

Fundamentals of Strategic Management

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Strategy

Top management's plans to attain outcomes consistent with the organization's mission and goals.

Competitive advantage

A state whereby a business unit's successful strategies cannot be easily duplicated by its competitors.

Strategic Management

The continuous process of assessing its external environment and its internal strengths and weaknesses, formulating and implementing strategies, and exerting strategic control to achieve success.

Today's business world is global, Internet driven, and obsessed with speed. The challenges it creates for strategic managers are often complex, ambiguous, and unstructured. Add to this the constant allegations of top management wrongdoings, ethical blunders, and skyrocketing executive compensation, and it is easy to see why firm leaders are under greater pressure than ever to respond to strategic problems quickly, decisively, and responsibly. Hence, the need for effective strategic management has never been more pronounced than it is today. This text presents a framework for addressing these immediate strategic challenges.

This chapter introduces the notion of strategic management, highlights its importance, and presents a five-step process for strategically analyzing an organization. The remaining chapters expand on the various steps in the process, with special emphasis on their application to ongoing enterprises.

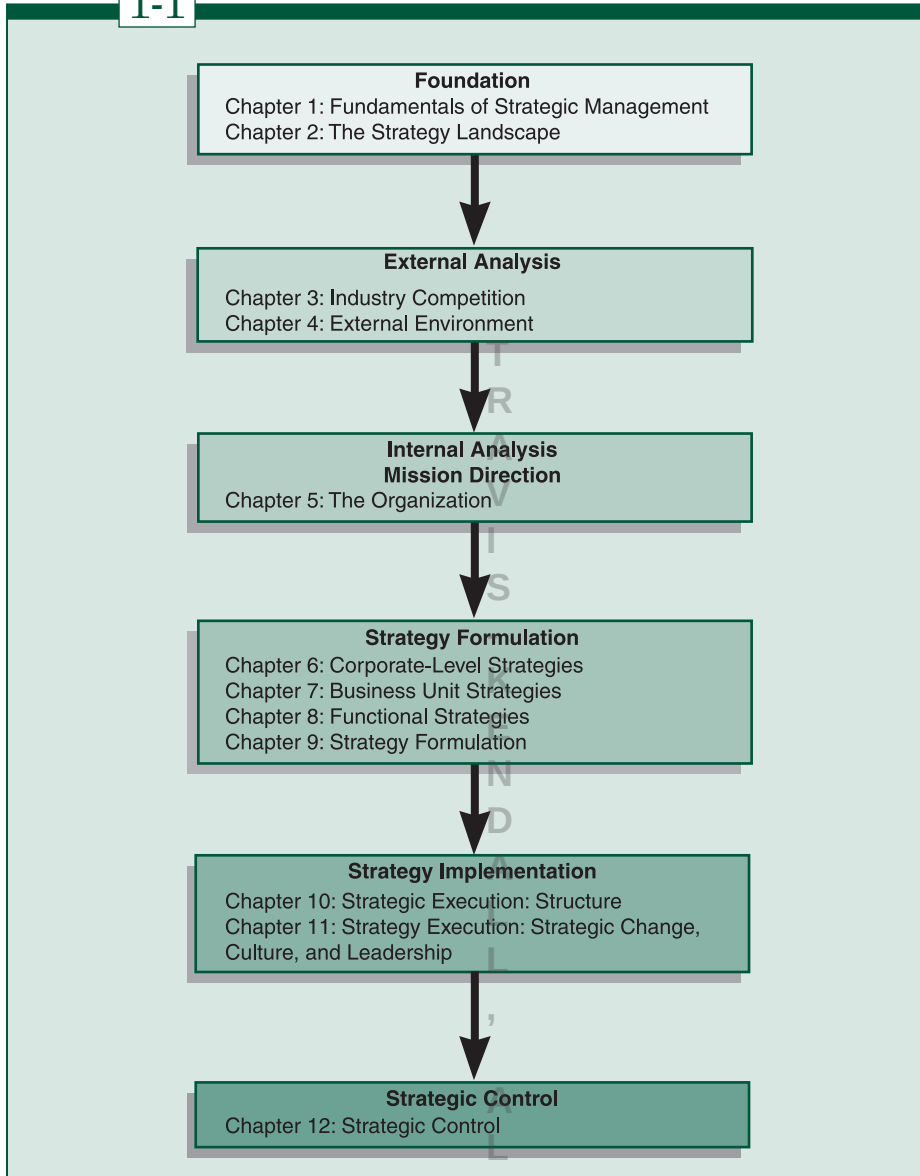
1-1 What Is Strategic Management?

Strategy refers to top management's plans to develop and sustain **competitive advantage**—a state whereby a firm's successful strategies cannot be easily duplicated by its competitors¹—so that the organization's mission is fulfilled.² Following this definition, it is assumed that an organization has a plan, its competitive advantage is understood, and that its members understand the reason for its existence. These assumptions may appear self-evident, but many strategic problems can be traced to fundamental misunderstandings associated with defining the strategy. Debates over the nature of the organization's competitive advantage, its mission, and whether a strategic plan is really needed can be widespread.³ Comments such as "We're too busy to focus on developing a strategy" or "I'm not exactly sure what my company is really trying to accomplish" can be overheard in many organizations.

Strategic management is a broader term than *strategy* and is a process that includes top management's analysis of the environment in which the organization operates prior to formulating a strategy, as well as the plan for implementation and control of the strategy. The difference between a strategy and the strategic management process is that the latter includes considering what must be done before a strategy is formulated through assessing the success of an implemented strategy. The strategic management process can be summarized in five steps, each of which is discussed in greater detail in subsequent chapters of the book (see Figure 1-1).⁴

- 1. External analysis:** Analyze the opportunities and threats or constraints that exist in the organization's external environment, including industry and macroenvironmental forces.
- 2. Internal analysis:** Analyze the organization's strengths and weaknesses in its internal environment. Consider the appropriateness of its mission.
- 3. Strategy formulation:** Formulate strategies that build and sustain competitive advantage by matching the organization's strengths and weaknesses with the environment's opportunities and threats.
- 4. Strategy execution:** Implement the strategies that have been developed.
- 5. Strategic control:** Measure success and make corrections when the strategies are not producing the desired outcomes.

Is it necessary to address these steps sequentially? The answer depends on one's perspective. *Outsiders* analyzing a firm should apply a systematic approach that progresses through these steps in order. Doing so develops to a holistic understanding of the firm, its industry, and its strategic challenges.

FIGURE 1-1 Organization of the Book

In organizations, however, strategies are being formulated, implemented, and controlled simultaneously while external and internal factors are being assessed and reassessed. In addition, changes in one stage of the strategic management process will inevitably affect other stages as well. After a planned strategy is implemented, for example, it often requires modification as conditions change. Hence, because these steps are so tightly intertwined, *insiders* treat all of the steps as a single integrated, ongoing process.⁵

Consider the strategic management process at a fast-food restaurant chain. At any given time, top managers are likely assessing changes in consumer taste preferences and food preparation, analyzing the activities of competitors, working to overcome firm weaknesses, controlling remnants of a strategy implemented several years ago, implementing a strategy formulated several months ago, and formulating strategic plans for the future. Although each of these activities can

Business Model

The economic mechanism by which a business hopes to sell its goods or services and generate a profit.

be linked to a distinct stage in the strategic management process, they occur simultaneously.

An effective strategy is built on the foundation of the organization's **business model**, the mechanism whereby the organization seeks to earn a profit by selling its goods. In a general sense, all firms seek to produce a product or service and sell it at a price higher than its production and overhead costs, thereby generating a profit. A business model is stated in greater detail, however. For example, a magazine publisher might adopt a "subscription model," an "advertising model," or perhaps some combination of the two. Profits would be generated primarily from readers in the former case whereas they would come primarily from advertisers in the latter case. Needless to say, identifying a firm's business model is rarely difficult at a basic level, but can become more complex when considering intricate details. Progressive firms often devise innovative business models that extract revenue—and ultimately profits—from sources not identified by competitors.

Developing a successful strategy for the firm is not an easy task. Realistically, a number of factors are typically associated with successful strategies, including the following:

1. Strategic managers thoroughly understand the competitive environment in which the organization competes.
2. Strategic managers understand the organization's resources and how they translate into strengths and weaknesses.
3. The strategy is consistent with the mission and goals of the organization.
4. Plans for putting the strategy into action are designed with specificity before it is implemented.
5. Possible future changes in the proposed strategy (i.e., strategic control) are evaluated before the strategy is adopted.

Careful consideration of these factors reinforces the interrelatedness of the steps in the strategic management process. Each factor is most closely associated with one of the five steps, yet they fit together like pieces of a puzzle. The details associated with the success factors—and others—will be discussed in greater detail in future chapters.

Top managers make effective strategic decisions when they remain informed of issues that affect their industries, as well as the business world in general. Information vital to effective strategic decision making can be found in a variety of publications. In addition to the business sections of most major newspapers, publications such as *Fortune*, *Business Week*, *Industry Standard*, *Strategy+Business*, and *Wall Street Journal* report on a wide variety of strategic management topics (see Table 1-1). Not only are these concepts of interest to top managers, but they are also a concern for employees, supervisors, and middle managers of all organizations. An appreciation of the organization's strategy helps all of its members relate their work assignments more closely to the direction of the organization.

Strategic management is not limited to for-profit organizations. Top managers of any organization, regardless of profit or nonprofit status, must understand the organization's environment and its capabilities and develop strategies to assist the enterprise in attaining its goals. Drexel University President Constantine Papadakis, for example, is widely considered to be a leading strategic thinker among university top executives. The innovative Greek immigrant promotes Drexel through aggressive marketing, while campaigning for an all-digital library without books. In many respects, he manages the university in the same way that other executives manage profit-seeking enterprises. Interestingly, his salary in 2005 was about \$900,000 per year—not including

TABLE 1-1 Select Online Sources of Business Strategy News

Publication	Contact Information
<i>Business Week</i>	www.businessweek.com
<i>E-Commerce Times</i>	www.ecommercetimes.com
<i>Economist</i>	www.economist.com (payment required for full access)
<i>Fast Company</i>	www.fastcompany.com
<i>Forbes</i>	www.forbes.com
<i>Fortune</i>	www.fortune.com
<i>Industry Standard</i>	www.thestandard.com (e-commerce)
<i>Strategy+Business</i>	www.strategy-business.com (payment required for full access)
<i>Wall Street Journal</i>	http://wsj.com (payment required for full access)

income from outside sources—making him one of the highest paid university presidents in the country.⁶

1-1a Intended and Realized Strategies

A critical challenge facing organizations is the reality that strategies are not always implemented as originally planned. Henry Mintzberg introduced two terms to help clarify the shift that often occurs between the time a strategy is formulated and the time it is implemented. An **intended strategy**, that which management originally planned, may be realized just as it was planned, in a modified form, or even in an entirely different form. Occasionally, the strategy that management intends is actually realized, but the intended strategy and the **realized strategy**, which is what management actually implements, usually differ.⁷ Hence, the original strategy may be realized with desirable or undesirable results, or it may be modified as changes in the firm or the environment become known.

The gap between the intended and realized strategies usually results from unforeseen environmental or organizational events, better information that was not available when the strategy was formulated, or an improvement in top management's ability to assess its environment. Although it is important for managers to formulate responsible strategies based on a realistic and thorough assessment of the firm and its environment, things invariably change along the way. Hence, it is common for such a gap to exist, creating the need for constant strategic action if a firm is to stay on course. Instead of resisting modest strategic changes when new information is discovered, managers should search for new information and be willing to make such changes when necessary. This activity is part of strategic control, the final step in the strategic management process.

Intended Strategy

The original strategy top management plans and intends to implement.

Realized Strategy

The strategy top management actually implements.

1-1b Scientific and Artistic Perspectives on Strategic Management

Top executives should take one of two different perspectives on the approach to strategic management. Most strategy scholars have endorsed a *scientific perspective*, whereby strategic managers are encouraged to systematically assess the firm's external environment and evaluate the pros and cons of myriad alternatives before formulating strategy. The business environment is seen as largely objective, analyzable, and at least somewhat predictable. As such, strategic managers should follow a systematic process of environmental, competitive, and internal analysis and build the organization's strategy on this foundation.

