can enhance a firm's resources. Such *competence-enhancing changes* are exactly what a Darwinian evolutionist would expect. Just as a change in climate, say colder weather, disadvantages some species but favors others, so too every environmental change creates winners as well as losers. The important difference is that the strategist can perhaps do more to take advantage of large-scale changes in environmental opportunity than species with or without fat, fur, and other decisive characteristics.

## CONCLUSIONS FOR THE STRATEGIST

Every strategist inherits a stock of resources that have accumulated over time, including his or her own personal assets. The strategist must consider how to do the following:

- Fully exploit the potential of these resources
- Invest in their maintenance and improvement
- Summon the will to leave them behind when assets more appropriate to changing conditions must be developed.

Valuable competitive resources are flexible. They are like shocks in a car that buffer travelers from many bumps in the road. You know that Marks & Spencer continues to be pressured by cut-rate retailers and high-value brands. It has to refurbish past resources but also develop new ones to meet these challenges. Disney is similarly changing its strategy in the face of a changing competitive environment. Its characters are still among its formidable assets, but they are increasingly augmented by other resources.

The fact that current competence and the resources that support it tend to erode is one of the most enduring and generalizable observations of strategy. It is not just that competitive resources cannot last forever; it is also that the resource-based strengths of the past tend to become weaknesses in the future. Distinctive resources in particular become anchors that are very difficult to leave behind.

Thinking about current and potential resources is the first subject in what we call the “heart” of strategy. In the next chapters we focus on four additional topics that also must be considered before strategy can be defined. In Chapter 3 we attend to the needs and desires of current and potential customers. In Chapter 4 we add the challenge of identifying opportunity. In Chapter 5 we look at rivals and draw on economic theories that expand the resource perspective. In Chapter 6 we consider how this analysis will change over time.

### Key Concepts

**Resources** are assets that can be used to meet performance demands. They are often subdivided into **tangible resources** that have a physical reality, such as buildings, machinery, and supplies, and **intangible resources** that are not directly visible, such as knowledge and reputation.

**Capabilities** are combinations of resources that create value. They tend to be valuable if they become **routines**—regular and predictable patterns in organizational behavior that persist over time even though the individuals involved change.

Many similar resources, capabilities, and routines are used by all (or virtually all) industry participants. Although it seems unlikely that success

can be achieved without them, strategists are advised to pay particular attention to **distinctive competencies**—the resources, capabilities, and routines that are unique to their organization. The process of generating competitive resources must, by definition, be difficult, or all competitors would quickly be able to copy any activity which is rewarded in the market. Although it is not easy to understand how competitive advantage is achieved, the distinctive competencies that yield advantage must be expected to erode over time because of **mimetic behavior** by competitors, who follow patterns observed in the behavior of others. **Socially complex activities** are particularly difficult to understand and hard to imitate. These tend to be important components of distinctive competencies.

Theory and empirical research suggest that a resource is more likely to be competitively useful if it is **rare** or not widely available, **nontradable** on the open market, **nonsubstitutable** by alternative resources, **inimitable** or unique, and **flexible** or adaptable. The benefits these resources bring must also be **nonappropriatable**; that is, they cannot be captured by other actors, such as competitors.

Investment creates a **resource flow** that feeds current organizational activity. That flow can be usefully distinguished from **resource stocks**, which are the result of investments and activities over time. The latter typically supports sustained competitive advantage. The deployment of resources and the possibility of accumulating additional resources depends on the position of the firm. Resource accumulation requires time and does not happen automatically. The **socialization** of employees and other actors, through direct communication and informal interaction, is an important contribution to building understanding of why resources are valuable and how they are accumulated.

**Strategic risk** is an estimate of strategists' uncertainty about outcomes associated with the strategic activities they undertake. **Causal ambiguity** refers to the lack of readily apparent connections between a firm's activities and its competitive success. In addition to the problems of limited human understanding, risk comes from the possibility of **competence-destroying change** in the environment that reduces or extinguishes the value of past asset stocks. Some firms, however, will benefit from **competence-enhancing changes** that increase the value of their resources, just as Darwinian evolutionists predict.

### Questions for Further Reflection

1. Choose a personal goal. What resources do you have to achieve it? Do you need others? What activities support them? What investments are needed (and when should they be made?) How should you position yourself? Would branding activities be helpful?

2. Identify a startup organization that you know firsthand or from information on the Internet. Specify its strategy as you understand it. Identify key activities necessary to support the strategy and the resources needed to carry it out. Do you think current strategy is realistic?
3. Identify a battle between competitors. (For example, in the next chapter we will look at Nike versus Adidas.) Does either company have a competitive advantage? How long do you expect the advantages you identify to last? What would you suggest as a strategic advisor hired by one of these competitors?

### WORKSHEET 2.1

#### A Tool for Analyzing Resources

The Resource-Based Theory of the Firm offers a useful vocabulary for understanding current advantage and future potential. These are inevitably comparative assessments. The columns in Worksheet 2.1 (which should be labeled) can be used in various ways to compare key resources and capabilities.

**Option 1:** Specify a level of analysis and compare your resource pool (column 1) with the resources of two competitors (columns 2 and 3). You might consider comparisons with nearest competitors or industry leaders.

**Option 2:** To summarize strategic effort, compare your organization's resources at a point in the past (column 1) with present resources (column 2) and the resources you and others are trying to develop by some specific date in the future (column 3).

**Option 3:** To assess your personal fit with your job setting, put the resources you use in your job in column 1, the resources of your unit in column 2, and the resources used by your organization in column 3. Use a second color to add personal resources that are not currently in use and consider one or more of the following questions:

1. Are there additional ways in which I could add value with my current resources?
2. Are there opportunities to combine my skills with the skills of others?
3. How can I extend my personal resources in this environment?
4. What other jobs (in this organization or others) might utilize different combinations of resources or teach me more?

<b>Resource Analysis</b> Worksheet 2.1	<b>Organization:</b> Time Frame:
<b>Analyst(s):</b>  Black = current resources (date ____ ) Blue = anticipated resources (date ____ )	<b>Strategy Summary:</b>

Tangible Resources			
Intangible Resources			
Capabilities			
Routines			
Distinctive Competencies			
Competitive Advantages			

**WORKSHEET 2.2**  
Activity Map—A Tool for Connecting Strategic Investments

Identify an organization's primary competitive advantage and the activities and investments that create it.

**Step 1:** Put the name of the primary competitive advantage in a circle in the center of this worksheet. (If you are not sure that there is a competitive advantage, identify the distinctive competence that is the most promising contributor to future advantage.)

**Step 2:** In black pen, list and connect activities that generate this competence.

**Step 3:** In blue pen, list and connect the investments that support this competence.

**Step 4:** Circle, in red, the distinctive competencies on your map. We reiterate a caution in the text: research shows that actors tend to overestimate the extent of their distinctive competencies. Ask yourself:

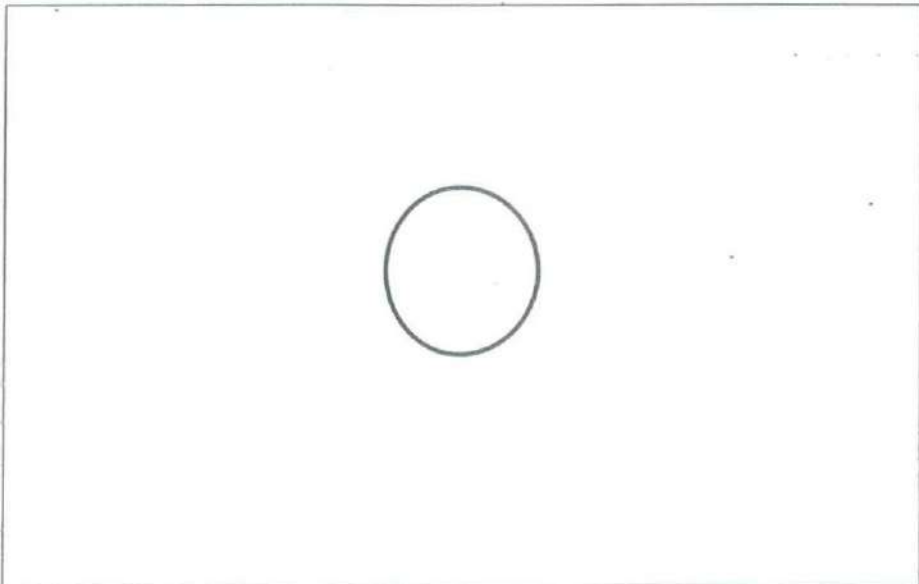
- Are you confusing hope or intention with actual results?
- Do you have supporting evidence that supports your claims?

**Step 5:** On one or more copies of your map, use a fourth color to brainstorm additional resources and investments that might further reinforce your advantage, focusing especially on the development of distinctive competencies.

**ALTERNATIVES**

- Put two competencies on the same page and consider their connections.
- Focus on the results of your distinctive competency by drawing arrows that point to its consequences for customers and other stakeholders.

<b>Competitive Advantage Analysis</b> Worksheet 2.2	<b>Organization:</b> Time Frame:
<b>Analyst(s):</b>  Black = activities Blue = investments Red (circled) = distinctive competence Fourth color = strategic additions	<b>Strategy Summary:</b>

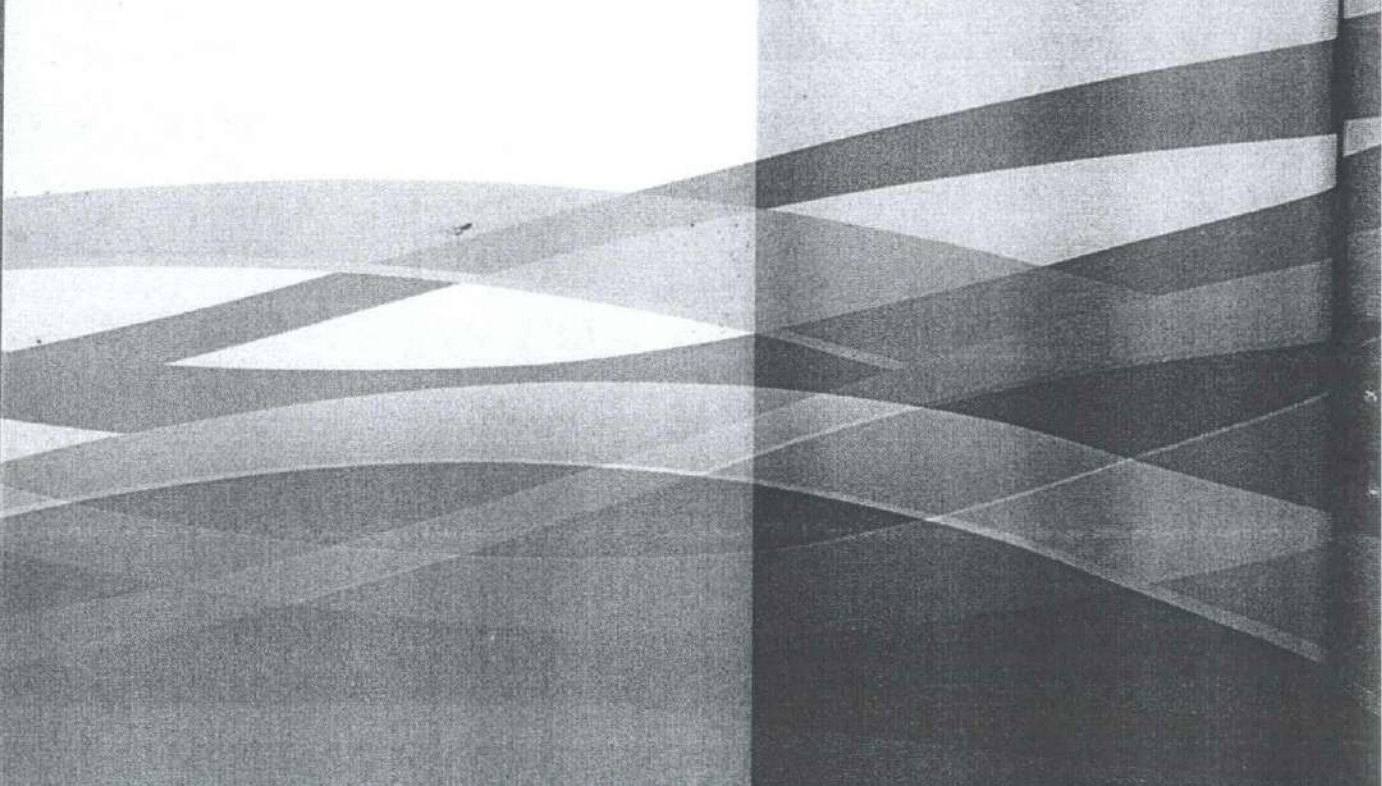


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- 1 DEFINING STRATEGY
  - 2 DEVELOPING RESOURCES
  - 3 SERVING CUSTOMERS
  - 4 SEEKING OPPORTUNITY
  - 5 COMPETING WITH RIVALS
  - 6 SPECIFYING A BUSINESS MODEL
  - 7 CONSIDERING CORPORATE STRATEGY
  - 8 THINKING GLOBALLY
  - 9 ACTING RESPONSIBLY
  - 10 ENSURING EXECUTION
  - 11 MANAGING KNOWLEDGE
  - 12 PROVIDING LEADERSHIP
  - 13 PERSONAL STRATEGIZING
- 

# 3

## Serving Customers



You have excellent training to be a strategist: you have been a customer all your life. But many strategists confuse their experience and their customers' experience, and too few focus on customers as the basis of their strategy. We argue in this chapter that it is critical to collect (and continue collecting) information from the people your organization serves, and then use it!

Organizations exist to provide value to some client or customer group. That might seem obvious, but it is easy for those inside the organization to focus on day-to-day activities that keep them far away from the recipients of their efforts. Without a strong customer connection, strategists are at risk of developing organizational competencies that have little or no market value.

Strategists with a strong customer orientation also focus on employees. They consider the resources and activities that help employees understand changing desires of current customers and assess whether they might profitably serve new customers. However, as with other things in life, a positive idea can be taken too far; companies still must make money while attending to customer needs.

.....  
*This chapter puts what customers value at the center of strategic thinking by answering five questions:*

Why is the customer relationship increasingly critical?

- Customers are becoming more sophisticated and demanding
- New technology allows new forms of customer contact
- Competitors are raising expectations
- Coproduction is increasing

What is a service mentality?

- Organizational activities matched to customer needs and desires
- Customers seen from a positive perspective
- Employees who understand that their success comes from service
- A climate that supports and reinforces service

What are the guidelines for a customer-based business model?

- Definition of the business in customer, not production, terms
- Clarity about the needs to be satisfied
- Choices about how needs will be satisfied

How do companies gather data to identify and understand their customers?

- Analyze customer experience
- Map customer perceptions of the market
- Track marketing information
- Anticipate the consequences of demographic trends

Involve customers in design and selection

Use ethnography techniques

Can the customer connection be overemphasized?

Service levels have to fit strategy

Some customers are too expensive to serve

Today's happy customers are not necessarily tomorrow's customers

Smart companies have always paid attention to their customers' buying decisions as one important indication of needs and trends. New technology is allowing not just more detailed tracking, but new ways of directly interacting with customers at the point of purchase. Shoes provide an interesting example.

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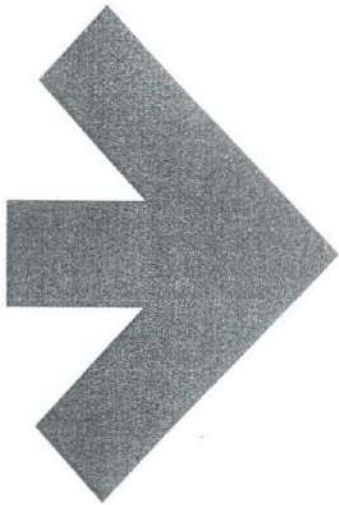
### MASS CUSTOMIZATION OF ATHLETIC FOOTWEAR: A "WIN-WIN" TREND?

For decades, the general public's athletic footwear selection was limited to seasonal mass-produced styles, sizes, and colors. Only world-class athletes were able to purchase footwear designed for their specific needs. In late November 1999, Nike began to reverse the situation with the NIKEiD range. Customers everywhere had the chance to select shoe color and an eight-character embroidered name for a 5 percent price premium.

Six months later, Adidas pilot-tested a much larger range of mass customization options with the mi adidas line of soccer boots offered in select retail outlets in six major European cities. Adidas "fitting experts" scanned customers' feet to measure their exact length, width, and pressure distribution. Customers could try on basic prototypes fit to each foot. After selecting personal fit preferences, customers used the PC to view and select shoe material, an embroidered monogram, and stud profiles. They also chose the color of the main boot, outer sole, stripes, and collar. A 50 percent premium was charged. The shoes were built in one of three factories in Indonesia or China and delivered in approximately three weeks.

A significant number of customers loved the idea of having a say in the design and fit of their footwear. Adidas benefited by observing customer preference and aggregating this into market research information. The findings were used to improve the customized product line and to forecast customer demands for standard lines. Some information, such as preferred color combinations, was particularly helpful on a regional level. The experience increased customer loyalty through satisfying final products and a trouble-free reordering system.

Following the successful pilot, Adidas provided its technology to many more retail stores and extended the product line to include running shoes, tennis shoes, and golf clubs. Products are now sold through special events, in traditional retail outlets, at major sporting contests, and online.



Not surprisingly, competition increased. NIKEiD expanded to allow consumers to select a number of different features for running, basketball, and cross-training shoes that it sells online. In 2006 the company announced the iPod Sports Kit.<sup>1</sup> The Apple website suggests:

You don't just take iPod nano on your run. You let it take you. Music is your motivation. But what if you want to go further? Thanks to a unique partnership between NIKE and Apple, your iPod nano becomes your coach. Your personal trainer. Your favorite workout companion. Introducing Nike + iPod.<sup>2</sup>

**Mass customization** allows a large number of customers to personalize product characteristics.

*Mass customization* improves product delivery not just to those with special needs or sensitivity to fashion, but also to those who would like to repurchase the very same product over time. However, the strategy has blurred traditional retail boundaries, with some controversy around who "owns" particular customers and information about them—the manufacturer, the retailer who initially customizes the product, or the retailer who subsequently takes follow-up orders? Further, the profit consequences of mass customization are not always clear. The setup costs can be high, and not all customizers have been able to develop the new skills and contacts required.

