FUNDAMENTALS OF STRATEGY

FIFTH EDITION

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Pearson

About *Fundamentals of Strategy*

Based on the twelfth edition of the market-leading *Exploring Strategy*, this book concentrates on the fundamental issues and techniques of strategy. The book will particularly suit those on short courses in strategy focused on strategy analysis, or studying strategy as part of a wider degree, perhaps in the sciences or engineering. This fifth edition of *Fundamentals of Strategy* reflects contemporary business issues and is updated to reflect the covid-19 pandemic. Concepts that are particularly relevant given the recent crisis include PESTEL and scenario analysis (Chapter 2), dynamic capabilities (Chapter 4), stakeholders and corporate social responsibility (Chapter 5) and strategic change (Chapter 9).

Readers of *Fundamentals of Strategy* can be sure that they have the core concepts of strategy in this book, while knowing that they can easily go deeper into particular topics by referring to the complete twelfth edition of *Exploring Strategy*. There they will find extended treatments of the issues covered here, as well as greater attention to issues of strategy development and change and the role of the strategist. *Exploring Strategy* also offers more cases and deeper exploration of issues through 'Thinking Differently' modules, 'strategy lenses' and 'commentaries'. A brief contents of *Exploring Strategy* can be found on p. v. Teachers familiar with *Exploring Strategy* will find that the definitions, concepts and the content of *Fundamentals of Strategy* are entirely consistent, making it easy to teach courses using the different books in parallel.

Fundamentals of Strategy now has nine chapters, with the emphasis on what *Exploring Strategy* terms the 'strategic position' and 'strategic choices' facing organisations. Under 'strategic position', *Fundamentals* introduces macro-environmental and industry analysis, resource and capability analysis, stakeholders and culture. Under 'strategic choices', the book addresses business-level strategy, business models, corporate-level strategy, international strategy, strategic entrepreneurship, innovation and mergers and acquisitions. The final ninth chapter, 'Strategy in action', raises implementation issues such as organisational structure, managerial systems and strategic change.

We believe that *Fundamentals of Strategy* brings the proven benefits of *Exploring Strategy* to the growing number of students on shorter courses. We hope that you will enjoy using it too.

A guide to getting the most from all the features and learning materials of *Fundamentals of Strategy* follows this preface.

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The *development stage* is an experimental one, typically with few players, little direct rivalry and highly differentiated products. The five forces are likely to be weak, therefore, though profits may actually be scarce because of high investment requirements. The next stage is one of *high growth*, with rivalry low as there is plenty of market opportunity for everybody. Low rivalry and keen buyers of the new product favour profits at this stage, but these are not certain. Barriers to entry may still be low in the growth stage, as existing competitors have not built up much scale, experience or customer loyalty. Suppliers can be powerful too if there is a shortage of components or materials that fast-growing businesses need for expansion. The *shake-out stage* begins as the market becomes increasingly saturated and cluttered with competitors. Profits are variable, as increased rivalry forces the weakest competitors out of the business. In the *maturity stage*, barriers to entry tend to increase, as control over distribution is established and economies of scale and experience curve benefits come into play. Products or services tend to standardise, with relative price becoming key. Buyers may become more powerful as they become less avid for the industry's products and more confident in switching between suppliers. Profitability at the maturity stage relies on high market share, providing leverage against buyers and competitive advantage in terms of cost. The *decline stage* can be a period of extreme rivalry, especially where there are high exit barriers, as falling sales force remaining competitors into dog-eat-dog competition. However, survivors in the decline stage may still be profitable if competitor exit leaves them in a monopolistic position. Figure 3.2 summarises some of the conditions that can be expected at different stages in the life cycle.

It is important to avoid putting too much faith in the inevitability of life-cycle stages. One stage does not follow predictably after another. First, industries vary widely in the length of their growth stages. Many internet-based industries have matured quickly and moved through the stages in less than a decade, for example online travel and dating services. Second, some industries can rapidly 'de-mature' through radical innovation. Thus, the telephony industry, based for nearly a century on fixed-line telephones, rejuvenated rapidly with the introduction of mobile and internet telephony.

