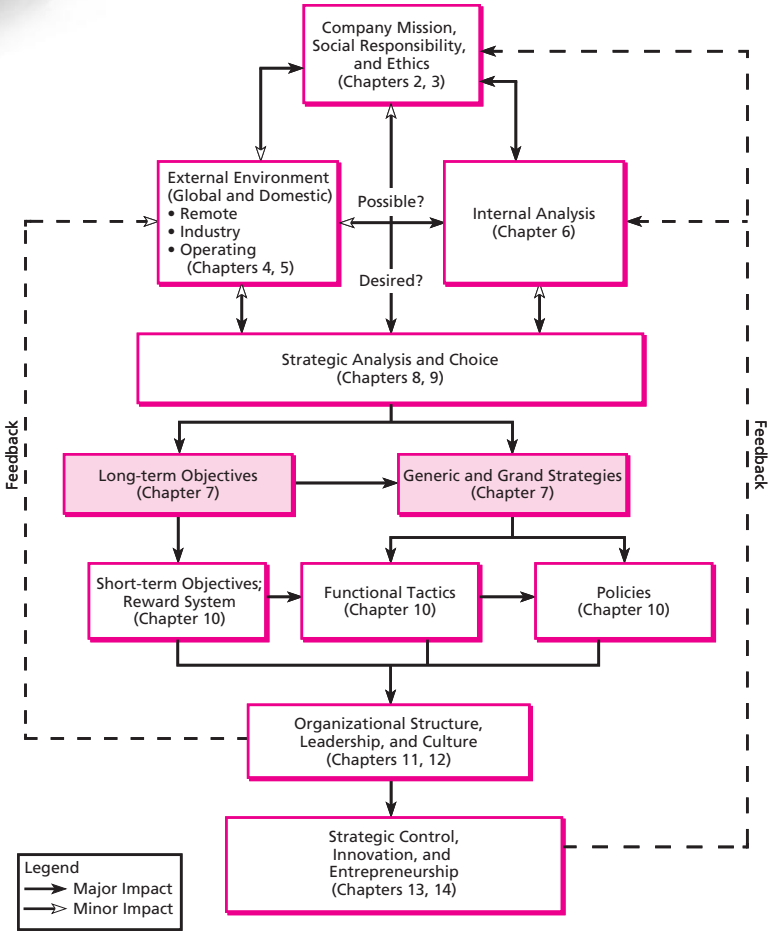
Chapter **Seven**

Long-Term Objectives and Strategies

After reading and studying this chapter, you should be able to

1. Discuss seven different topics for long-term corporate objectives.
2. Describe the five qualities of long-term corporate objectives that make them especially useful to strategic managers.
3. Explain the generic strategies of low-cost leadership, differentiation, and focus.
4. Discuss the importance of the value disciplines.
5. List, describe, evaluate, and give examples of the 15 grand strategies that decision makers use as building blocks in forming their company's competitive plan.
6. Understand the creation of sets of long-term objectives and grand strategies options.



The company mission was described in Chapter 2 as encompassing the broad aims of the firm. The most specific statement of aims presented in that chapter appeared as the goals of the firm. However, these goals, which commonly dealt with profitability, growth, and survival, were stated without specific targets or time frames. They were always to be pursued but could never be fully attained. They gave a general sense of direction but were not intended to provide specific benchmarks for evaluating the firm's progress in achieving its aims. Providing such benchmarks is the function of objectives.[1]

The first part of this chapter will focus on long-term objectives. These are statements of the results a firm seeks to achieve over a specified period, typically three to five years. The second part will focus on the formulation of grand strategies. In combination, these two components of long-term planning provide a comprehensive general approach in guiding major actions designed to accomplish the firm's long-term objectives.

The chapter has two major aims: (1) to discuss in detail the concept of long-term objectives, the topics they cover, and the qualities they should exhibit; and (2) to discuss the concept of grand strategies and to describe the 15 principal grand strategy options that are available to firms singly or in combination, including three newly popularized options that are being used to provide the basis for global competitiveness.

LONG-TERM OBJECTIVES

Strategic managers recognize that short-run profit maximization is rarely the best approach to achieving sustained corporate growth and profitability. An often repeated adage states that if impoverished people are given food, they will eat it and remain impoverished; however, if they are given seeds and tools and shown how to grow crops, they will be able to improve their condition permanently. A parallel choice confronts strategic decision makers:

1. Should they eat the seeds to improve the near-term profit picture and make large dividend payments through cost-saving measures such as laying off workers during periods of slack demand, selling off inventories, or cutting back on research and development?
2. Or should they sow the seeds in the effort to reap long-term rewards by reinvesting profits in growth opportunities, committing resources to employee training, or increasing advertising expenditures?

For most strategic managers, the solution is clear—distribute a small amount of profit now but sow most of it to increase the likelihood of a long-term supply. This is the most frequently used rationale in selecting objectives.

To achieve long-term prosperity, strategic planners commonly establish long-term objectives in seven areas:

Profitability The ability of any firm to operate in the long run depends on attaining an acceptable level of profits. Strategically managed firms characteristically have a profit objective, usually expressed in earnings per share or return on equity.

Productivity Strategic managers constantly try to increase the productivity of their systems. Firms that can improve the input-output relationship normally increase profitability. Thus, firms almost always state an objective for productivity. Commonly used productivity objectives are the number of items produced or the number of services rendered per unit of input. However, productivity objectives sometimes are stated in terms of desired cost decreases. For example, objectives may be set for reducing defective items, customer

[1] The terms *goals* and *objectives* are each used to convey a special meaning, with goals being the less specific and more encompassing concept. Most authors follow this usage; however, some use the two words interchangeably, while others reverse the usage.

complaints leading to litigation, or overtime. Achieving such objectives increases profitability if unit output is maintained.

Competitive Position One measure of corporate success is relative dominance in the marketplace. Larger firms commonly establish an objective in terms of competitive position, often using total sales or market share as measures of their competitive position. An objective with regard to competitive position may indicate a firm's long-term priorities. For example, Gulf Oil set a five-year objective of moving from third to second place as a producer of high-density polypropylene. Total sales were the measure.

Employee Development Employees value education and training, in part because they lead to increased compensation and job security. Providing such opportunities often increases productivity and decreases turnover. Therefore, strategic decision makers frequently include an employee development objective in their long-range plans. For example, PPG has declared an objective of developing highly skilled and flexible employees and, thus, providing steady employment for a reduced number of workers.

Employee Relations Whether or not they are bound by union contracts, firms actively seek good employee relations. In fact, proactive steps in anticipation of employee needs and expectations are characteristic of strategic managers. Strategic managers believe that productivity is linked to employee loyalty and to appreciation of managers' interest in employee welfare. They, therefore, set objectives to improve employee relations. Among the outgrowths of such objectives are safety programs, worker representation on management committees, and employee stock option plans.

Technological Leadership Firms must decide whether to lead or follow in the marketplace. Either approach can be successful, but each requires a different strategic posture. Therefore, many firms state an objective with regard to technological leadership. For example, Caterpillar Tractor Company established its early reputation and dominant position in its industry by being in the forefront of technological innovation in the manufacture of large earthmovers. E-commerce technology officers will have more of a strategic role in the management hierarchy of the future, demonstrating that the Internet has become an integral aspect of corporate long-term objective setting. In offering an e-technology manager higher-level responsibilities, a firm is pursuing a leadership position in terms of innovation in computer networks and systems. Officers of e-commerce technology at GE and Delta Air have shown their ability to increase profits by driving down transaction-related costs with Web-based technologies that seamlessly integrate their firms' supply chains. These technologies have the potential to "lock in" certain suppliers and customers and heighten competitive position through supply chain efficiency.

Public Responsibility Managers recognize their responsibilities to their customers and to society at large. In fact, many firms seek to exceed government requirements. They work not only to develop reputations for fairly priced products and services but also to establish themselves as responsible corporate citizens. For example, they may establish objectives for charitable and educational contributions, minority training, public or political activity, community welfare, or urban revitalization. In an attempt to exhibit their public responsibility in the United States, Japanese companies, such as Toyota, Hitachi, and Matsushita, contribute more than $500 million annually to American educational projects, charities, and nonprofit organizations.

Qualities of Long-Term Objectives

What distinguishes a good objective from a bad one? What qualities of an objective improve its chances of being attained? These questions are best answered in relation to five criteria that should be used in preparing long-term objectives: flexible, measurable over time, motivating, suitable, and understandable.

Flexible Objectives should be adaptable to unforeseen or extraordinary changes in the firm's competitive or environmental forecasts. Unfortunately, such flexibility usually is increased at the expense of specificity. One way of providing flexibility while minimizing its negative effects is to allow for adjustments in the level, rather than in the nature, of objectives. For example, the personnel department objective of providing managerial development training for 15 supervisors per year over the next five-year period might be adjusted by changing the number of people to be trained. In contrast, changing the personnel department's objective of "assisting production supervisors in reducing job-related injuries by 10 percent per year" after three months had gone by would understandably create dissatisfaction.

Measurable Objectives must clearly and concretely state what will be achieved and when it will be achieved. Thus, objectives should be measurable over time. For example, the objective of "substantially improving our return on investment" would be better stated as "increasing the return on investment on our line of paper products by a minimum of 1 percent a year and a total of 5 percent over the next three years."

Motivating People are most productive when objectives are set at a motivating level—one high enough to challenge but not so high as to frustrate or so low as to be easily attained. The problem is that individuals and groups differ in their perceptions of what is high enough. A broad objective that challenges one group frustrates another and minimally interests a third. One valuable recommendation is that objectives be tailored to specific groups. Developing such objectives requires time and effort, but objectives of this kind are more likely to motivate.

Objectives must also be achievable. This is easier said than done. Turbulence in the remote and operating environments affects a firm's internal operations, creating uncertainty and limiting the accuracy of the objectives set by strategic management. To illustrate, the rapidly declining U.S. economy in 2000–2003 made objective setting extremely difficult, particularly in such areas as sales projections. Motorola provides a good example of well-constructed company objectives. Motorola saw its market share of the mobile telephone market shrink from 26 to 14 percent between 1996 and 2001, while its main rival Nokia captured all of Motorola's lost share and more. As a key part of a plan to recapture its market position, Motorola's CEO challenged his company with the following long-term objectives:

1. Cut sales, marketing, and administrative expenses from $2.4 billion to $1.6 billion in the next fiscal year.
2. Increase gross markings from 20 to 27 percent by 2002.
3. Reduce the number of Motorola telephone styles by 84 percent to 20 and the number of silicon components by 82 percent to 100 by 2003.

Suitable Objectives must be suited to the broad aims of the firm, which are expressed in its mission statement. Each objective should be a step toward the attainment of overall goals. In fact, objectives that are inconsistent with the company mission can subvert the firm's aims. For example, if the mission is growth oriented, the objective of reducing the debt-to-equity ratio to 1.00 would probably be unsuitable and counterproductive.

Understandable Strategic managers at all levels must understand what is to be achieved. They also must understand the major criteria by which their performance will be evaluated. Thus, objectives must be so stated that they are as understandable to the recipient as they are to the giver. Consider the misunderstandings that might arise over the objective of "increasing the productivity of the credit card department by 20 percent within two years." What does this objective mean? Increase the number of outstanding cards? Increase the use of outstanding cards? Increase the employee workload? Make productivity gains each year? Or hope that the new computer-assisted system, which should improve

productivity, is approved by year 2? As this simple example illustrates, objectives must be clear, meaningful, and unambiguous.

The Balanced Scorecard

balanced scorecard
A set of four measures directly linked to a company's strategy: financial performance, customer knowledge, internal business processes, and learning and growth.

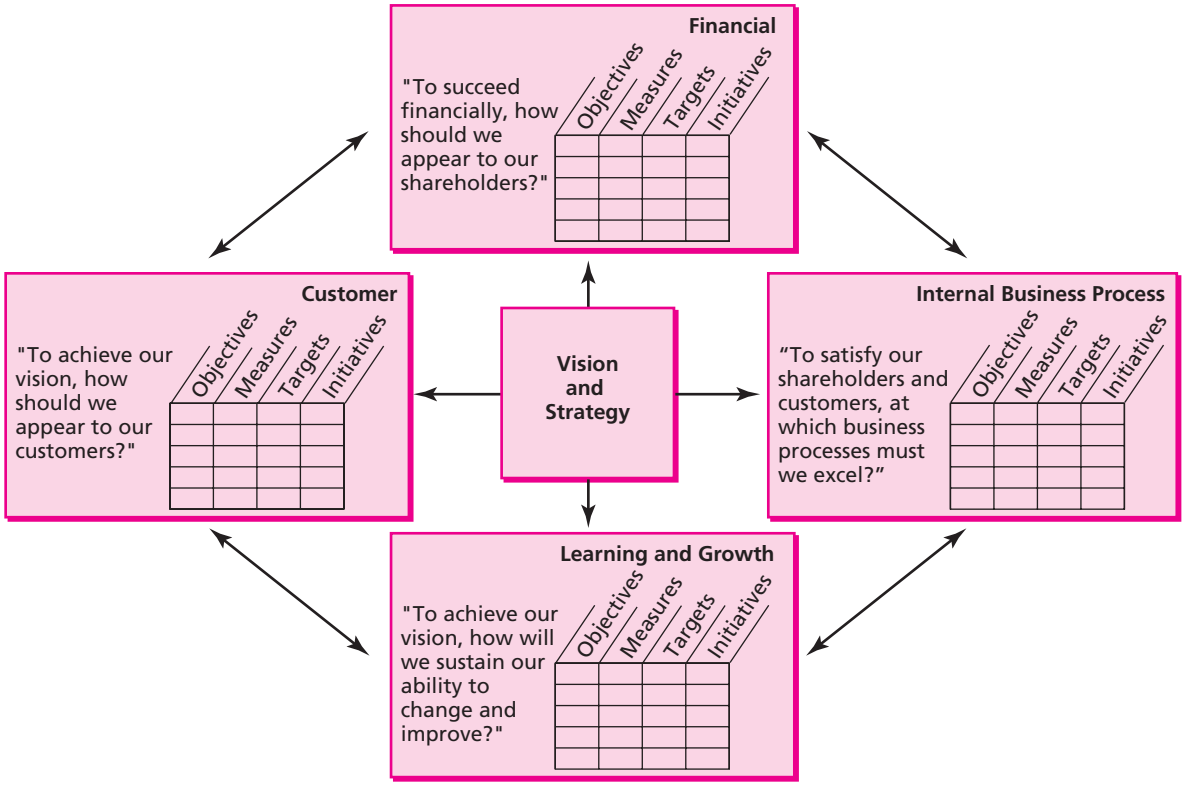
The **balanced scorecard** is a set of measures that are directly linked to the company's strategy. Developed by Robert S. Kaplan and David P. Norton, it directs a company to link its own long-term strategy with tangible goals and actions. The scorecard allows managers to evaluate the company from four perspectives: financial performance, customer knowledge, internal business processes, and learning and growth.

The balanced scorecard, as shown in Exhibit 7.1, contains a concise definition of the company's vision and strategy. Surrounding the vision and strategy are four additional boxes; each box contains the objectives, measures, targets, and initiatives for one of the four perspectives:

- The box at the top of Exhibit 7.1 represents the financial perspective and answers the question "To succeed financially, how should we appear to our shareholders?"
- The box to the right represents the internal business process perspective and addresses the question "To satisfy our shareholders and customers, what business processes must we excel at?"

Exhibit 7.1 **The Balanced Scorecard**

The balanced scorecard provides a framework to translate a strategy into operational terms



Source: Reprinted by permission of *Harvard Business Review*. Exhibit from "Using the Balanced Scorecard as a Strategic Management System," by Robert S. Kaplan and David P. Norton, January–February 1996. Copyright © 1996 by the Harvard Business School Publishing Corporation; all rights reserved.

- The learning and growth box at the bottom of Exhibit 7.1 answers the question "To achieve our vision, how will we sustain our ability to change and improve?"
- The box at the left reflects the customer perspective and responds to the question "To achieve our vision, how should we appear to our customers?"

All of the boxes are connected by arrows to illustrate that the objectives and measures of the four perspectives are linked by cause-and-effect relationships that lead to the successful implementation of the strategy. Achieving one perspective's targets should lead to desired improvements in the next perspective, and so on, until the company's performance increases overall.

A properly constructed scorecard is balanced between short- and long-term measures, financial and nonfinancial measures, and internal and external performance perspectives.

The balanced scorecard is a management system that can be used as the central organizing framework for key managerial processes. Chemical Bank, Mobil Corporation's US Marketing and Refining Division, and CIGNA Property and Casualty Insurance have used the Balanced Scorecard approach to assist in individual and team goal setting, compensation, resource allocation, budgeting and planning, and strategic feedback and learning.

GENERIC STRATEGIES

Many planning experts believe that the general philosophy of doing business declared by the firm in the mission statement must be translated into a holistic statement of the firm's strategic orientation before it can be further defined in terms of a specific long-term strategy. In other words, a long-term or grand strategy must be based on a core idea about how the firm can best compete in the marketplace.

generic strategy
A core idea about how a firm can best compete in the marketplace.

The popular term for this core idea is **generic strategy.** From a scheme developed by Michael Porter, many planners believe that any long-term strategy should derive from a firm's attempt to seek a competitive advantage based on one of three generic strategies:

1. Striving for overall *low-cost leadership* in the industry.
2. Striving to create and market unique products for varied customer groups through *differentiation.*
3. Striving to have special appeal to one or more groups of consumer or industrial buyers, *focusing* on their cost or differentiation concerns.

Advocates of generic strategies believe that each of these options can produce above average returns for a firm in an industry. However, they are successful for very different reasons.

Low-Cost Leadership

Low-cost leaders depend on some fairly unique capabilities to achieve and sustain their low-cost position. Examples of such capabilities are having secured suppliers of scarce raw materials, being in a dominant market share position, or having a high degree of capitalization. Low-cost producers usually excel at cost reductions and efficiencies. They maximize economies of scale, implement cost-cutting technologies, stress reductions in overhead and in administrative expenses, and use volume sales techniques to propel themselves up the earning curve. The commonly accepted requirements for successful implementation of the low-cost and the other two generic strategies are overviewed in Exhibit 7.2.

A low-cost leader is able to use its cost advantage to charge lower prices or to enjoy higher profit margins. By so doing, the firm effectively can defend itself in price wars, attack competitors on price to gain market share, or, if already dominant in the industry,

EXHIBIT 7.2
Requirements for Generic Competitive Strategies

Source: Adapted with the permission of The Free Press, a division of Simon & Schuster Adult Publishing Group, from *Competitive Strategy: Techniques for Analyzing Industries and Competitors* by Michael E. Porter. Copyright © 1980, 1998 by The Free Press. All rights reserved.

