Chapter 2

Chapter 2

Analyzing the External Environment of the Firm: *Creating Competitive Advantages*

Summary/Objectives

PowerPoint Slide 2: Learning Objectives

The purpose of this chapter is to familiarize students with techniques for evaluating a firm's external environment. This chapter focuses on the value managers add when they have a sense of events outside the company. By focusing on external events, managers are able to stay a step ahead of competitors by accurately anticipating and promptly responding to actions that can impact the organization. The chapter is organized into three sections.

1. The environmentally aware organization. Emphasize that managers use scanning, monitoring, and competitive intelligence to develop forecasts. Also, the role of scenario planning is discussed.

2. The influence of the six broad segments (demographic, sociocultural, political/legal, technological, economic, global) of the general environment of the firm.

3. The role of the competitive (also called the task or industry) environment and its analysis through the application of Porter's five-forces model. We address how industry and competitive practices are being affected by the Internet and digital technologies. We also address the concept of strategic groups. Managers use strategic groups to identify who its main competitors are and how a company fits in with the overall industry in which it competes.

Lecture/Discussion Outline

We lead off the chapter with the opening case of Cell Zone in LEARNING FROM MISTAKES. Here's a firm that clearly did a poor job of recognizing and understanding the opportunity and threats in the external environment. Ask:

Discussion Question 1: *What is the biggest stumbling block for Cell Zone?*

Response guidelines: Students should understand that there are a few links in the chain of events that prevent Cell Zone's success. Most obviously, there is the issue of low demand for the product. Few restaurants and libraries are willing to pay Cell Zone, or otherwise devote space, for its cell phone booths. Restaurants might support Cell Zone if loud cell phone conversations were more of a problem, and if Cell Zone offered an effective response. The next possible issue is the rise of quiet text messaging as a way to communicate in a more considerate way. In effect, a new technology, text messaging, solved much of the loud cell phone conversation problem.

But both these issues may be only part of Cell Zone's problem. Students may identify other relevant issues, such as the effectiveness of the Cell Zone booths, the possibility of imitation booths that may use similar design, consumers' use of other areas within restaurants for talking on their cell phones, and the possible unwillingness of customers to use the booths.

Discussion Question 2: *Are there other market segments where Cell Zone might work?*

Response guidelines: Students may come up with a few intriguing suggestions. After they do, instructors may want to develop characteristics of the market segments. Some characteristics may be:

- Situations where calls contain confidential information that should not be overheard, such as by lawyers, executives, military, police, and doctors.
- Places where the atmosphere requires quiet, such as libraries, lecture halls, or concert halls.

These two characteristics suggest segments such as law firms, prisons, government offices, schools, concert halls, and doctor's offices. This list is only suggestive, and students can be encouraged to consider other possibilities.

I. Enhancing Awareness of the External Environment

PowerPoint Slide 3: The Importance of External Environment
PowerPoint Slide 4: Enhancing Awareness of the External Environment
PowerPoint Slide 5: Environmental Scanning & Monitoring
PowerPoint Slide 6: Competitive Intelligence
PowerPoint Slide 7: Environmental Forecasting
PowerPoint Slide 9: SWOT Analysis

We address three important processes—scanning, monitoring, and gathering competitive intelligence—which managers use to develop environmental forecasts. EXHIBIT 2.1 depicts relationships among these activities. Also, we address scenario analysis and its role in anticipating future major changes in the external environment as well as the role of SWOT analysis.

We lead off the section with a discussion of Ram Charan's concept of "perceptual acuity"—the ability to sense what is coming before the fog clears. We give three examples of what three CEOs have done to improve their perceptual acuity: met with key managers periodically to discuss what is going on, met with the CEOs of other organizations four times a year, and asked outsiders to critique their firm's strategy.

Teaching Tip: *Most students in your class will not likely be CEOs or top executives. So, one way to help them apply this idea is to ask them how they could apply it in their present position—or in a job to which they immediately aspire. Hopefully, they will come up with ideas such as spending time with people in their organization to address issues outside of their immediate job, describing how their efforts affect other* *areas/departments in the firm, and seeking perspectives of colleagues and friends who work in a different organization. The key point, of course, is to encourage them to look at issues from a broader perspective instead of focusing on their immediate work responsibilities.*

A. The Role of Scanning, Monitoring, Competitive Intelligence, and Forecasting

1. Environmental Scanning

Environmental scanning involves surveillance of the firm's external environment to predict environmental changes to come and detect changes that are already underway. We discuss the example of how Procter & Gamble, with its wide range of household products, can be a good barometer of household spending.

Discussion Question 3: *Would these "tips" be equally appropriate for all industries? Why? Why not?*

Discussion Question 4: *Could such an approach be used in other industries? What investments would be required?*

Environmental scanning can also involve obtaining information from your customer base. The SUPPLEMENT below provides an example of how this was effectively used by an online contact-lens retailer, Coastal Contacts.

Extra Example: Ask your Customers for Ideas

Coastal Contacts, one of the largest online contact-lens retailers in North America, came out of its two-day planning session with few ideas about how to spur growth. Thus, over the next six months CEO Roger Hardy and his senior team called customers each week to see whether they had any ideas. To the company's surprise, one recurring theme emerged—customers wanted to get their lenses the next day. "We started overnighting everything," he reports. Sales in the U.S., where he recently made the change, were up 41 percent for the year, bringing company sales to $155 million.

Source: Harnish, V. 2011. Five ways to get your strategy right. *Fortune*. April 11: 42.

Discussion Question 5: *What are some other examples of firms that got excellent ideas by simply asking their customers for input?*

2. Environmental Monitoring

Environmental monitoring tracks the evolution of trends, events, or streams of activities in the external environment. In this section, we present some of the factors monitored by three organizations: Motel 6, Pier 1 Imports, and Johnson and Johnson Medical Products. Such factors are vital for managers in determining their firm's strategic direction and resource allocations.

The SUPPLEMENT below represents the factors that the Director of Planning of Vought Aircraft considered critical. You may initially ask the students:

Discussion Question 6: *What indicators do you believe a firm should monitor that produces both (1) weapon systems for the military, and, (2) key components for the commercial aircraft industry?*

Extra Example: Factors to Monitor—Vought Aircraft

Commercial Aircraft:

1. Oil prices
2. Age of fleet of airlines
3. Profitability of airlines

Defense Department:

1. Where weapons are in the life cycle
2. Mission requirements of the military

Source: Authors' interviews.

The SUPPLEMENT below discusses how Cisco, the $47 billion (2014 revenues) networking giant, learned from its mistakes during the Internet bust in 2001—and now carefully it monitors its inventory levels. It points out that managers must monitor key aspects of the firm's internal environment—as well as the firm's external environment.

Extra Example: How Cisco Learned from Its Mistakes

In April 2001, Cisco made one of the more painful confessions of the Internet bust: It had so much networking gear piled up that it had to take a $2.5 billion write-off for equipment that it figured nobody would ever buy. It has been working hard ever since to make sure that such a thing never happens again.

Supply chain chief Angel Mendez is grilled at monthly reviews by CEO John Chambers and other top executives. Now, Cisco has half the inventory it did in 2001—even though its revenues are twice as large. Says Mendez: "It didn't take John eight years to start asking questions (about inventory levels). He asks about every eight minutes."

Source: Burrows, P. 2009. Tech: Lean and Ready to Spring. *BusinessWeek*.
April 27: 14-16.

Discussion Question 7: *Are you aware of other firms that have failed to effectively monitor key aspects of their internal environment (e.g., excessive numbers of employees and layers of management; high levels of inventory that became obsolescent; insufficient sales, marketing, engineers, etc. to meet increasing demand for goods/services and innovations, etc.)?*

The SUPPLEMENT below discusses why Caterpillar may serve as a macroeconomic early-warning system.

Extra Example: Caterpillar—A Macroeconomic Early-Warning System?

Although it is hard to confuse a 40-ton excavator with a crystal ball, forecasters could do worse than tracking retail sales of the huge, yellow machines sold by Caterpillar Inc. Being the largest seller of equipment used to build stuff or extract the stuff from the ground used to build that stuff, Caterpillar's customers' appetite is sort of a macroeconomic early-warning system.

Two big worries—the slowdown in China's property market and a related slump in demand for commodities from crude oil to iron ore—show up quickly in its monthly sales reports, helpfully broken down by region and type of machinery.

2014 has, not surprisingly, been a tough year for the firm's shareholders. Its stock price trailed the S&P 500 by 31 percent.

Source: Jakab, S. 2015. Caterpillar is stuck in its cocoon. *Wall Street Journal*. April 23: C1.

3. Competitive Intelligence

Competitive intelligence helps firms define and understand their industry and identify rivals' strengths and weaknesses. Done properly, competitive intelligence helps a company to avoid surprises by effectively anticipating and responding to competitors' moves.

