Chapter 1
Strategic Leadership: Managing the Strategy-Making Process for Competitive Advantage

Opening Case
Wal-Mart

Wal-Mart is one of the most extraordinary success stories in business history. Started in 1962 by Sam Walton, Wal-Mart has grown to become the world’s largest corporation. In the financial year ending January 31, 2004, the discount retailer whose mantra is “every day low prices” had sales of nearly $256 billion, five thousand stores in ten countries (almost three thousand are in the United States), and 1.3 million employees. Some 8 percent of all retail sales in the United States are made at a Wal-Mart store. Wal-Mart is not only large but also very profitable. In 2003, the company earned a return on invested capital of 14.7 percent, significantly better than rivals Costco and Target, which earned 9.4 percent and 10 percent, respectively (another major rival, Kmart, emerged from bankruptcy protection in 2004). As shown in the accompanying figure, Wal-Mart has been consistently more profitable than its rivals for years.

Wal-Mart’s superior profitability reflects a competitive advantage that is based on the successful implementation of a number of strategies. In 1962 Wal-Mart was one of the first companies to apply the self-service supermarket business model developed by grocery chains to general merchandise (two of its rivals, Kmart and Target, were established in the same year). Unlike its rivals, who focused on urban and suburban locations, Sam Walton’s Wal-Mart concentrated on small southern towns that were ignored by its rivals. Wal-Mart grew quickly by pricing lower than local mom-and-pop retailers, often putting them out of business. By the time Kmart and Target realized that small towns could support a large discount general merchandise store, Wal-Mart had preempted them. These towns, which were large enough to support one discount retailer, but not two, provided a secure profit base for Wal-Mart.

However, there is far more to the Wal-Mart story than location strategy. The company was also an innovator in information systems, logistics, and human resource practices. Taken together, these strategies resulted in higher productivity and lower costs than rivals, which enabled the company to earn a high profit while charging low prices. Wal-Mart led the way among American retailers in developing and implementing sophisticated product-tracking systems using bar-code technology and checkout scanners. This information technology enabled Wal-Mart to track what was selling and adjust its inventory accordingly so that the products found in a store matched local demand. By avoiding overstocking, Wal-Mart
did not have to hold periodic sales to shift unsold inventory. Over time, it linked this information system to a nationwide network of distribution centers where inventory was stored and then shipped to stores within a 300-mile radius on a daily basis. The combination of distribution centers and information centers enabled Wal-Mart to reduce the amount of inventory it held in stores and devote more of that valuable space to selling and reducing the amount of capital it had tied up in inventory.

With regard to human resources, the tone was set by Sam Walton, who believed that employees should be respected and rewarded for helping to improve the profitability of the company. Underpinning this belief, Walton referred to employees as “associates.” He established a profit sharing scheme for all employees, and after the company went public in 1970, he initiated a program that allowed employees to purchase Wal-Mart stock at a discount to its market value. Wal-Mart was rewarded for this approach by high employee productivity, which translated into lower operating costs and higher profitability.

As Wal-Mart grew larger, the sheer size and purchasing power of the company enabled it to drive down the prices that it paid suppliers and to pass on those savings to customers in the form of lower prices, which enabled Wal-Mart to gain more market share and hence demand even lower prices. To take the sting out of the persistent demands for lower prices, Wal-Mart shared its sales information with suppliers on a daily basis, enabling them to gain efficiencies by configuring their own production schedules to sales at Wal-Mart.

Already by the 1990s, Wal-Mart was the largest general seller of general merchandise in America. To sustain its growth, Wal-Mart started to diversify into the grocery business, opening 200,000-square-foot supercenter stores that sold groceries and general merchandise under the same roof. Wal-Mart also diversified into the warehouse club business with the establishment of Sam’s Club. With its entry into Mexico in 1991, the company began expanding internationally. By pursuing these expansion strategies, Wal-Mart aims to increase sales to over $400 billion by 2010, up from $40 billion today, thereby solidifying its scale-based advantage.

Despite all of its success, Wal-Mart has experienced problems. In some parts of America, such as California and the Northeast, there has been a backlash against Wal-Mart, particularly by small town residents who see Wal-Mart as a threat to local retailers. Increasingly, Wal-Mart has found it difficult to get planning permission to open up new stores in these towns. In addition, despite the long-held belief that employees should be treated well, Wal-Mart has been the target of lawsuits from employees who claim that they were pushed to work long hours without overtime pay, and from female employees claiming that the culture of Wal-Mart discriminates against them. While some observers believe that these complaints have little merit, others argue that they are signs that the company has become too large and may be encountering limits to profitable growth.

![Graph: Profitability in the U.S. Retail Industry, 1994–2003](image)
Overview

Why do some companies succeed while others fail? Why has Wal-Mart been able to do so well in the fiercely competitive retail industry, while others like Kmart have struggled? In the personal computer industry, what distinguishes Dell from less successful companies such as Gateway? In the airline industry, how is it that Southwest Airlines has managed to keep increasing its revenues and profits through both good times and bad, while rivals such as US Airways and United Airlines have had to seek bankruptcy protection? How did Sony come to dominate the market for videogames with its highly successful PlayStation, while former industry leader Sega saw its market share slump from 60 percent in the early 1990s to less than 10 percent by 2000, and finally pulled out of the market in 2001? What explains the persistent growth and profitability of Nucor Steel, now the largest steel market in America, during a period when many of its once larger rivals disappeared into bankruptcy?

In this book, we argue that the strategies that a company’s managers pursue have a major impact on its performance relative to its competitors. A strategy is a set of related actions that managers take to increase their company’s performance. For most, if not all, companies, achieving superior performance relative to rivals is the ultimate challenge. If a company’s strategies result in superior performance, it is said to have a competitive advantage. Wal-Mart’s strategies produced superior performance from 1994 to 2003; as a result, Wal-Mart has enjoyed a competitive advantage over its rivals. How did Wal-Mart achieve this competitive advantage? As explained in the Opening Case, it was due to the successful pursuit of a number of strategies by Wal-Mart’s managers, most notably the company’s founder, Sam Walton. These strategies enabled the company to lower its cost structure, charge low prices, gain market share, and become more profitable than its rivals. (We will return to the example of Wal-Mart several times throughout this book in a Running Case that examines various aspects of Wal-Mart’s strategy and performance.)

This book identifies and describes the strategies that managers can pursue to achieve superior performance and provide their company with a competitive advantage. One of its central aims is to give you a thorough understanding of the analytical techniques and skills necessary to identify and implement strategies successfully. The first step toward achieving this objective is to describe in more detail what superior performance and competitive advantage mean and to explain the pivotal role that managers play in leading the strategy-making process.

Strategic leadership is about how to most effectively manage a company’s strategy-making process to create competitive advantage. The strategy-making process is the process by which managers select and then implement a set of strategies that aim to achieve a competitive advantage. Strategy formulation is the task of selecting strategies, whereas strategy implementation is the task of putting strategies into action, which includes designing, delivering, and supporting products; improving the efficiency and effectiveness of operations; and designing a company’s organization structure, control systems, and culture. Paraphrasing the well-known saying that “success is 10 percent inspiration and 90 percent perspiration,” in the strategic management arena we might say that “success is 10 percent formulation and 90 percent implementation.” The task of selecting strategies is relatively easy (but requires good analysis and some inspiration); the hard part is putting those strategies into effect.

By the end of this chapter, you will understand how strategic leaders can manage the strategy-making process by formulating and implementing strategies that enable a company to achieve a competitive advantage and superior performance. Moreover, you will learn how the strategy-making process can go wrong and what managers can do to make this process more effective.
Strategic leadership is concerned with managing the strategy-making process to increase the performance of a company, thereby increasing the value of the enterprise to its owners, its shareholders. As shown in Figure 1.1, to increase shareholder value, managers must pursue strategies that increase the profitability of the company and ensure that profits grow (for more details, see the Appendix to this chapter). To do this, a company must be able to outperform its rivals; it must have a competitive advantage.

Maximizing shareholder value is the ultimate goal of profit-making companies, for two reasons. First, shareholders provide a company with the risk capital that enables managers to buy the resources needed to produce and sell goods and services. Risk capital is capital that cannot be recovered if a company fails and goes bankrupt. In the case of Wal-Mart, for example, shareholders provided Sam Walton’s company with capital to build stores and distribution centers, invest in information systems, purchase inventory to sell to customers, and so on. Had Wal-Mart failed, its shareholders would have lost their money; their shares would have been worthless. Thus, shareholders will not provide risk capital unless they believe that managers are committed to pursuing strategies that give them a good return on their capital investment. Second, shareholders are the legal owners of a corporation, and, their shares therefore represent a claim on the profits generated by a company. Thus, managers have an obligation to invest those profits in ways that maximize shareholder value. Of course (as explained later in this book), managers must behave in a legal, ethical, and socially responsible manner while working to maximize shareholder value.

By share value, we mean the returns that shareholders earn from purchasing shares in a company. These returns come from two sources: (a) capital appreciation in the value of a company’s shares and (b) dividend payments. For example, between January 2 and December 31, 2003, the value of one share in the bank JPMorgan increased from $23.96 to $35.78, which represents a capital appreciation of $11.82. In addition, JPMorgan paid out a dividend of $1.30 a share during 2003. Thus, if an investor had bought one share of JPMorgan on January 2 and held on to it for the entire year, her return would have been $13.12 ($11.82 + $1.30), an impressive 54.8 percent return.
on her investment. One reason JPMorgan's shareholders did so well during 2003 was that investors came to believe that managers were pursuing strategies that would both increase the long-term profitability of the company and significantly grow its profits in the future.

One way of measuring the **profitability** of a company is by the return that it makes on the capital invested in the enterprise. The return on invested capital (ROIC) that a company earns is defined as its net profit over the capital invested in the firm (profit/capital invested). By **net profit**, we mean net income after tax. By **capital**, we mean the sum of money invested in the company: that is, stockholders' equity plus debt owed to creditors. So defined, profitability is the result of how efficiently and effectively managers use the capital at their disposal to produce goods and services that satisfy customer needs. A company that uses its capital efficiently and effectively makes a positive return on invested capital.

The **profit growth** of a company can be measured by the increase in net profit over time. A company can grow its profits if it sells products in markets that are growing rapidly, gains market share from rivals, increases the amount it sells to existing customers, expands overseas, or diversifies profitably into new lines of business. For example, between 1994 and 2004 Wal-Mart increased its net profit from $2.68 billion to $10.1 billion. It was able to do this because the company (a) took market share from rivals such as Kmart, (b) established stores in nine foreign nations that collectively generated $41 billion in sales by 2004, and (c) entered the grocery business. Because of the increase in net profit, Wal-Mart's earnings per share increased from $0.59 to $2.35; as a result, each share became more valuable.

Together profitability and profit growth are the principal drivers of shareholder value (see the Appendix to this chapter for details). To both boost profitability and to grow profits over time, managers must formulate and implement strategies that give their company a competitive advantage over rivals. Wal-Mart's strategies have done this. As a result, investors who purchased Wal-Mart's stock in January 1994, when the shares were trading at $11 each, would have made a 500 percent return if they had held on to them through until December 2004, when they were trading at $55 each. By pursuing strategies that lead to high and sustained profitability and profit growth, Wal-Mart's managers have thus rewarded shareholders for their decisions to invest in the company.

One of the key challenges managers face is to simultaneously generate high profitability and increase the profits of the company. Companies that have high profitability but whose profits are not growing will not be as highly valued by shareholders as a company that has both high profitability and rapid profit growth (see the Appendix for details). At the same time, managers need to be aware that if they grow profits but profitability declines, that too will not be as highly valued by shareholders. What shareholders want to see, and what managers must try to deliver through strategic leadership, is **profitable growth**: that is, high profitability and sustainable profit growth. This is not easy, but some of the most successful enterprises of our era have achieved it—companies such as Dell, Microsoft, Intel, and Wal-Mart.

