



Kellogg
School of Management

MGMT-431: Business Strategy
The Seven Big Ideas

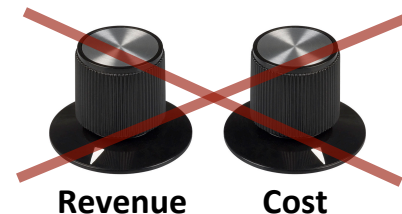
Overview

QUESTION

- What should a firm do in order to earn **long-run profits**?

ANSWER

- Answering this question is **easy**: Raise revenues and cut costs
- Answering this question is **hard**:
 - Firms don't control revenues and costs directly and independently
 - Many choices a firm can make influence both revenues and costs, which means that choices will almost always involve **trade-offs**
 - How these trade-offs work in a particular instance depends on the particular **context** of the firm



APPROACH

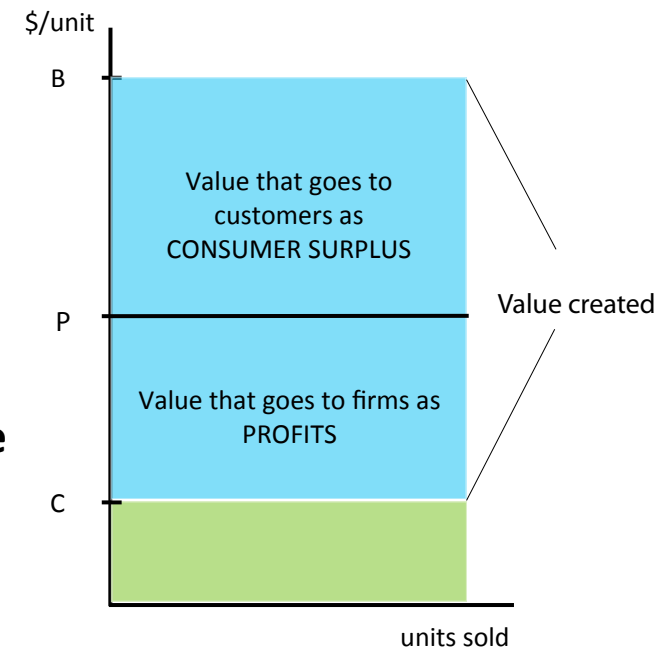
- Aim is to train students to think well. Must learn by doing.
- Lectures to explain (mostly simple) concepts combined with Socratic discussion of 3 or 4 popular press articles
- Longer and more involved case discussions

Value Creation and Capture

Remember the profit function. And use it!

KEY CONCEPTS

- The fundamental purpose of the firm is to undertake activities that **create value**
 - Value Created = (Customer benefits - Per unit costs) * Quantity sold = $(B - C) * Q$
- A product or service must create benefits for the **end user** in order to create value
 - Consumers will choose products that maximize their consumer surplus $(B - P)$
- A firm's objective is to **maximize profits**: $\Pi = (P - C) * Q$
 - A strategy can be profitable only if it increases P, reduces C, or increases Q
 - Strategy choices almost always involve **trade-offs**
- A firm must create value in order capture value as profits
- Creating value does not inevitably result in **capturing value**



Value Creation and Capture application

Can Chipotle increase its profits by using “fair food” tomatoes?

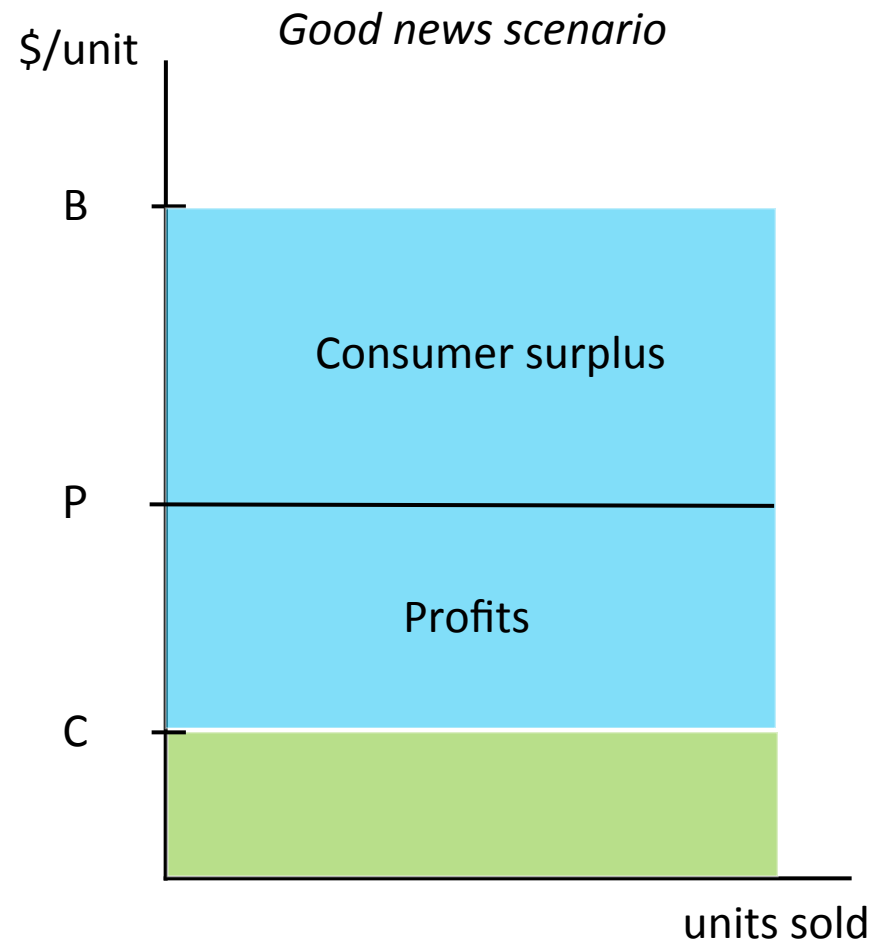
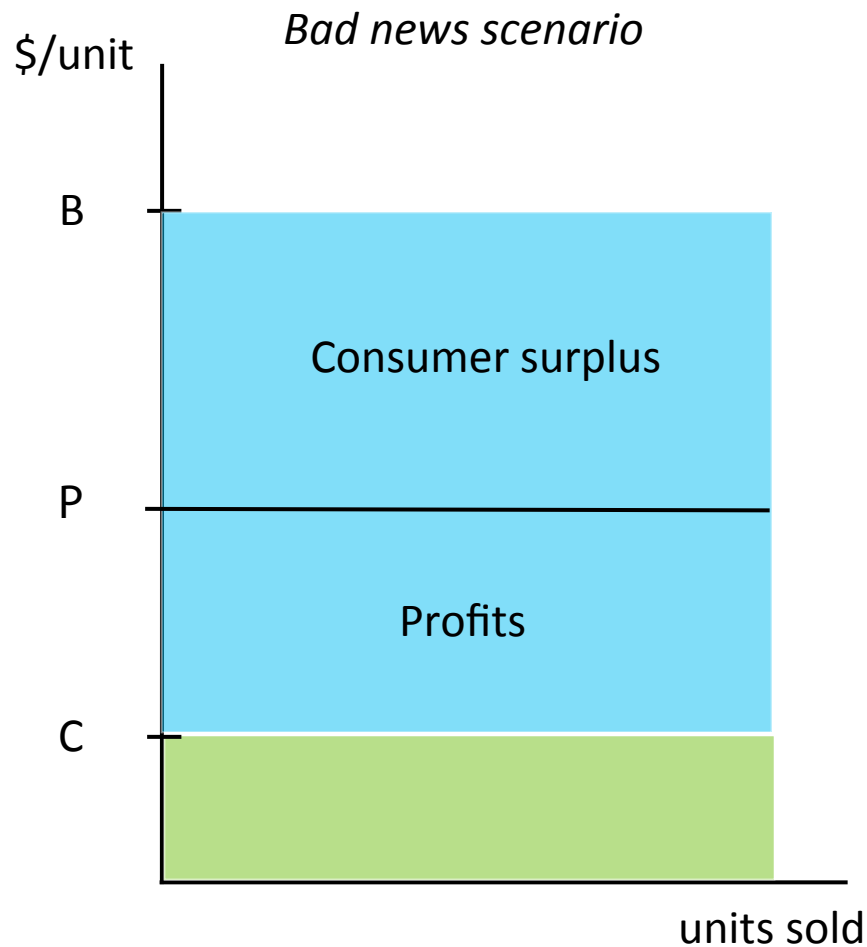
CHIPOTLE EXAMPLE

