**Chapter 1 Lecture Note**

**Strategy, Business Models, and Competitive Advantage**

Chapter Summary

Chapter one explores the fundamental concepts surrounding organizational strategy. It begins with an explanation of the term strategy and discusses why companies need a distinctive strategy in order to compete successfully. Next, it explores why a company must have a viable business model and the five most dependable strategic approaches for setting a company apart. The chapter wraps up with an illustration of how a company’s strategy tends to evolve over time due to changing business conditions and the three tests for winning strategies.

Lecture Outline

**I. The Importance of Managing Strategically**

1. A company’s strategy spells out why the company matters in the marketplace by defining its approach to creating superior value for customers and how capabilities and resources will be employed to deliver the desired value to customers.

2. In effect, managers must determine how many and which strategic options to pursue including:

a. How to create products or services that attract and please customers.

b. How to position the company in the industry.

c. How to develop and deploy resources to build valuable competitive capabilities.

d. How each functional piece of the business (R&D, supply chain activities, production, sales and marketing, distribution, finance, and human resources) will be operated.

e. How to achieve the company’s performance targets.

CORE CONCEPT

A company’s **strategy** explains why the company matters in the marketplace by specifying an approach to creating superior value for customers and determining how capabilities and resources will be utilized to deliver the desired value to customers.

**II. The Importance of Strategic Uniqueness**

1. For a company to matter in the minds of customers, its strategy needs a distinctive element that sets it apart from rivals and produces a competitive edge.

2. Simply trying to mimic the strategies of the industry’s successful companies never works.

3. Every company’s strategy needs to have some distinctive element that draws in customers and produces a competitive edge.

**III. Strategy and a Company’s Business Model**

1. A company’s business model is management’s blueprint for delivering a valuable product or service to customers in a manner that will yield an attractive profit.

2. The two elements of a company’s business model are:

a. *Customer value proposition* - The company’s approach to satisfying buyer wants and needs at a price customers will consider a good value.

b. *Profit formula* - The company’s approach to determining a cost structure that will allow for acceptable profits given the pricing tied to its customer value proposition

CORE CONCEPT

A company’s **business model** sets forth how its strategy and operating approaches will create value for customers, while at the same time generate ample revenues to cover costs and realize a profit. The two elements of a company’s business model are its (1) customer value proposition and (2) its profit formula.

Concepts & Connections - 1.1 Pandora, Sirius XM, and Over-the-Air Broadcast Radio: Three Contrasting Business Models

Discussion Question: 1. What is the prominent difference between the business models of these three organizations?

Answer: While all three provide essentially the same type of entertainment service, the business models employed by Pandora, Sirius XM, and Over-The-Air Broadcast Radio are completely different. In the area of value proposition (what the customer sees), Sirius XM provides commercial free entertainment with some local content based upon a monthly fee, while Broadcast Radio provides entertainment with some local content with interruptions for commercials without a fee. Pandora bridges these two methods. In one mode it operates more like Over-the-Air Broadcast Radio in that it provides entertainment without a fee that includes targeted advertisements, with the added benefit of allowing the listener to customize the music mix. In the other mode, listeners can elect to go ad-free for a fee using Pandora One.

For profit, Sirius XM must attract a large enough customer base in order to cover costs and provide profit, while Broadcast Radio must attract a large enough advertiser base to cover costs and provide profit. Pandora, once again bridging the two, generates profit by either an advertiser base or through ad-free services.

**IV. Strategy and the Quest for Competitive Advantage**

1. The heart and soul of any strategy is the actions and moves in the market place that managers are taking to gain a competitive edge over rivals.

a. Low Cost Provider - Achieving a cost-based advantage over rivals.

b. Broad Differentiation - Seeking to differentiate the company’s product or service from rivals’ in ways that will appeal to a broad spectrum of buyers.

c. Focused Low Cost – Concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by having lower costs than rivals and thus being able to serve niche members at a lower priced.

d. Focused Differentiation – Concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by offering niche members customized attributes that meet their tastes and requirements better than rivals’ products.

e. Best Cost Provider - Giving customers more value for the money by satisfying buyers’ expectations on key quality/features/performance/service attributes, while beating their price expectations.

CORE CONCEPT

A company achieves **sustainable competitive advantage** when an attractively large number of buyers develop a durable preference for its products or services over the offerings of competitors, despite the efforts of competitors to overcome or erode its advantage.

**V. The Importance of Capabilities in Building and Sustaining Competitive Advantage**

1. Winning a *sustainable* competitive edge over rivals with any of the five strategies relies on two interrelated efforts:

a. Building competitively valuable capabilities that rivals cannot readily match.

b. Having a distinctive product offering.