Managers do not make strategic decisions in a competitive vacuum. Their company is competing against other companies for customers. Competition is a rough-and-tumble process in which only the most efficient and effective companies win out. It is a race without end. To maximize shareholder value, managers must formulate and implement strategies that enable their company to outperform rivals—that give it a
A company is said to have a competitive advantage over its rivals when its profitability is greater than the average profitability of all other companies competing for the same set of customers. The higher its profitability relative to rivals, the greater its competitive advantage will be. A company has a sustained competitive advantage when its strategies enable it to maintain above-average profitability for a number of years. As discussed in the Opening Case, Wal-Mart had a significant and sustained competitive advantage over rivals such as Target, Costco, and Kmart between 1994 and 2003.

If a company has a sustained competitive advantage, it is likely to gain market share from its rivals, and thus grow its profits more rapidly than those of rivals. Thus, competitive advantage will also lead to higher profit growth than rivals.

The key to understanding competitive advantage is appreciating how the different strategies managers pursue over time can create activities that fit together to make a company unique or different from its rivals and able to persistently outperform them. A business model is managers’ conception of how the set of strategies their company pursues should mesh together into a congruent whole, enabling the company to gain a competitive advantage and achieve superior profitability and profit growth. In essence, a business model is a kind of mental model, or gestalt, of how the various strategies and capital investments made by a company should fit together to generate above-average profitability and profit growth. A business model encompasses the totality of how a company will:

- Select its customers
- Define and differentiate its product offerings
- Create value for its customers
- Acquire and keep customers
- Produce goods or services
- Deliver those goods and services to the market
- Organize activities within the company
- Configure its resources
- Achieve and sustain a high level of profitability
- Grow the business over time

The business model at discount stores such as Wal-Mart, for example, is based on the idea that costs can be lowered by replacing a full-service retail format with a self-service format and providing a wider selection of products that are sold in a large-footprint store that contains minimal fixtures and fittings. These savings can then be passed on to consumers in the form of lower prices, which in turn grow revenues and help the company to achieve further cost reductions from economies of scale. Over time, this business model has proved superior to the business models adopted by smaller full-service mom-and-pop stores and by traditional high-service department stores such as Sears. The business model, known as the self-service supermarket business model, was first developed by grocery retailers in the 1950s and was later refined and improved by general merchandisers such as Wal-Mart. More recently, the same basic business model has been applied to toys (Toys “R” Us), office supplies (Staples, Office Depot), and home improvement supplies (Home Depot and Lowe’s).

Wal-Mart outperformed close rivals, like Kmart, who adopted the same basic business model because Wal-Mart’s strategies differed in key areas and because it
implemented the business model more effectively. As a result, over time Wal-Mart created unique activities that have become the foundation of its competitive advantage. For example, Wal-Mart was one of the first retailers to make strategic investments in distribution centers and information systems, which lowered the costs of managing inventory (see the *Opening Case*). This gave Wal-Mart a competitive advantage over rivals such as Kmart, which suffered from poor inventory controls and thus higher costs. So although Wal-Mart and Kmart pursued a similar business model, key differences in the choice of strategies and the effectiveness of implementation created two unique organizations: one that attained a competitive advantage and one that ended up with a competitive disadvantage.

The business model that managers develop may not only lead to higher profitability and thus competitive advantage at a point in time, but it may also help the firm to grow its profits over time, thereby maximizing shareholder value while maintaining or even increasing profitability. Wal-Mart’s business model was so efficient and effective that it enabled the company to take market share from rivals like Kmart and thereby increase its profits over time. In addition, Wal-Mart was able to grow profits further by applying its business model to new international markets and opening stores in nine different countries, as well as by adding groceries to its product mix in large Wal-Mart supercenters.

It is important to recognize that in addition to its business model and associated strategies, a company’s performance is also determined by the characteristics of the industry in which it competes. Different industries are characterized by different competitive conditions. In some, demand is growing rapidly, and in others it is contracting. Some might be beset by excess capacity and persistent price wars, others by excess demand and rising prices. In some, technological change might be revolutionizing competition. Others might be characterized by a lack of technological change. In some industries, high profitability among incumbent companies might induce new companies to enter the industry, and these new entrants might depress prices and profits in the industry. In other industries, new entry might be difficult, and periods of high profitability might persist for a considerable time. Thus, the different competitive conditions prevailing in different industries might lead to differences in profitability and profit growth. For example, average profitability might be higher in some industries and lower in other industries because competitive conditions vary from industry to industry.

Figure 1.2 shows the average profitability, measured by ROIC, among companies in several different industries between 1997 and 2003. The drug industry had a favorable competitive environment: demand for drugs was high and competition was generally not based on price. Just the opposite was the case in the steel and air transport industries: both are extremely price competitive. In addition, the steel industry was characterized by declining demand, excess capacity, and price wars. Exactly how industries differ is discussed in detail in Chapter 2. For now, the important point to remember is that the profitability and profit growth of a company are determined by two main factors: its relative success in its industry and the overall performance of its industry relative to other industries.³

A final point concerns the concept of superior performance in the nonprofit sector. By definition, nonprofit enterprises such as government agencies, universities, and charities are not in “business” to make profits. Nevertheless, they are expected to use their resources efficiently and operate effectively, and their managers set goals to
measure their performance. The performance goal for a business school might be to get its programs ranked among the best in the nation. The performance goal for a charity might be to prevent childhood illnesses in poor countries. The performance goal for a government agency might be to improve its services while not exceeding its budget. The managers of nonprofits need to map out strategies to attain these goals. They also need to understand that nonprofits compete with each other for scarce resources, just as businesses do. For example, charities compete for scarce donations, and their managers must plan and develop strategies that lead to high performance and demonstrate a track record of meeting performance goals. A successful strategy gives potential donors a compelling message as to why they should contribute additional donations. Thus, planning and thinking strategically are as important for managers in the nonprofit sector as they are for managers in profit-seeking firms.

Managers are the lynchpin in the strategy-making process. It is individual managers who must take responsibility for formulating strategies to attain a competitive advantage and for putting those strategies into effect. They must lead the strategy-making process. The strategies that made Wal-Mart so successful were not chosen by some abstract entity know as the company; they were chosen by the company’s founder, Sam Walton, and the managers he hired. Wal-Mart’s success, like the success of any company, was based in large part upon how well the company’s managers performed their strategic roles. In this section we look at the strategic roles of different managers. Later in the chapter we discuss strategic leadership, which is how managers can effectively lead the strategy-making process.

In most companies, there are two main types of managers: general managers, who bear responsibility for the overall performance of the company or for one of its major self-contained subunits or divisions, and functional managers, who are re-
The corporate level of management consists of the chief executive officer (CEO), other senior executives, and corporate staff. These individuals occupy the apex of decision making within the organization. The CEO is the principal general manager. In consultation with other senior executives, the role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the goals of the organization, determining what businesses it should be in, allocating resources among the different businesses, formulating and implementing strategies that span individual businesses, and providing leadership for the entire organization.
Consider General Electric as an example. GE is active in a wide range of businesses, including lighting equipment, major appliances, motor and transportation equipment, turbine generators, construction and engineering services, industrial electronics, medical systems, aerospace, aircraft engines, and financial services. The main strategic responsibilities of its CEO, Jeffrey Immelt, are setting overall strategic goals, allocating resources among the different business areas, deciding whether the firm should divest itself of any of its businesses, and determining whether it should acquire any new ones. In other words, it is up to Immelt to develop strategies that span individual businesses; his concern is with building and managing the corporate portfolio of businesses to maximize corporate profitability.

It is not his specific responsibility to develop strategies for competing in the individual business areas, such as financial services. The development of such strategies is the responsibility of the general managers in these different businesses, or business-level managers. However, it is Immelt's responsibility to probe the strategic thinking of business-level managers to make sure that they are pursuing robust business models and strategies that will contribute toward the maximization of GE's long-run profitability, to coach and motivate those managers, to reward them for attaining or exceeding goals, and to hold them to account for poor performance.

Corporate-level managers also provide a link between the people who oversee the strategic development of a firm and those who own it (the shareholders). Corporate-level managers, and particularly the CEO, can be viewed as the agents of shareholders. It is their responsibility to ensure that the corporate and business strategies that the company pursues are consistent with maximizing profitability and profit growth. If they are not, then ultimately the CEO is likely to be called to account by the shareholders.

A business unit is a self-contained division (with its own functions—for example, finance, purchasing, production, and marketing departments) that provides a product or service for a particular market. The principal general manager at the business level, or the business-level manager, is the head of the division. The strategic role of these managers is to translate the general statements of direction and intent that come from the corporate level into concrete strategies for individual businesses. Thus, whereas corporate-level general managers are concerned with strategies that span individual businesses, business-level general managers are concerned with strategies that are specific to a particular business. At GE, a major corporate goal is to be first or second in every business in which the corporation competes. Then the general managers in each division work out for their business the details of a business model that is consistent with this objective.

Functional-level managers are responsible for the specific business functions or operations (human resources, purchasing, product development, customer service, and so on) that constitute a company or one of its divisions. Thus, a functional manager’s sphere of responsibility is generally confined to one organizational activity, whereas general managers oversee the operation of a whole company or division. Although they are not responsible for the overall performance of the organization, functional managers nevertheless have a major strategic role: to develop functional strategies in their area that help fulfill the strategic objectives set by business- and corporate-level general managers.

In GE’s aerospace business, for instance, manufacturing managers are responsible for developing manufacturing strategies consistent with corporate objectives. More-
over, functional managers provide most of the information that makes it possible for business- and corporate-level general managers to formulate realistic and attainable strategies. Indeed, because they are closer to the customer than the typical general manager is, functional managers themselves may generate important ideas that subsequently may become major strategies for the company. Thus, it is important for general managers to listen closely to the ideas of their functional managers. An equally great responsibility for managers at the operational level is strategy implementation: the execution of corporate- and business-level plans.

We can now turn our attention to the process by which managers formulate and implement strategies. Many writers have emphasized that strategy is the outcome of a formal planning process and that top management plays the most important role in this process. Although this view has some basis in reality, it is not the whole story. As we shall see later in the chapter, valuable strategies often emerge from deep within the organization without prior planning. Nevertheless, a consideration of formal, rational planning is a useful starting point for our journey into the world of strategy. Accordingly, we consider what might be described as a typical formal strategic planning model for making strategy.

The formal strategic planning process has five main steps:

1. Select the corporate mission and major corporate goals.
2. Analyze the organization’s external competitive environment to identify opportunities and threats.
3. Analyze the organization’s internal operating environment to identify the organization’s strengths and weaknesses.
4. Select strategies that build on the organization’s strengths and correct its weaknesses in order to take advantage of external opportunities and counter external threats. These strategies should be consistent with the mission and major goals of the organization. They should be congruent and constitute a viable business model.
5. Implement the strategies.

The task of analyzing the organization’s external and internal environment and then selecting appropriate strategies constitutes strategy formulation. In contrast, as noted earlier, strategy implementation involves putting the strategies (or plan) into action. This includes taking actions consistent with the selected strategies of the company at the corporate, business, and functional levels, allocating roles and responsibilities among managers (typically through the design of organization structure), allocating resources (including capital and money), setting short-term objectives, and designing the organization’s control and reward systems. These steps are illustrated in Figure 1.4 (which can also be viewed as a plan for the rest of this book).

Each step in Figure 1.4 constitutes a sequential step in the strategic planning process. At step 1, each round or cycle of the planning process begins with a statement of the corporate mission and major corporate goals. This statement is shaped by the existing business model of the company. The mission statement is followed by the foundation of strategic thinking: external analysis, internal analysis, and strategic choice. The strategy-making process ends with the design of the organizational structure and the culture and control systems necessary to implement the
FIGURE 1.4
Main Components of the Strategic Planning Process

STRATEGY FORMULATION

Existing Business Model

Mission, Vision, Values, and Goals
Chapter 1

External Analysis: Opportunities and Threats
Chapter 2

SWOT Strategic Choice

Internal Analysis: Strengths and Weaknesses
Chapter 3

Functional-Level Strategies
Chapter 4

Business-Level Strategies
Chapters 5, 6, and 7

Global Strategies
Chapter 8

Corporate-Level Strategies
Chapters 9 and 10

STRATEGY IMPLEMENTATION

Governance and Ethics
Chapter 11

Designing Organization Structure
Chapters 12 and 13

Designing Organization Culture
Chapters 12 and 13

Designing Organization Controls
Chapters 12 and 13

FEEDBACK
organization’s chosen strategy. This chapter discusses how to select a corporate mission and choose major goals. Other parts of strategic planning are reserved for later chapters, as indicated in Figure 1.4.

