

How the Strategy Process Killed Innovation at Microsoft



Zune, Microsoft's (failed) digital media player.
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SINCE MICROSOFT LAUNCHED Windows 3.0 in 1990, it has dominated the industry for PC operating system (OS) software with a 90 percent market share. Microsoft's huge installed base of Windows operating systems on PCs and its long-term relationships with original equipment manufacturers (OEMs), such as Dell, HP, and Lenovo, create tremendous entry barriers for newcomers. Intel's semiconductor chips are the perfect complement to Microsoft's operating system. Every time Microsoft releases a new operating system, demand for Intel's latest microprocessor goes up, because new operating systems require more computing power. Because of the complementary nature of their products, Microsoft's and Intel's alternating advances have created a virtuous cycle, benefiting from network effects. The successful combination of Microsoft's Windows and Intel's processors has produced the *Wintel* (a portmanteau of Windows and Intel) standard in the PC industry. By 1999, Microsoft was the most valuable company on the planet.

Fast-forward to 2017, two years after Microsoft released Windows 10, its latest version of the ubiquitous operating system. For the past quarter century, Microsoft's business model was to establish and maintain the dominance of the Wintel standard in the PC industry. With this standard, Microsoft made money off consumer and business application software such as its Office Suite. Microsoft remains hugely profitable: With some \$85 billion in annual revenues in 2016, it generated over \$20 billion in profits! Windows and Office still generate about 40 percent of Microsoft's total revenues and 75 percent of profits. The gross margin of "classic" Office is 90 percent, while the new cloud-based Office 365 only has a 50 percent profit margin.

Although Microsoft is highly profitable, its stock price was flat through the 2000s, trailing the tech-heavy NASDAQ-100 by a wide margin. This started to change even before Satya Nadella became CEO in 2014, but under Nadella's strategic focus of "mobile first, cloud first," Microsoft's stock market valuation has appreciated rapidly in recent years, in fact, more than doubling over a recent five-year period. Yet Microsoft is having to work hard for its performance to match that of other tech companies such as Google, Apple, and Amazon because they created entirely new areas of computing from scratch, and as a consequence, their stock prices have soared. One reason Microsoft's fell and flattened in the 2000s was that it saw its mission differently. Protecting its existing portfolio, Microsoft largely failed to commercialize any category-defining products or services. Why? The answer: Microsoft's strategy process killed innovation!

Top-Down Strategy Process Killed Bottom-Up Strategic Initiatives at Microsoft

Microsoft actually came up with some major breakthroughs, but failed to successfully commercialize them. The root of the problem seemed to lie with Microsoft's top-down strategy process. Once Windows became the industry standard in 1990, Microsoft's strategy was defensive: Any new product or extension had to strengthen the existing Windows-Office franchise; if not, it would be "killed." Here are some great products and services that Microsoft invented, but never commercialized.

ONLINE SEARCH

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Google is now the leading search and online advertising company, with close to \$100 billion in annual revenues and a market capitalization of some \$700 billion in 2017, making it one of the most valuable companies globally. What haunts former Microsoft CEO Steve Ballmer is that Microsoft had its own working prototype of a Google forerunner, called Keywords, long before Google's ascent.

Scott Banister, then a student at the University of Illinois at Urbana-Champaign, had come up with the idea of adding paid advertisements to internet searches. He quit college and drove his Geo hatchback to the San Francisco Bay Area to start Keywords, later joining an online ad company called LinkExchange. In 1998, incidentally the year Google was founded, Microsoft bought LinkExchange for some \$265 million. The newly formed Microsoft online search team urged top managers to continue to invest in the burgeoning online search technology. Instead, Microsoft executives shut down the project in 2000 because they did not see a viable business model in it. One team member actually approached Ballmer and explained that he thought Microsoft was making a huge mistake. But Ballmer said he wanted to manage through delegation and would not reverse a decision made by managers three levels below him. This decision put an end to Microsoft's first online advertising venture.