**Customer-based strategy** focuses on identifying and serving customer needs and desires.

Although some companies that tried mass customization, such as Levi Strauss, have now exited the market, we believe that customization is part of an irreversible trend. Customers are increasingly savvy. They want and expect more. Strategists have to keep track of and anticipate these demands. They use a *customer-based strategy* with the assumption that satisfying customers will also maximize success in reaching more traditional performance goals, including returns to stockholders.

## WHY IS THE CUSTOMER RELATIONSHIP INCREASINGLY CRITICAL?

**Customer contact** is a measure of the amount of user involvement in planning, executing, and delivering a good or service.

Different businesses have different levels of *customer contact*, as suggested in Table 3.1.<sup>3</sup>

TABLE 3.1 THE RANGE OF TRADITIONAL CONTACTS WITH CUSTOMERS

Low Contact	Medium Contact	High Contact
Mining	Retail outlets	Gourmet restaurants
Farming	Public transportation	Health centers
Manufactured commodities (e.g., chemicals)	Fast-food chains	Real estate agents
	Libraries	Caregivers (e.g., day care)

**Intellectual capital** summarizes the knowledge, skills, and capabilities used by an organization to produce goods and services.

Attention to producing tangible goods has always dominated the management of businesses on the left side of this table, while customer relations were more important for businesses on the right side. Traditionally, customer contact tended to be seen as a cost to be minimized by firms operating in industries on the left of the table, while it became a possible source of advantage toward the right.

Today, these distinctions are increasingly tenuous, and contact with the customer is becoming more important for almost all organizations. As a result, the ownership and manipulation of physical capital, once considered the engine of economic growth, has been economically dominated by the *intellectual capital* used to supply more integrated products and services. Several different things are happening: customers are becoming more sophisticated; new technology is allowing for new ways of customer contact; competitors are raising expectations; and coproduction is increasing.

### Customers Are Becoming More Sophisticated and Demanding

Twenty-first-century customers often know what they want. Comments from other customers (often on the web) provide widely available information before a buying decision is made. Contemporary life also provides more opportunities for consumption. In many countries people assume they will have twenty-four-hour, seven-days-a-week access to their bank accounts, for example. In the United States, customers with relatively modest holdings expect personal bankers to offer financial planning services and other support from a single point of contact. Twenty years ago, only the very wealthy invested money directly in the stock market. Now, more than 50 percent of American consumers have bought and sold stocks, bonds, or mutual funds. For retail banks, this means that customers demand access to a much wider array of services, well beyond the personal checking and savings accounts of their parents' generation.

Customer demands are increasing in every sector we can think of. For example, doctors are more and more likely to see patients who know (or believe they know) more about their particular ailment than the professional they visit. But this is not the only challenge facing the health care industry. As Figure 3.1 shows, physicians and nurses typically see the value they add to health care in terms of medical expertise and technology. Customer surveys, however, show that customers' perceptions of value in health care are much broader. In fact, patients may be relatively unconcerned about the technical quality of physicians' services. They take for granted that the doctor is properly trained. (When was the last time you queried your physician about his or her credentials?) Instead, patients' perceptions of value include whether the physician seems caring and friendly, whether the exam room is comfortable, whether the physician is on time for appointments, and even whether convenient parking is available.

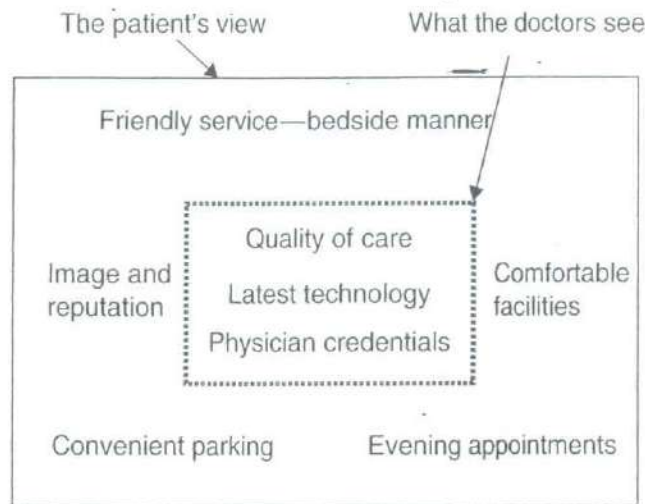


Figure 3.1 – Perceptions of Desirable Attributes of Health Care Services

These first examples come from business relations with individual customers. If we add the vast increase in business-to-business services, the changing nature of customer relations is even more important. Many companies are outsourcing activities in which they do not have a competitive advantage, for example, but outsourcers can be very sophisticated customers because they have experience in carrying out the activities that they now seek to buy in the marketplace. They not only know what they want, they have direct knowledge about the processes and costs involved.

So much research on perceptions of product and service quality has been done that it is difficult to succinctly summarize.<sup>4</sup> Table 3.2 provides an overview of key factors that customers tend to care about.

TABLE 3.2 FEATURES THAT CAN AFFECT CUSTOMER PERCEPTIONS OF THE QUALITY OF AN ORGANIZATION’S GOODS OR SERVICES

Goods	Services	Environment (Actual or Virtual)
Cost/performance (value received from core attributes of the good)	Professionalism (knowledgeability of service provider)	Accessibility (ease of locating and navigating provider site)
Features (available extras)	Concern/responsiveness (interest in meeting customer’s needs)	Ambience (tangible features of the site that may or may not receive conscious attention)
Functionality (ease of use in comparison to value received)	Fit (match between customer needs and services provided)	Security (ability to protect welfare of site visitors)
Constraints (limits on what can be done with the product)	Interaction (willingness to accept input and share control decisions)	Novelty (newness in comparison to past experience)

(continued)

TABLE 3.2 (CONTINUED)

Goods	Services	Environment (Actual or Virtual)
Reliability (probability of malfunctioning)	Trustworthiness (ability to keep promises and maintain confidentiality)	Personnel (appearance and behavior of employees)
Serviceability (ease of maintenance and repair)	Flexibility (capacity to respond to additional or altered information)	Customer commonalities (buyers' perceptions of their similarities and differences compared to other buyers)
Aesthetics (attractiveness of design, touch, smell, etc.)	Recovery (individual and organizational skill in solving problems)	
Speed (time elapsed between order and delivery)	Reputation (recognition of service quality by others)	
Reputation (product recognition by others)	Cost/value received (perception of benefits gained)	

Source: Based on S. Schneider & S. S. White, *Service Quality* (Thousand Oaks, CA: Sage, 2004), Chapter 2.

Note that customers make judgments about tangible, physical characteristics that might be objectively confirmed by others. They also make judgments that are more subjective, comparative, and potentially idiosyncratic. As the line between goods and services blur, and both are included in a bundle that includes experiences like “novelty”, the categories listed increasingly overlap. Furthermore, what one observer would find a positive (for example, “many people buying this product or using this service look like me”), others might find a negative. The details can be worked out only in the context of a particular company’s activities, at a particular point in time, with a specific set of consumers.

### New Technology Allows New Forms of Customer Contact

New technologies enable more contact with customers, but also lead customers to expect more contact. New information technologies, in particular, cause firms to re-examine how they can create value for customers. For example, the Internet is a competitive threat to large brick and mortar retailers such as Barnes & Noble and Borders bookstores. As we know, a search engine can provide a consumer with many more product choices than a brick and mortar store, no matter how big that store is physically. In order to compete, bookstores are developing *experience-oriented strategies*. They often provide coffee, easy chairs, and products that might appeal to literary clientele. They also offer sales online, with returns in the store, something an e-tailer such as Amazon cannot match. This is an important trend, one we discuss in more detail later in the chapter.

The connectivity and scope provided by the Internet has changed the nature of almost all business. Consider newspapers, a business with

Experience-oriented strategies support the process of consuming an organization’s offerings.

mid-range customer contact in Table 3.1. In the established business model, journalists create copy; editors make decisions about content; supervise layout, and control the appearance of the paper; and the results are transmitted to presses that create the physical product. Then, using an extensive distribution system, the paper is delivered to individual homes, newsstands, libraries, and many other venues on a daily basis. Today's newspapers exist for three reasons: (1) they have sufficient product circulation, (2) they can use circulation numbers to attract advertising revenue, and (3) they have found ways to create economies of scale in printing and distribution.

As we all know, the growth of television undercut this model with visually dramatic and timelier reportage. But most television news offers relatively little detail in comparison to print, and a significant though shrinking newspaper market still exists.

Now television viewing is declining. With the availability of the Internet, customers for news can act as their own editors, choosing what personally interests them from a variety of media. Only the stories and features that are likely to interest them need to be sent to their personal computer at work or at home. Classified advertisements also are a natural online product; the ads can be placed with respect to users' activities and are more easily updated online. Meanwhile, distribution and printing costs are relatively small.

Although the Internet is the driving force in this example of changing relations with customers, many other technological changes are also changing the world economy. Travel and transportation are increasingly economical. Manufacturing can be carried out on a smaller and smaller scale. The materials available for manufacture are increasingly sophisticated. Trained workers are more available around the globe. These and other drivers of a changing economy are bringing the customer into closer contact with organizations. Companies can do more for their customers, closer to the time and place of desired delivery, in more varied forms.

### **Competitors Are Raising Expectations**

Increasing contact with customers is also driven by competition. In the next three chapters we discuss the changing face of rivalry; in this chapter we simply note that the search for competitive advantage has led firms to increase their efforts to connect with particular customer groups they can serve well.

As goods become more information intensive and interactive, one especially important move is to increase service offerings. That trend includes manufacturing firms. For example, when airlines order a new Boeing jet, they do not get GE engines, they get a fixed-price maintenance agreement from GE charged at so many dollars for each hour of flight. Airlines really do not care about owning engines; what they want is a guarantee that they will be able to be in the air earning revenue. They now get that from a traditional manufacturer, GE, with

a new sense of service. Rather than a remote relationship through a second party (Boeing), GE has a direct connection with the airline customers that use their products. Ideally, more knowledge leads to better service and greater profits.

The same story can be found in almost every industry, even the manufacture of commodities. Consider the following service strategy from the chemical industry.

### Sharing Environmental Costs

Specialty chemicals were traditionally sold in bulk to automobile manufacturers, which used them in different production processes. The chemical companies charged the automobile firms by the quantity of the material used; they maximized their profitability by maximizing the amount of chemicals they sold and by minimizing production and transportation costs. Customers were motivated to purchase only the chemicals needed to complete the production process, while meeting their quality standards. An apparently unrelated issue was that the automobile manufacturer was responsible for the environmental costs associated with using chemicals.

The result of the traditional buyer-seller relationship was that there was no incentive for chemical companies to invest in research to develop less environmentally harmful products. Today, however, the chemical buyer and seller are much more likely to have cost-sharing arrangements in which the automobile manufacturer never actually purchases or handles chemicals. Instead, the chemical supplier performs the production process that uses the application of its chemicals at the auto manufacturer's site. The chemical company takes responsibility for maintaining a prescribed level of quality for production at a fixed price. If they can reduce the costs associated with this production process by making the process more efficient (including reducing the costs associated with hazardous waste), then both parties share in the savings.<sup>5</sup>

In short, instead of selling and buying products alone, many manufacturers are selling services and purchasing services alongside tangible goods. At the same time, service firms often offer more products than they did in the past. Hotels, for example, have started to sell the robes, cosmetics, shower curtains, and even beds found in their rooms. This is possible because of partnerships with manufacturers, which results in customers receiving more extensive service.

### Coproduction Is Increasing

At the extreme, the line between customer and seller blurs, and *coproduction* with customers begins to take place.<sup>6</sup> We began this chapter by referring to mass customization, an idea that has grown tremendously

**Coproduction** directly involves customers in the creation of the goods, services, or experiences they consume.

**Cost-sharing** strategies allocate costs between members of an alliance, including alliances between customers and producers.

in popularity. Dell is an outstanding example. Its basic business model is to have customers select desired features of laptops, PCs, printers, and other technology goods it offers online. Toys (Mattel, Lego), jeans (Lands' End), and cosmetics (Procter & Gamble) are among the broad range of other products that offer customer design involvement.

Coproduction is often a subtle form of *cost sharing*. For example, airlines often ask customers to check themselves into flights they have prebooked: once an identifying credit card is entered into a special service kiosk, the customer checks and prints boarding cards. In fact, self-service can be found everywhere in America—as customers clear their tables in fast-food restaurants, pump gas and clean their windows at gas stations, and check out the goods they chose from shelves in grocery stores. In some cases, consumption accompanies such participatory acts—in self-guided museum tours and interactive theater, for example. In other cases, the coproducing customer benefits from faster, cheaper, or more personalized exchange.

Closer customer involvement in the creation and consumption of goods and services can also be found outside the retail arena. Cisco Systems, the largest manufacturer of the electronic routers and switches that constitute the Internet backbone, is a good example. Cisco dominates many of the markets it is in,<sup>7</sup> but the company did not achieve success by itself—its customers are an important part of the picture.

### Coproducing Networks

Cisco manufactures products that allow computers to talk to each other on networks and the Internet. Its customers are mostly large businesses and public-sector organizations that are building networks to support their increasingly complicated activities: Cisco has built its strategy on the notion that it sells complex equipment to technicians and engineers in these technology-intensive settings. The key to selling in such a situation is to provide a product that fits the customer's design criteria. To create the necessary relationship between its own engineers and the customers, Cisco holds "networking parties" where technicians get to know each other. Cisco also frequently becomes a partner with its customers, forming joint ventures such as one with KPMG that offers network-consulting services.

Cisco doesn't just give lip service to customer service; it has invested millions of dollars in an online customer service website. This is not your ordinary help desk. The system allows customers to ask sophisticated questions about Cisco's technology, including how it fits with their own system's architecture. Engineering aids make navigating the system easy for customer engineers, and the net result is that customers essentially write their own order.<sup>8</sup>

Most important from the customer's perspective, the same system allows customers to diagnose and solve technical problems for

themselves—getting answers much faster than if they wait for a voice on the phone or (much worse) the arrival of an on-site technician. In data transmission, seconds of downtime mean millions of dollars lost (not to mention unhappy users). In this case, the best way to serve the customer is through the customer's own technical service staff.<sup>9</sup>

## WHAT IS A SERVICE MENTALITY?

Many people know that services are beginning to dominate economic activity.<sup>10</sup> In the United States and in Europe, approximately 80 percent of high-wage employment and 73% of low-wage is generated by providing services.<sup>11</sup> The numbers would be even higher if statisticians could calculate the growing service content of goods produced in other sectors. We want to be sure you know what service means.

### Organizational Activities Matched to Customer Needs And Desires

As noted in the introduction to this chapter, perhaps the most important imperative of a service perspective is the move from what Peter Drucker calls an internal perspective to an external one. Table 3.3, expanded from a book called *Customer-Centered Strategy* by Professor Mark Jenkins, suggests the significant difference in questions asked by the strategist.

TABLE 3.3 THE CONTRAST BETWEEN INTERNAL STRATEGIC QUESTIONS AND EXTERNAL STRATEGIC QUESTIONS

Internal Perspective	External Perspective
What are our competencies and strengths?	What are the characteristics of our customers?
What are our weaknesses?	What are customers' values?
How do we stack up against the strengths and weaknesses of our competitors?	What is the customers' price sensitivity?
	How do our current customers identify and rank providers of what they want?
	What kind of future customer groups will we be able to serve?

Source: M. Jenkins, *Customer-Centered Strategy: Thinking Strategically about Your Customers* (Philadelphia: Trans-Atlantic, 1997).

Of course, strategists need to ask the questions in both columns, but as we noted at the beginning of this chapter, companies often have great difficulty moving from an internal to an external focus. Giving more thought to issues in the column on the right often leads to a significant change in strategy. An illustration can be found in this story from a traditional customer-contact business.

### — The Town Librarian and the Latchkey Children

The town librarian was becoming increasingly concerned. Each day at about 3 p.m., a flood of schoolchildren came into the library's reading rooms. At about 5 p.m. the tide of children began to turn. By 6 p.m. the library was quiet once again. A survey revealed that the library was being used as an informal day-care center for "latchkey" children (so called because they would have to use their own key if they went home after school while their parents were at work.)

The reading rooms, quiet and sparsely populated most of the day, were becoming increasingly noisy and crowded. Books, particularly fragile paperbacks, were left in untidy heaps on library tables or on the floor with spines cracking. Tired assistants faced mountains of reshelving before they could leave for the day. The constant traffic to the bathrooms kept the janitor busy with special efforts to keep them neat, clean, and well stocked.

One library that felt the pressure had a budget funded from general revenues by the town's budget committee. The budget committee had not increased the library's budget for two years, even to keep up with inflation. It might be expected that staff would feel it was not the library's job to care for latchkey children. This is a task that should be done by parents or perhaps other day-care providers. What should the town librarian do?<sup>12</sup>

The librarian's easiest response in this brief example would seem to be establishing new rules that require children to be accompanied by adults when visiting the library. An entrepreneurially oriented strategist, on the other hand, saw the situation just described as an opportunity to create greater value for customers. A library is traditionally defined as a place to keep books and make them available to the public. To that end, libraries have elaborate inventory and recording systems that track where books are and which patrons have borrowed them. But is this the only way to interpret the library's mission? Is there an opportunity to redefine the mission to provide greater value to customers?

The strategic librarian decided to enhance the value provided by her organization. She emphasized that the library was part of the educational and cultural assets of the town—a potential provider of chamber music performances as well as book review clubs and places for students to study. More specifically, the influx of latchkey children was reassessed as a chance to encourage reading and a love for books among the library's future customers. The library began to offer story hours and art classes. Volunteers, especially retired people, were brought in to work during after-school hours to help cover expenses. As a result, the citizens voted for an increase in their local taxes so that the library could improve the services it was offering to the community.

