CHAPTER SIX

Internal Analysis

We have met the enemy and he is us.
—*Pogo*

Self-conceit may lead to self-destruction.
—*Aesop, "The Frog and the Ox"*

The fish is last to know if it swims in water.
—*Chinese proverb*

Should the existing strategy be enhanced, expanded, altered, or replaced? Are existing assets and competencies adequate to win? An internal analysis of the business will help the strategist address these questions. This exploration is similar in scope to an analysis of a competitor or strategic group, but much richer and deeper because of its importance to strategy and because much more information is available.

Just as strategy can be developed at the level of a business, a group of businesses, or the firm, internal analysis can also be conducted at each of these levels. Of course, analyses at different levels will differ from each other in emphasis and content, but their structure and thrust will be the same. The common goal is to identify organizational strengths, weaknesses, and constraints and, ultimately, to develop responsive strategies, either exploiting strengths or correcting or compensating for weaknesses.

Four aspects of internal analysis will be discussed in this chapter. The first, financial performance, provides an initial approximation as to how the business is doing. The second, an analysis of other performance dimensions such as customer satisfaction, product quality, brand association, relative cost, new products, and employee capability, can often provide a more robust link to future profitability. The third is an analysis of the strengths and weaknesses that are the basis of current and future strategies. The fourth is an identification and prioritization of the threats and opportunities facing the firm.

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The final section explores the relationship between strategy and the analysis of the organization, its competitors, and the market. It suggests that successful strategy occurs when organization strengths are matched against market needs and competitor weaknesses.

FINANCIAL PERFORMANCE—SALES AND PROFITABILITY

Internal analysis often starts with an analysis of current financials, measures of sales and profitability. Either can signal a change in the market viability of a product line and the ability to produce competitively. Furthermore, they provide an indicator of the success of past strategies and thus can often help in evaluating whether strategic changes are needed. In addition, sales and profitability at least appear to be specific and easily measured. As a result, it is not surprising that they are so widely used as performance evaluation tools.

Sales and Market Share

A sensitive measure of how customers regard a product or service can be sales or market share. After all, if the value proposition to a customer changes, sales and share should be affected, although there may be an occasional delay caused by market and customer inertia.

Sales levels can be strategically important. Increased sales can mean that the customer base has grown. An enlarged customer base, if we assume that new customers will develop loyalty, will mean future sales and profits. Increased share can provide the potential to gain SCAs in the form of economies of scale and experience curve effects. Conversely, decreased sales can mean decreases in customer bases and a loss of scale economies.

A problem with using sales as a measure is that it can be affected by short-term actions, such as promotions by a brand and its competitors. Thus, it is necessary to separate changes in sales that are caused by tactical actions from those that represent fundamental changes in the value delivered to the customer, and it is important to couple an analysis of sales or share with an analysis of customer satisfaction and loyalty, which will be discussed shortly.

Profitability

The ultimate measure of a firm's ability to prosper and survive is its profitability. Although both growth and profitability are desirable, establishing a priority between the two can help guide strategic decision making.

A host of measures and ratios reflect profitability, including margins, costs, and profits. Building on the assets employed leads to the return on assets (ROA) measure, which can be decomposed with a formula developed by General Motors and DuPont in the 1920s.

$$\text{ROA} = \frac{\text{profits}}{\text{sales}} \times \frac{\text{sales}}{\text{assets}}$$

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Thus, return on assets can be considered as having two causal factors. The first is the profit margin, which depends on the selling price and cost structure. The second is the asset turnover, which depends on inventory control and asset utilization.

The determination of both the numerator and denominator of the ROA terms is not as straightforward as might be assumed. Substantial issues surround each, such as the distortions caused by depreciation and the fact that book assets do not reflect intangible assets, such as brand equity, or the market value of tangible assets.

Measuring Performance: Shareholder Value Analysis

The concept of shareholder value, an enormously influential concept during the past two decades, provides another perspective on financial performance. Each business should earn an ROA (based on a flow of profits emanating from an investment) that meets or exceeds the costs of capital, which is the weighted average of the cost of equity and cost of debt. Thus, if the cost of equity is 16 percent and the cost of debt is 8 percent, the cost of capital would be 12 percent if the amount of debt was equal to the amount of equity; if there were only one-fourth as much debt as equity, then the cost of capital would be 14 percent. If the return is greater than the cost of capital, shareholder value will increase, and if it is less, shareholder value will decrease.

Some of the routes to increasing shareholder value are as follows:

- Earn more profit by reducing costs or increasing revenue without using more capital.
- Invest in high-return products (this, of course, is what strategy is all about).
- Reduce the cost of capital by increasing the debt to equity ratio or by buying back stock to reduce the cost of equity.
- Use less capital. Under shareholder value analysis, the assets employed are no longer a free good. If improved just-in-time operations can reduce the inventory, it directly affects shareholder value.