We briefly address the importance of competitive intelligence to firms in the banking, airline, and automobile industry.

Discussion Question 8: *What are other industries where competitive intelligence is extremely important? How might such information be collected?*

We address how the Internet has accelerated the speed at which firms can find competitive intelligence.

STRATEGY SPOTLIGHT 2.1 discusses some of the ethical guidelines that United Technologies has implemented.

Discussion Question 9: *Are you aware of ethical guidelines that other companies have developed? Were they effective? Why? Why not?*

Teaching Tip: *The discussion of Competitor Intelligence provides the instructor with an opportunity to introduce the subject of ethics into the classroom. We suggest presenting scenarios that are not "black and white." For example, a firm advertises a position in order to get a chance to interview employees of a rival company with no intention to hire them. While this may not be illegal, clearly it is difficult to justify morally. The ensuing discussion will help to clarify the distinction between illegal and unethical behavior.*

4. Environmental Forecasting

Environmental scanning, monitoring, and competitive intelligence are important inputs for analyzing the external environment. However, they are of little use unless they provide raw material that is accurate enough to help managers make accurate forecasts.

We address the twin problems of either assuming that the world is certain and open to precise predictions, or the assumption that it is uncertain and totally unpredictable. And, we provide the famous example of poor forecasting by Digital Equipment Corp., which caused it to ignore the potential of personal computers. We also provide several other predictions about the future of technology which did not pan out.

Discussion Question 10: *What are some other errors in forecasting with which you are familiar?*

It should be interesting to ask students to provide a few more examples of technology forecasts that really missed the mark—some of them go farther back in time than the ones listed in the text. A few of them are listed in the SUPPLEMENT below.

You might even ask them what forecasts/predictions for the future of technology that they have.

Extra Example: Technology Forecasts That Missed the Mark

1946: "Television won't be able to hold on to any market it captures after the first six months. People will soon get tired of staring at a plywood box every night." —20th Century Fox Studio executive Darryl Zanuck

1959: "Before man reaches the moon, your mail will be delivered within hours from New York to Australia by guided missiles. We stand on the threshold of rocket mail."—U.S. Postmaster General Arthur Summerfield

1961: "There is practically no chance communications space satellites will be used to provide better telephone, telegraph, television, or radio service inside the United States."—Federal Communications Commission (FCC) commissioner T.A.M. Craven

1966: "Remote shopping, while entirely feasible, will flop." —Time Magazine

Source: Dunn, M. 2016. 20 tech predictions that failed. www.news.com.au. March 8: np.

5. Scenario Analysis

Scenario analysis provides a set of tools that enable managers to imagine threats and opportunities the future may bring. As a general rule, scenarios should be used by businesses whose external environments are prone to fundamental or sudden change and whose anticipation of such change is of vital strategic importance.

It is important to note that scenario analysis draws on a wide range of disciplines and interests, among them economics, psychology, sociology, and demographics.

> ***Discussion Question 11:*** *Why must scenario analysis and scenario planning draw on a variety of disciplines and interests?*

We provide a detailed example of how PPG Industries has benefited from the use of scenario analysis and planning.

We address the value of a firm in creating an environmentally aware organization—which includes environmental scanning and monitoring, as well as competitive intelligence, forecasting, and scenario planning. In contrast, the late Steve Jobs (Apple's former Chairman) took a far different approach to determining what customers *really* wanted. We discuss Jobs' distaste for sophisticated approaches to market research.

> ***Discussion Question 12:*** *Would such a mindset work for other organizations? Why? Why not? (Firms in commodity industries—which experience much less uncertainty than technology industries have less need for such "intuition" since these industries face much less dramatic change in market demand and technologies. And, of course, very few firms have the visionary genius of a Steve Jobs! Also, you might point out how Ron Johnson (who was fired as CEO of J.C. Penney in early April 2013) relied too much on his intuition and drove the firm into the ground—and almost into bankruptcy.*

B. SWOT Analysis

We briefly address SWOT Analysis at this point. SWOT stands for strengths, weaknesses, opportunities, and threats. SWOT analysis provides a framework for analyzing these four elements of a company's internal and external environment.

It is important to note that SWOT analysis provides the "raw material," that is, a basic listing of conditions and factors inside and outside of a company.

> ***Discussion Question 13:*** *What do you consider to be some of the major advantages and disadvantages of SWOT analysis? (This issue is addressed in more detail in Chapter 3, but you should point out that a key disadvantage is that strengths may not necessarily convert to sources of competitive advantage that are sustainable in the marketplace.)*

II. The General Environment

PowerPoint Slide 10: The General Environment
PowerPoint Slide 11: The Demographic Segment
PowerPoint Slide 12: The Sociocultural Segment
PowerPoint Slide 13: The Political/Legal Segment
PowerPoint Slide 14: The Technological Segment
PowerPoint Slide 15: The Economic Segment
PowerPoint Slide 16: The Global Segment
PowerPoint Slide 17: General Environment: Relationships among Elements

The general environment consists of factors that can have a dramatic effect on a firm's strategy. Typically, a firm has little ability to predict trends and events in the general environment, and even less ability to control them.

We divide the general environment into six segments: demographic, sociocultural, political/legal, technological, economic, and global.

EXHIBIT 2.2 provides examples of key trends and events in each of the six segments of the general environment

Discussion Question 14: *How will the factors in Exhibit 2.3 affect specific industries?*

Discussion Question 15: *Which factors are more difficult to predict than others? (e.g., macroeconomic changes are typically more difficult to predict than demographic changes)*

Discussion Question 16: *How are these factors interrelated?*

Discussion Question 17: *What factors that are not listed in this exhibit do you feel are important?*

A. The Demographic Segment

Demographics are the most easily understood and quantifiable elements of the general environment. Demographics include elements such as the aging population, rising or declining affluence, changes in ethnic composition, geographic distribution of the population, and income level disparities.

Discussion Question 18: *What are the implications of ethnic diversity for the work place?*

Discussion Question 19: *What implications does the migration to the South and West in the United States have for individual businesses?*

> ***Discussion Question 20:*** *How does the "graying of America" affect U. S. companies?*

Among the trends we discuss are the aging of the population and how it may differentially affect a wide variety of industries. We also discuss the increasing number of older Americans and its importance for attracting and retaining older workers.

Ask:

> ***Discussion Question 21:*** *It might be interesting to ask what the implications (of the aging of the population) are for today's organization (e.g., how can firms attract and retain older workers, changes in financial and non-financial incentives, etc.) as well as for public policy (e.g., changes in tax policies, increasing the number of immigrants, etc.).*

We also provide INSIGHTS FROM RESEARCH: New Tricks: Research Debunks Myths about Older Workers (in text, The General Environment section). Here, results from a meta-analysis points out some findings about older workers many people would find counterintuitive. The findings concluded older workers are NOT less motivated, more resistant to change, less trusting, less healthy, or more valuable to work-family issues. The only "myth" supported by the data was older workers are less willing to participate in training and career development.

> ***Discussion Question 22:*** *What are the practical implications of these findings? (Hint: as noted in the IFR: provide more opportunities for younger and older workers to work together; promote positive attributes of older workers; and, engage employees in open discussions about stereotypes. The broader learning point would be to encourage students to always question their assumption bases—they might be wrong, at times!)*

Strong backgrounds in science, technology, engineering, and math (STEM), as well as social networks that provide a venue for the sharing of resources and ideas.

B. The Sociocultural Segment

Sociocultural forces influence the values, beliefs, and lifestyles of a society. Examples include a higher percentage of women in the workforce, dual-income families, increases in the number of temporary workers, greater concern for healthy diets and physical fitness, greater interest in the environment, and families postponing having children.

> ***Discussion Question 23:*** *Name two industries that have benefited from the growing awareness about health and fitness. Also name two that have been adversely affected by this trend.*

> ***Discussion Question 24:*** *What must firms do to attract and retain women employees? Why are such efforts becoming increasingly important?*

The section also addresses the increased educational attainment of women in the workplace. We discuss increases in both the number of degrees granted to women as well as the increased formation of businesses by women.

Ask:

> ***Discussion Question 25:*** *Can you think of any other important implications this trend has for businesses in a specific industry?*

The SUPPLEMENT below provides some perspective on why the job market for women should be very attractive over the next several years.

Extra Example: A Favorable Job Market for Women for Years to Come!

The job market for women should be very good, according to British futurist Ian Pearson, founder of consultancy Futurizon and author of *You Tomorrow*. As we move further toward a service economy, skills like communication and collaboration will move to the forefront. "I call it the care economy," he says. "A lot of women already work in those roles, and there will be more tomorrow."