Concepts & Connections - 1.2 Starbucks’ Strategy in the Specialty Coffee Market

Discussion Question: 1. How did Starbucks develop a sustainable competitive advantage in the specialty coffee market?

Answer: Starbucks has developed a unique customer experience through their store ambiance that is difficult and expensive for rivals to match. This experience which includes the product, the environment it is served in, and the service itself, is intended to create an emotional attachment with their customers. Their product offerings are broad and include not only coffee and specialty coffee drinks, but also teas, fresh pastries, and other merchandise. They have carefully nurtured their global brand through strategic expansion, and ensure the consistency of the customer experience through the consistency of their store operations.

**VI. Why a Company’s Strategy Evolves over Time**

1. Every company must be willing and ready to modify its strategy in response to changing market conditions, advancing technology, competitive moves, shifting buyer needs and preferences, emerging market opportunities, new ideas for improving the strategy, and mounting evidence that the strategy is not working well.

2. Most of the time a company’s strategy evolves incrementally from management’s ongoing efforts to fine tune pieces of the strategy, but, on occasion, major strategy shifts are called for.

3. The evolving nature of a company’s strategy means the typical company strategy is a blend of (1) proactive moves to improve the company’s financial performance and secure a competitive edge and (2) adaptive reactions to unanticipated developments and fresh market conditions.

4. **Figure** **1.1,** **A** **Company’s** **Strategy** **is** **a** **Blend** **of** **Proactive** **Initiatives** **and** **Reactive** **Adjustments,** depicts the typical blend found within a company’s strategy.

5. A company’s realized strategy tends to be a combination of proactive and reactive elements.

CORE CONCEPT

A company’s **realized strategy** is a combination deliberate planned elements and unplanned emergent elements. Some components of a company’s deliberate strategy will fail in the marketplace and become abandoned strategy elements.

**VII. The Three Tests of a Winning Strategy**

1. Three Questions can be used to distinguish a winning strategy from a so-so or flawed strategy:

a. How well does the strategy fit the company’s situation?

b. Is the strategy helping the company achieve a sustainable competitive advantage?

c. Is the strategy producing good company performance?

1. Strategies that come up short on one or more of the above tests are plainly less appealing than strategies passing all three tests with flying colors.

**VIII. Why Crafting and Executing Strategy are Important Tasks**

1. High-achieving enterprises are nearly always the product of astute, creative, and proactive strategy making.

2. Indeed, good strategy and good strategy execution are the most telling signs of good management.

**IX. The Road Ahead**

1. Throughout the remaining chapters and the accompanying case collection, the spotlight is trained on the foremost question in running a business enterprise: What must managers do, and do well, to make a company a winner in the marketplace?

2. The mission of this book is to provide a solid overview of what every business student and aspiring manager needs to know about crafting and executing strategy.

**Assurance of Learning Exercises**

1. Based on your experiences as a coffee consumer, does Starbucks’ strategy as described in Concepts & Connections 1.2 seem to set it apart from rivals? Does the strategy seem to be keyed to a cost-based advantage, differentiating features, serving the unique needs of a niche, or some combination of these? What is there about Starbucks’ strategy that can lead to sustainable competitive advantage?

Response:

**Setting Itself Apart** - The student should identify key elements in Starbucks’ strategy that set it apart from rivals. These include their unique customer experience. This experience which includes the product, the environment it is served in, and the service itself, is intended to create an emotional attachment with their customers. Their product offerings are broad and include not only coffee and specialty coffee drinks, but also teas, fresh pastries, and other merchandise. They have carefully nurtured their global brand through strategic expansion, and ensure the consistency of the customer experience through the consistency of their store operations.

**Elements of Strategy** - The student should identify that Starbucks’ strategy seems to by keyed on differentiating features as described above as well as targeting some specific niche elements. These include customers who prefer a companies that make a commitment to corporate responsibility including protecting the environment and community where they operate and engaging in ‘fair trade’ practices with their suppliers.

**Sustainable Competitive Advantage** - The student should identify that developing a sustainablecompetitive advantage relies on a) building competitively valuable capabilities that rivals cannot readily match and b) having a distinctive product offering. Further, they should be able to highlight that the two areas described above are both distinctive and difficult to match.

2. Go to <http://www.nytco.com/investors> and check whether *The New York Times* ’ recent financial reports indicate that its business model is working. Does the company’s business model remain sound as more consumers go to the Internet to find general information and stay abreast of current events and news stories? Is its revenue stream from advertisements growing or declining? Does its cost structure allow for acceptable profit margins?

