Fourth Edition

Modern Competitive Strategy

Gordon Walker

Tammy L. Madsen

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Dedications

To Nancy, Emma, Curran, and Ian
To Stephen

About the Authors

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Preface

This book focuses on what makes firms successful over time, ultimately within industries that are global in scope. It is comprehensive yet succinct, discipline-based yet practical, highly general yet applicable to currently emerging industries—all of this, we hope, without sacrificing quality of content or style. *Modern Competitive Strategy* is appropriate for teaching at all levels—undergraduate, MBA, and EMBA—and understandable to students both with and without business experience. To this end, it serves as a relatively complete introduction to strategy as an academic and practical discipline. Furthermore, it is flexible in its fit to course length—module, quarter, or semester.

The organization of the book has changed slightly from the third edition. Strategic planning has been moved from the second to the sixth chapter and combined with strategy execution as a new section. This makes good sense since planning and execution are tightly wedded in theory and practice. Otherwise, except for some small changes in the internal organization of several chapters, the book's structure remains substantially the same.

The Fourth Edition has six parts. After the introductory chapter in Part One, the book has the following five parts:

- *Building Competitive Advantage*
- *Strategy Execution and Strategic Planning*
- *Strategic Boundaries*
- *Expanding the Scope of the Firm*
- *Governing the Firm*

Each part deals with a separate set of strategic issues as the firm grows from one to many lines of business and from competing in one region to competing in nondomestic markets. After the introductory chapter, Part Two, *Building Competitive Advantage,* lays out the concept of strategy in a single business and argues that strategy is about achieving high relative performance over time. By performance, we mean economic, and by relative, we mean compared to competitors in a firm's industry. Our focus throughout is on what drives cash flows for the business. To have higher earnings than rivals, the superior firm produces more value for the customer at a lower cost and defends the sources of this advantage—the firm's resources and capabilities—from imitation. This traditional but robust approach to defining competitive advantage pervades the book, and, we believe, is becoming widely accepted in the strategy field. The chapters in Part Two focus first on the competitive advantage of the firm, then on the firm's industry, and finally, on the how firms in an industry compete over time, particularly across the industry life cycle.

Part Three, *Strategy Execution and Strategic Planning,* lays out how successful firms build competitive advantage through strategy execution and planning. Our approach is to pose a desired market position that the firm targets and to articulate the process through which the position is achieved. In this book, planning is part of this process, that is, part of execution itself, not the reverse, as in many other frameworks using a formulation and implementation approach. Since there are many successful firms that have no plan per se, we believe our approach is closer to reality. All firms thus have a strategy; some are simply better conceived and better executed than others.

In Part Four, *Strategic Boundaries,* we focus on vertical integration, outsourcing, and partnering. We feel it is important to separate these common boundary choices and examine their logics individually, even as they overlap. Part Four relies deeply on the extensive literature on these topics developed over the past 40 years, at least since Oliver Williamson's seminal book on markets and hierarchies. At the same time, we include a number of recent models and empirical studies that expand on his framework and others.

Part Five, *Expanding the Scope of the Firm,* concerns competing in global markets and growth through diversification. Geographical expansion challenges firms in both the developed world and emerging markets, a distinction we highlight. The theory and frameworks we draw on are based closely on traditional and recent studies. Our focus is mostly on Asia. In turn the chapters on diversification and multibusiness firms rely on the host of research on this important topic.

Last, Part Six, *Governing the Firm,* outlines the major issues of corporate governance, including its legal and institutional frameworks, in a single chapter. We believe ownership of the firm and board characteristics have substantial implications for strategy and therefore, for performance. The issues are more than simply problems of compliance, as recent research shows. As in the rest of the book, we expand the discussion to international examples.

We believe our approach in this book, has three main advantages:

(1) It provides a practical, discipline-based underpinning to the discussion of important strategy topics and allows the student to make connections among these topics as the course proceeds. By the end of the course, the student should see that many strategic problems can be understood as elaborations of a small number of theoretical frameworks. Thus, the course is an integrated experience.