Generic Strategy	Commonly Required Skills and Resources	Common Organizational Requirements
Overall cost leadership	Sustained capital investment and access to capital. Process engineering skills. Intense supervision of labor. Products designed for ease in manufacture. Low-cost distribution system.	Tight cost control. Frequent, detailed control reports. Structured organization and responsibilities. Incentives based on meeting strict quantitative targets.
Differentiation	Strong marketing abilities. Product engineering. Creative flare. Strong capability in basic research. Corporate reputation for quality or technological leadership. Long tradition in the industry or unique combination of skills drawn from other businesses. Strong cooperation from channels.	Strong coordination among functions in R&D, product development, and marketing. Subjective measurement and incentives instead of quantitative measures. Amenities to attract highly skilled labor, scientists, or creative people.
Focus	Combination of the above policies directed at the particular strategic target.	Combination of the above policies directed at the regular strategic target.

simply benefit from exceptional returns. As an extreme case, it has been argued that National Can Company, a corporation in an essentially stagnant industry, is able to generate attractive and improving profits by being the low-cost producer.

In the wake of the tremendous successes of such low-cost leaders as Wal-Mart and Target, only a rare few companies can ignore the mandate to reduce cost. Yet, doing so without compromising the key attributes of a company's products or services is a difficult challenge. One company that has succeeded in its efforts to become a low-cost leader while maintaining quality standards is Nucor. The company's Top Strategist, Daniel Dimicco, is profiled in Exhibit 7.3.

Differentiation

Strategies dependent on differentiation are designed to appeal to customers with a special sensitivity for a particular product attribute. By stressing the attribute above other product qualities, the firm attempts to build customer loyalty. Often such loyalty translates into a firm's ability to charge a premium price for its product. Cross-brand pens, Brooks Brothers suits, Porsche automobiles, and Chivas Regal Scotch whiskey are all examples.

The product attribute also can be the marketing channels through which it is delivered, its image for excellence, the features it includes, and the service network that supports it. As a result of the importance of these attributes, competitors often face "perceptual" barriers to entry when customers of a successfully differentiated firm fail to see largely identical products as being interchangeable. For example, General Motors hopes that customers will accept "only genuine GM replacement parts."

Because advertising plays a major role in a company's development and differentiation of it brand, many strategists use celebrity spokespeople to represent their companies. These spokespeople, most often actors, models, and athletes, help give the company's products and services a popular, successful, trendy, modern, cache. An example of such a celebrity

Top Strategist

Daniel Dimicco, CEO of Nucor

Exhibit 7.3

Nucor has long been known as the best operator in the steel business and is especially famous for its enlightened workforce relations and commitment to new technologies. It pays line workers according to their productivity and listens to, and implements, their ideas to make the process better. Responsibility is pushed as close to the front line as possible. For most of its history, Nucor only grew organically, but under CEO Daniel Dimicco the company has found it's often cheaper to buy than build. Now executives export the Nucor way to a series of acquired plants: in the past year, it has bought Connecticut Steel, Harris Steel Group, and the assets of Verco Manufacturing. Acquisitions such as Verco, a maker of steel floors and roof decks, help broaden Nucor's product line and support its migration into higher-margin products.

Source: Reprinted with special permission from "The *BusinessWeek* 50—The Best Performers," *BusinessWeek,* March 26, 2007. Copyright © 2007 The McGraw-Hill Companies.

endorser is Dwyane Wade of the Miami Heat, who is discussed in Exhibit 7.4, Strategy in Action.

Focus

A focus strategy, whether anchored in a low-cost base or a differentiation base, attempts to attend to the needs of a particular market segment. Likely segments are those that are ignored by marketing appeals to easily accessible markets, to the "typical" customer, or to customers with common applications for the product. A firm pursuing a focus strategy is willing to service isolated geographic areas; to satisfy the needs of customers with special financing, inventory, or servicing problems; or to tailor the product to the somewhat unique demands of the small- to medium-sized customer. The focusing firms profit from their willingness to serve otherwise ignored or underappreciated customer segments. The classic example is cable television. An entire industry was born because of a willingness of cable firms to serve isolated rural locations that were ignored by traditional television services. Brick producers that typically service a radius of less than 100 miles and commuter airlines that serve regional geographic areas are other examples of industries where a focus strategy frequently yields above-average industry profits.

A well-known brand that is enjoying tremendous success with a focus strategy is the automobile manufacturer Lamborghini. Its financial turnaround, which is based on controlled growth, is described in Exhibit 7.5, Strategy in Action.

While each of the generic strategies enables a firm to maximize certain competitive advantages, each one also exposes the firm to a number of competitive risks. For example, a low-cost leader fears a new low-cost technology that is being developed by a competitor; a differentiating firm fears imitators; and a focused firm fears invasion by a firm that largely targets customers. As Exhibit 7.6 suggests, each generic strategy presents the firm with a number of risks.

Strategy in Action

Exhibit 7.4

Building a Megabrand Named Dwyane

BusinessWeek

Practice is over at American Airlines Arena, and Dwyane Wade takes a minute to explain how he's putting his touch on a new mobile phone. The All-Star guard for the Miami Heat and a self-proclaimed budding businessman is helping wireless carrier T-Mobile USA Inc. design a limited-edition Sidekick, the texting device/cell phone beloved by 20-somethings.

Wade is changing the marketing landscape in ways other phenoms can learn from. He isn't simply endorsing products, he's partnering with major brands to design items other than sports equipment and apparel. On February 17, 2007, the weekend of the NBA All-Star Game, the D Wade Sidekick—the T-Mobile device he co-designed—was introduced with much fanfare.

Team Wade, led by agent Henry Thomas, aims to transform its young client into one of the top 10 brands in sports. The idea, says marketing strategist Andrew Stroth of Chicago's CSMG Sports Ltd., is to create a global brand that transcends sports. "Forget his peers in the NBA," he says. "We want people to think of Dwyane Wade the same way they think of [David] Beckham, Jordan, and Tiger."

Wade's original Converse contract was worth $500,000 a year. But after Wade showed his mettle in the 2005 playoffs, the Converse contract was renegotiated to about $10 million a year. As part of the deal, Converse agreed to make not only Wade basketball shoes but also casual and active attire. He'll receive incentives based on the success of these breakout categories, says Ric Wilson, sports marketing chief at Converse. "Converse is backed by the Nike engine, and it gives us the opportunity to reinvent Converse with Wade as the face."

But the most innovative aspect of the Wade branding campaign may be its Web strategy—which was born from a moment of serendipity in the sky. Team Wade had already launched a Web site but knew they needed to leverage the Internet more effectively to engage his young fans. On October, 17, 2006, on a flight from New York to Chicago, Stroth sat next to a Google executive. They agreed the two camps should meet. The next week, in Chicago, Google reps preached moving beyond "independent sites" such as Wade's. Those sites, along with charity appearances, TV ads, and video games, make for an "episodic" relationship between the athlete and fans. But digital media allow for brands to be built daily or hourly—what Google calls "dialogue" marketing.

So Team Wade gave Google the go-ahead to develop a plan that would make Dwyanewade.com an integral part of fans' daily digital lives. The goal? A fully interactive site built by Google with Google Search functions embedded. Fans would get a customized mix of e-mail, sports news feeds, flash games, and promotional messages.

Source: Reprinted with special permission from Roger O. Crockett, "Building a Megabrand Named Dwyane," *BusinessWeek,* February 12, 2007. Copyright © 2007 The McGraw-Hill Companies.

THE VALUE DISCIPLINES

International management consultants Michael Treacy and Fred Wiersema propose an alternative approach to generic strategy that they call the value disciplines.[2] They believe that strategies must center on delivering superior customer value through one of three value disciplines: operational excellence, customer intimacy, or product leadership.

Operational excellence refers to providing customers with convenient and reliable products or services at competitive prices. Customer intimacy involves offerings tailored to match the demands of identified niches. Product leadership, the third discipline, involves offering customers leading-edge products and services that make rivals' goods obsolete.

Companies that specialize in one of these disciplines, while simultaneously meeting industry standards in the other two, gain a sustainable lead in their markets. This lead is derived from the firm's focus on one discipline, aligning all aspects of operations with it. Having decided on the value that must be conveyed to customers, firms understand more clearly what must be done to attain the desired results. After transforming their

[2] The ideas and examples in this section are drawn from Michael Treacy and Fred Wiersema, "Customer Intimacy and Other Value Disciplines," *Harvard Business Review* 71, no. 1 (1993), pp. 84–94.

Strategy in Action

Exhibit 7.5

A Burst of Speed at Lamborghini

BusinessWeek

After years of restructuring, the sports car maker is finally a serious rival to Ferrari.

Lamborghini has long held mythic sway over car aficionados. Its exotic flying-saucer design, its horsepower on steroids, and its deafening engines have been a powerful draw for fans such as comedian Jay Leno and actor Jamie Foxx. But for years, Lamborghini suffered from financial woes and quality problems. The Italian super-sports-car maker went through six owners in 16 years and spent 1978–1981 in bankruptcy. So for most of Lamborghini's 44-year history, it has been a mere speck in Ferrari's rearview mirror, selling just about 250 cars a year at $274,000 for a Gallardo Spyder and $354,000 for a Murcielago roadster.

Now an infusion of German cash is helping Lamborghini burn rubber. In 1998, automaker Audi bought the company. After spending some $500 million revamping production and developing models, Lamborghini has the scale to mount a real challenge to Ferrari. In 2006, Lamborghini says it sold more than 2,000 cars, and sales in the U.S. shot up 48 percent in the first 10 months alone. The company today has about 100 showrooms worldwide, up from only 45 in 1998, although Ferrari still has roughly twice as many dealers.

Besieged with orders, Lamborghini's factory in Sant'Agata Bolognese, near Modena, is running full tilt, turning out 10 cars daily. That's brisk, considering it takes a worker an entire day just to cut and hand-stitch one leather seat. Still, it's not fast enough for all the Lamborghini lovers getting in line. Both the 640-hp Murcielago and the 520-hp Gallardo have one-year waiting lists.

With sales finally soaring, Lamborghini is on a stronger financial footing, too. Cost-cutting helped boost 2006 operating margins to nearly 4 percent, up from 1.8 percent in 2005, Morgan Stanley estimates. The brokerage predicts pretax profit could more than double in 2007, to $14 million, as revenues increase 30 percent to $400 million. That's still small compared with Ferrari's expected 2006 sales of $1.9 billion and 5,400 cars. But by tapping into Audi's engineering expertise, purchasing power, and supplier relationships, Lamborghini could eventually match Ferrari's sales—and surpass its 12 percent operating margin.

To preserve its super-luxury image, Lamborghini will take a page from Ferrari and pursue profits over growth. In 2007, it expects to expand sales less than 10 percent. "We are a niche of a niche," says chief executive Stephan Winkelmann. The former Fiat executive wants to boost earnings with limited-edition models packed with pricey options. Another untapped vein for Lamborghini is clothing and other gear emblazoned with its raging-bull logo. The company is starting to license merchandise, a business that generates some $200 million a year each for Ferrari and Porsche.

Source: Reprinted with special permission from Gail Edmondson, "A Burst of Speed at Lamborghini," *BusinessWeek,* January 15, 2007. Copyright © 2007 The McGraw-Hill Companies.

organizations to focus on one discipline, companies can concentrate on smaller adjustments to produce incremental value. To match this advantage, less focused companies require larger changes than the tweaking that discipline leaders need.

Operational Excellence

Operational excellence is a specific strategic approach to the production and delivery of products and services. A company that follows this strategy attempts to lead its industry in price and convenience by pursuing a focus on lean and efficient operations. Companies that employ operational excellence work to minimize costs by reducing overhead, eliminating intermediate production steps, reducing transaction costs, and optimizing business processes across functional and organizational boundaries. The focus is on delivering products or services to customers at competitive prices with minimal inconvenience. Exhibit 7.7, Strategy in Action, provides an example of successful operational excellence in the personal computer (PC) industry.

Operational excellence is also the strategic focus of General Electric's large appliance business. Historically, the distribution strategy for large appliances was based on

EXHIBIT 7.6
Risks of the Generic Strategies

Source: Adapted with the permission of The Free Press, a division of Simon & Schuster Adult Publishing Group, from *Competitive Strategy: Techniques for Analyzing Industries and Competitors* by Michael E. Porter. Copyright © 1980, 1998 by The Free Press. All rights reserved.

Risks of Cost Leadership	Risks of Differentiation	Risks of Focus
Cost of leadership is not sustained: • Competitors imitate. • Technology changes. • Other bases for cost leadership erode.	Differentiation is not sustained: • Competitors imitate. • Bases for differentiation become less important to buyers.	The focus strategy is imitated. The target segment becomes structurally unattractive: • Structure erodes. • Demand disappears.
Proximity in differentiation is lost.	Cost proximity is lost.	Broadly targeted competitors overwhelm the segment: • The segment's differences from other segments narrow. • The advantages of a broad line increase.
Cost focusers achieve even lower cost in segments.	Differentiation focusers achieve even greater differentiation in segments.	New focusers subsegment the industry.

requiring that dealers maintain large inventories. Price breaks for dealers were based on order quantities. However, as the marketplace became more competitive, principally as a result of competition for multibrand dealers like Sears, GE recognized the need to adjust its production and distribution plans.

The GE system addresses the delivery of products. As a step toward organizational excellence, GE created a computer-based logistics system to replace its in-store inventories model. Retailers use this software to access a 24-hour online order processing system that guarantees GE's best price. This system allows dealers to better meet customer needs, with instantaneous access to a warehouse of goods and accurate shipping and production information. GE benefits from the deal as well. Efficiency is increased since manufacturing now occurs in response to customer sales. Additionally, warehousing and distribution systems have been streamlined to create the capability of delivering to 90 percent of destinations in the continental United States within one business day.

Firms that implement the strategy of operational excellence typically restructure their delivery processes to focus on efficiency and reliability, and use state-of-the art information systems that emphasize integration and low-cost transactions.

Customer Intimacy

Companies that implement a strategy of customer intimacy continually tailor and shape products and services to fit an increasingly refined definition of the customer. Companies excelling in customer intimacy combine detailed customer knowledge with operational flexibility. They respond quickly to almost any need, from customizing a product to fulfilling special requests to create customer loyalty.

Customer-intimate companies are willing to spend money now to build customer loyalty for the long term, considering each customer's lifetime value to the company, not the profit of any single transaction. Consequently, employees in customer-intimate companies go to great lengths to ensure customer satisfaction with low regard for initial cost.

Home Depot implements the discipline of customer intimacy. Home Depot clerks spend the necessary time with customers to determine the product that best suits their needs,

Strategy in Action

Exhibit 7.7

A Racer Called Acer

BusinessWeek

It's a good thing Gianfranco Lanci likes coffee. He shuttles between his home in Milan and job in Taiwan as president of computer maker Acer Inc. "You cannot waste time, since you spend so much time already on the plane," says Lanci, 52. "The coffee," he adds, "also helps."

Acer seems to be on a caffeine kick of its own. Americans who know the brand likely recall it hit the big time in the 1990s, then quickly fell into obscurity. While Acer remains weak in the United States, globally it's no. 4 in PCs overall, behind Hewlett-Packard, Dell, and Lenovo. In 2006, Acer boosted its share by 1.2 percentage points, to 5.9 percent, according to IDC Corp. That puts Acer just behind Lenovo, which rose to no. 3 when it bought IBM PC division two years ago. Lenovo is "successful in China, [but] we are growing everywhere," says Acer CEO J. T. Wang.

The battle to overtake Lenovo is about more than just bragging rights. The PC industry has shrunk to a handful of players, and more consolidation is likely. For Acer, getting bigger is "a survival issue," says Kevin Chang, an analyst in Taipei with Credit Suisse Group. "You need to be a top-three player to make a sustainable profit." Acer had sales of $11.1 billion in 2006 and profits of $338 million, estimates Credit Suisse.

Acer has been gaining ground thanks to low-cost machines and unconventional distribution. It shuns direct sales, instead selling only through distributors and outsourcing all production to factories in China. Acer has also been the driving force in price wars that have taken a toll on former no. 1 Dell Inc. Although Acer has some premium offerings, such as its Ferrari line of sleek machines in red racing stripes, it typically underprices competitors by 5 to 10 percent. Even so, Acer usually offers retailers a bigger chunk of the selling price than rivals do.

The strategy is working: Sales have more than doubled since 2003, although it has cut Acer's profit margin to about 2 percent, or less than half that of HP or Dell.

To keep the momentum going, Acer must expand beyond its stronghold in Europe. There, it's the market leader in laptops and no. 3 overall, thanks to Lanci. Now Acer is taking the fight directly to China, where it is no. 9. In 2005, Acer revamped its operation on the mainland, halving head count to 200 and outsourcing distribution.

Acer also hopes to improve its position in the United States, where it has just 1.8 percent of the market. Acer has raised its profile with U.S. consumers over the past two years through deals to sell its wares at Wal-Mart, CompUSA, and Circuit City—which could ultimately pay off with big companies, says U.S. sales chief Mark Hill.

Source: Reprinted with special permission from Bruce Einhorn, "A Racer Called Acer," *BusinessWeek,* January 29, 2007. Copyright © 2007 The McGraw-Hill Companies.

because the company's business strategy is built around selling information and service in addition to home-repair and improvement items. Consequently, consumers concerned solely with price fall outside Home Depot's core market.

Companies engaged in customer intimacy understand the difference between the profitability of a single transaction and the profitability of a lifetime relationship with a single customer. The company's profitability depends in part on its maintaining a system that differentiates quickly and accurately the degree of service that customers require and the revenues their patronage is likely to generate. Firms using this approach recognize that not every customer is equally profitable. For example, a financial services company installed a telephone-computer system capable of recognizing individual clients by their telephone numbers when they call. The system routes customers with large accounts and frequent transactions to their own senior account representative. Other customers may be routed to a trainee or junior representative. In any case, the customer's file appears on the representative's screen before the phone is answered.

The new system allows the firm to segment its services with great efficiency. If the company has clients who are interested in trading in a particular financial instrument, it can group them under the one account representative who specializes in that instrument.

This saves the firm the expense of training every representative in every facet of financial services. Additionally, the company can direct certain value-added services or products to a specific group of clients that would have interest in them.

Businesses that select a customer intimacy strategy have decided to stress flexibility and responsiveness. They collect and analyze data from many sources. Their organizational structure emphasizes empowerment of employees close to customers. Additionally, hiring and training programs stress the creative decision-making skills required to meet individual customer needs. Management systems recognize and utilize such concepts as customer lifetime value, and norms among employees are consistent with a "have it your way" mind set.

Product Leadership

Companies that pursue the discipline of product leadership strive to produce a continuous stream of state-of-the-art products and services. Three challenges must be met to attain that goal. Creativity is the first challenge. Creativity is recognizing and embracing ideas usually originating outside the company. Second, innovative companies must commercialize ideas quickly. Thus, their business and management processes need to be engineered for speed. Product leaders relentlessly pursue new solutions to problems. Finally, firms utilizing this discipline prefer to release their own improvements rather than wait for competitors to enter. Consequently, product leaders do not stop for self-congratulation; they focus on continual improvement.