The concept of shareholder value is theoretically valid.[1] If a profit stream can be estimated accurately from a strategic move, the analysis will be sound. The problem is that short-term profits (known to affect stock return and thus shareholder wealth) are easier to estimate and manipulate than long-term profits. Investors who assume that short-term profits predict longer-term profits pay undue attention to the former, as does the top management of a company with numerical targets to meet. The discipline to invest in a strategy that will sacrifice short-term financial performance for long-term prospects is not easy to come by, especially if some of the future prospects are in the form of options. For example, the investment in Saturn by General Motors should have been seen as an option to expand that nameplate if a gas shortage should occur and smaller cars became more popular. Unfortunately, Saturn was seen as a stand-alone business and did not receive the new car investment that would have made it a viable platform to compete with the Japanese firms. Similarly, when

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Black & Decker bought the small-appliance division of GE, it bought an option to take the business into related areas.

The impact of reducing investment is also not without risks. When, for example, Coca-Cola sold off its bottlers to reduce investment and improve shareholder value, its control of the quality of its product may have been reduced. In general, investment reduction often means outsourcing, with its balancing act between flexibility and loss of control over operations. A company that outsources its call center reduces its control over customer interaction.

One danger of shareholder value analysis is that it reduces the priority given to other stakeholders such as employees, suppliers, and customers, each of whom represents assets that can form the basis for long-term success. It can be argued that the shareholder has the least risk because he or she is very likely diversified and thus has only a small part of a portfolio at risk. In contrast, employees, suppliers, and sometimes customers have more to lose if the firm fails. Further, the shareholder does not in any practical way have any influence over the management of the firm. Thus, it might be reasonable to elevate the priority of other shareholders. P&G, for one, puts customers first, arguing in part that if customers are delighted with the products, shareholders will benefit in the long term. Other firms have explicitly put employees first, assuming that if they are productive, shareholders will eventually benefit. Making the shareholders the first priority can lead to programs such as cost reduction possibly involving degrading the customer experience. This results in short-term profits and therefore enhanced shareholder value but undercuts the firm's strength in the long-term.

In fact, shareholder value management has met with very mixed results. However, one study of the experience of 125 firms found similarities among those that had applied shareholder value concepts successfully.[2] These companies:

- Gave priority to shareholder value over other goals, particularly growth goals.
- Provided intensive training throughout the organization regarding shareholder value and made it a practical tool for business managers at all levels. The philosophy was not restricted to the executive suite.
- Were disciplined in identifying the drivers of shareholder value. For example, for a call center, drivers could be the length of time to answer calls and the quality of responses.
- Reduced overhead by adapting the current accounting system and integrating shareholder value analysis with strategic planning.

These firms found a variety of benefits. First, the concept led to value-creating divestments that otherwise would not have occurred. Second, firms were able to transfer corporate planning and decision making to decentralized business units because all units tended to use the same logic, metrics, and mindset. Third, the business investment horizon tended to be longer, with projects with multi-year time frames getting approved. Fourth, the new recognition that capital had a cost tended to generate better strategic decisions.

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PERFORMANCE MEASUREMENT—BEYOND PROFITABILITY

One of the difficulties in strategic market management is developing performance indicators that convincingly represent long-term prospects. The temptation is to focus on short-term profitability measures and to reduce investment in new products and brand images that have long-term payoffs.

The concept of net present value represents a long-term profit stream, but it is not always operational. It often provides neither a criterion for decision making nor a useful performance measure. It is somewhat analogous to preferring $6 million to $4 million. The real question involves determining which strategic alternative will generate $6 million and which will generate $4 million.

It is necessary to develop performance measures that will reflect long-term viability and health. The focus should be on the assets and competencies that underlie the current and future strategies and their SCAs. What are the key assets and competencies for a business during the planning horizon? What strategic dimensions are most crucial: to become more competitive with respect to product offerings, to develop new products, or to become more productive? These types of questions can help identify performance areas that a business should examine. Answers will vary depending on the situation, but, as suggested by Figure 6.1, they will often include customer satisfaction/brand loyalty, product/service quality, brand/firm associations, relative cost, new product activity, and manager/employee capability and performance.

Customer Satisfaction/Brand Loyalty

Perhaps the most important asset of many firms is the loyalty of the customer base. Measures of sales and market share are useful but potentially inaccurate indicators of

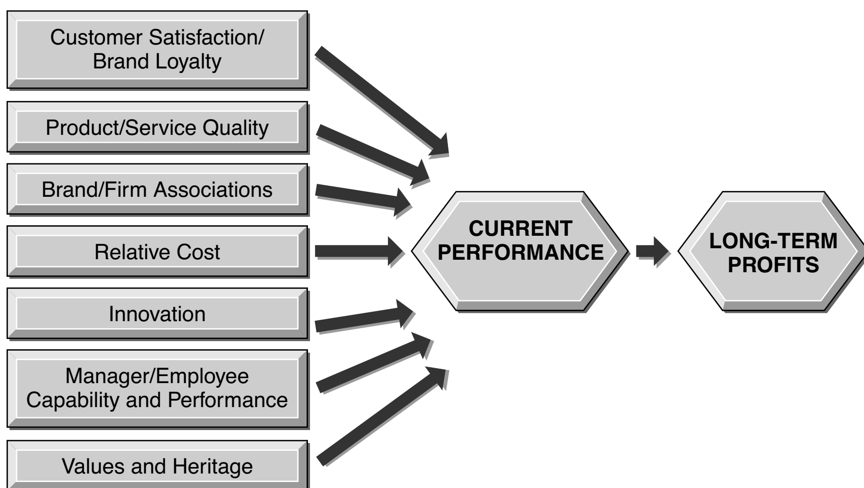

Figure 6.1 Performance Measures Reflecting Long-term Profitability

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how customers really feel about a firm. Such measures can reflect market inertia and are noisy, in part, because of competitor actions and market fluctuations. Measures of customer satisfaction and brand loyalty are much more sensitive and provide diagnostic value as well.