Some organizations go through a new cycle of the strategic planning process every year. This does not necessarily mean that managers choose a new strategy each year. In many instances, the result is simply to modify and reaffirm a strategy and structure already in place. The strategic plans generated by the planning process generally look out over a period of one to five years, with the plan being updated, or rolled forward, every year. In most organizations, the results of the annual strategic planning process are used as input into the budgetary process for the coming year so that strategic planning is used to shape resource allocation within the organization. Strategy in Action 1.1 looks at how Microsoft uses strategic planning to drive its resource allocation decisions.

The first component of the strategic management process is crafting the organization’s mission statement, which provides the framework or context within which strategies are formulated. A mission statement has four main components: a statement of the raison d’être of a company or organization—it’s reason for existence—which is normally referred to as the mission; a statement of some desired future state, usually referred to as the vision; a statement of the key values that the organization is committed to; and a statement of major goals.

The Mission

A company’s mission describes what it is that the company does. For example, the mission of Kodak is to provide “customers with the solutions they need to capture, store, process, output, and communicate images—anywhere, anytime.” In other words, Kodak exists to provide imaging solutions to consumers. In its mission statement, Ford Motor Company describes itself as a company that is “passionately committed to providing personal mobility for people around the world…. We anticipate consumer need and deliver outstanding products and services that improve people’s lives.” In short, Ford is a company that exists to satisfy consumer needs for personal mobility; that is its mission. Both of these missions focus on the customer needs that the company is trying to satisfy rather than on particular products (imaging and personal mobility rather than conventional film or cameras and automobiles). These are customer-oriented rather than product-oriented missions.

An important first step in the process of formulating a mission is to come up with a definition of the organization’s business. Essentially, the definition answers these questions: “What is our business? What will it be? What should it be?” The responses guide the formulation of the mission. To answer the question, “What is our business?” a company should define its business in terms of three dimensions: who is being satisfied (what customer groups), what is being satisfied (what customer needs), and how customers’ needs are being satisfied (by what skills, knowledge, or distinctive competencies). Figure 1.5 illustrates these dimensions.

This approach stresses the need for a customer-oriented rather than a product-oriented business definition. A product-oriented business definition focuses on the characteristics of the products sold and the markets served, not on which kinds of customer needs the products are satisfying. Such an approach obscures the company’s true mission because a product is only the physical manifestation of applying a particular skill to satisfy a particular need for a particular customer group. In
There is a widespread belief that strategic planning does not apply to high-tech industries. “You can’t plan for the unpredictable,” the argument goes, “and technology markets are characterized by rapid and unpredictable change, so why bother with planning?” Nevertheless, the world’s most successful high-tech company, Microsoft, has had a formal strategic planning process in place for many years. The genesis of Microsoft’s planning process goes back to 1994 when the rapidly growing company hired Bob Herbold from Procter & Gamble as Microsoft’s chief operations officer. Herbold was hired to bring some operating discipline to Microsoft’s fluid, freewheeling culture but to do so without undermining the entrepreneurial values and passion for innovation that had made Microsoft so successful. Microsoft’s top managers, Bill Gates and Steve Balmer, had been growing increasingly frustrated with the lack of operating efficiency and coherence at Microsoft, and they wanted to do something about it.

One area that Herbold focused on was strategic planning, which was almost nonexistent when he arrived. What did exist was “a rat’s nest of incompatible planning approaches used by the different units and divisions…. Bill [Gates] wanted a more formal planning process because, as he said, ‘We have no sense of where we will be in two years except for the product guys saying they have great new products coming along.’” At the very least, Gates felt that Microsoft needed some sense of its financial outlook for the next year or two that it could communicate to investors.

Herbold, Gates, and Balmer understood that any assumptions underlying a plan could be made invalid by unforeseen changes in the business environment, and such changes were commonplace in the software industry. At the same time, they acknowledged that Microsoft had some fairly traditional businesses with established revenue streams, such as Microsoft Office and Windows, and the company needed a plan for the future to craft a strategy for these businesses, focus product development efforts, and allocate resources to these businesses. Moreover, the company needed to plan for the future of its newer businesses, such as MSN, the videogame business (Xbox), and its hand-held computer business.

What has emerged at Microsoft is a three-year planning process that compares the subsequent performance of divisions and units against the strategies and goals outlined in the plan to determine future resource allocation. The planning process is built on a standard format that makes it easy to compare the performance data obtained from each of Microsoft’s different businesses or divisions. Planning data include projections for market share, revenues, and profits three years into the future, as well as a statement of major strategies and goals. These projections are updated every year in a rolling plan because the industry changes so much.

Unit strategies are hashed out over the year in strategic planning review meetings between top managers (Gates and Balmer) and division managers. Typically, the unit managers develop strategies, and the top managers probe the strategic thinking of unit managers, asking them to justify their assumptions and ultimately approving, amending, or not approving the unit strategy. Unit strategies are also debated at regular strategy conferences, which Gates and Balmer normally attend.

The strategies that result from these processes are the product of an intense dialogue between top management and unit managers. Unit managers are held accountable for any commitments made in the plan. Thus, the plan not only drives resource allocation, it is also used as a control mechanism. Gates and Balmer determine the overall strategy of Microsoft in consultation with the board of directors, although many of the ideas for new businesses, new products, and acquisitions do not come from the top. Instead, they are proposed by employees within the units and approved if they survive scrutiny.

The planning process is formal, decentralized, and flexible. It is formal insofar as it is a regular process that uses standard information to help drive resource allocation for the coming year and holds managers accountable for their performance. It is decentralized insofar as unit managers propose many of the strategies that make up the plan, and those plans are accepted only after scrutiny by the top managers. It is flexible in that top managers do not see the plan as a straitjacket, but as a document that helps to map out where Microsoft may be going over the next few years. All managers recognize that the assumptions contained in the plan may be invalidated by unforeseen events, and they are committed to rapidly changing strategies if the need arises, as it has often in the past.8
practice, that need may be served in many different ways, and a broad customer-oriented business definition that identifies these ways can safeguard companies from being caught unaware by major shifts in demand.

By helping anticipate demand shifts, a customer-oriented mission statement can also assist companies in capitalizing on changes in their environment. It can help answer the question, “What will our business be?” Kodak’s mission statement—to provide “customers with the solutions they need to capture, store, process, output, and communicate images”—is a customer-oriented statement that focuses on customer needs rather than a particular product (or solution) for satisfying those needs, such as chemical film processing. For this reason, it is helping to drive Kodak’s current investments in digital imaging technologies, which are starting to replace its traditional business based on chemical film processing.

The need to take a customer-oriented view of a company’s business has often been ignored. History is littered with the wreckage of once-great corporations that did not define their business or defined it incorrectly so that ultimately they declined. In the 1950s and 1960s, many office equipment companies such as Smith Corona and Underwood defined their businesses as being the production of typewriters. This product-oriented definition ignored the fact that they were really in the business of satisfying customers’ information-processing needs. Unfortunately for those companies, when a new technology came along that better served customer needs for information processing (computers), demand for typewriters plummeted. The last great typewriter company, Smith Corona, went bankrupt in 1996, a victim of the success of computer-based word-processing technology.
In contrast, IBM correctly foresaw what its business would be. In the 1950s, IBM was a leader in the manufacture of typewriters and mechanical tabulating equipment using punch-card technology. However, unlike many of its competitors, IBM defined its business as providing a means for information processing and storage, rather than just supplying mechanical tabulating equipment and typewriters. Given this definition, the company’s subsequent moves into computers, software systems, office systems, and printers seem logical.

Vision The vision of a company lays out some desired future state; it articulates, often in bold terms, what the company would like to achieve. The vision of Ford, for example, is “to become the world’s leading consumer company for automotive products and services.” This vision is challenging; judged by size, Ford is currently the world’s number 3 company behind General Motors and Toyota. Attaining this vision will thus be a stretch for Ford, but that is the point. Good vision statements are meant to challenge a company by articulating some ambitious but attainable future state that will help to motivate employees at all levels and to drive strategies.

Nokia, the world’s largest manufacturer of mobile (wireless) phones, operates with a very simple but powerful vision: “If it can go mobile, it will!” This vision implies that not only will voice telephony go mobile (it already has), but so will a host of other services based on data, such as imaging and Internet browsing. This vision has led Nokia to develop multimedia mobile handsets that not only can be used for voice communication but that also take pictures, browse the Internet, play games, and manipulate personal and corporate information.

Values The values of a company state how managers and employees should conduct themselves, how they should do business, and what kind of organization they should build to help a company achieve its mission. Insofar as they help drive and shape behavior within a company, values are commonly seen as the bedrock of a company’s organizational culture: the set of values, norms, and standards that control how employees work to achieve an organization’s mission and goals. An organization’s culture is commonly seen as an important source of its competitive advantage. For example, Nucor Steel is one of the most productive and profitable steel firms in the world. Its competitive advantage is based in part on the extremely high productivity of its work force, something, the company maintains, that is a direct result of its cultural values, which determine how it treats its employees. These values are as follow:

- “Management is obligated to manage Nucor in such a way that employees will have the opportunity to earn according to their productivity.”
- “Employees should be able to feel confident that if they do their jobs properly, they will have a job tomorrow.”
- “Employees have the right to be treated fairly and must believe that they will be.”
- “Employees must have an avenue of appeal when they believe they are being treated unfairly.”

At Nucor, values emphasizing pay for performance, job security, and fair treatment for employees help to create an atmosphere within the company that leads to high employee productivity. In turn, this has helped to give Nucor one of the lowest cost structures in its industry, which helps to explain the company’s profitability in a very price-competitive business.
In one study of organizational values, researchers identified a set of values associated with high-performing organizations that help companies achieve superior financial performance through their impact on employee behavior. These values included respect for the interests of key organizational stakeholders: individuals or groups that have an interest, claim, or stake in the company, in what it does, and in how well it performs. They include stockholders, bondholders, employees, customers, the communities in which the company does business, and the general public. The study found that deep respect for the interests of customers, employees, suppliers, and shareholders was associated with high performance. The study also noted that the encouragement of leadership and entrepreneurial behavior by mid- and lower-level managers and a willingness to support change efforts within the organization contributed to high performance. Companies found to emphasize such values consistently throughout their organization include Hewlett-Packard, Wal-Mart, and PepsiCo. The same study identified the values of poorly performing companies—values that, as might be expected, are not articulated in company mission statements: (1) arrogance, particularly to ideas from outside the company; (2) a lack of respect for key stakeholders; and (3) a history of resisting change efforts and “punishing” mid- and lower-level managers who showed “too much leadership.” General Motors was held up as an example of one such organization. According to the authors, a mid- or lower-level manager who showed too much leadership and initiative there was not promoted!

**Major Goals** Having stated the mission, vision, and key values, strategic managers can take the next step in the formulation of a mission statement: establishing major goals. A goal is a precise and measurable desired future state that a company attempts to realize. In this context, the purpose of goals is to specify with precision what must be done if the company is to attain its mission or vision.

Well-constructed goals have four main characteristics:

1. They are precise and measurable. Measurable goals give managers a yardstick or standard against which they can judge their performance.
2. They address crucial issues. To maintain focus, managers should select a limited number of major goals to assess the performance of the company. The goals that are selected should be crucial or important ones.
3. They are challenging but realistic. They give all employees an incentive to look for ways of improving the operations of an organization. If a goal is unrealistic in the challenges it poses, employees may give up; a goal that is too easy may fail to motivate managers and other employees.
4. They specify a time period in which they should be achieved when that is appropriate. Time constraints tell employees that success requires a goal to be attained by a given date, not after that date. Deadlines can inject a sense of urgency into goal attainment and act as a motivator. However, not all goals require time constraints.

Well-constructed goals also provide a means by which the performance of managers can be evaluated.