- **Tomato pickers** in Florida earn 45 cents per 32 pound bucket of tomatoes picked (\$10,000 - \$12,000 per year), a rate that has gone up only 5 cents in 30 years
- The Coalition of Immokalee Workers has called for fast food restaurants who use tomatoes to pay pickers an extra **penny per pound** for tomatoes
- **Chipotle** advertises itself as “**Food with integrity**” and emphasizes its use of sustainably farmed ingredients
- Will Chipotle increase its profits if it switches to “**fair food**” tomatoes?



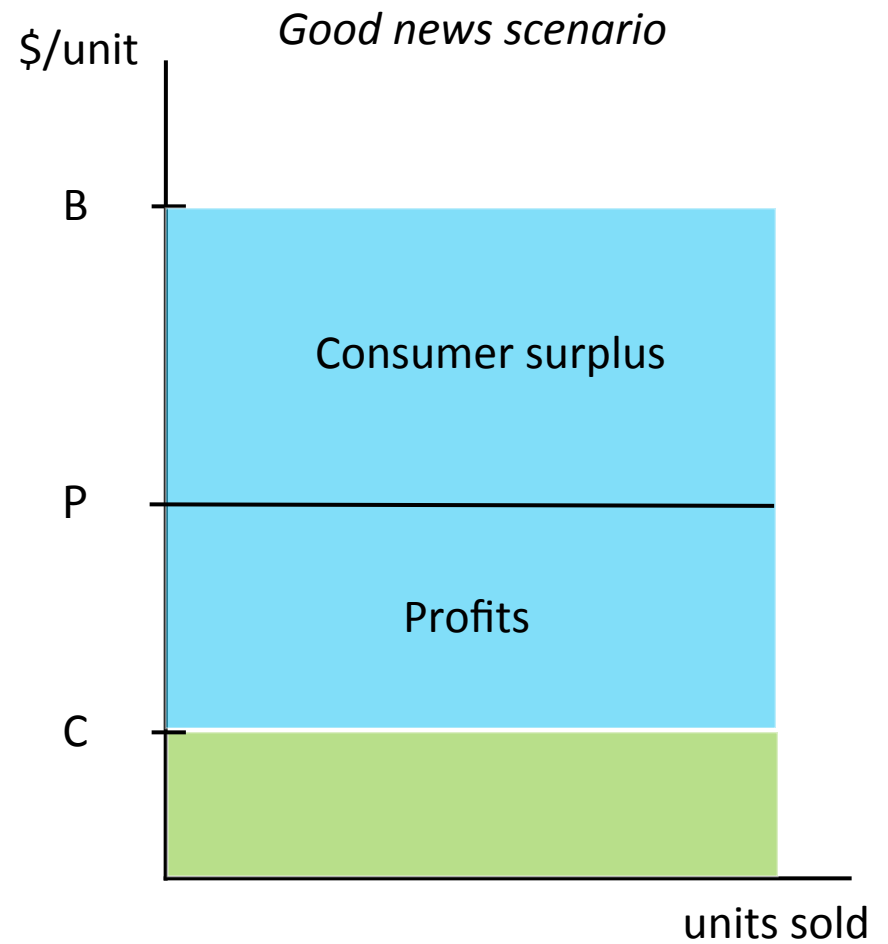
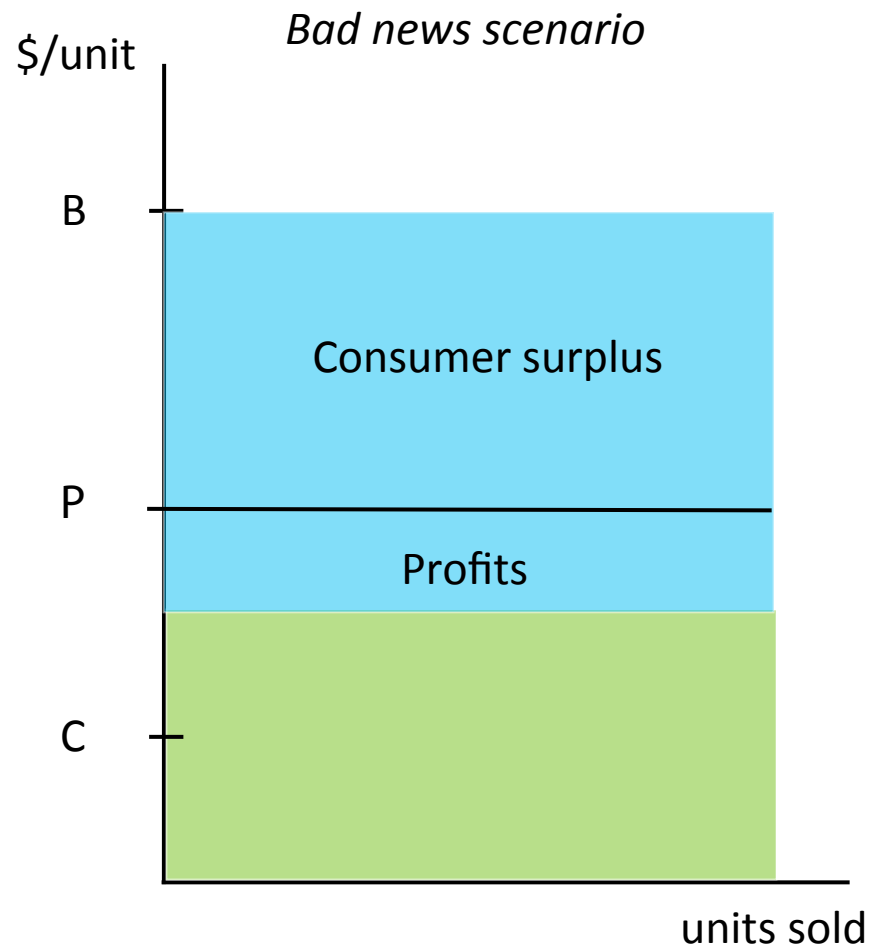
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VALUE CREATION AND CAPTURE