(2) It offers a clear way to understand the similarities and differences between single and multibusiness strategic issues. Identifying how a business can be improved as part of a multibusiness enterprise is a central management task. However, this

task cannot be accomplished if the business and its parent organization are not understood in a common strategic framework. In essence, there can be no concept of corporate strategy without a clear and practical concept of business strategy.

(3) Our experience with the frameworks in the book is that they are especially well suited for teaching cases from any era—from early Microsoft to Zara, Google, and Apple. Further, when students read the business press, they will be able to see the applicability of what they're being taught. Also, it has been our experience that senior executives resonate with the approach taken in the book and relate its frameworks in their own decision making.

As mentioned above, these benefits can be realized at any level of instruction. It can be gratifying to see undergraduates respond appropriately and enthusiastically to almost the same material that executive MBAs appreciate for somewhat different reasons. The undergrads like the clarity, coherence, and consistency of the approach to strategy, while EMBAs can take much of the material and apply it directly to their work. Needless to say, regular MBAs can experience the material in both ways. Several revised teaching supplements are available to adopters of this text: an instructor's manual, including lecture notes, multiple-choice questions, and suggested cases for each chapter; a computerized test bank; and PowerPoint slides with key figures from the book; suggested class exercises; and other lecture materials. Select supplements and additional resources are available from the book website at www.mhhe.com/mcs4e.

What Is New in This Edition?

The most obvious and gratifying enhancement to the book is the addition of Tammy Madsen as coauthor. She brings deep knowledge of the strategy field, wide experience of companies, especially and importantly in northern California, and many years of using the book beneficially in the classroom. Her contributions are central to the book's improvement, both currently and in the future.

As for general changes, the book has been rewritten for style and organization. One major structural change is in the placement of Strategic Planning. This chapter and Strategy Execution now form their own part of the book, as mentioned above, an improvement over the organization of the third edition. We have made a concerted effort throughout to add examples and frameworks related to modern icons of firm success, such as Google and Apple. It has been interesting to see how easily the logic the book adopted originally could be applied to these relatively new companies in a cogent way.

Many new sidebars have also been added to chapters to enhance their substance and relevance. Some examples: the Execution chapter now includes a section on networks; the Vertical Integration chapter contains new sidebars on Coca-Cola Bottlers and on Zara; the chapter on Strategy over Time now shows the role of the iPhone in its industry life cycle; and the Competitive Advantage chapter has many new sidebars on Google, Apple, and other firms to illustrate major points. Also, where appropriate, we have extended the content to global competition, especially regarding China and its economy.

The teaching supplements for the fourth edition include an instructor's manual, PowerPoint files, and test bank, which are available on the Online Learning Center at www.mhhe.com/mcs4e.

Complementary cases are also available to incorporate into your class with Create™ at www.mcgrawhillcreate.com. Create allows you to select cases from Harvard, Ivey, Darden, NACRA, and more. You can either assemble your own course materials, selecting the chapters, cases, and readings that will work best for you, or choose from several ready-to-go, author-recommended complete course solutions—ExpressBooks, which include chapters, cases, and readings, pre-loaded in Create. Among the pre-loaded solutions, you'll find options for undergrad, MBA, accelerated, and other strategy courses.

The Many Contributors to the Book

Many people have helped in preparing this book. The list grows with every edition. Without their assistance, there would be no book at all. Initially, Steve Postrel was remarkably helpful in commenting on the material. His input was critical for choosing and organizing content throughout the book, but especially in Chapter 3. Cathy Maritan has also been enormously helpful in pointing out where the book could be improved and where it was effective. We have benefited from conversations with Nick Argyres, Jackson Nickerson, Russ Coff, Anita McGahan, Marvin Lieberman, Rich Makadok, Bruce Kogut, Margie Peteraf, David Hoopes, David and Rachel Croson, Gary Moskowitz, Michael Jacobides, Ron Adner, Tim Folta, Javier Gimeno, Tom Moliterno, Ed Zajac, Andy Spicer, Jordan Siegel, Pankaj Ghemawat, Gautam Ahuja, Asli Arikan, Dan Levinthal, Robert Burgelman, Michael Leiblein, Jon O'Brien, and Nydia MacGregor. We have appreciated the perspectives and insights of the executives who have discussed aspects of the book with us. We have had helpful conversations with Paul Passmore, Greg Mutz, John Alexander, Charles Palmer, Jack McCarty, Bill Truxal, Raymond Herpers, Chuck Armstrong, Warren Miller, and Atul Vohra; and we benefited from the insights of Chris Papenhause, University of Massachusetts–Dartmouth, who reviewed the third edition.