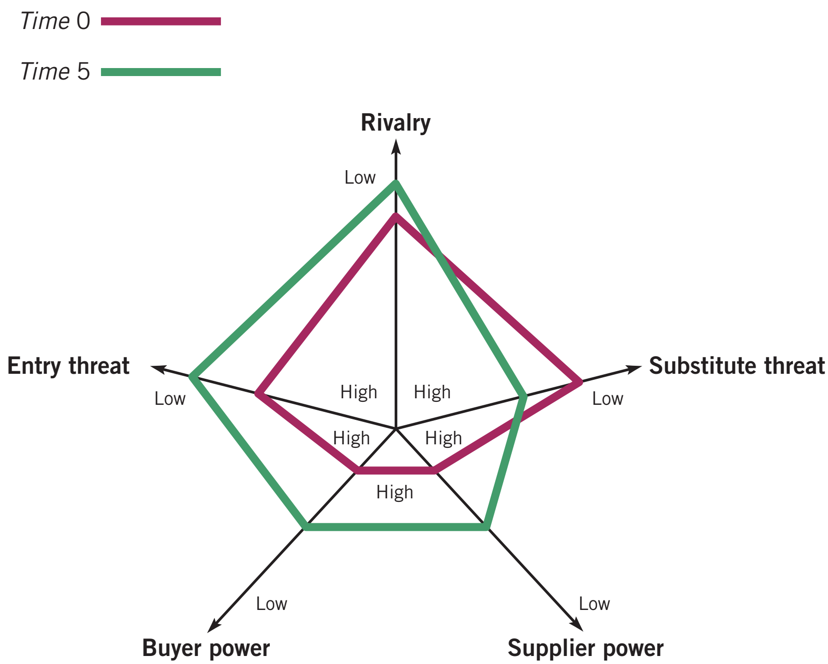
3.3.2 Comparative industry structure analyses

The previous sub-section raised the issue of how competitive forces may change over time. The industry life cycle thus underlines the need to make industry structure analysis dynamic. This implies that we not only need to understand the current strength of the competitive forces, but how it may change over time. One effective means of doing this is to compare the competitive five forces over time in a simple 'radar plot'.

Figure 3.3 provides a framework for summarising the power of each of the five forces on five axes. Power diminishes as the axes go outwards. Where the forces are low, the total area enclosed by the lines between the axes is large; where the forces are high, the total area enclosed by the lines is small. The larger the enclosed area, therefore, the greater is the profit potential. In Figure 3.3, the industry at Time 0 (represented by the red lines) has relatively low rivalry (just a few competitors) and faces low substitution threats. The threat of entry is moderate, but both buyer power and supplier power are relatively high. Overall, this looks like only a moderately attractive industry to invest in.

However, given the dynamic nature of industries, managers need to look forward. Figure 3.3 represents five years forward by the green lines. Managers are predicting in this case some rise in the threat of substitutes (perhaps new technologies will be developed). On the other hand, they predict a falling entry threat, while both buyer power and supplier power will be easing. Rivalry will reduce still further. This looks like a classic case of an industry in which a few players emerge with overall dominance. The area enclosed by the green lines

Figure 3.3 Comparative industry structure analysis



is large, suggesting a relatively attractive industry. For a firm confident of becoming one of the dominant players, this might be an industry well worth investing in.

Comparing the five forces over time on a radar plot thus helps to give industry structure analysis a dynamic aspect. The lines are only approximate, of course, because they aggregate the many individual elements that make up each of the forces into a simple composite measure. Such radar plots can nonetheless be both a useful device for initial analysis and an effective summary of a final, more refined and dynamic analysis.

3.4 Competitors and markets

An industry or sector may be too high a level to provide for a detailed understanding of competition. The five forces can impact differently on different kinds of players, requiring a more fine-grained understanding. For example, Hyundai and Porsche may be in the same broad industry (automobiles), but they are positioned differently: they are protected by different barriers to entry and competitive moves by one are unlikely to affect the other. It is often useful to disaggregate. Many industries contain a range of companies, each of which have different capabilities and compete on different bases. Some of these competitor differences are captured by the concept of *strategic groups*. Customers too can differ significantly, and these can be captured by distinguishing between different *market segments*. Thinking in terms of different strategic groups and market segments provides opportunities for organisations to develop highly distinctive positionings within broader industries. Besides disaggregating the analysis of industry competition these approaches may help in understanding how value is created differently by different competitors.

3.4.1 Strategic groups

Strategic groups are organisations within the same industry or sector with similar strategic characteristics, following similar strategies or competing on similar bases.[8] These characteristics are different from those in other strategic groups in the same industry or sector. For example, in the grocery retailing industry, supermarkets, convenience stores and corner shops each form different strategic groups. There are many different characteristics that distinguish between strategic groups and these can be grouped into two major categories of strategic dimensions (see Figure 3.4). First, the *scope* of an organisation's activities (such as product range, geographical coverage and range of distribution channels used). Second, the *resource commitment* (such as brands, marketing spend and extent of vertical integration). Which characteristics are relevant differs from industry to industry, but typically important are those characteristics that separate high performers from low performers. It helps to make a competitive force analysis first as it identifies different types of rivals.