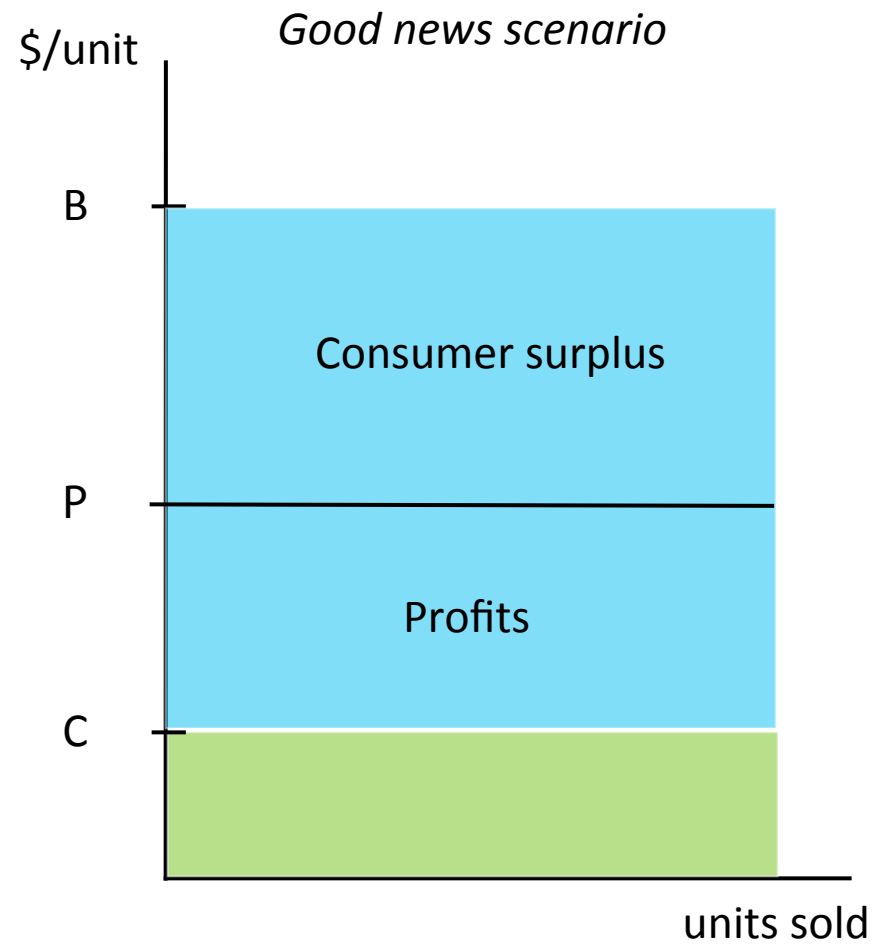
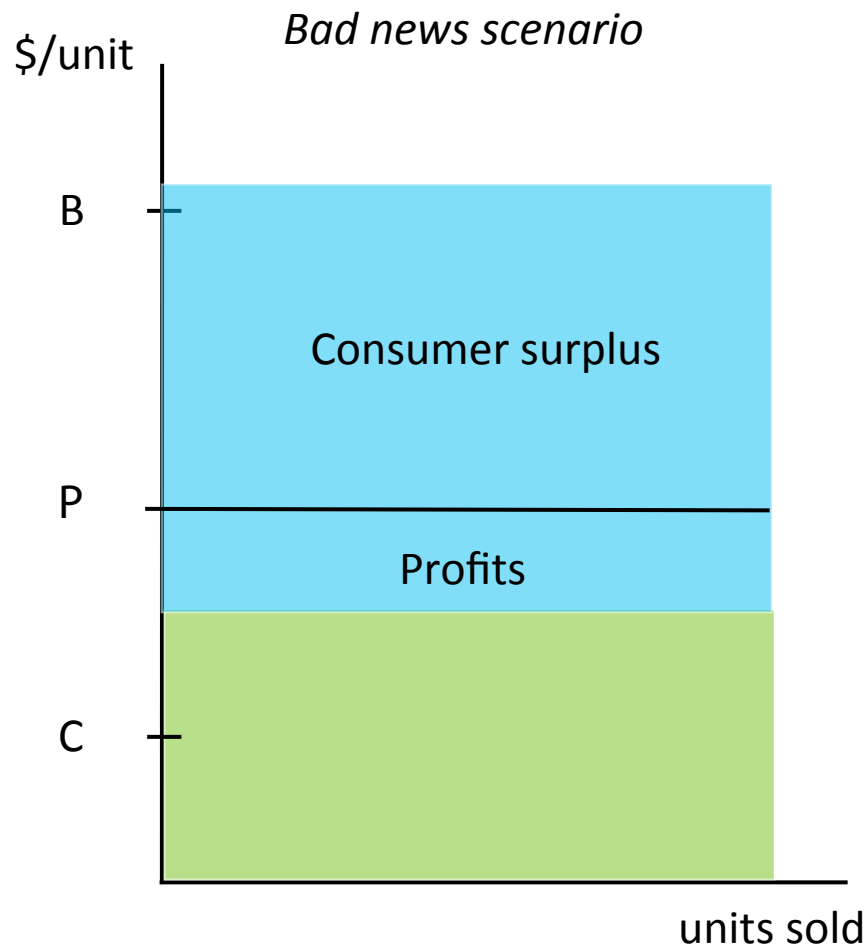
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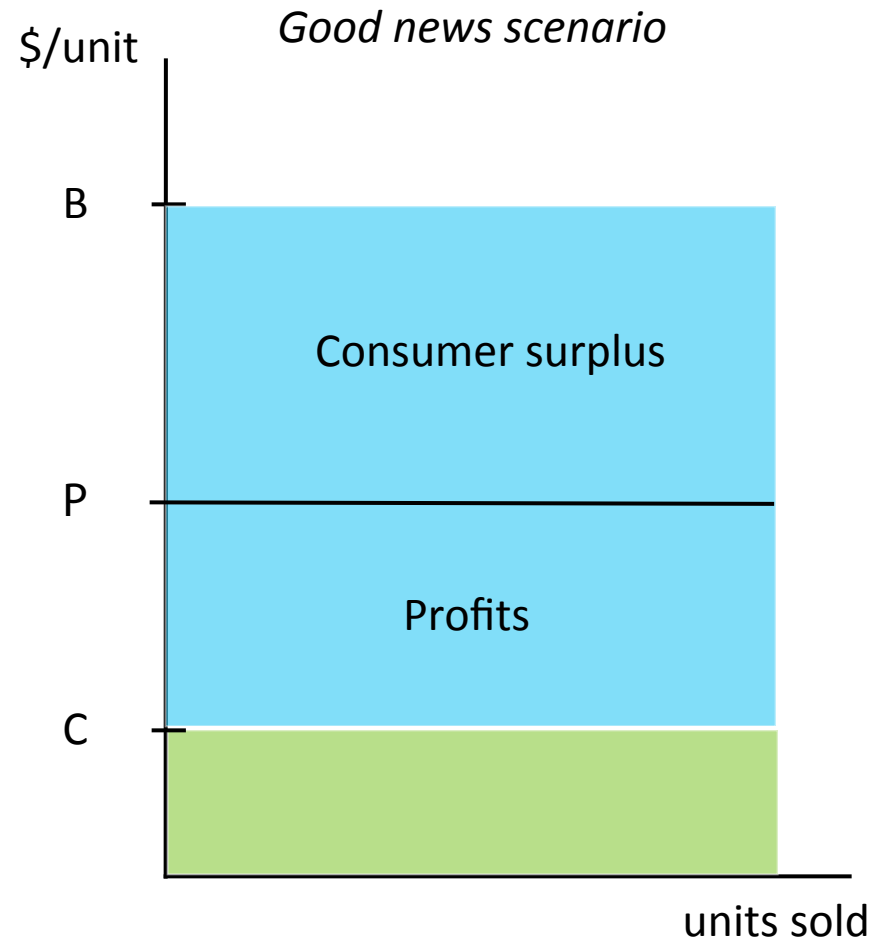
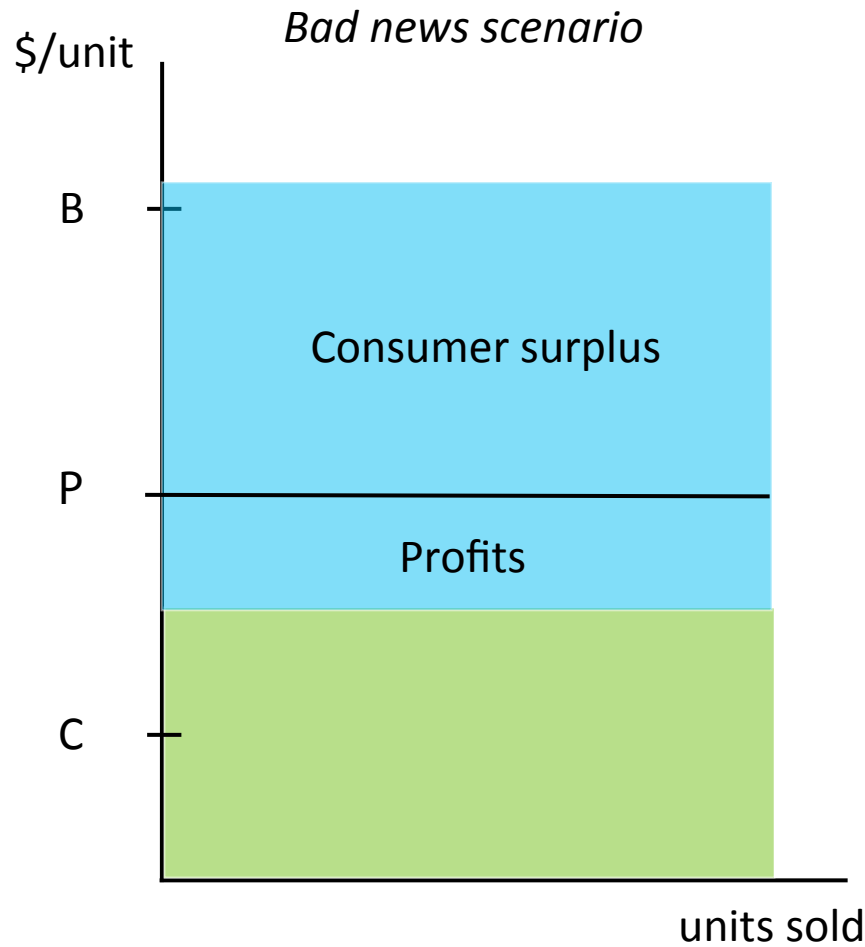