### Customers Seen from a Positive Perspective

The librarian's dilemma was successfully resolved only because the library stopped seeing after-school visitors as a problem. It is easy to view people outside the organization in a negative light. Customers in particular often want things the organization does not and perhaps cannot provide. Different individuals and groups can make contradictory demands. They often present urgent requests that the company did not anticipate.

Various responses to these potential difficulties are possible; some of them are defensive, even hostile. Indeed, strategy is often seen as intrinsically competitive, and many of its well-known principles come from the military, where strategy helps determine life-and-death contests. Military success is often fueled by the energy that comes from defending home and property, a perspective that puts the organization and its allies on center stage.

Business strategists often take the same perspective, and Chapter 5 summarizes some important thinking about the need to "defend" profits from the demands of buyers and suppliers. In this chapter, however, we want to emphasize that the traditional military mindset does not work well with a customer-centered strategy. It is hard to think about truly pleasing someone who is viewed (even subconsciously) as the enemy.

This raises one of the inherent complexities of strategy: the strategist must balance requirements for survival of the organization with requirements for serving the customer. Paying attention to only one set of requirements is very likely to subvert the other. Yet the successful middle ground, in our view, increasingly puts the customer at the center of strategy, and that requires a *positive model of human behavior*. Not only customers, but also suppliers, distributors, and especially the company's own employees must be assumed to be well-meaning. Encountering a few people with ill will is almost inevitable, but they must be treated as special cases. It is important that dealing with outliers does not jeopardize a basically positive mindset.<sup>13</sup>

More specifically, successful customer-centered strategists do the following:

- Respect customers as capable of identifying and making decisions about their needs<sup>14</sup>
- Assume that the needs and interests of the customer will change and require adaptation by the organization
- Adopt a partnership perspective in responding to customer needs.

These are viable principles for a wide range of organizations—including those with business-to-business strategies and those that serve children, the mentally ill, and other customers who traditionally have not been given a voice in service delivery.

**Positive models of human behavior** assume that most people are intrinsically well-meaning in their interactions with others.

Customer-centered strategists assume that positive principles will need organizational support to become practical.<sup>15</sup> They do not assume, as we will describe at the end of the chapter, that all customer requests can or should be fulfilled. Nonetheless, the central idea is that by meeting customer requests, even those that initially seem difficult or impossible, the organization is likely to be in a better, more financially sound position in the future.

### **Employees Who Understand That Their Success Comes from Service**

A third key component of a service mentality involves employees. It is difficult for people who are not happy to happily serve customers. That would seem obvious, but it is an observation that makes significant demands on the strategist. The basic guidelines for trying to make employees happy mirror those just suggested for successful interaction with customers: respect, adaptation, and partnership. The field of human resource management is devoted to choosing and supporting effective employees, and thus in this strategy text we will not cover the subject in depth. However, the link between employees and customers must be made clear by management if people within the organization are to gain satisfaction from serving customers.

As an example, we return to Cisco. Its service success depends not only on connecting strongly with customers, as described earlier in this chapter, but also on a strong connection with employees.

#### **How Cisco Keeps Its Employees Happy**

Faced with the need to attract and retain the best technical minds in the very competitive Silicon Valley job market and other sites, Cisco developed a distinctive competence in satisfying employees as a way to achieve distinctive customer satisfaction. The company regularly shows up on lists of the best companies to work for,<sup>16</sup> and it has made good use of its Internet expertise in keeping employees happy. The employee services website provides speedy access to the company database of résumés and job positions. Employees can directly access their personnel files. They can find information about stock options and other benefits (almost all employees are shareholders). The site also catalogs company learning programs and allows employees to book training on their own.<sup>17</sup> It fully reimburses tuition up to an annual maximum of \$7,500.<sup>18</sup>

The match between employee success and customer service is also made clear. A customer-oriented mentality is central to Cisco's culture, and customer satisfaction is a major part of performance appraisal and compensation for managers and employees alike. Early in its history, Cisco established a customer advocacy function. That means that

“anyone in the company can ring the bell” if he or she finds a dissatisfied customer. All employees thus have a responsibility for carrying out a central feature of the firm’s strategy. Making this critical activity part of data kept and shared emphasizes its centrality to the way the company operates.<sup>19</sup>

Service climates support and reinforce satisfying customers.

### A Climate That Supports and Reinforces Service

Happy employees do not automatically make customers happy. The culture of the organization, as well as its processes and systems, must highlight the importance of customer service and support its delivery. Organization “climate” is a concept that tries to capture the overall experience of employees at work; a *service climate* more specifically creates the expectation that customers will be respected and served. Strategists provide the tools and relationships that help that happen. They establish practices, policies, and procedures that are actually used by their employees. Potential contributions to that climate, identified from the research literature, are outlined in Table 3.4.

TABLE 3.4 CONTRIBUTIONS TO SERVICE CLIMATE

Dimension	Requirements for Effective Service
Equipment	Reliable tools for customer support are available.
Training	Purpose and methods of customer contact are made clear.
Personnel	A sufficient number of staff are trained in customer support and made available to customers.
Systems for work processing	Processes for interacting with customers are in place.
Record keeping	Records of past contacts are available.
Evaluation and learning	Outcomes of transactions are recorded and evaluated.
Reward	Service success is recognized.
Management	Successful practices are routinized through subsequent training and system modifications. Problems and anomalies are addressed.
Communication and marketing	Customers are aware of the purpose and benefits of the organization’s efforts.

Source: Based on S. Schneider & S. S. White, *Service Quality* (Thousand Oaks, CA: Sage, 2004).

Clearly a lot of tools and activities are needed, but the strategist does not have to do it all. Just as customers can be effective participants in production, so can employees. The people on the “front line” of service are the ones who have the detailed knowledge to make a customer-centered strategy a success.<sup>20</sup>

## WHAT ARE THE GUIDELINES FOR A CUSTOMER-BASED BUSINESS MODEL?

More and more organizations are developing a customer-oriented definition of their business. Doing so, as Figure 3.2 from Derek Abell shows, means addressing three fundamental questions.



Figure 3.2 — Abell's Model of Business Definition

Source: D. F. Abell, *Defining the Business: The Starting Point of Strategic Planning* (Upper Saddle River, NJ: Prentice-Hall, 1980).

### Definition of the Business in Customer, Not Production, Terms

The purpose of Abell's first question, "Who is being satisfied?" is to elicit a clear description of what the customer values. Unless a product or service satisfies specific needs or wants, it cannot be expected to generate revenue. That means the customer should drive vision and mission; although other stakeholders are important to business success, especially shareholders and employees. The account that follows is a reminder of how even companies that satisfy their customers at one point in time can lose contact.

#### Encyclopedia Britannica Loses a Long-Standing Business

Encyclopedia Britannica established one of the best-known brands in the world by selling multivolume sets of encyclopedias. In the 1990s, however, its sales declined by more than 50 percent. Its nicely bound volumes sold for \$1,500–\$2,000. That was hard to justify compared to Microsoft's Encarta CD-ROM, which sold for \$50 or came free with the purchase of many computers with a CD drive.

Encarta, a licensed product from the publishing company Funk & Wagnall's, had traditionally been sold in grocery stores. When Encarta

was first introduced, Britannica did not respond. Decision makers thought that an electronic encyclopedia was an inferior product, a toy, and believed customers would be able to easily see the greater benefits of their offering.

They were wrong. Britannica misunderstood both its competitors and its customers. It was not competing against Encarta, with its vastly different cost structure; it was competing against the computer. The parents who once invested in the leading encyclopedia (long considered the best home learning tool for children) now used their money to buy what they considered an even more vital learning tool, a computer. Encarta just came along as a “free” additional feature.

When decision makers at Britannica finally recognized the competitive threat this new bundle of products posed, they decided to give away a CD version of their encyclopedia with the purchase of a printed version, and to sell the CD-ROM version for \$1000. As you probably know, this strategy was not successful. Facing tough on-line competition from Wikipedia and a review by the well-regarded journal *Nature* that showed that Wikipedia citations were close to encyclopedias in accuracy,<sup>21</sup> Britannica continued to decline and was sold to new owners. They developed an online encyclopedia at [www.britannica.com](http://www.britannica.com), which features contributions from leading scholars, including several Nobel Prize winners, daily updates, and links to the *New York Times* and the BBC. That is an advance in content compared to previous paper volumes, yet competitor Wikipedia is regularly cited as one of the top ten sites visited on the web—demonstrating the success of a very different model of how information can be gathered.<sup>22</sup>

### Clarity about the Needs to Be Satisfied

Defining the customers who are most strategic to serve can be difficult.<sup>23</sup> The question of *what* needs or wants to satisfy can be even harder. Consider a mundane product such as an elevator. The customer is multifaceted. A manufacturer must think about the owner or developer of the building, the general contractor who builds the structure (and actually purchases the elevators), the architect who designs and selects the elevators, the companies who lease space in the building and, of course, the users of the elevator. Otis significantly increased its revenue when it decided which of these customers it would focus on serving.

#### Moving Up by Narrowing Down

At Otis Elevator, the worldwide leader in “vertical transportation” for high-rise buildings,<sup>24</sup> strategists look at their customers’ experience and see opportunities to satisfy well after the purchase phase. Indeed, Otis

has built the profitability of its business by emphasizing excellent service downstream. Otis strategists decided to focus on the elevator in use and its maintenance, rather than the obvious point of purchase, where price competition is rampant.

The company is proud to say that it knows an elevator needs service before the customer. It achieves this by placing a computer chip in the elevator's operating system that reports maintenance issues back to Otis. Ready to respond is a massive corps of factory trained service representatives stationed around the world.<sup>25</sup>

In addition to the complexities of purchase and use by multiple customers, most companies serve many different market segments and in each of these (by definition) customer demands differ. Targeting segments is an important strategic decision, and tracking and analyzing them is essential to the bottom line. Some segments grow faster than others, and some are more profitable than others.

This is the domain of marketing strategy. As an overview, we will simply note that market segments can be defined by attributes of the product, attributes of the customer, or both. Figure 3.3 lists typical segments in the automobile industry. Figure 3.4 shows how product and buyer attributes (in this case, geographic location) can be used to create a segmentation matrix. The purpose of creating a segmentation matrix is to identify the segments that the organization currently serves or would like to serve, to evaluate the attractiveness of each segment, and to design a strategy for competing in chosen segments.

- |  |   |
|--|---|
| <ul style="list-style-type: none"> <li>• Product attributes                     <ul style="list-style-type: none"> <li>- Size</li> <li>- Price</li> <li>- Design</li> <li>- Performance</li> <li>- Quality</li> <li>- Service level</li> <li>- Prestige</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Buyer attributes                     <ul style="list-style-type: none"> <li>- Consumer                             <ul style="list-style-type: none"> <li>• Upper Income</li> <li>• Middle Income</li> <li>• Lower Income</li> </ul> </li> <li>- Industrial                             <ul style="list-style-type: none"> <li>• Large corporate</li> <li>• Small &amp; mid-market</li> </ul> </li> <li>- Geography                             <ul style="list-style-type: none"> <li>• Domestic</li> <li>• European</li> </ul> </li> </ul> </li> </ul> |
|--|---|

Figure 3.3—Consumer Dimensions for Segmentation of the Auto Industry

Other characteristics can be used to segment markets, including age, gender, occupation, education, religion, and nationality.

	North America	Western Europe	Eastern Europe	Western Asia	China	Southeast Asia	Central Asia	Africa
Passenger sedans (luxury)								
Midsize passenger sedans								
Sport-utility vehicles								
Passenger minivans								
Delivery vans								
Heavy trucks								
Specialty vehicles								

Figure 3.4 – Buyer and Product Attributes

Buyer behavior, which includes factors such as extent of use, degree of brand loyalty, usage rate, benefits sought, and lifestyle, is also a common way to measure and identify segments. Again, the strategic decision is whom the organization can best serve, based on the best combination of what customers want and what the company can provide.

### Choices about How Needs Will Be Satisfied

As the strategist considers who might be served and what needs might be met, Abell's third question about *how* needs will be met takes us back to the notion of distinctive competencies. Strategists ask: What do we as an organization do that the customer specifically values? But they also ask: How do we do it differently and better than the competition? What resources are required to meet the needs we have identified now and in the future? These questions direct attention back to internal resources—it does little good to seek a business definition that is customer oriented if the organization lacks the capability to deliver on customer needs with attractive products and services.

At the beginning of Chapter 2, we discussed Disney, a vast company that has established itself as a trusted guide to family entertainment.

**Synergy**  
enables one  
resource to  
increase the  
impact of others.



Worksheet 3.1:  
The Growth  
Matrix—A Tool  
for Expanding  
Product/Service/  
Experience  
.....

Disney offers its customers vacations, films, videos, books, music, sporting events, and other family activities. But independent firms produce most of the products and services that Disney offers for sale. The most important role that people at Disney perform is selecting products that will enhance its reputation for high-quality entertainment. The organization concentrates on the job of maintaining the trust of families worldwide for quality products and services.

They are looking for *synergy*. Ideally, some of the same resources can be leveraged in multiple segments. Brand names help this happen. For example, although the Mercedes emblem has different meanings for different segments (prestige in luxury cars, dependability in heavy trucks), the brand has value as a quality image that crosses all of Daimler AG's segments. That allows the firm to expand its business by leveraging a pool of resources into new market segments. Disney does the same thing in its multiple markets.

Once again we suggest that you gain some direct experience with considering how a company can grow by meeting multiple customer needs. Worksheet 3.1 will help drive home the key ideas of the chapter.

## HOW DO COMPANIES GATHER DATA TO IDENTIFY AND UNDERSTAND THEIR CUSTOMERS?

Satisfying the customer is a moving target. Too often, firms lose track of what the customer really values. It is much easier to focus on the physical product or technology and to assume it suits customers than to really engage with customers in all of their complexity. Neglecting to stay connected with customers is particularly easy for a company that has been successful for some time. Strategists can believe that they know what their customers value, while their customers' perceptions of value changes over time. We have already described Encyclopedia Britannica as an example of such a value shift.

To make life more difficult for the strategist, customer composition itself is often changing. In part this has to do with strategic choices deliberately made by the organization. We have just pointed out, for example, that resources have more value when they are leveraged across multiple markets. Seeking synergy, businesses may expand their customer base or emphasize new markets or new market segments. When they succeed, the definition of customer value is almost certain to change, and the resources required to serve the customer are likely to shift. If the overall customer-based strategy is not reassessed, financial benefits from expanding the market are unlikely to develop. Four activities may be particularly helpful: analyzing customer experiences with a product or service, mapping customer perceptions of the market,

tracking marketing information, and anticipating the consequences of demographic trends.

### Analyze Customer Experiences

Although the key exchange between buyer and seller is an economic transaction, in reality there are many more points of customer contact. Each offers an opportunity to learn about the customer, or for the customer to learn about the organization. A *customer experience map* may lead to insights about what customer satisfaction and behaviors really mean—or could mean—as a basis for competitive advantage.

Figure 3.5 offers an example of such a map, with some questions that might provide useful input to customer-centered strategy.

A customer experience map summarizes contact with a product or service from a customer's perspective.

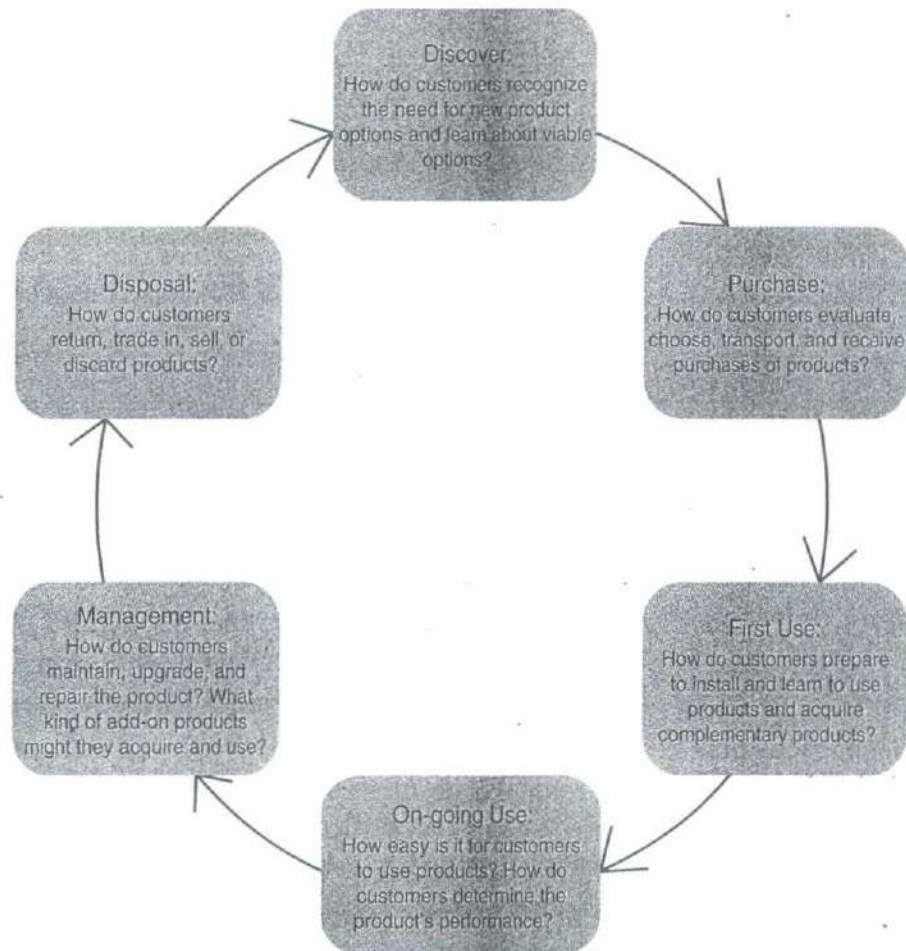


Figure 3.5 — The Customer Experience Life Cycle

It can be helpful to ask customers directly about how they use a product or service. Customers often offer valuable insights. It is also true, however, that busy customers may not think directly about their experience. Strategists therefore need to observe and infer experience from more general evidence.<sup>26</sup>

Customer perception maps indicate market distinctions made by a significant number of customers or potential customers.