For example, Johnson & Johnson's organizational design brings good ideas in, develops them quickly, and looks for ways to improve them. In 1983, the president of J&J's Vistakon Inc., a maker of specialty contact lenses, received a tip concerning an ophthalmologist who had conceived of a method to manufacture disposable contact lenses inexpensively. Vistakon's president received this tip from a J&J employee from a different subsidiary whom he had never met. Rather than dismiss the tip, the executives purchased the rights to the technology, assembled a management team to oversee the product's development team to oversee the product's development, and built a state-of-the-art facility in Florida to manufacture disposable contact lenses called Acuvue. Vistakon and its parent, J&J, were willing to incur high manufacturing and inventory costs before a single lens was sold. A high-speed production facility helped give Vistakon a six-month head start over the competition that, taken off guard, never caught up.

Like other product leaders, J&J creates and maintains an environment that encourages employees to share ideas. Additionally, product leaders continually scan the environment for new-product or service possibilities and rush to capitalize them. Product leaders also avoid bureaucracy because it slows commercialization of their ideas. In a product leadership company, a wrong decision often is less damaging than one made late. As a result, managers make decisions quickly, their companies encouraging them to decide today and implement tomorrow. Product leaders continually look for new methods to shorten their cycle times.

The strength of product leaders lies in reacting to situations as they occur. Shorter reaction times serve as an advantage in dealings with the unknown. For example, when competitors challenged the safety of Acuvue lenses, the firm responded quickly and distributed data combating the charges to eye care professionals. This reaction created goodwill in the marketplace.

Product leaders act as their own competition. These firms continually make the products and services they have created obsolete. Product leaders believe that if they do not develop a successor, a competitor will. So, although Acuvue is successful in the marketplace, Vistakon continues to investigate new material that will extend the wearability of contact lenses and technologies that will make current lenses obsolete. J&J and other innovators recognize that

the long-run profitability of an existing product or service is less important to the company's future than maintaining its product leadership edge and momentum.

GRAND STRATEGIES

grand strategy
A master long-term plan that provides basic direction for major actions directed toward achieving long-term business objectives.

While the need for firms to develop generic strategies remains an unresolved debate, designers of planning systems agree about the critical role of grand strategies. **Grand strategies,** often called master or business strategies, provide basic direction for strategic actions. They are the basis of coordinated and sustained efforts directed toward achieving long-term business objectives.

The purpose of this section is twofold: (1) to list, describe, and discuss 15 grand strategies that strategic managers should consider and (2) to present approaches to the selection of an optimal grand strategy from the available alternatives.

Grand strategies indicate the time period over which long-range objectives are to be achieved. Thus, a grand strategy can be defined as a comprehensive general approach that guides a firm's major actions.

The 15 principal grand strategies are concentrated growth, market development, product development, innovation, horizontal integration, vertical integration, concentric diversification, conglomerate diversification, turnaround, divestiture, liquidation, bankruptcy, joint ventures, strategic alliances, and consortia. Any one of these strategies could serve as the basis for achieving the major long-term objectives of a single firm. But a firm involved with multiple industries, businesses, product lines, or customer groups—as many firms are—usually combines several grand strategies. For clarity, however, each of the principal grand strategies is described independently in this section, with examples to indicate some of its relative strengths and weaknesses.

Concentrated Growth

Many of the firms that fell victim to merger mania were once mistakenly convinced that the best way to achieve their objectives was to pursue unrelated diversification in the search for financial opportunity and synergy. By rejecting that "conventional wisdom," such firms as Martin-Marietta, KFC, Compaq, Avon, Hyatt Legal Services, and Tenant have demonstrated the advantages of what is increasingly proving to be sound business strategy. A firm that has enjoyed special success through a strategic emphasis on increasing market share through concentration is Chemlawn. With headquarters in Columbus, Ohio, Chemlawn is the North American leader in professional lawn care. Like others in the lawn care industry, Chemlawn is experiencing a steadily declining customer base. Market analysis shows that the decline is fueled by negative environmental publicity, perceptions of poor customer service, and concern about the price versus the value of the company's services, given the wide array of do-it-yourself alternatives. Chemlawn's approach to increasing market share hinges on addressing quality, price, and value issues; discontinuing products that the public or environmental authorities perceive as unsafe; and improving the quality of its workforce.

concentrated growth
A grand strategy in which a firm directs its resources to the profitable growth of a single product, in a single market, with a single dominant technology.

These firms are just a few of the majority of businesses worldwide firms that pursue a concentrated growth strategy by focusing on a dominant product-and-market combination. **Concentrated growth** is the strategy of the firm that directs its resources to the profitable growth of a dominant product, in a dominant market, with a dominant technology. The main rationale for this approach, sometimes called a market penetration strategy, is that by thoroughly developing and exploiting its expertise in a narrowly defined competitive arena, the company achieves superiority over competitors that try to master a greater number of product and market combinations.

Rationale for Superior Performance

Concentrated growth strategies lead to enhanced performance. The ability to assess market needs, knowledge of buyer behavior, customer price sensitivity, and effectiveness of promotion are characteristics of a concentrated growth strategy. Such core capabilities are a more important determinant of competitive market success than are the environmental forces faced by the firm. The high success rates of new products also are tied to avoiding situations that require undeveloped skills, such as serving new customers and markets, acquiring new technology, building new channels, developing new promotional abilities, and facing new competition.

A major misconception about the concentrated growth strategy is that the firm practicing it will settle for little or no growth. This is certainly not true for a firm that correctly utilizes the strategy. A firm employing concentrated growth grows by building on its competencies, and it achieves a competitive edge by concentrating in the product-market segment it knows best. A firm employing this strategy is aiming for the growth that results from increased productivity, better coverage of its actual product-market segment, and more efficient use of its technology.

Conditions That Favor Concentrated Growth

Specific conditions in the firm's environment are favorable to the concentrated growth strategy. The first is a condition in which the firm's industry is resistant to major technological advancements. This is usually the case in the late growth and maturity stages of the product life cycle and in product markets where product demand is stable and industry barriers, such as capitalization, are high. Machinery for the paper manufacturing industry, in which the basic technology has not changed for more than a century, is a good example.

An especially favorable condition is one in which the firm's targeted markets are not product saturated. Markets with competitive gaps leave the firm with alternatives for growth, other than taking market share away from competitors. The successful introduction of traveler services by Allstate and Amoco demonstrates that even an organization as entrenched and powerful as the AAA could not build a defensible presence in all segments of the automobile club market.

A third condition that favors concentrated growth exists when the firm's product markets are sufficiently distinctive to dissuade competitors in adjacent product markets from trying to invade the firm's segment. John Deere scrapped its plans for growth in the construction machinery business when mighty Caterpillar threatened to enter Deere's mainstay, the farm machinery business, in retaliation. Rather than risk a costly price war on its own turf, Deere scrapped these plans.

A fourth favorable condition exists when the firm's inputs are stable in price and quantity and are available in the amounts and at the times needed. Maryland-based Giant Foods is able to concentrate in the grocery business largely due to its stable long-term arrangements with suppliers of its private-label products. Most of these suppliers are makers of the national brands that compete against the Giant labels. With a high market share and aggressive retail distribution, Giant controls the access of these brands to the consumer. Consequently, its suppliers have considerable incentive to honor verbal agreements, called bookings, in which they commit themselves for a one-year period with regard to the price, quality, and timing of their shipments to Giant.

The pursuit of concentrated growth also is favored by a stable market—a market without the seasonal or cyclical swings that would encourage a firm to diversify. Night Owl Security, the District of Columbia market leader in home security services, commits its customers to initial four-year contracts. In a city where affluent consumers tend to be quite transient, the length of this relationship is remarkable. Night Owl's concentrated growth strategy has been reinforced by its success in getting subsequent owners of its customers'

homes to extend and renew the security service contracts. In a similar way, Lands' End reinforced its growth strategy by asking customers for names and addresses of friends and relatives living overseas who would like to receive Lands' End catalogs.

A firm also can grow while concentrating, if it enjoys competitive advantages based on efficient production or distribution channels. These advantages enable the firm to formulate advantageous pricing policies. More efficient production methods and better handling of distribution also enable the firm to achieve greater economies of scale or, in conjunction with marketing, result in a product that is differentiated in the mind of the consumer. Graniteville Company, a large South Carolina textile manufacturer, enjoyed decades of growth and profitability by adopting a "follower" tactic as part of its concentrated growth strategy. By producing fabrics only after market demand had been well established, and by featuring products that reflected its expertise in adopting manufacturing innovations and in maintaining highly efficient long production runs, Graniteville prospered through concentrated growth.

Finally, the success of market generalists creates conditions favorable to concentrated growth. When generalists succeed by using universal appeals, they avoid making special appeals to particular groups of customers. The net result is that many small pockets are left open in the markets dominated by generalists, and that specialists emerge and thrive in these pockets. For example, hardware store chains, such as Home Depot, focus primarily on routine household repair problems and offer solutions that can be easily sold on a self-service, do-it-yourself basis. This approach leaves gaps at both the "semiprofessional" and "neophyte" ends of the market—in terms of the purchaser's skill at household repairs and the extent to which available merchandise matches the requirements of individual homeowners.

Risk and Rewards of Concentrated Growth

Under stable conditions, concentrated growth poses lower risk than any other grand strategy; but, in a changing environment, a firm committed to concentrated growth faces high risks. The greatest risk is that concentrating in a single product market makes a firm particularly vulnerable to changes in that segment. Slowed growth in the segment would jeopardize the firm because its investment, competitive edge, and technology are deeply entrenched in a specific offering. It is difficult for the firm to attempt sudden changes if its product is threatened by near-term obsolescence, a faltering market, new substitutes, or changes in technology or customer needs. For example, the manufacturers of IBM clones faced such a problem when IBM adopted the OS/2 operating system for its personal computer line. That change made existing clones out of date.

The concentrating firm's entrenchment in a specific industry makes it particularly susceptible to changes in the economic environment of that industry. For example, Mack Truck, the second-largest truck maker in America, lost $20 million as a result of an 18-month slump in the truck industry.

Entrenchment in a specific product market tends to make a concentrating firm more adept than competitors at detecting new trends. However, any failure of such a firm to properly forecast major changes in its industry can result in extraordinary losses. Numerous makers of inexpensive digital watches were forced to declare bankruptcy because they failed to anticipate the competition posed by Swatch, Guess, and other trendy watches that emerged from the fashion industry.

A firm pursuing a concentrated growth strategy is vulnerable also to the high opportunity costs that result from remaining in a specific product market and ignoring other options that could employ the firm's resources more profitably. Overcommitment to a specific technology and product market can hinder a firm's ability to enter a new or growing product market that offers more attractive cost-benefit trade-offs. Had Apple Computers maintained

its policy of making equipment that did not interface with IBM equipment, it would have missed out on what have proved to be its most profitable strategic options.

Concentrated Growth Is Often the Most Viable Option

Examples abound of firms that have enjoyed exceptional returns on the concentrated growth strategy. Such firms as McDonald's, Goodyear, and Apple Computers have used firsthand knowledge and deep involvement with specific product segments to become powerful competitors in their markets. The strategy is associated even more often with successful smaller firms that have steadily and doggedly improved their market position.

The limited additional resources necessary to implement concentrated growth, coupled with the limited risk involved, also make this strategy desirable for a firm with limited funds. For example, through a carefully devised concentrated growth strategy, medium-sized John Deere & Company was able to become a major force in the agricultural machinery business even when competing with such firms as Ford Motor Company. While other firms were trying to exit or diversify from the farm machinery business, Deere spent $2 billion in upgrading its machinery, boosting its efficiency, and engaging in a program to strengthen its dealership system. This concentrated growth strategy enabled it to become the leader in the farm machinery business despite the fact that Ford was more than 10 times its size.

The firm that chooses a concentrated growth strategy directs its resources to the profitable growth of a narrowly defined product and market, focusing on a dominant technology. Firms that remain within their chosen product market are able to extract the most from their technology and market knowledge and, thus, are able to minimize the risk associated with unrelated diversification. The success of a concentration strategy is founded on the firm's use of superior insights into its technology, product, and customer to obtain a sustainable competitive advantage. Superior performance on these aspects of corporate strategy has been shown to have a substantial positive effect on market success.

A grand strategy of concentrated growth allows for a considerable range of action. Broadly speaking, the firm can attempt to capture a larger market share by increasing the usage rates of present customers, by attracting competitors' customers, or by selling to nonusers. In turn, each of these options suggests more specific options, some of which are listed in the top section of Exhibit 7.8.

When strategic managers forecast that their current products and their markets will not provide the basis for achieving the company mission, they have two options that involve moderate costs and risk: market development and product development.

Market Development

market development
A grand strategy of marketing present products, often with only cosmetic modification, to customers in related marketing areas.

Market development commonly ranks second only to concentration as the least costly and least risky of the 15 grand strategies. It consists of marketing present products, often with only cosmetic modifications, to customers in related market areas by adding channels of distribution or by changing the content of advertising or promotion. Several specific market development approaches are listed in Exhibit 7.8. Thus, as suggested by the figure, firms that open branch offices in new cities, states, or countries are practicing market development. Likewise, firms are practicing market development if they switch from advertising in trade publications to advertising in newspapers or if they add jobbers to supplement their mail-order sales efforts.

Market development allows firms to leverage some of their traditional strengths by identifying new uses for existing products and new demographically, psychographically, or geographically defined markets. Frequently, changes in media selection, promotional appeals, and distribution signal the implementation of this strategy. Du Pont used market development when it found a new application for Kevlar, an organic material that police,

EXHIBIT 7.8
Specific Options under the Grand Strategies of Concentration, Market Development, and Product Development

Source: Adapted from Philip Kotler and Kevin Keller, *Marketing Management,* 12th ed., 2006. Reprinted by permission of Pearson Education, Upper Saddle River, NJ.

Concentration (increasing use of present products in present markets):

1. Increasing present customers' rate of use:
   a. Increasing the size of purchase.
   b. Increasing the rate of product obsolescence.
   c. Advertising other uses.
   d. Giving price incentives for increased use.
2. Attracting competitors' customers:
   a. Establishing sharper brand differentiation.
   b. Increasing promotional effort.
   c. Initiating price cuts.
3. Attracting nonusers to buy the product:
   a. Inducing trial use through sampling, price incentives, and so on.
   b. Pricing up or down.
   c. Advertising new uses.

Market development (selling present products in new markets):

1. Opening additional geographic markets:
   a. Regional expansion.
   b. National expansion.
   c. International expansion.
2. Attracting other market segments:
   a. Developing product versions to appeal to other segments.
   b. Entering other channels of distribution.
   c. Advertising in other media.

Product development (developing new products for present markets):

1. Developing new-product features:
   a. Adapt (to other ideas, developments).
   b. Modify (change color, motion, sound, odor, form, shape).
   c. Magnify (stronger, longer, thicker, extra value).
   d. Minify (smaller, shorter, lighter).
   e. Substitute (other ingredients, process, power).
   f. Rearrange (other patterns, layout, sequence, components).
   g. Reverse (inside out).
   h. Combine (blend, alloy, assortment, ensemble; combine units, purposes, appeals, ideas).
2. Developing quality variations.
3. Developing additional models and sizes (product proliferation).

security, and military personnel had used primarily for bulletproofing. Kevlar now is being used to refit and maintain wooden-hulled boats, since it is lighter and stronger than glass fibers and has 11 times the strength of steel.

The medical industry provides other examples of new markets for existing products. The National Institutes of Health's report of a study showing that the use of aspirin may lower the incidence of heart attacks was expected to boost sales in the $2.2 billion analgesic market. It was predicted that the expansion of this market would lower the market share of nonaspirin brands, such as industry leaders Tylenol and Advil. Product extensions currently planned include Bayer Calendar Pack, 28-day packaging to fit the once-a-day prescription for the prevention of a second heart attack.

Another example is Cheesebrough-Ponds, a major producer of health and beauty aids, which decided several years ago to expand its market by repacking its Vaseline Petroleum Jelly in pocket-size squeeze tubes as Vaseline "Lip Therapy." The corporation decided to place a strategic emphasis on market development, because it knew from market studies

that its petroleum-jelly customers already were using the product to prevent chapped lips. Company leaders reasoned that their market could be expanded significantly if the product were repackaged to fit conveniently in consumers' pockets and purses.

Product Development

product development
A grand strategy that involves the substantial modification of existing products that can be marketed to current customers.

Product development involves the substantial modification of existing products or the creation of new but related products that can be marketed to current customers through established channels. The product development strategy often is adopted either to prolong the life cycle of current products or to take advantage of a favorite reputation or brand name. The idea is to attract satisfied customers to new products as a result of their positive experience with the firm's initial offering. The bottom section in Exhibit 7.8 lists some of the options available to firms undertaking product development. A revised edition of a college textbook, a new car style, and a second formula of shampoo for oily hair are examples of the product development strategy.

Similarly, Pepsi changed its strategy on beverage products by creating new products to follow the industry movement away from mass branding. This new movement was designed to attract a younger, hipper customer segment. Pepsi's new products include a version of Mountain Dew, called Code Red, and new Pepsi brands, called Pepsi Twist and Pepsi Blue.

The product development strategy is based on the penetration of existing markets by incorporating product modifications into existing items or by developing new products with a clear connection to the existing product line. The telecommunications industry provides an example of product extension based on product modification. To increase its estimated 8 to 10 percent share of the $5 to $6 billion corporate user market, MCI Communication Corporation extended its direct-dial service to 146 countries, the same as those serviced by AT&T, at lower average rates than those of AT&T. MCI's addition of 79 countries to its network underscores its belief in this market, which it expects to grow 15 to 20 percent annually. Another example of expansions linked to existing lines is Gerber's decision to engage in general merchandise marketing. Gerber's recent introduction included 52 items that ranged from feeding accessories to toys and children's wear. Likewise, Nabisco Brands seeks competitive advantage by placing its strategic emphasis on product development. With headquarters in Parsippany, New Jersey, the company is one of three operating units of RJR Nabisco. It is the leading producer of biscuits, confections, snacks, shredded cereals, and processed fruits and vegetables. To maintain its position as leader, Nabisco pursues a strategy of developing and introducing new products and expanding its existing product line. Spoon Size Shredded Wheat and Ritz Bits crackers are two examples of new products that are variations on existing products.

The development of new products is so critical to companies in many industries that a cottage industry has sprung up to help provide them. To read about one of the firms that specialize in idea creation, see Exhibit 7.9, Strategy in Action.

Innovation

innovation
A grand strategy that seeks to reap the premium margins associated with creation and customer acceptance of a new product or service.

In many industries, it has become increasingly risky not to innovate. Both consumer and industrial markets have come to expect periodic changes and improvements in the products offered. As a result, some firms find it profitable to make **innovation** their grand strategy. They seek to reap the initially high profits associated with customer acceptance of a new or greatly improved product. Then, rather than face stiffening competition as the basis of profitability shifts from innovation to production or marketing competence, they search for other original or novel ideas. The underlying rationale of the grand strategy of innovation is to create a new product life cycle and thereby make similar existing products obsolete. Thus, this strategy differs from the product development strategy of extending an existing

Strategy in Action

Exhibit 7.9

Inside a White-Hot Idea Factory

BusinessWeek

Some big names are turning to upstart Fahrenheit 212 to dream up new products.

For several years, spirits giant Diageo rode high on the popularity of its Smirnoff Ice beverage. Then consumers got bored, and the party was over. Try as it might, the no. 1 global liquor company couldn't reignite sales of Ice—a crucial part of its Smirnoff brand. So Diageo turned to Fahrenheit 212, a tiny New York outfit that promises to help clients dream up hit products and services. Fahrenheit listened, then disappeared.