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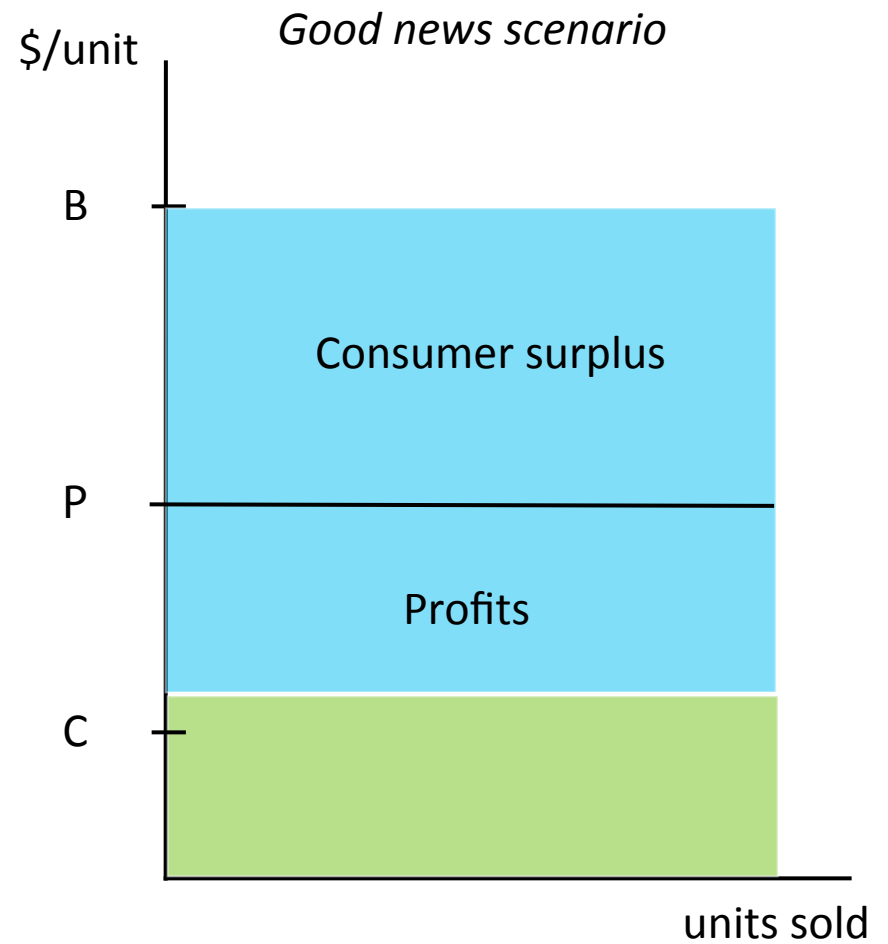
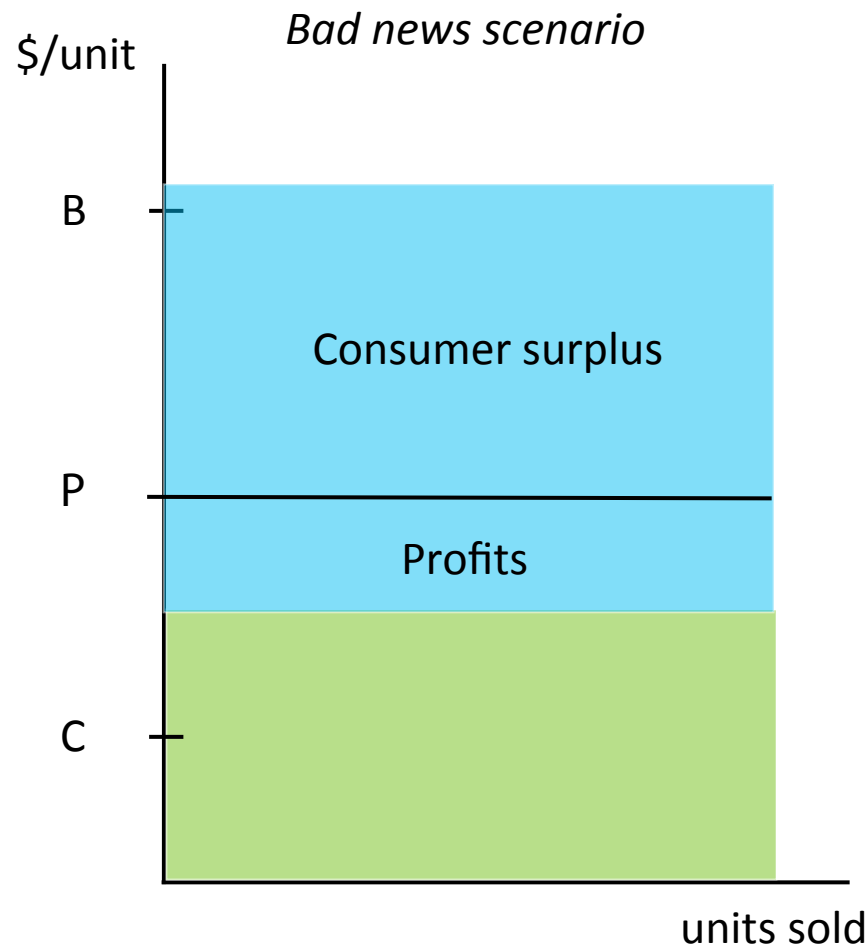
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*Costs go up a lot, benefits only a little
Difficult to increase price and profits*