We are indebted to our students, who allowed us to experiment with the book's concepts as they applied to a wide range of teaching cases. This experience was essential for helping us appreciate how the book's ideas worked in the classroom. In many cases, the linkages between the ideas and their range of applicability were not clear until the ideas were taught.

Our publisher has provided invaluable assistance in putting this book together. Our editors at McGraw-Hill/Irwin—Laura Spell, and especially our developmental editor, Andrea Scheive—have been constantly supportive of this project and remarkably patient about its development. Thanks also to Katie Benson, editorial coordinator; Kelly Hart, content project manager, who kept us on schedule with such a deft hand.

Finally, our families and significant others deserve the greatest thanks. It will take a long time for us to repay their kindness and generosity.

Gordon Walker
Tammy L. Madsen

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Introduction

1 What Is Strategy?

CHAPTER 1

What Is Strategy?

Chapter Outline

Why Study Business Strategy?

In the modern era, the world economy has converged on a single approach to producing and selling products—call it market capitalism. Not all countries follow this model—there are a few holdouts (Cuba, North Korea, Laos). But over time more and more nations have adopted it as the way to manage their economies. There are varieties of market capitalism — the United States has one, China has another, Brazil a third — that differ primarily in the role of the state. However, all share a commitment to one key institution: the privately held firm.

In capitalist societies, firms compete with new products or ideas in the hope of success, and in spite of the threat of failure. The system works because the churning of firms and products, driven by competition, improves, on average, how well the people in a country live materially. And as living standards improve, the global economy moves forward.

This book addresses the question of what makes a firm successful. The approach here focuses on how firms succeed by attracting customers and at the same time making superior profits, which are necessary to sustain operations and satisfy investors. How the firm does this is called its strategy, a concept that means both where a business is positioned in its market and how it manages to compete within that position.

Since every firm competes in a market, every firm has a strategy, whether explicit or not. Some strategies are more profitable than others. This is true no matter what industry the firm is in, or what broader conditions—social or economic—the firm faces.

For example, Walmart competes at the low end of the mass merchandizing market, selling low-price goods. At the same time, Walmart's costs are very low. So even though it offers relatively cheap products, the company does well financially. Target sells slightly fancier merchandise than Walmart and so is more upscale. The question is: Which company is more profitable (in terms of its return on sales)—Walmart at the low end or Target with its higher-value products? It turns out that Target has higher profitability because on average it offers value to its customers more efficiently. The sources of Target's achievement are the assets, practices, and contracts it has designed and executed consistently. If Walmart could imitate these sources of Target's productivity, there would be a horse race in higher-value mass merchandising, leading to lower prices. But so far, because of both inertia and uncertainty in the demand for Target's products, Walmart has remained pretty much at the low end.

We usually put the word *competitive* before strategy to emphasize the persistent rivalry a firm faces in its markets. Because this competition is frequently head-to-head (e.g., Coke versus Pepsi, Intel versus AMD, Boeing versus Airbus), it is sometimes seen as warfare, especially in sales. But overgeneralizing military analogies, however interesting and motivating they may be (e.g., Sun Tzu's teachings; the observe, orient, decide, and act, or OODA, loop), can be dangerous.[1]

Unlike armies, firms have customers; and because they compete for customer accounts, firms don't act like soldiers fighting a battle. For example, competing firms do not confront each other directly, which means that there is no face-to-face contact where one firm tries to kill the other. Customer purchasing decisions determine success and failure, not arms and munitions. It is important to know the competition very well, but attention to the customer comes first. *In fact, without a customer, a firm produces nothing of value at all.*

Competition means that the goal of every business is to gain and sustain an advantage over rivals. This means achieving a strong market position and protecting it from attack by other firms. In the short term a strong position produces superior financial returns, but over time competition will erode these returns by pushing prices down. So in the long term both a good *offense*—a strong position—and a good *defense*—effective protection from rivalry—are necessary, and neither is sufficient. When both exist, the firm is said to have a **sustainable competitive advantage**.