Health care and personal services are the fastest-growing sectors of the economy and are dominated by women. In the U.S. 15 million women hold health and education jobs, up from 2.5 million in 1964. They are already the majority of nurses, pharmacists, and physical therapists, and by 2020 employment in health care is projected to grow 29 percent and personal care and services by 27 percent. The trend is not limited to the U.S. Globally, women are more than two-thirds of the graduates in health care and education programs.

In the U.S. women now hold 51.6 percent of all managerial and professional jobs. A new focus on "soft skills" like mentoring, inspiring, collaboration and building relationship may benefit women. In a comprehensive study of more than 7,000 leaders, women ranked higher than men in 12 out of 16 leadership attributes.

Source: Goudreau, J. 2012. A golden age for working women. *Forbes*. December 24: 56.

C. The Political/Legal Segment

Political processes and legislation influence the regulations with which industries must comply. Some important elements of the political/legal arena include tort reform, the Americans with Disabilities Act (ADA), the repeal of the Glass-Stegall Act in 1999 (now banks may offer brokerage services), deregulation of utilities and other industries, and increases in the federally mandated minimum wage.

> ***Discussion Question 26:*** *What do you see as some of the pros/cons of the Americans with Disabilities (ADA) Act?*

We close this section with a brief discussion of how legislation in the U.S. has restricted the number of H-1B visas for highly skilled professionals. We discuss the proactive step Microsoft has taken (e.g. setting up a research facility in Vancouver, Canada) to address this issue.

> ***Discussion Question 27:*** *Should the U.S. Congress increase the number of H-1B visas? Why? Why not?)*

STRATEGY SPOTLIGHT 2.2 addresses conflict minerals legislation that was passed by the U.S. Congress in 2010 (as part of the Dodd-Frank Reform and Protection Act). It requires that companies disclose whether any tin, tantalum, tungsten, or gold in their supply chain is connected to violent militia groups in the Congo or nine surrounding countries—including Angola, Rwanda, and Sudan.

We address the challenges (e.g., supply chain) and associated expenses that firms have faced in endeavoring to conform to this legislation.

> ***Discussion Question 28:*** *What are some of the challenges associated with companies conforming to this legislation? Do you have ideas about how companies could lower their associated expenses and perform the associated tasks more efficiently? Could lobbying be effective?*

In the SUPPLEMENT below we offer more information on this legislation and its impact.

Extra Example: Conflict Minerals Legislation

A pink My Little Pony balloon would not typically evoke images of rifle-toting warlords in the Democratic Republic of Congo. However, Park City Holdings, the decorations and costumes retailer, recently disclosed a possible link to securities regulators, helping to put it near the bottom of a list ranking companies on their compliance with laws against using minerals mined in war-torn regions across Africa. (Tin gives the balloons a special sheen!)

Park City also lost points because it did not thoroughly describe which products used which materials and the firm did not "take leadership" in engaging smelters, refiners and region-vetting efforts, a study said. How much of a "black mark" this is, is subject to interpretation because such "good practice" indicators—created for a study by the Responsible Sourcing Network—are not among the requirements of disclosure rules.
Such an example helps to point out that products that would seem to be quite "innocuous" can still be affected by such legislation, in part, because their factors of production are typically not widely known by most people.

Source: Browning, L. 2015. Companies struggle to comply with rules on conflict materials. *www.nytimes.com*. September 8: np.

D. The Technological Segment

Developments in technology lead to new products and services and improve how they're produced and delivered to the end user. Innovations can create entirely new industries and alter existing industries.

> ***Discussion Question 29:*** *Ask students to speculate on the impact of the following technologies on American industry: (1) the Internet, (2) manufacturing innovations (e.g., robotics), (3) genetic engineering/designer genes. (The last items may provoke some heated discussion regarding the ethical implications.)*

We discuss the key implications that the Internet, information technology, and nanotechnology has had on industry—in particular, its impact on productivity gains.

We also address a fascinating issue: some of the promising future applications of nanotechnology and how it will impact some industries.

We close out the section by addressing some of the "downsides" of technology. In addition to ethical issues, we discuss environmental damage, such as the emission of greenhouse gases. We discuss BP Amoco's innovative approach to this matter.

The SUPPLEMENT below discusses how SkyMall, the inflight magazine was forced into bankruptcy by technology—smartphones and tablets.

Extra Example: It Seems That Technology Killed SkyMall

The firm behind the inflight catalog, SkyMall, filed for bankruptcy protection. It is clearly a victim of evolving rules and technology that now permit airline passengers to keep their smartphones and tablets powered up during flights.

For 25 years it sold quirky products like a Darth Vader toaster or a paper-towel holder with USB ports. However, SkyMall is now seeking a court supervised sale of its assets, according to papers filed on January 22, 2015 with the Phoenix Bankruptcy Court.

CEO Scott Wiley cited a "crowded, rapidly evolving and intensely competitive" retail environment as the reason for the firm's recent struggles. And, he said, "With the increased use of electronic devices on planes, fewer people browsed the SkyMall inflight catalog."

SkyMall had revenue of $33.7 million in 2013. But, its sales sank to only 15.8 million for the nine months ending on September 28, 2014.

Source: Corrigan, T. 2015. SkyMall Succumbs to a New Jet Age. *Wall Street Journal*. January 24–25: B3.

> ***Discussion Question 30:*** *Are you aware of other cases where technology is a key factor that is reshaping—or adversely affecting—an industry? What industries are most likely to be influenced by technological changes?*

E. The Economic Segment

The economy has an impact on all industries, from suppliers of raw materials to manufacturers of finished goods and services, as well as all organizations in the service, wholesale, retail, government, and nonprofit sectors of economies. Key indicators include interest rates, unemployment rates, the consumer price index (CPI), the Gross Domestic Product (GDP), and net disposable income.

> ***Discussion Question 31:*** *Compare the impact of rising (or declining) interest rates on the overall demand for the following industries: (1) housing (will have a significant impact), (2) automobiles (will have a significant impact), (3) fast food (will have very little effect).*

F. The Global Segment

Globalization provides both opportunities to access larger potential markets and a broad base of factors of production such as raw materials, labor, skilled managers, and technical professionals. However, such endeavors carry many political, social, and economic risks.

Examples of important elements in the global segment include currency exchange rates, increasing global trade, the economic emergence of India, China's admittance to the World Trade Organization, trade agreements among regional blocs (e.g., EC), and the GATT Agreement (lowering of tariffs).

> ***Discussion Question 32:*** *Provide examples of firms that have succeeded (stumbled) in their efforts to expand into international markets. What factors can explain their success (failure)?*

We also address the rising middle class in emerging countries and how it has led to increased employment in those countries by multinationals.

> ***Discussion Question 33:*** What are the risks associated with accessing a larger potential market overseas as a result of the process of globalization? Do the risks of globalization outweigh its benefits?

G. Relationships among Elements of the General Environment

In our discussion of the general environment, we have addressed many relationships among the various elements.

EXHIBIT 2.3 provides many examples of how the impact of trends or events in the general environment can vary across industries.

The SUPPLEMENT below provides some insights on how many elements of the General Environment are interrelated. It is a rather interesting context—Cairo, Egypt after the Arab Spring.

Extra Example: Entrepreneurship in Cairo after the Arab Spring

A different type of grassroots revolution has begun in the aftermath of the Arab Spring. According to Ramez Mohamed, CEO of Flat6Labs, a Cairo-based startup accelerator, entrepreneurship has thrived over the past two years. He contends that Egypt's youth feel empowered to make a difference, one venture at a time.

Here are some of his firm's most promising startups and the opportunity that they are tackling:

- **Ekshef**: With an Arabic-only platform and Yelp-like rating system, the service enables Egyptians to search, review, and recommend doctors from the directory. *Opportunity:* The country has more than 75,000 health care clinics, but it is hard for patients to find the right physician.
- **Nafham**: The service condenses the country's public-school curriculum into online, crowdsourced lessons. Users can vote up or down based on quality. Its staff also produces video content. *Opportunity:* Egypt's rising population is putting a squeeze on classroom space.
- **Eshtery:** The utility lets users shop by scanning codes on signs around town and having the items delivered to them. The business was inspired by Home Plus, a supermarket that offers a similar service in South Korea. *Opportunity:* It is hard to buy groceries if you work two hours from the market.
- **Ogra:** A mobile app, a la Uber, which connects passengers with reliable drivers. *Opportunity:* With social tensions spilling onto the street, public transportation that is dependable is hard to find.

Source: Anonymous. 2013. Emerging tech scene: Cairo. *Fast Company*. March: 31.

For the Ninth Edition, we have added the topic of "Big Data/Data Analytics" as one of the new features with numerous examples and "Strategy Spotlights" throughout the text. Here, we introduce the topic and provide Spotlight 2.3 as an example of how it can be applied to monitor federal, state, and local government expenditures.