The firm reemerged with some startling advice: forget the Smirnoff Ice brand for now. Instead, Diageo should use its malt technology to create wildly different Smirnoff drinks. Among Fahrenheit's 10 or so fully realized products: Smirnoff Raw Tea, which appeared in August, and Smirnoff Source, an alcoholic water expected to launch this spring.

Fahrenheit 212 specializes in a new approach to product development. With little to no inside knowledge of its clients, the company dives into their problems and within months cooks up a portfolio of products it thinks will solve them. One part management consultant, one part advertising agency, and one part design house, Fahrenheit 212 attempts to deliver ready-to-go answers, including everything from an analysis of each potential market down to the design and packaging of the product itself. As companies seek to maximize efficiency by outsourcing just about everything, Fahrenheit 212 promises to serve up something most chief executives dream about: new products created from existing assets that will earn sizable revenue from untapped markets.

Spun off from advertising agency Saatchi & Saatchi in November 2006, Fahrenheit 212 expects to generate only about $8 million in revenues in 2007. But it has signed up an impressive roster of clients. It won't disclose specifics, but Fahrenheit has come up with new applications for Samsung's LCD panels, cooked up new products for Hershey as the company moves beyond candy, and is helping NBC Universal identify new sources of revenue in the digital world.

Clients think of the firm as a way to make long-shot bets without having to use their own research and development resources. "Samsung is a lean organization. We can't afford to have people coming up with ideas that don't work," says chief marketing officer Gregory Lee. "The people at Fahrenheit are very helpful because they are working on ideas that can fail—it allows you to experiment a bit." What's more, Fahrenheit ties much of its compensation to the success of the product, making it an even safer bet.

Source: Reprinted with special permission from Burt Helm, "Inside a White-Hot Idea Factory," *BusinessWeek,* January 15, 2007. Copyright © 2007 The McGraw-Hill Companies.

product's life cycle. For example, Intel, a leader in the semiconductor industry, pursues expansion through a strategic emphasis on innovation. With headquarters in California, the company is a designer and manufacturer of semiconductor components and related computers, of microcomputer systems, and of software. Its Pentium microprocessor gives a desktop computer the capability of a mainframe. Exhibit 7.10, Strategy in Action, makes an important point. Companies under pressure to innovate often supplement their own R&D efforts by partnering with other firms in their industry that have complementary needs.

While most growth-oriented firms appreciate the need to be innovative, a few firms use it as their fundamental way of relating to their markets. An outstanding example is Polaroid, which heavily promotes each of its new cameras until competitors are able to match its technological innovation; by this time, Polaroid normally is prepared to introduce a dramatically new or improved product. For example, it introduced consumers in quick succession to the Swinger, the SX-70, the One Step, and the Sun Camera 660.

Few innovative ideas prove profitable because the research, development, and pre-marketing costs of converting a promising idea into a profitable product are extremely high. A study by the Booz Allen & Hamilton management research department provides some understanding of the risks. As shown in Exhibit 7.11, Booz Allen & Hamilton found that less than 2 percent of the innovative projects initially considered by 51 companies

Strategy in Action

Exhibit 7.10

The Power of the Pipeline for Bristol-Myers Squibb

BusinessWeek

As interim CEO James M. Cornelius tries to steady Bristol's wobbly finances—the New York drug maker, Bristol-Myers Squibb just recorded its first quarterly loss since 1995—the one part of the company he's barely touching is Dr. Elliot Sigal's. Bristol has launched eight new drugs since Sigal became head of development in 2002, has three cancer drugs in late-stage development, and has more than a dozen compounds in its pipeline to treat diseases ranging from diabetes to depression. With many growth-starved Big Pharma companies desperate for new potential blockbusters, and a verdict due soon in the Plavix trial, a Bristol acquisition, predicts Morgan Stanley analyst Jami Rubin, "is not a question of if. It's a question of when."

Sigal has turned around Bristol's unproductive research labs using a combination of hard and soft incentives. He has fine-tuned a compensation plan that ties scientists' bonuses to the drugs they discover, awarding the highest premiums to the compounds that reach late-stage clinical trials. Sigal keeps his troops motivated by introducing them to patients who have been treated with Bristol's drugs, most recently bringing in a cancer patient who has benefited from Bristol's new product, Sprycel.

Another way Sigal has managed to pump up Bristol's pipeline is through what he calls the globalization of the research process. While developing Sprycel, for example, the company recruited 911 trial patients in 33 countries. Because the drug treats a rare form of leukemia, it would have taken several months to find enough patients just in the United States.

Bristol has also become more selective in choosing its partners, seeking deals that will fill holes in its strategy of developing drugs to address large, unmet medical needs without stretching its resources too thin. In January 2007, Bristol structured a smart deal with London-based drug giant AstraZeneca PLC to develop two diabetes drugs.

Investors and potential acquirers will be watching closely for the verdict in the Plavix patent trial. Bristol is expected to prevail and regain its exclusive hold on the market until 2011. But the damage has already been done: Bristol's generic rival, Weston (Ontario)-based Apotex Inc., flooded distribution channels with six months' worth of its version of Plavix before a judge ordered it to stop selling the drug last August.

The Plavix debacle only underscores the urgency of Sigal's quest to generate a variety of new drug candidates that will mitigate the risk of future patent losses.

Source: Reprinted with special permission from Arlene Weintraub, "The Power of the Pipeline: Bristol-Myers Squibb is Beset with Troubles, But Its New-Drug Potential Makes It a Target," *BusinessWeek,* February 26, 2007. Copyright © 2007 The McGraw-Hill Companies.

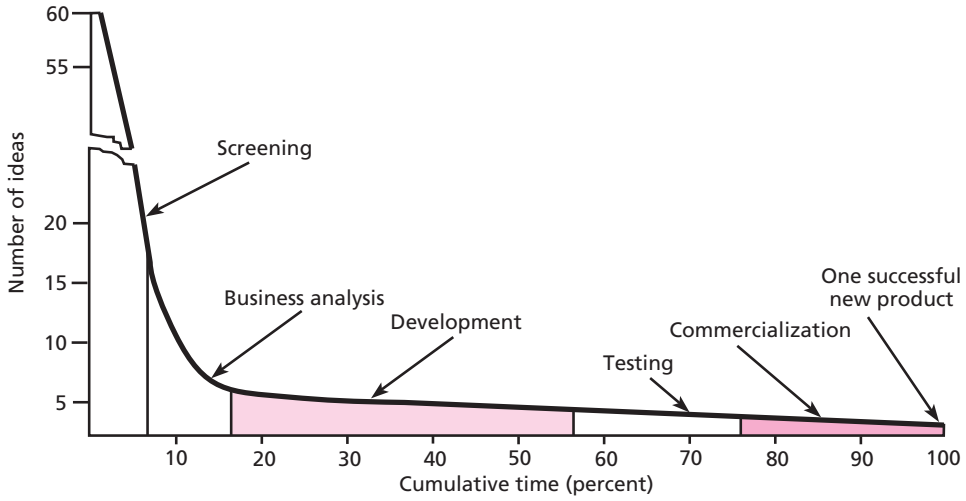
eventually reached the marketplace. Specifically, out of every 58 new product ideas, only 12 pass an initial screening test that finds them compatible with the firm's mission and long-term objectives, only 7 remain after an evaluation of their potential, and only 3 survive development attempts. Of the three survivors, two appear to have profit potential after test marketing and only one is commercially successful.

Horizontal Integration

horizontal integration
A grand strategy based on growth through the acquisition of similar firms operating at the same stage of the production-marketing chain.

When a firm's long-term strategy is based on growth through the acquisition of one or more similar firms operating at the same stage of the production-marketing chain, its grand strategy is called **horizontal integration**. Such acquisitions eliminate competitors and provide the acquiring firm with access to new markets. One example is Warner-Lambert's acquisition of Parke Davis, which reduced competition in the ethical drugs field for Chilcott Laboratories, a firm that Warner-Lambert previously had acquired. Another example is the long-range acquisition pattern of White Consolidated Industries, which expanded in the refrigerator and freezer market through a grand strategy of horizontal integration, by acquiring Kelvinator Appliance, the Refrigerator Products Division of Bendix Westinghouse Automotive Air Brake, and Frigidaire Appliance from General Motors.

Exhibit 7.11
Decay of New Product Ideas (51 Companies)



Nike's acquisition in the dress shoes business and N. V. Homes's purchase of Ryan Homes have vividly exemplified the success that horizontal integration strategies can bring.

The attractions of a horizontal acquisition strategy are many and varied.[3] However every benefit provides the parent firm with critical resources that it needs to improve overall profitability. For example, the acquiring firm that uses a horizontal acquisition can quickly expand its operations geographically, increase its market share, improve its production capabilities and economies of scale, gain control of knowledge-based resources, broaden its product line, and increase its efficient use of capital. An added attraction of horizontal acquisition is that these benefits are achieved with only moderately increased risk, because the success of the expansion is principally dependent on proven abilities.

A horizontal merger can provide the firm with an opportunity to offer its customers a broader product line. This motivation has sparked a series of acquisitions in the security software industry. Because Entrust purchased Business Signatures, the consolidated company is able to offer banks a full suite of antifraud products. Similarly, Verisign's acquisitions of m-Qube and Snapcentric, enabled Verisign to expand its cross-marketing options by offering password-generating software, transaction monitoring software, and identity protection. RSA Security's horizontal acquisitions started with the purchase of PassMark, which reduced competitors in the authentication software space. RSA Security then acquired Cyota to provide its customers with both transaction monitoring and authentication software. As a final example, Symantec bought both Veritas Software and WholeSecurity to provide its customers of storage with additional features, such as antivirus software.

The motivation to gain market share has prompted the financial industry to feature horizontal merger strategies. The acquisition of First Coastal Bank by Citizens Business Bank provided new bases of operation in Los Angeles and Manhattan for Citizen Business Bank. The merger of Raincross Credit Union with Visterra Credit Union enabled these credit unions to achieve the size to justify the expansion of services their customers were demanding.

Some horizontal mergers are motivated by the opportunity to combine resources as a means to improve operational efficiency. In the energy industry, for example, there were eight announced horizontal acquisitions with a combined value of $64 billion between January 2004 and January 2007. In each case, increased operational efficiencies resulted

[3] This section was drawn from John A. Pearce II and D. Keith Robbins, "Strategic Transformation as the Essential Last Step in the Process of Business Turnaround," *Business Horizons* 50, no. 5 (2008).

from the elimination of duplicated costs. In 2005, Duke Energy acquired Cinergy Corp. for $14.1 billion. The friendly takeover worked well because Duke's Energy North America division was a great match with Cinergy's energy trading operation and provided economies of scale and scope. The combined company lowered costs by an estimated $400 million per year by using a broad platform to serve both electricity and natural gas customers.[4]

A second example of an efficiency-driven merger is one between Constellation and FPL, which saves between $1.5 and $2.1 billion by eliminating overlapping operations.[5] Another example is the acquisition of Green Mountain Power by Gaz Metro, a subsidiary of Northern New England Energy Power for $187 million. The merger was prompted by Green Mountain Power's expiring supplier contracts that threatened it with high costs of going to suppliers who were out of its geographic region—but within the region of Gaz Metro. The horizontal acquisition enabled Green Mountain Power to avail itself of Gaz Metro's suppliers.

Deutsche Telekom's growth strategy was horizontal acquisition. Deutsche Telekom was a dominant player in the European wireless services market, but without a presence in the fast-growing U.S. market in 2000. To correct this limitation, Deutsche Telekom horizontally integrated by purchasing the American firm Voice-Stream Wireless, a company that was growing faster than most domestic rivals and that owned spectrum licenses providing access to 220 million potential customers.

Vertical Integration

vertical integration
A grand strategy based on the acquisition of firms that supply the acquiring firm with inputs or new customers for its outputs.

When a firm's grand strategy is to acquire firms that supply it with inputs (such as raw materials) or are customers for its outputs (such as warehousers for finished products), **vertical integration** is involved. To illustrate, if a shirt manufacturer acquires a textile producer—by purchasing its common stock, buying its assets, or exchanging ownership interests—the strategy is vertical integration. In this case, it is *backward* vertical integration, because the acquired firm operates at an earlier stage of the production-marketing process. If the shirt manufacturer had merged with a clothing store, it would have been *forward* vertical integration—the acquisition of a firm nearer to the ultimate consumer.

Amoco emerged as North America's leader in natural gas reserves and products as a result of its acquisition of Dome Petroleum. This backward integration by Amoco was made in support of its downstream businesses in refining and in gas stations, whose profits made the acquisition possible.

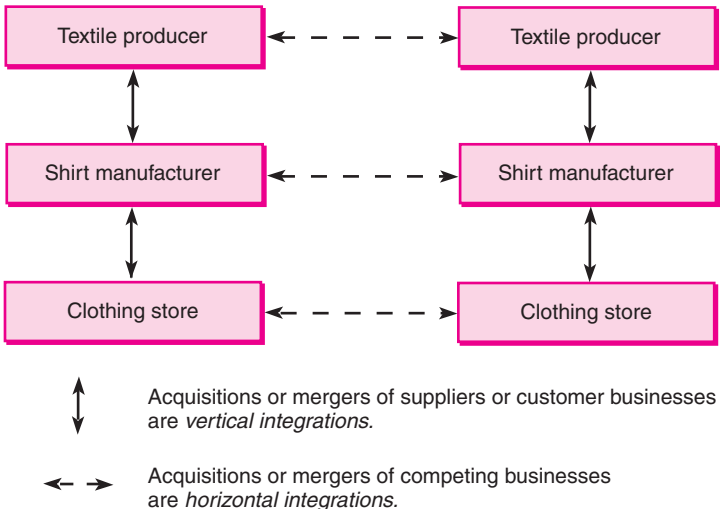
Exhibit 7.12 depicts both horizontal and vertical integration. The principal attractions of a horizontal integration grand strategy are readily apparent. The acquiring firm is able to greatly expand its operations, thereby achieving greater market share, improving economies of scale, and increasing the efficiency of capital use. In addition, these benefits are achieved with only moderately increased risk, because the success of the expansion is principally dependent on proven abilities.

The reasons for choosing a vertical integration grand strategy are more varied and sometimes less obvious. The main reason for backward integration is the desire to increase the dependability of the supply or quality of the raw materials used as production inputs. That desire is particularly great when the number of suppliers is small and the number of competitors is large. In this situation, the vertically integrating firm can better control its costs and, thereby, improve the profit margin of the expanded production-marketing system. Forward integration is a preferred grand strategy if great advantages accrue to stable production. A firm can increase the predictability of demand for its output through forward integration; that is, through ownership of the next stage of its production-marketing chain.

[4] G. Terzo, "Duke and Cinergy Spur Utility M&A, "*The Investment Dealer's Digest IDD,* January 16, 2006, p. 1.

[5] J. Fontana, "A New Wave of Consolidation in the Utility Industry," *Electric Light and Power,* 84, no. 4 (July/August 2006), pp. 36–38.

Exhibit 7.12
Vertical and Horizontal Integrations



Some increased risks are associated with both types of integration. For horizontally integrated firms, the risks stem from increased commitment to one type of business. For vertically integrated firms, the risks result from the firm's expansion into areas requiring strategic managers to broaden the base of their competencies and to assume additional responsibilities.

Concentric Diversification

concentric diversification
A grand strategy that involves the operation of a second business that benefits from access to the first firm's core competencies.

Concentric diversification involves the acquisition of businesses that are related to the acquiring firm in terms of technology, markets, or products. With this grand strategy, the selected new businesses possess a high degree of compatibility with the firm's current businesses. The ideal concentric diversification occurs when the combined company profits increase the strengths and opportunities and decrease the weaknesses and exposure to risk. Thus, the acquiring firm searches for new businesses whose products, markets, distribution channels, technologies, and resource requirements are similar to but not identical with its own, whose acquisition results in synergies but not complete interdependence.

Abbott Laboratories pursues an aggressive concentric growth strategy. As described in Exhibit 7.13, Strategy in Action, Abbott seeks to acquire a wide range of businesses that have some important connection to its basic business. In recent years, this strategy has led the company to acquire pharmaceuticals, a diagnostic business, and a medical device manufacturer.

Conglomerate Diversification

conglomerate diversification
A grand strategy that involves the acquisition of a business because it presents the most promising investment opportunity available.

Occasionally a firm, particularly a very large one, plans to acquire a business because it represents the most promising investment opportunity available. This grand strategy is commonly known as **conglomerate diversification**. The principal concern, and often the sole concern, of the acquiring firm is the profit pattern of the venture. Unlike concentric diversification, conglomerate diversification gives little concern to creating product-market synergy with existing businesses. What such conglomerate diversifiers as ITT, Textron, American Brands, Litton, U.S. Industries, Fuqua, and I. C. Industries seek is financial synergy. For example, they may seek a balance in their portfolios between current businesses with cyclical sales and acquired businesses with countercyclical sales, between high-cash/low-opportunity and low-cash/high-opportunity businesses, or between debt-free and highly leveraged businesses.

Strategy in Action

Exhibit 7.13

Diagnosis: Shrewd Moves

BusinessWeek

Over nine months, Abbott Laboratories has dished out $10.1 billion for acquisitions, including $3.7 billion for cholesterol drug specialists Kos Pharmaceuticals Inc. In 2006, many analysts figured, chairman and chief executive Miles D. White would take a breather to allow the company to absorb its newest assets or lighten its $7 billion debt load. They figured wrong.

Just a month after closing the deal for Kos, Abbott was set to announce on January 18, 2007, that it was selling about two-thirds of its $4 billion diagnostics business to General Electric Co. for $8.1 billion in cash. While emphasizing that he's not going to rush into doing deals, White says he'll likely use the money to buy more medical products outfits to help boost overall sales and profits by at least 10 percent a year into the next decade. When it comes to acquisitions, White says, "you can never afford to rest."

White, 51, has been wheeling and dealing almost since the day in 1999 that he was promoted to CEO, after earlier heading Abbott's diagnostics operations. He began with a bang, paying $7.2 billion in cash for the Knoll Pharmaceuticals Co. subsidiary of Germany's BASF in 2001. Among other deals, White bought TheraSense Inc., an Alameda (California) maker of devices that monitor blood glucose, for $1.2 billion in cash in 2004.

While many big drug companies have come to rue their growth-by-acquisition strategies, analysts say Abbott has done well. The Knoll purchase, for example, yielded Humira, a drug for rheumatoid arthritis that topped $2 billion in sales in 2006. And a $4.1 billion takeover of Guidant Corp.'s stent operations in early 2006 gave Abbott a drug-coated stent, branded Xience. If it passes final clinical trials, it could hit the U.S. market by year-end; it's projected to reach $1.5 billion in sales in 2008. Abbott hasn't overpaid and has been adroit in integrating personnel and facilities, often putting managers of acquired entities in charge of similar Abbott units.