The ultimate proof of a successful strategy is superior profitability, as shown in a firm's financial reports. Financial reports are the scorecard that measures how well a firm performs. Investors pore over these reports in order to decide where to put their money, and managers are rewarded when performance improves. So it is foolish to talk about strategy without paying close attention to how well a firm is doing financially compared to its competitors.

What Defines a Successful Strategy?

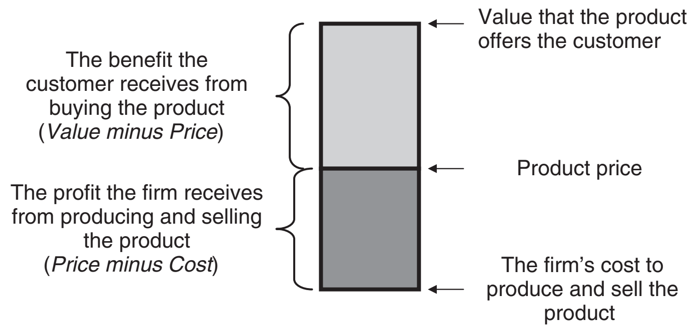
No single position in a market is necessary for business success. Some companies compete effectively at the high end of the market by providing superior value to customers through an appealing design, functionality, or brand. Apple iPhone is a good example (see the sidebar later in the chapter). Other firms succeed because of their low costs. Walmart in mass market merchandising and Nucor in steel represent this category.

But high value and low cost are only the two endpoints of the market. Can a firm succeed somewhere in the middle of this spectrum? The answer is absolutely yes, as the Target example shows. Another good illustration is Dannon Yogurt in the 1990s. Dannon offered the best combination of customer value and marginal cost, even as it was flanked on one side of the market by more upscale competitors and on the other side by firms with lower costs.[2] In fact, a firm can succeed anywhere in the market as long as its product attracts enough customers and the firm can sell it at a low enough cost to achieve superior profitability.

A good offense starts with an emphasis on the transaction with the customer. The transaction can be broken into two parts: (1) the value of the product to the customer less the price of the product (the bigger the difference, the more customers buy); and (2) the price of the product minus its cost to the firm (the bigger the difference, the more money the firm makes) (see Figure 1.1). Every successful strategy focuses on both of these parts. Some firms emphasize value first (Apple Computer), some cost first (Nucor), and some the combination of value and cost (Dannon Yogurt).

What about defense? Some firms succeed by focusing on preempting the competition. They do this by swamping the market in the early stages of industry development and then by defending their dominant positions aggressively. An excellent example is Microsoft. A lot has

FIGURE 1.1 | The Transaction with the Customer



been written about how Microsoft came to dominate PC operating systems, much of it based on antitrust cases in the United States and Europe that began in 1994 and 2000, respectively. These cases focused more on how the company defended its dominant market position than on whether the position was superior to that of competitors. To understand how Microsoft sustained its dominance, we therefore need to lay out how firms protect their market positions.

A market position can be defended in two ways. The first is to induce high rates of **customer retention** by keeping customers from defecting to rivals. The simple way to do this is to make defection expensive. The higher the **switching costs** a customer must incur in moving to a new product, the longer he or she is likely to stay with the current product. The second way is making sure that competition for customers is low. This can be accomplished by **preventing imitation**. Imitation is deterred when (1) copying the firm's product is difficult and expensive and (2) the costs of entry into the market are high. Microsoft used both of these defenses—high switching costs and high copying/entry costs—to become dominant in PC operating software.