As we note in the text, corporations are increasingly collecting and analyzing data on their customers, including data on customer characteristics, purchasing patterns, employee productivity, and physical asset utilization. Such efforts have the potential to help firms better customize their product and service offerings to customers as well as more efficiently use the resources of the company. We provide examples of Pepsi and Kaiser Permanente as well as some figures on how its use has dramatically increased in recent years—as well as how it can improve a firm's performance.

STRATEGY SPOTLIGHT 2.3 provides an example of how big data can be used in the public sector, i.e., how to monitor governmental expenditures. Examples, which should be of particular interest to students, is how it can help detect malfeasance and acts of corruption by public officials.

> ***Discussion Question 34:*** *How can governments—as well as "public watchdogs"—effectively use big data to monitor governmental expenditures? (It might be interesting to see how students can come up with ideas/insights about how to avoid problems associated with the proverbial "fox guarding the henhouse."*

III. The Competitive Environment

PowerPoint Slide 18: The Competitive Environment
PowerPoint Slide 19: Porter's Five Forces Model of Industry Competition
PowerPoint Slide 20: The Threat of New Entrants
PowerPoint Slide 22: The Bargaining Power of Buyers
PowerPoint Slide 23: The Bargaining Power of Suppliers
PowerPoint Slide 24: The Threat of Substitute Products & Services
PowerPoint Slide 25: The Intensity of Rivalry among Competitors in an Industry
PowerPoint Slide 26: How the Internet and Digital Technologies Affect Competitive Forces
PowerPoint Slide 27: Using Industry Analysis: A Few Caveats

Here, we draw upon a well-known analytic tool, Michael Porter's five-forces model of industry competition. We introduce this model and discuss examples of each force. We then address the impact of the Internet on the five forces and the strategic groups concept and its implications for studying rivalry and competition.

A. Porter's Five-Forces Model of Industry Competition

EXHIBIT 2.4 illustrates Porter's five-forces model of industry competition

When introducing this model, it is useful to show how the model provides insight into an industry's dynamics and expected profit levels. The SUPPLEMENT below provides such an analysis on the paint and allied products industry. The analysis is restricted to the trade sales (i.e., house paint) segment of the industry. The competitive forces are very different for other segments such as the specialized high-tech automobile finishes.

Note: For our purposes of illustrating the "basics" of the "five forces," the analysis has been simplified. We assume buyers to be consumers, although there are, of course, other distinct groups such as hardware stores, and large discounters such as Wal-Mart. Obviously firms' bargaining power vis-à-vis paint manufacturers vary significantly. Similarly, our analysis assumes the industry's products to be commodity products. However, there are exceptions, such as Olympic Stain, that have successfully differentiated their products on the basis of quality.

Extra Example: The Paint and Allied Products (PAP) Industry

An analysis of the Paints and Allied Products industry (SIC 2851), using the five-forces model, demonstrates why this industry has traditionally been caught in a price-cost squeeze and is unable to pass on rising raw material costs to its customers.

To illustrate the price-cost squeeze that this industry is facing, consider that between the years 1995 to 2000, the PPI (producer price index—the price for which it sells its output) of the PAP industry increased an average of only 2 percent. The PPI for petroleum refining and related products—a key supplier to this industry—increased at a rate of 6 percent over this same period of time. Hence the price of this key raw material was roughly twice the rate of inflation (about 3 percent); whereas, the PAP industry was lower than the rate of inflation. Thus, the PAP industry has been unable—due to unfavorable industry competitive forces—to pass on cost increases to their suppliers; thus eroding profitability.

Consider the PAP industry in terms of each of Porter's Five Forces:

Threats of Entry: Very High (minimal capital investment needed, little proprietary technology, regional firms can compete in local markets due to high transportation costs, little brand identification of existing competitors)

Buyer Power: Very High (low brand loyalty, relatively little product differentiation, relatively low switching costs)

Supplier Power: High (especially for petroleum derivative raw materials—a key input in industry)

Substitute Products: High (plastics, wood paneling, wallpaper coverings, etc.)

Rivalry: High (competition is based mostly on price competition, because of little brand loyalty and product differentiation; easy entry and exit from the industry gives rise to frequent price wars; little price leadership exhibited by larger firms)

Sources: www.bls.gov (Bureau of Labor Statistics); www.ita.doc.gov (International Trade Administration)

It is useful to point out that there can also be very profitable opportunities to compete in industries that have overall low profits. For example, in the paint industry, Olympic Stain has typically been a very successful and highly profitable firm because they have found an attractive niche in the market and developed a differentiated product (through product development and advertising).

We also provide a brief discussion of some of the competitive forces affecting the hotel industry.

1. Threat of New Entrants

After summarizing the major barriers to entry, ask students to provide examples of industries characterized by each of these entry barriers. This may help them to understand what initially may appear to be rather complex ideas.

We discuss the concept of "the era of Lego innovation." Here, valuable advances in technology can be attained by imaginatively combining components and software available to everyone. Clearly, this serves to lower entry barriers.

> ***Teaching Tip:*** *The chapter explains how economies of scale and economies of experience (learning curve) erect significant entry barriers. In the auto industry, U.S. manufacturers such as Ford and G.M. have high economies of scale (being the large producers) and all the benefits of learning curve (having been in the business for almost a century). Despite these advantages, foreign auto producers have entered the U.S. market and have increasingly gained market share over the past few decades. Ask the students why this happened? Does this prove that the concepts we discussed are wrong? Or does it point out that additional factors have to be considered? Point out that foreign producers have the benefits of lower labor costs and/or have developed better manufacturing technologies (such as Toyota's lean manufacturing).*

2. Bargaining Power of Buyers

Briefly summarize some of the conditions under which a supplier group may become powerful. It may be interesting to discuss how things have changed (if they have) with regard to the power of buyers of talent (i.e., businesses of varying sizes and industries) and suppliers of talent (i.e., business school graduates—either undergraduate or MBA).

STRATEGY SPOTLIGHT 2.4 discusses how Apple uses its buyer power to negotiate very low rental rates—compared to other stores—for its stores in shopping malls. This is because its powerful brand/products can help drive customers to the mall and increase overall sales in a mall by as much as 10 percent. Roughly speaking, Apple pays 2 percent of sales—compared to other tenants who may pay as much as 15 percent of sales. It might be very interesting to point out the "fun fact" that Apple stores draw more visitors than Disney does in all of its theme parks throughout the world combined.

Discussion Question 35: *Can you think of other tenants that would be able to negotiate low rental rates? Why?*

The SUPPLEMENT below explains that many huge consumer product firms are going to cut the amount of money they will spend on advertising. Clearly, this will enhance their buyer power.

Extra Example: Large Consumer Product Firms Cut Advertising Budgets

Procter & Gamble is planning to make deep cuts in its number of advertising agencies. It hopes to save up to half-a-billion dollars in fees that it now pays to outside firms to help pitch its wide variety of everyday items—from Gillette razors, to Tide detergent, to Pantene hair care, to Bounty paper towels.

Needless to say, this worries Madison Avenue. P&G is joining other companies—such as Unilever, L'Oreal SA, Coca-Cola Co, S.C. Johnson, and Visa—that are all trying to force advertisers to either lower prices or risk losing the business altogether. These firms are striving to offset slow growth with cost cuts.

P&G CFO Jon Moeller said the household-products giant plans to "significantly simplify and reduce" the number of agencies it works with on ads, media buying, public relations, package design and in-store marketing. Similarly, Unilever, which spent about $7 billion on advertising and marketing in 2014, is currently reviewing its global media-buying business. A person familiar with the issue said the process is driven in part by the need to find "cost savings and efficiencies."

Such pressures have prompted extensive industry consolidation. For example, giants Publicis Groupe SA and Omnicom Group Inc. tried—but failed—to merge in 2014. The agencies remain at the behest of clients that are in an increasingly frugal mood.

Source: Tadena, N. & Ng, Serena, A. S. 2015. P&G Joins the Movement to Reduce Costs. *Wall Street Journal*. April 27: B1-B2.

3. Bargaining Power of Suppliers

Briefly discuss some of the conditions under which a supplier group may become powerful. The bargaining power of suppliers can be presented as the mirror opposite of the bargaining power of suppliers. For example, the relative sizes and concentrations largely determine the bargaining power of the two parties involved in the transaction.

The section discusses how catfish farmers in Mississippi increased their buyer power by forming a cooperative—Delta Pride Catfish.

4. The Threat of Substitute Products and Services

Emphasize that the viability of a substitute product depends largely on its relative price-performance trade-off, i.e., more value for the same price or the same value for a lower price. Examples are electronic security systems versus security guards, and the use of steel versus plastic for components in the manufacture of automobiles.