Guidelines for Measuring Satisfaction and Loyalty

First, problems and causes of dissatisfaction that may motivate customers to change brands or firms should be identified. In fact, the most sensitive and insightful information comes from those who have decided to leave a brand or firm. Thus, exit interviews for customers who have abandoned a brand can be productive. Second, there is a big difference between a brand or firm being liked and the absence of dissatisfaction. The size and intensity of the customer group that truly likes a brand or firm should be known. Third, the lifetime value of a customer based on their usage level and the time period that they are expected to be attached to the firm's offerings is often a useful concept. Estimation of lifetime value for key segments can be illuminating. Fourth, measures should be tracked over time and compared with those of competitors. Relative comparisons and changes are most important.

Product and Service Quality

A product (or service) and its components should be critically and objectively compared both with the competition and with customer expectations and needs. How good a value is it? Can it really deliver superior performance? How does it compare with competitor offerings? How will it compare with competitor offerings in the future given competitive innovations? One common failing of firms is to avoid tough comparisons with a realistic assessment of competitors' current and potential offerings. A newly appointed CEO of Frito-Lay once put all programs on hold for a year until the firm's manufacturing units around the world were able to make products that would win blind taste tests. He realized that product quality was a necessary condition for success.

Product and service quality are usually based on several critical dimensions that can be identified and measured over time. For example, an automobile manufacturer can measure defects, ability to perform to specifications, durability, repairability, and features. A bank might be concerned with waiting time, accuracy of transactions, and the quality of the customer experience. A computer manufacturer can examine relative performance specifications and product reliability as reflected by repair data. A business that requires better marketing of a good product line is very different from one that has basic product deficiencies.

Brand/Firm Associations

An often overlooked asset of a brand or firm is what customers think of it. What are its associations? What is its perceived quality? Perceived quality, which is sometimes very different from actual quality, can be based on experience with past products or services and on quality cues, such as retailer types, pricing strategies, packaging, advertising, and typical customers. Is a brand or firm regarded as expert in a product

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or technology area (such as designing and making sailboats)? Innovative? Expensive? For the country club set? Is it associated with a country, a user type, or an application area (such as racing)? Such associations can be key strategic assets for a brand or firm.

Associations can be monitored by regularly asking customers to describe their use experiences and to tell what a brand or firm means to them. The identification of changes in important associations will likely emerge from such efforts. Structured surveys using a representative sample of customers can provide even more precise tracking information.

Relative Cost

A careful cost analysis of a product (or service) and its components, which can be critical when a strategy is dependent on achieving a cost advantage or cost parity, involves tearing down competitors' products and analyzing their systems in detail. The Japanese consultant Ohmae suggested that such an analysis, when coupled with performance analysis, can lead to one of the four situations shown in Figure 6.2.[3]

If a component such as a car's braking system or a bank's teller operation is both more expensive than and inferior to that of the competition, a strategic problem requiring change may exist. An analysis could show, however, that the component is such a small item in terms of both cost and customer impact that it should be ignored. If the component is competitively superior, however, a cost-reduction program may not be the only appropriate strategy. A value analysis, in which the component's value to the customer is quantified, may suggest that the point of superiority could support a price increase or promotion campaign. If, on the other hand, a component is less expensive than that of the competition, but inferior, a value analysis might suggest

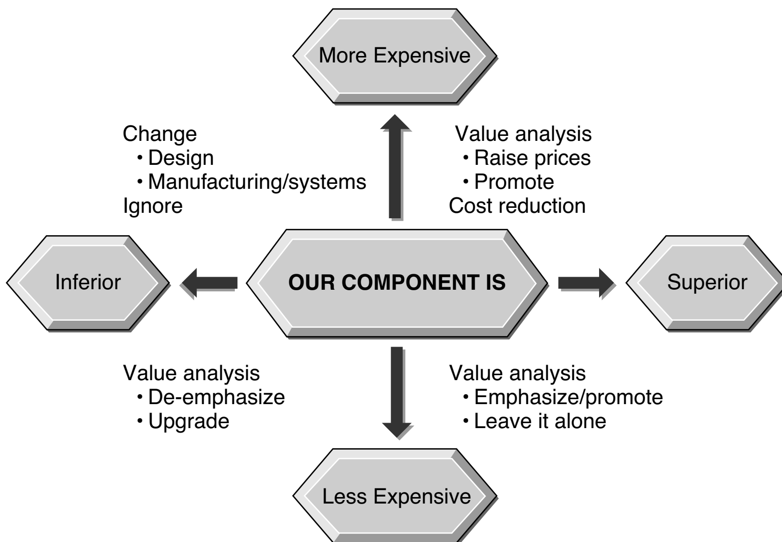

Figure 6.2 Relative Cost vs. Relative Performance—Strategic Implications

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that it be de-emphasized. Thus, for a car with a cost advantage but handling disadvantage, a company might de-emphasize its driving performance and position it as an economy car. An alternative is to upgrade this component. Conversely, if a component is both less expensive and superior, a value analysis may suggest that the component be emphasized, perhaps playing a key role in positioning and promotion strategies.