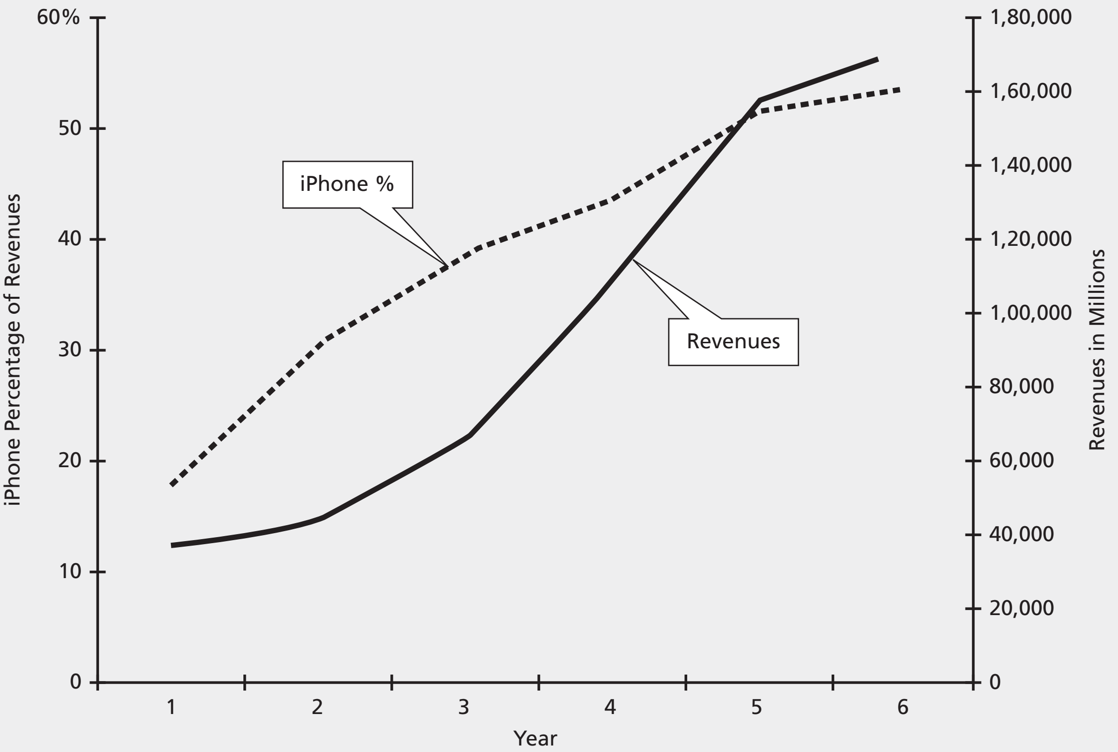
Can a firm play both offense and defense effectively? The clear answer is yes. A very good illustration is the Apple iPhone, as shown in the sidebar.

Apple iPhone

After being almost destroyed as a computer company by the Wintel standard, Apple restarted in 1997 under its founder, Steve Jobs, as a much smaller, but better capitalized, and more focused business. The Apple we know now really began with the iPod (and iTunes), which was followed by a host of new devices the company sells today (iPod Touch and Nano, iPhone, and iPad). The star in this group has been the iPhone, contributing over 53% to Apple's astonishing $171B in annual revenues in 2013 (see Figure 1.2). How did this product become so successful?

The design for an Apple mobile phone started in 2003. The first attempt called the ROKR was introduced in 2006. Jointly designed by Apple, Motorola, and Cingular, it failed almost immediately. Apple then decided to develop a phone on its own, and clouded in secrecy the project produced major innovations in touch screen technology, the phone's operating system, and a host of other components. Jobs had to wrest control over design from Cingular (afterwards part of AT&T), the phone company chosen to sell the product and that traditionally had dictated a phone's functions and appearance. Apple had barely finished the prototype for the iPhone when Jobs introduced it at the company's annual trade show in January 2007. It was an instant success, selling over 1 million phones in eight months worldwide, and fomenting a shakeout in international mobile phones (see Chapter 4, Strategy over Time). The iPhone 2 and 3G were introduced in 2008; the iPhone 4 in 2010; the iPhone 5 in 2012 and the iPhone 6 in 2014.

FIGURE 1.2 | iPhone Percentage of Apple Revenue



Source: Fred Vogelstein, "The Untold Story: How the Iphone Blew Up the Wireless Industry," *Wired Magazine,* January 9, 2008; Yoni Heisler, "Apple's iPhone: The Untold Story," *Network World,* September 13, 2012; and James Mitchell, Paul Faris, and Robert Spekman, "The Apple iPhone," Darden School of Business, University of Virginia, March, 2010.