We discuss substitutes and give the example of how the use of teleconferencing poses a threat to the airline industry. We also explain why hybrid cars are becoming a less attractive substitute to gasoline power cars—as the latter's miles per gallon (MPG) has closed the gap in recent years.

5. The Intensity of Rivalry among Competitors in an Industry

After discussing the factors that lead to intense rivalry in an industry, provide an example of an industry in which competition has recently been intense. For example, most students are familiar with the recurring price wars in the U. S. airline industry. Ask them to explain this using the factors discussed (e.g., undifferentiated service, low switching costs, slow industry growth, numerous competitors, etc.) You might point out that this industry was expected to report huge losses in 2001 even before the September 11, 2001 terrorist attack. Beginning in late 2005, the airlines' problems were further aggravated by extremely high fuel costs.

In this section, we discuss the intense rivalry between Uber and Lyft in the taxi industry. This provides an example that intense rivalry can take place on factors other than pricing in an industry that is highly profitable.

The SUPPLEMENT below is Michael Porter's response to a question as to whether or not he would add a "sixth force" if he were developing his framework today.

Extra Example: Should There Be a "Sixth Force?" Michael Porter's Perspective

"There have been two nominees for the sixth force. One is government. After much further work using and teaching the framework, I have reaffirmed my original conclusion that government is not a sixth force because there is no monotonic (direct linear) relationship between the strength and influence of government and profitability of an industry. You can't say that 'government is low, industry profitability is high.' It all depends on exactly what government does. Also, there are many different parts of government, each with its own distinct impacts. And, how do you assess the consequence of what government does? Well, you look at how it affects the five forces.

"The other, more recent, candidate for a sixth force involves organizations whose products and services are complementary to the primary organization's products and services. Again, there is no monotonic relationship between the extent of complements and profitability. Sometimes having many complements is consistent with high industry profitability, sometimes with low profitability. It has to do with how complements affect the five forces.… Clearly, complements have much to do with the size of the pie, but their role in the division of the pie is independent of other factors."

Source: Argyres, N. & McGahan, A. M. 2002. An interview with Michael Porter. *Academy of Management Executive*. 16 (2): 43-52.

EXHIBIT 2.5 provides a summary of key points from the discussion of industry five-forces analysis.

B. How the Internet and Digital Technologies Are Affecting the Five Competitive Forces

The changes caused by the Internet economy have made strategizing more challenging. Strategic analysis, informed formulation, and successful implementation may be even more difficult in the Internet era because of the uncertainty surrounding the new technology. In this section, we address the impact of the Internet and digital technologies in terms of Porter's five-forces model of competition.

1. The Threat of New Entrants

In most industries, new entrants will be a bigger threat because the Internet lowers barriers to entry. Thus, scale economies may be less important in an Internet context, and new entrants can go to market with lower capital costs.

Businesses launched on the Internet may enjoy savings on traditional expenses such as office rent, salaries, and postage. Thus, a new entrant could use the savings to charge lower prices and compete on price despite an incumbent competitor's scale advantages. Alternatively, a new entrant may be able to serve a market more effectively, with more personalized services and greater attention to product details. Then they could build a reputation in their niche and charge premium prices.

Another potential benefit for Internet-based businesses is access to distribution channels. Manufacturers or distributors that can reach potential outlets for their products via the Internet may be encouraged to enter markets that were previously closed to them. Such access is not guaranteed, however.

Discussion Question 36: *What are some examples of industries where there have been a lot of new entrants because of the Internet? Have these new entrants been successful? How have incumbent firms reacted?*

2. The Bargaining Power of Buyers

The Internet may increase buyer power by providing consumers with more information to make buying decisions and lowering switching costs. But, by giving buyers new ways to access sellers, the Internet may also suppress the power of traditional buyer channels that have concentrated buying power in the hands of a few. In this section, we address two types of buyers: end users and buyer channel intermediaries.

End users are the final customers in a distribution channel. Internet sales activity that is labeled “B2C” is concerned with end users. Because a large amount of consumer information is available on the Internet, end users can easily shop for quality merchandise and bargain for price concessions. Switching costs are also potentially lower because the cost of switching may involve only a few clicks of the mouse to find and view a competing product or service online.

Buyer channel intermediaries are the wholesalers and distributors who serve as “middlemen” between manufacturers and end users. In some industries buyer channels are dominated by powerful players. The Internet, however, makes it easier and less expensive for businesses to reach customers directly. Thus, the Internet may increase the power of incumbent firms relative to these traditional buyer channels.

Discussion Question 37: *What are some other ways that end users can increase their buying power by using the Internet?*

STRATEGY SPOTLIGHT 2.5 addresses the role of the Internet in shaking up the legal services industry. It has clearly led to an increase in the power of buyers.

Discussion Question 38: *What are some examples of other companies that have used the Internet to enhance their buying power?*

3. The Bargaining Power of Suppliers

The Internet has streamlined and quickened the process of acquiring supplies. But the extent to which the Internet is a benefit or a detriment to suppliers may depend on where the supplier is positioned along the supply chain.

Suppliers provide products or services to other businesses. The term “B2B” is used to refer to businesses that supply or sell to other businesses. On the one hand, the Internet makes it possible for suppliers to access more customers at a relatively lower cost per customer. On the other hand, because buyers can comparatively shop more easily and negotiate prices faster, suppliers may not be able to hold on to them. This is especially damaging to supply chain intermediaries, such as product distributors, who may not be able to stop suppliers from directly accessing other potential business customers.

> ***Discussion Question 39:*** *What can supply chain intermediaries do to strengthen their position, that is, make it worthwhile for their customers in the supply chain to continue using their services?*

> ***Discussion Question 40:*** *What are some examples of companies that have abandoned their traditional method of reaching customers and are using the Internet to reach customers directly?*

One of the greatest threats to supplier power is that the Internet inhibits a supplier's ability to offer highly differentiated products or unique services. Other factors may, in contrast, contribute to stronger supplier power:

1. The growth of Web-based business in general may create more downstream outlets for suppliers to sell to.

2. Suppliers may be able to create Web-based purchasing arrangements that make purchasing easier and discourages their customers from switching.

3. The use of proprietary software that links buyers to a supplier's website may create a rapid, low-cost ordering capability that discourages the buyer from seeking other sources of supply.

4. Suppliers will have greater power to the extent that they can reach end users directly without intermediaries.

A process known as **disintermediation** is removing organizations or business process layers responsible for intermediary steps in the value chain in many industries. The Internet is also creating an opening for new functions. These new activities are entering the value chain by a process known as **reintermediation**, the introduction of new types of intermediaries. Electronic delivery is an example.

> ***Discussion Question 41:*** *What are some examples of new companies that have emerged to offer new types of electronic intermediary functions?*

> ***Discussion Question 42:*** *If you were Home Depot, what would you do if one of your major suppliers responded that they intended to sell directly to consumers online anyway?*

4. The Threat of Substitutes

In general, the threat of substitutes is heightened because the Internet introduces new ways to accomplish the same tasks.

The primary factor that leads to substitution is economic—consumers will use a product or service until a substitute that meets the same need becomes available at a lower cost. The economies created by Internet technologies have led to the development of numerous substitutes for traditional ways of doing business. An example is provided:

1. Online electronic storage by companies such as Dropbox and Amazon Web Services.

Discussion Question 43: *What are some other examples of Internet companies that are offering products or services that are viable substitutes for existing products or services?*

5. The Intensity of Competitive Rivalry

Because the Internet provides more tools and means for competing, rivalry among competitors is likely to be more intense. The Internet increases rivalry by making it difficult for firms to differentiate themselves and by shifting customers' attention to issues of price.

Discussion Question 44: *What do you think the impact of diminishing brand loyalty will be on the intensity of competitive rivalry? Explain.*

Discussion Question 45: *What are some examples of companies that still rely heavily on brand loyalty to maintain their market power and sales?*

Rivalry is more intense when switching costs are low and product or service differentiation is minimized. The Internet has "commoditized" products that might previously have been regarded as rare or unique. The Internet also eliminates the importance of location making products that were previously distant readily available online. This makes competitors more equally balanced, thus intensifying rivalry.

The problem is made worse for marketers because of shopping infomediaries that search the Web for the best prices. Such infomediary services may be good for consumers, but they increase business rivalry by consolidating the marketing messages that consumers use to make purchases to a few key pieces of information that the selling company has little control over.

Discussion Question 46: *What steps can companies take to make their online business more distinctive or unique?*

Discussion Question 47: *What are some examples of companies that have maintained the distinctiveness of their online business? What features make them distinct? Are these features sustainable?*

C. Using Industry Analyses: A Few Caveats

This section was written as a "caveat" to address some limitations of Porter's five-forces model. First, managers should not always avoid low profit industries. We provide examples of Paychex and WellPoint Health Networks.