### Map Customer Perceptions of the Market

One method strategists can borrow from marketers to help understand the connection between products and customers is to develop a visual *customer perception map* of the market. Doing so typically involves choosing important dimensions of customer behavior or characteristics, measuring customer responses along these dimensions, and then plotting responses on a grid that represents the perceptual space in which products or services exist.

In aggregate, customer perception maps may suggest overly crowded territories where too many rivals are competing for the same segment, or they may reveal opportunities where there are underserved or unrecognized needs. Figure 3.6 illustrates such a map for the automobile industry.

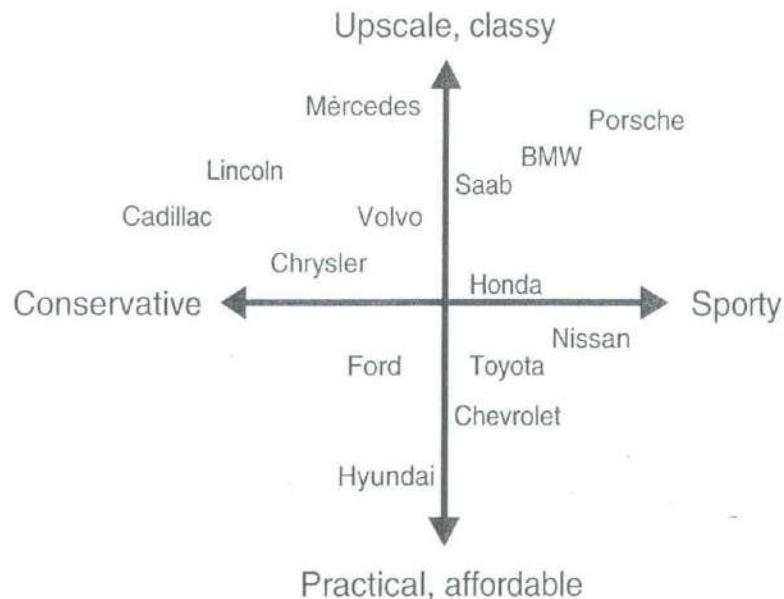


Figure 3.6 — Customer Perception Map of the Automobile Industry

Notice that the map uses subjective terms such as *classy* and *practical* to define a market. These words come directly from customer descriptions of the product. Perception maps are intended to trace how customers think about the competitive space and to give manufacturers information to position, or reposition, product offerings. The purpose of re-positioning strategies is to seek out more profitable segments or to increase the differentiation or “space” between one product and others.

Thus, in the automobile industry, it might make sense for Saab to reposition if it wants to differentiate itself from Volvo on the one side and BMW on the other. That might mean incorporating the high safety standards of Volvo with an updated BMW styling package. Note too, that the upscale, conservative segment is particularly well represented

in the automobile industry; that makes sense because baby boomer consumers with big disposable incomes value such cars though it is jeopardized by rising prices of gasoline. The sporty, practical segment appears to be underserved. Perhaps this is because competing in the lower right corner of the grid is difficult (manufacturing a sporty but affordable car) or unprofitable (avid consumers tend to be young men who don't have a lot to spend). The overall point is that it doesn't make sense to assume that it will be strategic to fill every hole in a map like this, but such a map does offer important evidence for choices that should be less contested. (Unless, of course, your competitor is working with a similar map and aiming toward the same uncontested space!)

### **Track Marketing Information**

Tracking elusive information about the customer has become a major activity. Most companies have specialists to gather and analyze detailed information about customers. Customer satisfaction surveys are obvious examples of this search for data.

But how can companies identify shifts in interests? Ideally strategists find clues before a trend is obvious to most consumers. Smart strategists create as well as respond to demand by reinforcing new interests and behaviors. The sources of information for this kind of strategy are often indirect. For instance, do you ever wonder why you keep getting offers for credit cards, even after you turned the last several offers down? That is because data from every transaction you make is collected. Credit card companies, like American Express, analyze customer statements and then sell mailing lists to customers of their own who seek buying patterns that match what they are trying to sell. If you have purchased a house, leased a car, taken out a mortgage, or done anything else that might change your status, you are especially likely to get a mailing. In fact, the computer system at American Express collects more than 450 pieces of information on every one of its cardholders. The data is updated weekly and used to target marketing for all kinds of products—magazines, cruise vacations, and exercise videotapes, among others. The company's website generates sales in travel and other kinds of purchases. But equally important, each site visit offers an opportunity to learn one more thing about the customer's preferences by monitoring his or her electronic visits.

In their efforts to gather similar consumer data, several companies have been accused of invading people's privacy. For example, Microsoft provides a Media Player in its software suite that has what some consumers say is a privacy-invading feature. Media Player keeps a log, stored in the user's own computer, of the DVDs that the computer plays. The software sends this log back to Microsoft, which sells it to other companies that match the interests of the consumer with movie and music advertisements that subsequently pop up on the user's screen.

These examples flag an ethical issue: technology has allowed companies to capture vast amounts of personal information about customers without their knowledge and use it to build detailed dossiers on individuals. We will return to this issue in our discussion of corporate social responsibility in Chapter 9.

### **Anticipate the Consequences of Demographic Trends**

As a last source of information that can help companies develop customer-based strategies, consider demographics. Virtually every company is affected by demographic changes in the population. Changes in age, birth rate, work behavior, and ethnic mix in a population will be reflected in profound changes in the customers available to serve and what they will expect.

For example, the financial collapse of the 1930s depressed birth rates in the United States for almost fifteen years. Then, after World War II, the birth rate grew at an unusually high rate, producing what was later called the baby boom. Since the 1970s, the U.S. birth rate has been dropping. Perhaps more interesting, the age at which the first child is born has been increasing. When the baby boom generation reached its thirties and forties in the 1980s and 1990s, these dynamics affected size and timing of the next “baby boomlet.”

The ripple effects of uneven birth rates are enormous. At present, and for the first time in U.S. history, the largest segment of the population is also the most affluent and has the most political power. Furthermore, in the United States and every other developed country, but also in China and Brazil, the birth rate is now well below the replacement rate of 2.2 live births per woman of reproductive age. The decline in the young population is changing markets in fundamental ways. Growth in family formation has been the driving force in all domestic markets in the developed world. The mass market that emerged in all rich countries after World War II has been youth-determined from the start. It has now become middle-age-determined, or perhaps more accurately, split into two—a middle-age-determined mass market and a much smaller youth-determined one.

Because the supply of young people is dramatically decreasing, new employment patterns designed to attract and hold on to the growing number of older educated people is expected to become increasingly important. At the same time, although politicians everywhere still promise to save the existing pension systems, it is highly likely that in another decade or two people will have to keep working until their midseventies.

All of this suggests that new business opportunities will rise in the areas of health, entertainment, travel, and financial services in particular. For example, as people continue to age and live longer, there will be demand for medical and health advice, medications, treatments, and diet and exercise plans. With regard to entertainment, experienced

consumers will want to travel to unique parts of the world and seek educational experiences, excitement, and aesthetic pleasures they have not experienced before. Financial services will be expected to keep pace—providing opportunities for individuals to manage the assets that make these experiences possible.

Worksheet 3.2 offers an opportunity to explore alternatives in the context of a particular product or service.



#### Worksheet 3.2:

Customer  
Survey—A  
Tool for  
Understanding  
Buyer  
Experience  
.....

### Involve Customers in Design and Selection

The discussion of Adidas and Nike that initiated this chapter suggests how customers can become more actively involved in product decisions. The next step is to involve customers in more strategic decisions. Professor Frank Pille, who co-directs the MIT Smart Customization Group and works at the University of Aachen in Germany, has devoted his career to developing this idea.<sup>27</sup> He is particularly interested in how customers can begin to make the research and design decisions once seen as a major company capability. Here is an intriguing example:

Crowdcasting broadcasts a company's problem to a specific—and carefully chosen—group. Think of . . . crowdcasting as a private backstage party you can't get into if you're not on the list. In Idea Crossing's Innovation Challenge, contestants sign confidentiality agreements, and their strategic solutions become the property of the corporate sponsors. At the 2004 Innovation Challenge, Sprint executives asked participants to devise new services featuring high-speed wireless technologies; last year IBM searched for ways to market itself to businesses in China and India—countries that send large contingents of MBA students to the event.<sup>28</sup>

### Use Ethnography Techniques

An increasing number of companies are using anthropological tools to understand the customer's world. This approach assumes that customers may be unable to articulate their needs and desires, or may not be interested in doing so. Storylistening, pioneered by Olaf Rughase, is one promising technique.<sup>29</sup> The purpose is to gather data about the customer's world from very general customer accounts without using preconceived categories. A compatible approach focuses on observing customer activities. Ethnography, the description of people and activities in specific places, is especially valuable when moving into markets with which strategists have little previous experience.<sup>30</sup>

Whatever tool is used to gather data, the overall intention is summarized in Figure 3.7. It suggests that there is a natural interplay between the issues discussed in Chapter 2 and those discussed in this chapter. Constant interaction allows strategists to think about different ways customers can be served, alternative customer groups to be served, and possible market evolution.

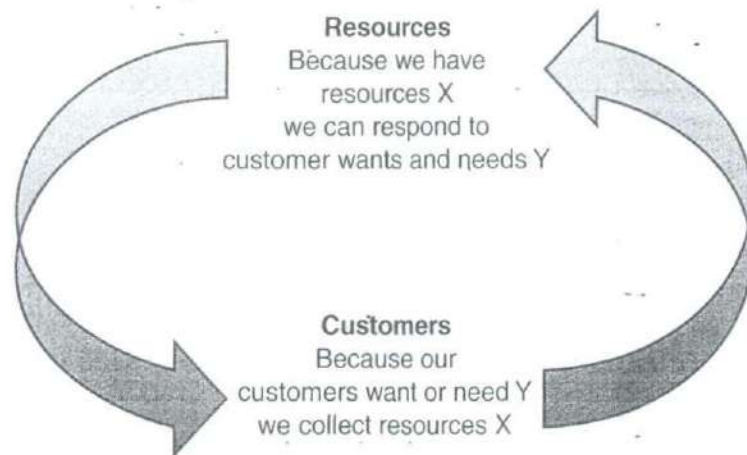


Figure 3.7 — The Interplay between Resources and Customer Information

## CAN THE CUSTOMER CONNECTION BE OVEREMPHASIZED?

We are enthusiastic about engaging customers and believe that closer customer contact characterizes today's competitive environment. However, no organization has infinite resources to serve customers. The following issues seem particularly important in thinking about this aspect of strategic decision making.

### Service Levels Have to Fit Strategy

The Nordstrom department store chain is famous for offering outstanding customer service that fits its upscale merchandise and facilities. During the Christmas shopping season, for example, a live pianist plays a grand piano, and wine is served in most store lobbies. There are also legendary stories of customers having been served well beyond their expectations. For example, one of the authors of this book found himself in urgent need of a haircut while visiting San Francisco. The nearby Nordstrom's salon was booked for the day, but the accommodating manager not only suggested an alternative, he also called the competitor and made the appointment! At the time, your author couldn't help thinking, "Why aren't all my retail experiences like this?"

But this level of customer service is clearly not appropriate for all retailers. Wal-Mart, for example, is not in a position to offer the same level of service and expertise on the shopping floor as Nordstrom does. Wal-Mart follows a low-cost strategy, and paying store clerks what Nordstrom pays would undermine its competitive advantage. Yet to increase the customer's perception of service, Wal-Mart stations greeters at the store's entrance. Usually part-time semiretired workers, these greeters offer a friendly, low-cost way to enhance the customer's experience.

The contrast between Nordstrom and Wal-Mart shows that the level and kind of customer service should be driven by strategy. The strategy must be focused on using customer service as a means of *adding value*, which means that the customer is willing to pay for the level of service provided. American Express reflects this distinction in how it charges for its card services—\$36 for the basic card (most service is delivered through automated phone or Internet systems) versus \$300 for platinum (the wait for telephone service is virtually nil and members have twenty-four-hour access to concierge services).

### Some Customers Are Too Expensive to Serve

A somewhat cynical *80/20 rule* is often reported by service providers: “80% of my effort goes to serving 20% of my clients.” To the extent that such a significant imbalance exists, and the resource-eating group can be encouraged (retrained, restricted) to decrease their demands, profits will rise.

Organizations have to be careful that their activities do not increase the percentage of overly expensive customer demands. An online survey, for example, may give the impression that the customer will receive a personal reply. If thousands of customers respond, the organization may not have that capacity.

One of the foremost advocates of quality customer service identifies an even more problematic group of undesirable “jaycustomers”: the thief, the rule breaker, the belligerent, the feuder (who gets into arguments with others), the vandal, and the deadbeat.<sup>31</sup> The wise strategist obviously tries to avoid such customers, because they use resources that could be used in more productive ways.

Even committed and well-meaning customers can create unrecoverable costs. Mass customization, the interesting strategy mentioned at the beginning of this chapter, is one example. Working with customers as discrete individuals with different needs by definition means variability, and variability has a cost. Mass customizers often justify the cost of contact by treating the exchange not just as a sale but as a chance to learn about potential customer needs and interests in a larger market. However, learning about customers and then using that knowledge also has significant cost for the organization. Experience suggests that few organizations have the capacity to process the customer information that is available to them.

Strategists can reduce unnecessary variability by structuring encounters and providing orienting information in an accessible form before contact is made.<sup>32</sup> Examples can be found everywhere: improved setup instructions for goods that must be assembled, increased information provided before stressful events such as surgery, and so on. Although information from the organization helps, organizations also create venues where customers inform each other (such as student-to-student tutoring and support groups). If monitored, these encounters can reinforce the customer relationship and also reduce costs.

### Today's Happy Customers Are Not Necessarily Tomorrow's Customers

We have already discussed the widely accepted truism that success at one point in time can become the anchor that keeps an organization from identifying new needs in the marketplace and succeeding at a later point in time. Clayton Christensen, a professor at Harvard University, is well known for arguing that technically sophisticated customers are currently attractive sources of information but they can tie the firm to a particular knowledge base and give them little experience with other emerging technologies.<sup>33</sup>

Within reason, strategists may therefore choose to spend resources interacting with customers who do not bring significant current returns to the business. The justification (which of course must be examined) is that they are exploring options that may be valuable in the future.<sup>34</sup>

Strategists must also think about noncustomers. Yellowtail is an Australian wine that leaped ahead of its competitors to become American's number one import within a few years after its introduction. Strategists did that by breaking industry tradition and thinking about people who do *not* buy wine. They found that people who drank beer and hard liquor did not like the taste of wine, and were put off by the snob factors associated with wine. A sweeter wine with a wallaby on the label significantly expanded the market.<sup>35</sup>

## CONCLUSIONS FOR THE STRATEGIST

As a strategist, you must remember your own customer experiences, but not rely on them. Customer needs tend to vary widely across various segments or groupings. Understanding and mapping varied customer experience allows the strategist to provide organizational products and services at various points in this process.

As a general rule, the most important way to stay in touch with customers is to engage them as they experience your product or service. Smart strategists tend to ask their customers questions. They track their behavior in detail. They engage customers and set up situations in which customers are willing to coproduce products, services, and experiences that they then pay for. This is the information that fuels innovation and entrepreneurial response—the subject of our next chapter.

### Key Concepts

**Customer-based strategy** focuses on identifying and serving customer needs, often with the assumption that satisfying customers will also maximize success in reaching more traditional performance goals, particularly stockholder value. Ideally this results in unique **intellectual capital**—knowledge, skills, and capabilities that an organization can use to produce goods, services and experiences for its competitive advantage.

All companies can use a customer-based strategy, including those that use **mass customization** to allow a large number of customers to personalize product characteristics and those who use **experience-oriented strategies** to emphasize the process of consuming their offerings.

A customer-based strategy requires **customer contact**, which is measured by user involvement in planning, executing, and delivering a good, service, or customer experience. It can lead to **coproduction**, which directly involves customers in the creation of the goods and services they consume. This is typically a **cost-sharing** strategy that allocates costs between customers and producers.

We suggest that **positive models of human behavior** (which assume most people are intrinsically well-meaning toward others) are required for almost all successful customer-centered strategies. One goal is the achievement of **synergies** that enable one resource to increase the impact of other resources.

Service is an increasingly important component of company activities, and companies with a positive **service climate** have established practices, policies, and procedures for successfully interacting with customers that are actually used by their employees. Finally, a service-oriented strategy almost always involves collecting data from and about customers. A **customer experience map** summarizes contact with a product or service from a customer's perspective. A **customer perception map** indicates distinctions they make about products in a specific market. Both can be used as a basis for identifying underserved customer needs for further strategic consideration.

### Questions for Further Reflection

1. Analyze one of your experiences as a satisfied customer. What strategies did the company follow to please you? Would you appreciate other reinforcing offerings from this company? Can you identify several other kinds of customers who must be satisfied in different ways?
2. Find a company that has recently changed its strategy significantly (airline companies that no longer serve food, for example, or grocers that deliver online orders). Which customers are likely to be more or less served by this change in direction? Can you suggest ways to improve the likelihood of success by intensifying customer orientation? Does the company risk providing too much service?
3. Identify an industry that is beginning to produce services or products that have not been offered before. (Think of a new type of Internet service, for example, or an innovative product introduction in a sport that interests you.) Do you see an opportunity for a new complementary business? (Industries

in transition tend to offer more new opportunities than more established ones.) Is there a potential for cooperation with customers? What valuable information would you expect the company to gain from close contact with customers?

**WORKSHEET 3.1**  
**The Growth Matrix—A Tool for Expanding Product/Service/Experience**

A great deal of research suggests that strategists tend to follow the path established by previous decisions, but you have alternatives. This worksheet compares moves in three different directions.