In 2003, Microsoft got a second chance to enter the online advertising business when some mid-level engineers proposed buying Overture Services, an innovator in combining internet searches with advertisements. This time, Ballmer, joined by Microsoft co-founder Bill Gates, decided not to pursue the idea because they thought Overture was overpriced. Shortly thereafter, Yahoo bought Overture for \$1.6 billion. In 2008, Ballmer offered to buy Yahoo for close to \$50 billion to help his company gain a foothold in the paid-search business where Google rules. Fortunately for Microsoft, the offer was turned down by Yahoo, which was sold for \$4.5 billion to Verizon in 2017.

Having missed two huge opportunities to pursue promising strategic initiatives that emerged from lower levels within the firm, Microsoft has been playing catch-up in online search and advertising ever since. In the summer of 2009, after spending billions of dollars and being about a decade late, it launched its own search engine, Bing. Industry pundits joked that Bing is an acronym for "Because It's Not Google."

PORTABLE MUSIC PLAYER

In 2001, Apple launched the iPod, a portable music player, with which the floundering company's resurgence began. This was followed up in 2003 by the launch of iTunes Music Store with 200,000 songs at 99 cents each. The iPod and iTunes laid the foundation of Apple's hugely successful ecosystem tightly integrating software, hardware, and services. In 2005, during an employee meeting, one Microsoft engineer asked Steve Ballmer whether Microsoft should compete with Apple's iPod and iTunes. In a sarcastic tone, Ballmer asked the room for a show of hands, "How many people think Microsoft is in the business of selling music?"¹ Not surprisingly, none of the intimidated Microsoft employees raised their hands. More than a year later, Microsoft introduced its own digital music player, the Zune (see photo above), which flopped.

TABLET COMPUTERS

Long before Apple launched the iPad in early 2010, the inventor of Microsoft's highly successful Xbox gaming console had developed a tablet computer called the Courier. The Courier was a fully functioning tablet that folded like a book and allowed users to draw on a touchscreen, among other features. Rather than compete against Apple, Ballmer informed the Courier team that he was pulling the plug on the tablet to redirect resources to the next version of Windows, the launch for which was more than two years away. To add insult to injury, it was Windows 8, Microsoft's failed attempt to straddle desktop and mobile computing.

In the meantime, Apple had sold more than 250 million iPads, which have been instrumental in strengthening Apple's ecosystem. This ecosystem allows Apple to be the world's leader in mobile computing. (One other mobile computing invention that Microsoft killed was wearable devices such as smart watches.)

OFFICE FOR IPHONE

As soon as Apple released the iPhone in 2007, Microsoft engineers tweaked the company's PC-based Office Suite to run on the Apple mobile device. Ballmer shut the project down—he had a visceral disdain for Apple, once stomping on an iPhone in an all-employee meeting when he saw a subordinate using the popular Apple device—telling the group that Microsoft needed to focus its resources on Windows 8. Page 457

In the meantime, Apple has garnered over \$1.2 billion in iPhone sales since it was launched in 2007, making it one of the most successful products ever. In 2017, the average price for an iPhone was close to \$700. Apple's 10th anniversary phone, the iPhone X, is the first smartphone to cross the \$1,000 price threshold. Although Apple holds some 15 percent market share in the smartphone industry, it captures more than 90 percent of the profits. A whopping two-thirds of Apple's annual revenues of some \$220 billion is from iPhone sales, surely sufficient to have paid a handsome licensing fee for a Microsoft Office Suite for the iPhone.

CLOUD-BASED OFFICE SOFTWARE

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Long before cloud-based computing took off, Microsoft in 2000 developed a fully functioning suite of software applications for the web including an Office-type word-processing software called NetDocs. This project was discontinued in 2001 because Ballmer feared it would cannibalize sales of the "classic" Office suite. This opened the door for Google to offer cloud-based computing applications such as Google Docs, Google Slides, and Google Sheets, which with Google Drive and Gmail make up the core of Google's cloud-based computing services. These in turn established Google Chrome as the dominant web browser and helped Google's Android become the leading mobile operating system with some 80 percent market share. In contrast, Microsoft's Windows has less than 1 percent market share in mobile computing.