White's dealmaking has lifted Abbott's top and bottom lines. In 2006, Abbott earned $3.8 billion on sales of $22.5 billion, with gross margins nearing 59 percent, says Glenn J. Novarro of Banc of America Securities in New York. That's up roughly 10 percent annually from $2.4 billion in net income on $13.2 billion in sales in 1999, when gross margins were 54.5 percent, and puts Abbott ahead of Merck, Bristol-Myers Squibb, and Eli Lilly in sales and earnings growth.

Abbott has a 20-person business development team that works full-time with chiefs of Abbott units to find and evaluate deals. "We make sure we're up-to-date on our homework so that if we want to get into a new segment, we can," White says. "We won't be doing nothing."

Source: Reprinted with special permission from Michael Arndt, "Diagnosis: Shrewd Moves," *BusinessWeek,* January 29, 2007. Copyright © 2007 The McGraw-Hill Companies.

The principal difference between the two types of diversification is that concentric diversification emphasizes some commonality in markets, products, or technology, whereas conglomerate diversification is based principally on profit considerations.

Several of the grand strategies discussed above, including concentric and conglomerate diversification and horizontal and vertical integration, often involve the purchase or acquisition of one firm by another. It is important to know that the majority of such acquisitions fail to produce the desired results for the companies involved. Exhibit 7.14, Strategy in Action, provides seven guidelines that can improve a company's chances of a successful acquisition.

Motivation for Diversification

Grand strategies involving either concentric or conglomerate diversification represent distinctive departures from a firm's existing base of operations, typically the acquisition or internal generation (spin-off) of a separate business with synergistic possibilities counterbalancing the strengths and weaknesses of the two businesses. For example, Head Ski sought to diversify into summer sporting goods and clothing to offset the seasonality of its "snow" business. Additionally, diversifications occasionally are undertaken as unrelated

Strategy in Action

Exhibit 7.14

Seven Deadly Sins of Strategy Acquisition

1. The wrong target.

The first step to avoid such a mistake is for the acquirer and its financial advisors to determine the strategic goals and identify the mission. The product of this strategic review will be specifically identified criteria for the target.

The second step required to identify the right target is to design and carry out an effective due diligence process to ascertain whether the target indeed has the identified set of qualities selected in the strategic review.

2. The wrong price.

The key to avoiding this problem lies in the acquirer's valuation model. The model will incorporate assumptions concerning industry trends and growth patterns developed in the strategic review.

3. The wrong structure.

The two principal aspects of the acquisition process that can prevent this problem are a comprehensive regulatory compliance review and tax and legal analysis.

4. The lost deal.

The letter of intent must spell out not only the price to be paid but also many of the relational aspects that will make the strategic acquisition successful. Although an acquirer may justifiably focus on expenses, indemnification, and other logical concerns in the letter of intent, relationship and operational concerns are also important.

5. Management difficulties.

The remedy for this problem must be extracted from the initial strategic review. The management compensation structure must be designed with legal and business advisors to help achieve those goals. The financial rewards to management must depend upon the financial and strategic success of the combined entity.

6. The closing crisis.

Closing crises may stem from unavoidable changed conditions, but most often they result from poor communication. Negotiators sometimes believe that problems swept under the table maintain a deal's momentum and ultimately allow for its consummation. They are sometimes right—and often wrong. Charting a course through an acquisition requires carefully developed skills for every kind of professional—business, accounting, and legal.

7. The operating transition crisis.

Even the best conceived and executed acquisition will prevent significant transition and postclosing operation issues. Strategic goals cannot be achieved by quick asset sales or other accelerated exit strategies. Management time and energy must be spent to ensure that the benefits identified in the strategic review are achieved.

Source: From Academy of Management Review by D.A. Tanner. Copyright © 1991 by Academy of Management. Reproduced with permission of Academy of Management via Copyright Clearance Center.

investments, because of their high profit potential and their otherwise minimal resource demands.

Regardless of the approach taken, the motivations of the acquiring firms are the same:

- Increase the firm's stock value. In the past, mergers often have led to increases in the stock price or the price-earnings ratio.
- Increase the growth rate of the firm.
- Make an investment that represents better use of funds than plowing them into internal growth.
- Improve the stability of earnings and sales by acquiring firms whose earnings and sales complement the firm's peaks and valleys.
- Balance or fill out the product line.
- Diversify the product line when the life cycle of current products has peaked.
- Acquire a needed resource quickly (e.g., high-quality technology or highly innovative management).

- Achieve tax savings by purchasing a firm whose tax losses will offset current or future earnings.
- Increase efficiency and profitability, especially if there is synergy between the acquiring firm and the acquired firm.[6]

Turnaround

turnaround
A grand strategy of cost reduction and asset reduction by a company to survive and recover from declining profits.

For any one of a large number of reasons, a firm can find itself with declining profits. Among these reasons are economic recessions, production inefficiencies, and innovative breakthroughs by competitors. In many cases, strategic managers believe that such a firm can survive and eventually recover if a concerted effort is made over a period of a few years to fortify its distinctive competencies. This grand strategy is known as **turnaround.** It typically is begun through one of two forms of retrenchment, employed singly or in combination:

1. *Cost reduction.* Examples include decreasing the workforce through employee attrition, leasing rather than purchasing equipment, extending the life of machinery, eliminating elaborate promotional activities, laying off employees, dropping items from a production line, and discontinuing low-margin customers.
2. *Asset reduction.* Examples include the sale of land, buildings, and equipment not essential to the basic activity of the firm and the elimination of "perks," such as the company airplane and executives' cars.

Interestingly, the turnaround most commonly associated with this approach is in management positions. In a study of 58 large firms, researchers Shendel, Patton, and Riggs found that turnaround almost always was associated with changes in top management.[7] Bringing in new managers was believed to introduce needed new perspectives on the firm's situation, to raise employee morale, and to facilitate drastic actions, such as deep budgetary cuts in established programs.

Strategic management research provides evidence that the firms that have used a *turnaround strategy* have successfully confronted decline. The research findings have been assimilated and used as the building blocks for a model of the turnaround process shown in Exhibit 7.15, Strategy in Action.

The model begins with a depiction of external and internal factors as causes of a firm's performance downturn. When these factors continue to detrimentally impact the firm, its financial health is threatened. Unchecked decline places the firm in a turnaround situation.

A *turnaround situation* represents absolute and relative-to-industry declining performance of a sufficient magnitude to warrant explicit turnaround actions. Turnaround situations may be the result of years of gradual slowdown or months of sharp decline. In either case, the recovery phase of the turnaround process is likely to be more successful in accomplishing turnaround when it is preceded by planned retrenchment that results in the achievement of near-term financial stabilization. For a declining firm, stabilizing operations and restoring profitability almost always entail strict cost reduction followed by a shrinking back to those segments of the business that have the best prospects of attractive profit margins. The need for retrenchment was reflected in unemployment figures during the 2000–2003 recession. More layoffs of American workers were announced in 2001 than in any of the previous eight

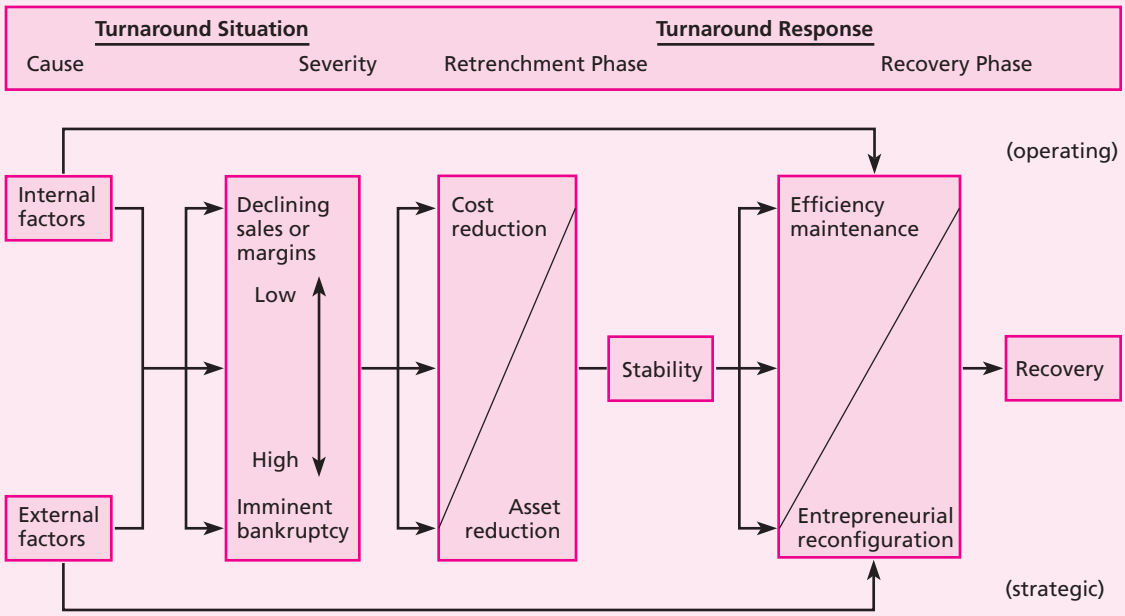
[6] Godfrey Devlin and Mark Bleackley, "Strategic Alliances—Guidelines for Success," *Long Range Planning,* October 1988, pp. 18–23.

[7] Other forms of joint ventures (such as leasing, contract manufacturing, and management contracting) offer valuable support strategies. They are not included in the categorization, however, because they seldom are employed as grand strategies.

Strategy in Action

Exhibit 7.15

A Model of the Turnaround Process



years when U.S. companies announced nearly 2 million layoffs as the economy sunk into its first recession in a decade.

The immediacy of the resulting threat to company survival posed by the turnaround situation is known as *situation severity.* Severity is the governing factor in estimating the speed with which the retrenchment response will be formulated and activated. When severity is low, a firm has some financial cushion. Stability may be achieved through cost retrenchment alone. When turnaround situation severity is high, a firm must immediately stabilize the decline or bankruptcy is imminent. Cost reductions must be supplemented with more drastic asset reduction measures. Assets targeted for divestiture are those determined to be underproductive. In contrast, more productive resources are protected from cuts and represent critical elements of the future core business plan of the company (i.e., the intended recovery response).

Turnaround responses among successful firms typically include two stages of strategic activities: retrenchment and the recovery response. *Retrenchment* consists of cost-cutting and asset-reducing activities. The primary objective of the retrenchment phase is to stabilize the firm's financial condition. Situation severity has been associated with retrenchment responses among successful turnaround firms. Firms in danger of bankruptcy or failure (i.e., severe situations) attempt to halt decline through cost and asset reductions. Firms in less severe situations have achieved stability merely through cost retrenchment. However, in either case, for firms facing declining financial performance, the key to successful turnaround rests in the effective and efficient management of the retrenchment process.

The primary causes of the turnaround situation have been associated with the second phase of the turnaround process, the *recovery response.* For firms that declined primarily

Strategy in Action

Exhibit 7.16

It Just Got Hotter in Kraft's Kitchen

BusinessWeek

As Kraft Foods Inc. used to remind consumers, America spells cheese k-r-a-f-t. Lately, those letters have been spelling something else: frustration. Since Altria Group Inc. spun off a minority interest in Kraft in mid-2001, the stock price of the packaged-food giant has risen just 12.6 percent, lagging its peer group, the Standard & Poor's 500-stock index, and even bank certificates of deposit.

On January 31, 2007, Altria said it will distribute its remaining 88.6 percent stake in Kraft to shareholders on March 30. Altria may have been OK with an underachiever; if nothing else, Kraft's steadiness helped balance the uncertainties of Altria's cigarette business.

In the short term, in fact, Kraft's results may suffer. Analysts say Rosenfeld will have to hike outlays on marketing, R&D, and information technology to make up for inadequate spending in the past. Kraft also will have to pay 4.9 percent more for raw ingredients in 2007, after benefiting from a small cost decline in 2006, figures analyst Edgar Roesch of Banc of America Securities. In addition, the overnight release of nearly 1.5 billion Kraft shares is expected to swamp demand.

Higher expenses in 2007 should keep returns close to flat. David Nelson, an analyst with Credit Suisse, predicts Kraft will net $3.1 billion, or $1.90 a share, in 2007 on sales of $35.1 billion. Nelson's target price for Kraft stock over the next 12 months: $31 a share, the same price it opened at in its initial public offering 5½ years ago.

Kraft has a lot going for it, of course. The Northfield (Illinois) company is the nation's biggest maker of packaged foods and second worldwide only to Nestlé of Switzerland. Look through the kitchens of 200 U.S. households and you'll find a Kraft product in all but one of them. Its brands include Oscar Mayer, Post, and Nabisco. A half-dozen boast sales of more than $1 billion a year, while 50 top $100 million. And the company has also had some new successes. Sales of its South Beach Diet line of products, introduced in early 2005, rose to $350 million last year, estimates analyst Roesch. Its California Pizza Kitchen frozen pizzas are selling well, too.

Problem is, other old brands like Velveeta, Maxwell House, and Jell-O are sinking. Like its rivals, Kraft has extended product lines to get the most from its blockbusters. But the strategy may be played out. The company already markets 14 varieties of Oreo cookies, for instance.

Under Altria, management used acquisitions, such as the $18.9 billion takeover of Nabisco in 2000, to overcome slow internal growth. Rosenfeld says that now Kraft will be better able to use its stock, worth $57.8 billion, to make more buys. She has started unloading noncore or underperforming brands; on January 23, 2007, Kraft sold it slow-growth Cream of Wheat brand for $200 million. Others sales could include Oscar Mayer, Planters nuts, and Grey Poupon mustard.

Source: Reprinted with special permission from Michael Arndt, "It Just Got Hotter in Kraft's Kitchen," *BusinessWeek,* February 12, 2007. Copyright © 2007 The McGraw-Hill Companies.

as a result of external problems, turnaround most often has been achieved through creative new entrepreneurial strategies. For firms that declined primarily as a result of internal problems, turnaround has been most frequently achieved through efficiency strategies. *Recovery* is achieved when economic measures indicate that the firm has regained its predownturn levels of performance.

Divestiture

divestiture strategy
A grand strategy that involves the sale of a firm or a major unit of a firm as a going concern.

A **divestiture strategy** involves the sale of a firm or a major component of a firm. Sara Lee Corp. (SLE) provides a good example. It sells everything from Wonderbras and Kiwi shoe polish to Endust furniture polish and Chock Full o'Nuts coffee. The company used a conglomerate diversification strategy to build Sara Lee into a huge portfolio of disparate brands. A new president, C. Steven McMillan, faced stagnant revenues and earnings. So he consolidated, streamlined, and focused the company on its core categories—food, underwear, and household products. He divested 15 businesses, including Coach leather goods, which together equaled more than 20 percent of the company's revenue, and laid off 13,200 employees, nearly 10 percent of the workforce. McMillan used the cash from asset sales to snap up brands that

enhanced Sara Lee's clout in key categories, like the $2.8 billion purchase of St. Louis–based breadmaker Earthgrains Co. to quadruple Sara Lee's bakery operations. In another case of divestitures, Kraft Foods found that it could improve its overall operations by selling some of its best-known brands, as discussed in Exhibit 7.16, Strategy in Action.

When retrenchment fails to accomplish the desired turnaround, as in the Goodyear situation, or when a nonintegrated business activity achieves an unusually high market value, strategic managers often decide to sell the firm. However, because the intent is to find a buyer willing to pay a premium above the value of a going concern's fixed assets, the term *marketing for sale* is often more appropriate. Prospective buyers must be convinced that because of their skills and resources or because of the firm's synergy with their existing businesses, they will be able to profit from the acquisition.

Corning undertook a turnaround that followed retrenchment with divestitures. In 2001, Corning found itself in a declining market for its core product of fiber-optic cable. The company needed to develop a strategy that would allow it to turn around its falling sales and begin to grow once more. It began with retrenchment. Corning laid off 12,000 workers in 2001 and another 4,000 in 2002. Corning also began the divestiture of its noncore assets, such as its nontelecom businesses and its money-losing photonics operation, to stabilize its financial situation so that it could begin its recovery.

The reasons for divestiture vary. They often arise because of partial mismatches between the acquired firm and the parent corporation. Some of the mismatched parts cannot be integrated into the corporation's mainstream activities and, thus, must be spun off. A second reason is corporate financial needs. Sometimes the cash flow or financial stability of the corporation as a whole can be greatly improved if businesses with high market value can be sacrificed. The result can be a balancing of equity with long-term risks or of long-term debt payments to optimize the cost of capital. A third, less frequent reason for divestiture is government antitrust action when a firm is believed to monopolize or unfairly dominate a particular market.

Although examples of the divestiture grand strategy are numerous, CBS Inc. provides an outstanding example. In a two-year period, the once diverse entertainment and publishing giant sold its Records Division to Sony, its magazine publishing business to Diamandis Communications, its book publishing operations to Harcourt Brace Jovanovich, and its music publishing operations to SBK Entertainment World. Other firms that have pursued this type of grand strategy include Esmark, which divested Swift & Company, and White Motors, which divested White Farm.

Liquidation

liquidation
A grand strategy that involves the sale of the assets of the business for their salvage value.

When **liquidation** is the grand strategy, the firm typically is sold in parts, only occasionally as a whole—but for its tangible asset value and not as a going concern. In selecting liquidation, the owners and strategic managers of a firm are admitting failure and recognize that this action is likely to result in great hardships to themselves and their employees. For these reasons, liquidation usually is seen as the least attractive of the grand strategies. As a long-term strategy, however, it minimizes the losses of all the firm's stockholders. Faced with bankruptcy, the liquidating firm usually tries to develop a planned and orderly system that will result in the greatest possible return and cash conversion as the firm slowly relinquishes its market share.

Planned liquidation can be worthwhile. For example, Columbia Corporation, a $130 million diversified firm, liquidated its assets for more cash per share than the market value of its stock.

Bankruptcy

bankruptcy
When a company is unable to pay its debts as they become due, or has more debts than assets.

Business failures are playing an increasingly important role in the American economy. In an average week, more than 300 companies fail and file for **bankruptcy**. More than 75 percent of these financially desperate firms file for a *liquidation bankruptcy*—they agree to a complete distribution of their assets to creditors, most of whom receive a small fraction of

the amount they are owed. Liquidation is what the layperson views as bankruptcy: the business cannot pay its debts, so it must close its doors. Investors lose their money, employees lose their jobs, and managers lose their credibility. In owner-managed firms, company and personal bankruptcy commonly go hand in hand.

The other 25 percent of these firms refuse to surrender until one final option is exhausted. Choosing a strategy to recapture its viability, such a company asks the courts for a *reorganization bankruptcy.* The firm attempts to persuade its creditors to temporarily freeze their claims while it undertakes to reorganize and rebuild the company's operations more profitably. The appeal of a reorganization bankruptcy is based on the company's ability to convince creditors that it can succeed in the marketplace by implementing a new strategic plan, and that when the plan produces profits, the firm will be able to repay its creditors, perhaps in full. In other words, the company offers its creditors a carefully designed alternative to forcing an immediate, but fractional, repayment of its financial obligations. The option of reorganization bankruptcy offers maximum repayment of debt at some specified future time if a new strategic plan is successful.