As noted earlier, although most companies operate with a variety of goals, the central goal of most corporations is to maximize shareholder returns, and doing this requires both high profitability and sustained profit growth. Thus, most companies operate with goals for profitability and profit growth. However, it is important
that top managers do not make the mistake of overemphasizing current profitability to the detriment of long-term profitability and profit growth.\textsuperscript{18} The overzealous pursuit of current profitability to maximize short-term ROIC can encourage such misguided managerial actions as cutting expenditures judged to be nonessential in the short run—for instance, expenditures for research and development, marketing, and new capital investments. Although cutting current expenditure increases current profitability, the resulting underinvestment, lack of innovation, and diminished marketing can jeopardize long-run profitability and profit growth. These expenditures are vital if a company is to pursue its long-term mission and sustain its competitive advantage and profitability over time. Despite these negative consequences, managers may make such decisions because the adverse effects of a short-run orientation may not materialize and become apparent to shareholders for several years or because they are under extreme pressure to hit short-term profitability goals.\textsuperscript{19} It is also worth noting that pressures to maximize short-term profitability may drive managers to act unethically. This apparently occurred during the late 1990s at Enron Corporation, Tyco, WorldCom, and Computer Associates, where managers systematically inflated profits by manipulating financial accounts in a manner that misrepresented the true performance of the firm to shareholders. (Chapter 11 provides a detailed discussion of the issues.)

To guard against short-run behavior, managers need to ensure that they adopt goals whose attainment will increase the long-run performance and competitiveness of their enterprise. Long-term goals are related to such issues as product development, customer satisfaction, and efficiency, and they emphasize specific objectives or targets concerning such things as employee and capital productivity, product quality, and innovation. The Opening Case mentioned how managers at Wal-Mart used information technology to track sales of individual items at individual stores; this information then enabled them to reduce inventory costs. To achieve long-run performance goals, Wal-Mart had to improve its efficiency, and reducing inventory was one of many steps in that direction. Only by paying constant attention to their processes and operations can companies improve their customer satisfaction, productivity, product quality, and innovation over the long run. Managers’ ability to make the right decisions gives their companies a competitive advantage and boosts long-term performance. Both analysts and shareholders watch how well a company makes these decisions and attains its goals, and its stock price fluctuates according to the perception of how well it has succeeded. Positive shareholder perceptions boost stock price and help maximize the returns from holding a company’s stock.

The second component of the strategic management process is an analysis of the organization’s external operating environment. The essential purpose of the external analysis is to identify strategic opportunities and threats in the organization’s operating environment that will affect how it pursues its mission. Three interrelated environments should be examined at this stage: the industry environment in which the company operates, the country or national environment, and the wider socioeconomic or macroenvironment.

Analyzing the industry environment requires an assessment of the competitive structure of the company’s industry, including the competitive position of the company and its major rivals. It also requires analysis of the nature, stage, dynamics, and history of the industry. Because many markets are now global markets, analyzing the industry environment also means assessing the impact of globalization on competi-
tion within an industry. Such an analysis may reveal that a company should move some production facilities to another nation, that it should aggressively expand in emerging markets such as China, or that it should beware of new competition from emerging nations. Analyzing the macroenvironment consists of examining macro-economic, social, government, legal, international, and technological factors that may affect the company and its industry.

Internal analysis, the third component of the strategic planning process, serves to pinpoint the strengths and weaknesses of the organization. Such issues as identifying the quantity and quality of a company’s resources and capabilities and ways of building unique skills and company-specific or distinctive competencies are considered here when we probe the sources of competitive advantage. Building and sustaining a competitive advantage requires a company to achieve superior efficiency, quality, innovation, and responsiveness to its customers. Company strengths lead to superior performance in these areas, whereas company weaknesses translate into inferior performance.

The next component of strategic thinking requires the generation of a series of strategic alternatives, or choices of future strategies to pursue, given the company’s internal strengths and weaknesses and its external opportunities and threats. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as a SWOT analysis. Its central purpose is to identify the strategies that will create a company-specific business model that will best align, fit, or match a company’s resources and capabilities to the demands of the environment in which it operates. Managers compare and contrast the various alternative possible strategies against each other and then identify the set of strategies that will create and sustain a competitive advantage:

- **Functional-level strategy**, directed at improving the effectiveness of operations within a company, such as manufacturing, marketing, materials management, product development, and customer service
- **Business-level strategy**, which encompasses the business’s overall competitive theme, the way it positions itself in the marketplace to gain a competitive advantage, and the different positioning strategies that can be used in different industry settings—for example, cost leadership, differentiation, focusing on a particular niche or segment of the industry, or some combination of these
- **Global strategy**, addressing how to expand operations outside the home country to grow and prosper in a world where competitive advantage is determined at a global level
- **Corporate-level strategy**, which answers the primary questions: What business or businesses should we be in to maximize the long-run profitability and profit growth of the organization, and how should we enter and increase our presence in these businesses to gain a competitive advantage?

The strategies identified through a SWOT analysis should be congruent with each other. Thus, functional-level strategies should be consistent with, or support, the company’s business-level strategy and global strategy. Moreover, as we explain later in this book, corporate-level strategies should support business-level strategies. When taken together, the various strategies pursued by a company constitute a viable business model. In essence a SWOT analysis is a methodology for choosing
between competing business models and for fine-tuning the business model that managers choose. Thus, at Wal-Mart a SWOT analysis might be used to fine-tune and improve aspects of the self-service supermarket business model. In contrast, when Microsoft entered the videogame market with its Xbox offering, it had to settle on the best business model for competing in this market. Microsoft used a SWOT type of analysis to compare alternatives and settled on a “razor and razor blades” business model in which the Xbox console is priced below cost to build sales (the “razor”), while profits are made from royalties on the sale of games for the Xbox (the “blades”).

Having chosen a set of congruent strategies to achieve a competitive advantage and increase performance, managers must put those strategies into action: Strategy has to be implemented. Strategy implementation involves taking actions at the functional, business, and corporate levels to execute a strategic plan. Thus implementation can include, for example, putting quality improvement programs into place, changing the way a product is designed, positioning the product differently in the marketplace, segmenting the marketing and offering different versions of the product to different consumer groups, implementing price increases or decreases, expanding through mergers and acquisitions, or downsizing the company by closing down or selling off parts of the company. These and other topics are discussed in detail in Chapters 4 through 10.

Strategy implementation also entails designing the best organization structure and the best culture and control systems to put a chosen strategy into action. In addition, senior managers need to put a governance system in place to make sure that all within the organization act in a manner that is not only consistent with maximizing profitability and profit growth but also legal and ethical. In this book we look at the topic of governance and ethics in Chapter 11, we discuss the organization structure, culture, and controls required to implement business-level strategies in Chapter 12, and the structure, culture, and controls required to implement corporate-level strategies in Chapter 13.

The feedback loop in Figure 1.4 indicates that strategic planning is ongoing; it never ends. Once a strategy has been implemented, its execution must be monitored to determine the extent to which strategic goals and objectives are actually being achieved and to what degree competitive advantage is being created and sustained. This information and knowledge pass back up to the corporate level through feedback loops and become the input for the next round of strategy formulation and implementation. Top managers can then decide whether to reaffirm the existing business model and the existing strategies and goals or suggest changes for the future. For example, if a strategic goal proves too optimistic, the next time a more conservative goal is set. Or feedback may reveal that the business model is not working, so managers may seek ways to change it.

The basic planning model suggests that a company’s strategies are the result of a plan, that the strategic planning process itself is rational and highly structured, and that the process is orchestrated by top management. Several scholars have criticized the formal planning model for three main reasons: the unpredictability of the real
world, the role that lower-level managers can play in the strategic management process, and the fact that many successful strategies are often the result of serendipity, not rational strategizing. They have advocated an alternative view of strategy making.21

Critics of formal planning systems argue that we live in a world in which uncertainty, complexity, and ambiguity dominate, and in which small chance events can have a large and unpredictable impact on outcomes.22 In such circumstances, they claim, even the most carefully thought out strategic plans are prone to being rendered useless by rapid and unforeseen change. In an unpredictable world, there is a premium on being able to respond quickly to changing circumstances and to alter the strategies of the organization accordingly.

A dramatic example of this occurred in 1994 and 1995 when Microsoft CEO Bill Gates shifted the company strategy after the unanticipated emergence of the World Wide Web (see Strategy in Action 1.2). According to critics of formal systems, such a flexible approach to strategy making is not possible within the framework of a traditional strategic planning process, with its implicit assumption that an organization’s strategies need to be reviewed only during the annual strategic planning exercise.

Another criticism leveled at the rational planning model of strategy is that too much importance is attached to the role of top management, particularly the CEO.23 An alternative view now gaining wide acceptance is that individual managers deep within an organization can and often do exert a profound influence over the strategic direction of the firm.24 Writing with Robert Burgelman of Stanford University, Andy Grove, the former CEO of Intel, noted that many important strategic decisions at Intel were initiated not by top managers but by the autonomous action of lower-level managers deep within Intel who, on their own initiative, formulated new strategies and worked to persuade top-level managers to alter the strategic priorities of the firm.25 These strategic decisions included the decision to exit an important market (the DRAM memory chip market) and to develop a certain class of microprocessors (RISC-based microprocessors) in direct contrast to the stated strategy of Intel’s top managers. Strategy in Action 1.2 details how autonomous action by two young employees drove the evolution of Microsoft’s strategy toward the Internet. In addition, the prototype for another Microsoft product, the Xbox videogame system, was developed by four lower-level engineering employees on their own initiative. They then successfully lobbied top managers to dedicate resources toward commercializing their prototype. Another famous example of autonomous action, in this case at 3M, is given in Strategy in Action 1.3.

Autonomous action may be particularly important in helping established companies deal with the uncertainty created by the arrival of a radical new technology that changes the dominant paradigm in an industry.26 Top managers usually rise to preeminence by successfully executing the established strategy of the firm. Therefore, they may have an emotional commitment to the status quo and are often unable to see things from a different perspective. In this sense, they are a conservative force that promotes inertia. Lower-level managers, however, are less likely to have the same commitment to the status quo and have more to gain from promoting new technologies and strategies. They may be the ones to first recognize new strategic opportunities (as was the case at both Microsoft and 3M) and lobby for strategic change.
Business history is replete with examples of accidental events that help to push companies in new and profitable directions. What these examples suggest is that many successful strategies are not the result of well-thought-out plans but of serendipity, that is, of stumbling across good things unexpectedly. One such example occurred at 3M during the 1960s. At that time, 3M was producing fluorocarbons for sale as coolant liquid in air-conditioning equipment. One day, a researcher working with fluorocarbons in a 3M lab spilled some of the liquid on her shoes. Later that day when she spilled coffee over her shoes, she watched with interest as the coffee formed into little beads of liquid and then ran off her shoes without leaving a stain. Reflecting on this phenomenon, she realized that a fluorocarbon-based liquid might turn out to be useful for protecting fabrics from liquid stains, and so the idea for Scotch Guard was born. Subsequently, Scotch Guard became one of 3M's most profitable products.

A young programmer at the University of Illinois in 1993, Mark Andreesen, had developed the first browser, known as Mosaic. In 1994, he left Illinois and joined a start-up company, Netscape, which produced an improved browser, the Netscape Navigator, along with software that enabled organizations to create webpages and host them on computer servers. These developments led to a dramatic and unexpected growth in the number of people connecting to the Internet. In 1990, the Internet had 1 million users. By early 1995, the number had exceeded 80 million and was growing exponentially.

Prior to the emergence of the Web, Microsoft did have a strategy for exploiting the Internet, but it was one that emphasized set-top boxes, video on demand, interactive TV, and an online service, MSN, modeled after AOL and based on proprietary standards. In early 1994, Gates received e-mails from two young employees, Jay Allard and Steve Sinofsky, who argued that Microsoft's current strategy was misguided and ignored the rapidly emerging Web. In companies with a more hierarchical culture, such action might have been ignored, but in Microsoft, which operates as a meritocracy in which good ideas trump hierarchical position, it produced a very different response. Gates convened a meeting of senior executives in April 1994 and then wrote a memo to senior executives arguing that the Internet represented a sea change in computing and that Microsoft had to respond.