Sources of Cost Advantage

The many routes to cost advantage will be discussed in Chapter 8. They include economies of scale, the experience curve, product design innovations, and the use of a no-frills product offering. Each provides a different perspective to the concept of competing on the basis of a cost advantage.

Average Costing

In average costing, some elements of fixed or semivariable costs are not carefully allocated but instead are averaged over total production. Average costing can provide an opening for competitors to enter an otherwise secure market. Large customers can be much more profitable than small ones and premium priced products can be more lucrative than value priced ones. A product line that is subsidizing other lines is vulnerable, representing an opportunity to competitors and thus a potential threat to a business.

Innovation

Does the R&D operation generate a stream of new product concepts? How does the flow of patents compare to that for competitors? Is the process from product concept to new product introduction well managed? Is there a track record of successful new products that has affected the product performance profile and market position?

Are the new products arriving in the marketplace in a timely fashion? Time to market is particularly important in many industries, from cars to software.

More broadly, does the organizational culture support innovation? Is it possible to generate substantial (if not transformational) innovations in addition to incremental innovations? Are there programs to precipitate innovation?

Manager/Employee Capability and Performance

Also key to a firm's long-term prospects are the people who must implement strategies. Are the human resources in place to support current and future strategies? Do those who are added to the organization match its needs in terms of types and quality or are there gaps that are not being filled? Is there enough diversity so that the organization can identify and respond to new threats and opportunities when they are not within the existing business arena?

An organization should be evaluated not only on how well it obtains human resources but also on how well it nurtures them. A healthy organization will consist of individuals who are motivated, challenged, fulfilled, and growing in their professions. Each of these dimensions can be observed and measured by employee surveys and

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group discussions. Certainly the attitude of production workers was a key factor in the quality and cost advantage that Japanese automobile firms enjoyed throughout the past three decades. In service industries such as banking and fast foods, the ability to sustain positive employee performance and attitude is usually a key success factor.

Values and Heritage

The firms with strong performance over time usually have a well-defined set of values that are both known and accepted within the organization, values that are more than simply increasing financial return. Strong values that guide and even inspire are enhanced if they are supported by a well known and relevant heritage. Values and a heritage not only create a strong and consistent brand but also support the business strategy. In fact, when business falters, one tact that often works is to return to the roots of the business—what made it strong in the first place. When McDonald's faltered, a turnaround was based in part on their historic core values of service, people, convenience, quality, and good prices.

Values provide a reason to believe in for employees and will influence the brand as a result. Among the values that are often influential are the organizational associations discussed in Chapter 9 such as innovation, social responsibility, concern for the customer, quality, service, and being globally and environmentally responsible.

Having a heritage based on a founder or on early success can be a guide and a value anchor. Consider L.L. Bean with a vision of their founder who designed a shoe for hunters that was waterproof. When the first batch had a problem, he took them all back. His focus on the customer and on the outdoors and the outdoorsmen continue to guide the firm. General Electric still has the innovation emphasis that was the hallmark of its founder Thomas Edison.

More generally, values are best communicated inside and outside a firm with stories. People remember and respond to stories. A firm should strive to have a story bank, a set of stories that collectively illustrate the values of the firm. The stories are not limited to the heritage of the firm but can reflect the actions of an employee or a program. The legend that Nordstrom's once took back a damaged tire says so much about their customer service.

STRENGTHS AND WEAKNESSES

In developing or implementing strategy, it is important to identify the assets and competencies that represent areas of strength and weakness. A successful strategy needs to be based on assets and competencies because it is generally easier for competitors to duplicate what you do rather than who you are. Further, current assets and competencies, as illustrated in Chapter 11, can be leveraged to create new businesses.

Figure 3.4 had a partial list of the types of assets and competencies that an organization might develop. There were more than three dozen, organized under the categories of innovation, manufacturing, access to capital, management, marketing, and customer base. This checklist is a good place to start when identifying the most relevant assets and competencies. Another are the motivating questions introduced

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in Chapter 3 that identify assets and competencies important to customers, those developed by successful competitors, and those representing large or important parts of the value added chain.

Each asset or competence relevant to the business, such as a new product development capability, access to low-cost labor, an innovative culture, brand strength, or a loyal customer base, should be evaluated as to its strength and impact.

Is it dominant in that it provides a point of advantage that has endured and is likely to remain so in the future? The service delivery capability of Disney theme parks, for example, is so superior that other firms study its operation. Is the organization willing to invest to make the asset or competence dominant into the future? Certainly, Disney has shown this willingness over many decades. The investment commitment needs to be factored into the financial resource picture. It may mean that resources for new ventures will be limited.