The Bankruptcy Situation

Imagine that your firm's financial reports have shown an unabated decline in revenue for seven quarters. Expenses have increased rapidly, and it is becoming difficult, and at times not possible, to pay bills as they become due. Suppliers are concerned about shipping goods without first receiving payment, and some have refused to ship without advanced payment in cash. Customers are requiring assurances that future orders will be delivered and some are beginning to buy from competitors. Employees are listening seriously to rumors of financial problems and a higher than normal number have accepted other employment. What can be done? What strategy can be initiated to protect the company and resolve the financial problems in the short term?

Chapter 7: The Harshest Resolution

If the judgment of the owners of a business is that its decline cannot be reversed, and the business cannot be sold as a going concern, then the alternative that is in the best interest of all may be a liquidation bankruptcy, also known as Chapter 7 of the Bankruptcy Code. The court appoints a trustee, who collects the property of the company, reduces it to cash, and distributes the proceeds proportionally to creditors on a pro rata basis as expeditiously as possible. Because all assets are sold to pay outstanding debt, a liquidation bankruptcy terminates a business. This type of filing is critically important to sole proprietors or partnerships. Their owners are personally liable for all business debts not covered by the sale of the business assets unless they can secure a Chapter 7 bankruptcy, which will allow them to cancel any debt in excess of exempt assets. Although they will be left with little personal property, the liquidated debtor is discharged from paying the remaining debt.

The shareholders of corporations are not liable for corporate debt and any debt existing after corporate assets are liquidated is absorbed by creditors. Corporate shareholders may simply terminate operations and walk away without liability to remaining creditors. However, filing a Chapter 7 proceeding will provide for an orderly and fair distribution of assets to creditors and thereby may reduce the negative impact of the business failure.

Chapter 11: A Conditional Second Chance

A proactive alternative for the endangered company is reorganization bankruptcy. Chosen for the right reasons, and implemented in the right way, reorganization bankruptcy can provide a financially, strategically, and ethically sound basis on which to advance the interests of all of the firm's stakeholders.

A thorough and objective analysis of the company may support the idea of its continuing operations if excessive debt can be reduced and new strategic initiatives can be undertaken. If the realistic possibility of long-term survival exists, a reorganization under Chapter 11 of the Bankruptcy Code can provide the opportunity. Reorganization allows a business debtor to restructure its debts and, with the agreement of creditors and approval of the court, to continue as a viable business. Creditors involved in Chapter 11 actions often receive less than the total debt due to them but far more than would be available from liquidation.

A Chapter 11 bankruptcy can provide time and protection to the debtor firm (which we will call the *Company*) to reorganize and use future earnings to pay creditors. The Company may restructure debts, close unprofitable divisions or stores, renegotiate labor contracts, reduce its workforce, or propose other actions that could create a profitable business. If the plan is accepted by creditors, the Company will be given another chance to avoid liquidation and emerge from the bankruptcy proceedings rehabilitated.

Seeking Protection of the Bankruptcy Court

If creditors file lawsuits or schedule judicial sales to enforce liens, the Company will need to seek the protection of the Bankruptcy Court. Filing a bankruptcy petition will invoke the protection of the court to provide sufficient time to work out a reorganization that was not achievable voluntarily. If reorganization is not possible, a Chapter 7 proceeding will allow for the fair and orderly dissolution of the business.

If a Chapter 11 proceeding is the required course of action, the Company must determine what the reorganized business will look like, if such a structure can be achieved, and how it will be accomplished while maintaining operations during the bankruptcy proceeding. Will sufficient cash be available to pay for the proceedings and reorganization? Will customers continue to do business with the Company or seek other more secure businesses with which to deal? Will key personnel stay on or look for more secure employment? Which operations should be discontinued or reduced?

Emerging from Bankruptcy

Bankruptcy is only the first step toward recovery for a firm. Many questions should be answered: How did the business get to the point at which the extreme action of bankruptcy was necessary? Were warning signs overlooked? Was the competitive environment understood? Did pride or fear prevent objective analysis? Did the business have the people and resources to succeed? Was the strategic plan well designed and implemented? Did financial problems result from unforeseen and unforeseeable problems or from bad management decisions?

Commitments to "try harder," "listen more carefully to the customer," and "be more efficient" are important but insufficient grounds to inspire stakeholder confidence. A recovery strategy must be developed to delineate how the company will compete more successfully in the future.

An assessment of the bankruptcy situation requires executives to consider the causes of the Company's decline and the severity of the problem it now faces. Investors must decide whether the management team that governed the company's operations during the downturn can return the firm to a position of success. Creditors must believe that the company's managers have learned how to prevent a recurrence of the observed and similar problems. Alternatively, they must have faith that the company's competencies can be sufficiently augmented by key substitutions to the management team, with strong support in decision making from a board of directors and consultants, to restore the firm's competitive strength.

The 12 grand strategies discussed earlier, used singly and much more often in combinations, represent the traditional alternatives used by firms in the United States. Recently, three new grand types have gained in popularity (thus totaling the 15 grand strategies

we said we would discuss); all fit under the broad category of corporate combinations. Although they do not fit the criterion by which executives retain a high degree of control over their operations, these grand strategies deserve special attention and consideration especially by companies that operate in global, dynamic, and technologically driven industries. These three newly popularized grand strategies are joint ventures, strategic alliances, and consortia.

Joint Ventures

joint venture
A grand strategy in which companies create a co-owned business that operates for their mutual benefit.

Occasionally two or more capable firms lack a necessary component for success in a particular competitive environment. For example, no single petroleum firm controlled sufficient resources to construct the Alaskan pipeline. Nor was any single firm capable of processing and marketing all of the oil that would flow through the pipeline. The solution was a set of **joint ventures**, which are commercial companies (children) created and operated for the benefit of the co-owners (parents). These cooperative arrangements provided both the funds needed to build the pipeline and the processing and marketing capacities needed to profitably handle the oil flow.

The particular form of joint ventures discussed above is *joint ownership.* In recent years, it has become increasingly appealing for domestic firms to join foreign firms by means of this form. For example, Diamond-Star Motors is the result of a joint venture between a U.S. company, Chrysler Corporation, and Japan's Mitsubishi Motors corporation. Located in Normal, Illinois, Diamond-Star was launched because it offered Chrysler and Mitsubishi a chance to expand on their long-standing relationship in which subcompact cars (as well as Mitsubishi engines and other automotive parts) are imported to the United States and sold under the Dodge and Plymouth names.

The joint venture extends the supplier-consumer relationship and has strategic advantages for both partners. For Chrysler, it presents an opportunity to produce a high-quality car using expertise brought to the venture by Mitsubishi. It also gives Chrysler the chance to try new production techniques and to realize efficiencies by using the workforce that was not included under Chrysler's collective bargaining agreement with the United Auto Workers. The agreement offers Mitsubishi the opportunity to produce cars for sale in the United States without being subjected to the tariffs and restrictions placed on Japanese imports.

As a second example, Bethlehem Steel acquired an interest in a Brazilian mining venture to secure a raw material source. The stimulus for this joint ownership venture was grand strategy, but such is not always the case. Certain countries virtually mandate that foreign firms entering their markets do so on a joint ownership basis. India and Mexico are good examples. The rationale of these countries is that joint ventures minimize the threat of foreign domination and enhance the skills, employment, growth, and profits of local firms.

It should be noted that strategic managers understandably are wary of joint ventures. Admittedly, joint ventures present new opportunities with risks that can be shared. On the other hand, joint ventures often limit the discretion, control, and profit potential of partners, while demanding managerial attention and other resources that might be directed toward the firm's mainstream activities. Nevertheless, increasing globalization in many industries may require greater consideration of the joint venture approach, if historically national firms are to remain viable.

Collaborative Growth in China through Joint Ventures[8]

A prime example of the value of joint ventures is seen in their use by foreign businesses that seek to do business in China. Until very recently, China enthusiastically invited foreign

[8] This section was drawn from Pearce II and Robbins, "Strategic Transformation as the Essential Last Step in the Process of Business Turnaround."

investment to help in the development of its economy. However, in the early 2000s, China increased its regulations on foreign investment to moderate its economic growth and to ensure that Chinese businesses would not be at a competitive disadvantage when competing for domestic markets. The new restrictions require local companies to retain control of Chinese trademarks and brands, prevent foreign investors from buying property that is not for their own use, limit the size of foreign-owned retail chains, and restrict foreign investment in selected industries.[9] With these increasing regulations, investment in China through joint ventures with Chinese companies has become a prominent strategy for foreign investors who hope to circumvent some of the limitations on their strategies, therefore more fully capitalizing on China's economic growth.

In China, a host country partner can greatly facilitate the acceptance of a foreign investor and help minimize the costs of doing business in an unknown nation. Typically, the foreign partner contributes financing and technology, while the Chinese partner provides the land, physical facilities, workers, local connections, and knowledge of the country.[10] In a wholly owned venture, the foreign company is forced to acquire the land, build the workspace, and hire and train the employees, all of which are especially expensive propositions in a country in which the foreign company lacks guanxi.[11] Additionally, because China restricts direct foreign investment in the life insurance, energy, construction of transportation facilities, higher education, and health care industries, asset or equity joint ventures are sometimes the only option for foreign firms.

Foreign partners in equity joint ventures benefit from speed of entry to the Chinese market, tax incentives, motivational and competitive advantages of a mutual long-term commitment, and access to the resources of its Chinese partner. In 2006, two large joint ventures in the media industry were created when Canada's AGA Resources partnered with Beijing Tangde International Film and Culture Co and when the United States' Sequoia Capital formed a joint venture with Hunan Greatdreams Cartoon Media.[12] Joint ventures in China's asset management industry include the 2006 partnerships between Italy's Banca Lombarda, the United States' Lord Abbett, and Chinese companies.

Similar opportunities exist for international joint ventures in the construction and operation of oil refineries, in the building of the nation's railroad transportation system, and in the development of specific geographic areas. In special economic zones, foreign firms operate businesses with Chinese joint venture partners. The foreign companies receive tax incentives in the form of rates that are lower than the standard 30 percent corporate tax rate. For example, in the Shanghai Pudong New Area, a 15 percent tax rate applies.[13]

The number of international joint ventures is increasing because of China's admission to the World Trade Organization (WTO). Under the conditions of its membership, China is expanding the list of industries that permit foreign investment.[14] As of 2007, for example, foreign investors that participate with Chinese partners in joint ventures are permitted to hold an increased share of JVs in several major industries: banks (up to 20 percent), investment funds (33 percent), life insurance (50 percent), and telecommunications (25 percent).

[9] E. Kurtenbach, "China Raising Stakes for Foreign Investment," *Philadelphia Inquirer*, September 24, 2006.

[10] Ying Qui, "Problems of Managing Joint Ventures in China's Interior: Evidence from Shaanxi," *Advanced Management Journal* 70, no. 3 (2005), pp. 46–57.

[11] J. A. Pearce II and R. B. Robinson Jr., "Cultivating Guanxi as a Corporate Foreign-Investor Strategy," *Business Horizons* 43, no. 1 (2000), pp. 31–38.

[12] Andrew Bagnell, "China Business," *China Business Review* 33, no. 5 (2006), pp. 88–92.

[13] N. P. Chopey, "China Still Beckons Petrochemical Investments," *Chemical Engineering* 133, no. 8 (2006) pp. 19–23.

[14] "China's WTO Scorecard: Selected Year-Three Service Commitments," *The US-China Business Council* (2005), pp. 1–2.

Strategy in Action

Exhibit 7.17

Yahoo!'s Unlikely Amigos

BusinessWeek

Evidently the newspapers are going to try to partner their way out of it. In this case, "it" is whatever disadvantages the medium faces in the online world. And sliding revenues, reported by major newspaper companies in the last half of 2006. And those companies' steep stock price declines. A nine-company consortium representing more than 215 U.S. dailies has already signed on with Yahoo!—itself no stranger to share price slippage of late—to partner with Yahoo! HotJobs in an online classifieds venture. This consortium, including the likes of E. W. Scripps (which is mulling what it may do with its newspapers), Hearst Newspapers, and MediaNews Group, is in a 90-day exclusive negotiating period with the online giant over at least five key areas to broaden the partnership. And the three companies behind the online help-wanted classifieds site careerbuilder.com—Gannett, McClatchy, and Tribune—are discussing an alliance to create an online ad network.

Both groups welcome other partners, but the Yahoo! partnership has had better luck in scoring them so far. Morris Communications and Media General have signed on since the HotJobs deal was announced. New York Times Co. and the newspaper division of Advance Publications (which also owns the glossy magazine world's Conde Nast Publications) are discussing joining up as well, say executives familiar with the matter.

The Yahoo! partnership has a weakness for wacky monikers. The online giant and its "Nine Amigos" have assigned at least five "tiger teams" to explore relationships with Yahoo!. Among them: extending distribution of Amigos news stories with Yahoo! including spotlighting them in search results; turning over Amigos site-search engines to Yahoo! and creating co-branded search toolbars; finding ways to integrate Yahoo!'s local search with newspapers' data; having newspaper sales staffs sell Yahoo! ads to local advertisers and having Yahoo! staff sell national ads for the Amigos sites; and allowing the Amigos Web sites to use Yahoo!'s ad technology.

You can argue that newspapers are dealing with a sworn enemy here, but the reality is more nuanced. The big online players have a horrible record in tailoring products to local markets.

Yahoo! seeks a fix appropriate to its content-centric ways. The world's no. 1 portal is betting that, like Microsoft, it can't do local by itself. It's also betting there is huge upside in the local space for the kinds of display ads in which it still outshines Google. And it's a nod to the reality that advertisers remain more comfortable having their ads around tamer and more traditional media rather than, say, user-generated videos. As for the newspapers, nuances aside, they are dealing with the kind of company—online, and measuring profit by the billion—that they once feared. But these days, they fear reality more.

Source: Reprinted with special permission from Jon Fine, "Yahoo!'s Unlikely Amigos," *BusinessWeek,* January 29, 2007. Copyright © 2007 The McGraw-Hill Companies.

Strategic Alliances

strategic alliances
Contractual partnerships because the companies involved do not take an equity position in one another

Strategic alliances are distinguishable from joint ventures because the companies involved do not take an equity position in one another. In many instances, strategic alliances are *partnerships* that exist for a defined period during which partners contribute their skills and expertise to a cooperative project. For example, one partner provides manufacturing capabilities while a second partner provides marketing expertise. In other situations, a strategic alliance can enable similar companies to combine their capabilities to counter the threats of a much larger or new type of competitor. Exhibit 7.17, Strategy in Action, provides an example of a strategic alliance that provides "strength in numbers."

Strategic alliances are sometimes undertaken because the partners want to develop in-house capabilities to supplant the partner when the contractual arrangement between them reaches its termination date. Such relationships are tricky because, in a sense, the partners are attempting to "steal" each other's know-how. Exhibit 7.18, Global Strategy in Action, lists some important questions about their learning intentions that prospective partners should ask themselves before entering into a strategic alliance.

In other instances, strategic alliances are synonymous with *licensing agreements*. Licensing involves the transfer of some industrial property right from the U.S. licensor to a motivated licensee in a foreign country. Most tend to be patents, trademarks, or technical

Global Strategy in Action — Exhibit 7.18

Key Issues in Strategic Alliance Learning

Objective	Major Questions
1. Assess and value partner knowledge.	• What were the strategic objectives in forming the alliance? • What are the core competencies of our alliance partner? • What specific knowledge does the partner have that could enhance our competitive strategy?
2. Determine knowledge accessibility.	• How have key alliance responsibilities been allocated to the partners? • Which partner controls key managerial responsibilities? • Does the alliance agreement specify restrictions on our access to the alliance operations?
3. Evaluate knowledge tacitness and ease of transfer.	• Is our learning objective focused on explicit operational knowledge? • Where in the alliance does the knowledge reside? • What are we trying to learn and how can we use the knowledge?
4. Establish knowledge connections between the alliance and the partner.	• Are parent managers in regular contact with senior alliance managers? • Has the alliance been incorporated into parent strategic plans? • What is the level of trust between parent and alliance managers?
5. Draw on existing knowledge to facilitate learning.	• In the learning process, have efforts been made to involve managers with prior experience in either/both alliance management and partner ties? • Are experiences with other alliances being used as the basis for managing the current alliance?
6. Ensure that partner and alliance managerial cultures are in alignment.	• Is the alliance viewed as a threat or an asset by parent managers? • In the parent, is there agreement on the strategic rationale for the alliance? • In the alliance, do managers understand the importance of the parent's learning objective?

Source: From *Academy of Management Executive* by Andrew C. Inkpen. Copyright © 1998 by Academy of Management. Reproduced with permission of Academy of Management via Copyright Clearance Center.

know-how that are granted to the licensee for a specified time in return for a royalty and for avoiding tariffs or import quotas. Bell South and U.S. West, with various marketing and service competitive advantages valuable to Europe, have extended a number of licenses to create personal computers networks in the United Kingdom. Another example of licensing is discussed in Exhibit 7.19, Strategy in Action, which describes UTEK Corporation's successful strategy for licensing discoveries resulting from research efforts at universities.

Another licensing strategy is to contract the manufacturing of its product line to a foreign company to exploit local comparative advantages in technology, materials, or labor. MIPS Computer Systems has licensed Digital Equipment Corporation, Texas Instruments, Cypress Semiconductor, and Bipolar Integrated Technology in the United States and Fujitsu, NEC, and Kubota in Japan to market computers based on its designs in the partner's country.

Strategy in Action

Exhibit 7.19

A Matchmaker for Inventors

BusinessWeek

For George E. Inglett, a researcher with the U.S. Department of Agriculture, the eureka moment came in 1995. Searching for a use for oat hulls, he shoveled a couple of pounds into a high-speed centrifuge in his lab in Peoria, Illinois. What emerged was a white gel with no taste or calories. Adding it to food cut the fat and calories dramatically but the gel had no impact on taste or texture. Inglett had discovered nutrition's Holy Grail: an all-natural fat substitute.

Inglett's discovery might have been for naught without UTEK Corp., which ultimately found a small company to commercialize his product: ZTrim in Mundelein, Illinois. UTEK, a technology matchmaker with an unusual business model, gives researchers like Inglett an outlet for their ideas, and it gives companies like ZTrim a way to outsource innovation by providing access to a database of more than 35,000 discoveries that would otherwise go unnoticed.

For university and government researchers struggling to license their discoveries, UTEK can make all the difference. Many universities have technology-transfer offices that are understaffed and underfunded. And many risk-averse companies are unwilling to take a flyer on an interesting idea with uncertain commercial potential. The result: only about 30 percent of the 18,000 discoveries made by university and government researchers each year ever see the light of day as commercial products.

North Carolina A&T State University's experience is instructive. When a researcher there stumbled on a way to detect microscopic cracks in an airplane fuselage, the discovery, while promising, turned out to be nearly impossible to sell. The technology-transfer office spent two years scouring North America and Europe for a buyer.

Then UTEK showed up, with Material Technologies Inc. in tow. Unlike other technology-transfer companies, which license technologies they've acquired or charge fees to broker deals, UTEK pays the research lab for licensing rights to its discovery. It then sells those rights to the client company for shares of stock, which UTEK agrees to hold for one year. UTEK might pay $500,000 for the discovery and receive stock worth $2.5 million. A lot can happen in a year—UTEK's stake in ZTrim, for example, ballooned to $6 million.