According to this perspective, strategic managers should be trained, highly skilled analytical thinkers capable of digesting a myriad of objective data and

translating it into a desired direction for the firm. “Strategy scientists” tend to minimize or reject altogether the role of imagination and creativity in the strategy process, and are not generally receptive to alternatives that emerge from any process other than a comprehensive, analytical approach.

Others, however, have a different view. According to the *artistic perspective* on strategy, the lack of environmental predictability and the fast pace of change render elaborate strategy planning as suspect at best. Instead, strategists should incorporate large doses of creativity and intuition in order to design a comprehensive strategy for the firm.⁸ Mintzberg’s notion of a craftsman—encompassing individual skill, dedication, and perfection through mastery of detail—embodies the artistic model. The strategy artist senses the state of the organization, interprets its subtleties, and seeks to mold its strategy like a potter molds clay. The artist visualizes the outcomes associated with various alternatives and ultimately charts a course based on holistic thinking, intuition, and imagination.⁹ “Strategy artists” may even view strategic planning exercises as time poorly spent and may not be as likely as those in the science school to make the effort necessary to maximize the value of a formal planning process.¹⁰

This text acknowledges the validity of the artistic perspective but emphasizes the scientific view. Creativity and innovation are important and encouraged, but are most likely to translate into organizational success when they occur as part of a comprehensive approach to strategic management. Nonetheless, the type of formal, systematic strategic planning proposed in this text is not without its critics. Some charge that such models are too complex to apply, or that they apply only to businesses in highly certain environments.¹¹ Others emphasize that the stages in the process are so closely interrelated and that considering them as independent steps may be counterproductive. Still others, such as Mintzberg, argue that planning models stifle the creativity and imagination that is central to formulating an effective strategy.¹² Although these views have merit, the comprehensive, systematic model proposed herein is presented as a proper foundation for understanding the strategic management process. It does not, however, preclude the application of other approaches.

1-2 Influence on Strategic Management

The roots of the strategic management field can be traced to the 1950s when the discipline was originally called “business policy.” Today, strategic management is an eclectic field, drawing upon a variety of theoretical frameworks. Three prominent perspectives are summarized in Table 1-2 and discussed in this section.

TABLE 1-2 Theoretical Perspectives on Firm Performance

Theoretical Perspective	Primary Influence on Firm Performance	How Perspective Is Applied to the Case Analysis
Industrial organization (IO) theory	Structure of the industry	Industry analysis portion of the external environment
Resource-based theory	Firm’s unique combination of strategic resources	Analysis of internal strengths and weaknesses
Contingency theory	Fit between the firm and its external environment	Strengths, weaknesses, opportunities, and threats (SWOT) analysis and SW/OT matrix

Industrial organization (IO), a branch of microeconomics, emphasizes the *influence of the industry environment* upon the firm. The central tenet of industrial organization theory is the notion that a firm must adapt to influences in its industry to survive and prosper; thus, its financial performance is primarily determined by the success of the industry in which it competes. Industries with favorable structures offer the greatest opportunity for firm profitability.¹³ Following this perspective, it is more important for a firm to choose the correct industry within which to compete than to determine *how* to compete within a given industry. Recent research has supported the notion that industry factors tend to play a dominant role in the performance of most firms, except for those that are the notable industry leaders or losers.¹⁴

IO assumes that an organization's performance and ultimate survival depend on its ability to *adapt* to industry forces over which it has little or no control. According to IO, strategic managers should seek to understand the nature of the industry and formulate strategies that feed off the industry's characteristics.¹⁵ Because IO focuses on industry forces alone, strategies, resources, and competencies are assumed to be fairly similar among competitors within a given industry. If one firm deviates from the industry norm and implements a new, successful strategy, then other firms will rapidly mimic the higher performing firm by purchasing the resources, competencies, or management talent that have made the leading firm so profitable. Hence, although the IO perspective emphasizes the industry's influence on individual firms, it is also possible for firms to influence the strategy of rivals, and in some cases even modify the structure of the industry.¹⁶

Perhaps the opposite of the IO perspective, **resource-based theory** views performance primarily as a function of a firm's ability to utilize its resources.¹⁷ Although environmental opportunities and threats are important, a firm's unique resources comprise the key variables that allow it to develop a **distinctive competence**, enabling the firm to distinguish itself from its rivals and create competitive advantage. "Resources" include all of a firm's tangible and intangible assets, such as capital, equipment, employees, knowledge, and information.¹⁸ An organization's resources are directly linked to its capabilities, which can create value and ultimately lead to profitability for the firm. Hence, resource-based theory focuses primarily on individual firms rather than on the competitive environment.

If resources are to be used for **sustained competitive advantage**—a firm's ability to enjoy strategic benefits over an extended time—those resources must be valuable, rare, not subject to perfect imitation, and without strategically relevant substitutes.¹⁹ Valuable resources are those that contribute significantly to the firm's effectiveness and efficiency. Rare resources are possessed by only a few competitors, and imperfectly imitable resources cannot be fully duplicated by rivals. Resources that have no strategically relevant substitutes enable the firm to operate in a manner that cannot be effectively imitated by others, and thereby sustain high performance.

According to **contingency theory**, the most profitable firms are likely to be those that develop a *beneficial fit* with their environment. In other words, a strategy is most likely to be successful when it is consistent with the organization's mission, its competitive environment, and its resources. Contingency theory represents a *middle ground* perspective that views organizational performance as the joint outcome of environmental forces and the firm's strategic actions. Firms can become proactive by choosing to operate in environments where opportunities and threats match their strengths and weaknesses.²⁰ Should the industry environment change in a way that is unfavorable to the firm, its top managers should consider leaving that industry and reallocating its resources to other, more favorable industries.

Industrial Organization (IO)

A view based in micro-economic theory which states that firm profitability is most closely associated with industry structure.

Resource-Based Theory

The perspective that views performance primarily as a function of a firm's ability to utilize its resources.

Distinctive Competence

Unique resources, skills, and capabilities that enable a firm to distinguish itself from its competitors and create competitive advantage.

Sustained Competitive Advantage

A firm's ability to enjoy strategic benefits over time.

Contingency Theory

A view which states that the most profitable firms are likely to be the ones that develop the best fit with their environment.

Each of these three perspectives has merit and has been incorporated into the strategic management process laid out in this text. The industrial organization view is seen in the industry analysis phase, most directly in Michael Porter's "five forces" model. Resource-based theory is applied directly to the internal analysis phase and the effort to identify an organization's resources that could lead to sustained competitive advantage. Contingency theory is seen in the strategic alternative generation phase, where alternatives are developed to improve the organization's fit with its environment. Hence, multiple perspectives are critical to a holistic understanding of strategic management.²¹

1-3 Strategic Decisions

How does one think and act strategically, and who makes the decisions? The answers to these questions vary across firms and may also be influenced by factors such as industry, age of the firm, and size of the organization. In general, however, strategic decisions are marked by four key distinctions.

1. They are based on a systematic, comprehensive analysis of internal attributes and factors external to the organization. Decisions that address only part of the organization—perhaps a single functional area—are usually not considered to be strategic decisions.
2. They are long term and future oriented, but are built on knowledge about the past and present. Scholars and managers do not always agree on what constitutes the "long term," but most agree that it can range anywhere from several years in duration to more than a decade.
3. They seek to capitalize on favorable situations outside the organization. In general, this means taking advantage of opportunities that exist for the firm, but it also includes taking measures to minimize the effects of external threats.
4. They involve choices. Although making win-win strategic decisions may be possible, most involve some degree of trade-off between alternatives, at least in the short run. For example, raising salaries to retain a skilled workforce can increase wages, and adding product features or enhancing quality can increase the cost of production. Such trade-offs, however, may diminish in the long run, as a more skilled, higher paid workforce may be more productive than a typical workforce, and sales of a higher quality product may increase, thereby raising sales and potentially profits. Decision makers must understand these complex relationships across the business spectrum.



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Top Management Team

A team of top-level executives, headed by the CEO, all of whom play instrumental roles in the strategic management process.

Because of these distinctions, strategic decision making is generally reserved for the top executive and members of the **top management team**. The chief executive is the individual ultimately responsible (and generally *held* responsible) for the organization's strategic management, but this person rarely acts alone. Except in the smallest companies, the CEO relies on a *team* of top-level executives—including members of the board of directors, vice presidents, and various line and staff managers—all of whom play instrumental roles in strategically managing the firm. Generally speaking, the quality of strategic decisions improves dramatically when more than one capable executive participates in the process.²²

The size of the team on which the top executive relies for strategic input and support can vary from firm to firm. Companies organized around functions such as marketing and production generally involve the heads of the functional departments in strategic decisions. Very large organizations often employ corporate-level strategic planning staffs and outside consultants to assist top executives in the process. The degree of involvement of top and middle managers in the strategic management process also depends on the personal philosophy of the CEO.²³

Some chief executives are known for making quick decisions, whereas others have a reputation for involving a large number of top managers and others in the process.

Input to strategic decisions, however, need not be limited to members of the top management team. To the contrary, obtaining input from others throughout the organization, either directly or indirectly, can be quite beneficial. In fact, most strategic decisions result from the streams of inputs, decisions, and actions of many people. For example, an employee in a company's research and development department attends a trade show where vendors discuss a new product or production process idea that seems relevant to the company. The employee relates the idea to the next level manager who, in turn, modifies and passes it along to a higher level manager. Eventually, the organization's marketing and production managers discuss a version of the idea, and later present it to top management. The CEO ultimately decides to incorporate the idea into the ongoing strategic planning process. This example illustrates the indirect involvement of individuals throughout the organization in the strategic management process. Top management is ultimately responsible for the final decision, but this decision is based on a culmination of the ideas, creativity, information, and analyses of others²⁴ (see Strategy at Work 1-1).

Ethics and social responsibility are also key concerns in strategic decision making. Simply stated, the moral components and social outcomes associated with a strategic decision, such as the effects of closing an existing production facility in search of lower costs abroad, should be considered alongside economic concerns. These issues are discussed in greater detail in Chapters 6 through 9 under the umbrella of strategy formulation (see Case Analysis 1-1).



STRATEGY AT WORK 1 - 1

Strategic Decisions

Strategic decisions, by their nature, may be characterized by considerable risk and uncertainty. Unpredictable environmental changes can quickly threaten well-conceived plans. Most strategic decision makers clearly recognize this danger and learn to adapt. Here are two examples.

1. Like all air carriers, American Airlines faces a number of challenges: international terrorism, steadily rising costs, unstable national economies, uncertain volumes of domestic traffic, and protectionist threats to international traffic. In the face of these threats, CEO Robert Crandall suggests that senior managers rarely know the outcomes of these situations anyway and should be accustomed to dealing with the uncertainty associated with critical strategic decisions.
2. Bernard Food Industries Inc. is a fifty-three-year-old family-held business of more than 1,500 sugar-free, low-fat, and low-calorie food products. At first, the company sold most of its products to hospitals, nursing homes, and other such institutions. In 1996,

however, Steve Bernard, the founder's son, decided to expand the market. Although only a handful of companies were marketing such products at that time, Bernard viewed the Web as the future. The firm's online subsidiary, eDietShop (www.diet-shop.com) performed extremely well and quintupled retail sales in the first two years and has continued to grow, developing into one of its industry's leaders by the mid-2000s. As Bernard put it, "We didn't turn to the Web because other people were doing it but because we knew where we wanted our business to go."

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Case Analysis 1-1

Step 1: Introduction of the Organization

The first step in the case analysis process is to develop familiarity with the organization, a basic task not directly related to a specific theory or set of concepts presented in this chapter. Analyzing an ongoing enterprise begins with a general introduction and understanding of the company. When was the organization founded, why, and by whom? Is any unusual history associated with the organization? Is it privately or publicly held? What is the company's mission? Has the mission changed since its inception?

It is also important at this point to identify the business model on which the organization's success is predicated. In other words, what is the basic profit-generating idea behind the company? Determining this information is simple for some companies (Ford, for example, hopes to sell cars and offer consumer financing at a profit) but may be complicated for others where revenue streams and competitive advantage are more difficult to identify.

1-4 Summary

Top managers face more complex strategic challenges today than ever before. Strategic management involves analysis of an organization's external and internal environments, formulation and implementation of its strategic plan, and strategic control. These steps in the process are interrelated and typically done simultaneously in many firms.

A firm's intended strategy often requires modification before it has been fully implemented due to changes in environmental and/or organizational conditions. Because these changes are often difficult to predict, substantial changes in the environment may transform an organization's realized strategy into one that is quite different from its intended strategy.