**Step 1:** In the top left corner of this matrix, list the markets currently served by a specific organization that interests you.

**Step 2:** Move to the top middle section of the matrix and think about existing products from your company and its current competitors.

**Step 3:** Consider possible extensions of current products/services in this market and list them in the top right corner. You are trying to add options that go beyond current product/service/experience offerings that meet needs you know exist in current markets.

Now consider options with much greater strategic risk.

**Step 4:** Identify new markets that your company might serve in the bottom left corner of the matrix.

**Step 5:** In the bottom middle section, identify any existing products/services/experiences serving these markets.

**Step 6:** In the bottom right section, identify plausible new offerings in new markets.

**EXTENSION**

- Role-play the most important competitor of the company you chose, and follow the preceding steps for that organization.

<p><b>Growth Matrix</b> Worksheet 3.1</p>	<p><b>Organization:</b> Time Frame:</p>
<p><b>Analyst(s):</b></p> <p>Black = current portfolio                  Blue = possibilities                  Red (circled) = greatest performance potential</p>	<p><b>Strategy Summary:</b></p>

Existing Markets	Existing Products	New Products for Existing Markets
New Markets	Products Currently Serving New Markets	New Products for New Markets

**WORKSHEET 3.2**  
**Customer Survey—A Tool for Understanding Buyer Experience**

Customers make judgments about both the intangible, physical characteristics of a product, service, or experience and the subjective aspects. Consider how customers evaluate a specific company's offering.

**Step 1:** Identify product/service/experience combination that is purchased.

**Step 2:** Interview several customers and fill in the table of customer perceptions.

**Step 3:** Think of how the product/service/experience might be improved to meet customer needs. Complete the right column with these ideas.

**Step 4:** Circle the ideas for improvement that are most feasible. Star the ideas that might lead to the greatest market.

**ALTERNATIVE**

- Select a product. Focus on improving the following characteristics: cost/performance, features, functionality, constraints, reliability, serviceability, aesthetics, speed, and reputation.

<b>Customer Survey</b> Worksheet 3.2	<b>Organization:</b> <b>Service Time Frame:</b>
<b>Analyst(s):</b>	<b>Strategy Summary:</b>

	Customer Perception	How to Improve Perception
<b>Professionalism</b> (know-how of service provider)		
<b>Concern/responsiveness</b> (interest in meeting customer needs)		
<b>Fit</b> (match between customer needs and services provided)		
<b>Interaction</b> (willingness to accept input and share control decisions)		
<b>Trustworthiness</b> (ability to keep promises and maintain confidentiality)		
<b>Flexibility</b> (capacity to respond to additional or changed information)		
<b>Recovery</b> (individual and organizational skill in solving problems)		
<b>Reputation</b> (recognition of service quality by others)		
<b>Cost/value received</b> (perception of benefits gained)		

#### NOTES

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- 1 DEFINING STRATEGY
  - 2 DEVELOPING RESOURCES
  - 3 SERVING CUSTOMERS
  - 4 SEEKING OPPORTUNITY
  - 5 COMPETING WITH RIVALS
  - 6 SPECIFYING A BUSINESS MODEL
  - 7 CONSIDERING CORPORATE STRATEGY
  - 8 THINKING GLOBALLY
  - 9 ACTING RESPONSIBLY
  - 10 ENSURING EXECUTION
  - 11 MANAGING KNOWLEDGE
  - 12 PROVIDING LEADERSHIP
  - 13 PERSONAL STRATEGIZING

# 4

## Seeking Opportunity



Would you like to start your own business? Are you hoping it will make you rich? Or are you the kind of person who values security and wants to avoid an uncertain environment? The epilogue of this book suggests that employment security is increasingly unlikely. We therefore urge everyone to anticipate changing jobs and acquire a range of skills to manage his or her career. In this chapter we make the same argument to organizational strategists.

As new technology develops and customer needs change, there is an increasing possibility that another individual or organization will find a better way of providing the products, services, and experiences you deliver now. A core part of what it means to be a strategist is therefore to think and act like an entrepreneur. Whether you are motivated by the need to defend an existing competitive position or the desire to establish a new one, the very heart of strategy is about inventing new ways to connect resources and customers.

.....  
*We explore the importance of continually thinking about new opportunities by considering three important questions:*

What signals the capacity to develop opportunity?

Characteristics of individuals who recognize and develop opportunities

Teams that develop opportunities

Capabilities of organizations that develop opportunities

What are the processes of opportunity development?

Recognizing opportunities

Finding resources

Managing innovation

What are the differences between small firm and corporate entrepreneurship?

Small firm entrepreneurship

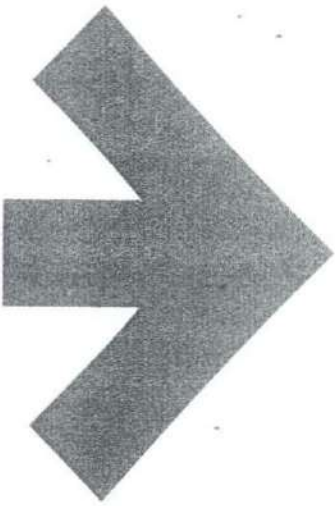
Corporate entrepreneurship

Is ambidexterity the answer?

The basic idea is that all strategists must be opportunistic, though obviously some environments require more attention to new opportunities than others. Consider Jeff Bezos, the entrepreneur who started Amazon and who continues to aggressively seek opportunities for his established business.

.....

## JEFF BEZOS AND AMAZON.COM



Jeff Bezos made the decision to start Amazon.com after reflecting on “regret-minimization.” He imagined himself at age 80 looking back on his life: “Would I regret having given up an almost certain multi-million dollar bonus [if I remain with my current employer] to go out and start my own company? . . . Of course I wouldn’t. At age 80, I doubt if I will even remember the bonus. But if I . . . pass up the chance to participate in a historic opportunity like the development of the World Wide Web, I would . . . [regret] it for the rest of my life.”<sup>1</sup>

Bezos spoke to his parents, who agreed to loan him \$300,000 from their retirement savings to pursue the opportunities created by the Internet. He and his wife, MacKenzie, then left New York for a new life in a rented two-bedroom house in the Seattle suburb of Bellevue, Washington. Jeff converted the garage into a workspace and with a small team of collaborators spent more than a year creating the Amazon.com website and developing the database programs to support it. The website was tested by 300 friends and family members in June 1995 and became available to the public the following month.

In the first thirty days, Amazon sold books in fifty states and forty-five countries. Brick-and-mortar competitors, such as Borders and Barnes & Noble, were slow to respond. They had little sense of the opportunities the Internet provided or the competitive threat posed by the likes of Amazon.

The company went public in May 1997, the same year that Barnes & Noble opened its online store. By 1998, Amazon.com had 4 million customers and was valued at \$6 billion—more than Borders, Barnes & Noble, and all of the other independent booksellers combined. At that point, Amazon began selling videos, toys, and electronics. It also launched ventures in the United Kingdom and Germany.

By the end of 2007, Amazon had net sales of \$ 10.7 billion, 44 percent of which originated from outside the United States. It boasts that it has “Earth’s biggest selection,” selling items as varied as cameras and outdoor plants. Some analysts have argued that Amazon should focus on its core competence—books. But the “everything” concept has proved successful. That includes retailers such as Target (a partner since 2001) along with smaller third-party sellers make up approximately 28 percent of all sales on Amazon.

Although it took Amazon seven years to turn its first profit, \$256 million in 2003, the profit picture is still rockier than some investors had hoped as the company continues to pursue new opportunities. For example, Amazon recently unveiled a new service called Unbox, through which customers can download content from six major studios and several TV channels.<sup>2</sup> Almost simultaneously, Steve Jobs announced a very similar service at Apple, showcasing the exclusive deal with Disney we mentioned in Chapter 2.<sup>3</sup> A key controversy in the new market is pricing—Amazon is narrowing margins, even of mass retailers like Wal-Mart. Another uproar has to do with consumer rights—to date the content Amazon

offers remains the property of the seller, at a price that the seller determines.<sup>4</sup> Clearly the contours of opportunity, and the route to profits, are still being explored.<sup>5</sup>

## WHAT SIGNALS THE CAPACITY TO DEVELOP OPPORTUNITY?

The founding of Amazon illustrates how an insightful individual, evolving opportunities, and a pool of potential resources shape strategic action. Uncertainty abounds—about customer needs; resource availability, and the specific offerings that will make a profit. Jeff Bezos, the entrepreneur, initially recognized an opportunity to provide books from online orders. He initially coordinated resource development in his garage. Over time, Amazon acquired additional resources to support growing numbers of customers, products, and sales. As the firm met success, it “co-evolved” with the Internet, changing the nature of available opportunities as it changed itself.<sup>6</sup>

The ongoing story of Amazon also illustrates that recognizing and developing opportunities continues to be important for established companies. One example from the early days of the company involves the resource gap that emerged as Bezos and his staff began to recognize the weaknesses of their virtual bookstore. Initially, they thought book publishers could ship directly to customers based on orders from Amazon. This “drop shipment” approach meant that Amazon would rarely take physical possession of what it sold. Bezos and his team reasoned that it was a good idea to minimize inventory costs and maximize inventory turnover by being a virtual seller. Unfortunately, the book suppliers (publishers or distributors) did not always respond as quickly as expected, coordination problems developed, and in the end the virtual model increased stockouts and lengthened delivery times to customers.

To reduce these problems, Amazon began to take on some inventory. This created more problems. The lack of well-located physical warehouses and inadequate logistical systems slowed Amazon’s inventory turnover and further frustrated its efforts to turn a profit. By 2000, Amazon’s inventory turnover was less than half that of its brick-and-mortar rivals. Fortunately, the Amazon team acted to close this gap by securing the necessary resources, including a network of warehouses dispersed around the world and innovative software that manages orders and deliveries.

Bezos was responding to the opportunity provided by growing Internet usage. But recognizing and responding to a trend does not always produce profits. The failure of so many Internet-based businesses (the “dot-bomb” phenomenon) is proof that many did not understand the opportunity (and risk) of the Internet. *Strategic* entrepreneurship means

recognizing *profitable* opportunities—building a business and achieving competitive advantage, as shown in Figure 4.1.

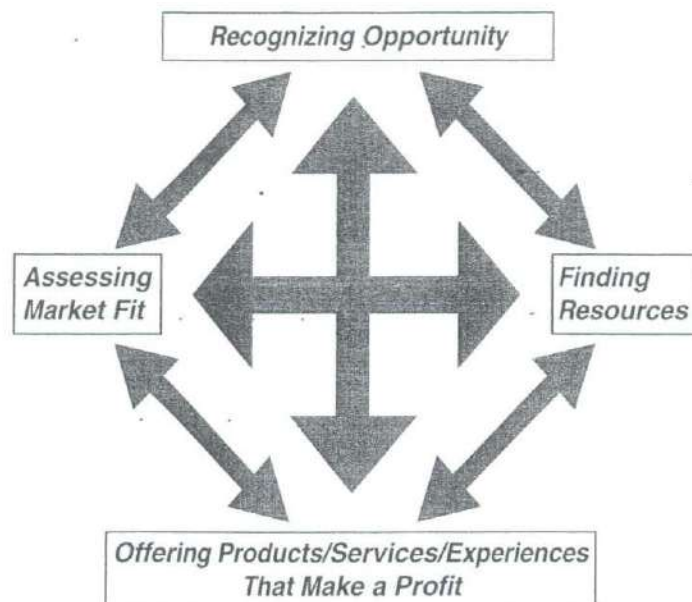


Figure 4.1 — Developing a Strategic Opportunity

Source: Adapted from J. Timmons, as cited in B. Bygrave & A. Zacharakis, *The Portable MBA in Entrepreneurship* (3rd ed.; New York: Wiley, 2003).

Entrepreneurs recognize opportunities, assess fit between market and their company, find and combine resources, develop innovative solutions, take risks, and strive to make a profit.

Entrepreneurial teams are groups of individuals who bring their collective and often complementary skills and resources to a new venture.

An innovation is a new idea that is brought to market.

An opportunity is a chance to offer a new or better product, service, or experience to customers. Skill in opportunity recognition can be found in entrepreneurial individuals, teams, and organizations that threaten established businesses. Thus even strategists enjoying tremendous competitive advantages must understand the sources of new ideas and how they are developed.

### Characteristics of Individuals Who Recognize and Develop Opportunities

Research shows that entrepreneurial individuals are not quite the same as the rest of us. *Entrepreneurs* tend to have a stronger need for achievement, higher risk-taking propensity, greater perseverance, more commitment to a task, bigger vision, higher creativity, and more tolerance for ambiguity. Individuals who want to become entrepreneurs also tend to have more positive attitudes toward risk and independence.<sup>7</sup> The entrepreneur can be an individual working alone, but often *entrepreneurial teams* bring a pool of competencies to a new venture.

Individuals who are able to develop *an innovation* into a market offering are also leaders. Facing risk and tackling the challenges of a new venture requires immense courage and energy. Their most important entrepreneurial characteristic is the ability to imagine a future reality in

the form of an innovative product, a new business process, or an entirely new industry. Yet realizing that vision requires other leadership skills, including the ability to learn and the ability to teach.

Figure 4.2 summarizes entrepreneurial leadership roles. Some individuals developing a new opportunity are creative and innovative; others are more adept with management skills and business know-how. Combining these two dimensions produces four roles: promoters, inventors, managers, and transformational leaders. Although *transformational leader* is an attractive description, and critical for the development of a new opportunity, in reality all four roles are likely to be required to bring a new idea to market.

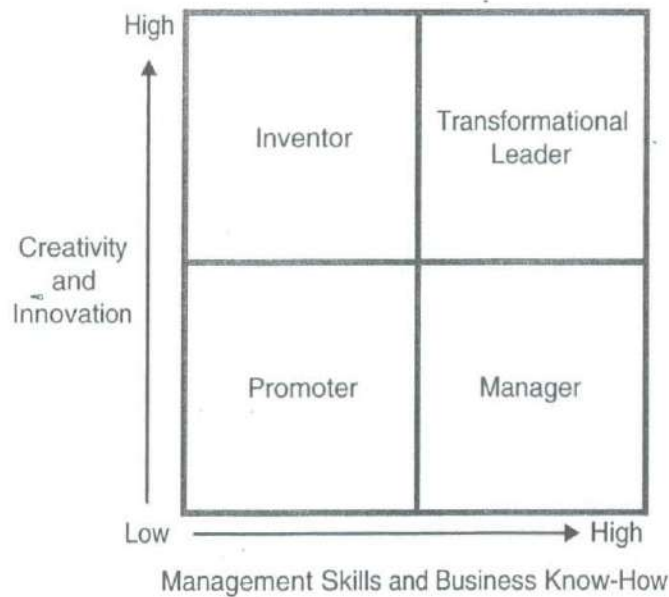


Figure 4.2 — Entrepreneurial Leadership Roles

Source: Adapted from J. Lange, presentation to Governor Craig Benson’s Entrepreneur’s Workshop (2003).

The individuals who recognize and develop opportunities come from all sectors of society. A recent college graduate who sets up her own software company may be an entrepreneur. But likewise, vendors on the streets of New York City, retailers at the local farmer’s market, and yoga enthusiasts opening new studios are all potentially developing new opportunities.

Historically, women and minorities have been underrepresented among entrepreneurs. Women own approximately 28 percent of small businesses in the United States. Racial minorities own 15 percent—including Hispanics (6 percent), Asians and Pacific Islanders (4 percent), Blacks (4 percent), and American Indians and Alaska Natives (1 percent). These percentages are below the representation of these groups in the overall

population. Current research suggests that minorities and women tend to be less ambitious about the amount of initial capital they need and have smaller, slower growing businesses.<sup>8</sup> There is no reason to believe that minority entrepreneurs' underrepresentation and underfunding have anything to do with innate ability, however, and women and minority-owned businesses are increasingly important in the U.S. and world economies. Although there is no country in the world where women are *more* active in entrepreneurship than men, there are a few where they come very close, including Thailand, China, and South Africa.<sup>9</sup>

Before concluding the discussion of individual entrepreneurs, it also is important to recognize that despite hits such as Amazon, success rarely comes from a first "blockbuster" project. The typical scenario is a series of entrepreneurial efforts over time, some of which fail. Among the other attributes of entrepreneurs, it is therefore important to add *persistence*. Can you visualize yourself as a *serial entrepreneur* who continues to recognize and develop opportunities? Consider Sally Edwards's experience.

**Serial entrepreneurs** start a number of entrepreneurial efforts over time.

### Serial Entrepreneur: Sally Edwards

Sally Edwards graduated from the University of California at Berkeley with a degree in exercise physiology and a secondary teaching credential in 1970. After volunteering for two years with the American Red Cross in Vietnam, Sally returned home to a teaching position. After three years, she yearned to try something different that would match her interests in people and sports. In 1976, with \$3,000, the 28-year-old cofounded Fleet Feet, a specialty running store, in a Victorian-style house in Sacramento, California.

Over the next seventeen years, Sally expanded the franchise to forty locations in fifteen states with more than \$20 million in annual sales. In the process, she completed an MBA at National University in Sacramento. Finally, in 1998, she sold Fleet Feet and took time off to travel around the world.

Sally returned to California with renewed energies and ideas and cofounded Yuba Shoe Sports Snowshoes, which she then sold three years later. This serial entrepreneur's latest venture is Heart Zones, a fitness education company that teaches people how to use heart rate monitors to stay healthy. Heart Zones services have recently expanded to firms that are interested in lowering employee stress levels.

Sally is an entrepreneur who likes to start new businesses, but turns to other managers for the daily operations: "I am now interested in empowering others and not [being] involved in the business on a day to day basis." When asked what advice she has for business school students, Sally said, "It's important to follow your heart and do something that you love and that you are good at."<sup>10</sup>

### Teams That Develop Opportunities

Although individual entrepreneurs are important, Sally Edwards's experience and that of many others suggests that most of the time opportunity development involves more than one person. Few individuals, after all, have all of the skills and knowledge necessary to maximize the chances of success for a new venture. For example, an individual who identifies a new technology may have a scientific or engineering background but lack business skills. If savvy, he or she will seek partners who know about accounting, finance, and management systems. A number of now-famous companies were founded by technical-business pairs, including Honda Motor Company, Genentech, and Hewlett-Packard.