CAR SOFTWARE

In the early 2000s, dozens of Microsoft engineers developed—on their own time—car software that allowed drivers to use online maps, have e-mails translated to voice and read to them, as well as play digital music. Ballmer shut the project down, arguing that Microsoft—one of the most cash-rich companies on the planet—could not afford another big bet at the moment.

Today, Tesla is as much a software and sustainable energy company as it is a car company, with a market cap of more than \$60 billion. Both Tesla and Google are proving that driverless cars (all based on software and sensors) are viable within a few years and promise to be a multibillion-dollar industry.

While still CEO, Ballmer admitted problems in Microsoft's strategic management process—to a degree: "The biggest mistakes I claim I've been involved with are where I was impatient—because we didn't have a business yet in something, we should have stayed patient."² Ballmer, who became Microsoft's CEO in 2000, was replaced in 2014 by Satya Nadella. Under Nadella, Microsoft has made strides in reinventing itself with a "mobile first, cloud first" strategy. Can Microsoft once again innovate successfully?

Microsoft's strategy often gets its most critical look when it holds its developers' conference and announces new initiatives. Even though the jury may still be out for the long term, in recent years Microsoft has been getting much better press, even as its stock evaluations rise. Pundits applaud how Microsoft is releasing, fixing, and refining products like a modern cloud company. The company has broken free of Windows platforms and gone to universal availability, sometimes jumping from device to device. And it has even found new ways to provide iOS and Android apps. In short, it appears its cloud first, mobile first approach is allowing Microsoft to offer competitively matched experiences across consumers' platform of choice.³

Moreover, Nadella has created a culture in which the company manages a full stack of hardware, software, and data centers, and where bottom-up innovation appears to be embraced. In fact, failure is accepted as part of that process. Microsoft has created prototype labs so new ideas can be developed and tested, and if necessary, "to fail faster." In 2017, *The Economist* proclaimed that Microsoft has indeed transformed its culture for the better, but that getting cloud computing right remains a hard thing to do.

DISCUSSION QUESTIONS

1. Describe the strategic management process at Microsoft under CEO Steve Ballmer (2000–2014). How were strategic decisions made? What were the strengths and weaknesses of this approach? Explain in detail.
2. Although Microsoft invented some promising computing breakthroughs, and often before competitors, why did Microsoft fail to successfully commercialize them?
3. Why is it so difficult for CEOs of large and successful companies such as Microsoft to balance *exploitation*—applying current knowledge to enhance firm performance in the short term—with *exploration*—searching for new knowledge that may enhance a firm's future performance? What are the trade-offs? How could they be reconciled?
4. In contrast, what can you infer from information in the case about the current design of Microsoft's strategy process under Microsoft CEO Satya Nadella, who started in 2014?
5. What advice would you give Nadella in his current efforts?

Apple: The iPhone Turns 10, so What's Next?