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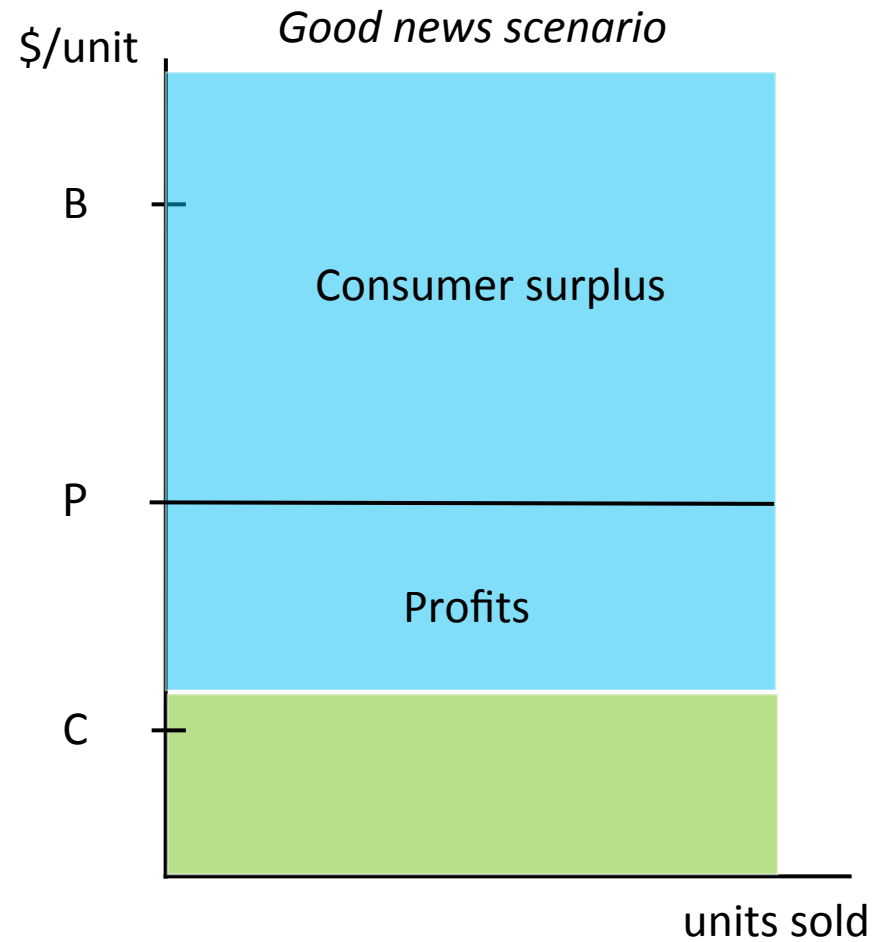
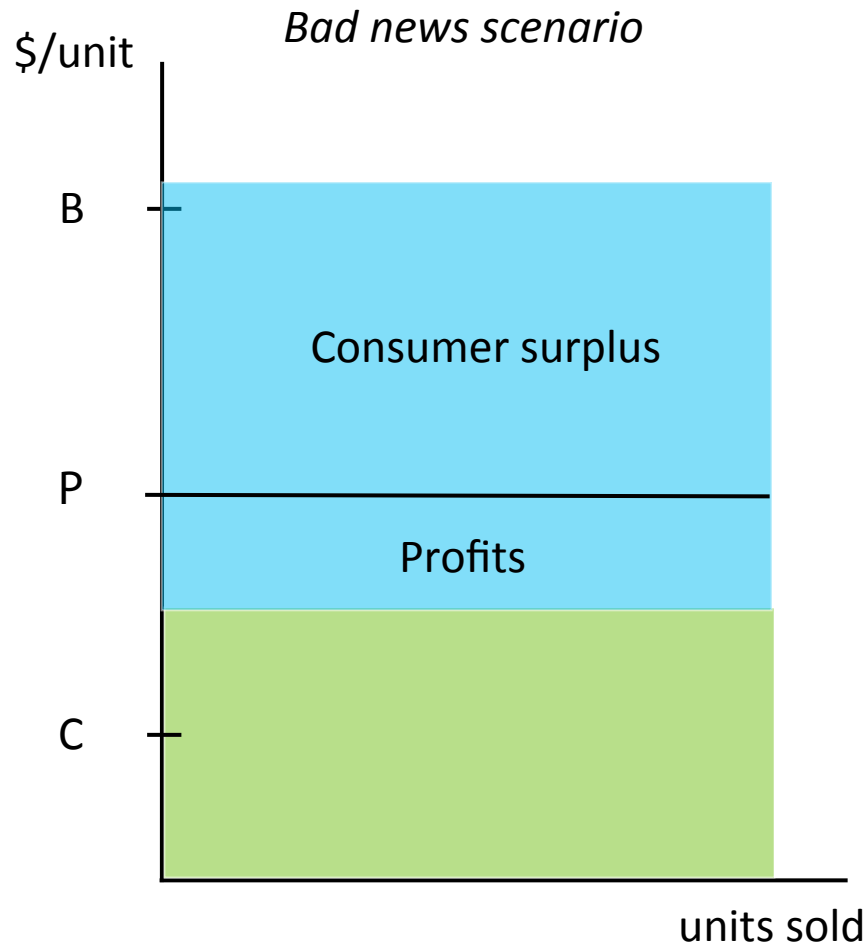
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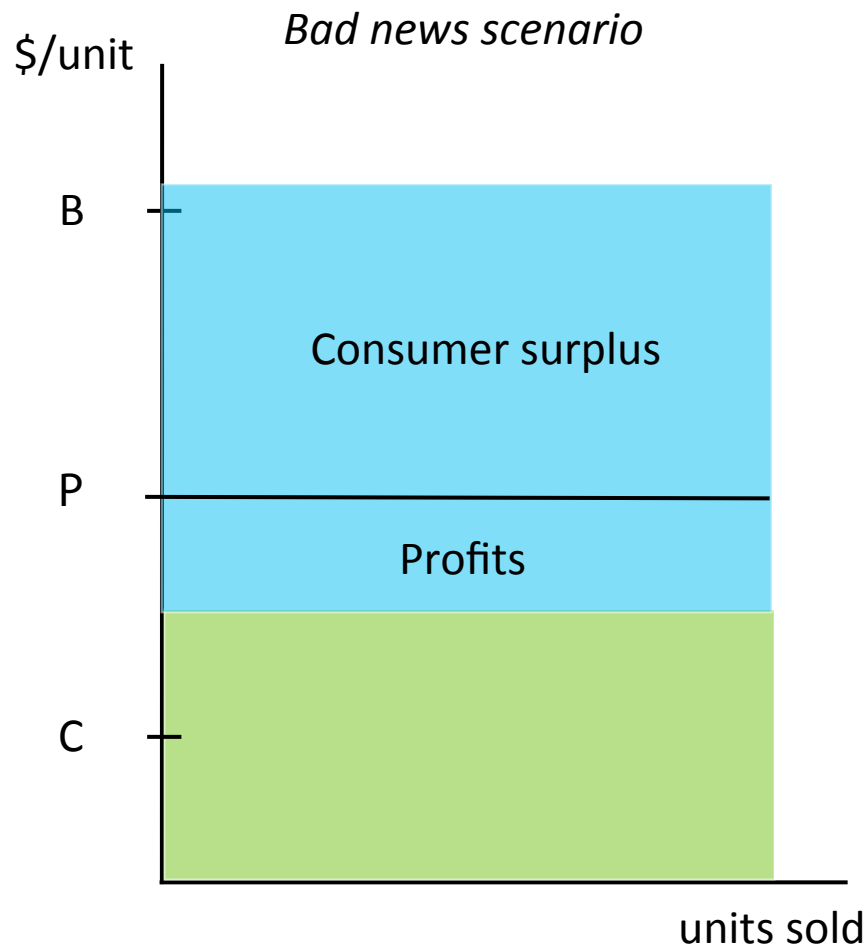
