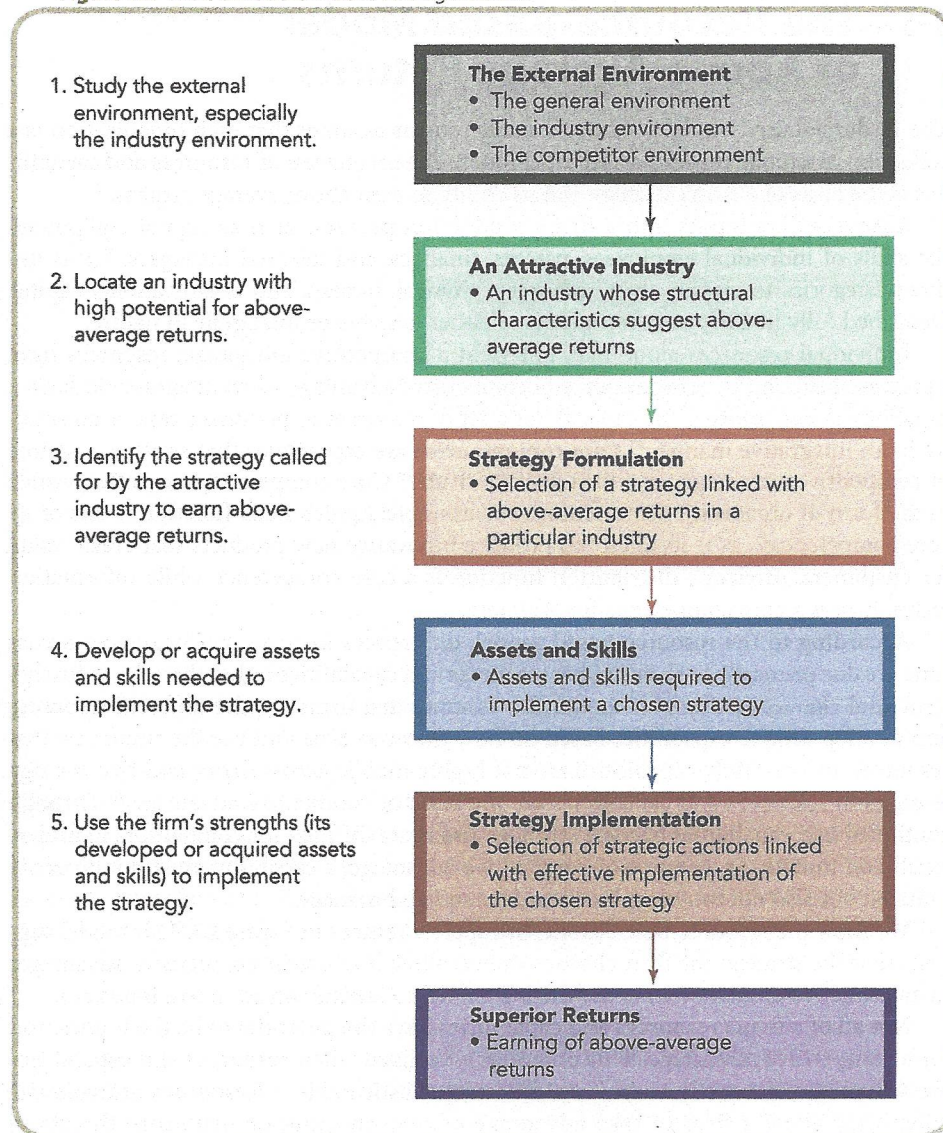


suggests that firms can earn above-average returns by producing either standardized products at costs below those of competitors (a cost leadership strategy) or by producing differentiated products for which customers are willing to pay a price premium (a differentiation strategy). We discuss the cost leadership and product differentiation strategies fully in Chapter 4.

As shown in Figure 1.2, the I/O model suggests that firms earn above-average returns by studying the external environment effectively as the foundation for identifying an attractive industry and implementing an appropriate strategy in it. For example, in some industries, firms can reduce competitive rivalry and erect barriers to entry by forming joint ventures. In turn, reduced rivalry increases the profitability potential of firms that are collaborating.⁸³ Companies that develop or acquire the internal skills needed to implement strategies required by the external environment are likely to succeed, while those that do not are likely to fail.⁸⁴ Hence, this model suggests that the characteristics

Figure 1.2 The I/O Model of Above-Average Returns



over time. A firm's focus and past core competencies may actually slow change and strategic flexibility.⁷⁵

To be strategically flexible on a continuing basis and to gain the competitive benefits of such flexibility, a firm must develop the capacity to learn. Continuous learning provides the firm with new and up-to-date skill sets, which allow it to adapt to its environment as it encounters changes.⁷⁶ Firms capable of applying quickly what they have learned exhibit the strategic flexibility and the capacity to change in ways that will increase the probability of dealing successfully with uncertain, hypercompetitive environments.

1-2 The I/O Model of Above-Average Returns

From the 1960s through the 1980s, those leading organizations believed that the external environment rather than the internal organization was the strongest influence on the choice of strategy.⁷⁷ The industrial organization (I/O) model of above-average returns explains the external environment's dominant influence on the choice of strategy and the actions associated with it. The logic of the I/O model is that a set of industry characteristics, including economies of scale, barriers to market entry, diversification, product differentiation, the degree of concentration of firms in the industry, and market frictions, determine the profitability potential of an industry or a segment of it as well as the actions firms should take to operate profitably.⁷⁸ We examine these industry characteristics and explain their influence in Chapter 2.

Grounded in economics, four underlying assumptions explain the I/O model. First, the model assumes that the external environment imposes pressures and constraints that determine the strategies that would result in above-average returns. Second, most firms competing within an industry or within a segment of that industry are assumed to control similar strategically relevant resources and to pursue similar strategies in light of those resources. Third, firms assume that their resources are highly mobile, meaning that any resource differences that might develop between firms will be short-lived. Fourth, the model assumes that organizational decision makers are rational individuals who are committed to acting in the firm's best interests, as shown by their profit-maximizing behaviors.⁷⁹

The I/O model challenges firms to find the most attractive industry in which to compete. An assumption supporting the need to find the most attractive industry is that firms possess the same types of resources with value and that these resources are mobile across companies. This means that a firm is able to increase its performance only when it competes in the industry with the highest profit potential and learns how to use its resources to implement the strategy required by the industry's structural characteristics. The competitive realities associated with the I/O model find firms imitating each other's strategies and actions taken to implement them.⁸⁰

The five forces model of competition is an analytical tool firms use to find the industry that is the most attractive for them. The model (explained in Chapter 2) encompasses several variables and tries to capture the complexity of competition. The five forces model suggests that an industry's profitability (i.e., its rate of return on invested capital relative to its cost of capital) is a function of interactions among five forces: suppliers, buyers, competitive rivalry among firms currently in the industry, product substitutes, and potential entrants to the industry.⁸¹

Firms use the five forces model to identify the attractiveness of an industry (as measured by its profitability potential) as well as the most advantageous position for the firm to take in that industry, given the industry's structural characteristics.⁸² The model