The strategic management field has been influenced by such perspectives as industrial organization theory, resource-based theory, and contingency theory. Although they are based on widely varied assumptions about what leads to high performance, each of these perspectives has merit and contributes to an overall understanding of the field.

Strategy formulation is the direct responsibility of the CEO, who also relies on a team of other individuals, including the board of directors, vice presidents, and various managers. In its final form, a strategic decision is crafted from the streams of inputs, decisions, and actions of the entire top management team.

Key Terms

business model
competitive advantage
contingency theory
distinctive competence

industrial organization
intended strategy
realized strategy
resource-based theory

strategic management
strategy
sustained competitive advantage
top management team

Review Questions and Exercises

1. Is it necessary that the five steps in the strategic management process be performed sequentially? Why or why not?
2. What is the difference between an intended strategy and a realized strategy? Why is this distinction important?
3. How have outside perspectives influenced the development of the strategic management field?
4. Does the CEO *alone* make the strategic decisions for an organization? Explain.

Practice Quiz

True or False

1. A strategy seeks to develop and sustain competitive advantage.
2. Strategic management refers to formulating successful strategies for an organization.
3. Each step in the strategic management process is independent so that changes in one step will not substantially affect other steps.
4. The intended strategy and the realized strategy can never be the same.
5. Whereas industrial organization theory emphasizes the influence of industry factors of firm performance, resource-based theory emphasizes the role of firm factors.
6. Strategic decisions are made solely by and are ultimately the responsibility of the chief executive alone.

Multiple Choice

7. Strategies are formulated in the strategic management stage that occurs immediately after
 - A. the assessment of internal strengths and weaknesses.
 - B. implementation of the strategy.
 - C. control of the strategy.
 - D. none of the above
8. The strategy originally planned by top management is called the
 - A. grand strategy.
 - B. realized strategy.
 - C. emergent strategy.
 - D. none of the above

9. The notion that successful firms tend to be the ones that adapt to influences in their industries is based on
 - A. industrial organization theory.
 - B. resource-based theory.
 - C. contingency theory.
 - D. none of the above
10. The notion of distinctive competence is consistent with
 - A. industrial organization theory.
 - B. resource-based theory.
 - C. contingency theory.
 - D. none of the above
11. In order to contribute to sustained competitive advantage, firm resources should be
 - A. valuable and rare.
 - B. not subject to perfect imitation.
 - C. without strategically relevant resources.
 - D. all of the above.
12. Which of the following is not a characteristic of strategic decisions?
 - A. They are long term in nature.
 - B. They involve choices.
 - C. They do not involve trade-offs.
 - D. All of the above are characteristics of strategic decisions.

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READING 1 - 1

Insight from *strategy+business*

Southwest Airline's Herb Kelleher is widely viewed as an effective organizational leader and strategic thinker. Under his leadership, the low-cost airline recorded thirty consecutive years of profits, a feat unmatched in the industry. Kelleher provides insight into his philosophy and perspectives on strategy and success in this chapter's strategy+business reading.

Herb Kelleher: The Thought Leader Interview

The cofounder and chairman of Southwest Airlines tells why a firm's people are everything.

By Chuck Lucier

The airline industry is a tough place to make a buck: too many competitors, price-sensitive customers, high capital intensity, boom-or-bust cyclicalities, powerful suppliers, and often intransigent unions. Nevertheless, Herb Kelleher, the cofounder and chairman of Southwest Airlines, created the sort of value that any company leader would envy.

From its start in 1971, Southwest has grown into the fourth-largest airline in the United States, with 30 consecutive years of profitability, in an industry in which no other company has been profitable for even five straight years. Total shareholder returns during that period were almost double the returns for the S&P 500. Southwest has managed to accrue a market capitalization larger than that of the rest of the American airlines combined. Major competitors have tried to imitate Southwest with clones. Many entrepreneurial startups in the United States and Europe, including JetBlue and Ryanair, cite Southwest as their inspiration.

Southwest's achievements are widely attributed to its relentless focus. From the start, Southwest's strategy has been to draw travelers not from other airlines, but from cars, buses, and trains, by providing them the least expensive and fastest service available. To support the strategy, the company determined to fly only one type of airplane, the Boeing 737, and to substitute linear flying for the hub-and-spoke model that has prevailed in the industry. But at the center of Southwest's success are its culture and employees. "Your spirit," says Mr. Kelleher, a man fabled for his willingness to party hard with his staff, is "the most powerful thing of all."

In recognition of the inspiration he provides all who study and practice strategy, for his contributions in redefining

how companies think about strategy, and for his achievements in redefining an industry, in November 2003 Mr. Kelleher was granted the Lifetime Achievement Award by the Strategic Management Society (SMS), the prestigious global association of academic and corporate strategists.

At the SMS annual meeting in Baltimore, Md., where Mr. Kelleher accepted the award, *strategy+ business* contributing editor and "Breakthrough Thoughts" co-columnist Chuck Lucier led a spirited public conversation with Mr. Kelleher about Southwest's success.

S+B: Let's start with some words from your award. You made an "audacious commitment" to putting employees first, customers second, and shareholders third. How did you get away with that for 20 years?

KELLEHER: When I started out, business school professors liked to pose a conundrum: Which do you put first, your employees, your customers, or your shareholders? As if that were an unanswerable question. My answer was very easy: You put your employees first. If you truly treat your employees that way, they will treat your customers well, your customers will come back, and that's what makes your shareholders happy. So there is no constituency at war with any other constituency. Ultimately, it's shareholder value that you're producing.

S+B: A dollar invested at Southwest's 1972 initial public offering is worth \$1,400 today. Does that come solely from putting your employees first?

KELLEHER: We have been successful because we've had a simple strategy. Our people have bought into it.

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Our people fully understand it. We have had to have extreme discipline in not departing from the strategy.

We basically said to our people, there are three things that we're interested in. The lowest costs in the industry – that can't hurt you, having the lowest costs. The best customer service – that's a very important element of value. We said beyond that we're interested in intangibles – a spiritual infusion – because they are the hardest things for your competitors to replicate. The tangible things your competitors can go out and buy. But they can't buy your spirit. So it's the most powerful thing of all.

S+B: Not to deny the importance of intangibles, but what's the source of Southwest's cost advantage?

KELLEHER: The cost advantage is very important because we started out with a philosophy that we were going to charge low fares, come hell or high water. We were going to enable more people to fly. It didn't matter whether we had competition or not. In other words, we just said we're a different type of cat. When we get a load factor that gets into the 70 or 75 percent range over an appreciable period of time, we don't increase fares. We add flights and put additional seats in. So if you come from that basic position, that this is what you are, then of course you have to have low costs.

Now, how do you get low costs? Through a lot of things, including the inspiration that you give your people, their productivity, the fact that they feel that they're doing something that is really significant and that they enjoy. If you take all of Southwest's compensation together – wage rates, profit sharing, the full 401(k) match, the stock options that our people have – Southwest employees are the most highly compensated people in the airline industry. One of our pilots just retired with \$8 million in his profit-sharing account. Now, you have to do well to produce that.

Meeting Life's Needs

S+B: A compensation scheme based on stock is great when the company is doing well. But when the stock doesn't do well, you can have a motivation problem.

KELLEHER: Absolutely, that is a risk. So we don't just give people stock options. We have an educational team that goes around and explains to them what stock options are, how they work, the fact that it's a longer-term investment. From 1990 to 1994, the airline industry as a whole lost \$13 billion. Southwest Airlines was profitable during that entire time, but our stock was

battered. Eighty-four percent of our employees continued with Southwest Airlines stock during that four-year period. That's the kind of confidence and faith that you have to engender, so people have a longer-term view, and they're not trying to outplay the market every day.

S+B: Virtually all of the major U.S. airlines have tried to copy you at some point. None of them has come remotely close. What's so hard? It looks like it ought to be a pretty simple model.

KELLEHER: We've had many airlines that professed that they were going to be low-fare carriers. There's only one problem: They had high costs. You can do that, but Chapter 11 is your destiny.

I think the difficulty for them is the cultural aspect of it. That cannot be duplicated. One of the things that demonstrates the power of people is when the United Shuttle took out after us in Oakland. They had all the advantages. I mean, they had first-class seats for those who don't want to fly anything but first class. They had a global frequent flyer program, which we did not have. They probably spent \$25 million or \$30 million on their advertising campaign. I probably have something like a thousand letters at my office that tell you why they finally receded from Oakland. Those letters say, "Herb, I tried them, but I just like your people more, so I'm back." Don't ever doubt, in the customer service business, the importance of people and their attitudes.

S+B: So now we're back to the intangibles – the "spirit" competitors can't go buy. How does a company create a culture like that?

KELLEHER: We used to have a corporate day. Companies would come in from around the world and they were interested in how we hired, trained, that sort of thing. Then we'd say, "Treat your people well and they'll treat you well," and then they'd go home disappointed. It was too simple.

S+B: Or too hard.

KELLEHER: Or too hard – because it's a vast mosaic with thousands of little pieces that you have to keep putting in place every day. It's not a programmatic thing. It can't be. It has to come from the heart, not the head. If it's programmatic, everybody will know that and say, "Hell, they're not sincere; they don't really care, they're just telling us that they care." It has to be a continuous stream of one-on-one communication, not like you sit down and say, "Boy, communication is pretty important.

Let's really communicate for the next six months and then move on to what's really significant. It has to be part of your fabric; it has to be something that you do really as a product of your soul.

I'll give you an illustration of why this works, if I might. When the industry was deregulated. I sat down with our very, very creative advertising agency, GSD&M, from Austin. (We call them "Greed, Sex, Drugs, and Money.") They said, "Okay, now we have deregulation, Herb. Airlines can fly wherever they want to. What's different about Southwest Airlines?" I said, "Our people are different." That's where the "Spirit of Southwest" campaign was born. That could have been a huge risk because we were telling the world on television, radio, newspapers that our people are different and they're better and they're special and they welcome customers. We ran that campaign for probably six or seven years and never had anybody write in and say, "You're wrong. Your people are not special." Which I think demonstrates that they are.

S+B: Is that why Southwest flight attendants sing?

KELLEHER: Southwest flight attendants sing because they want to. We don't program our flight attendant training to teach people to sing or tell jokes. What we say is, "If that is your basic personality, feel free to go ahead and do it." We're not trying to train you to be anything different from what you really are. If singing buoys up your heart, makes you feel good, go ahead and do it. We have tried to say to our people, "You don't have to put on a mask, you don't have to be an automaton when you come to work. You can just be yourself" Wasn't it Robert Frost who said, "Isn't it a shame that people's minds work furiously until they get to work?" Well, that's because they feel that they become artificial and constrained by the workplace.

S+B: One of your values in the mission statement is humility as a corporation. With all of your wonderful results, is Southwest really humble?

KELLEHER: No question. I constantly have warned our people over the years that, as we became bigger and more successful, our primary potential enemy was ourselves, not our competitors. Getting cocky, getting complacent, thinking that the world was our oyster, disregarding our competitors, both new and old. I think humility is very important in keeping your eye on the carrot, keeping focused outwardly instead of inwardly,

and knowing when you have to change. An investor in the airline industry some years ago that I was talking to said, "Southwest Airlines is the most humble and disciplined airline that I deal with." I said, "The two go together."

S+B: Why do they go together?

KELLEHER: Because you can't really be disciplined in what you do unless you are humble and open-minded. Humility breeds open-mindedness – and really, what we try to do is establish a clear and simple set of values that we understand. That simplifies things; that expedites things. It enables the extreme discipline I mentioned in describing our strategy. When an issue comes up, we don't say we're going to study it for two and a half years. We just say, "Southwest Airlines doesn't do that. Maybe somebody else does, but we don't." It greatly facilitates the operation of the company.

For example, we bought Morris Air. They were a Salt Lake City carrier with only about 14 or 16 airplanes. We were much larger. When we paid a visit to their headquarters, I told our people, "When you get there, shut up. You can ask questions. But you cannot lecture. You cannot tell people the way they ought to do things. You know why? Because we're on a learning expedition. Let the Morris Air people tell us. They're new, they're young, they're fresh, they're untrammelled. Let them tell us the ideas that they have." And we got some fabulous ideas as a consequence of it, and basically *that's* the value of humility.