UTEK has had more hits than misses, including deals involving technologies for fertilizer production, pollution monitoring, even land mine detection. Since 2003 the number of tech-transfer deals UTEK has brokered has quadrupled, despite robust competition, which includes 10 publicly traded tech-transfer companies. UTEK, which went public in 2000, now holds equity stakes in 55 companies, for a portfolio valued at $60 million. And each year it adds several thousand discoveries to its database.

Source: Reprinted with special permission from Louis Lavelle, "A Matchmaker for Investors; UTEK is Earning Big Bucks by Pairing Brainstorms with Businesses," *BusinessWeek,* February 26, 2007. Copyright © 2007 The McGraw-Hill Companies.

Service and franchise-based firms—including Anheuser-Busch, Avis, Coca-Cola, Hilton, Hyatt, Holiday Inns, Kentucky Fried Chicken, McDonald's, and Pepsi—have long engaged in licensing arrangements with foreign distributors as a way to enter new markets with standardized products that can benefit from marketing economies.

Outsourcing is a basic approach to strategic alliances that enables firms to gain a competitive advantage. Significant changes within many segments of American business continue to encourage the use of outsourcing practices. Within the health care arena, an industry survey recorded 67 percent of hospitals using provider outsourcing for at least one department within their organization. Services such as information systems, reimbursement, and risk and physician practice management are outsourced by 51 percent of the hospitals that use outsourcing.

Another successful application of outsourcing is found in human resources. A survey of human resource executives revealed 85 percent have personal experience leading an outsourcing effort within their organization. In addition, it was found that two-thirds of pension departments have outsourced at least one human resource function. Within customer service and sales departments, outsourcing increases productivity in such areas as product information, sales and order taking, sample fulfillment, and complaint handling. For an interesting example of the use of outsourcing to save money in the retail sector, see Exhibit 7.20, Strategy in Action.

Strategy in Action

Exhibit 7.20

What Happens to That Scarf You Really Hated?

BusinessWeek

Shoppers, on average, return about 6 percent of everything they buy. That proportion spikes in January to nearly 10 percent. This used to be a sore point for retailers. Rather than try to make sense of a hodgepodge of generally used, sometimes broken goods with packaging shredded or instructions missing, stores tended just to write the lot off as a loss. But over the past decade, an opportunistic industry has sprung up to give the reject pile a new lease on life.

Most big-box retailers—Sears, Target, Best Buy, Kohl's, and many others—now outsource the handling of returns to companies that specialize in so-called reverse logistics. These third parties' job, basically, is to pick up a store's returns and figure out what to do with them—restock an item, sell it somewhere else, like in Peru or at a flea market, or throw it in the trash.

For retailers, it's a way to squeeze money from what previously was a cost center, because they get a cut of any eventual sales. Genco, the biggest such service provider, charges stores a management fee to collect and sort the products at its 33 return centers. If it's able to sell a returned item to a secondary market, the proceeds are split with the retailer. Newgistics, an Austin (Texas) company, handles returns specifically for online sales—where return rates can surge up to 20 percent—for Amazon.com, J. Crew, and Nordstrom, among others, charging by package. Other companies, such as Liquidity Services, don't charge a fee, only taking a cut from auctions of the goods.

The best gift you can give a returns processor is to bring back something for no other reason than you just changed your mind. If that item gets back to a Genco center, for example, the manufacturer may give the retailer a credit for the return (free money). Then Genco will send the defect-free, originally wrapped product back to the retailer to be sold again (more money).

Pittsburgh-based, privately held Genco helped develop this niche in 1993 when, as a $34 million-a-year company, it started handling returns for Wal-Mart Stores Inc. By 2006, Genco had $570 million in revenue. Now it does logistics work for more than 100 clients.

The trick for logistics companies is to find other places for returned merchandise. Much of what Genco sells goes to closeout retailers or dollar stores. If something is defective, it goes back to the manufacturer, or if that's not possible, Genco will try to fix it. It even puts products up on eBay. Each retailer has its own restrictions about its returned goods' eventual home. About 40 percent of Genco's $1 billion in turnover comes from goods it sells in secondary markets overseas. Some retailers require Genco to scrub the product of logos; some just want the highest bid.

Source: Reprinted with special permission from Brian Hindo, "What Happens to that Scarf You Really Hated?" *BusinessWeek,* January 15, 2007. Copyright © 2007 The McGraw-Hill Companies.

Consortia, *Keiretsus*, and *Chaebols*

consortia
Large interlocking relationships between businesses of an industry.

keiretsus
A Japanese consortia of businesses that is coordinated by a large trading company to gain a strategic advantage.

chaebol
A Korean consortia financed through government banking groups to gain a strategic advantage.

Consortia are defined as large interlocking relationships between businesses of an industry. In Japan such consortia are known as ***keiretsus;*** in South Korea as ***chaebols.***

In Europe, consortia projects are increasing in number and in success rates. Examples include the Junior Engineers' and Scientists' Summer Institute, which underwrites cooperative learning and research; the European Strategic Program for Research and Development in Information Technologies, which seeks to enhance European competitiveness in fields related to computer electronics and component manufacturing; and EUREKA, which is a joint program involving scientists and engineers from several European countries to coordinate joint research projects.

A Japanese *keiretsu* is an undertaking involving up to 50 different firms that are joined around a large trading company or bank and are coordinated through interlocking directories and stock exchanges. It is designed to use industry coordination to minimize risks of competition, in part through cost sharing and increased economies of scale. Examples include Sumitomo, Mitsubishi, Mitsui, and Sanwa.

A South Korean chaebol resembles a consortium or keiretsu except that they are typically financed through government banking groups and are largely run by professional managers trained by participating firms expressly for the job.

Strategy in Action — Exhibit 7.21

A Profile of Strategic Choice Options

	Six Strategic Choice Options					
	1	2	3	4	5	6
Interactive opportunities	West Coast markets present little competition		Current markets sensitive to price competition		Current industry product lines offer too narrow a range of markets	
Appropriate long-range objectives (limited sample):						
Average 5-year ROI.	15%	19%	13%	17%	23%	15%
Company sales by year 5.	+ 50%	+ 40%	+ 20%	+ 0%	+ 35%	+ 25%
Risk of negative profits.	.30	.25	.10	.15	.20	.05
Grand strategies	Horizontal integration	Market development	Concentration	Selective retrenchment	Product development	Concentration

SELECTION OF LONG-TERM OBJECTIVES AND GRAND STRATEGY SETS

At first glance, the strategic management model, which provides the framework for study throughout this book, seems to suggest that strategic choice decision making leads to the sequential selection of long-term objectives and grand strategies. In fact, however, strategic choice is the simultaneous selection of long-range objectives and grand strategies. When strategic planners study their opportunities, they try to determine which are most likely to result in achieving various long-range objectives. Almost simultaneously, they try to forecast whether an available grand strategy can take advantage of preferred opportunities so the tentative objectives can be met. In essence, then, three distinct but highly interdependent choices are being made at one time. Several triads, or sets, of possible decisions are usually considered.

A simplified example of this process is shown in Exhibit 7.21, Strategy in Action. In this example, the firm has determined that six strategic choice options are available. These options stem from three interactive opportunities (e.g., West Coast markets that present little competition). Because each of these interactive opportunities can be approached through different grand strategies—for options 1 and 2, the grand strategies are horizontal integration and market development—each offers the potential for achieving long-range objectives to varying degrees. Thus, a firm rarely can make a strategic choice only on the basis of its preferred opportunities, long-range objectives, or grand strategy. Instead, these three elements must be considered simultaneously, because only in combination do they constitute a strategic choice.

In an actual decision situation, the strategic choice would be complicated by a wider variety of interactive opportunities, feasible company objectives, promising grand strategy options, and evaluative criteria. Nevertheless, Exhibit 7.21 does partially reflect the nature and complexity of the process by which long-term objectives and grand strategies are selected.

In the next chapter, the strategic choice process will be fully explained. However, knowledge of long-term objectives and grand strategies is essential to understanding that process.

SEQUENCE OF OBJECTIVES AND STRATEGY SELECTION

The selection of long-range objectives and grand strategies involves simultaneous, rather than sequential, decisions. While it is true that objectives are needed to prevent the firm's direction and progress from being determined by random forces, it is equally true that objectives can be achieved only if strategies are implemented. In fact, long-term objectives and grand strategies are so interdependent that some business consultants do not distinguish between them. Long-term objectives and grand strategies are still combined under the heading of company strategy in most of the popular business literature and in the thinking of most practicing executives.

However, the distinction has merit. Objectives indicate what strategic managers want but provide few insights about how they will be achieved. Conversely, strategies indicate what types of actions will be taken but do not define what ends will be pursued or what criteria will serve as constraints in refining the strategic plan.

Does it matter whether strategic decisions are made to achieve objectives or to satisfy constraints? No, because constraints are themselves objectives. The constraint of increased inventory capacity is a desire (an objective), not a certainty. Likewise, the constraint of an increase in the sales force does not ensure that the increase will be achieved, given such factors as other company priorities, labor market conditions, and the firm's profit performance.

DESIGNING A PROFITABLE BUSINESS MODEL

business model
A clear understanding of how the firm will generate profits and the strategic actions it must take to succeed over the long term.

The process of combining long-term objectives and grand strategies produces a **business model**. Creating an effective model requires a clear understanding of how the firm will generate profits and the strategic action it must take to succeed over the long term.

Adrian Slywotzky and David Morrison identified 22 business models—designs that generate profits in a unique way.[15] They present these models as examples, believing that others do or can exist. The authors also believe that in some instances profitability depends on the interplay of two or more business models. Their study demonstrates that the mechanisms of profitability can be very different but that a focus on the customer is the key to the effectiveness of each model.

Slywotzky and Morrison suggest that the two most productive questions asked of executives are these:

1. What is our business model?
2. How do we make a profit?

The classic strategy rule suggested, "Gain market share and profits will follow." This approach once worked for some industries. However, because of competitive turbulence

[15] This section is excerpted from A. J. Slywotzky, D. J. Morrison, and B. Andelman, *The Profit Zone; How Strategic Business Design Will Lead You To Tomorrow's Profits* (New York: Times Books, 1997).

caused by globalization and rapid technological advancements, the once-popular belief in a strong correlation between market share and profitability has collapsed in many industries.

How can businesses earn sustainable profits? The answer is found by analyzing the following questions: Where will the firm make a profit in this industry? How should the business model be designed so that the firm will be profitable? Slywotzky and Morrison describe the following profitability business models as ways to answer those questions.

1. *Customer development customer solutions profit model.* Companies that use this business model make money by finding ways to improve their customers' economics and investing in ways for customers to improve their processes.

2. *Product pyramid profit model.* This model is effective in markets where customers have strong preferences for product characteristics, including variety, style, color, and price. By offering a number of variations, companies can build so-called product pyramids. At the base are low-priced, high-volume products, and at the top are high-priced, low-volume products. Profit is concentrated at the top of the pyramid, but the base is the strategic firewall (i.e., a strong, low-priced brand that deters competitor entry), thereby protecting the margins at the top. Consumer goods companies and automobile companies use this model.

3. *Multicomponent system profit model.* Some businesses are characterized by a production/marketing system that consists of components that generate substantially different levels of profitability. In hotels, for example, there is a substantial difference between the profitability of room rentals and that of bar operations. In such instances, it often is useful to maximize the use of the highest-profit components to maximize the profitability of the whole system.

4. *Switchboard profit model.* Some markets function by connecting multiple sellers to multiple buyers. The switchboard profit model creates a high-value intermediary that concentrates these multiple communication pathways through one point or "switchboard" and thereby reduces costs for both parties in exchange for a fee. As volume increases, so too do profits.

5. *Time profit model.* Sometimes, speed is the key to profitability. This business model takes advantage of first-mover advantage. To sustain this model, constant innovation is essential.

6. *Blockbuster profit model.* In some industries, profitability is driven by a few great product successes. This business model is representative of movie studios, pharmaceutical firms, and software companies, which have high R&D and launch costs and finite product cycles. In this type of environment, it pays to concentrate resource investments in a few projects rather than to take positions in a variety of products.

7. *Profit multiplier model.* This business model reaps gains, repeatedly, from the same product, character, trademark capability, or service. Think of the value that Michael Jordan Inc. creates with the image of the great basketball legend. This model can be a powerful engine for businesses with strong consumer brands.

8. *Entrepreneurial profit model.* Small can be beautiful. This business model stresses that diseconomies of scale can exist in companies. They attack companies that have become comfortable with their profit levels with formal, bureaucratic systems that are remote from customers. As their expenses grow and customer relevance declines, such companies are vulnerable to entrepreneurs who are in direct contact with their customers.

Strategy in Action

Exhibit 7.22

Where Dell Went Wrong

BusinessWeek

At Dell, how it all began is never forgotten. Even on January 31, 2007, as founder Michael S. Dell returned to the role of CEO after 18 months of bad news and faltering financials, the press release trumpeted how, 23 years ago, Dell launched what would become a $56 billion business with just $1,000 and a simple idea.

Like many long-forgotten former champions, Dell succumbed to complacency in the belief that its business model would always keep it far ahead of the pack. While Dell broadened its product line, it never dealt with the vast improvement in the competition or used its lead in direct sales and the cash generated to invest in new business lines, talent, or innovation that could provide another competitive edge. "Dell is a textbook example of single-formula growth: 'We make PCs cheap. This is what we do, and we do it a lot,'" says Jim Mackey, managing director at the Billion Dollar Growth Network. "You can grow very fast when you're on a single formula, but when you get to a certain point, you don't have the ability to create new growth."

"When it's all you can do to keep up with the growth your current business model is providing, you just don't feel that urgency," says Harvard Business School professor Clayton Christensen. "It's hard to get worried." He visited Dell's Round Rock (Texas) offices in 1998 and again in 2000, and warned Dell and then-CEO Kevin Rollins that they needed to focus on growth five to eight years out, on the model that would augment their built-to-order machines. Instead, Dell pushed its model into new types of hardware, such as storage, printers, and TVs, in the hopes of making easy profits by selling products made by other companies.

Hubris crept in. In 1999, Dell bought a start-up called ConvergeNet, which had a sophisticated storage product that turned out to be not ready for prime time. Dubbing rival EMC Corp. the "Excessive Margin Company," Dell seemed to expect storage to follow the same pattern PCs had, moving from pricey, feature-laden models into a standards-based commodity. Dell underestimated the competition and is an also-ran in the segment. By 2005, PC rivals, particularly HP, which has taken the market-share lead from Dell, had closed the efficiency gap and were enjoying resurgent sales at retail stores.

Dell's loyalty to its business model could make it difficult to recapture growth. Dell has suggested a new offensive to enlarge its computer services business, which so far has focused largely on repair and upgrading of Dell's hardware. Dell has struggled to find other growth areas large enough to matter. After a promising start in printers, moving quickly to no. 3, the most recent quarterly data from research firm IDC shows Dell's market share at 3.6 percent, down from 6.2 percent the previous year. Its once-promising move into networking gear has fizzled, and its share in the storage systems market is flat compared with a year ago.

Source: Reprinted with special permission from Nanette Byrnes, "Where Dell Went Wrong," *BusinessWeek,* February 19, 2007. Copyright © 2007 The McGraw-Hill Companies.

9. *Specialization profit model.* This business model stresses growth through sequenced specialization. Consulting companies have used this design successfully.

10. *Installed base profit model*. A company that pursues this model profits because its established user base subsequently buys the company's brand of consumables or follow-on products. Installed base profits provide a protected annuity stream. Examples include razors and blades, software and upgrades, copiers and toner cartridges, and cameras and film.

11. *De facto standard profit model.* A variant of the installed base profit model, this model is appropriate when the installed base model becomes the de facto standard that governs competitive behavior in the industry.

Exhibit 7.22, Strategy in Action, discusses the business model of Dell. Once praised as innovative, it is now criticized as overly narrow, blind to opportunities, and insufficiently ambitious.

Summary

Before we learn how strategic decisions are made, it is important to understand the two principal components of any strategic choice; namely, long-term objectives and the grand strategy. The purpose of this chapter was to convey that understanding.

Long-term objectives were defined as the results a firm seeks to achieve over a specified period, typically five years. Seven common long-term objectives were discussed: profitability, productivity, competitive position, employee development, employee relations, technological leadership, and public responsibility. These, or any other long-term objectives, should be flexible, measurable over time, motivating, suitable, and understandable.

Grand strategies were defined as comprehensive approaches guiding the major actions designed to achieve long-term objectives. Fifteen grand strategy options were discussed: concentrated growth, market development, product development, innovation, horizontal integration, vertical integration, concentric diversification, conglomerate diversification, turnaround, divestiture, liquidation, bankruptcy, joint ventures, strategic alliances, and consortia.

Key Terms

balanced scorecard, *p. 202*
bankruptcy, *p. 227*
business model, *p. 237*
chaebol, *p. 235*
concentrated growth, *p. 211*
concentric diversification, *p. 221*
conglomerate diversification, *p. 221*
consortia, *p. 235*
divestiture strategy, *p. 226*
generic strategy, *p. 203*
grand strategy, *p. 211*
horizontal integration, *p. 218*
innovation, *p. 216*
joint venture, *p. 230*
keiretsus, *p. 235*
liquidation, *p. 227*
market development, *p. 214*
product development, *p. 216*
strategic alliances, *p. 232*
turnaround strategy, *p. 224*
vertical integration, *p. 220*

Questions for Discussion

1. Identify firms in the business community nearest to your college or university that you believe are using each of the 15 grand strategies discussed in this chapter.
2. Identify firms in your business community that appear to rely principally on 1 of the 15 grand strategies. What kind of information did you use to classify the firms?
3. Write a long-term objective for your school of business that exhibits the seven qualities of long-term objectives described in this chapter.
4. Distinguish between the following pairs of grand strategies:

   a. Horizontal and vertical integration.
   b. Conglomerate and concentric diversification.
   c. Product development and innovation.
   d. Joint venture and strategic alliance.

5. Rank each of the 15 grand strategy options discussed in this chapter on the following three scales:

High ———————— Low
Cost

High ———————— Low
Risk of failure

High ———————— Low
Potential for exceptional growth

6. Identify firms that use the eight specific options shown in Exhibit 7.8 under the grand strategies of concentration, market development, and product development.

Chapter 7 Discussion Case

BusinessWeek

VW's New Strategic Plan for the United States—Part 1: *Crispin Porter + Bogusky's Plan to Rekindle Our Love Affair with VW*

1 Remember the Volkswagen Rabbit? The boxy, fuel-efficient hatchback was launched in 1974 to replace the legendary Beetle as the company's big seller and was the first VW made in the United States. It also became known for catching fire and breaking down, and thus became the symbol of VW's collapse in America through the 1980s. At the insistence of VW's German parent, the Rabbit name was killed in 1985, and the Westmoreland (Pennsylvania) assembly plant was shuttered soon after.