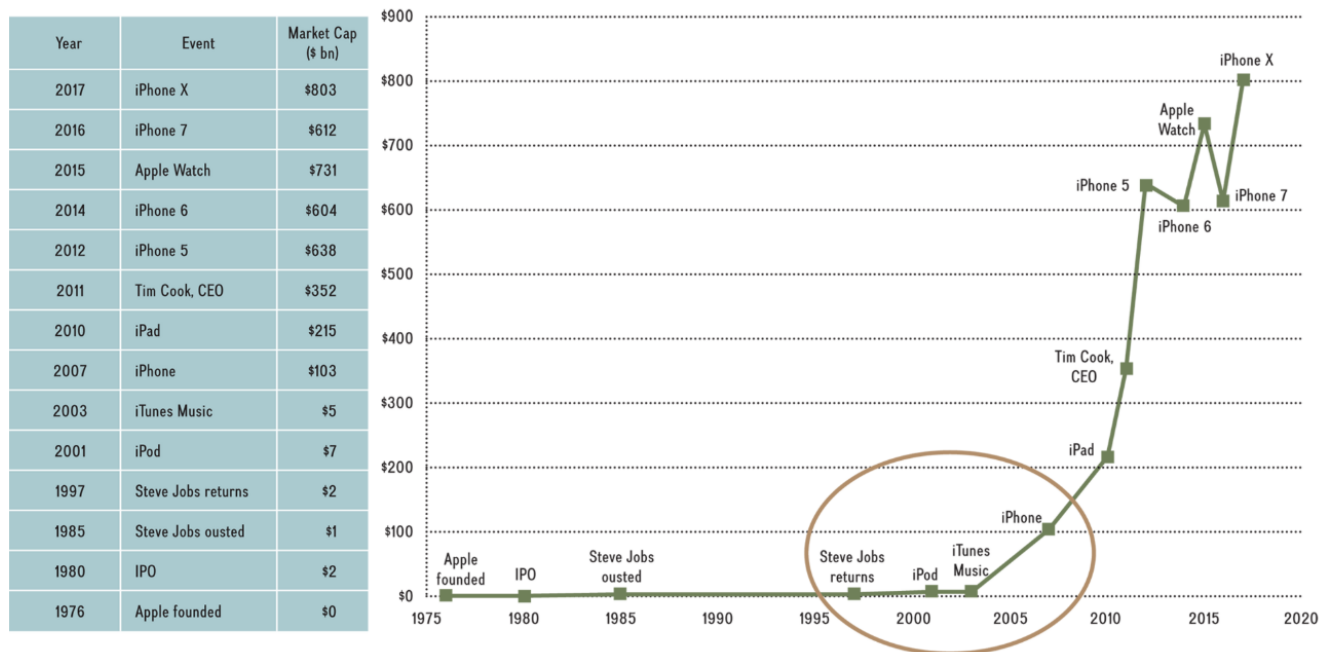


At Apple's new headquarters in Cupertino, California, the futuristic building emphasizes open spaces with plenty of natural light to allow for random encounters among employees to foster creativity and innovation. The building, reminiscent of a sci-fi spaceship, cost an estimated \$5 billion, making it the most expensive office space built. In front, Tim Cook, CEO Apple.

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IN 2017, THE 10TH ANNIVERSARY of the iconic iPhone, Apple became the first company whose stock market valuation crossed the \$800 billion threshold, making it the most valuable company of all time.¹ Many expect Apple to be also the first company that reaches a stock market valuation of \$1 trillion! Some 20 years earlier, Apple would likely have gone bankrupt if archival Microsoft (which enjoyed the same position with a valuation of \$615 billion in December 1999) had not invested \$150 million in Apple.

Apple got to where it is today by implementing a potent competitive strategy. That strategy, conceptualized by co-founder Steve Jobs, combines innovation in products, services, and business models. From near-bankruptcy in 1997, Apple's revitalization really took off in 2001 (see [Exhibit MC5.1](#)) when it introduced the iPod, a portable digital music player, the same year it opened its first retail stores. Apple's stores earn the highest sales per square foot of any retail outlets, including luxury stores such as jeweler Tiffany & Co. and LVMH, purveyor of fine handbags and other luxury goods.



In 2003, Apple soared even higher when it opened the online store iTunes. Apple didn't stop there. In 2007, the company revolutionized the smartphone market with the introduction of the iPhone. Just three years later, Apple created the tablet computer industry by introducing the iPad, thus beginning to reshape the publishing and media industries. Further, for each of its iPod, iPhone, and iPad lines of businesses, Apple followed up with incremental product innovations that extended each product category, culminating in the 10th anniversary edition of the iPhone launched in 2017. By combining tremendous brainpower, intellectual property, and iconic brand value, Apple has enjoyed dramatic increases in revenues, profits, and stock market valuation.

A Good Strategy

Why was Apple so successful? Why did Microsoft's once superior market valuation evaporate? Why did Apple's competitors, such as Sony, Dell, Hewlett-Packard (HP), Nokia, and BlackBerry, struggle or go out of business? The short answer is: Apple had a better strategy. But this raises the question: What is a good strategy? A good strategy is more than a mere goal or a company slogan. A good strategy defines the competitive challenges facing an organization through a critical and honest assessment of the status quo. A good strategy also provides an overarching approach (policy) on how to deal with the competitive challenges identified. Last, a good strategy requires effective implementation through a coherent set of actions. A *good strategy*, therefore, consists of three elements:²

1. A *diagnosis* of the competitive challenge.
2. A *guiding policy* to address the competitive challenge.
3. A *set of coherent actions* to implement the firm's guiding policy.