Growth and Change

S+B: You've grown from a few people to more than 34,000. How much did growth change the way you manage Southwest?

KELLEHER: It didn't really. Your tactics change, but your basic strategy does not. Our mission statement is eternal. Our mission statement deals solely with people. That never changes – in any way, shape, or form. The focus of Southwest Airlines has always been on its people, regardless of how large we grew. Everybody would keep saying to me, "Wait until you get to a thousand, wait until you get to 5,000, wait until you get to 10,000" – as if there was some bright line when you go over from the humanistic and entrepreneurial into the totally managerial. There is no such line in dealing with your people. Making them happy with what they're doing, making them proud of what they're doing, putting them in a position where they're telling their grandchildren

that Southwest Airlines gave me a greater reach than I ever would have had by myself – that continues to be effective whether you've got 5,000, 15,000, or 35,000.

One of the things that we do is continue to emphasize that we value our people as people, not just as workers. Any event that you have in your life that is celebratory in nature or brings grief you hear from Southwest Airlines. If you lose a relative, you hear from us. If you're out sick with a serious illness, you hear from us, and I mean by telephone, by letter, by remembrances from us. If you have a baby, you hear from us. What we're trying to say to our people is, "Hey, wait a second, we value you as a total person, not just between eight and five."

S+B: A lot of things are changing in the industry that might undermine the strategy you have followed for a long time. For example, you're doing transcontinental flights. Does that require big changes in what you do?

KELLEHER: No. I'll tell you, that was an interesting exercise because basically we've always tried to be empiricists and not theorize about what people want. When we started flying longer haul, even our own people would say, "Herb, you've got to have meals." We've got to do this and we've got to do that. I said, "I'm not sure, but let's just start flying and see." Well, here are these people from Nashville who want to fly to Los Angeles. It costs them \$1,200 less round trip, which gives them a lot of money to buy a dinner at Chasen's, and they save two hours of their time because they don't go through a hub. You think they care whether we have airline meals?

That's another thing that we tried to do over the years: ready, fire, aim. In our business, where capital assets travel at over 500 miles an hour, you don't have a lot of time to fool around with aiming, because by the time you're finished aiming, somebody else will already be there. So get out there, do it, and clean up the mistakes afterward.

S+B: You're being honored today as a "lifetime strategist." Did you have a vision for the whole thing? Thirty-five years ago, did you write, "We're going to become the largest airline with the lowest cost"?

KELLEHER: Oh, no. We didn't write it down because when you write things down you confine yourself. That's why we have never used the fancy titles for empowerment, total quality, etc. Every time you talk jargon you

find that people assume that they have the same thing in mind when they really don't. We don't apply labels to things because they prevent you from thinking expansively.

Basically what we said 35 years ago was that Texas was captive: Braniff had a monopoly among the larger cities; Trans Texas had a monopoly among the smaller cities. The fares were very high. Because the short-haul passenger was merely an addendum to long-haul service, the short-haul passenger was being totally neglected. In other words, flights from San Antonio to Dallas were scheduled in terms of what your arrival was in Seattle or Paris. It looked like an opportunity to do something a lot better: provide higher-quality air service at lower fares.

One of the things that people, I think, didn't understand is that we started out saying we're going to give you more for less, not less for less. We're going to give you new airplanes, not old airplanes. We're going to give you the best on-time performance. We're going to give you the people who are most hospitable.

We've never done the long-range planning that is customary in many businesses. When planning became big in the airline community, one of the analysts came up to me and said, "Herb, I understand you don't have a plan." I said that we have the most unusual plan in the industry: Doing things. That's our plan. What we do by way of strategic planning is we define ourselves and then we redefine ourselves.

S+B: There's a big market opportunity in Europe. Haven't you missed the boat there?

KELLEHER: It wasn't a boat that we ever wanted to get on. It's just way beyond our competence. International service has lots of complications. You're dealing with different cultures. You're dealing with currency exchanges. Compared with going into Raleigh-Durham and operating at 84.3 percent load factor on opening day, it's much more complex. We would have to vary our fleet.

We have had most of the European carriers coming to Southwest Airlines and saying, "We have to be competitive for the first time in a long time. What should we do?" We said, "First of all, find out what your customers want. Basically, you have dictated to your customers. Would they prefer to give up the babysitting service in Frankfurt in order to get a \$15 reduction in fares?" The startups in Europe like Ryanair also asked our opinion about what they could do and how they could do it.

It was interesting because 15 or 20 years ago there was the assumption that Southwest Airlines

could succeed with things in the United States that Europeans would not accept in Europe. I said that's exactly what everybody told me when Southwest started: that people in the U.S. would not accept it. Well, you have to educate people as to the value of what you're providing. Obviously Ryanair and easyJet are very successful. I think you'll see more and more of that kind of activity not only on the continent but also in Central America, South America, and Asia.

Boards and CEOs

S+B: I'd like to get your views on some cross-industry issues. How much has the CEO's job changed in the last 20 years? How much do you think it will change in the future?

KELLEHER: I think the CEO's job has changed a lot in the last 20 years. I don't say that it's necessarily for the better or the worse, but there has been a significant change. I think that CEOs of substantial companies have now become public figures, whether they want to be or not. You might as well acknowledge that. With all the media coverage of companies, you're going to be in the limelight. You're going to have to be able to respond to the media. You're going to have to be able to address the public. That's different.

Also, of course, as we've gotten more complex in America, we have become more regulated. So you spend a lot more of your time dealing with various governmental agencies than you did in the past. When I started practicing law, I would estimate that 5 percent of our total practice involved some kind of interface with the government in one of its myriad forms – local, state, or national. When I stopped practicing law, it was about 60 percent. I think that's just a manifestation of what's happened in business – that the regulatory aspects of it are now much more important than they used to be, and you have to know how to deal with those because that is a fact of life.

S+B: What about the relationship with the board? With changes in governance, Sarbanes-Oxley, and so forth, how is that going to shift?

KELLEHER: That's not really a problem. If you were running your company right, if you weren't trying to deceive someone, if you were basically making judgments that were intended to tell the public as closely as you could exactly what your earnings were, then Sarbanes-Oxley and the New York Stock Exchange regulations are just minor addenda to what you're already doing. It may take

you a little more time. It may cost you a little more money to comply. But it's not unduly burdensome.

The primary thing I'm concerned about is that the new compliance focus distracts your board of directors, and this is relatively new. When you see that your board is now spending three hours focusing on regulatory issues and a half hour on the company's business and what it plans to do, you have the feeling that perhaps it's taking people away from focusing on results and achievement, at least on an interim basis.

Another thing that concerns me is the impact on internal controls. I've asked several heads of big accounting concerns, "What's going to be your criteria of what's material and immaterial?" Business judgment has to enter into it. Years ago, our internal audit department concluded that some passengers were defrauding us. So audit went out and bought a \$300,000 system and hired two people to operate and maintain it. So I asked them, "How much are we losing here?" They said \$18,000. I said, "Let them steal \$18,000. We're spending \$65,000 a year to keep people from stealing \$18,000."

It reminds me of a fellow who owned a chain of theaters in Texas. He had a manager of 17 years standing, and went in and fired him one day. The guy says, "After 17 years and this enormous success that we have had, how can you fire me?" The owner said, "Well, for the first 15 years you were stealing \$800 a month, and you were worth that. But lately you've been stealing \$1,200 a month, and you're not worth that." So I hope we don't just surrender business judgment and say that every little thing that goes awry from the accounting standpoint is as important as every other thing that might go awry. That concerns me a little bit.

S+B: I think boards play two very different roles. On the one hand, they play the role of cop: "Boy, this thing is out of control, it's not working very well. We need to find a new CEO." On the other hand, they help management by offering advice and counsel and by playing a sounding-board role. Are we in danger of losing the sounding-board role?

KELLEHER: I'm concerned about that. It's not that I rebel against any of the changes that have been made, because I think in and of themselves they are salutary and not particularly burdensome. But I am a little bit worried about the psychological reaction to them. I was talking to a CEO in Dallas probably a month ago and he said, "I formulated a new strategic paper. It proposes that

my company go into another business. I've been trying to present it to the board during the last two meetings, but we were so preoccupied with compliance issues and fear of noncompliance that I haven't been able to present it to the board."

Training Entrepreneurs

S+B: You funded the Herb Kelleher Center for Entrepreneurship at the University of Texas. Why?

KELLEHER: Because I think it's very important to Texas and to our country that we preserve our entrepreneurial spirit. As you get bigger and things get more complex, I think there is more of a tendency to get mired in the details, to get mired in the bureaucratic aspects of things and the hierarchical aspects of things. One of the things I always tried to do was to keep the entrepreneurial spirit alive at Southwest Airlines, even as we grew bigger and more complex. That's where the job creation is coming from. It's from the small businesses, not big businesses.

S+B: What would you like business schools to be doing better?

KELLEHER: By and large, our business schools, at least in the United States, are doing a far better job today than perhaps they were doing 30 years ago. Now, business schools are actually talking about entrepreneurship, perhaps kindling that spark in their students. They're

focusing more on dealing with employees and how you achieve good relationships with your employees. They teach more about customer service and how to do customer service. They've gotten away from pure financial analysis and planning, to some extent, which I think is very important if you're going to have a well-rounded CEO.

S+B: What advice would you give brand-new CEOs if they wanted to have the kind of success you've had?

KELLEHER: First of all, they have to focus intently upon what's important and what's unimportant, not be trapped in bureaucracy and hierarchy. Be results- and mission-oriented. Keep it as simple as they possibly can, so that the values and the destination of the organization are well understood by all the people that are part of it so that they can feel that they are truly participants in it. I don't know whether it was Calvin Coolidge or Bianca Jagger who said – they're both thin, that's why I get them confused – "the business of business is business." We've always said, "The business of business is people."

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The Strategy Landscape

2

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The world is flat. *New York Times* foreign affairs correspondent Thomas Friedman's 2005 bestseller presents his spin on a phenomenon that has changed the world forever: globalization. In *The World Is Flat*, Friedman argues that the period of American world economic domination has ended because changes during the last two decades have leveled or "flattened" the economic playing field for those in other countries, most notably India and China.¹

The dot-com boom and subsequent bust around the turn of the century contributed significantly to the emergence of Friedman's "flat world." During the bubble, telecommunications companies were replete with cash and invested hundreds of millions of dollars to lay fiber-optic cables across the ocean floors, cables that currently and inexpensively connect countries such as India and China to the United States. The dot-com bust resulted in significant stock market losses, forcing companies to cut spending wherever possible. Hence, many turned to opportunities for cost-cutting created by the fiber-optic cables and began to offshore jobs as a means of addressing a new economic reality. As Indian entrepreneur Jerry Rao explained, any work that can be digitized and moved from one location to another will be moved. Indeed, approximately half a million U.S. Internal Revenue Service (IRS) tax returns are actually completed by accountants in India each year.²

The notion of a level economic playing field creates a number of challenges for Western firms and societies, one of which is the debate over free trade. Supporters contend that a flatter world is here to stay and that efforts to thwart it will only stifle growth in economic powers such as the United States, an argument Friedman echoes. Proponents charge that the unbridled global trade drives down wages and will ultimately result in a reduced standard of living in developed nations.

One thing is clear. The effects of globalization have altered the world in dramatic ways over the past two decades, and these effects are especially clear in the business world. From a strategic management perspective, many traditional approaches to managing a firm remain valid, but must be considered in light of these changes. This chapter highlights key trends that have altered how progressive firms today should be managed.

2-1 Outsourcing and Offshoring

Outsourcing
Contracting out a firm's noncore, nonrevenue-producing activities to other organizations primarily (but not always) to reduce costs.

Outsourcing involves contracting out a firm's noncore, nonrevenue-producing activities to other organizations primarily (but not always) to reduce costs. This method has become more widespread in the United States in recent years. Many consumers and activists have become increasingly concerned about trade deficits with other nations and job losses that occur when a firm moves a production facility abroad or a retailer stocks its shelves with imported products.³ A number of American firms have closed production facilities in the United States and opened new ones in Mexico, China, India, and other countries where labor costs are substantially lower and regulations are less inhibitive.⁴

The facts are compelling. The U.S. trade deficit grew 6.5 percent to \$763 billion in 2006, with China responsible for \$233 billion of the gap.⁵ Chinese firms export large quantities of everything from apparel to electronics to the United States. When world garment quotas expired in 2005, China's lead in apparel exports increased even further.⁶ Hence, outsourcing—specifically to China—is a sensitive issue among a number of politicians and business leaders.