Is it strong but vulnerable? Are others catching up? Should the firm attempt to invest to regain a dominant position so that it is a point of advantage? If so, what program at what cost is implied? Or should the firm retreat so that the asset or competence is simply a modest advantage over some competitors and a point of parity with respect to others?

Is the asset or competence adequate, a point of parity? Is it strong enough so that customers do not avoid the firm because of it? If so, is that a satisfactory long-term position? Can advantage be achieved on other dimensions? What investment is implied to maintain the current strength so that it does not become a point of disadvantage? Product quality is often in this situation. If Target, for example, can deliver quality adequate enough so that customers do not use a quality judgment as a reason to exclude Target from their consideration set, the battle will shift to other dimensions on which Target is likely to excel.

Is it a liability? Is it holding back the firm from gaining and retaining customers? Consider the Korean automobile firms whose quality and social acceptability deficit precluded people from buying their products. They needed to convert this liability to a point of parity.

THREATS AND OPPORTUNITIES

The other half of an internal analysis is the identification of threats and opportunities. In the external analysis, a host of potential threats and opportunities will have been identified. The internal challenge is to determine which are most relevant for the firm's business and to prioritize them. The dimensions used to manage strategic uncertainly in general, immediacy and impact, are appropriate when assessing threats and opportunities.

Those threats that are imminent and have high impact should drive a strategic imperative, a program that has the highest priority. If there is a visible quality problem (such as contaminated Perrier water or defective tires on Ford Explorers, for example), fixing that problem and thus addressing the associated threat needs to be a high priority. When the threat is of low impact or is not immediate, a more measured response is possible.

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BENCHMARKING

Comparing the performance of a business component with others is called *benchmarking.* The goal is to generate specific ideas for improvement, and also to define standards at which to aim. One target may be competitors: what cost and performance levels are they achieving, and how? Knowing your deficits with respect to the competition is the first step to developing programs to eliminate them. Best-practice companies are another target. Thus, many benchmark against Disney in terms of delivering consistent service in their theme parks, or Amazon as the standard for Internet e-commerce operations and customer support. Looking outside one's own industry is often a way to break away from the status quo and thereby create a real advantage.

The most extreme threat is one that potentially makes the business model obsolete. AOL with its "You've got mail" greeting and a route to the Internet for newbies and the intimidated, had a dominant business model with some 35 million subscribers. However, it failed to respond to the fact that its customers eventually obtained more sophistication and better equipment. AOL was in a position to be the social network Internet company, but instead watched others like MySpace and Facebook assume that role and allowed its value proposition to erode. Dialing up the threat to the business model in a timely fashion and making the organization responsive might have led to a very different outcome for AOL.

Threats can come in the form of a strategic problem or a liability. Strategic problems, events, or trends adversely affecting strategy generally need to be addressed aggressively and corrected even if the fix is difficult and expensive. Strategic liabilities—the absence of an asset (such as good location) or competence (for example, new-product skills)—usually require a different response. A business often copes over time with a liability by adjusting strategies in a way that will neutralize that liability. A firm that lacks new product competencies might engage in a systematic product acquisition strategy.

An opportunity similarly can be evaluated as to whether its impact will be immediate and major. If so, the organization should be set up to move quickly and decisively. One study found that most organizations only get faced with a "golden opportunity" once or twice a decade. The mark of a firm that can adapt to new conditions and still come out a market leader is recognizing and reacting to such opportunities. Opportunities that have a low impact or are in the future may justify serious investment and perhaps an experimental entry into a new business area to gain information, but the resource commitment is likely to be more modest.

In general, lost opportunities are costly and are only too common. As Drucker wrote in several forms, managers need to spend more time on opportunities and less on solving problems.

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FROM ANALYSIS TO STRATEGY

In making strategic decisions, inputs from a variety of assessments are relevant, as the last several chapters have already made clear. However, the core of any strategic decision should be based on three types of assessments. The first concerns organizational strengths and weaknesses. The second evaluates competitor strengths, weaknesses, and strategies because an organization's strength is of less value if it is neutralized by a competitor's strength or strategy. The third assesses the competitive context, the customers and their needs, the market, and the market environment in order to determine how attractive the selected market will be, given the business strategy.

The goal is to develop a strategy that exploits business strengths and competitor weaknesses and neutralizes business weaknesses and competitor strengths. The ideal is to compete in a healthy, growing industry with a strategy based on strengths that are unlikely to be acquired or neutralized by competitors. Figure 6.3 summarizes how these three assessments combine to influence strategy.

GE's decision to sell its small-appliance division illustrates these strategic principles. Small appliances were a part of GE's legacy and linked to its lamp and major-appliance product lines in the minds of retailers and customers. The small-appliance industry was not profitable, however, in part because of overcapacity and the power of the retailer. Also, cost pressures contributed to a reduction in product performance and reliability. Further, GE's strengths, such as its technological superiority and financial resources, were not leveraged in the small-appliance business, as any innovation could be copied. Thus, GE decided that a strategic fit did not exist, and it sold the small-appliance business to Black & Decker.