Teaching Tip: *Even when industry analysis shows that an industry is unattractive, there are a few firms that seem to be able to earn high returns. For example, Southwest Airlines has been consistently profitable in an otherwise unattractive industry over the past several years. Does this mean that industry analysis is misleading? You may point out that industry analysis is useful to predict an industry's average profitability, but not necessarily, a single firm's profitability. This is a good opportunity to introduce the role of the strategist in outperforming industry norms.*

Second is the idea that business is not always a zero-sum game— which is an assumption that is implicit in Porter's five-forces model. We discuss how companies can collaborate with suppliers for mutually beneficial outcomes.

The SUPPLEMENT below provides a rather counterintuitive perspective on rivalry in an industry. With examples from Yoplait and McDonald's, sometimes a firm can benefit from a rival's new product.

Extra Example: Firms Can Benefit from a Rival's New Product

Conventional wisdom that a rival's launch can hurt a firm's profits is often correct. But not always. Research has shown that companies sometimes see profits increase after a rival's rollout—even when they don't aggressively seek ways to undermine the new product's sales.

The underlying mechanism is rather straightforward: When a firm extends a product line, it often raises the prices of its existing products. These hikes may be designed to make the new product look cheaper and thus more attractive by comparison or to capture the value customers place on a broader line of offerings. As the company adjusts its pricing, its competitors can follow suit without risking customer defections over price.

For example, consider what happened with Yoplait became the first major producer to market low-fat yogurt in the United States. Although Dannon took a 5 percent hit in units sold during the new product's initial year, the vast majority of its customers did not defect to Yoplait. Instead, they preferred Dannon's style of yogurt. And, since Yoplait had raised prices across its product line, Dannon raised its prices as well, by more than 10 percent. Thus, despite the 5 percent decrease in volume, Dannon's revenue increased by 5 percent.

A similar dynamic plays out in fast food. My research shows that McDonald's franchisees who open additional outlets (a type of horizontal product extension) often price the menu items in all their locations higher than before. This allows competing Burger Kings to raise their prices as well. At independent Burger Kings in Silicon Valley, this has led to increase margins more than 10 percent of the time.

Source: Thomadsen, R. 2013. You can benefit from a rival's new product. *Harvard Business Review*. 91(4): 24.

The third issue we raise is that the five-forces analysis has often been criticized for being a static, rather than a dynamic, analysis. Brandenberger and Nalebuff introduced the concept of the value net, which we include in EXHIBIT 2.6.

The concept of complementors is often considered to be the single most important contribution of value net analysis. Complements typically are products or services that have a potential impact on the value of the firms' own product and services. We provide the examples of complements (software and microprocessors) in the personal computer industry and the video game industry. (As we noted in an earlier supplement, Professor Michael Porter would not add complements to the "five forces" because they don't have a *direct linear relationship* to industry profitability. However, they clearly can have an impact on an industry's profitability.)

D. Strategic Groups within Industries

Most of your students are probably very interested in the automobile industry. EXHIBIT 2.7 provides a strategic grouping of the worldwide automobile industry. It is rather clear from the discussion in the text that the intensity of competition within strategic groups is much more intense than competition across groups.

Point out four benefits of strategic groups as an analytical tool:

1. Strategic groupings help a firm identify mobility barriers that protect a group from attacks by other groups.

2. It helps a firm to identify groups whose competitive position may be marginal or tenuous.

3. It helps chart the future directions of firms' strategies.

4. It helps in thinking through the implications of each industry trend for the strategic group as a whole.

It may be interesting to ask the students what dynamics they envision in the automobile industry, i.e., how membership in strategic groups may change and if new strategic groups may emerge.

Discussion Question 48: *What are some of the strategic groups in other industries with which you may be familiar? What are the implications? (e.g., retailing)*

We close with an example with an industry closely related to the one addressed in this section—motorcycles. The SUPPLEMENT below discusses the two major clusters in this industry and how the basis for competition is quite different.

Extra Example: The Two Key Strategic Groups in the Motorcycle Industry

In most industries, firms cluster around a relatively small number of strategic positions and within each cluster hold similar ideas about how to compete. In the motorcycle industry, there are two major clusters of firms.

The Japanese producers—Honda, Yamaha, Suzuki, and Kawasaki—compete on technical innovation and lower costs. The Harley-Davidsons and Ducatis, in contrast, view their business through a very different lens—as entertainment. Here's how Federic Minoli, the CEO and chairman of Ducati from 1996 to 2007 described his decision to build a museum celebrating the firm before he repaired a damaged factory: "Ducati is not, or not only, a motorcycle company. We sell something more: a dream, passion, a piece of history."

Analyze most industries, and you will find a similar situation: two or three groups of firms jostling for position upon the same two or three competitive mountaintops. Now consider the major U.S. airlines. They all struggled for many years in cutthroat competition around the same position until Herb Kelleher of Southwest Airlines saw a different, low-cost way to compete.

Source: Gavetti, G. 2011. The new psychology of strategic leadership. *Harvard Business Review*. 89 (7/8): 118-125.

IV. Issue for Debate

The topic should be of interest to many students because, of course, many of them (or close relatives) may be financing their education. This program at Purdue University is different from a traditional loan because students would repay the debt based on a fixed rate linked to their expected income. In effect, it may save them thousands of dollars compared to typical loans—but it could also cost them far more if they land high-paying jobs. In other words, it endeavors to bring in "market forces" when determining how much students should borrow to fund their education. That is, a chemical engineering student would pay a smaller percentage of their salary over a period of years—compared to a student studying comparative literature. One benefit, of course, is that it would provide students with information "up front" regarding the predicted earnings of various courses of study.

> ***Discussion Question 1:*** *Thinking back to when you were a senior or junior (since most students take the course as a senior when they are close to graduation—either as an undergraduate or MBA student), would you be interested in taking out an ISA?*

Response Guideline: This should spur some spirited debate. Perhaps, some students would favor the opportunity to have funding based on their future earnings—whereas some may feel that they would be "giving up" too much if they were to earn a much higher income than they would expect. And, most would probably prefer the shorter payment periods for these loans.

> ***Discussion Question 2:*** *In general, what do you see as the main advantage (or disadvantage) of such a program?*

Response guideline: As implied above, one's perspective may vary depending on such factors as their risk preference, desire to discharge their loans as quickly as possible, and "fear" that they might be giving up too much if their chosen career area turns out to be much more lucrative than they had expected.

> ***Discussion Question 3:*** *Do you think it will become successful? And, if so, do you foresee a market for truly private ISAs in the future?*

Response guideline: This question should generate some interesting discussion. Perhaps some would feel that it has too much of an element of "gambling", i.e., taking a chance with an uncertain future. Others may feel that it would provide more transparency in what the expected financial outcomes were for different chosen fields of study. And, still others may believe that a benefit of it would be that it would eliminate the costs to the federal government when there are loan defaults (even though such debts are very hard to have forgiven in bankruptcy cases). As a general comment: It may turn out that a student's perspective is influenced by their perspective on the role of government versus free enterprise, to some extent…

V. Reflecting on Career Implications

Below, we provide some suggestions on how you can lead the discussion on the career implications for the material in Chapter 2.

- **Creating the Environmentally Aware Organization:** Advancing your career requires constant scanning, monitoring, and intelligence gathering to find out not only about future job opportunities but also to understand how employers' expectations are changing. Consider using websites such as LinkedIn to find opportunities. Merely posting your resume on a site such as LinkedIn may not be enough. Instead, consider in what ways you can use such sites for scanning, monitoring, and intelligence gathering.

Students will likely be very interested in the topic of learning about new job opportunities and their associated skill requirements and compensation. Later in the course, there will be specific advice related to finding jobs through networking. Here, the point is to raise in students a general awareness of the types of career options available to them. On LinkedIn, job postings are grouped in various ways. Employers list desired skills and experience. Students should browse a number of these postings in order to identify trends concerning the types of skills that are currently in demand. To find compensation levels, students can join LinkedIn and ask experts. Compensation is a very tricky topic, though, because companies will tailor it to the specific skills of their chosen candidate. The point here is that students will gain from learning about the job market in their fields and how their specific skills and capabilities match up with what the market values. A related topic to consider is the value of experience. Ask students why employers value experience in addition to skills and training. The question does not have an obvious answer. Students should appreciate that as they progress through their careers, they will gain subtle and powerful capabilities related to, for example, leadership, handling complex situations, and stakeholder relations

- **SWOT Analysis:** As an analytical method, SWOT analysis is applicable for individuals as it is for firms. It is important for you to periodically evaluate your strengths and weaknesses as well as potential opportunities and threats to your career. Such analysis should be followed by efforts to address your weaknesses by improving your skills and capabilities.