The competencies needed within the team can be defined only in terms of the new venture itself. According to Ed Catmull, president of Pixar Animation Studios, "If you give a great idea to a mediocre team, they will screw it up. But if you give a mediocre idea to a great team, they will fix it or throw it away and come up with something different."<sup>11</sup> Elaborating on the ideas expressed in Figure 4.2, teams not only need to cultivate skills in opportunity recognition and creativity but also must develop in areas such as operations and administration.

The competencies of the initial team represent the "gene pool" from which the venture's future distinctive competencies will evolve. More specifically, without the right mix of people in the core team, a new venture is unlikely to develop a competitive advantage. For this reason, potential investors look very carefully at who is on the management team, and many venture capitalists identify the people involved as one of most important considerations in their decision to invest.<sup>12</sup> Corporate strategists evaluating new ideas proposed to their business units are similarly evaluative.

### Capabilities of Organizations That Develop Opportunities

Although individuals and teams are key actors in the development of a new product, service, or experience, the organizational context also has a critical role to play. The concept of *entrepreneurial orientation* has been developed to describe an organization's ability to recognize and respond to new opportunities.<sup>13</sup>

**Autonomy** Some organizations find it quite difficult to recognize new opportunities. The financial controls and management systems necessary for keeping an established business efficient will almost certainly interfere with the freewheeling, creative efforts of entrepreneurial-oriented individuals and teams. Later in this chapter we will describe how new venture divisions or other independent units can be established

**Entrepreneurial orientation** describes an organization's ability to promote autonomy, innovativeness, proactiveness, competitive aggressiveness, and risk taking.

in larger organizations to shelter entrepreneurial activity from bureaucratic controls. These relatively autonomous work units enable creative thinking and risk taking even while established businesses are more controlled.

**Innovativeness** Firms that bring new ideas to market are able to break away from existing technology and conventional practice to grasp state of the art concepts. Innovation may be on several levels: technology, product-market, or administrative process. A breakthrough or *radical innovation* may completely transform a company or an industry. An example of a radical innovation is the introduction of digital photography, which displaced the need for instant photography and also most chemical photography. Another example of a radical innovation would be the introduction of a personal flying craft that would replace cars, just as cars were a radical innovation replacing horses. *Incremental innovations* enhance current products or processes and make up about 85 to 90 percent of a firm's product development portfolio.<sup>14</sup> An example of an incremental innovation is the shift from black-and-white to color televisions. Another example is how several major dental product manufacturers have added whitening ingredients to their toothpastes. Although radical and incremental innovations differ in many respects, including the amount of autonomy they tend to require, both offer opportunities.

**Proactiveness** An organization is likely to develop new opportunities to the extent that it responds proactively to future environment changes affecting customer needs and desires. In addition, entrepreneurial organizations do not wait to see what rivals do. Instead, they are more likely to pursue *first-mover* status by introducing a new product or service ahead of other firms. As a result, their offerings are more likely to be associated in the customer's mind with the product category, and they have a head start on becoming the market leader. An example of a first mover is Napster, mentioned in Chapter 1.

It should be noted, however, that choosing to be a *second mover* can also be proactive, because this strategic position offers the opportunity to learn from first movers. As one example among many, consider the development of mobile phones, with market share increasing among companies that brought later, but more sophisticated, models to market.

**Competitive Aggressiveness** *Competitive aggressiveness* refers to a firm's willingness to take on its competitors. Organizations that develop new ideas do not shy away from rivals or seek to defend established positions. Some hope to take market share from others. Typically, they are more willing than other organizations to engage in aggressive techniques

Radical innovations are a significant departure from currently available product or service offerings.

Incremental innovations contribute to the improvement of existing product or service offerings.

First movers in a new product or service category can potentially define an innovation's characteristics in the minds of buyers, gaining valuable name recognition and brand loyalty.

Second movers have the potential advantage of learning from and improving on the efforts of first movers.

such as price cutting. Even the firms that try to establish a new market often cannibalize existing offerings. Think of mobile phones' impact on the profitability of landlines, roadside kiosks, and hotel phone services.

**Risk Taking** The kinds of organizations we are profiling embrace risk taking of all kinds—financial risk, business risk, and personal risk. This willingness to gamble often gives them an advantage over more conservative organizations. Entrepreneurial firms are more likely to launch a product based on new technology, for example, while others wait to see if the technology can be “proven.” It would be a mistake, however, to assume that entrepreneurs are inevitably gamblers. Often they spend considerable effort assessing risk and acquiring the information needed to reduce it.

In summary, the capacity to recognize and develop a market opportunity can be found in individuals, teams, and entire organizations. In many ways, it is the essence of what it means to be a successful strategist. But what do these innovators actually do?

## WHAT ARE THE PROCESSES OF OPPORTUNITY DEVELOPMENT?

Many people interested in business strategy hope for a “big win.” We all know that the odds of identifying that kind of opportunity are not that promising, but real-life examples feed our dreams. Consider the phenomenal growth of Crocs Footwear.

### Crocs Feed a Fad

“Crocodiles are tough and strong animals with no natural predators. Crocodiles are equally good in land and water and live for a very long time, a great description of our Crocs shoes!” according to the crocs.com website.<sup>15</sup> You have probably seen their “incredibly ugly” but “incredibly comfortable” shoes on an incredibly broad range of people—kids, grandmothers, nurses, and beach volleyball players, not to mention celebrities Matt Damon, Jennifer Garner, Teri Hatcher, James Gandolfini, Jack Nicholson, and Al Pacino.<sup>16</sup> Founded in July 2002, the company sold \$1 million worth of shoes in 2004, \$100 million in 2005, and more than \$300 million in shoes and related accessories in 2006.<sup>17</sup>

That's pretty good for three buddies who thought they could sell a new boating shoe. Their initial insight was that the new spa shoes one of them brought on a sailing trip had good traction and didn't mark the deck. The first prototypes from the company they founded were almost instantly successful in the boating market, but as many consumers

know, the shoe quickly attracted a much broader following. Some feel that the timing was right—many people had been wearing sport shoes for nonsporting activities, but the most stylish offerings are expensive. The first Crocs, in contrast, were sold for \$19, and low prices have been retained even at Nordstrom's and other classy outlets.

This kind of growth leads to major supply problems, as well as inevitable imitation. The founders purchased the Canadian company that produced the original spa shoe and its patents and acquired the factories that were initially making the shoe and the suppliers of the proprietary resin from which the shoe is made. That allowed them to win lawsuits against several imitators and provided a basis for setting up additional production facilities in Mexico, China, and other locations as demand skyrocketed.<sup>18</sup>

Although the demand is in part the result of a fad that cannot be expected to last, a more sustainable market may be medical. All shoes have arch support, which differentiates Crocs them from simple thongs. Three models have been expressly developed for users with special needs, including a shoe for diabetics. A recent article in the *Washington Post* reports that Crocs “are featured prominently on the Web site of the . . . American Podiatric Medical Association [APMA] (<http://www.apma.org/>) . . . [and] have been awarded the APMA Seal of Acceptance. The APMA takes special note of the fact that Croslite [the material used in making Crocs] ‘warms and softens with body heat and molds to the users’ feet, while remaining extremely lightweight.’”<sup>19</sup> The resin also resists bacteria and fungus.

Two other growth areas are international sales and new products. In addition to clothing and objects such as garden kneelers and spa pillows made from Croslite, the company continues to develop new models of footwear, including a high-fashion line called YOU introduced in late 2007. The company website does a good job of expressing the core idea that guides these developments:

Despite our rapid success, we still stand behind to the core values of Crocs Footwear. We are committed to making a lightweight, comfortable, slip-resistant, fashionable and functional shoe that can be produced quickly and at an affordable price to our customers.<sup>20</sup>

The founders of Crocs had an initial business plan, but clearly that intended strategy was quickly overtaken by success that no one could predict. Their realized strategy had to account for issues that many less fortunate start-ups do not have to face. Nevertheless, it is possible to identify three common processes in opportunity development: recognizing opportunity, finding resources, and managing innovation.

### Recognizing Opportunities

The first part of *opportunity recognition* is often called *discovery*. It represents the basic insight underlying a new business idea. This insight

**Opportunity recognition** involves discovering an idea and forming it into a business concept.

might come from an unanticipated “Eureka moment,” such as the recognition of how well a spa ~~she~~ performed on a sailboat, or from a more disciplined deliberation. For example, strategists can consider the characteristics of the macro environment reviewed in Chapter 1. They can actively scan the environment for technological, political/legal, economic, demographic, and cultural trends. An example of the latter process can be found in the work of Sergey Brin and Larry Page, two computer science students at Stanford University who exhaustively researched the process of data mining on the Web and then developed proprietary technology to perform Web searches better and more efficiently. They later commercialized the system in the form of a new business venture: Google.com.

Another example is Canada’s Cirque du Soleil, whose performances have been seen by 40 million people around the world and whose revenues, after just two decades, exceed those achieved by Ringling Brothers and Barnum & Bailey after a century of operations. Rather than emulate existing firms, Cirque du Soleil “reinvented” the circus by focusing on human performance and appealing to a new customer audience of adults and corporate clients. INSEAD business school professors Chan Kim and Renée Mauborgne use the term *blue ocean* to describe the uncontested market space that Cirque du Soleil and other entrepreneurial organizations have created. Blue oceans are “industries not in existence today—the unknown market space, unconstrained by competition.” In contrast, *red oceans* “represent all the industries in existence today—the known market space. In red oceans, industry boundaries are defined and accepted and the competitive rules of the game are well understood.”<sup>21</sup>

After discovery, the business potential of an idea must be evaluated. Idea formation—the process of evaluating, formulating, and refining a business idea into a business concept or business model—is a process we describe in much greater detail in Chapter 6. Typically, external circumstances play a big role in the extent to which a business model becomes a viable venture. Timing, the *synchronicity* of the entrepreneur’s discovery with market need or market interest, plays a *huge* role.

Whether an idea is viable as a business concept depends on whether it is:

- Attractive—meets a market need
- Attainable—doable
- Value creating—likely to produce a profit

If an idea meets these basic criteria, it may be said to be a viable business concept. Typically, more formal *feasibility analysis* then solidifies the definition of the opportunity. That involves evaluating the skills and readiness of the individual strategist and team, as well as determining

**Synchronicity**  
is the time-sensitive match between the entrepreneur’s recognition of opportunity and occurrence of market need.

**Feasibility analysis**  
evaluates the human and financial resources available for launching a new venture.

the availability of and access to the resources required for launching the new venture.

### Finding Resources

Entrepreneurial firms are often challenged by a lack of resources. Depending on the nature of the business, 20 to 40 percent of new ventures fail within their first year. By year 2, the failure rate jumps to 30 to 60 percent, and by year 10 it's a whopping 90 percent.<sup>22</sup> Most of these businesses fail for lack of resources. The firms that succeed fit their strategies to their resource profiles.<sup>23</sup>

As discussed in Chapter 2, firms are bundles of resources, including employees, financial capital, brands, and physical facilities. New firms must determine the need for, and then acquire, these varied resources. How much financial capital is typically needed? One of the things that make Crocs Footwear such a compelling story is that its growth was supported by \$239 million earned in the largest initial public offering ever attempted in the footwear industry. Surprisingly, very little cash is involved in the more typical initial start-up. Of current Fortune 500 firms, 25 percent began with less than \$5,000, 50 percent with less than \$25,000 and 75 percent with less than \$100,000. In fact, fewer than 5 percent of Fortune 500 firms began with more than \$1 million.<sup>24</sup> Clearly, financial capital is not the only resource required to turn an idea into a business.

Figure 4.3 shows that in addition to physical and financial capital, those who develop a new opportunity also need human resources

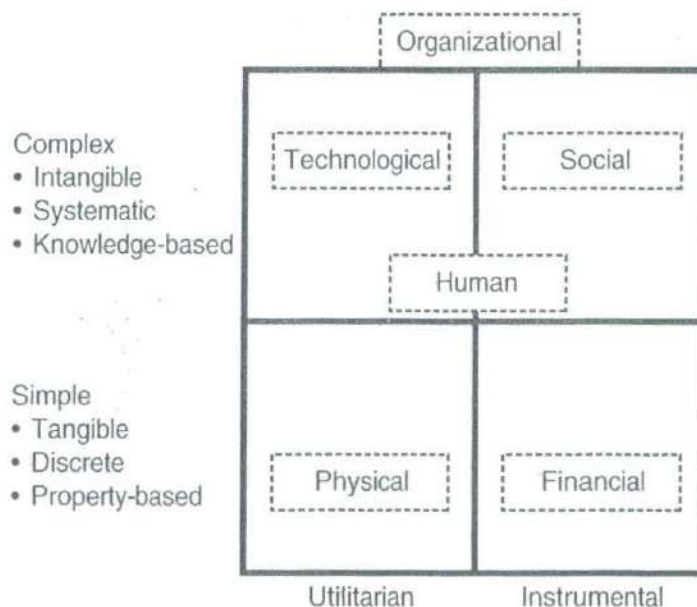


Figure 4.3 — Varied Resources Required for Opportunity Development

Source: Adapted from C. G. Brush, P. G. Greene, & Hart, M. M., From Initial Idea to Unique Advantage: The Entrepreneurial Challenge of Constructing a Resource Base, *Academy of Management Executive* 15: 64–80.

**Utilitarian resources** are required to produce a good or service.

**Instrumental resources** are not directly required to produce a good or service, but are helpful for acquiring needed resources.

**Social capital** is the resource pool available from relationships with others.

**Product innovations** are changes in the product or service offered to an existing or new market.

**Process innovations** do not change the offering itself, but change the way in which the organization operates.

(managers and employees), social capital (relationships with other individuals and firms), technological resources (know-how), and organizational capital (routines, capabilities, and competencies) to be successful. As the figure suggests, these resources can be classified in terms of whether they are simple or complex and whether they are used in the operations of the venture (*utilitarian resources*) or acquiring needed inputs (*instrumental resources*). The second category includes financial capital used to acquire opportunity-specific inputs, including technological resources.

The point of Figure 4.3 is to remind those who try to develop a new opportunity that success requires the accumulation of all five types of resources. Moreover, although simple resources may be essential, we know from Chapter 2 that such resources are easily duplicated. Acquiring complex resources is central to developing advantage.<sup>25</sup>

The paths that entrepreneurial strategists follow to accumulate necessary resources vary. Some start with financial capital in their bank account. Others rely on relationships with bankers, venture capitalists, or family members to gain needed financing. In fact, studies of new ventures have demonstrated that the *social capital* available from relationships plays a big role in predicting a new venture's success.<sup>26</sup> Although many different paths are possible, entrepreneurs who ignore the need for one or more of these resources are likely to be disappointed.

### Managing Innovation

Some strategists identify new opportunities by considering characteristics and changes in customer groups, as described in Chapter 3. Others discover opportunities by observing changes in the larger macro environment, including technology and social systems. One distinction useful for brainstorming is the difference between *product innovation* and *process innovation*. Particularly interesting innovations have begun to combine these conceptually distinct alternatives, as you will remember from the discussion in Chapter 3 of Otis Elevator's reorientation from selling machinery to servicing elevators.

As products and services blur and organizational processes change to support new offerings, an interesting conceptual distinction involves the extent to which entrepreneurial ideas depart from what is currently available in the marketplace. As we mentioned earlier, incremental innovations that utilize current capabilities are at one end of a simplifying continuum; they are a relatively small step away from existing offerings. Radical innovations, on the other hand, are very different from current products and services. These are riskier explorative ideas that require a good deal of strategic attention (and luck) to succeed. Radical innovations are likely to involve the development of new resources, including new networks of suppliers, distributors, buyers, and complementary

Competence-destroying innovations make existing product or service offerings obsolete.

products. If successful, they will be *competence-destroying innovations* for firms currently active in the market, and thus likely to be actively resisted, once their potential is recognized. One part of the strategist's job in established companies is to anticipate and counter newcomers; strategists in the challenging firm must counter these moves.

Though we have just offered a set of academic terms, the world is full of excellent practical illustrations. In transportation, for example, the invention of the airplane was one of a long line of competence-destroying innovations from the perspective of those providing transportation by rail, bus, ship, and automobile. At a more refined level of analysis, the significant increase in size of the Airbus 380, which can hold more than 850 passengers in economy configuration,<sup>27</sup> is a more incremental innovation. It is still potentially competence-destroying for Boeing, however, because it can carry so many more passengers than the fleet they offer to buyers.

All of this is part of a process that can be predicted in general terms. Figure 4.4 summarizes the observation that the performance of any given solution (such as Boeing's 747) tends to peak over time as the limit of a given technology is reached. Strategists then tend to put their effort into a new technology. Initially this new effort is unlikely to yield the performance benefits of current technology, but a successful contender provides greater benefits over time.