What ultimately emerged was a 180-degree shift in Microsoft's strategy. Interactive TV was placed on the back burner, and MSN was relaunched as a Web service based on HTML. Microsoft committed to developing its own browser technology and within a few months had issued Internet Explorer to compete with Netscape's Navigator (the underlying technology was gained by an acquisition). Microsoft licensed Java, a computer language designed to run programs on the Web, from a major competitor, Sun Microsystems. Internet protocols were built into Windows 95 and Windows NT, and Gates insisted that henceforth Microsoft's applications, such as the ubiquitous Office, embrace the WWW and have the ability to convert documents into an HTML format. The new strategy was given its final stamp on December 7, 1995, Pearl Harbor Day, when Gates gave a speech arguing that the Internet was now pervasive in everything Microsoft was doing. By then, Microsoft had been pursuing the new strategy for a year. In short, Microsoft quickly went from a proprietary standards approach to one that embraced the public standards on the WWW.1

Serendipity and Strategy

Business history is replete with examples of accidental events that help to push companies in new and profitable directions. What these examples suggest is that many successful strategies are not the result of well-thought-out plans but of serendipity, that is, of stumbling across good things unexpectedly. One such example occurred at 3M during the 1960s. At that time, 3M was producing fluorocarbons for sale as coolant liquid in air-conditioning equipment. One day, a researcher working with fluorocarbons in a 3M lab spilled some of the liquid on her shoes. Later that day when she spilled coffee over her shoes, she watched with interest as the coffee formed into little beads of liquid and then ran off her shoes without leaving a stain. Reflecting on this phenomenon, she realized that a fluorocarbon-based liquid might turn out to be useful for protecting fabrics from liquid stains, and so the idea for Scotch Guard was born. Subsequently, Scotch Guard became one of 3M's most profitable products.
products and took the company into the fabric protection business, an area it had never planned to participate in.27

Serendipitous discoveries and events can open up all sorts of profitable avenues for a company. But some companies have missed out on profitable opportunities because serendipitous discoveries or events were inconsistent with their prior (planned) conception of what their strategy should be. In one of the classic examples of such myopia, a century ago the telegraph company Western Union turned down an opportunity to purchase the rights to an invention made by Alexander Graham
Henry Mintzberg’s model of strategy development provides a more encompassing view of what strategy actually is. According to this model, illustrated in Figure 1.6, a company’s realized strategy is the product of whatever planned strategies are actually put into action (the company’s deliberate strategies) and of any unplanned, or emergent, strategies. In Mintzberg’s view, many planned strategies are not implemented because of unpredicted changes in the environment (they are unrealized). **Emergent strategies** are the unplanned responses to unforeseen circumstances. They arise from autonomous action by individual managers deep within the organization, from serendipitous discoveries or events, or from an unplanned strategic shift by top-level managers in response to changed circumstances. They are *not* the product of formal top-down planning mechanisms.

Mintzberg maintains that emergent strategies are often successful and may be more appropriate than intended strategies. Richard Pascale has described how this was the case for the entry of Honda Motor Co. into the U.S. motorcycle market.28 When a number of Honda executives arrived in Los Angeles from Japan in 1959 to establish a U.S. operation, their original aim (intended strategy) was to focus on selling 250-cc and 350-cc machines to confirmed motorcycle enthusiasts rather than 50-cc Honda Cubs, which were a big hit in Japan. Their instinct told them that the Honda 50s were not suitable for the U.S. market, where everything was bigger and more luxurious than in Japan.

However, sales of the 250-cc and 350-cc bikes were sluggish, and the bikes themselves were plagued by mechanical failure. It looked as if Honda’s strategy was going to fail. At the same time, the Japanese executives who were using the Honda 50s to run errands around Los Angeles were attracting a lot of attention. One day they got a
call from a Sears, Roebuck buyer who wanted to sell the 50-cc bikes to a broad market of Americans who were not necessarily motorcycle enthusiasts. The Honda executives were hesitant to sell the small bikes for fear of alienating serious bikers, who might then associate Honda with “wimpy” machines. In the end, however, they were pushed into doing so by the failure of the 250-cc and 350-cc models.

Honda had stumbled onto a previously untouched market segment that was to prove huge: the average American who had never owned a motorbike. Honda had also found an untried channel of distribution: general retailers rather than specialty motorbike stores. By 1964, nearly one out of every two motorcycles sold in the United States was a Honda.

The conventional explanation for Honda’s success is that the company redefined the U.S. motorcycle industry with a brilliantly conceived intended strategy. The fact was that Honda’s intended strategy was a near disaster. The strategy that emerged did so not through planning but through unplanned action in response to unforeseen circumstances. Nevertheless, credit should be given to the Japanese management for recognizing the strength of the emergent strategy and for pursuing it with vigor.

The critical point demonstrated by the Honda example is that successful strategies can often emerge within an organization without prior planning in response to unforeseen circumstances. As Mintzberg has noted, strategies can take root virtually wherever people have the capacity to learn and the resources to support that capacity.

In practice, the strategies of most organizations are probably a combination of the intended (planned) and the emergent. The message for management is that it needs to recognize the process of emergence and to intervene when appropriate, killing off bad emergent strategies but nurturing potentially good ones. To make such decisions, managers must be able to judge the worth of emergent strategies. They must be able to think strategically. Although emergent strategies arise from within the organization without prior planning—that is, without going through the steps illustrated in Figure 1.4 in a sequential fashion—top management still has to evaluate emergent strategies. Such evaluation involves comparing each emergent strategy with the organization’s goals, external environmental opportunities and threats, and internal strengths and weaknesses. The objective is to assess whether the emergent strategy fits the company’s needs and capabilities. In addition, Mintzberg stresses that an organization’s capability to produce emergent strategies is a function of the kind of corporate culture that the organization’s structure and control systems foster. In other words, the different components of the strategic management process are just as important from the perspective of emergent strategies as they are from the perspective of intended strategies.

Despite criticisms, research suggests that formal planning systems do help managers make better strategic decisions. A study that analyzed the results of twenty-six previously published studies came to the conclusion that, on average, strategic planning has a positive impact on company performance. Another study of strategic planning in 656 firms found that formal planning methodologies and emergent strategies both form part of a good strategy formulation process, particularly in an unstable environment. For strategic planning to work, it is important that top-level managers plan not just in the context of the current competitive environment but also in the context of the future competitive environment. To try to forecast what that future will look like, managers can use scenario planning techniques to plan for different possible
futures. They can also involve operating managers in the planning process and seek to shape the future competitive environment by emphasizing strategic intent.

One reason that strategic planning may fail over the long run is that strategic managers, in their initial enthusiasm for planning techniques, may forget that the future is inherently unpredictable. Even the best-laid plans can fall apart if unforeseen contingencies occur, and that happens all the time in the real world. The recognition that uncertainty makes it difficult to forecast the future accurately led planners at Royal Dutch Shell to pioneer the scenario approach to planning.

In the scenario approach, managers are given a set of possible future scenarios for the development of competition in their industry. Some scenarios are optimistic and some pessimistic, and then teams of managers are asked to develop specific strategies to cope with each different scenario. A set of industry-specific indicators are chosen and used as signposts to track the development of the industry and to determine the probability that any particular scenario is coming to pass. The idea is to get managers to understand the dynamic and complex nature of their environment, think through problems in a strategic fashion, and generate a range of strategic options that might be pursued under different circumstances.32

The scenario approach to planning has spread rapidly among large companies. According to one survey, over 50 percent of the Fortune 500 companies use some form of scenario planning.33

A serious mistake that some companies have made in constructing their strategic planning process has been to treat planning as an exclusively top management responsibility. This ivory tower approach can result in strategic plans formulated in a vacuum by top managers who have little understanding or appreciation of current operating realities. Consequently, top managers may formulate strategies that do more harm than good. For example, when demographic data indicated that houses and families were shrinking, planners at GE’s appliance group concluded that smaller appliances were the wave of the future. Because they had little contact with home builders and retailers, they did not realize that kitchens and bathrooms were the two rooms that were not shrinking. Nor did they appreciate that working women wanted big refrigerators to cut down on trips to the supermarket. GE ended up wasting a lot of time designing small appliances with limited demand.

The ivory tower concept of planning can also lead to tensions between corporate-, business-, and functional-level managers. The experience of GE’s appliance group is again illuminating. Many of the corporate managers in the planning group were recruited from consulting firms or top-flight business schools. Many of the functional managers took this pattern of recruitment to mean that corporate managers did not think they were smart enough to think through strategic problems for themselves. They felt shut out of the decision-making process, which they believed to be unfairly constituted. Out of this perceived lack of procedural justice grew an us-versus-them mindset that quickly escalated into hostility. As a result, even when the planners were right, operating managers would not listen to them. For example, the planners correctly recognized the importance of the globalization of the appliance market and the emerging Japanese threat. However, operating managers, who then saw Sears Roebuck as the competition, paid them little heed.

Finally, ivory tower planning ignores the important strategic role of autonomous action by lower-level managers and serendipity.
Correcting the ivory tower approach to planning requires recognizing that successful strategic planning encompasses managers at all levels of the corporation. Much of the best planning can and should be done by business and functional managers who are closest to the facts; in other words, planning should be decentralized. The role of corporate-level planners should be that of facilitators who help business and functional managers do the planning by setting the broad strategic goals of the organization and providing the resources required to identify the strategies that might be required to attain those goals.

It is not enough to involve lower-level managers in the strategic planning process, however; they also need to perceive that the decision-making process is fair, a concept that Chan Kim and Renee Mauborgne refer to as procedural justice.\textsuperscript{34} If people perceive the decision-making process to be unjust, they are less likely to be committed to any resulting decisions and to cooperate voluntarily in activities designed to implement those decisions. Consequently, the strategy chosen might fail for lack of support among those who must implement it at the operating level.

The formal strategic planning model has been characterized as the fit model of strategy making. This is because it attempts to achieve a fit between the internal resources and capabilities of an organization and external opportunities and threats in the industry environment. Gary Hamel and C. K. Prahalad have criticized the fit model because it can lead to a mindset in which management focuses too much on the degree of fit between the existing resources of a company and current environmental opportunities, and not enough on building new resources and capabilities to create and exploit future opportunities.\textsuperscript{35} Strategies formulated with only the present in mind, argue Prahalad and Hamel, tend to be more concerned with today’s problems than with tomorrow’s opportunities. As a result, companies that rely exclusively on the fit approach to strategy formulation are unlikely to be able to build and maintain a competitive advantage. This is particularly true in a dynamic competitive environment, where new competitors are continually arising and new ways of doing business are constantly being invented.

As Prahalad and Hamel note, again and again, companies using the fit approach have been surprised by the ascent of competitors that initially seemed to lack the resources and capabilities needed to make them a real threat. This happened to Xerox, which ignored the rise of Canon and Ricoh in the photocopier market until they had become serious global competitors; to General Motors, which initially overlooked the threat posed by Toyota and Honda in the 1970s; and to Caterpillar, which ignored the danger Komatsu posed to its heavy earthmoving business until it was almost too late to respond.

The secret of the success of companies like Toyota, Canon, and Komatsu, according to Prahalad and Hamel, is that they all had bold ambitions that outstripped their existing resources and capabilities. All wanted to achieve global leadership, and they set out to build the resources and capabilities that would enable them to attain this goal. Consequently, top management created an obsession with winning at all levels of the organization that they sustained over a ten- to twenty-year quest for global leadership. It is this obsession that Prahalad and Hamel refer to as strategic intent. They stress that strategic intent is more than simply unfettered ambition. It encompasses an active management process, which includes “focusing the organization’s attention on the essence of winning; motivating people by communicating the value of...”

\textsuperscript{34} Chan Kim and Renee Mauborgne, \textit{Competing for the Future}, p. 22.