Strategic groups can be mapped onto two-dimensional charts – for example, one axis might be the extent of product range and the other axis the size of marketing spend. One method for choosing key dimensions by which to map strategic groups is to identify top performers (by growth or profitability) in an industry and to compare them with low performers. Characteristics that are shared by top performers, but not by low performers, are likely to be particularly relevant for mapping strategic groups. For example, the most profitable firms in an industry might all be narrow in terms of product range, and lavish in terms of marketing spend, while the less profitable firms might be more widely spread in terms of products and restrained in their marketing. Here the two dimensions for mapping would be product range and marketing spend. A potential recommendation for the less profitable firms would be to cut back their product range and boost their marketing.

Figure 3.4 Some characteristics for identifying strategic groups

Strategic dimensions are based on the extent to which organisations differ in terms of **characteristics** such as:

Scope of activities

- Extent of product (or service) range
- Extent of geographical coverage (e.g. national, regional, global)
- Number of market segments served
- Distribution channels used

Resource commitment

- Extent (number) of **branding**
- **Marketing effort** (e.g. advertising spread, size of salesforce)
- Extent of **vertical integration**
- Product or service **quality**
- R&D spending and technological leadership (leader vs. follower)
- **Size** of organisation

The strategic group concept is useful in at least three ways. First, for *understanding competition*: managers can focus on their direct competitors within their particular strategic group, rather than the whole industry as rivalry often is strongest between these. Second, in *analysing strategic opportunities*: strategic group maps can identify the most attractive 'strategic spaces' within an industry. Finally, strategic groups are helpful when *analysing mobility barriers*. Of course, moving across the strategic group map to take advantage of opportunities is not costless. Often it will require difficult decisions and rare resources. Strategic groups are therefore characterised by 'mobility barriers', obstacles to movement from one strategic group to another. These are the equivalent to barriers to entry in five forces analysis, but between different strategic groups within the same industry.

3.4.2 Market segments

The concept of strategic groups discussed above helps with understanding the similarities and differences in terms of competitor characteristics. Industries can also be disaggregated into smaller and specific market sections known as segments. The concept of market segment focuses on differences in *customer* needs. A **market segment**[9] **is a group of customers who have similar needs that are different from customer needs in other parts of the market.** Where these customer groups are relatively small, such market segments are often called 'niches'. Dominance of a market segment or niche can be very valuable, for the same reasons that dominance of an industry can be valuable following five forces reasoning.

Segmentation should reflect an organisation's strategy[10] and strategies based on market segments must keep customer needs firmly in mind. Therefore, two issues are particularly important in market segment analysis:

- *Variation in customer needs.* Focusing on customer needs that are highly distinctive from those typical in the market is one means of building a long-term segment strategy. Customer needs vary for a whole variety of reasons – some of which are identified in Table 3.1.

Table 3.1 Some bases of market segmentation

Type of factor	Consumer markets	Industrial/organisational markets
Characteristics of people/organisations	Age, gender, ethnicity Income Family size Life-cycle stage Location Lifestyle	Industry Location Size Technology Profitability Management
Purchase/use situation	Size of purchase Brand loyalty Purpose of use Purchasing behaviour Importance of purchase Choice criteria	Application Importance of purchase Volume Frequency of purchase Purchasing procedure Choice criteria Distribution channel
Users' needs and preferences for product characteristics	Product similarity Price preference Brand preferences Desired features Quality	Performance requirements Assistance from suppliers Brand preferences Desired features Quality Service requirements

Theoretically, any of these factors could be used to identify distinct market segments. However, the crucial bases of segmentation vary according to market. In industrial markets, segmentation is often thought of in terms of industrial classification of buyers: steel producers might segment by automobile industry, packaging industry and construction industry, for example. On the other hand, segmentation by buyer behaviour (e.g. direct buying versus those users who buy through third parties such as contractors) or purchase value (e.g. high-value bulk purchasers versus frequent low-value purchasers) might be more appropriate. Being able to serve a highly distinctive segment that other organisations find difficult to serve is often the basis for a secure long-term strategy.

- *Specialisation* within a market segment can also be an important basis for a successful segmentation strategy. This is sometimes called a 'niche strategy'. Organisations that have built up most experience in servicing a particular market segment should not only have lower costs in so doing, but also have built relationships which may be difficult for others to break down. Experience and relationships are likely to protect a dominant position in a particular segment. However, precisely because customers value different things in different segments, specialised producers may find it very difficult to compete on a broader basis. For example, a small local brewery competing against the big brands on the basis of its ability to satisfy distinctive local tastes is unlikely to find it easy to serve other segments where tastes are different, scale requirements are larger and distribution channels are more complex.