Response:

**General** - The responses developed by the students may include information such as the following. The New York Times Company is a leading media company that includes The New York Times, the International Herald Tribune, The Boston Globe, 15 other daily newspapers and more than 50 Web sites. The company’s core purpose is to enhance society by creating, collecting and distributing high-quality news, information and entertainment.

**Is the business model working** - The student should note that the company’s annual revenue has declined steadily over the last five reporting periods from $2.939B in 2008 to $1.990B in 2012, while net income has fluctuated greatly over the period with a profit of $107M in 2010, a loss of $57.8M in 2008, a loss of $39.67M in 2011, and a recent profit of $133M in 2012. This illustrates a reducing value proposition (revenue) as well as an ineffective and unpredictable profit formula (earnings). The conclusion the student should reach is that the business model is not working effectively.

**Transition to Internet** - Based on a review of the Web site, students should recognize there is evidence the company’s business model is both changing and evolving. The company was proactive in assessing several changes in the media industry. For example, consumers are increasingly getting news and information from the Web, and advertisers are paying lower rates online than for print. When the print and digital operations of newspapers in the U. S. are combined, audiences are growing. These changes were also complicated by the downturn in the U. S. economy. The company believes it has earned the trust of its readers by employing professional journalists to verify news for truth, for accuracy and for context. The company also believes that “newspapers play a critical role in the civic life of our country. Information is the lifeblood of our democracy, and the work that our journalists do enables citizens to make thoughtful decisions.” While newspapers will continue to be an important medium, the company recognizes it must provide high-quality journalism in an increasing number of ways.

Thus, the Times Company has embarked on transforming from a company focused primarily on print to one that is increasingly digital in focus and multiplatform in delivery. This strategy involves a four-pronged emphasis on the following: (1) introduce new products and services both in print and online (goal is to deliver high-quality journalism so consumers can access it wherever and whenever they want it); (2) strengthen digital research and development capability to support the development of new products and alliances; (3) aggressively restructure the cost base via expense reductions in several areas; and (4) rebalance the portfolio of businesses through both acquisitions and divestitures (sell assets that no longer fit well with the Company).

**Revenue stream from advertisements** - The students should highlight that while the company has expanded and intends to continue to expand their digital offerings to generate revenue, the largest portion of the company’s revenues are currently from traditional print products where advertising revenues are declining. Fiscal 2012 was the first time in the company’s history that circulation revenues surpassed advertising revenues. This was in large part due to the significant growth in digital subscription base, which at year-end totaled approximately 668,000 paying subscribers to the company’s digital products.

**Cost Structure** - The students should highlight that operating costs as a percent of revenue declined from approximately 97% in 2008 and 2009 to approximately 92% in 2010 through 2012. The company has reduced its operating costs by reducing staff as well as benefits and implementing general cost-control measures across the company. To ensure acceptable profit margins, the company will need to continue managing expenses and possibly implementing further cost-control measures. However, as the company has pointed out in their annual report, these efforts could also adversely affect the company’s ability to attract and retain key employees, which could ultimately hurt the quality of the products.

3. Elements of eBay’s strategy have evolved in meaningful ways since the company’s founding in 1995. After reviewing all of the links at the company’s investor relations site, which can be found at [investor.ebayinc.com](http://investor.ebayinc.com), prepare a one to two page report that discusses how its strategy has evolved. Your report should also assess how well eBay’s strategy passes the three tests of a winning strategy.

Response:

**Strategy Evolution** - The student’s report should identify that the company’s strategy has evolved as technology has evolved and changed how and when people connect to the internet. As the CEO describes in his letter to shareholders, “Five years ago we only “connected” to the Internet when we sat in front of a laptop or desktop computer. Today we connect to the web seven days a week, 24 hours a day through our smartphones and other connected devices. This is impacting every dimension of our lives, including how we shop and how we pay.” In this sense, the company has diversified its product offering to include not only merchandise through its ‘commerce partners’ but also payment methods while at the same time broadening its distribution channels to include all types of ‘connected’ devices. The company feels that the pace of innovation will continue to accelerate and intends to keep pace with that change.

**Strategy Assessment** - The student’s report should include specific indications that the company’s strategy is a winner to as follows.

a. Does the strategy fit the company’s situation? - Yes, the company’s strategy fits the evolving world of e-commerce and internet connectivity.

b. Does the strategy helping the company achieve a sustainable competitive advantage? - Yes, the growing base of commerce partners which include retailers of all sizes as well as the ability to handle secure global payment transactions have created a sustainable competitive advantage.

c. Does the strategy producing good company performance? - Yes, market growth ($175B in Commerce Volume in 2012 with $14.1 in Revenue) and profit growth ($2.6B in Net Income in 2012) indicate strong performance.