\textsuperscript{35} Gary Hamel and C. K. Prahalad, \textit{The Resource-Based View of the Firm}, p. 42.
the target; leaving room for individual and team contributions; sustaining enthusiasm by providing new operational definitions as circumstances change; and using intent consistently to guide resource allocations.\textsuperscript{36}

Thus, underlying the concept of strategic intent is the notion that strategic planning should be based on setting an ambitious vision and ambitious goals that stretch a company and then finding ways to build the resources and capabilities necessary to attain that vision and those goals. As Prahalad and Hamel note, in practice the two approaches to strategy formulation are not mutually exclusive. All the components of the strategic planning process that we discussed earlier (see Figure 1.4) are important.

In addition, say Prahalad and Hamel, the strategic management process should begin with a challenging vision, such as attaining global leadership, that stretches the organization. Throughout the subsequent process, the emphasis should be on finding ways (strategies) to develop the resources and capabilities necessary to achieve these goals rather than on exploiting existing strengths to take advantage of existing opportunities. The difference between strategic fit and strategic intent, therefore, may just be one of emphasis. Strategic intent is more internally focused and is concerned with building new resources and capabilities. Strategic fit focuses more on matching existing resources and capabilities to the external environment.

Even the best-designed strategic planning systems will fail to produce the desired results if managers do not use the information at their disposal effectively. Consequently, it is important that strategic managers learn to make better use of the information they have and understand why they sometimes make poor decisions. One important way in which managers can make better use of their knowledge and information is to understand how common cognitive biases can result in good managers making bad decisions.\textsuperscript{37}

The rationality of human decision makers is bounded by our own cognitive capabilities. \textsuperscript{38} We are not supercomputers, and it is difficult for us to absorb and process large amounts of information effectively. As a result, when making decisions, we tend to fall back on certain rules of thumb, or heuristics, that help us to make sense out of a complex and uncertain world. However, sometimes these rules lead to severe and systematic errors in the decision-making process.\textsuperscript{39} Systematic errors are those that appear time and time again. They seem to arise from a series of cognitive biases in the way that human decisionmakers process information and reach decisions. Because of cognitive biases, many managers end up making poor strategic decisions.

A number of biases have been verified repeatedly in laboratory settings, so we can be reasonably sure that they exist and that we are all prone to them.\textsuperscript{40} The prior hypothesis bias refers to the fact that decisionmakers who have strong prior beliefs about the relationship between two variables tend to make decisions on the basis of these beliefs, even when presented with evidence that their beliefs are wrong. Moreover, they tend to seek and use information that is consistent with their prior beliefs, while ignoring information that contradicts these beliefs. To put this bias in a strategic context, it suggests that a CEO who has a strong prior belief that a certain strategy makes sense might continue to pursue that strategy, despite evidence that it is inappropriate or failing.

Another well-known cognitive bias, escalating commitment, occurs when decisionmakers, having already committed significant resources to a project, commit
even more resources even if they receive feedback that the project is failing. This may be an irrational response; a more logical response would be to abandon the project and move on (that is, to cut your losses and run), rather than escalate commitment. Feelings of personal responsibility for a project apparently induce decision-makers to stick with a project despite evidence that it is failing.

A third bias, reasoning by analogy, involves the use of simple analogies to make sense out of complex problems. The problem with this heuristic is that the analogy may not be valid. A fourth bias, representativeness, is rooted in the tendency to generalize from a small sample or even a single vivid anecdote. This bias violates the statistical law of large numbers, which says that it is inappropriate to generalize from a small sample, let alone from a single case. In many respects, the dot-com boom of the late 1990s was based on reasoning by analogy and representativeness. Prospective entrepreneurs saw some of the early dot-com companies such as Amazon and Yahoo! achieve rapid success, at least judged by some metrics. Reasoning by analogy from a very small sample, they assumed that any dot-com could achieve similar success. Many investors reached similar conclusions. The result was a massive wave of startups that jumped into the Internet space in an attempt to capitalize on the perceived opportunities. That the vast majority of these companies subsequently went bankrupt is testament to the fact that the analogy was wrong and the success of the small sample of early entrants was no guarantee that all dot-coms would succeed.

The final cognitive bias is referred to as the illusion of control: the tendency to overestimate one’s ability to control events. General or top managers seem to be particularly prone to this bias: having risen to the top of an organization, they tend to be overconfident about their ability to succeed. According to Richard Roll, such overconfidence leads to what he has termed the hubris hypothesis of takeovers. Roll argues that top managers are typically overconfident about their ability to create value by acquiring another company. Hence, they end up making poor acquisition decisions, often paying far too much for the companies they acquire. Subsequently, servicing the debt taken on to finance such an acquisition makes it all but impossible to make money from the acquisition.

Because most strategic decisions are made by groups, the group context within which decisions are made is clearly an important variable in determining whether cognitive biases will operate to adversely affect the strategic decision-making process.

The psychologist Irvin Janis has argued that many groups are characterized by a process known as groupthink and as a result make poor strategic decisions. Groupthink occurs when a group of decisionmakers embarks on a course of action without questioning underlying assumptions. Typically, a group coalesces around a person or policy. It ignores or filters out information that can be used to question the policy and develops after-the-fact rationalizations for its decision. Commitment to the mission or goals becomes based on an emotional rather than an objective assessment of the “correct” course of action. The consequences can be poor decisions.

This phenomenon may explain, at least in part, why companies often make poor strategic decisions in spite of sophisticated strategic management. Janis traced many historical fiascoes to defective policymaking by government leaders who received social support from their in-group of advisers. For example, he suggested that President John F. Kennedy’s inner circle suffered from groupthink when the members of this group supported the decision to launch the Bay of Pigs invasion of Cuba in 1961, even though available information showed that it would be
an unsuccessful venture and would damage U.S. relations with other countries.

Janis has observed that groupthink-dominated groups are characterized by strong pressures toward uniformity, which make their members avoid raising controversial issues, questioning weak arguments, or calling a halt to soft-headed thinking. As discussed in Strategy in Action 1.4, the Senate Intelligence Committee believed that groupthink biased CIA and other reports on Iraq’s weapons of mass destruction that the Bush Administration subsequently used to justify the 2003 invasion of that nation.

The existence of cognitive biases and groupthink raises the issue of how to bring critical information to bear on the decision-making mechanism so that a company’s strategic decisions are realistic and based on thorough evaluation. Two techniques known to enhance strategic thinking and counteract groupthink and cognitive biases are devil’s advocacy and dialectic inquiry (Figure 1.7).44 Devil’s advocacy requires the generation of both a plan and a critical analysis of the plan. One member of the decision-making group acts as the devil’s advocate, bringing out all the reasons that might make the proposal unacceptable. In this way, decisionmakers can become aware of the possible perils of recommended courses of action.

Dialectic inquiry is more complex, for it requires the generation of a plan (a thesis) and a counterplan (an antithesis) that reflect plausible but conflicting courses of
were “either overstated, or were not supported by the underlying intelligence reporting.”

One of the most critical parts of the Senate report dealt with the prewar assessment of Iraq’s nuclear weapons program. The report stated that the 2002 National Intelligence Estimate represented a sharp break from previous assessments, which had concluded that Iraq had not reconstituted its nuclear weapons program. The Senate report stated that the CIA made a significant shift in its assessment shortly after Vice President Dick Cheney began stating publicly that Iraq had actively reconstituted its nuclear weapons program. The implication was that the CIA gave the administration the information it thought it wanted, rather than accurate information. Moreover, the Senate report claimed that the CIA’s leading advocate of the Iraqi nuclear weapons threat withheld evidence from analysts who disagreed with him, misstated the analysis and information produced by others, and distributed misleading information both inside and outside the agency. The committee also concluded that the CIA overstated what it knew about Iraq’s attempts to procure uranium from Niger and that it delayed for months examining documents pertaining to those attempts that would later prove to be forgeries.

On the topic of biological weapons, the Senate report concluded that none of the claims about Iraq’s biological weapons or capabilities was supported by intelligence and that claims that Iraq had restarted its chemical weapons program were the results of “analytical judgments” and not based on hard evidence. The intelligence on biological weapons came from a single Iraqi defector code-named “Curve Ball” who was apparently an alcoholic and, in the opinion of the one person who had interviewed him, a Pentagon analyst, “utterly useless as a source.” When the same analyst saw information provided by Curve Ball included in a speech that Colin Powell made to the United Nations to justify war with Iraq, he contacted the CIA to express his concerns. A CIA official quickly responded in an e-mail: “Let’s keep in mind the fact that this war’s going to happen regardless of what Curve Ball said or didn’t say. The powers that be probably aren’t terribly interested in whether Curve Ball knows what he is talking about.”

In sum, the Senate report painted a picture of intelligence institutions that selectively interpreted information to support what they thought administration policy was, while ignoring or dismissing contradictory information—sure signs of groupthink. At the same time, the report concluded that there was no evidence of undue political pressure by policymakers in the administration or Congress. Instead, the committee blamed intelligence leaders “who did not encourage analysts to challenge their assumptions, fully consider alternative arguments, accurately characterize the intelligence reporting, or council analysts who lost their objectivity.” Be this as it may, an objective observer might also wonder why neither the Senate nor the administration asked hard questions about the quality and source of the intelligence information in the run-up to the war.45

Strategic managers listen to a debate between advocates of the plan and counterplan and then decide which plan will lead to the higher performance. The purpose of the debate is to reveal the problems with definitions, recommended courses of action, and assumptions of both plans. As a result of this exercise, strategic managers are able to form a new and more encompassing conceptualization of the problem, which then becomes the final plan (a synthesis). Dialectic inquiry can promote strategic thinking.

Another technique for countering cognitive biases is the outside view, which has been championed by Nobel Prize winner Daniel Kahneman and his associates.46 The outside view requires planners to identify a reference class of analogous past strategic initiatives, determine whether those initiatives succeeded or failed, and evaluate the project at hand against those prior initiatives. According to Kahneman, this technique is particularly useful for countering biases such as the illusion of control (hubris), reasoning by analogy, and representativeness. Thus, for example, when considering a potential acquisition, planners should look at the track record of acquisitions made by other enterprises (the reference class), determine if they succeeded or failed, and objectively evaluate the potential acquisition against that reference class.
Kahneman argues that such a “reality check” against a large sample of prior events tends to constrain the inherent optimism of planners and produce more realistic assessments and plans.

One of the key strategic roles of both general and functional managers is to use all their knowledge, energy, and enthusiasm to provide strategic leadership for their subordinates and develop a high-performing organization. Several authors have identified a few key characteristics of good strategic leaders that do lead to high performance: (1) vision, eloquence, and consistency; (2) articulation of a business model; (3) commitment; (4) being well informed; (5) willingness to delegate and empower; (6) astute use of power; and (7) emotional intelligence.47

One of the key tasks of leadership is to give an organization a sense of direction. Strong leaders seem to have a clear and compelling vision of where the organization should go, are eloquent enough to communicate this vision to others within the organization in terms that energize people, and consistently articulate their vision until it becomes part of the organization’s culture.48

In the political arena, John F. Kennedy, Winston Churchill, Martin Luther King Jr., and Margaret Thatcher have all been held up as examples of visionary leaders. Think of the impact of Kennedy’s sentence, “Ask not what your country can do for you; ask what you can do for your country,” of King’s “I Have a Dream” speech, and of Churchill’s “we will never surrender.” Kennedy and Thatcher were able to use their political office to push for governmental actions that were consistent with their vision. Churchill’s speech galvanized a nation to defend itself against an aggressor, and King was able to pressure the government from outside to make changes in society.

Examples of strong business leaders include Microsoft’s Bill Gates; Jack Welch, the former CEO of General Electric; and Sam Walton, Wal-Mart’s founder. For years, Bill Gates’s vision of a world in which there would be a Windows-based personal
computer on every desk was a driving force at Microsoft. More recently, the vision has evolved into one of a world in which Windows-based software can be found on any computing device, from PCs and servers to videogame consoles (Xbox), cell phones, and hand-held computers. At GE, Jack Welch was responsible for articulating the simple but powerful vision that GE should be first or second in every business in which it competed, or exit from that business. Similarly, it was Sam Walton who established and articulated the vision that has been central to Wal-Mart’s success: passing on cost savings from suppliers and operating efficiencies to customers in the form of everyday low prices.