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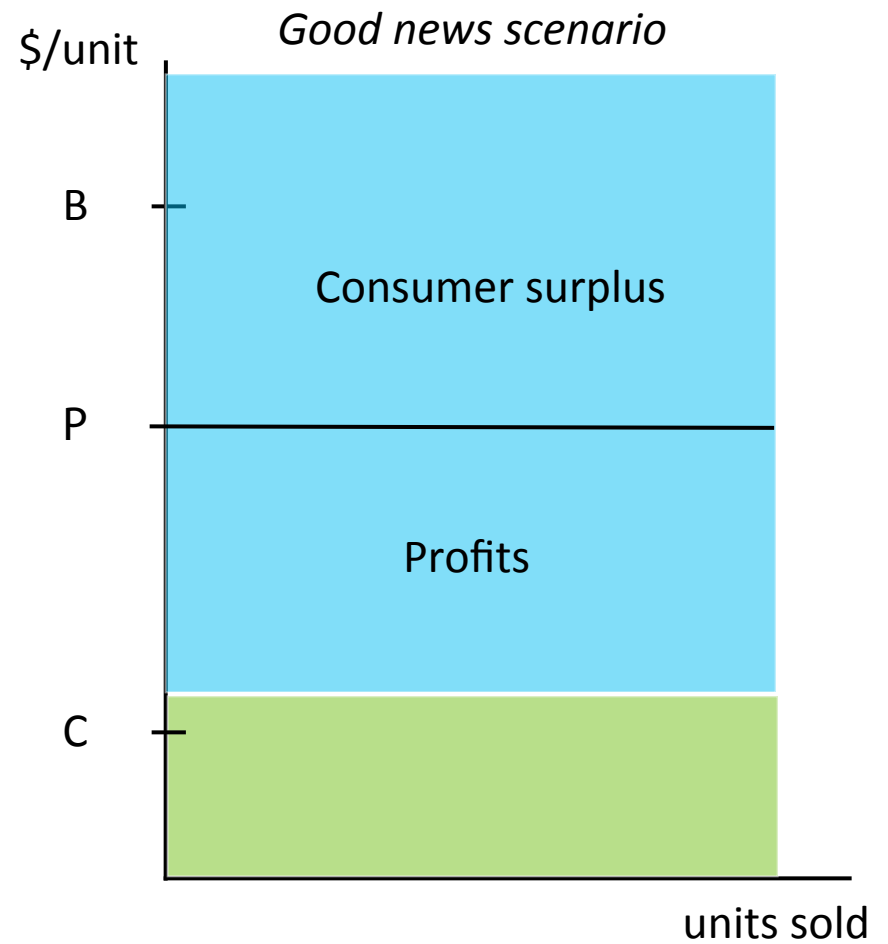
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VALUE CREATION AND CAPTURE