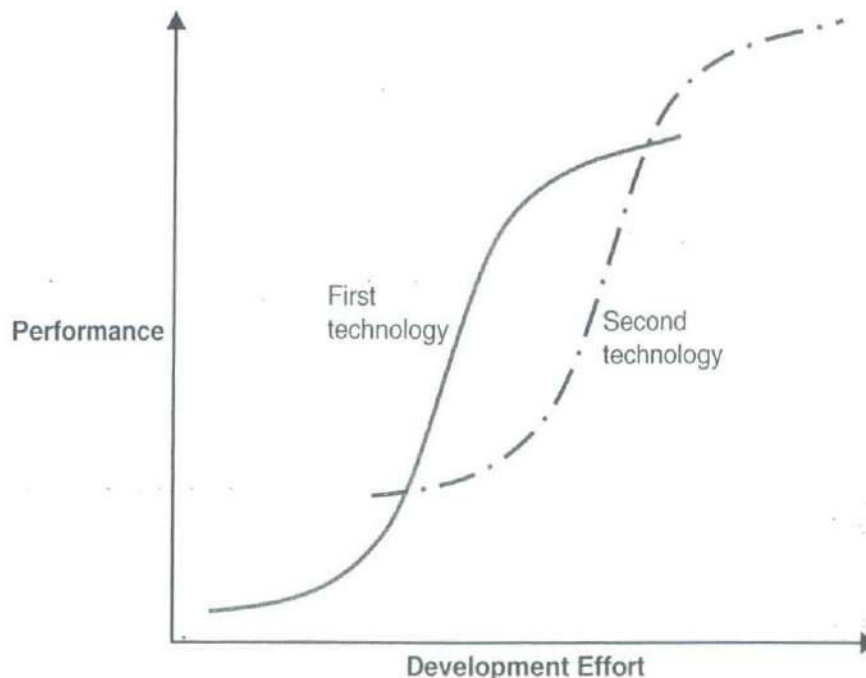


Figure 4.4 – Technology S-Curves

The profit made from performance improvement from the second technology is driven by the number of users who adopt it. In the case of a successful innovation, the first few innovative users are followed by a greater number of adopters. Marketing strategy is centrally important to reaching these early buyers, whose needs and interests vary.

**Innovators** are the first few percent of a new offering's users, who try the product or service because of its innovative qualities.

**Early adopters** are the larger group of users who are drawn to an offering's innovative qualities but tend to be more evaluative than innovators.

**Early majority users** fall in the first half of the total set of an innovation's users; compared to innovators, they tend to be less responsive to technological or innovative content and more responsive to practical features and credibility.

**Late majority users** are the large, conservative group in a community slower than all except the laggards.

**Laggards** are the users in a community who are slowest to adopt a new product.

Everett Rogers suggested some time ago that the adoption of a successful innovation tends to follow an S-curve of its own, as shown in Figure 4.5.<sup>28</sup> A relatively small number of adventurous *innovators* are drawn to new products by companies that successfully communicate the unique features of their innovation. A more difficult marketing task is to entice a larger set of *early adopters* to the new product, service, or experience. They tend to be more evaluative; though they are also drawn to the innovation's new features, they do not adopt unless the benefits of a new offering are clear. This group tends to include many opinion leaders. They are important for attracting the *early majority users*, who, according to Rogers and others,<sup>29</sup> adopt a new innovation only if they can be shown that it is relatively easy to use, reliable, and consistent with existing ways of doing things. Attracting the *late majority users* and *laggards* requires persuasive communication about these features. These potential users are primarily drawn by the simplicity and cost-effectiveness of an increasingly familiar and no longer "new" product, service, or experience.<sup>30</sup>

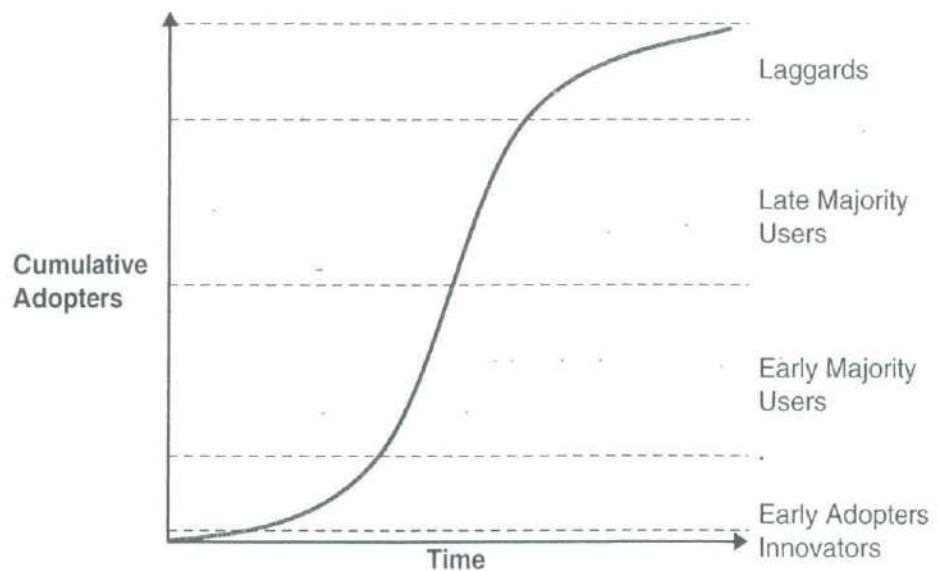


Figure 4.5 — S-Curve of Cumulative Adopters

A critical area of innovation management is to learn from users. *Lead users* are particularly important to identify. Their profile is similar to the bulk of adopters, but they are motivated to help the entrepreneurial organization meet their needs. The term was coined by MIT professor Eric von Hippel. His idea is that lead users, a term that includes customers and noncustomers, are passionate about meeting certain needs or desires. Often they have invented solutions themselves and are typically willing to discuss their ideas and inventions with producers.<sup>31</sup>

Lead users are similar to the majority of an innovation's users and are willing to help the producers improve their product, service, or experience.



Worksheet 4.1:  
S-Curve  
Analysis—A  
Tool for  
Explaining User  
Characteristics  
.....

How do the first adopters differ from the next set of users? Can you anticipate the demands of late adopters? Given our emphasis on connecting with customers, it won't surprise you that we suggest you take the time to fill out Worksheet 4.1. It encourages you to think about how a wide range of customers might contribute to a specific product or service that interests you.

Before concluding this discussion of managing innovation, we will remind you that in today's world, wise strategists also seek inputs from trusted suppliers in developing a new opportunity. For highly technical products, the supplier may even locate an office at the producer's site to maximize their involvement. Automobile and aircraft manufacturers have become particularly reliant on these partnerships. One advantage they gain is more diverse ideas for innovation. Boeing makes the following claim:

Supplier diversity is key to doing business in the global century. As Boeing increasingly focuses on its core competencies in high-end design, engineering, and systems integration, we need suppliers that are highly focused on their own core competencies, continually striving to create additional value in everything they do. Small and diverse companies have proved in competition that they bring innovation, flexibility, and strength to our supply base, as well as a passion for helping Boeing deliver the strongest possible solutions to our own customers.<sup>32</sup>

This statement reflects a core idea in opportunity development. Many new ideas come from smaller, more flexible firms. If you are attracted to this role, however, you should remember that although the economic system as a whole benefits from a diversity of ideas, the entrepreneurial pool includes many failures as well as a few successes.

## WHAT ARE THE DIFFERENCES BETWEEN SMALL FIRM AND CORPORATE ENTREPRENEURSHIP?

Many of the ideas we have just presented come from studies of entrepreneurship, which people often believe is restricted to relatively young and small companies. However, opportunity development is also important to large established organizations. Not all of these companies are like Boeing, whose strategy depends on new product development. *Intrapreneurship* or *corporate entrepreneurship* is increasingly important to all organizations. The process and behaviors involved are remarkably similar to those we associate with entrepreneurship in smaller firms, though there are some important differences that we describe after a review of the classic small firm situation.

### Small Firm Entrepreneurship

Small and medium-sized enterprises (SMEs) are an engine for economic growth. In the U.S. economy, SMEs produce 75 percent of new jobs and 55 percent of America's technical innovation. Approximately 52 percent of U.S. workers are employed by firms with no more than 500 people. In addition to 5.7 million firms in America with less than 100 employees, nearly 18 million Americans consider themselves self-employed.<sup>33</sup> In other countries, self-employment and SMEs play an even larger role in the local economy.<sup>34</sup>

Many small businesses are not entrepreneurial, but as we have already observed, entrepreneurs in small business can often respond more quickly to industrial and economic changes than entrepreneurs in larger businesses. Without the bureaucracy and public oversight typically found in larger firms, small firms tend to be more nimble and more flexible. Therefore, small firms tend to lead the way in generating new ideas for an industry or group. But with all their flexibility, small firms lack the experience, industry recognition, and customer familiarity that larger firms command. They are therefore highly vulnerable to competition from large, established competitors.

The vulnerability of size is increased by the uncertainties associated with all new ventures (whether a significant need exists, what resources are needed to satisfy that need, and how to match the two—as depicted in Figure 4.1). These problems explain the low survival rates of new ventures. The effect is so prevalent that economists describe it with a special term: *liability of newness*.

One of the most obvious differences between new or small firms and larger, more established firms is differential access to financial capital. Established firms can draw on their own treasury to support a new business concept. In contrast, the capital base of small firms is typically quite meager. The financing needed to start up the new venture (*start-up capital*) may come from a variety of sources, such as banks, friends, family, other personal contacts, venture capitalists, corporate partners, and angel investors. *Bootstrapping* entrepreneurs rely instead on their personal financial resources in the start-up phase.

Once the firm has begun to conduct business and generate sales, the chances of obtaining outside financing from venture capitalists, banks, and other public sources increase. Venture capital, a form of private equity financing, has advantages and disadvantages. One advantage is that venture capital enables more rapid growth than might otherwise be possible. *Venture capitalists* are likely to invest in early stages of development, taking risks that bankers or the general public would not consider. Venture capital financing also provides access to the advice and expertise of the financiers. Many venture capitalists have deep knowledge about specific industries or technologies that can be crucial

**Liability of newness** recognizes the vulnerability that comes from lack of experience, industry recognition, and customer familiarity.

**Start-up capital** is the financial requirement for initiating a new venture.

**Bootstrapping** is the use of an entrepreneurial individual's personal resources to finance a new business.

**Venture capitalists** are investors who search for and provide capital to entrepreneurs.

to new venture success.<sup>35</sup> They also bring the kind of experience and business acumen that many individuals recognizing a new opportunity lack. Venture capital investments typically range between \$500,000 and \$5 million.

Venture capital usually comes with conditions, however. Backers may require membership on the board or a significant ownership stake in a company formed to realize a new opportunity. Once a venture capitalist is involved, initial partners are no longer free to do whatever they please. Conflicts may arise between what the founders want to do and what the venture capitalist thinks is best. This kind of conflict may seem to be a disadvantage, but research suggests that disagreements about the business between entrepreneurs and venture capitalists may actually be beneficial to the venture's performance, because it airs and potentially resolves problems.<sup>36</sup>

Entrepreneurs may also pursue less traditional sources of financing, such as leasing equipment or real estate, bartering noncash items to exchange for goods and services, seeking credit from suppliers, and even using credit cards. Still another financial option comes from *angel investors*, private individual investors who provide seed capital to early-stage ventures, especially firms that have demonstrated capability. The average angel investor provides \$37,000 of funding to a new venture. In addition to money, angels typically offer expertise, experience, and contacts. Once established, a new venture may also seek funding through an *initial public offering* (IPO), in which company stock is sold to the public.

Some forms of opportunity development do not require a brand new start-up. The most common of these is *franchising*. A franchise is a "business opportunity by which the owner, producer, or distributor for a service or trademarked product (the franchisor) grants exclusive rights to an entrepreneur (the franchisee) for the local distribution of the product or service, and in return receives a payment or royalty and conformance to quality standards."<sup>37</sup> Franchising plays a significant role in the U.S. economy, employing 8.5 million people, constituting 42 percent of all retail sales, and accounting for 20 percent of the gross domestic product. Familiar examples of franchised businesses include McDonald's and many other chain restaurants, small retailers such as The Body Shop, and service firms such as Meineke Mufflers.

Franchising has several advantages. In a successful operation, the most important thing gained by the *franchisee* is the knowledge of how to run the business and make a profit. Often a franchisee also gains national advertising, a good brand, and the consumer recognition that these activities produce. These benefits come at a price, of course, in the form of the fees and royalties assessed by the franchisor. Using resource-based theory, the problem with this opportunity from the franchisee's point of view is that the franchisor often appropriates most of the profit.

From the perspective of the *franchisor*, franchising can be seen as a way to grow. A small firm can become a large firm if a new venture

**Angel investors** are private individuals who provide seed capital to early-stage ventures.

**Initial public offerings** (IPOs) sell stock in a new venture to individual and institutional investors.

**Franchising** is an opportunity to obtain exclusive rights to a brand and business model in a specific locality in return for a royalty.

is imitable and sufficiently attractive to small-business entrepreneurs. This requires a logic whereby the venture is reproduced over and over again across different geographic regions. Consider the late Dame Anita Roddick's experience with The Body Shop.

### The Body Shop

Born in the small English seaside town of Littlehampton in 1942, Anita Roddick grew up working at her family's Italian restaurant. This early entrepreneurial experience and a period of travelling that she describes as a "university without walls" served her well in 1976, when her husband, Gordon, left for a ten-month horseback-riding trip through South America. Anita had to provide for her two young daughters and decided to sell handmade cosmetics from ingredients she put together in her garage. She started with only fifteen products, but packaged these into five different sizes to give the appearance of having many more.

The products were popular, and Roddick raised the capital for a second store by selling half of the business for \$8,000. Looking back, she says that "running that first shop taught me business is not financial science, it's about trading: buying and selling. It's about creating a product or service so good that people will pay for it."<sup>38</sup>

By the time Gordon returned home, he found his wife running a thriving business and suggested that The Body Shop begin offering franchises. By 1978, Body Shop franchises were open across the United Kingdom and Europe, with the first foreign store established in Brussels.

From the beginning, Anita promoted The Body Shop as an experiment in "profits with principles." The company campaigned for Greenpeace, shunned advertising, and promised only natural products that were not tested on animals. These values attracted many potential entrepreneurs as franchisees. The Body Shop grew rapidly and went public in 1984. International expansion continued with a store in New York opening in 1988. In 1994, The Body Shop Direct was launched to sell directly into homes.

In 1997, Roddick tried but failed to turn The Body Shop into a charity.<sup>39</sup> By 2002, Anita and Gordon had resigned as co-chairs to be non-executive directors and "creative consultants." The Body Shop expanded in Asia and South Africa and launched an Internet business. Approximately 70 percent of all stores were owned by franchisees.

Then the company agreed to an offer from L'Oréal, the French cosmetics giant. The acquisition was widely condemned, because both L'Oréal and Nestlé, owner of 25 percent of L'Oréal stock, had been criticized for animal rights abuses. An industry website reported, however, that "Body Shop sales continued to climb. The announcement was made alongside the figures for the full financial year, which revealed that sales reached \$1.5 billion. A spokesperson said the figure was mainly driven by the addition of 88 new stores worldwide, as well as a strong growth in its Internet sales in the U.S., along with a good response to its Body Shop at Home channel."<sup>40</sup>

Unfortunately, Anita Roddick died on September 10, 2007, of a massive heart attack. Tony Juniper, director of Friends of the Earth, wrote in the *Evening Standard* that “Anita did more than run a successful ethical business: she was a pioneer of the whole concept of ethical and green consumerism. There are quite a few business people today who claim green credentials, but none came anywhere near Anita in terms of commitment and credibility.”<sup>41</sup>

### Corporate Entrepreneurship

Also termed *intrapreneurship*<sup>42</sup> or *internal corporate venturing*, *corporate entrepreneurship* means bringing entrepreneurial processes into a large, existing enterprise. Corporate entrepreneurs have certain advantages and disadvantages compared to small firm entrepreneurs. Most important, they benefit from the firm’s existing resources, including financial capital but also their current capabilities and competencies.

The Body Shop provides a clear example of the continuing need to pursue new opportunities. Cosmetics.com reports that “sales [have] been boosted by product innovation, [including] a number of new launches” along with “a comprehensive restructuring programme to up production efficiencies.”<sup>43</sup> Increasing size requires and facilitates many such changes, but those seeking new corporate opportunities face disadvantages too. Estimates vary, but more than half of corporate ventures fail. Some put the failure rate (in terms of managers’ expectations for profitability) between 60 and 85 percent.<sup>44</sup> The Irish drinks producer Diageo offers several examples of apparently plausible ideas that did not add value to the parent company.

**Corporate entrepreneurship** is an effort by enterprises with large, established businesses to discover new opportunities.

#### Failed Corporate Venturing at Diageo

Diageo is a Dublin, Ireland-based premium drinks conglomerate whose major brands include Guinness, Baileys, Smirnoff, and Johnnie Walker. In July 2000, Diageo established a New Business Ventures (NBV) unit run by Graham Sumeray. The unit’s mandate was to create businesses in other sectors while increasing demand for core products.

One failed venture was an attempt to leverage the Guinness brand by offering Ireland travel packages and theme tours to customers in the United States. An in-bar TV venture, Translucis, was sold in 2003. Another failed venture was a wireless media channel called Nightfly. The entrepreneurial idea was to use mobile phones as a marketing channel; customers were to be signed up for the service in local bars and restaurants. Launched in 2000, Nightfly closed three years later. According to Sumeray, “The conclusion of our review was that the business needed a partner to take it to the next stage. We had several offers on

the table, but none were compelling enough, so we decided to close the business."<sup>45</sup>

Diageo's experience demonstrates that even with resources, including very strong brands, developing new opportunities is risky. In November 2003, the company closed the NBV unit to refocus on its core business.<sup>46</sup>

What is it about large organizations that seems to defeat corporate new ventures? A key issue seems to be difficulties of moving beyond past success. Sources of current success (core competencies or core capabilities) become sources of *inertia* that make corporate venturing less likely;<sup>47</sup> theorists have called this the *core rigidities* problem.

As we saw in Chapter 2, organization structures and processes represent important elements of an organization's core capabilities. These organizational assets are highly specialized and are critical supports for a profitable business. But the same structures and processes, by definition, will be misaligned with the strategy needed by a corporate venture in a new competitive context. They are almost inevitably rigidities standing in the way of a new venture that will require other structures and processes. Consider the difference between the requirements of running a national financial newspaper, such as the *Wall Street Journal*, and running a financial information website, such as [www.wallstreetjournal.com](http://www.wallstreetjournal.com).

**Inertia** is the tendency to continue in a current state.

**Core rigidities** are sources of current success that make new-venture development difficult.

### The Complex Face of News Delivery

In the print edition of the *Wall Street Journal*, printing technology dominates operations; in the interactive edition, Web-based computing is key. In print, news is delivered on a daily basis—reporting often reflects back over months or even years. On the Internet, news is delivered *now*, "in real time." This changes not only delivery and distribution processes but also the production processes (writing for real time versus journalistic analysis). In terms of processes and core activities, these are quite different businesses.