Another key characteristic of good strategic leaders is their ability to identify and articulate the business model the company will use to attain its vision. A business model is managers’ conception of how the various strategies that the company pursues fit together into a congruent whole. At Wal-Mart, for example, it was Sam Walton who identified and articulated the basic business model of the company: the self-service supermarket business model. The various strategies that Wal-Mart has pursued over the years have refined this basic model, creating one that is now unique in terms of its efficiency and effectiveness. Although individual strategies can take root in many different places in an organization, and although their identification is not the exclusive preserve of top management, only strategic leaders have the perspective required to make sure that the various strategies fit together into a congruent whole and form a valid and compelling business model. If strategic leaders lack a clear conception of what the business model of the company is or should be, it is likely that the strategies the firm pursues will not fit together, and the result will be lack of focus and poor performance.

Strong leaders demonstrate their commitment to their vision and business model by actions and words, and they often lead by example. Consider Nucor’s former CEO, Ken Iverson. Nucor is a very efficient steel maker with perhaps the lowest cost structure in the steel industry. It has turned in thirty years of profitable performance in an industry where most other companies have lost money because of a relentless focus on cost minimization. In his tenure as CEO, Iverson set the example: he answered his own phone, employed only one secretary, drove an old car, flew coach class, and was proud of the fact that his base salary was the lowest of the Fortune 500 CEOs (Iverson made most of his money from performance-based pay bonuses). This commitment was a powerful signal to employees that Iverson was serious about doing everything possible to minimize costs. It earned him the respect of Nucor employees and made them more willing to work hard. Although Iverson has retired, his legacy lives on in the cost-conscious organization culture that has been built at Nucor, and like all other great leaders, his impact will last beyond his tenure.

Effective strategic leaders develop a network of formal and informal sources who keep them well informed about what is going on within their company. Herb Kelleher at Southwest Airlines, for example, was able to find out much about the health of his company by dropping in unannounced on aircraft maintenance facilities and helping workers perform their tasks; McDonald’s Ray Kroc and Wal-Mart’s Sam Walton routinely dropped in unannounced to visit their restaurants and stores. Using informal and unconventional ways to gather information is wise because formal channels can be captured by special interests within the organization or by gatekeepers, managers who may misrepresent the true state of affairs to the leader, such as may
have happened at Enron. People like Kelleher who constantly interact with employees at all levels are better able to build informal information networks than leaders who closet themselves and never interact with lower-level employees.

High-performance leaders are skilled at delegation. They recognize that unless they learn how to delegate effectively, they can quickly become overloaded with responsibilities. They also recognize that empowering subordinates to make decisions is a good motivation tool and often results in decisions being made by those who must implement them. At the same time, astute leaders recognize that they need to maintain control over certain key decisions. Thus, although they will delegate many important decisions to lower-level employees, they will not delegate those that they judge to be of critical importance to the future success of the organization, such as articulating the company’s vision and business model.

In a now classic article on leadership, Edward Wrapp noted that effective leaders tend to be very astute in their use of power. He argued that strategic leaders must often play the power game with skill and attempt to build consensus for their ideas rather than use their authority to force ideas through; they must act as members of a coalition or its democratic leaders rather than as dictators. Jeffery Pfeffer has articulated a similar vision of the politically astute manager who gets things done in organizations through the intelligent use of power. In Pfeffer’s view, power comes from control over resources that are important to the organization: budgets, capital, positions, information, and knowledge. Politically astute managers use these resources to acquire another critical resource: critically placed allies who can help them attain their strategic objectives. Pfeffer stresses that one does not need to be a CEO to assemble power in an organization. Sometimes quite junior functional managers can build a surprisingly effective power base and use it to influence organizational outcomes.

Emotional intelligence is a term that Daniel Goldman coined to describe a bundle of psychological attributes that many strong and effective leaders exhibit:

- Self-awareness—the ability to understand one’s own moods, emotions, and drives, as well as their effect on others
- Self-regulation—the ability to control or redirect disruptive impulses or moods, that is, to think before acting
- Motivation—a passion for work that goes beyond money or status and a propensity to pursue goals with energy and persistence
- Empathy—the ability to understand the feelings and viewpoints of subordinates and to take those into account when making decisions
- Social skills—friendliness with a purpose

According to Goldman, leaders who possess these attributes—who exhibit a high degree of emotional intelligence—tend to be more effective than those who lack these attributes. Their self-awareness and self-regulation help to elicit the trust and confidence of subordinates. In Goldman’s view, people respect leaders who, because they are self-aware, recognize their own limitations and, because they are self-regulating, consider decisions carefully. Goldman also argues that self-aware and self-regulating individuals tend to be more self-confident and therefore better able to cope with ambiguity and more open to change. A strong motivation exhibit-
ited in a passion for work can also be infectious, helping to persuade others to join together in pursuit of a common goal or organizational mission. Finally, strong empathy and social skills can help leaders earn the loyalty of subordinates. Empathetic and socially adept individuals tend to be skilled at managing disputes between managers, better able to find common ground and purpose among diverse constituencies, and better able to move people in a desired direction than leaders who lack these skills. In short, Goldman argues that the psychological makeup of a leader matters.

Summary of Chapter

1. A strategy is an action that a company takes to attain one or more of its goals.
2. The major goal of companies is to maximize the returns that shareholders get from holding shares in the company. To maximize shareholder value, managers must pursue strategies that result in high and sustained profitability and also in profit growth.
3. The profitability of a company can be measured by the return that it makes on the capital invested in the enterprise. The profit growth of a company can be measured by the growth in earnings per share. Profitability and profit growth are determined by the strategies managers adopt.
4. A company has a competitive advantage over its rivals when it is more profitable than the average for all firms in its industry. It has a sustained competitive advantage when it is able to maintain above-average profitability over a number of years. In general, a company with a competitive advantage will grow its profits more rapidly than rivals.
5. General managers are responsible for the overall performance of the organization or for one of its major self-contained divisions. Their overriding strategic concern is for the health of the total organization under their direction.
6. Functional managers are responsible for a particular business function or operation. Although they lack general management responsibilities, they play a very important strategic role.
7. Formal strategic planning models stress that an organization’s strategy is the outcome of a rational planning process.
8. The major components of the strategic management process are defining the mission, vision, and major goals of the organization; analyzing the external and internal environments of the organization; choosing a business model and strategies that align an organization’s strengths and weaknesses with external environmental opportunities and threats; and adopting organizational structures and control systems to implement the organization’s chosen strategies.
9. Strategy can emerge from deep within an organization in the absence of formal plans as lower-level managers respond to unpredicted situations.
10. Strategic planning often fails because executives do not plan for uncertainty and because ivory tower planners lose touch with operating realities.
11. The fit approach to strategic planning has been criticized for focusing too much on the degree of fit between existing resources and current opportunities, and not enough on building new resources and capabilities to create and exploit future opportunities.
12. Strategic intent refers to an obsession with achieving an objective that stretches the company and requires it to build new resources and capabilities.
13. In spite of systematic planning, companies may adopt poor strategies if their decision-making processes are vulnerable to groupthink and if individual cognitive biases are allowed to intrude into the decision-making process.
14. Devil’s advocacy, dialectic inquiry, and the outside view are techniques for enhancing the effectiveness of strategic decision making.
15. Good leaders of the strategy-making process have a number of key attributes: vision, eloquence, and consistency; ability to craft a business model; commitment; being well informed; a willingness to delegate and empower; political astuteness; and emotional intelligence.
Discussion Questions

1. What do we mean by strategy? How is a business model different from a strategy?
2. What do you think are the sources of sustained superior profitability?
3. Between 1997 and 2004 Microsoft’s ROIC fell from 32 percent to 17.5 percent. Over the same period, Microsoft’s profits grew from $3.45 billion to $11.33 billion. How can a company have declining profitability (as measured by ROIC) but growing profits? What do you think explains this situation at Microsoft? For 2004, analysts predicted that Microsoft’s ROIC would jump to 35 percent. Why do you think this was the case? Was it due to any change in the company’s strategy?
4. What are the strengths of formal strategic planning? What are its weaknesses?
5. Discuss the accuracy of this statement: Formal strategic planning systems are irrelevant for firms competing in high-technology industries where the pace of change is so rapid that plans are routinely made obsolete by unforeseen events.
6. Pick the current or a past president of the United States and evaluate his performance against the leadership characteristics discussed in the text. On the basis of this comparison, do you think that the president was/is a good strategic leader? Why?

Practicing Strategic Management

SMALL-GROUP EXERCISE
Designing a Planning System

Break up into groups of three to five people each, and discuss the following scenario. Appoint one group member as a spokesperson for the group, who will communicate your findings to the class when called on to do so by the instructor.

You are a group of senior managers working for a fast-growing computer software company. Your product allows users to play interactive role-playing games over the Internet. In the past three years, your company has gone from being a start-up enterprise with 10 employees and no revenues to a company with 250 employees and revenues of $60 million. It has been growing so rapidly that you have not had time to create a strategic plan, but now your board of directors is telling you that they want to see a plan, and they want it to drive decision making and resource allocation at the company. They want you to design a planning process that will have the following attributes:

1. It will be democratic, involving as many key employees as possible in the process.
2. It will help to build a sense of shared vision within the company about how to continue to grow rapidly.
3. It will lead to the generation of three to five key strategies for the company.
4. It will drive the formulation of detailed action plans, and these plans will be subsequently linked to the company’s annual operating budget.

Design a planning process to present to your board of directors. Think carefully about who should be included in this process. Be sure to outline the strengths and weaknesses of the approach you choose, and be prepared to justify why your approach might be superior to alternative approaches.

ARTICLE FILE 1

At the end of every chapter in this book is an article file task. The task requires you to search newspapers or magazines in the library for an example of a real company that satisfies the task question or issue.

Your first article file task is to find an example of a company that has recently changed its strategy. Identify whether this change was the outcome of a formal planning process or whether it was an emergent response to unforeseen events occurring in the company’s environment.

STRATEGIC MANAGEMENT PROJECT
Module 1

To give you practical insight into the strategic management process, we provide a series of strategic modules; one is at the end of every chapter in this book. Each module asks you to collect and analyze information relating to the material discussed in that chapter. By completing these strategic modules, you will gain a clearer idea of the overall strategic management process.
The first step in this project is to pick a company to study. We recommend that you focus on the same company throughout the book. Remember also that we will be asking you for information about the corporate and international strategy of your company, as well as its structure. We strongly recommend that you pick a company for which such information is likely to be available.

There are two approaches that can be used to select a company to study, and your instructor will tell you which one to follow. The first approach is to pick a well-known company that has a lot of information written about it. For example, large publicly held companies such as IBM, Microsoft, and Southwest Airlines are routinely covered in the business and financial press. By going to the library at your university, you should be able to track down a great deal of information on such companies. Many libraries now have comprehensive Web-based electronic data search facilities such as ABI/Inform, the Wall Street Journal Index, the F&ES Index, and the Nexis-Lexis databases. These enable you to identify any article that has been written in the business press on the company of your choice within the past few years. A number of nonelectronic data sources are also available and useful. For example, F&ES Predicasts publishes an annual list of articles relating to major companies that appeared in the national and international business press. S&P Industry Surveys is also a great source for basic industry data, and Value Line Ratings and Reports contains good summaries of a firm’s financial position and future prospects. Collect full financial information on the company that you pick. This can be accessed from Web-based electronic databases such as the Edgar database, which archives all forms that publicly quoted companies have to file with the Securities and Exchange Commission (SEC); for example, 10-K filings can be accessed from the SEC’s Edgar database. Most SEC forms for public companies can now be accessed from Internet-based financial sites, such as Yahoo!’s finance site (www.finance.yahoo.com/).

A second approach is to pick a smaller company in your city or town to study. Although small companies are not routinely covered in the national business press, they may be covered in the local press. More important, this approach can work well if the management of the company will agree to talk to you at length about the strategy and structure of the company. If you happen to know somebody in such a company or if you have worked there at some point, this approach can be very worthwhile. However, we do not recommend this approach unless you can get a substantial amount of guaranteed access to the company of your choice. If in doubt, ask your instructor before making a decision. The key issue is to make sure that you have access to enough interesting information to complete a detailed and comprehensive analysis.