Another key beneficiary of the outsourcing trend is India. General Electric's Jack Welch was instrumental in one of the earliest partnerships with India. Welch first met with the Indian government in 1989, and GE formed a joint venture to

develop and market medical equipment with Wipro Ltd. in 1990. By the mid-1990s, much of GE's software development and maintenance activities had been shifted to Indian companies. GE Capital Services (Gecis) established the first international call center in India in 1999. GE sold 60 percent of Gecis for \$500 million in 2004, freeing it to compete against IBM, Accenture, and Indian firms.⁷ In 2005, India received more than \$17 billion from foreign corporations outsourcing a variety of jobs to the emerging Asian country.⁸

Some analysts suggest that wage differences between the United States and countries such as China and India could spark increased global outsourcing in a broad array of professional and technical fields, such as architecture, accounting, and even law.⁹ The outsourcing of legal jobs from the United States—especially to India—has also risen in recent years and approached thirty thousand jobs abroad in 2007. The argument is simple. According to one analyst, developing a particular legal database for contracts might cost about \$60,000 in the United States, compared to only \$5,000 in India.¹⁰

Chinese firms have begun to compete for many of the IT outsourcing contracts that U.S. firms originally awarded to companies in India. Consulting firm A. T. Kearney still ranks India highest among outsourcing countries based on financial structure, business environment, and people skills and availability. India is followed by China, Malaysia, and the Czech Republic. However, Kearney believes China can catch India as it improves its accounting, financial, and IT skills, but probably not until the early 2010s.¹¹

Although outsourcing offers opportunities for firms throughout the world, it presents challenges as well. Consider the automobile industry in China. In 2005, Daimler-Chrysler and Honda launched an effort to build inexpensive cars in China and export them to parts of the developed world, including the United States.¹² In 2006, General Motors unveiled the Cadillac SLS in Beijing in an effort to capitalize on a luxury car market in China that skyrocketed from about 10,000 cars in 2004 to about 125,000 in 2007.¹³ However, beneficiaries of American outsourcing efforts are experiencing some difficulties as well. As sales of cars in China skyrocketed in the past decade, Chinese automobile manufacturers began to experience many of the problems common to producers in other parts of the world: excess capacity, intense price competition, and declining profits.

When implemented properly, outsourcing can cut costs, improve performance, and refocus the core business. Many outsourcing efforts fail, however, due to unforeseen hidden costs, loss of control of the outsourced activity, or simply outsourcing activities that should not be outsourced.¹⁴ For example, Cincinnati's Standard Textile experienced a number of problems when it opened its first factory in northern China in 2005. The heating did not work for two weeks, causing more than an inconvenience for workers whose job is to separate thousands of fine cotton threads. Custom-made parts ordered from Chinese suppliers did not meet specifications. Early on, Chinese authorities hiked electric charges for the plant by 18 percent.¹⁵

Cost savings aside, excessive outsourcing can leave a firm in a compromised position. When an organization no longer performs key activities, it loses expertise and can find itself at the mercy of suppliers. When a company's resource strengths erode, the available array of strategic options becomes much more limited. Reevaluating suppliers and changing them when necessary is a proactive means of managing this downside.¹⁶

Politicians have also kept a careful watch on outsourcing trends. Growing concern in the 2000s over the flood of inexpensive textile products from China resulted in agreements in 2005 and 2006 to curb exports to Europe and the

Offshoring
Relocating some or all of a firm's manufacturing or other business processes to another country, typically to reduce costs.

United States. In response, the Chinese government offered preferential treatment to firms producing higher priced items when calculating the volume of their exports, thereby encouraging them to develop and produce higher quality, premium products.¹⁷

Offshoring means relocating some or all of a firm's manufacturing or other business processes to another country, typically to reduce costs. This method is similar to outsourcing, but enables the firm to retain control of the operations abroad instead of relinquishing them to other firms. A key incentive for outsourcing and offshoring—cost containment—is the same, however.

The globalization effect that has fostered an increase in outsourcing and offshoring has also had other effects that are not as easy to identify. As Ford and General Motors eliminated jobs in Detroit in the mid-2000s and continued production overseas, Asian manufacturers and their top-tier suppliers were expanding operations in the United States, particularly in the South. In 2003, for example, Toyota affiliate Denso Corporation opened a new auto air-conditioning plant in rural Osceola, Arkansas—a town of nine thousand that had suffered greatly from the outsourcing of textile jobs in the previous decade. Hence, Asian company success in the United States can bode well for local suppliers, especially when shipping components in from abroad can be too costly.¹⁸

Interestingly, Ford's recent "Red, White, and Bold" advertising campaign encouraged Americans to be patriotic and purchase a Ford Mustang instead of an "imported" vehicle. However, 2006 data from the U.S. National Highway Traffic Safety Administration showed that only 65 percent of the parts for the 2005 Mustang came from the United States or Canada, compared to 90 percent of the parts for the 2005 Toyota Sienna, a vehicle built in Indiana. Many vehicles produced by other Asian carmakers such as Honda and Nissan are also built in the United States with predominantly local parts.¹⁹ Hence, while outsourcing and offshoring remain vibrant topics in American political debates, it has become increasingly difficult to distinguish "local" products from "imported" ones.

Rising health care costs have created incentives for many firms to outsource or offshore their production, most notably in the United States where employers often pay a significant portion of employee health insurance premiums and where such costs are rising an average of 15 percent per year. Union Pacific, for example, has stopped hiring smokers in states where it is legal to do so. Publisher Gannett began adding fifty dollars to premiums of smokers who do not participate in a smoking cessation program. The issue became even more pronounced in late 2005 when a draft of an internal Wal-Mart memo proposed that the retailer cut costs by discouraging "unhealthy" people from applying for jobs. The memo proposed adding physical activity to all jobs—such as requiring cashiers to collect shopping carts—so that those not able to perform the tasks would be less likely to apply.²⁰

Health care costs at General Motors approached \$6 billion in 2005, prompting the giant automaker to consider asking its hourly employees to pay more of their own expenses, a move that always meets stiff resistance when union negotiations begin. Like many other firms, GM has broadened its efforts to encourage healthy living by discouraging unhealthy habits and adding gym facilities at some of its production plants.²¹ Hence, all firms—especially large ones based in the United States—are challenged to cover these expenses or consider shifting production to countries where costs are lower or health care is provided through government agencies.

The debate over outsourcing and offshoring is complex and can take on a new tack when companies outsource business activities that are politically sensitive or have safety concerns. In 2005, for example, JetBlue flew a number of its Airbus

A320 jets to El Salvador for maintenance. In the same year, about half of U.S. carrier heavy-overhaul work was performed outside of the United States.²² As emerging nations develop, however, their firms may find it useful to outsource certain activities to more developed nations. In 2004, for example, Indian telephone giant Bharti Tele-Ventures outsourced hundreds of millions of dollars of work to Western firms. Most of Bharti's information technology services, including billing and internal e-mail systems, were contracted to IBM.²³

Although conventional wisdom is that the wages of unskilled workers decline when firms pursue cheaper labor abroad, some have suggested that global outsourcing and offshoring can have a positive effect on both wages and economic development in the richer nation. According to economist Anthony Venables, an industry in a richer nation may rely on local inputs such as specialized workers that are not available to its competitors in new foreign markets. The proximity to these inputs can create a substantial advantage in the new market, boosting productivity throughout the industry and enabling the firms to pay higher wages.²⁴

The outsourcing/offshoring debate can also be difficult to resolve because of differences in regulatory environments and the complexity of relationships among firms across borders. A lack of data is also a key concern. Chinese officials, for example, compute trade deficits differently from their American counterparts and always calculate lower figures. In India, the number of information technology professionals who provide services to offshore customers rose from about 276,000 in 2002 to over 500,000 in 2004. Exports of private U.S. services to India are likely to reach \$10 billion by 2010. Hence, it is difficult to determine the extent to which such an exchange is beneficial to both nations from a trade perspective.²⁵

Some firms have attempted to avoid the outsourcing controversy, as is the case with the "Big Three" U.S. auto producers. Because union contracts prevent global outsourcing under certain conditions, the automakers simply pressure suppliers to outsource.²⁶ In addition, a number of firms have become more sensitive to this issue. In 2004, for example, E-Loan announced that customers would be given a choice about whether loan applications will be processed in Delhi or Dallas, with the latter taking as much as two days longer.²⁷

Interestingly, the assumption that outsourcing always refers to firms in developed nations seeking labor from emerging economies is not always true. Following the layoff of a large number of airline pilots in the mid-2000s, many American pilots departed U.S.-based carriers for airlines in China, India, Southeast Asia, and the Middle East. Pilots who faced a glut in the United States found a shortage of experienced pilots in most parts of the world. Many have secured attractive compensation and benefits in their new positions in other countries.²⁸

In sum, outsourcing and offshoring offer intriguing options to strategic managers. In an increasingly competitive global marketplace, firms must take steps to minimize costs and improve efficiency. These steps may not be taken without political or buyer repercussions in the home market, however, as recent developments in the United States illustrate.

2-2 Commoditization and Mass Customization

Two key trends of the 1990s and 2000s have changed the context of strategic management. From a strategy perspective, **commoditization** refers to the increasing difficulty firms have in distinguishing their products and services from those of their rivals. Rapid advances in technology have created numerous opportunities for firms to

Commoditization

The increasing difficulty that firms have distinguishing their products and services from those of their rivals.

differentiate their products from those of their competitors – differentiation that can exceed the needs of buyers and even confuse them. Buyers become inundated with an excessive number of options and little time to investigate or comprehend most of them. In an effort to simplify their choices, buyers view products as commodities and tend to reduce purchase decisions to a few key factors, such as a major product feature, reliability, or convenience. If buyers are unable to readily distinguish among the competitors along these factors, they may view the product as a commodity and base their final purchase decision on price. Hence, while firms may be doing all they can to set themselves and their products apart from the competition, customers may not see them quite as distinguishable.

Commoditization can create serious problems for firms that end up spending more to enhance product features only to be met with buyers who are inexorably price conscious. In a relatively short time, for example, digital cameras have overtaken film cameras as the product of choice. Whereas most film cameras had only a limited number of options, digital cameras can be complex to evaluate and many come with thick manuals describing all of the features and controls. Although camera aficionados appreciate the bells and whistles, many consumers may be confused by such features or simply may not wish to invest much time into learning how to use what they perceive as a low-involvement product. Unless camera producers or retailers can break through this confusion, such buyers may limit their product consideration set on the basis of only one or two key features such as brand, size, or the number of megapixels, and then base a final purchase decision on price.

Mass Customization

The ability to individualize product and service offerings to meet specific buyer needs.

A second trend, **mass customization**, refers to the ability to individualize product and service offerings to meet specific buyer needs. Like commoditization, its prominence has also been fostered by advances in technology. It occurs, for example, when Amazon.com suggests top-selling books for customers at its Web site based on previous product searches or purchases. In this way, Amazon.com takes a commodity—the same product that could be readily purchased as other retailers—and customizes its presentation to individual consumers.

Mass customization is important because it enables firms to personalize offerings while building **economies of scale**, which is the decline in unit costs of a product or service that occurs as the absolute volume of production increases. In a general sense, customization and economies of scale are inversely related. Scale economies develop when a firm produces a large quantity of a product, thereby eliminating its ability to satisfy individual needs with specialized products. Although not easy to achieve, mass customization—via technology and creative approaches—enables firms to achieve both customization and economies of scale.

Commoditization and mass customization are related to some extent. In some respects, technology enabling mass customization can enable firms to combat encroaching commoditization. When both trends are considered in concert, it becomes clear that successful firms must find a way to cut through all of the confusion and reach buyers in meaningful, personalized ways while maintaining production efficiencies.

Economies of Scale

The decline in unit costs of a product or service that occurs as the absolute volume of production increases.