Figure 6.3 Structuring Strategic Decisions

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KEY LEARNINGS

- Sales and profitability analysis provide an evaluation of past strategies and an indication of the current market viability of a product line.
- Shareholder value holds that the flow of profits emanating from an investment should exceed the cost of capital (which is the weighted average of the cost of equity and cost of debt). Routes to achieving shareholder value—such as downsizing, reducing assets employed, and outsourcing—can be risky when they undercut assets and competencies.
- Performance assessment should go beyond financials to include such dimensions as customer satisfaction/brand loyalty, product/service quality, brand/firm associations, relative cost, new product activity, and manager/employee capability and performance.
- Assets and competencies can represent a point of advantage, a point of parity, or a liability. Threats and opportunities that are both imminent and important should trigger strategic imperatives, programs with high priority.

FOR DISCUSSION

1. Explain shareholder value analysis. Why might it help firms? Why might it result in bad decisions?
2. Look at the quotations that begin Chapters 2 through 6. Which one do you find the most insightful? Why? Under what circumstances would its implications not hold?
3. What performance measure would you consider most important for McDonald's? For Chevrolet?
4. Conduct a strengths, weakness, opportunities, and threats (SWOT) analysis for Ford. For Frito-Lay.

NOTES

1. For an excellent review of the risks of shareholder value see Allan A. Kennedy, *The End of Shareholder Value,* Cambridge, MA: Perseus Publishing, 2000.
2. Philippe Haspeslagh, Tomo Noda, and Fares Boulos, "It's Not Just About the Numbers," *Harvard Business Review,* July–August 2001, pp. 65–73.
3. Kenichi Ohmae, *The Mind of the Strategist,* New York: Penguin Books, 1982, p. 26.

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Understanding and Working with Industry Trends

TRENDS IN RETAILING

Consider the following trends in food and nonfood retailing.

Nonfood Retailing

1. ***Moving away from the middle.*** Retailers are offering a more upscale experience. Macy's locations are getting a face-lift and image advertising. Bath & Body Works is transforming into an affordable beauty boutique. High end retailers such as Saks, Neiman's, Cole Hand, and Coach are clearly positioned to offer self-expressive benefits.

   At the same time, other retailers are moving down to compete with the discount stores. Discount stores such as TJ Max, Target, and outlet malls are becoming more important especially as consumers react to the recession.
2. ***Toward a better shopping lifestyle.*** Enclosed malls are in decline; they are being replaced by the "lifestyle center," which is a combination of stores such as Pottery Barn, Barnes & Noble, Gap, Victoria's Secret, and Williams-Sonoma, with open walkways and no department store. These are often in a revitalized urban setting.
3. ***Installation is included.*** Retailers are starting to offer services complementary to their products, in part to add to sales per square foot but also to differentiate their offerings. Best Buy, Home Depot, and Lowe's, for example, are among stores that have added installation service. Sears has an active home improvement service.
4. ***Faster fashion.*** The ability of retailers such as Zara, H&M, Forever 21, Target's Go International, and Uniclo to capture in-season trends by a fast-turnaround design and manufacturing cycle means that their stores are dynamic and interesting with new items flowing through.

Food Retailing

5. ***Private-label strength.*** Private-label goods continue to grow at a steady rate. The private label brands such as Safeway's "S" or Wal-Mart's Super Value offer exceptional price savings and tend to thrive in categories that don't see a lot of innovation. The high end private label brands such as Safeway Select often become competitive in terms of quality and even innovation while still offering lower prices
6. ***In-store media.*** Retailers are finding that conventional media are less effective and are going to in-store media including displays on shopping carts, couponing at the product site, and individualized couponing.

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7. ***Organic offerings.*** Organic food, one of the success factors of Whole Foods, is going mainstream. Safeway's O Organics are sold outside Safeway and Target's Archer Farms is adding energy to Target.
8. **Tracking purchases**. Many retailers, especially grocery stores, are tracking and rewarding customer purchases. The trend is toward rewarding the loyal customer with more information and targeted discounts. Some retailers employ high-tech payment systems that allow shoppers to check out with an identification number and a touch of a finger.

FOR DISCUSSION

1. What is driving each of these trends? Which are supported by underlying consumer trends? Identify them.
2. Which three trends will be around in five years? How would you forecast the probability that the trend will persist for that long?
3. What are the threats and opportunities represented by these trends for Macy's, Levi Straus, Safeway, and General Mills?
4. When might a retailer consider going against the trend?
5. Another potential trend is the return to a store's roots. Several retailers, such as Gap and Saks, lost core customers by attempting to appeal to younger buyers. As a result, they are now attempting to return to their roots and deliver the classic fashions that made them attractive to their now not-so-young customers. What possessed them to go trendy in the first place? Can they recapture the customers that they have alienated?

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A New, Dynamic Industry

THE ENERGY BAR INDUSTRY

In 1986, PowerBar, a firm in Berkeley, California, single-handedly created the energy bar category. Positioned as an athletic energy food, it was distributed at bike shops and events that usually involved running or biking. The target segment was the athlete who needed an efficient, effective energy source.

Six years later, seeking to provide an alternative to the sticky, dry nature of the PowerBar, a competitor, also located in Berkeley, developed an energy bar with superior taste and texture and branded it the Clif bar. About the same time, another competitor introduced the Balance bar, which offered a blend of protein, fat, and carbohydrates based on the nutrition formula associated with the "Zone diet." Faced with these challengers, PowerBar responded with Harvest (a bar with a much more accessible taste and texture) and ProteinPlus (an entry into the high-protein subcategory closely related to that defined by Balance).