What were the product's key features? The factors that contributed value to customers? First, it combined a phone with an iPod's music management system and web search, using a touch screen instead of a tactile keyboard. Also, it was composed of high-quality materials, had strong aesthetics (design, look and feel), the Apple brand, and the iTunes distribution system. Interestingly, the first iPhone did not have a broad range of apps. The powerful two-sided platform (users on one side, app developers on the other) was not developed until the iPhone 2. The diffusion of faster networks (3G and then 4G and LTE) served to enhance the value of the phone for web search. Based on these and new features (iOS updates, an explosion in apps, a thinner design, Siri the talking assistant), the phone became very popular, and revenues grew faster than other Apple products until 2013 when the iPad started to take off (again see Figure 1.2).

How about cost and profit? Apple had no real cost drivers internally but relied on its suppliers to develop economies of scale and scope, follow a steep learning curve for the production of each new component and, for most components and assembly, be based in a low-cost input location (China). The phone was expensive and the gross margin on the iPhone 4GB was estimated to be 38%—approximately the same as Apple's annual aggregate margins from 2011 to 2013.

How did Apple defend its phone from the competition? First, the apps, including iTunes, were iOS specific, raising the costs of switching to competitors. Switching costs were also increased through the ability of Apple products to sync with each other. In this way, it became difficult for a customer to move to any product outside the Apple family. The company prevented imitation through (1) sunk investments in brand and technology development, (2) its patents (always be litigating, especially against Samsung), and (3) its dedicated investments in some material suppliers (high-grade aluminum).

Is this strategy sustainable? Apple faces significant, increasing competition, primarily from lower-priced products with weaker brands, but not necessarily less functional devices. Also, in 2013 Apple's operating margins have decreased, indicating pricing pressure worldwide and rising costs in China. Further, Apple's brand is strong only with repeated, impressive innovation. Without a significant new product every two or three years, the Apple cachet may decline, giving competitors an opening and increasing price pressure even more. This logic is relevant even after the remarkable success of the iPhone 6 in late 2014. There can only be so many in this series before the line wears out. Then what?

We study strategy then to learn how businesses develop strong market positions and how they defend these positions once they are built. These two pillars of sustainable competitive advantage are the foundation of strategic thinking. Their combination in a strategy model is a formidable tool for improving financial performance over the long haul.

How Important Is Strategy, Really?

To get a sense of strategy's importance, we need to understand the full range of factors that predict a firm's profitability. Three types of factors have an impact: (1) macroeconomic forces, such as exchange rates, tax policy, regulation, and the ups and downs of the economy; (2) industry forces, such as competition and buyer and supplier power; and finally (3) characteristics of the business itself. Of these three types, research has shown that the firm's unique characteristics are frequently the most important, especially in manufacturing, service, and technology industries.[3]

Starting with macroeconomic factors, we would be foolish to ignore the pervasive effect they have on profits. For example, the rate of market growth can be very important. When global markets are expanding, as they were in the 1990s, firms in many industries make more money simply because demand is strong and products can be sold at higher prices. Sometimes one country can affect the fortunes of an entire region. The rise of China, for example, has been a boon to many companies in Korea, Japan, Taiwan, and the rest of Asia. Taxes and regulation also obviously affect how much money firms can make. Countries vary substantially in their fiscal policies and in their controls over products (see Chapter 9 on Global Strategy). Industry conditions also have an influence on profits. Some industries grow quickly (video games, social media) as others grow slowly (toasters, lawn mowers). Likewise, customers will buy everything firms produce in one industry, while in other industries companies struggle to sell anything. Some industries can be relatively cheap to enter and are overrun with competition (cattle ranching, money market funds, mobile phone apps), while the cost of entering other industries is prohibitive (automobiles, aluminum, global mobile phones). Even within industries that are hard to enter, firms can fight fiercely for a share of the market (Coke versus Pepsi) or live and let live (the global cement industry). Also, powerful buyers and suppliers can limit how much money firms make. Thus industry forces—competition, entry, buyers, and suppliers—as well as other factors such as substitute products (skis versus snowboards) constrain profits.