2-3 Strategy and the Internet

It is difficult to understand strategic management today without considering how the field has been changed by the emergence of the Internet in recent years. Initial Internet growth occurred in the most developed nations, but now the rest of the world is catching up. China passed the 100 million mark in Internet users in 2005, 60 percent of which are male and 71 percent of which are under thirty years of age.²⁹

The Internet has provided a new channel of distribution, a more efficient means of gathering and disseminating strategic information, and a new way of communicating with customers. In the early years of its inception, economic activity on the Web was dominated by “e-businesses” whose success and failure was almost solely dependent on the Internet. Today, most large, traditional firms—including such giants as Wal-Mart and General Electric—are utilizing the Internet to track customers, increase sales, and enhance visibility.³⁰

A key fundamental strategic change, however, concerns the dramatic shifts in organizational structure and their influences on viable business models. Put simply, many organizations are modifying their business models to augment their revenues through sources other than sales. As John Magretta put it, “A good business model begins with an insight into human motivations and ends in a rich stream of profits.”³¹

The Internet has unleashed a number of alternative business models, some successful and some not. Consider the business model of one short-lived dot-com. By early 2001, Cyberrebate had become a popular Web site, offering rebates with every product, some for the full purchase price. Critics charged that such a business could not sustain itself by giving away merchandise. However, a small percentage of customers (less than 10 percent, according to CEO Joel Granik) failed to collect their rebates for merchandise typically priced several times the retail level, and many others converted to products whose rebates constituted only part of the purchase prices.³² Time will determine the viability of such alternative business models. In Cyberrebate’s case, the company filed for Chapter 11 bankruptcy protection in May 2001.³³

Critics have challenged the notion that “new business models” are needed to compete in the “new economy.” Michael Porter noted that “many of the pioneers of Internet business . . . have competed in ways that violate nearly every precept of good strategy . . . By ignoring strategy, many companies have undermined the structure of their industries . . . and reduced the likelihood that they or anyone else will gain a competitive advantage.”³⁴ In essence, Porter and others have argued that the market forces that governed the traditional economy have not disappeared in the Internet economy; hence, many of the dot-coms that failed in 2000 did not succeed because they discarded these rules, set out to write their own, and built “bad business models.”

Interestingly, the success or failure of a business model may be a function of factors such as time, technology, or problems with execution, not the quality of the idea itself. As such, some business models may not prove successful at first, but with minor changes may become successful in a future period. For example, the concept of purchasing groceries online was originally unsuccessful, due to such factors as Web design, inefficient warehousing, and relatively high prices. By the mid-2000s, improvements in these areas, as well as technological advances and a more Internet-savvy consumer, sparked a turnaround among online grocers. The original model has now been enhanced and is yielding positive results.³⁵

The failure of many dot-coms notwithstanding, the Internet has spawned a key change in the structure of business. During the past two decades, organizations have engaged in a process economists refer to as “disaggregation and reaggregation.”³⁶ The economic basis for this transformation was proposed by Nobel Laureate Ronald Coase in what is called *Coase’s law*: A firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction on the open market.³⁷ In other words, large firms exist because they can perform most tasks—raw material procurement, production, human resource management, sales, and so forth—more



Source: Ablestock.com

efficiently than they would otherwise be performed if they were outsourced to the open market.

Recent advances in Internet and related technologies, however, coupled with rapid economic development in parts of Asia and Eastern Europe, have enabled firms to reorganize work processes and improve efficiency. As a result, it is much easier now than ever before to share and exchange information, and to “farm out” specific tasks to the most efficient parties across the globe. Today, more than a quarter of a million Indians manage call centers and perform telemarketing functions primarily for firms in the United States because they can perform the tasks—with the assistance of technology—more efficiently than their American counterparts. This fast growing service industry in India was virtually nonexistent just a decade ago.³⁸

As a result of this change, many progressive firms have placed less emphasis on performing all of the required activities themselves and have formed **partnerships**, or contractual relationships with enterprises outside the organization, to manage many of the functions that were previously handled in-house. Whereas *outsourcing* refers to specific agreements associated with a single task, *partnering* implies a longer term commitment associated with complex activities.

It is difficult to overstate the effects that disaggregation and reaggregation have had on business enterprises, and more specifically, the effort to manage them strategically. In many respects, a partner can be viewed as an extension of the organization. Partner capabilities and limitations are fast becoming as important as internal strengths and weaknesses. Although these changes are more pronounced in some markets than in others, the development of the Internet economy has significantly changed the nature of business in all industries. Although the strategic management process described herein is applicable to almost any organization, most successful companies have already developed a substantial presence on the Internet (see Strategy at Work 2-1).

Partnership

A contractual relationship with an enterprise outside the organization.

World Wide Web (WWW)

The vast assortment of computers on the Internet that support hypertext.

STRATEGY AT WORK 2 - 1

Strategy, the Internet, and Its Nomenclature

Perhaps the greatest technological influence on strategic management in the late twentieth century was the widespread dissemination of the Internet. The *Internet* is an intricate, interconnected assortment of computer networks capable of encoding and decoding specialized computer *protocols*, or specifications of how information is exchanged. The Internet infrastructure consists of several key components. The *backbone* refers to the high-speed telecommunication lines used to connect the various computers in the system. *Bandwidth* refers to a telecommunication line's capacity to transmit data. *Routers* are digital switches (i.e., dedicated computers) that organize and route Internet traffic throughout the backbone. The bandwidth enhancement forecast for the first decade of the twenty-first century will speed up the transfer of data across the Internet.

Point of presence (POP) refers to a point of access to the Internet. Individuals typically gain access to the

Internet by means of an *Internet Service Provider's (ISP's) POP*. Large organizations are typically connected to the Internet by integrating their hardware into a *local area network (LAN)* server and linking it directly to the Web. Such organizations often construct hardware and software *firewalls* to restrict access between users within and outside the LAN.

The **World Wide Web (WWW)** is the vast assortment of computers on the Internet that support *hypertext*, a form of text that allows for the proper encoding and decoding of material on the Web. *HyperText Markup Language (HTML)* is the “common denominator” that allows documents to be linked contextually. Software such as Netscape Composer and Microsoft Front Page has simplified the Web page development process by eliminating the need to program in HTML code.

2-4 Strategic Dimensions of the Internet

In addition to the movement toward disaggregation and reaggregation, the Internet has a number of characteristics closely associated with the strategic management process, the effects of which typically vary among industries. Five key interrelated strategic factors are discussed in this section.

2-4a Movement toward Information Symmetry

Information symmetry occurs when all parties to a transaction share the same information concerning that transaction. Information symmetry is an underlying assumption of the economics-based models of “pure competition.” **Information asymmetry**, when one party to a transaction has information that another does not, is the primary reason why many markets are less competitive than they otherwise would be. Firms have a distinct advantage when they possess information not available to their prospective buyers. On the other hand, buyers gain an advantage when they obtain access to this information.

Businesses often seek to promote information asymmetry and utilize the information edge to their own advantage. Automobile retailers, for example, rarely post their absolute bottom-line prices on their vehicles. Consumers are generally left to haggle with a number of dealers to estimate the true wholesale cost of the vehicle and the value of various options and accessories. The lack of consumer knowledge, as well as the lack of time and expertise required to obtain the information desired, results in higher selling prices for many of the retailers.

Following this example, the Internet provides a wealth of information to educate consumers. Independent vehicle test results, retailer Web sites, wholesale costs for new vehicles, and estimated trade-in values are only a few mouse clicks away. Some consumers may end up purchasing a vehicle from a sponsor of an informational site, and even educated consumers who do not complete part or all of the transaction process online will likely force their traditional retailer of choice to negotiate in a more competitive manner. Hence, this shift toward information symmetry is ultimately a detriment for firms and beneficial for buyers.

2-4b Internet as Distribution Channel

The Internet acts as a distribution channel for nontangible goods and services. Consumers can purchase items such as airline tickets, insurance, stocks, and computer software online without the necessity of physical delivery. For largely tangible goods and services, businesses can often distribute the “intangible portion” online, such as product and warranty information. When physical distribution can be replaced completely or in part by electronic distribution, transactions are likely to occur more rapidly and at lower costs.

2-4c Speed

The Internet offers numerous opportunities to improve the speed of the actual transaction, as well as the process that leads up to and follows it. Consumers and businesses alike can research information twenty-four hours a day. Orders placed online may be processed immediately. Software engineers in the United States can work on projects during the day and then pass their work along to their counterparts in India who can continue work while the Americans sleep. The pace of business has increased and has been accompanied by heightened expectations for speed by consumers.



Source: Ablestock.com

Information Symmetry

When all parties to a transaction share the same information concerning that transaction.

Information Asymmetry

When one party to a transaction has information that another does not.

2-4d Interactivity

The Internet provides extensive opportunities for interactivity that would otherwise not be available. Consumers can discuss their experiences with products and services on bulletin boards or in chat rooms. Firms can readily exchange information with trade associations that represent their industries. Users can share files with relative ease. Rumors and bad news can and will spread rapidly.

2-4e Potential for Cost Reductions and Cost Shifting

The Internet provides many businesses with opportunities to minimize their costs—both fixed and variable—and thereby enhance flexibility. Information can be distributed to thousands or millions of recipients without either the expense associated with the mail system or the equipment required to do so. The virtual storefront, for example, does not necessarily require an actual facility and may reduce transaction costs through automated online ordering systems, although this is not always the case.

2-5 Forms of Electronic Commerce

Electronic commerce activities can be classified into five basic categories by identifying businesses and consumers as initiators and recipients of the offer (see Figure 2-1). Business-to-business and business-to-consumer categories account for most global e-commerce activity. Businesses are commonly involved in more than one of these segments simultaneously and/or involved in both electronic (i.e., “clicks”) and traditional (i.e., “bricks”) forms of commerce, often referred to as **clicks and bricks**. It is widely believed that successful retail firms of the future will likely be the ones that adopted this combination approach.

Clicks and Bricks

The simultaneous application of both electronic (“clicks”) and traditional (“bricks”) forms of commerce.

Business-to-Business (B2B)

The segment of electronic commerce whereby businesses utilize the Internet to solicit transactions from each other.

2-5a Business-to-Business Segment

Business-to-business (B2B) is the largest classification of Internet business, with global transactions estimated to be \$6.8 trillion in 2007.³⁹ Because the Internet reduces transaction costs (costs associated with searching for suppliers, negotiating terms, etc.), the Internet provides exceptional opportunities for streamlining business-to-business operations. B2B is widely used as a means of increasing the efficiency of transactions. B2B firms seek to profit on the transactions among firms. Many consumers are unaware of the size of B2B relative to other forms.

Interestingly, the B2B segment experienced some turbulence in the early 2000s. Only about one-third of the more than two thousand new B2B start-ups in 2000 and 2001 survived into 2003. During this time, traditional brick-and-mortar



FIGURE 2-1 E-Commerce Matrix

		Offer Recipient		
		Business	Consumer	Government
Offer Initiator	Business	Business-to-Business (B2B)	Business-to-Consumer (B2C)	Business-to-Government (B2G)
	Consumer	Customer-to-Business (C2B)	Customer-to-Consumer (C2C)	

firms launched their own B2B initiatives to retain the transaction fees that otherwise would have been secured by the start-ups from the \$482 billion spent on B2B transactions in the United States.⁴⁰

2-5b Business-to-Consumer Segment

The **business-to-consumer (B2C)** segment is the second largest and fastest growing segment, including such competitors as Amazon.com and 1800flowers.com. Often referred to as **e-tailing**, B2C successes are often associated with advances in consumer acceptance of the Internet as a retail alternative. Global B2C transactions were estimated to be \$240 billion in 2007.⁴¹

B2C offers retailers certain advantages over traditional forms of retailing, one of which is the potential for a larger average transaction. For example, when consumers read the description of a book at Amazon.com, they also see what others who ordered the same book also purchased, resulting in opportunities for increased business.

B2C can reduce transaction costs by eliminating the need for much of the overhead associated with traditional retailing; however, it is easy to overestimate the extent to which overhead can be reduced. Many analysts believe that the “dot-com debacle” of 2000 and 2001, during which time a number of Internet businesses filed for bankruptcy, was due to expected efficiencies and overhead reductions that never fully materialized.

B2C can offer exceptional convenience for consumers by enabling them to search large catalogs in only a few seconds, build an order over several days, and configure various products and view actual prices. “Frequently Asked Questions” (FAQ) pages can provide customers with clear, accurate answers to their most common questions instantaneously and at virtually no cost to the business. Most studies suggest, however, that the vast majority of potential customers who select items for purchase abandon the site before completing the purchase, creating an interesting challenge for strategic managers at e-tailers.