The makers of the Clif bar observed that many women were athletes and many more were involved in fitness. They further observed that this half of the population had unique needs in terms of vitamins and supplements, and that the energy bar industry had yet to recognize or fill them—a classic case of unmet needs. As a result, they introduced Luna as the first nutritional (not energy) bar for women, using media and promotions targeting active females. The bar had a light crunchy texture, came in flavors like "lemon zest" and chai tea, and contained nearly two dozen vitamins, minerals, and nutrients. The target market consisted of time-strapped women who wanted both taste and nutrition and would appreciate a bar tailored to their needs.

Both in reaction to Luna's success and to expand the segments for which the category was relevant, PowerBar studied why women did not buy its products, which the firm considered to be nutritious, convenient, tasty, and able to provide a quick pick-me-up in mid-morning or mid-afternoon. One answer was that the calorie hit from any member of the PowerBar family was simply too great. In response, the firm created the almost indulgent, PowerBar-endorsed Pria. With only 110 calories, Pria was designed to respond to Luna while attracting new users into the category.

The Balance strategy was to introduce a series of products, all of which stuck to the original bar's 40/30/30 nutritional formula but had different taste and textures. These spinoffs included Balance Plus, Balance Outdoor (with no chocolate coating to melt), Balance Gold, Balance Satisfaction, and the Balance-endorsed Oasis, a bar designed for women. The big success was Balance Gold, which was positioned close to the candy bar category (indeed, its tagline was "like a candy bar") by containing ingredients such as nuts and caramel. Such a bar probably risked some of Balance's perceived authenticity as being an energy bar. However, because Balance entered the category from the diet perspective anyway and probably was never considered in the center of the energy bar world, the risk may have been acceptable.

In addition to the major brands, challengers from a variety of small and large firms advanced subcategories by positioning themselves around such factors as age (bars for seniors and kids) and health (products to fit dairy-free, diabetic, and heart-conscious diets), to say nothing of numerous textures, flavors, sizes, and coatings.

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Over a ten-year period, some 450 products were introduced. For example, the popularity of low-carbohydrate diets has prompted a host of entries, including Atkins Advantage, developed by the Atkins organization, which gained a substantial market share that peaked in 2003 and fell off sharply thereafter. Other participating brands include ZonePerfect, Met-Rx, GeniSoy, EAS, CarboLite, Carb Solutions, and Gatorade energy bars. Masterfoods' Snickers Marathon—a candy bar with a blend of vitamins, minerals, and protein—has blurred the division between candy and energy bars by seeking to gain share in the latter market. One concern of the energy bar industry is the skepticism among some quarters as to how qualitatively different its products are from candy bars in the first place.

The motivation for using an energy bar is primarily to provide a convenient energy boost. The original heritage of being a product to enhance the performance of top athletes engaged in demanding physical activities (like Lance Armstrong, a PowerBar endorser) created credibility and self-expressive benefits in the category's early years. Because household penetration was still under 20 percent, however, the major firms worked to generalize "performance" to be relevant to anyone who needs to perform well during the day. In fact, the industry dream is to get people to label the category "performance nutrition" and think of it as enhancing one's ability to complete any task.

New products in the category are going in several directions. A trend toward indulgent icings, coatings, and coverings has led some to morph toward candy bars. Others go the opposite way, using whole-grain ingredients for products somewhat like the original Clif bar and Quaker's Oatmeal Squares for women. The makers of the Clif bar also have introduced a Mojo line of salty snack bars to provide alternatives to sweet-tasting bars and the Clif Nectar bar, an entirely organic nut and fruit bar. PowerBar introduced Nut Naturals, a low glycemic index bar. There are bars positioned around ingredients such as protein or soy bars. A major Japanese brand of soy bars, SoyJoy is now in the market with a dry bar that will not be confused with a candy bar.

The energy bar category has gone mainstream, moving from the bike shops to the grocery stores and exploding from just over $100 million in revenue in 1996 to an estimated $2 billion or more a decade later, with expected future growth exceeding 10 percent per year. It is fueled both by the confluence of trends toward low-carb, portable, nutritious snacks and meal replacements (along with a general concern for health and weight control) and by the introduction of new products. Along the way, it became large enough to attract the attention of major packaged-goods firms. In 2000, Nestlé purchased PowerBar, which has remained the leading player, with the Clif bar (which has remained independent) emerging as its most formidable competitor. The Balance line of products was bought by Kraft, also in 2000.

Energy bars can be considered a part of a larger food bar category which is also growing rapidly. The market is divided fairly equally between granola bars (positioned as a snack food that is healthier than candy bars), breakfast/cereal/snack bars (used as a meal replacement), and energy bars. Energy bars have a far lower household penetration than the other food bar forms. The top marketers of food bars are Kellogg's (Nutri-Grain), Quaker Oats, General Mills, and Slim-Fast.