Interestingly, research shows that in general the most important influence on the firm's performance is the firm itself. What does this mean? First, in a single industry firms can differ widely in the resources and capabilities that affect profits, independent of macroeconomics and industry factors such as competition and entry barriers. Moreover, differences among firms are very often greater than those between industries or between macro shifts. So when these three levels—macro, industry, and firm—are analyzed together as contributors to profitability, firms come out on top: Their differences have the most powerful influence. This is one reason we focus on them so strongly in this book.

The Origins of Strategy

Where did strategy come from as a subject of study? The seven basic sources of thinking about strategy in capitalist systems are the following:

- Strategic planning tools.
- Industrial economics.
- Evolutionary economics.
- Case studies of exemplary companies.
- Business and industry history.
- Economic and organizational sociology.
- Institutional economics.

Each of these touches on the question of why some firms are more successful than others. But none provides a wholly satisfying answer. Only when viewed as a whole can they give us a reasonable framework for understanding competitive advantage.

Strategic Planning Strategy has evolved in part from planning tools for top managers (see Chapter 6).[4] Although it can improve performance markedly, strategic planning does not actually determine the array of investments managers choose from. Indeed, planning is neither necessary nor sufficient for higher performance. As long as a firm invests in projects that have a higher value than those of competitors, it doesn't need a formal strategic plan to be successful. However, planning models frequently capture key challenges and therefore can be very useful in identifying strategic problems. Without effective planning, a successful firm in a changing market can lose its advantage very quickly.

Industrial Economics Planning tools without an underlying economic logic have little benefit. The most salient discipline that provides such a logic is industrial economics (see Chapter 3).[5] A dominant tradition in this field, developed at Harvard in the 1950s, holds that industry forces, such as the degree of concentration in market shares, constrain what a firm can do. This so-called structure-conduct-performance paradigm is the basis of Michael Porter's famous book *Competitive Strategy*.[6] A more recent approach in economics is game theory, which also looks at the behavior of firms in an industry but only in terms of direct competitive interaction. Both these approaches to strategy assume that managers make decisions rationally. This may be true some of the time, but casual observation makes it hard to argue that it is true all the time.

Evolutionary Economics A third tradition in economics that applies to strategy but does not rely on rational decision making is evolutionary economics. Some of the work in this discipline focuses on the evolution of practices within firms and some focuses on the evolution of industries. Much of what is understood about how firms develop capabilities and how industries move through the stages of a life cycle is based on this tradition (see Chapter 4).[7]

While neither industrial nor evolutionary economics alone is enough to encompass the discipline of strategy, each makes critical contributions. In this book they are combined with mainstream strategic analysis to cover the key topics for understanding competitive advantage.

Business Cases A fourth building block of strategy analysis consists of in-depth case studies of exemplary companies.[8] Cases capture the challenges behind the investment decisions that create successful positions. Although cases cannot completely explain how a company competes, they provide important insights, especially by showing how firms develop innovations that competitors can't imitate. The concept of a distinctive competence or capability has been derived from case studies and is critical for analyzing a firm's strategy.

Business History Business and industry histories have also added significantly to strategy.[9] Because of their scope and detail, firm histories deepen the empirical base from which strategic concepts are formed. By describing competitive behavior over time, historians show how successful market positions have emerged.[10]

Economic Sociology The contributions of economic and organizational sociology to strategy are found in four areas.[11] First, analyses of industry trends, especially rates of firm failure, have shown the relative importance of firm size and age for survival. Second, the internal structures and processes of firms have been analyzed for their relative efficiency and potential for generating innovations. Third, the development of networks of organizations has been analyzed as a strategic resource. Fourth, advantages associated with geographical location have been identified. These contributions are important parts of the strategy domain.

Institutional Economics The final building block of strategy is institutional economics, which focuses on the effective governance of the firm's boundaries (see Chapters 7 and 8).[12] Governing the boundary through vertical integration, outsourcing, and partnering is critical for strategy execution and has become important in global industries over the past 30 years. Boundary decisions and the firm's market position are closely tied to each other since they depend crucially on what activities need to be controlled in order to succeed with customers.