The challenges associated with a successful e-tailing operation are simple to identify, yet difficult to resolve. Simply stated, e-tailers must persuade consumers to frequent their sites, stay there long enough to evaluate the offerings (i.e., e-tailers must create a site high in “stickiness”), and complete their purchases. Needless to say, e-tailers must be able to fulfill these orders as advertised.

2-5c Business-to-Government Segment

The segment of electronic commerce whereby businesses utilize the Internet to solicit transactions from government entities is known as **business-to-government (B2G)**. This segment has emerged as government agencies have realized that purchases can be handled efficiently when facilitated by the Internet. Global B2G expenditures were estimated to be approximately \$7 to \$8 billion in 2007.⁴²

2-5d Consumer-to-Consumer Segment

The **consumer-to-consumer (C2C)** segment involves utilization of the Internet as a facilitator of transactions involving only consumers. Because transaction costs can be quite high, intermediaries such as eBay are often required to manage the exchange of information and Paypal to facilitate payments. Many C2C businesses were established solely to take advantage of technological advantages of the Internet and/or to meet consumer needs specifically created by the existence of the Internet. Although companies such as eBay are widely recognized, the C2C category is tiny relative to B2B and B2C.

Business-to-Consumer (B2C)

The segment of electronic commerce whereby businesses utilize the Internet to solicit transactions from consumers, also known as *e-tailing*.

E-tailing

Another term for *business-to-consumer (B2C)*.

Business-to-Government (B2G)

The segment of electronic commerce whereby businesses utilize the Internet to solicit transactions from government entities.

Consumer-to-Consumer (C2C)

The segment of electronic commerce whereby consumers utilize the Internet to solicit transactions from each other.

Consumer-to-Business (C2B)

The segment of electronic commerce whereby consumers utilize the Internet to solicit transactions from businesses.

2-5e Consumer-to-Business Segment

In the **consumer-to-business (C2B)** segment, consumers generate the offer and businesses accept or decline it. This form of electronic commerce is the least developed of the four and includes competitors such as Priceline.com. Under the Priceline “reverse auction” model, consumers name their prices for goods and services such as airline tickets, hotel rooms, and long-distance phone service, and businesses are free to accept or reject them. Unlike traditional models, the reverse auction allows for price discrimination, because any given buyer does not know how much other buyers are paying for the same good or service.⁴³ Like C2C, the C2B category is tiny when compared to B2B and B2C.

2-6 Summary

The Internet has had a profound effect on the field of strategic management. It increases access to information for all parties involved in a transaction, acts as a distribution channel for nontangible goods and services, can improve transaction speed, offers opportunities for interactivity among participation in business transactions, and presents potential for cost reductions and cost shifting. Business-to-business (B2B) and business-to-consumer (B2C) segments are the two largest classifications of Internet-based business.

Key Terms

business-to-business	consumer-to-consumer	offshoring
business-to-consumer	economies of scale	outsourcing
business-to-government	e-tailing	partnership
clicks and bricks	information asymmetry	World Wide Web
commoditization	information symmetry	
consumer-to-business	mass customization	

Review Questions and Exercises

1. What is Friedman's thesis in his book, *The World Is Flat*?
2. What is the difference between outsourcing and offshoring?
3. What is the difference between commoditization and mass customization?
4. Has the advent of the Internet created new business models?
5. How has the development of the Internet affected the strategic management field?
6. What are the five categories of electronic commerce? Provide examples of each.

Practice Quiz

True or False

1. In *The World Is Flat*, Thomas Friedman argues that recent global and technological changes have increased the world dominance of Western powers such as the United States.
2. Outsourcing refers to contracting out a firm's non-core, nonrevenue-producing activities to other organizations primarily to reduce costs.
3. Mass customization refers to a process whereby firms are having a more difficult time distinguishing their products and services from those of their rivals.
4. The widespread application of the Internet has increased information asymmetry.
5. The fastest growing segment of Internet business is business-to-business (B2B).

6. The largest segment of Internet business is business-to-consumer (B2C).

Multiple Choice

7. Contracting out a firm's noncore, nonrevenue-producing activities to other organizations primarily to reduce costs is known as
- outsourcing.
 - offshoring.
 - mass customization.
 - commoditization.
8. A process whereby firms are having a more difficult time distinguishing their products and services from those of their rivals is known as
- outsourcing.
 - offshoring.
 - mass customization.
 - commoditization.
9. The ability to individualize product and service offerings to meet specific buyer needs is known as
- outsourcing.
 - offshoring.
 - mass customization.
 - commoditization.
10. The phenomenon of "disaggregation and reaggregation" has led to an increased emphasis on
- outsourcing.
 - partnerships.
 - the Internet.
 - all of the above
11. The state whereby one party has information that another does not is called
- information symmetry.
 - offshoring.
 - knowledge redistribution.
 - customization.
12. E-tailing is synonymous with which category of e-commerce?
- business-to-business
 - business-to-consumer
 - consumer-to-business
 - consumer-to-consumer

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READING 2 - 1

Insight from *strategy+business*

The Internet's influence on business models is undeniable, but not all firms have leveraged the Web successfully. This chapter's strategy + business reading examines the underlying economics that explains why some e-tailing ventures are successful and others are not.

The Hidden Costs of Clicks

Internet retailers are finally learning why books and luggage make money online—whereas shoes and toys do not.

By Tim Laseter, Elliot Rabinovich, and Angela Huang

Bags.com ranks as one of the more notable successes among Internet retailers. The leading online purveyor of luggage, eBags generates more than \$38 million in revenue a year and has been consistently profitable since its founding in 1998, in the heyday of the Internet bubble. Operating with minimal inventory thanks to direct “drop shipments” from manufacturers to end customers, eBags could be the model for the future of commerce.

But that model is still developing. eBags continues to expand and adapt its business. In 2004, the online retailer, which is based in Greenwood Village, Colo., acquired Shoedini.com, a seller of dress shoes for men and women, and renamed it 6pm.com. Having expanded from its original focus on luggage into backpacks, handbags, and other accessories, eBags considered shoes the next logical category for marketing synergies. Yet, despite the clear marketing logic, selling shoes online turned out to be more complicated than selling the other product lines.

The issue, as eBags discovered and as many online vendors have yet to understand, highlights the fundamental operational challenges of Internet retailing. It centers on a concept common in the business-to-business realm but rarely employed in a business-to-consumer context: cost-to-serve. Defined as the total supply chain cost from origin to destination, cost-to-serve incorporates such factors as inventory stocking, packaging, shipping, and returns processing. This metric also helps to explain why some of the early high-flying “e-tailers,” such as eToys and Webvan, failed miserably.

In the eBags example, the cost of serving shoe customers is far higher than the cost of serving luggage customers. The Shoedini acquisition more than doubled the number of SKUs that eBags handled, and the complexity of managing the inventory exploded. Most bags

come in two variations—usually different colors. But a shoe style comes in several colors and many sizes; there can be 30 or more variations of a single model.

Bags, furthermore, come in boxes that manufacturers use for shipping via small-package delivery to a fragmented base of mostly mom-and-pop retail customers. But shoes ship to retailers in bulk packaging rather than in individual boxes. When 6pm.com sells a pair of dress loafers direct to a consumer, the manufacturer thus has to incur extra shipping and handling costs to repackage and ship the shoes.

Most important, shoes have a short product life cycle—typically three to six months—and suffer from a high return rate. (Some customers order two pairs at a time, planning to return the pair that doesn't fit.) Luggage life cycles can last six years, and return rates are minimal. For eBags, this means that although shoes and luggage command similar gross margins, shoes carry a much higher cost-to-serve, and selling them online thus requires a different business model.

Understanding the cost-to-serve dynamics is more important than ever as online retailing continues its growth spurt. More than a third of U.S. households now shop online, according to a September 2005 report from Forrester Research, and annual sales of physical goods are expected to hit \$100 billion for the year.

Over the second decade of online retailing, the companies that truly grasp the drivers of cost-to-serve at the level of individual items and individual customers will unlock the full value-creating potential of online retailing as an alternative to—and complement of—traditional retailing.

Trial and Error

Back at the dawn of online retailing, highfliers like Value America (an online “department store”) and Webvan (an

Internet-based delivery service that focused its offerings on grocery items) did not comprehend the operational cost implications of their business models. Value America started with a virtual inventory model supposedly applicable to any branded product. Although its initial offering, computer hardware, sold well, shipping and handling costs for lower-value goods proved prohibitive, and an unmanageable flood of returns ultimately sank the company in August 2000. Less than a year later, in July 2001, Webvan declared bankruptcy after concluding that it would never turn a profit, despite its state-of-the-art supply chain with a hub-and-spoke network of delivery cross-docks and highly automated distribution centers. (The flaws in its economic model were highlighted in a Booz Allen Hamilton study more than a year before its collapse. See "The Last Mile to Nowhere: Flaws & Fallacies in Internet Home-Delivery Schemes," by Tim Laseter, Pat Houston, Anne Chung, Silas Byrne, Martha Turner, and Anand Devendran, *s+b*, Third Quarter 2000.)

Even Amazon.com did not fully appreciate all the factors driving its cost-to-serve. When Jeff Bezos opened his Internet store in 1995, he started with books, reasoning that it would be easier to offer the millions of titles in print online than through a traditional mail-order catalog. Although Mr. Bezos may not have fully grasped all of the inefficiencies inherent in the book industry, he saw that his model could minimize inventory risk — a significant problem in book retailing. Unlike other manufacturers, publishers take back all unsold copies of their product. Up to 30 percent of trade books ship back to the publisher at enormous cost to everyone: to the publisher, who refunds the payment to the retailer; to the retailer, who pays for shipping and restocking; and indirectly to the consumer. Amazon's online model minimizes the inherent inefficiency of placing potentially unsellable titles on thousands of retail bookshelves by relying instead on a relatively small inventory to support a "virtual bookshelf." If Amazon returns fewer books than a bricks-and-mortar retailer, it should be able to negotiate lower prices from the publishers (reflecting its lower cost-to-serve as a customer of the publisher). Amazon can then pass along those savings through lower prices to the consumer.

Although books worked for Amazon, toys were a different matter. As Jeff Bezos learned, the toy supply chain comes with a much higher cost-to-serve. Toys are more seasonal than books and demand for them is far less predictable. Magnifying those challenges, most toys are made in Asia, and the replenishment cycle can easily outlast the actual selling season. That means merchandisers must

accurately predict which toys will be hits and then buy enough inventory for the whole season; Amazon therefore gained no benefit from its "virtual shelves." Guessing too conservatively results in missed sales, and guessing too optimistically leads to write-offs because toy manufacturers do not typically accept returns of unsold goods. Without any toy merchandising expertise, Amazon guessed wrong for the 1999 holiday season and wrote off \$39 million in excess toy inventory in early 2000, having sold only \$95 million worth of toys.

Furthermore, conventional toy retailers enjoy advantages that traditional booksellers don't. Unlike Barnes & Noble, Wal-Mart and Toys "R" Us ship multiple truckloads of goods to each store weekly, which puts their transportation costs far below the cost of shipping individual toys to consumers. Recognizing these differences, Amazon gladly partnered with Toys "R" Us in 2000, shifting the inventory risk to the experts but leveraging the additional product lines to lower its own shipping cost for multi-item orders.

Nonetheless, the two partners had a falling-out in 2004, with dueling lawsuits in the New Jersey court system. This denouement suggests that the cost-to-serve for online toy retailing produced a financial model that would not support the two parties' aspirations adequately.

Channels and Brands

Although successful online retailing depends on a variety of factors, the cost-to-serve of a particular product category can explain much of the variance in the penetration rates of Internet sales. For example, according to the United States Census Bureau, in 2002 (the latest data available), 44 percent of retail sales of computer hardware and software took place via the Internet. Certainly tech-savvy computer buyers are more likely than the general population to shop online. But equally important, the high value-to-weight ratio of computers—especially as laptops become more popular—minimizes the importance of transportation cost and makes the category a low-cost-to-serve option over the Internet.

Cost-to-serve factors like inventory, packaging, shipping, and returns help explain why online sales of books outstrip online sales of other kinds of merchandise. E-commerce accounts for nearly 13 percent of the total bookstore and newsstand sales in the United States \$15 billion in 2002 (the latest year available from the U.S. Census Bureau)—and the same portion of the \$21 billion market for office equipment and supplies. By contrast, the Internet accounted for just 2.7 percent of the \$92 billion in U.S. sales of furniture and home furnishings.