2 So it was audacious indeed when Alex Bogusky, chief creative officer of Crispin Porter + Bogusky, which took over the VW advertising account last December, suggested resurrecting the Rabbit name. In a March 20,2006, meeting at the Auburn Hills (Michigan) headquarters of VW of America, with company brass and two members of its dealer council, Bogusky reasoned that the redesigned Golf launching in the United States this year had already been selling in Europe for two years, so auto writers probably wouldn't pay much attention to the stateside debut. "So let's change the story," offered the 42-year-old ad director before the assembled group. Nervous laughter followed. VW supervisory board chairman Ferdinand K. Piech, known for his bad temper and for insisting that VW have global model names, was certain to disapprove. But VW's U.S. chief, Adrian M. Hallmark, bought in and took the idea to the carmaker's German headquarters in Wolfsburg on March 25, 2006. Worldwide brand chief Wolfgang Bernhard said yes and ordered new signs, photography, and press releases to be rushed for the New York International Auto Show on April 12, despite whispers that Piech, already gunning for Bernhard's boss, management board chairman Bernd Pischetsrieder, was unhappy.

HATE MAIL

3 Many love the Rabbit idea, but plenty hate it. That's just the kind of strong, polarized reaction Bogusky and his partners like to provoke. VW's U.S. dealer council supports the move. But consider some of the hostile reaction: Peter M. DeLorenzo, founder and publisher of influential Webzine Autoextremist.com Inc., called the decision to return to the Rabbit name "pure, unadulterated lunacy," and wrote that if U.S. VW marketing chief Kerri Martin and her agency weren't stopped, they would "destroy the brand in the U.S. once and for all." Steven Wilhite, former VW marketing chief and current global chief marketing officer at Nissan Motor Co., pronounced the idea "brain-dead." Rance E. Crain, editor-in-chief of *Advertising Age*, editorialized that Crispin's first work for VW has been "so horrendously awful that [it] smoothes the way for [VW's] quick and complete withdrawal [from the American market]." Says a habitually cool Bogusky, wearing a Kiss T-shirt and stabbing his fork in the air as he scarfed banana pancakes at Greenstreet's, a cafe near his Miami office: "I like that they are talking about the work. If they aren't talking, then your brand is dead."

4 Indeed, Volkswagen is trying to avoid the kind of near-death experience it had in the early 1990s, when sales sank so low that German managers seriously pondered pulling up U.S. stakes altogether. At 224,000 cars sold last year, VW is a long way from the nadir of 49,000 in 1992. But to insiders who have watched the numbers drop by 131,000 sales per year since a peak of 355,648 in 2001, this period has felt eerily like the dark days a decade ago, before the New Beetle lifted the entire brand out of quicksand. Internal research shows a lasting loss of confidence in the brand after costly, repetitive quality problems: VW's U.S. division has lost more than $1 billion in each of the past two years, and this year could be nearly as bad. On May 2, 2006, Pischetsrieder had his contract renewed for six years, but only after intense pressure by the supervisory board to deliver better results with fewer job cuts than the 20,000 he wants. "No question about it, it's a five-alarm fire," says Crispin president Jeff Hicks.

5 Enter Crispin Porter + Bogusky, the eccentric ad shop in Miami that's known for using viral marketing and creating nutty characters like the Subservient Chicken for Burger King Holdings Inc.'s ailing franchises. VW had been through three years of coolly received ad efforts as it juggled a failed luxury sedan (the tony Phaeton, priced at more than $75,000) and the $50,000 Touareg SUV, alongside $20,000 Golfs and Jettas. Former agency Arnold Worldwide, saddled with temporary VW ad directors before marketing chief Kerri Martin arrived, struggled to make sense of it all. A year ago, Martin got the heady title of director of brand innovation, having been the celebrated marketing whiz at MINI USA and Harley-Davidson Inc. Crispin worked with her at MINI to create the kind of B-school case-study advertising excitement for which VW used to be known.

6 As Crispin tries to douse the flames engulfing the VW brand, it has to prove that it won the VW assignment on merit, not just as Martin's pet agency. Situated 1,300 miles south of Madison Avenue's groupthink, Crispin stands apart. Whether it was running MINI Cooper hatchbacks around cities atop Ford Excursion SUVs or getting teens to dump some 1,200 faux body bags at the door of a tobacco company for an antismoking campaign, Crispin has been changing the industry's playbook. It famously helped solve Burger King's

irrelevancy problem, especially with consumers aged 14 to 25, with the Subservient Chicken Web site, where a visitor could make a chicken do almost anything on command—dust furniture or play air guitar.

7 That simple, inexpensive, wacky idea has generated a staggering 460 million-plus hits in two years and helped Burger King post its first string of positive growth quarters in a decade. The agency's relaunch of the MINI brand helped the unit of BMW surpass sales targets by 80 percent. Crispin's success has fueled growth in its own staff from 105 in 2000 to 438. As it transforms marketing messages into entertainment time and again, "the agency has been redefining what consumers even recognize as advertising," says rival and admirer Jeff Goodby, co-chairman of Goodby, Silverstein & Partners in San Francisco.

8 It's early days, but it looks as if Crispin's style of marketing is working once more. Since its ads started running, VW sales are up, dealers are enthusiastic, Internet chatter about VW is as high as it has been since the public relations bonanza around the New Beetle in 1998. Just about every aspect of Crispin's work in its first five months on the job has been covered in major media outlets. As the agency and Martin have challenged many of VW's old ways and ignored some of the company's internal political trip-wires, the brand is being talked about again around the water cooler, a must for any consumer company today that hopes to not just survive but thrive.

WEB ALLURE

9 Volkswagen, of course, has its own special place in advertising history. Two separate agencies defined themselves, and advertising as a whole, in two different decades working for VW. In the 1960s it was Doyle Dane Bernbach, which created the headlines "Think Small" and "Lemon," pioneering the use of self-deprecating humor and wit to sell cars. "It was the first time ever that people talked about ads at cocktail parties and at work," says Andrew Langer, vice chairman of Lowe & Partners Worldwide, who worked at DDB then. In the 1990s, VW and Boston's Arnold Fortuna Lawner & Cabot, before it was Arnold Worldwide, ignited a new genre of storytelling mixed with independent rock music: the "Da Da Da" ad, playing the German song of the same title while two slackers drove around town in their Golf. "It fits your life," went the ad's voiceover, "or your complete lack thereof." Now it's Crispin's turn to make history—or humiliate itself trying—by taking on America's favorite advertising account for yet another comeback.

10 It certainly didn't take long for Crispin to get people talking again. In place of a subservient chicken, Crispin invented a German-accented, dominatrix-type blonde bombshell named Helga. She appears in ads with an effete German engineer named Wolfgang, whose message to introduce the GTI hatchback is "Unpimp Your Auto," a swipe at the over-accessorized, high-performance small Japanese cars often dubbed "rice rockets." Billboards for the GTI read "Auf Wiedersehen, sucka" and "Fast as Schnell."

11 Schnell, and then some. Day One on the account, December 6, 2005 the agency began to perform triage on the ailing carmaker. Bogusky, a Miami native who dropped out of art school though both parents are graphic artists, met with creative director Andrew Keller, 35, and more than 40 writers, art directors, and researchers in the agency's big conference room. The brief for the GTI read: "How does GTI regain its position as the original hot hatch?" By the way, Keller told the crowd, "we have to figure this out and execute a plan in time to launch during the Winter Olympics [on] February 6." That gave the team fewer than 60 days, with a Christmas holiday in the middle.

12 Crispin's cognitive anthropologists went to work. Two-hour in-home interviews with two dozen GTI buyers, all men 18 to 30, were done in five cities. The researchers sent the subjects an assignment in advance of visits: Make a collage with magazine pictures to illustrate how they felt about Japanese "tuner" cars, like Honda Civics, on which owners tack thousands of dollars in speed-enhancing and cosmetic accessories. Then cut out pictures representing the European tuner cars like GTI and BMW M cars that are accessorized at the German factories. One GTI fan contrasted cutouts of Tweety Bird and a tuner "dude" wearing a chrome dollar-sign necklace to represent the Asian tuner "posers" with images of a black wolf and Ninja warrior depicting the "more authentic and serious" Euro tuner crowd.

13 Crispin's researchers then asked them to write epitaphs on paper tombstones after the phrase "Here Lies the Japanese Hot Hatch," and recipes that begin with, "My perfect recipe for driving is . . ." One recipe reads: "One S-curve, a pinch of fishtail, two parts turbo toast, an ounce of hard rock music. Combine and bring to a boil." The strategy drawn from all this was to flog the GTI as tuned in Germany by speed-happy engineers rather than at some U.S. neighborhood retail joint.

14 In launching the GTI and reviving the Volkswagen brand in general, Crispin faced two challenges. First, since the debut of the New Beetle, the VW brand has become feminized, says Keller. Loyal young males who were hanging on to VW by a thread needed to be reassured. Too many men had come to view VW as a "chick's brand." Worse, women were turning away from VW because of quality issues. Second, VW loyalists had become baffled about the pricey Phaeton and Touareg and loaded Jettas with price tags topping $30,000. A decade into the popularity of small SUVs priced under $25,000, VW has none. "Affordable German engineering is a huge part of VW's DNA, and these decisions really confused customers," says Tom Birk, Crispin vice president for research and planning.

15 Crispin's employee handbook says advertising is "anything that makes our clients famous." So for the GTI, Bogusky and Keller are pulling no punches. This is a car built for driving fast and having fun. And for men, that inevitably leads to a certain amount of sex, they reckoned. That led to Helga, an over-the-top parody of a German nightclubbing valkyrie. She is in ads—and stars in VW's GTI Web site. Anyone configuring a GTI, choosing interior, wheels, engine, and the like, can take a

virtual test drive with the boot-wearing siren, who comments about each driver's selections. "I see from your paddle shifters, you're ready to go." And, "I luf leather." There are some 500 variations of GTI, and Helga can talk you through them all.

16 Helga and Wolfgang, says Hicks, are an example of taking an audience to a place they didn't know they wanted to go. "A lot of advertisers try and mirror what the research tells them. What we do is try and make the brand part of the pop culture." Ads featuring Helga and Wolfgang ran on TV in March and April 2006, but now enthusiasts all over the Net are downloading them. In one, engineer Wolfgang is consulting a young owner with an oversized intake port on his hood that sucks air into the engine compartment. Says Helga: "It's definitely sucking." Thanks to the Internet, VW has been fielding requests for copies of these ads from media outlets and VW clubs as far away as India.

17 A spike in Net chatter will go only so far. Although VW ranked third from the bottom in J. D. Power & Associates' 2005 Initial Quality Survey, it improved from the year before—by 10 percent fewer glitches per 100 cars. VW's quality woes have spread around the Net as fast as Helga's double entendres. This month, says VW, it will post another big improvement, while dealers are reporting half as many warranty repairs on new models as they did in 2004.

SEXY SYMBOL

18 Despite its hasty execution, the campaign has already achieved what Martin hoped it would. "We needed to ignite a new conversation with owners," she says. The viral dimension has worked well. For about two weeks, VW ads were the top download from video-sharing site YouTube.com. Wolfgang and Helga have become part of the new VW story. They have sites on MySpace.com, where more than 7,500 fans have signed up as Helga's "friends" and are downloading a printable life-size Helga. "Bachelor parties, maybe," quips Keller.

19 Can Crispin's edgy playfulness go over the line? With the suggestive content, charges of sexism have followed. TV ads for the Winter Olympics depicted young men so into their GTIs that one refused to roll up the window to shield his girlfriend's wind-blown hair and told her to stop "yackin" so he could enjoy the engine's growl. Another refused to take his girlfriend on an errand in his GTI because her weight would slow him down. Ouch. Nissan's Wilhite says he's all for shaking up VW's message, "but I can't go along with ads that marginalize women like beer commercials often do." Suzanne Farley, a Boston education consultant and owner of a 1999 VW Passat, agrees, saying the ads "made me feel weird, like they were talking right past me." But the agency just introduced its first work for Miller Lite and junked the predictable frat-boy approach. Instead, icons like Burt Reynolds and Pittsburgh Steelers running back Jerome Bettis thoughtfully discuss "man laws," like how long to wait before dating a buddy's ex-girlfriend.

20 There's no doubt that Crispin and Volkswagen's Martin are out to take some risks, and that for now at least they have a long leash from management, which is doing its part to supply the right products. VW is moving fast under Pischetsrieder and Bernhard to bring out several new models in the next 20 months, including a minivan, two light SUVS, and two sports cars—the Eos convertible and a new interpretation of the 1970s and 1980s VW Scirocco—all priced under $30,000. A pricier sedan larger than the Passat is due, too, to try to hold on to aging boomer fans. It's the fastest product proliferation in VW history, and Crispin had better get a coherent strategy to reposition the entire brand before the new models arrive. "We are on a whole new timetable for getting this brand right and will move faster than people around here thought we could," says Bernhard.

21 In an industry that celebrates the slogan, that magical line of ad copy that crystallizes a brand's essence, Crispin hasn't yet hit on one for VW. It did, however, kill off VW's 10-year-old "Drivers wanted" line. "A slogan or tag line is not important if the messaging is right," says Bogusky. Still, Crispin likes the VW logo so much that it came up with a gimmick in the GTI ads in which Wolfgang forms the V and W with his interlocked fingers. That's already sticking online. People selling VWs on eBay, for example, have turned up in pictures in their cars making the hand sign.

22 Crispin may offer a new slogan sometime in 2007. For now, it's giving each model its own campaign. It just relaunched the Jetta with ads that are far from funky or sexy. In an about-face from its usual humorous tack, Crispin spotlights the car's top side-impact safety ratings. And like almost everything else the agency does, even these sober-as-a-judge ads have stirred conversation. In one, two couples are chatting as they drive away from a movie house. The driver is distracted and gets creamed by an SUV in real time. The effect on the TV viewer is jolting. The ad moves from the crash to the people standing by, shaky but unharmed, looking at the crushed car. A survivor says, "Holy . . ." and the ad cuts to a video frame that says "Safe Happens." Requests for Jetta brochures went up 30 percent after the ads' debut. And dozens of newspapers and NBC's *The Today Show* have reported on their jarring quality. "When [*Today Show* host] Matt Lauer talks for seven minutes about our ads, I know it's right," says Santa Monica (California) VW dealer Mike Sullivan. GTI sales are at 20-year highs, and VW sales overall are up 20 percent this year since Crispin's ads began.

Source: Reprinted with special permission from David Kiley, "The Craziest Ad Guys in America," *BusinessWeek,* May 22, 2006. Copyright © 2007 The McGraw-Hill Companies.

DISCUSSION QUESTIONS

1. How would you describe VW's new intended business strategy?
2. How would you describe VW's new advertising strategy?
3. Explain how effective you believe that the advertising strategy will be in helping to achieve the business strategy of VW in the long term.

4. Do you agree with Martin (paragraph 18) when he concludes that the advertising campaign achieved its goal of "igniting a new conversation with owners"?
5. If ad copy "crystallizes a brand's essence," what is the essence of VW? If it can be easily changed with a new ad campaign, what do we know about VW's business strategy?

VW's New Strategic Plan for the United States—Part 2

1 Volkswagen's experience in the United States has always been one of highs and lows. But rarely have its fortunes sunk so low as now. Less than a decade ago, the quirky reinvented Beetle helped VW come roaring back from a previous crisis. But for the past three years, its U.S. operations have lost close to $1 billion annually.

2 Now it's trying again to save the brand in the United States. To head U.S. operations, it's bringing in Stefan Jacoby, a German with close ties to VW chairman Martin Winterkorn and supervisory board chairman Ferdinand K. Piech, who took control of the company this year after a shakeup that left Porsche as VW's controlling shareholder. Jacoby, 49, an accountant by training, made his mark as head of VWs global sales and marketing. Since Jacoby took charge, the company boosted its European market share to 20.3 percent from 18.1 percent, helping keep it solidly in place as the Continent's leading brand. With its U.S. fortunes in long-term decline, Jacoby is facing his biggest challenge yet. His mission: to meet Winterkorn's target of breaking even in the United States by 2009.

3 Only a year ago, VW was gearing up a huge marketing campaign to relaunch a revamped Rabbit and Jetta in a bid to recapture its niche as the affordable, stylish European car of choice for younger buyers. VW hired former MINI USA marketing chief Kerri Martin, who recruited super-hot U.S. ad agency Crispin Porter + Bogusky. The plan, as chronicled in Part 1 of this case study, was to create a VW renaissance.

4 It didn't work out that way. A string of attention-grabbing adds—one campaign showed people surviving crashes unscathed and another starred a German dominatrix named Helga—did little to juice sales of VW's two most important models, the Jetta and the Passat. "I've never seen a brand struggle so hard to understand the U.S. market and fail so miserably," says Rebecca Lindland, a director at consulting firm Global Insight Inc. VW's sales slid to 235,000 last year, from 338,000 in 2002. Martin left in December 2006, part of a shakeup when Porsche took over.

5 Making matters worse is the perception in the United States that VW's quality lags versus its Japanese rivals. VW's interiors, for example, don't stand up to the kind of abuse they get from U.S. drivers, who do a lot more eating, drinking coffee, and applying makeup in their cars than Europeans do. That's one factor in J. D. Power & Associates Inc. ranking VW in the bottom 20 percent for reliability, quality, and service. "That really hurts VW when its young customer base does so much online comparative shopping," says Power Information Network analyst Tom Libby.

6 To turn operations around, Jacoby has to battle the punishingly high euro and VW's limited manufacturing presence in North America. Even more important, the company needs to introduce new models that build on its long tradition of quirkiness and connect with U.S. consumers. Instead, the carmaker's more recent offerings feel bland. Dealers think VW blew a golden opportunity when it chose not to introduce an updated version of the wildly popular Microbus from the 1960s and 1970s. Instead, the company is launching a repackaged, Volkswagen-branded, Chrysler minivan. Casey Gunther, VW's top-selling U.S. dealer, in Coconut Creek, Florida, is worried. "We're missing the funkiness" that U.S. buyers expect from VW, he says. "The Germans don't understand." And unlike in Europe, affluent buyers don't see VW as an aspirational brand.

7 Winterkorn vows the turnaround of the U.S. business is his "no. 1 priority." But there's only so long any management can put up with nearly $1 billion annual losses. Says one executive close to VW: "For the first time in some time, the phrase 'If we are to stay in the U.S.' precedes a lot of conversations at VW."

Source: Reprinted with special permission from David Kiley and Gail Edmondson, "Can VW Finally Find Its Way In America? A Last-Ditch Drive Must Correct Disastrous Turns to Make the U.S. Profitable Again," *BusinessWeek,* July 23, 2007. Copyright © 2007 The McGraw-Hill Companies.

DISCUSSION QUESTIONS

1. Does the trouble at VW suggest that VW executives confused business strategy with advertising (a non-strategic marketing activity)?
2. What are three essential elements that you would prefer to see in an ad campaign which would parallel the message in VW's business strategy?
3. To help answer the question of whether VW should plan to stay in the U.S., what information would executives need to consider?
4. How do you explain the relative success of VW in Europe (paragraph 2) given its failure in the U.S.?
5. Does this case teach us something about the classic debate over "style versus substance"? If it does, how does what you learned apply generally to formulating a business strategy?