The SWOT analysis directly pertains to individuals, and students will usually grasp how it applies to them personally. A useful exercise is to have students complete a SWOT analysis on themselves and then pair with another and share reviews. As a check, ask student volunteers to share an element from each part to ensure that students are correctly classifying the elements. The next step is to ask students to make a plan to address their weaknesses. Plans may be of two types. One is to develop weak skills to the point they are not weaknesses. Two is to make a plan to avoid the weakness. For example, if a student were weak at quantitative analysis, then he or she could pursue a career, such as copywriting, that does not rely on that skill so much. The point here is that students should be aware of their SWOT profile and plan their careers accordingly.

- **General Environment:** The general environment consists of several segments, such as the demographic, sociocultural, political/legal, technological, economic, and global environments. It would be useful to evaluate how each of these segments can affect your career opportunities. Identify two or three specific trends (e.g., rapid technological change, aging of the population, increase in minimum wages) and their impact on your choice of careers. These also provide possibilities for you to add value to your organization.

When students choose a segment, they should identify a trend within that segment. Then they should be able to identify an industry that would benefit from that trend. This industry is therefore likely to be a growth industry that may provide good career opportunities. It also may be useful to identify some weaknesses in this logic, such as reversal of a trend, or having an industry become a magnet for workers, such as computer programming, where the labor supply may exceed demand. Within industries, there may be specific functions that will offer growth in areas that firms can exploit. An example may be e-business, where firms in many industries are revolutionizing their distribution channels in response to the increasing acceptance by consumers of e-tailing.

- **Five-Forces Analysis:** Before you go for a job interview, consider the five forces affecting the industry within which the firm competes. This will help you to appear knowledgeable about the industry and increase your odds of landing the job. It also can help you to decide if you want to work for that organization. If the “forces” are unfavorable, the long-term profit potential of the industry may be unattractive, leading to fewer resources available and—all other things being equal— fewer career opportunities.

It is good advice to do due diligence of a firm and its industry prior to a job interview. It helps job candidates to appear knowledgeable about their prospective employers, which may be a differentiator. In class discussions, it is probably less important to make a general conclusion of “favorableness” vs. “unfavorableness.” Better is to identify the specific forces that are the strongest threats to the industry. Then develop an argument as to how students, the candidates, can help firms to address these threats. Later, provided that students have offers from firms in multiple industries, students may use the assessment of industry overall attractiveness in their decision as to which offer to accept. In discussions of this issue, it may be useful to remind students that firm characteristics are a stronger explanation of firm success than industry environment. It may be better to work for a strong firm in an unattractive industry than for a weak firm in an attractive industry.

VI. Summary

Managers must analyze the external environment to minimize or eliminate threats and exploit opportunities. This involves a continuous process of environmental scanning and monitoring, as well as obtaining competitive intelligence on present and potential rivals. These activities provide valuable inputs for developing forecasts. In addition, many firms use scenario planning to anticipate and respond to volatile and disruptive environmental changes.

We identified two types of environment: the general environment and the competitive environment. The six segments of the general environment are demographic, sociocultural, political/legal, technological, economic, and global. Trends and events occurring in these segments, such as the aging of the population, higher percentages of women in the workplace, governmental legislation, and increasing (or decreasing) interest rates, can have a dramatic effect on your firm. A given trend may have a positive impact on some industries and a negative or neutral impact, or none at all on others.

The competitive environment consists of industry-related factors and has a more direct impact than the general environment. Porter's five-forces model of industry analysis includes the threat of new entrants, buyer power, supplier power, threat of substitutes, and rivalry among competitors. The intensity of these factors determines, in large part, the average expected level of profitability in an industry. A sound awareness of such factors, both individually and in combination, is beneficial not only for deciding what industries to enter but also for assessing how a firm can improve its competitive position. We also address how industry and competitive practices are being affected by Internet technologies. We also addressed some of the limitations of Porter's five-forces model, including its zero-sum perspective and its omission of the key role of complements. Although we discussed the general environment and competitive environment in separate sections, they are quite interdependent. A given environmental trend or event, such as changes in the ethnic composition of a population or a technological innovation, typically has a much greater impact on some industries than on others.

The concept of strategic groups is also very important to the external environment of a firm. No two organizations are completely different nor are they exactly the same. The question is how to group firms in an industry on the basis of similarities in their resources and strategies. The strategic groups concept is valuable for determining mobility barriers across groups, identifying groups with marginal competitive positions, charting the future directions of firm strategies, and assessing the implications of industry trends for the strategic group as a whole.

Chapter 2: Analyzing the External Environment of the Firm

Explain the profitability of an industry (of your choice) by applying the tools that you learned in this chapter (five-forces analysis). How can the five-forces zero-sum perspective be a disadvantage?

Teaching Suggestions:

You can organize the discussion on this topic around the following sub-questions:

★ What are the five forces that drive the profitability in an industry?

The five forces are:
1. The threat of new entrants
2. The bargaining power of suppliers
3. The bargaining power of buyers
4. The threat of substitute products and services

5. The intensity of rivalry among competitors in an industry

★ What are the barriers to entry into a particular industry? Are they high or low? What are the implications?

  Six major sources of entry barriers as outlined in the text are:
  1. Economies of scale
  2. Product differentiation
  3. Capital requirements
  4. Switching costs (one-time costs that the buyer faces when switching from one supplier's product or service to another)
  5. Access to distribution channels
  6. Cost disadvantages independent of scale (These derive from: proprietary product, favorable access to raw materials, government subsidies and, favorable government policies)

★ Who are the buyers in this industry? Are they powerful? What makes the buyers powerful (not powerful)? Are the buyers likely to engage in backward integration?

★ What are the implications of buyers bargaining power?

★ Who are the suppliers to your industry? Do you think the suppliers are powerful? What makes the suppliers powerful (not powerful) in your industry? Are there any 'switching costs?' What are the implications of high bargaining power of the suppliers in the industry?

★ If you are a firm in this industry, how would you define competition? Would you consider all firms operating in the industry as your competitors? Why/why not?

★ What are "strategic groups?" How would you know the "strategic groups" in your industry? What kind of dimensions should you choose when mapping the "strategic groups"? Why is it important to understand "strategic groups"? *(We provide the example of the worldwide automobile industry.)*

  The concept of 'strategic groups' is important because competition would be more intense among firms within the same strategic group as compared to competition with other firms in the industry. Some dimensions that can be used for mapping strategic groups are: breadth of product and geographic scope, price/quality, degree of vertical integration etc.

  You should emphasize that for strategic group mapping to serve any meaningful purpose, the dimensions should be chosen in a manner that they reflect the variety of strategic combinations in the industry. For example, in an industry where there is severe price-base competition, price may not be the right dimension to choose. Similarly, if all firms have the same level of product differentiation, then choosing product differentiation as a dimension would not serve the purpose.

★ What are the substitutes to your products or services? How do substitutes impact the profitability of your industry?

You might want to make a point here that identifying substitutes can be quite a difficult task sometimes. Firms in seemingly unrelated industries may be providing products or services that act as substitutes to each other. The example given in the text on the substitution between airline industry and teleconferencing would help highlight this point.

Some more interesting questions to ask would be the following:

★ If two industries have the same profitability levels, can you employ a common strategy in both the industries?

Even though two industries might have the same profitability levels, the underlying industry structures can be entirely different. For example, in both the automobile industry and in the Internet-based businesses, profit margins are quite low. However, while the entry barriers into the automobile industry are very high, the barriers are very low into the Internet-based businesses. Competition is intense in both the industries, whereas supplier and buyer bargaining powers are quite low. On the other hand, threat from substitutes such as the 'brick-and-mortar' stores, is very high in the Internet-based businesses, whereas the threat from substitutes is low in the automobile industry. (Some students might argue that the airline industry is a strong substitute and you would have to deal with that objection.) Thus, even if a firm operates in both these industries, it needs to formulate quite different strategies to suit the particular industry situation.

★ Why is the five-force analysis important?

It is important to understand these five forces because they affect a firm's ability to compete in a given market. This analysis helps in deciding whether or not to remain in a particular industry and also in choosing industries to enter. A sound understanding of the forces operating in an industry helps in assessing how to improve the firm's competitive position with regard to each of the five forces. You can ask students to give their own ideas on what strategies they would employ in the particular industries they have chosen for analysis.

★ Is the five-force analysis "zero sum" in perspective? Is that a disadvantage?

It would often be the case that students, in the position of a company, think about counteracting the effects of each force and blunting it. This is the essence of the zero-sum perspective. You can explain the importance of thinking "win-win" and establishing collaborative partnerships with suppliers and customers. For example, establishing long-term mutually beneficial relationships with suppliers improves a firm's ability to implement just-in-time (JIT) inventory systems, which let it manage inventories better and respond quickly to the market demands.