Your assignment for Module 1 is to choose a company to study and to obtain enough information about it to carry out the following instructions and answer the questions:

1. Give a short account of the history of the company, and trace the evolution of its strategy. Try to determine whether the strategic evolution of your company is the product of intended strategies, emergent strategies, or some combination of the two.
2. Identify the mission and major goals of the company.
3. Do a preliminary analysis of the internal strengths and weaknesses of the company and the opportunities and threats that it faces in its environment. On the basis of this analysis, identify the strategies that you think the company should pursue. (You will need to perform a much more detailed analysis later in the book.)
4. Who is the CEO of the company? Evaluate the CEO’s leadership capabilities.

**EXPLORING THE WEB**

**Visiting 3M**

Go to the website of 3M (www.3m.com) and visit the section that describes its history (www.3m.com/profile/looking/index.jhtml). Using the information contained there, map out the evolution of strategy at 3M from its establishment to the present day. To what degree do you think that this evolution was the result of detailed long-term strategic planning, and to what degree was it the result of unplanned actions taken in response to unpredictable circumstances?

**General Task** Search the Web for a company site with sufficient information to map out the evolution of that company’s strategy over a significant period of time. What drove this evolution? To what degree was it the result of detailed long-term strategic planning, and to what degree the result of unplanned actions taken in response to unpredictable circumstances?
Shattered Dreams: Level 3 Communications

In 1996 Jim Crowe sold MFS Communications, the local exchange telecommunications company that he had built up from scratch, to WorldCom for $14.3 billion. As part of that sale, WorldCom got MFS’s UUNet, which at the time was the owner of the largest fiber-optic network in the nation. The business at UUNet was booming, primarily because of explosive growth in the Internet and a surge in the volume of digital data that was pumped through UUNet’s fiber-optic pipes. As for Jim Crowe, at over $150 million his take from the sale of MFS elevated him to the ranks of the superrich. He had no reason to ever work again, but Jim Crowe was not the kind of man to sit back and relax. He wanted back in the game. Like many others at the time, he was convinced that the growth of the Internet was the mother of all business opportunities.

In 1997, Crowe’s belief seemed to get validation when UUNet’s chief scientist, Michael O’Dell, stated that Internet traffic was doubling every hundred days. This implied a growth rate of over 1,000 percent a year. O’Dell went on to say that there was not enough fiber-optic capacity to go around and that “demand will far outstrip supply for the foreseeable future.” Electrified by the potential opportunity, Crowe quickly established a company to build a state-of-the-art fiber-optic network. Called Level 3 Communications, the company was funded by a number of wealthy investors, including Crowe and Walter Scott Jr., an Omaha-based construction billionaire, Crowe’s former boss, and a close friend of the legendary investor Warren Buffet. Scott himself had been dazzled by a talk given by Microsoft’s Bill Gates in 1995 in which Gates stated that “the Internet was going to radically change the world.” Moreover, Scott had funded the establishment of MFS Communications, which started off its life as a subsidiary of Scott’s construction company. Not surprisingly, Scott saw Crowe as a strategic visionary.

With Crowe as CEO and Scott as chairman, Level 3 quickly raised $3 billion. In 1998 the company went public and immediately started building its fiber-optic network. By 2001, Level 3 had raised some $13 billion, much of it in the form of debt. Crowe had a very clear strategic plan. The goal was to raise money, rapidly build a high-capacity fiber-optic network that linked major cities in the United States, and then cut prices to attract demand from major users of fiber-optic networks, including corporations, Internet service providers like AOL, and traditional telecommunications companies. Crowe believed that demand for his network would be highly price elastic: a 1 percent cut in price would increase demand significantly more than 1 percent. He argued that if he cut prices, revenues would surge, quickly using the massive capacity that Level 3 was putting in the ground. Crowe was also a big advocate of strategic focus, believing that Level 3 should concentrate exclusively on carrying Internet traffic for service providers and corporations. The business model was straightforward: Since most of the costs of the business were fixed (the costs of building out the network), profitability would be highly leveraged to volume. Once the fixed costs were covered, it would be like printing money.

Level 3 was not alone. Around the same time there was a rush of companies entering the business or expanding their networks, including 360 Networks, Global Crossing, Qwest Communications, WorldCom, Williams Communications Group, Genuity Inc., and XO Communications. In all cases, the strategic plans were remarkably similar: raise the money, build the networks, cut prices, and they will come. Surging demand would soon catch up with capacity, resulting in a profit bonanza for those who had the foresight to build out their networks. It was a gold rush, and the first into the field would stake the best claims.

However, there were dissenting voices. As early as October 1998 an Internet researcher at AT&T Labs named Andrew Odlyzko published a paper that debunked the assertion that demand for Internet traffic was growing at 1,000 percent a year. Odlyzko’s careful analysis came to the conclusion that growth was much slower, only 100 percent a year. While still large, that growth rate was not nearly large enough to fill the massive flood of fiber-optic capacity that was entering the market. Moreover, Odlyzko noted that new technologies were increasing the amount of data that could be sent down existing fibers, reducing the need for new fiber. But with investment money flooding into the market, few paid any attention to him. UUNet was still using the 1,000 percent figure as late as September 2000.

As it turned out, Odlyzko was right. Capacity rapidly outstripped demand, and by late 2002 less than 3 percent of the fiber that had been laid in the ground was actually being used. While prices tumbled, the surge in volume that Crowe had bet on did not materialize. Unable to
service the debt they had taken on to build out their networks, company after company tumbled into bankruptcy, including WorldCom, 360 Networks, XO Communications, and Global Crossing. Level 3’s stock fell by more than 95 percent, but the company avoided bankruptcy because of an infusion of $500 million in cash from a group of investors led by Warren Buffet and some quick-footed work by Jim Crowe.

Crowe’s strategic shift involved the purchase of two software distribution companies, Software Spectrum and Corporate Software, that specialized in selling, installing, and maintaining software made by companies such as Microsoft on the PCs and servers of some nine thousand corporate clients. The logic underlying the acquisitions was that Level 3 could ultimately use its fiber-optic network to distribute and maintain the software, as opposed to doing that manually, thereby reducing costs. While neither business was profitable, Crowe was able to use the acquisitions to convince investors that Level 3 still had a viable long-term strategic vision. At the same time, with the balance sheet strengthened by a cash infusion, Level 3 purchased a bankrupt competitor, Genuity, for under $300 million, helping to consolidate the industry and acquiring Genuity’s customers. Finally, in early 2004 Level 3 announced that it would use its network to offer Voice over Internet Protocol services to consumers and corporations (voice telephone calls over the Internet, as opposed to over a traditional telecommunications network), thereby taking aim at the market currently dominated by traditional wire line telephone companies.

While none of these strategic moves guarantees the survival of Level 3, the trends are encouraging. Revenues expanded to $4 billion in 2003, up from $1.53 billion in 2002, while losses fell from $4.4 billion in 2002 to $721 million in 2003. Half of 2003 revenues came from the software distribution business. Crowe still believes that ultimately his original vision will be vindicated but that the current industry structure is unsustainable and there are still too many suppliers in the marketplace. Andrew Odlyzko, who debunked the original estimates of Internet growth, believes that the excess capacity situation in the industry will not be resolved until the end of the current decade.

**Case Discussion Questions**

1. What was the planned strategy of Level 3 Communications in the late 1990s?
2. Why was Level 3 Communications able to raise so much capital?
3. Was that strategy unrealized, or is it still part of the intended strategy of the firm?
4. What have been the emergent strategies of Level 3 over the last few years? How do these emergent strategies fit with Level 3’s original plans?
5. Were any cognitive biases at work at Level 3, other communications companies, and the investment community during 1997–2001? What were those biases? What were the effects of those biases? How might an entrepreneur like Jim Crowe have avoided them?
Appendix to Chapter 1

Enterprise Valuation, ROIC, and Growth

The ultimate goal of strategy is to maximize the value of a company to its shareholders (subject to the important constraints that this is done in a legal, ethical, and socially responsible manner). The two main drivers of enterprise valuation are return on invested capital (ROIC) and the growth rate of profits, \( g \).\(^{53}\)

ROIC is defined as net operating profits less adjusted taxes (NOPLAT) over the invested capital of the enterprise (IC), where IC is the sum of the company’s equity and debt (the method for calculating adjusted taxes need not concern us here). That is:

\[
\text{ROIC} = \frac{\text{NOPLAT}}{\text{IC}}
\]

Where

\[
\text{NOPLAT} = \text{revenues} - \text{cost of goods sold} - \text{operating expenses} - \text{depreciation charges} - \text{adjusted taxes}
\]

\[
\text{IC} = \text{value of shareholders' equity} + \text{value of debt}
\]

The growth rate of profits, \( g \), can be defined as the percentage increase in net operating profits (NOPLAT) over a given time period. More precisely:

\[
g = \left[\frac{\text{NOPLAT}_{t+1} - \text{NOPLAT}_t}{\text{NOPLAT}_t}\right] \times 100
\]

Note that if NOPLAT is increasing over time, earnings per share will also increase so long as (a) the number of shares stays constant, or (b) the number of shares outstanding increases more slowly than NOPLAT.

The valuation of a company can be calculated using discounted cash flow analysis and applying it to future expected free cash flows (free cash flow in a period is defined as NOPLAT — net investments).

It can be shown that the valuation of a company so calculated is related to the company’s weighted average cost of capital (WACC), which is the cost of the equity and debt that the firm uses to finance its business, and the company’s ROIC. Specifically:

- If ROIC > WACC, the company is earning more than its cost of capital and it is creating value.
- If ROIC = WACC, the company is earning its cost of capital and its valuation will be stable.
- If ROIC < WACC, the company is earning less than its cost of capital and it is therefore destroying value.

A company that earns more than its cost of capital is even more valuable if it can grow its net operating profits less adjusted taxes (NOPLAT) over time. Conversely, a firm that is not earning its cost of capital destroys value if it grows its NOPLAT. This critical relationship between ROIC, \( g \), and value is shown in Table A1.

In Table A1, the figures in the cells of the matrix represent the discounted present values of future free cash flows for a company that has a starting NOPLAT of $100, invested capital of $1,000, a cost of capital of 10 percent, and a 25-year time horizon after which ROIC = cost of capital.

The important points revealed by this exercise are as follows:

1. A company with an already high ROIC can create more value by increasing its profit growth rate rather than pushing for an even higher ROIC. Thus a company with an ROIC of 15 percent and a 3 percent growth rate can create more value by increasing its profit growth rate from 3 percent to 9 percent than it can by increasing ROIC to 20 percent.

### Table A1

<table>
<thead>
<tr>
<th>NOPLAT Growth, ( g )</th>
<th>ROIC 7.5%</th>
<th>ROIC 10.0%</th>
<th>ROIC 12.5%</th>
<th>ROIC 15%</th>
<th>ROIC 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>3%</td>
<td>887</td>
<td>1,000</td>
<td>1,058</td>
<td>1,113</td>
<td>1,170</td>
</tr>
<tr>
<td>6%</td>
<td>708</td>
<td>1,000</td>
<td>1,117</td>
<td>1,295</td>
<td>1,442</td>
</tr>
<tr>
<td>9%</td>
<td>410</td>
<td>1,000</td>
<td>1,354</td>
<td>1,591</td>
<td>1,886</td>
</tr>
</tbody>
</table>
2. A company with a low ROIC destroys value if it grows. Thus, if ROIC = 7.5 percent, a 9 percent growth rate for 25 years will produce less value than a 3 percent growth rate. This is because unprofitable growth requires capital investments, the cost of which cannot be covered. Unprofitable growth destroys value.

3. The best of both worlds is high ROIC and high growth.

Very few companies are able to maintain an ROIC > WACC and grow NOPLAT over time, but there are some notable examples, including Dell, Microsoft, and Wal-Mart. Because these companies have generally been able to fund their capital investment needs from internally generated cash flows, they have not had to issue more shares to raise capital. Thus growth in NOPLAT has translated directly into higher earnings per share for these companies, making their shares more attractive to investors and leading to substantial share price appreciation. By successfully pursuing strategies that result in a high ROIC and growing NOPLAT, these firms have maximized shareholder value.