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*Costs go up a little, benefits a lot
Easier to increase price and profits*

Irreplaceability (or Added Value)

Your irreplaceability is what you (uniquely) bring to the table.

KEY CONCEPTS

- A player's **Irreplaceability** is the total value with a player in the interaction minus the total value without that player in the interaction
 - a.k.a. (Size of the pie with you there) – (size of the pie without you)
 - a.k.a. **what you bring to the game**
- Your irreplaceable value is value that you **uniquely** create
- A player can't generally "take out" more than they "put in," which makes a player's irreplaceable value the **maximum** (but not the minimum) profit a player can expect
 - Players must have strategies that enable them to **obtain** their irreplaceability as profits
- For example, **Apple** is more irreplaceable in creation of value from the **iPhone** than the **carriers** are
 - Apple consequently earns much more of the profits generated by the iPhone than the carriers do



Irreplaceability application

What happens when Intel becomes irreplaceable in PCs?

INTEL EXAMPLE

- In 1981, **personal computers** had **not yet established** their value as business tools
- **IBM**, because of its history in “business machines” and computing became the **market-leading PC** and established an **architecture standard**
- **Intel** provided the **microprocessor** for the IBM PC, one of many outsourced components
- However, the microprocessor (and the operating system) turned out to be a **key defining component** of the architecture; little that IBM contributed uniquely was
- This became clear when **Compaq** introduced a PC based on the Intel 386 chip which was completely **compatible** with all software than ran on IBMs
- The PC market was quickly taken over by “**IBM clones**” that ran on the “**Wintel**” platform
- Intel (and Microsoft) were very profitable; IBM and other OEMs struggled



Industry Analysis

The Five Forces are always a good place to start.

KEY CONCEPTS

- Industry structure can explain the differences in profits **between** industries
- **The Five Forces** are
 - Rivalry (potential profits dissipated by price competition)
 - Entry (potential profits that go to other players)
 - Substitutes (potential profits that go to other products)
 - Supplier Power (potential profits that go to suppliers via high input prices)
 - Buyer Power (potential profits that go to buyers via low product prices)
- This framework is an expansive **checklist** to help understand the environment; it does not outline the “right” strategy
- The forces are **industry-level** feature and do not explain **differences in profits between firms**

Industry Analysis application

Why can't Boeing and Airbus make money selling airplanes?

AIRLINE INDUSTRY EXAMPLE

- In 2003, Airbus sold Iberia 12 new A340s for a price 40% below list, too low for Airbus to have made a profit on the deal. Why?

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- Orders are **large and infrequent**, and imply big **follow-on revenue** from parts
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- The Airbus A340 and Boeing 777 are **very similar** in flight range, seating capacity, fuel usage, and many other characteristics

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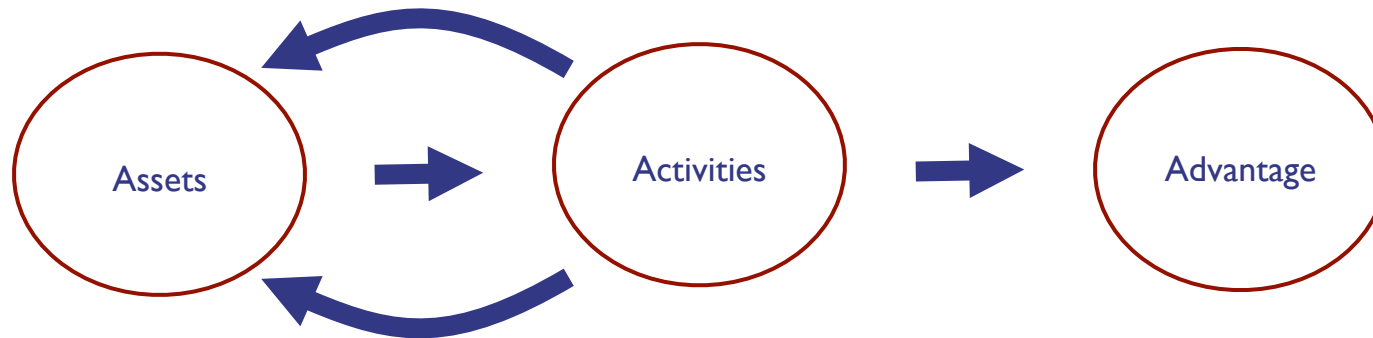
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→ **Entry:
Low**

Competitive Advantage

Assets enable activities that lead to competitive advantage.