3.5 Opportunities and threats

The concepts and frameworks discussed above and in Chapter 2 should be helpful in understanding the factors in the macro-, industry and competitor/market environments of an organisation. However, the critical issue is the *implications* that are drawn from this understanding in guiding strategic decisions and choices. The crucial next stage, therefore, is to draw from the environmental analysis specific strategic opportunities and threats for the organisation. Identifying these opportunities and threats is extremely valuable when thinking about strategic choices for the future (the subject of Chapter 6). Opportunities and threats form one half of the Strengths, Weaknesses, Opportunities and Threats (SWOT) analyses that shape many companies' strategy formulation (see Section 4.4.3). In responding strategically to the environment, the goal is to reduce identified threats and take advantage of the best opportunities.

The techniques and concepts in this and the previous chapter should help in identifying environmental threats and opportunities, for instance:

- *PESTEL analysis* of the macro-environment might reveal threats and opportunities presented by technological change, or shifts in market demographics or such like factors (see Chapter 2).
- Identification of *key drivers for change* can help generate different *scenarios* for managerial discussion, some more threatening and others more favourable.
- *Porter's five forces analysis* might, for example, identify a rise or fall in barriers to entry, or opportunities to reduce industry rivalry, perhaps by acquisition of competitors.

Summary

- The environment influence closest to an organisation includes the *industry or sector*.
- Industries and sectors can be analysed in terms of *Porter's five forces* – barriers to entry, substitutes, buyer power, supplier power and rivalry. Together with *complementors* these determine industry or sector attractiveness and possible ways of managing strategy.
- Industries and sectors are dynamic, and their changes can be analysed in terms of the *industry life cycle* and *comparative five forces radar plots*.
- Within industries *strategic group* analysis and *market segment* analysis can help identify strategic gaps or opportunities.

Recommended key readings

- The classic book on the analysis of industries is M.E. Porter, *Competitive Strategy*, Free Press, 1980. An update is available in M.E. Porter, 'The five competitive forces that shape strategy', *Harvard Business Review*, vol. 86, no. 1 (2008), pp. 58–77.
- For an in-depth discussion of how to apply Porter's Competitive Force Framework, see J. Magretta, *Understanding Michael Porter: The Essential Guide to Competition and Strategy*, Harvard Business Review Press, 2012.

References

1. See M.E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, Free Press, 1980, p. 5.
2. See endnote 1 above and M. Porter, 'The five competitive forces that shape strategy', *Harvard Business Review*, vol. 86, no. 1 (2008), pp. 58–77.
3. A. Brandenburger and B. Nalebuff, 'The right game', *Harvard Business Review*, July–August 1995, pp. 57–64.
4. See A. Brandenburger and B. Nalebuff, *Co-opetition*, Doubleday, New York, 1996 and K. Walley, 'Coopetition: an introduction to the subject and an agenda for research', *International Studies of Management and Organization*, vol. 37, no. 2 (2007), pp. 11–31.
5. For an overview of recent empirical research of strategy and network effects see D.P. McIntyre and M. Subramaniam, 'Strategy in network industries: a review and research agenda', *Journal of Management* (2009), pp. 1–24.
6. See for example F. Hacklin, B. Battistini, and G. Von Krogh. 'Strategic choices in converging industries', *MIT Sloan Management Review* 55.1 (2013): 65–73.
7. A classic academic overview of the industry life cycle is S. Klepper, 'Industry life cycles', *Industrial and Corporate Change*, vol. 6, no. 1 (1996), pp. 119–43.
8. For examples of strategic group analysis, see G. Leask and D. Parker, 'Strategic groups, competitive groups and performance in the UK pharmaceutical industry', *Strategic Management Journal*, vol. 28, no. 7 (2007), pp. 723–45; and W. Desarbo, R. Grewal and R. Wang, 'Dynamic strategic groups: deriving spatial evolutionary paths', *Strategic Management Journal*, vol. 30, no. 8 (2009), pp. 1420–39.
9. A useful discussion of segmentation in relation to competitive strategy is provided in M.E. Porter, *Competitive Advantage*, Free Press, 1985, Chapter 7.
10. For a discussion of how market segmentation needs to be broadly related to an organisation's strategy and not only narrowly focused on the needs of advertising see D. Yankelovich and D. Meer, 'Rediscovering market segmentation', *Harvard Business Review*, February, 2006, pp. 73–80.