First, consider the diagnosis of the competitive challenge. Above, we briefly traced Apple's renewal from the year 2001, when it hit upon the product and business-model innovations of the iPod/iTunes combination. Before that, Apple was merely a niche player in the desktop-computing industry and struggling financially. Steve Jobs turned the sinking company around by focusing on only two computer models (one laptop and one desktop) in each of two market segments (the professional market and the consumer market) as opposed to dozens of non-differentiated products within each segment. This streamlining of its product lineup enhanced Apple's strategic focus. Even so, the outlook for Apple was grim. Jobs believed that Apple, with less than 5 percent market share, could not win in the personal computer industry where desktops and laptops had become commoditized gray boxes. In that world, Microsoft, Intel, and Dell were the star performers. Jobs knew that he needed to create the "next big thing."³

A GUIDING POLICY

Second, Apple shifted its competitive focus away from personal computers to mobile devices. In doing so, Apple disrupted several industries through its product and business-model innovations. Combining hardware (i.e., the iPod) with a complementary service product (i.e., the iTunes Store) enabled Apple to devise a new business model. Users could now download individual songs legally (at 99 cents) rather than buying an entire CD or downloading the songs illegally using Napster and other file-sharing services. The availability of the iTunes Store drove sales of iPods. Along with rising sales for the new iPod and iTunes products, demand rose for iMacs. The new products helped disrupt the existing personal computer market, because people wanted to manage their music and photos on a computer that worked seamlessly with their mobile devices. Apple then leveraged the success of the iPod/iTunes business-model innovation, following up with product-category-defining innovations when launching the iPhone (in 2007) and the iPad (in 2010).

COHERENT ACTIONS

Third, Apple implemented its guiding policy with a set of coherent actions. Apple's coherent actions took a two-pronged approach: It drastically streamlined its product lineup through a simple rule—"we will make only one laptop and one desktop model for each of the two markets we serve, professional and consumer." It also disrupted the industry status quo through a potent combination of product and business-model innovations, executed at planned intervals. These actions allowed Apple to create a string of temporary competitive advantages (see [Exhibit MC5.1](#)). Taken together, this allowed Apple to sustain its superior performance for over a decade, making it the most valuable company on the planet in the process.

Past performance, however, is no guarantee of future performance. Microsoft was once the most valuable company in the world but has since struggled to keep up with Apple. At the same time, Microsoft, as well as Google, Samsung, Amazon, and others, are working hard to neutralize Apple's competitive advantage.

The trillion-dollar question is whether Apple can continue to maintain a competitive advantage in the face of increasingly strong competition and rapidly changing industry environments. In both mobile payment systems (Apple Pay launched in 2014) and music streaming (Apple Music launched in 2015), Apple was a late mover. The Apple Watch, introduced in 2015, is the first new product category Apple launched since the iPad in 2010. Although Apple continues to capture over 90 percent of profits in the smartphone industry, more than 60 percent of Apple's \$220 billion revenue comes from the iPhone. Moreover, China accounts for more than 20 percent of Apple's total revenues, a market that is becoming more and more volatile for the Cupertino, California, tech company. These are pressing issues that Apple CEO Tim Cook needs to address in order to sustain Apple's competitive advantage.

DISCUSSION QUESTIONS

1. Explain Apple's success over the past decade relative to its main competitors. Think about which industries it has disrupted and how.
2. Is Apple's success attributable to industry effects, firm effects, or a combination of both? Explain.
3. What are the greatest challenges Apple is facing? Detail them by internal weaknesses and external threats. How can Apple transform internal weaknesses into strengths, and external threats into opportunities?
4. Apply the three-step process for developing a *good strategy* outlined above (diagnose the competitive challenge, derive a guiding policy, and implement a set of coherent actions) to Apple's situation today. Which recommendations would you have for Apple to outperform its competitors in the future? Be specific.