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FOR DISCUSSION

1. Conduct a thorough analysis of this category's customers, competitors, market, and environment from the perspective of PowerBar. What are the key strategic questions? What additional information would you like to obtain? How would you obtain it? What are the threats and opportunities? In particular, address the following issues:
   - **a.** How is the market segmented? What are the key customer motivations and unmet needs? What are the similarities and differences among the segments? How might a company link customer motivations to value propositions?
   - **b.** Identify the competitors. Who are the most direct competitors? The indirect competitors? Substitute products? What are the strategic groups?
   - **c.** What are the market trends? The growth submarkets? The key success factors?
   - **d.** What are the environmental trends that will affect the industry? Generate two or three viable future scenarios.
2. How would you go about evaluating emerging submarkets? What criteria would you use to enter each? Consider PowerBar's reaction to the Clif organic bar.
3. Can brands such as Harvest, Luna, Balance Gold, Balance Satisfaction, and others be leveraged?
4. Will the energy bar category morph into food bars, with elements like diet, tasting like candy, and breakfast replacement dominating as the energy definition recedes? How can Nestlé's PowerBar keep that from happening and still maintain its mainstream/supermarket posture?
5. At what stage is the energy bar market relative to the product-life cycle? What strategies can be used to extend the life cycle? Do you see a consolidation on the horizon?
6. What are the prospects for the Japanese SoyJoy bar? It comes in multiple flavors but is rather dry. What strategy would you advise them to pursue?

Source: Adapted with the permission of the Free Press, a division of Simon & Schuster Adult Publishing Group, from David Aaker, *Brand Portfolio Strategy,* Chapter 4, "Brand Relevance," pp. 98–101.

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Evaluating and Assessing the Implications of a Transformation Innovation

TRANSFORMATIONAL INNOVATIONS

Business 2.0 nominated several firms with the potential to be game changers with transformational innovations. The magazine noted that the telephone was dismissed in 1876 by Western Union Telegraph (which was offered the technology for $100,000) and by J. Pierpoint Morgan, who called it a novelty with no commercial application. Yet the telephone as we know now transformed the communication industry. Will these firms transform industries as well? Or will they be historical footnotes?

Zopa—Peer-to-Peer Lending

Banking is a highly profitable industry, based in large part on its capacity to lend money provided by savers and in part by its use of credit cards to generate loans at high interest rates. Zopa, a U.K. startup, provides an alternative to banks by enabling people to lend to each other; both the borrower and lender potentially receive better rates than a bank would offer. People join Zopa either as borrowers or lenders. Zopa assesses the credit risk of borrowers using conventional information such as credit reports and verified income, as well as less conventional sources such as eBay ratings. Both borrowers and lenders are pooled so that an individual lender actually is part of a group that will lend money to a group of borrowers, thereby reducing default risks. Zopa processes the payments and receives a 1 percent fee shared by the borrower and lender. The Lending Club is a U.S. startup in a similar mode.

Eestor—A New Automobile Power Source

Eestor, formed in 2001, is developing a new solid-state battery in the form of high-power-density ceramic ultra-capacitors called Electrical Storage Units (ESUs). Although the technology is kept confidential by Eestor, reports indicate that an ESU can store over 10 times the energy of lead acid batteries at one-tenth the weight, can be recharged in minutes, has virtually unlimited recharge cycles, and has no over-heating risk or hazardous materials. In 2009, Eestor was able to obtain a third-party validation of its performance claims.

The automobile market is an important potential application. Eestor's ESUs can run not only small automobiles but even large SUVs. It has been estimated that an Eestor-powered car could drive 500 miles on about $9 worth of electricity and that the engine would cost just over $5,000, where a conventional gasoline engine costs from $3,000 to $5,000. A Toronto maker of low-speed electric cars called Feel Good Cars has apparently obtained an exclusive worldwide right to purchase ESUs from Eestor.

NextMedium

NextMedium facilitates the marketing of brand integration (a term that includes product placement but also brand presence without an actual product) in television shows, movies, and video games. NextMedium will help entertainment companies present their inventory of potential brand integration opportunities, with minimum

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bids set forth. It will then put that inventory in front of advertisers. When a brand integration opportunity is purchased, there is check-off approval by the creative entertainment professional. For advertisers, this will provide an easy way to view and select from the inventory of brand integration options. Through NextMedium advertisers can view or listen to their placement in its context. In addition, NextMedium will monitor the placement and provide information on the size and composition of the audience exposed to the placement.

FOR DISCUSSION

For each potential transformational innovation, answer the following questions.

1. Who are the industries and firms for which this would be a threat? What is the nature of the threat? How would you go about evaluating it? How can you forecast the impact? What similar examples from history can provide insights? How do they differ? How can you avoid making a decision like the Western Union CEO in 1876? Could this be an opportunity as well for these same firms? What prevents them from participating in the new technology?
2. Will this technology expand the market, bringing in new customers, or will it simply replace the existing business?
3. What are the strategic options for the firms with the transformational technology? What are the pros and cons of each?
4. How would you go about branding and positioning the new product class being proposed? How should it be labeled?

Source: Erick Schunfeld and Jeanette Bovzo, "The Next Disruptors," *Business 2.0*, October 2006, pp. 80–96.

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