KEY CONCEPTS



- We draw a **distinction** between assets and activities to emphasize the role of **strategic choices** in explaining differences in profitability *within* an industry
- Competitive advantage is the ability to be **consistently more profitable** than other firms in the same industry
 - Cost-based
 - Benefit-based
 - Niche-based
- Assets **don't automatically** generate advantage; it's what you **choose to do** with those assets that matters
- Competitive advantage is **not** attractive industry characteristics or competitive necessities. Not everything a profitable firm does is part of its competitive advantage.

Competitive Advantage application

Why is Enterprise Rent-a-car consistently the most profitable?

ENTERPRISE EXAMPLE

- Enterprise focuses on the **local** rather than airport rental market
 - **Accident/insurance** and **repair** customers
 - Customers who temporarily need an **extra** or **different** car
- It has created a distinctive set of **assets** and engages in a distinctive set of **activities** to meet the needs of these customers well and at low enough costs to be profitable
 - **Location**: Many small rental offices, in convenient but low-profile sites near where people live, work, or get cars repaired
 - **Human resource**: Hire college graduates, but from the bottom of the class, looking especially for athletes and fraternity/sorority types. Work in small teams in local offices doing everything from vacuuming cars to interacting with customers. Strong incentive pay based on customer satisfaction, promote almost entirely from within.
 - **Operations**: Maintain cars to keep them on the road 6 months longer than competitors.
 - **Insurance and referral relationships**: Information systems integrated with insurance companies. Foster relationships with car repair shops and dealerships in order to encourage referrals.



Sustainable Competitive Advantage

Why is this strategy great? And why isn't everyone doing it?

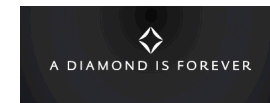
KEY CONCEPTS

- Strategies that will result in a sustainable competitive advantage generally exhibit four characteristics

- **Heterogeneity:** You can't do better by doing what everyone else does.



- **Inimitability:** Others will copy good decisions, unless something stops them.



- **Appropriability:** You must be able to capture some of the value created as profits.

- ▶ Co-specialization (whole is greater than the sum of the parts)



- **Foresight:** Act early to avoid losing out on opportunities or paying the full value of an asset.



- Some advantages **grow over time**, and grow more difficult to replicate or undermine.
- Strategies whose elements exhibit **consonance** (also called fit, coherence, co-specialization, or mutual reinforcement) are particularly robust

Sustainable Competitive Advantage application

Enterprise demonstrates sustainable competitive advantage.

ENTERPRISE EXAMPLE

Heterogeneous

- Enterprise focuses on the **local market** rather than on the airport market



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Heterogeneous

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Inimitable

- Enterprise has many **assets and activities** that are **difficult to copy**
 - large network of small local offices
 - fleet management software and expertise
 - employee culture
 - reputation and ECARS software integration with repair shops
 - relationships and ARMS software integration with insurance companies

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Appropriable

- Many aspects of Enterprise's strategy are **co-specialized** (or **mutually reinforcing**)
 - Social outgoing employees are good at developing and maintaining relationships with repair shops
 - Competitive employees and strong performance incentives are valuable in a business where developing local business matters
 - Relationships with insurance companies and repair shops are stable and profitable because Enterprise has good customer service
 - Social, outgoing, empowered employees are valuable for customers who have just been in an accident and value a helpful, streamlined process
 - Cars can be kept on the road longer because customers are not business travelers

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Foresight

- All these advantages were created **before** other rental car companies recognized that local market could be so profitable
 - Others can't enter without having Enterprise as a strong competitor
 - Enterprise reputation and relationships advantages grow stronger over time

Firm Scope: Integration within a business line

Integration is expensive, so make sure it is worth it.

KEY CONCEPTS

- A firm must have a **compelling reason** to become its own supplier or customer since it will **forego** taking advantage of an **efficient market** by doing so
- Depending on the context, vertical integration *may*:
 - **Foreclose** on rivals, increase rivals' costs, or avoid being foreclosed upon
 - Improve **information** flows and **incentives**
 - Avoid the risk of **opportunism**
 - Reduce transaction costs arising from **uncertainty**
- Always ask the question: "Why can't we just write a **contract** to achieve the same results?"

swatch[®] 



Firm Scope application

Frito-Lay had to grow their own potatoes in China.

FRITO-LAY IN CHINA EXAMPLE

- Pepsi saw **salty snacks** as an opportunity in China, both for its own sake and to make in-roads for Pepsi beverages against market leading Coke



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 - Local varieties turn dark when fried
 - Local potatoes are often bruised because they are harvested roughly by hand



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- Pepsi hired a **North Dakota potato-growing company** to manage farms in China
 - Applied **fungicide** that appeared to be what would have been used in the U.S., but killed half the crop
 - **Communicated poorly** with Chinese farm workers



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 - **Communicated poorly** with Chinese farm workers
- Finally, Pepsi created its **own farms**, hiring its **own local managers**



Firm Scope: Synergies between business lines

Good synergies are probable, concrete, and well understood.

KEY CONCEPTS

- Two activities (or business lines) should be combined within a firm if and only if their **combined** profits are higher than the **sum of the individual** profits that would be realized if they were in two separate companies
- **Synergies** exist when activities are more profitable when undertaken **together** than when undertaken **separately**.
- This will occur when the firm can realize synergies by combining two activities in such a way that the combination will
 - **Reduce** costs
 - **Increase** benefits
 - **Shift** market share
- **Beware** of fuzzy, implausible, tangential, poorly articulated, or speculative synergies

Firm Scope application

Disney sells the Disney experience many different ways

DISNEY EXAMPLE

- Disney's **characters** embody magic, childhood, fantasy, imagination, and nostalgia



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Firm Scope application

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- Disney's more **recent expansion** has been into businesses that are less related to its animated character core (ABC network, ESPN, Mighty Ducks hockey team, Hollywood records, Miramax)
- This has **reduced the opportunities** for realizing synergies



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12. The reward for success is that you face better, harder, but more interesting problems.