In addition, the key to making money with news on the Web is not just selling information. In fact, people are often unwilling to pay for information, because it is so freely available on the Web. The key in such a business is customization, value-added services, product sales, and advertising. All of these are driven by technology.

The challenge for management at the *Wall Street Journal* has been not only to learn how to compete on the Internet but also to prevent the core rigidities of the print edition from undermining the development of the interactive edition. Structurally, for example, the interactive edition needs technologists as decision makers, because technology drives new products and services on the Web. Journalists, not technologists, are

dominant in the leadership of the *Wall Street Journal*. By background and experience, they are in a poor position to make the judgments it takes to succeed in the highly competitive Internet format.

The solution to the core rigidities problem for the *Wall Street Journal* and many other large corporations is structural isolation: the corporate new venture is developed separately from the structure, systems, controls, or culture of the parent organization in order to promote corporate entrepreneurship. Thus, the interactive edition is a separate subsidiary of the *Wall Street Journal*, complete with all of the functions and support of an independent business. Reports suggest that it is successful. Indeed, it is one of few news and information website to be making money.

Many large corporations have launched successful new ventures. General Electric, for example, has capitalized on its position as a manufacturer of jet engines in the development of its business in equipment financing. Similarly, Walt Disney has exploited its brand and even specific characters across a wide range of different markets, including animated shorts, motion pictures, theme parks, television shows, and action figures. Richard Branson's company, Virgin, competes in industries as diverse as transatlantic air travel, record shops, and financial services. The economic performance of all three of these firms suggests the potential benefits of corporate entrepreneurship.

Structural isolation does not always require creating a separate business unit. Smaller, more informal *skunkworks* can be effective temporary environments for creative thinking and brainstorming. Whirlpool, for example, launched its first major brand in fifty years, Gladiator, from a skunkworks. Minnesota-based 3M, well known for its strong track record of new product development, often uses skunkworks. The firm has introduced more than 50,000 different products, including Scotch tape, optical films, insulation, drugs, and fuel cells. In an attempt to isolate innovative efforts from operations, 3M gives each engineer 15 percent of his or her time to explore new ideas. The hope is that this will stimulate creative juices and produce serendipitous discoveries.<sup>48</sup> Famously, the company's Post-it Notes were developed because of the "15 percent rule."

In addition to substantially different resource bases, corporate entrepreneurship and independent ventures differ in that corporate entrepreneurship can be (in fact, must be) supported by a much wider range of people up, down, and across the corporate hierarchy. For entrepreneurial initiatives to be successful in the corporate context, managers need to understand and embrace varied entrepreneurial roles. Figure 4.6 summarizes key requirements in ten entrepreneurial roles.

The figure suggests that different kinds of entrepreneurial initiatives require different types of support. Initiatives that are intended to improve

**Skunkworks**  
are independent  
units in larger  
organizations that  
are temporarily  
given autonomy  
to develop new  
ideas.

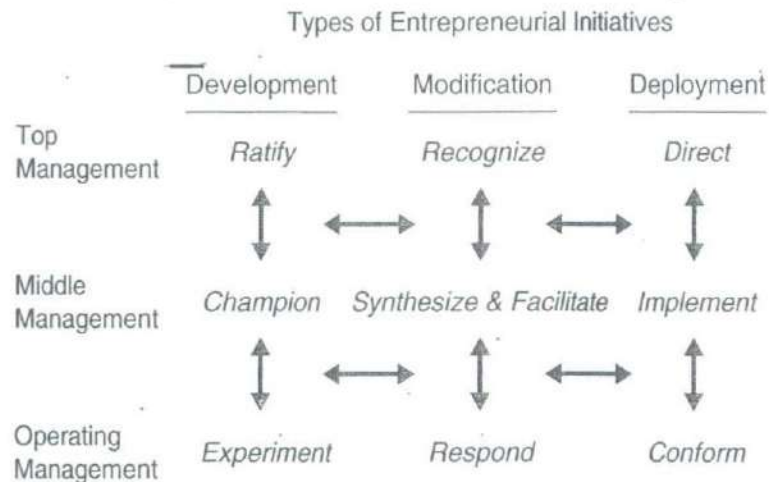


Figure 4.6 – Ten Managerial Roles in Corporate Entrepreneurship

Source: S. W. Floyd & P. J. Lane, Strategizing Throughout the Organization: Managing Role Conflict in Strategic Renewal, *Academy of Management Review* 25: 154–178.

the *deployment* of the organization’s resources by improving processes or entering adjacent market niches, for example, require more conventional roles—in which top management directs, middle managers implement, and operating management conforms to the established game plan. The knowledge, skills, systems, and processes needed for these incremental innovations are close to what the organization already knows. These initiatives are vital to the profitability and protection of an organization’s existing market, and in most organizations, initiatives of this type will predominate. Deployment initiatives do not produce whole new businesses. They reflect a rather minimal level of corporate entrepreneurship.

In more ambitious or radical corporate entrepreneurship efforts, the intent is to develop *new* competencies or capabilities. By definition, what the organization knows how to do, its current capabilities or competencies, have little relevance to the needs of a new entrepreneurial venture. (Remember the *Wall Street Journal’s* interactive edition.) For such initiatives, top management tends to play a more passive role, articulating a broad vision and ratifying projects that come closest to achieving it. The direction behind the autonomous initiatives—the specific goals and work methods used—emerges from the bottom up. Operating managers experiment with new ideas; middle managers recognize some of these as having high potential, provide resources for pilot projects, and *champion* those that succeed for ratification on a corporate scale.<sup>49</sup>

In between radical initiatives that develop new competencies and incremental initiatives that improve existing competencies, there are also initiatives that significantly modify competencies without changing them altogether. When Amazon.com went from selling books to the “sell everything” strategy, for example, the shift in context was enough to require significant modification of its merchandising and logistical competencies. Though these changes were more than incremental

**Champions** argue for an innovation’s support in an organizational setting, stimulating allocation of capital and required cooperation.

improvements, they did not reflect a radical change in how Amazon competes. The initiatives associated with such change were developed partly as the result of top management's recognizing the need for such modification. That insight, however, was based on middle managers' synthesis of the situation—explaining what needed to be changed and what needed to stay the same in the shift from selling books to selling toys, for example. This synthesis, in turn, developed out of interactions between operating-level managers who were tasked with responding to the new situation and middle managers who facilitated these responses using problem-solving processes that helped figure out what needed to be done. If such a shift had occurred in a much smaller enterprise, many of these roles might have been performed by one or two managers at the very top of the organization. In a larger, more complex organization, entrepreneurial roles must be spread up and down the management hierarchy.

Figure 4.7 summarizes how entrepreneurship evolves in corporate settings: beginning with the identification of entrepreneurial opportunity, depending on the emergence of entrepreneurial initiative (focused on capability deployment, modification, or development), and leading to the renewal of organizational capability.

Worksheet 4.2:  
Corporate  
Resources—A  
Tool for  
Entrepreneurship  
Planning  
.....

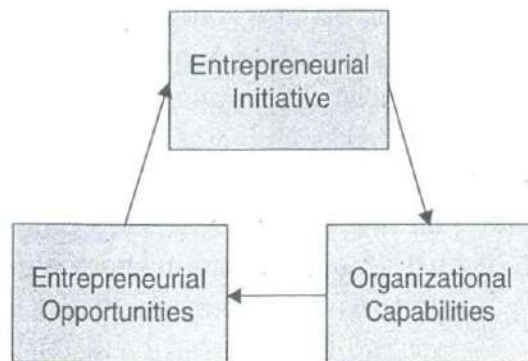


Figure 4.7 — Corporate Entrepreneurship

Source: Based on M. Jenkins & S. Floyd, Entrepreneurship, in M. Jenkins & V. Ambrosini (eds.), *Strategic Management: A Multiple Perspectives Approach* (London: Palgrave, 2002).

**Dual strategy** attempts to optimize current performance while simultaneously preparing for strategic changes that are expected to be necessary in the future.

### IS AMBIDEXTERITY THE ANSWER?

Derek Abell suggests that strategists often must follow a *dual strategy*.<sup>50</sup> In other words, they must keep two business models in mind. The first and most sure must fit today's competitive environment, matching current resources with current customers' needs and interests. The second business model, which is less sure, especially in its timing, anticipates

how the competitive environment is likely to evolve, how current customer needs might change, which new customers might become available, and how the resources of the firm (and its allies) will have to change to meet these circumstances.

Thinking in terms of dual strategies becomes more important if the expected future is quite different from the present. Many cautionary tales have been published about firms that believed the world would continue to reward their current model, and therefore went out of business.

### From Harnesses to Automobile Shops to Rental Properties

In 1897, 17-year-old Bert Conn finished his apprenticeship in a harness-making shop outside Cleveland, Ohio, and set up his own business making harnesses for horse-drawn carriages. For more than a decade, Bert ran a thriving business in the growing Cleveland metropolis. Then, in 1908, Henry Ford introduced the low-priced, efficient Model T. With customers wishing to trade four legs for four wheels, demand for Bert's harness-making skills were in decline.

To survive, Bert applied his sewing and fabric-fitting skills to designing soft fabric tops for the new automobiles. The business gradually expanded to include a full range of automobile parts by 1920 and was renamed Lorain Autoparts. Bert's son Wayne took over the business in the 1940s and made it a National Auto Parts Association (NAPA) franchise. New branch stores were added in the 1960s.

The family business encountered competitive threats in the 1980s in the form of discount chains such as Autozone. Lorain Autoparts could not compete against these lower-priced products and was forced to close its stores. The next generation of the Conn family now rent the stores to other retailers.<sup>51</sup>

One obvious prescription from the many stories like this one is to pay attention to the environment and the firms that appear to be shaping it. The more radical, more risky, and potentially much more profitable prescription is to adopt a business model that attempts to make discontinuous change happen.

Gary Hamel and C. K. Prahalad call this "competing for the future."<sup>52</sup> They suggest that strategists should not worry about predicting the future, but instead work to create the future they desire. This requires psychological change from strategists, who must "forget" current recipes for success and be willing to endure major changes within the organization as old relationships as well as processes are dissolved. A few companies, such as Nokia (a company that moved from making rubber boots for fishermen to digital phones for the world), have been able to do this with spectacular success. We go into the details of several other

**Ambidextrous organizations manage the inconsistent demands of supporting current businesses while developing new entrepreneurial opportunities.**

examples in the second half of this book. It should be obvious, however, that there are no guarantees—developing a business model is risky because it is impossible to know how the world will evolve or whether a given firm can be adapted to these new circumstances.

A few examples in this book suggest that it is possible to both maintain and improve the advantage of currently successful operations, and to consider new opportunities further afield. The ideal is to become an *ambidextrous* organization.<sup>53</sup> This is the ultimate challenge for the corporate entrepreneur: to anticipate and counter entrepreneurial attacks on the core business by developing new initiatives on its own, while also remaining alert to opportunities that are well beyond current success. It is not easy, but a number of companies have shown that it is possible.

## CONCLUSIONS FOR THE STRATEGIST

Chapters 2, 3, and 4 draw together three ideas that we put at the heart of strategy. First, as described in Chapter 2, strategists must gather resources and use them effectively. They must also establish and maintain close connections with their customers and seek new ways to satisfy them, as discussed in Chapter 3.

This chapter suggests that an entrepreneurial mindset, within both new and established companies, is helpful for identifying the many different projects that might be developed by matching resources with opportunities to serve customers. However, choice among these strategic alternatives depends not only on capabilities within the company, as discussed in this chapter, but on the capabilities of competitors. This is such an important topic that we devote the next three chapters to its development. Chapter 5 considers the competition for profit. Chapter 6 describes the importance of specifying a business model. Chapter 7 describes the competitive advantages and disadvantages of being part of a diversified corporation.

### Key Concepts

**Entrepreneurs** recognize opportunities, assess fit between the market and their organization, find and combine resources, develop innovative solutions, and strive to make a profit. The entrepreneur can be an individual working alone, but often **entrepreneurial teams** bring a pool of competencies to a new venture. In addition, organizations can be assessed as a whole for their ability to support entrepreneurial activity. **Serial entrepreneurs** start a number of entrepreneurial efforts over time.

**Radical innovations** are a significant departure from currently available product or service offerings. **Incremental innovations** contribute to the improvement of existing product or service offerings.

Timing is important. Often, the **first mover** in a new product or service category can define an innovation's characteristics in the minds of buyers, gaining valuable name recognition and brand loyalty. But the **second mover** in a new market also has potential advantages, especially the opportunity to learn from and improve on the efforts of first movers.

At each of these levels, the goal is **opportunity recognition**, or discovering an idea and forming it into a business concept. **Synchronicity** is the time-sensitive match between the entrepreneur's recognition of opportunity and occurrence of market need. **Feasibility analysis** evaluates the skills and readiness of the entrepreneur and determines the availability of and access to resources required for launching a new venture.

Entrepreneurship requires finding and utilizing resources. **Utilitarian resources** are required to produce a good or service. **Instrumental resources** are not directly required to produce a good or service, but are helpful for acquiring those resources. **Social capital** refers to the resources (both utilitarian and instrumental) available from relationships with others.

Entrepreneurship also involves the management of innovation. **Product innovations** are changes in the product or service offered to an existing or new market. **Process innovations** do not change the offering itself, but change the way in which the organization operates to produce a good or service. Either can be a **competence-destroying innovation** that makes existing product or service offerings obsolete. Resistance should therefore be anticipated, by both affected outsiders and managers of businesses losing ground within the entrepreneurial company itself.

The prototypic S-curve of technological innovation is due, in part, to the typical pattern of adoption within a social setting. **Innovators** are the first few percent of a new offering's users, who try a new offering because of its innovative qualities. **Early adopters** are the larger group of users who are drawn to an offering's innovative qualities, but tend to be more evaluative than innovators. They also tend to be opinion leaders in the social system adopting a new innovation. **Early majority users**, who fall in the first half of the total set of an innovation's users, are still ahead of average adopters in their social system. They tend to be less responsive to technological or innovative content and more responsive to practical features and credibility than innovators or early adopters. **Late majority users** are the large, conservative group in a community slower than all except the laggards. Finally, **laggards** are users in a community who are slowest to adopt a new product. **Lead users** are similar to the majority of an innovation's users, and are willing to help the producer improve its product or service to meet their needs.

**Liability of newness** is a new venture's comparative vulnerability due to a lack of experience, industry recognition, and customer familiarity. Often failures result from lack of capital. **Start-up capital** is the financial requirement for initiating a new venture. **Bootstrapping** is the use of an entrepreneurial individual's personal resources to finance a new business. **Venture capitalists** (VCs) are investors who search for and provide capital to entrepreneurs and can be critical as cash needs increase after start-up. An **angel investor** is a private individual who provides seed capital to early-stage ventures. An **initial public offering** (IPO) sells stock in a new venture to individual and institutional investors as an additional way to raise needed capital.

**Franchising** is an opportunity for entrepreneurial growth by offering exclusive rights to a brand and business model to other entrepreneurs in a specific locality in return for a royalty.

**Corporate entrepreneurship** is an effort by an enterprise with large, established businesses to discover new opportunities. Though corporations offer resources and many existing capabilities, organizational **inertia**, the tendency to remain in a current state, should be expected. More specifically, **core rigidities** are sources of current success that make new-venture development difficult.

In an effort to avoid problems from inertia and rigidity, corporations sometimes establish **skunkworks**—independent units that are temporarily given autonomy to develop new ideas. The chapter concludes with a brief discussion of **dual strategy**. This is an attempt to optimize current performance while simultaneously preparing for strategic changes that are expected to be necessary in the future. Recently, strategy theorists have suggested that it is important to become **ambidextrous** and manage the inconsistent demands of supporting current businesses while developing new entrepreneurial opportunities; both are necessary to sustain advantage over time in competitive environments:

### Questions for Further Reflection

1. Research a new start-up in your community. How did the entrepreneur discover the opportunity for the venture? How were resources gathered? What has been the response of early adopters?
2. Identify a new venture established by a corporation—perhaps Amazon, L'Oréal, or another company mentioned in this text. Can you identify positive and negative aspects of the corporate parent for the new venture?
3. Consider the macro environment discussed in Chapter 1 for a company that interests you. What technological, political/legal, economic, demographic, and cultural trends present entrepreneurial opportunities for this organization?

## WORKSHEET 4.1

### S-Curve Analysis—A Tool for Explaining User Characteristics

Consider how a product or service has made gains in the market and its users.

**Step 1:** Identify a product or service that has made significant gains in the market.

**Step 2:** Think of who the first adopters were. Describe their characteristics and demands in column 1.

**Step 3:** Think of the characteristics and demands of more recent users. Put your ideas into column 2.

**Step 4:** Anticipate the characteristics and demands of late adopters in column 3.

**Step 5:** Consider the strategic changes required to respond to these customers.

<b>S-Curve Analysis</b> Worksheet 4.1	<b>Product or Service:</b> Time Frame:
<b>Analyst(s):</b>	<b>Strategy Summary:</b>

<b>First Adopters</b>	<b>More Recent Users</b>	<b>Demands of Late Adopters</b>
<b>Strategic Response</b>	<b>Strategic Response</b>	<b>Strategic Response</b>

## WORKSHEET 4.2

### Corporate Resources—A Tool for Entrepreneurship Planning

Consider how a corporate parent could provide resources to a start-up.

**Step 1:** Identify a promising entrepreneurial start-up in your community.

**Step 2:** Think of several corporations that might be interested in acquiring such a company. Describe the resources that each corporate parent could bring to the start-up effort.

<b>Corporate Resources</b> Worksheet 4.2	<b>Start-Up:</b> Time Frame:
<b>Analyst(s):</b>	<b>Strategy Summary:</b>

<b>Potential Corporate Acquirer</b>	<b>Resources That a Corporate Parent Could Bring to the Start-Up</b>

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#### NOTES

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