Or consider the largest retail category, food and beverages. Online sales accounted for only two-tenths of 1 percent of the \$450 billion U.S. food and beverage retail sales total in 2002. As Webvan (and many investors) learned, targeting a huge market does not guarantee success if the cost-to-serve economics don't work.

Future growth in e-commerce will likely come from continued modification of existing supply chains rather than wholesale replacement. For example, despite the generally low level of Internet sales in furniture and housewares, Williams-Sonoma has achieved great success online. The company, which operates a mix of retail, catalog, and Internet channels under its eponymous store brand as well as the Pottery Barn and Hold Everything brands (among others), sold \$3.1 billion in fiscal 2005—52 percent through its traditional retail stores and 48 percent through its two direct-to-consumer channels. At \$3.3 million in annual sales for its average kitchenware store, Williams-Sonoma doesn't gain any significant transportation economies in shipping to its stores rather than directly to its customers. Ultimately, the company can maximize profits by assigning items to channels and brands to reach consumers at the lowest cost-to-serve.

Circuit City's Opportunity

Rather than minimizing the cost-to-serve across channels, traditional retailers often put their most popular items on their Web site. Although such an approach sounds logical, the reverse would typically work better. Traditional store-based retailing requires turning inventory quickly to justify expensive floor space. Slow-moving inventory—especially products with a high risk of obsolescence—can benefit from the centralized inventory pooling of online retailing. And if the product commands a high value-to-weight ratio, the cost penalty from direct-to-consumer shipping is minimal.

Circuit City, the “big box” consumer electronics and small appliances retailer, has an opportunity to minimize its cost-to-serve by making smart use of its many service options: in-store shopping, in-store or online ordering with delivery from the store, online ordering with store pickup, and online ordering with direct home delivery. Consumer electronics is a category currently underexploited by e-commerce. In 2002, only 2.5 percent of electronics and appliances sales went through online channels despite the fact that many electronic goods share the high value-to-weight ratio of computer hardware and software. Finding the optimal cost-to-serve for each product and customer category would give Circuit

City a competitive advantage over pure-play online retailers or less aggressive traditional competitors.

Circuit City operates a network of nine regional distribution centers to serve its 621 domestic stores. With average weekly sales of more than \$300,000 per store, Circuit City generates overall cost savings from its transportation network scale. But the relative importance of this bulk shipping network varies by product.

Consider the Hitachi 65” HDTV Display recently offered at \$1,299. It weighs 324 pounds and measures 5-feet-by-5-feet with a 28-inch depth. Shipment of such a bulky item through the company's full-truckload distribution network offers significant savings over a small-package shipment directly to a consumer's home via UPS. But, with relatively low unit sales and a short product life cycle, inventory held at the store represents a high cost and big risk. Circuit City might benefit from keeping a minimum inventory of this item at the store—even just a display model—and having customers order it online for in-store pickup after the next delivery from the regional distribution network.

A pure online offering might work best for the Sony HDV camcorder. Priced at around \$1,999, it is the most expensive model among the 60-plus camcorders that Circuit City sells, and it costs three to five times the price of the most popular models. As with the Hitachi HDTV, low unit sales of the Sony HDV camcorder may not justify stocking the item at the store because of the high inventory-carrying cost and risk of obsolescence. But unlike the Hitachi HDTV, the camcorder weighs very little—less than two pounds—and, accordingly, Circuit City's distribution network provides little transportation cost savings. Rather than stocking it at each of the nine regional distribution centers, Circuit City could gain further savings by pooling the inventory in a single national distribution center and shipping directly to customers' homes, minimizing the cost-to-serve for Circuit City as well as for the customer.

For each combination of customer and merchandise, there is an optimal cost-to-serve option among the different delivery choices: store inventory, store delivery, in-store pickup, and direct delivery. For customers living far from a store, for example, even for bulky products like the HDTV, the benefits of routing the goods through a regional distribution center (such as that maintained by Circuit City) may be offset by the extra costs of a two-step distribution cycle, compared to the simplicity of direct home delivery. Finding the optimal cost-to-serve at the levels of customer and item may be challenging, but it will be rewarding.

Even pure-play online retailers should consider the cost-to-serve in their pricing. Despite having the ability to customize Web pages to each individual, few companies fully leverage the potential to price products to reflect the different underlying costs. For example, eBags offers special pricing for bulk purchases for corporate sales, but it does not attempt to adjust shipping costs on the basis of a customer's geographic location. Such fine-tuned pricing could potentially increase the company's profitability. That's the kind of detail that retailers will have to consider as they grow their online businesses.

Accounting for Intangibles

Cost-to-serve in online retailing includes such factors as the expenses associated with inventory, transportation, and replication of the existing offerings of traditional retailers. But to get a truer sense of cost-to-serve, it should also take into account intangible costs to the customer. Consider the current approach to furniture retailing, one of the least customer-friendly supply chains in retailing.

Because there are so many manufacturers offering so many styles in so many woods, finishes, and fabrics, most furniture retailers display a limited selection of goods. Customers place their orders and then wait for the couch, table, or chair to be manufactured, shipped to the retailer, and finally delivered to their homes. The whole process regularly takes 12 or more weeks—a cost in “pain and suffering” that falls squarely on the customers.

Early attempts to improve on the furniture retailing process via the Internet proved daunting. Living.com and Furniture.com, two failed Web retailers, focused on the “consumer experience” by investing in technology to allow shoppers to visualize the furniture in virtual mockups of their home. These companies' supply chains—which, like Amazon's, depended on outside delivery services—proved untenable. The challenge of scheduling precisely timed home deliveries, something Amazon's products typically do not demand, proved to be beyond the ability of these nascent furniture retailers. Moreover, products often arrived damaged or unacceptable for some other reason, resulting in return rates of up to 35 percent of sales. Despite good efforts, the “virtual” model failed in the furniture category.

The Amazon online model doesn't work for furniture sellers. It would be better for them to emulate the

automotive industry. The big opportunity online for furniture retailers may lie not in eliminating storefronts, but in dramatically reducing the lead times in the order-to-delivery cycle. Car dealers resolve the choice challenge by sharing inventory information among dealerships and exchanging vehicles to better meet a particular customer's desires. Roughly half of the vehicles sold by a typical dealership come from such an exchange; the other half come from the dealer's own inventory on the lot. Similarly, with furniture, customers could check the “look and feel” of a display model, and the retailer would then locate the desired inventory at another store or at a centralized stock pool with delivery in days, not weeks. Such a business model would leverage the Internet's information-sharing power to lower the “cost” of long lead times without incurring an undue level of inventory investment.

In the end, future success for retailers of furniture, electronics, luggage—any sort of retailers—won't be a matter of expanding standard offerings to the burgeoning Internet channel or replicating existing online models. Despite the obvious marketing synergies, toys present different challenges from books, and shoes different challenges from luggage. Smart retailers will take a closer look at the costs of bringing each item to each consumer the cost-to-serve—to decide how to merchandise their offerings and ultimately grow their business by applying the right retail model at the right time.

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Real-Time Case 29: Wal-Mart

Sam Walton began his career in retailing as a J.C. Penney management trainee. He later leased a five-and-dime store in the rural community of Newport, Arkansas, in 1945. Five years later, he launched Walton 5 & 10, and by 1962, Walton owned fifteen Ben Franklin stores under the Walton name. Walton envisioned a rapid expansion of chain discount stores in small towns, a concept rejected by Ben Franklin. As a result, Sam and his brother James “Bud” Walton opened the first Wal-Mart Discount City in 1962. Wal-Mart Stores reached eighteen stores with sales of \$44 million in 1970, and the company went public.

The company continued to avoid the competition by opening stores in small and mid-sized towns. The company amassed 276 of its own stores with annual sales in excess of \$1 billion by 1980. Three years later, the first Sam’s Wholesale Club was opened, touting a cash-and-carry, membership-only warehouse format. Rapid growth continued through the 1980s and 1990s.

Today, the Bentonville, Arkansas-based firm operates almost 7,000 stores—about 60 percent in the United States—including traditional discount stores, supercenters that also sell groceries, and Sam’s Wholesale Clubs, as well as some Internet sales. Wal-Mart has stores in all fifty states and is the leading retailer in Canada and Mexico (through its Wal-Mart de México division). Wal-Mart also operates stores in Germany, Korea, Japan, and China, as well as other nations in Asia, Europe, and South America. The heirs of the late Sam Walton (Wal-Mart’s founder) own about 38 percent of the company.

It is almost impossible to separate Wal-Mart from its founder. The flamboyant leader was known for his charismatic style, emphasis on customer service, and high esteem for Wal-Mart employees. In fact, Walton is responsible for the first widespread use of “associates,” a term which connotes more respect for those who work for the large retailer. This commitment is seen in Wal-Mart’s contribution of about 6 percent of each associate’s salary to the company’s profit sharing plan. Associates can take their share in cash or stock when they leave the company. It is not unusual for 20-year employees to accumulate \$500,000 or more in company stock.

More than anything, however, Walton instilled a bias for action in managers and associates alike. Store change is constant, as opportunities for improvement were constantly being sought. Within each store, department managers act as entrepreneurs and are encouraged to innovate. CEO David Glass continued Walton’s commitment to cost control, innovation, greater emphasis on the upscale market, and a customer-centered culture until the top job was handed to Lee Scott in 2000. Following an incessant stream of criticism alleging such practices as unfair price competition and employment discrimination, Scott launched a concerted effort in late 2004 to defend Wal-Mart’s record, both as a successful retailer and a good corporate citizen. Wal-Mart is under constant pressure from environmental groups and organized labor, and defends itself against the most lawsuits of any firm in the United States.

Wal-Mart made an interesting move in 2006, lowering the prices of 300 generic prescription drugs to four dollars for a thirty-day supply. Continued growth efforts—especially in international markets—are anticipated. A smaller, neighborhood store format that carries both grocery and household items and sales of major appliances such as LCD televisions is also in the strategic mix.

Perspectives

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- Buckley, N., “Wal-Mart in offensive to boost image,” *Financial Times*, 9 September 2004, 30. Wal-Mart has been the brunt of criticism alleging unfair business and labor practices. CEO Lee Scott announced that the company will embark on a concerted effort to put its story across.
- Stringer, K., “Wal-Mart’s growth surge leaves dead stores behind,” *Wall Street Journal Online*, 15 September 2004. Wal-Mart’s success in many cities has resulted in moves to larger stores, often leaving “dead” ones that used to anchor strip malls unoccupied. This has created a growing problem for local economic developers.
- Sandoval, R., “Mexican retailers fight for survival against Wal-Mart,” *Dallas Morning News*, 13 March

2004. Three large Mexican grocery chains—Gigante, Comercial Mexicana, and Soriana—attempted to fuse their purchasing units to challenge Wal-Mart's clout, but Mexico's competition commission rejected their plan. The stores are appealing the decision.

- Culp, E., "Juggernaut Wal-Mart goes slow in Germany," *Sunday Business (London)*, 26 September 2004. Germany is the only company in the world where Wal-Mart is not profitable. Strategists are speaking more of adapting Wal-Mart's offerings to German consumers in an effort to revive the company's ninety-two stores there.
- Dunn, J., and Vuong, A., "Growth of big-box retailers leads to increase in discrimination lawsuits," *Tribune Business News*, 21 September 2004. During the last decade, Costco, Home Depot, and Wal-Mart expanded vigorously and hired tens of thousands of hourly employees, many of whom later became managers. All three firms, however, have been the targets of class action lawsuits alleging race and sex discrimination.
- Lyons, J., "In Mexico, Wal-Mart is defying its critics," *Wall Street Journal*, 5 March 2007. Wal-Mart is performing well in Mexico. Like many of their rural American

counterparts, Mexican shoppers are "more concerned about the cost of medicine and microwaves than the cultural incursions of a multinational corporation."

Case Challenges

- It is easy to become enamored with a company when it has enjoyed so much success over the years. What are Wal-Mart's weaknesses?
- Does Wal-Mart's new neighborhood store format run counter to the cost-cutting emphasis that is at least partially responsible for the success of its traditional stores? Explain.
- What challenges can Wal-Mart expect with its international expansion efforts?

Internet Sites of Interest

- Corporate Web site: www.walmart.com
- Web site of a key competitor: www.target.com
- National Retail Federation: www.nrf.com
- *DSN Retailing Today*: www.dsnretailingtoday.com