★ Do the competitive forces remain the same over a period of time? What impact will it have on profitability?

The key point is that in the five-force analysis, we are essentially taking a point in time and trying to understand the industry situation at that point in time. This is a static approach to understanding the competitive environment. However, these external forces and the strategies of the firms within industries change over time and thus change the structure of the industry itself. In order to understand how the profitability changes over time, game theoretic approaches are being used.

★ What is "Value Net?" Who are on the vertical and horizontal dimensions? How are those on the vertical dimension different from those on the horizontal dimension? Who are complementors?" How are complements different from substitutes? *(We provide the example of the video game industry.)*

The value net represents all players in the game and analyzes how their interactions affect a firm's ability to generate and appropriate value.

Suppliers and customers form the vertical dimension of the value net and the firm engages in transactions with them.

Substitutes and complements are on the horizontal dimension of the value net. These are the players with who the firm interacts but does not necessarily transact.

Substitute products or services serve the same purpose that the products and services from a chosen industry serve. Substitutes accentuate competition.

Complements are typically products or services that have a potential impact on the value of a firm's own products or services. The firms that produce complements are referred to as "complementors." For example, very sophisticated cameras may be useless if we do not have high-quality film to produce quality pictures. Powerful hardware might prove useless without software to make it work and highly sophisticated software may be useless if there is no hardware to support its working. Thus, complements in essence help to increase the performance and efficiency of products or services of a particular industry and thus improve their competitive situation vis-à-vis other products and substitutes.

End-of-Chapter Teaching Notes

Chapter 2: Analyzing the External Environment of the Firm

Summary Review Questions

1. Why must managers be aware of a firm's external environment? (in the text, Enhancing Awareness of the External Environment, LO 2-1)

Response:

Being responsive to the external environment enables firms to avoid strategic mistakes. It is possible for firms to become internally focused, efficient producers of obsolete goods and services (e.g. buggy whips, carbon paper). Rather, managers need to respond to opportunities and threats from the external environment in order to develop the most successful products and services.

2. What is gathering and analyzing competitive intelligence and why is it important for firms to engage in it? (in the text, Enhancing Awareness of the External Environment, LO 2-2)

Response:

Competitive intelligence is a firm's activities of collecting and interpreting data on competitors, defining and understanding the industry, and identifying competitors' strengths and weaknesses. It is not spying, fortune-telling, simple data collection, or an isolated activity within a firm. The purpose of competitive intelligence is to increase management's awareness of developments in the external environment, thereby increasing the quality of strategic decisions.

3. Discuss and describe the six elements of the external environment. (in the text, The General Environment, LO 2-4)

Response:

The six elements of the general environment are the demographic segment, the sociocultural segment, the political/ legal segment, the technological segment, the economic segment, and the global segment. The demographic segment refers to the statistics of a population, such as age, income characteristics, ethnic groups, and geographic distribution. The sociocultural segment refers to the values, beliefs, and lifestyles of a country. The political/legal segment refers to the creation and use of power within a country, including the effect of various regulations, including the areas of environmental protection, employment discrimination protection, and taxes.

The technological segment refers to new products and services derived from advances in engineering, applied science, and/or pure science. These new products and services can change manufacturing processes, create new industries, and alter the boundaries between industries. The economic segment refers to the level and change in monetary and macroeconomic factors such as unemployment, inflation, interest rates, and economic growth. The global segment refers to effects on a country's business environment from abroad, and include factors such as foreign competition, foreign market opportunities, foreign supply opportunities, legal changes due to international treaties, and regional economic integration.

4. Select one of these elements and describe some changes relating to it in an industry that interests you. (in text, The Competitive Environment, LO 2-5)

Response:

The answer will vary according to segment and industry chosen. Exhibit 2.5 may summarize some of the possible findings. The purpose of this question is to get students to classify various environmental changes into the segments and articulate why a change belongs in a particular segment. It might be useful to add a major change, the Internet, to the discussion. The Internet, from the technological segment, has wide-reaching impacts (see Strategy Spotlight 2.5).

5. Describe how the five forces can be used to determine the average expected profitability in an industry. (in text, The Competitive Environment, LO 2-5)

Response:

The five-forces model consists of the threat of new entrants, the bargaining power of buyers, the bargaining power of suppliers, the threat of substitute products and services, and the intensity of rivalry among competitors in an industry. Each force can be looked at as a way that the industry environment limits a firm's ability to earn profits through either raising prices or lowering costs.

The threat of new entrants limits a firm's ability to raise prices because then a new entrant may decide to enter the industry and offer a lower price. The bargaining power of buyers directly limits a firm's ability to raise prices. The bargaining power of suppliers directly limits a firm's ability to lower costs. The threat of substitute products and services limits a firm's ability to raise prices because customers would then buy the substitutes. The intensity of rivalry among competitors in an industry limits a firm's ability to raise prices because then customers would buy from a competitor.

6. What are some of the limitations (or caveats) in using five-forces analysis? (in text, The Competitive Environment, LO 2-5)

Response:

Three limitations of the five-forces analysis are 1) the implication that low-profitability industries should be avoided may not be optimal. Low-profitability industries may be profitable opportunities for firms with innovative business models that change the competitive landscape. 2) The five-forces model assumes a zero-sum game, with a firm's loss of profitability associated with another firm's gain. However, through strategic alliances or other forms of collaboration with suppliers, buyers, or other industry players, firms can gain both profitability and competitiveness. 3) The five-forces model is static and does not account for constant changes in competitive position that characterize many industries. Included in the dynamic analyses is the effect of complements, or other products and services that affect the value of a firm's own products and services. For example, software is a complement to hardware. Dynamic interactions between firms and complements can affect the profitability prospects for a firm outside of the five-forces model.

7. Explain how the general environment and industry environment are highly related. How can such interrelationships affect the profitability of a firm or industry? (in text, The General Environment and The Competitive Environment, LO 2-4 and LO 2-5)

Response:

The general environment can affect all of the five forces in various ways. A growing economy can reduce the intensity of rivalry within the industry because firms will be scrambling to meet growing demand. There is a detailed explanation of how the Internet, a development in the technological segment, affects each of the five forces.

8. Explain the concept of strategic groups. What are the performance implications? (in text, The Competitive Environment, LO 2-7)

Response:

Strategic groups are groups of firms, usually within an industry, that share similar strategies. The performance implications are that firms can group themselves with close competitors and 1) identify barriers between groups, 2) identify positions within the industry that are marginal or tenuous, and 3) chart directions for future strategic development. Strategic group analysis is a more fine-grained way to conduct competitor analysis, as the competitive environment of an industry may differ from the competitive environment of the strategic group.

Experiential Exercise

Select one of the following industries: personal computers, airlines, or automobiles. For this industry, evaluate the strength of each of Porter's five forces as well as complementors.

Response:

This exercise is very useful for helping students understand the value of the five-forces model. For undergraduate and even graduate classes, it might be useful to work with only one force at a time. In general, students may identify a number of firms and organizations for each of the five forces. To evaluate the strength of each force, it is important to refer to relevant characteristics. The list below shows these:

- Threat of new entrants—you can look at the barriers to entry for the industry, as indicated by economies of scale, product differentiation, capital requirements, and switching costs, as well as other types of cost disadvantages to new entrants, such as proprietary products, favorable access to raw materials, government subsidies, and favorable government policies.
- Bargaining power of buyers—identify buyers who are large or in concentrated buyer industries, standard or undifferentiated products, few buyer switching costs, buyer with low profits, buyer has a credible threat of backwards integration, or the buyer views the firm's products or services as undifferentiated.
- Bargaining power of suppliers—it is often a challenge to find suppliers, but to the extent you can, look for suppliers that are large and concentrated (few in number), suppliers with few substitutes, suppliers that view the firm's industry as a minor proportion of its sales, suppliers that provide an important input, suppliers with differentiated products, and suppliers that pose a credible threat of forward integration.
- Threat of substitute products and services—identify substitutes that are a) outside the industry, and b) that are an economical and feasible alternative for buyers.
- Intensity of rivalry—identify rivals within the industry and evaluate each rival's product offerings for being lower priced or of higher quality than the firm's offerings.

Then have students put them all together and provide a summary evaluation of the overall ability of the firm to set prices and control costs.

Application Questions and Exercises

1. Imagine yourself as the CEO of a large firm in an industry in which you are interested. Please (1) identify major trends in the general environment, (2) analyze their impact on the firm, and (3) identify major sources of information to monitor these trends. (Use Internet and library resources.)

Response:

Students should respond with a variety of industries and approaches. It may be useful to have students justify their classification of trends into segments of the general environment. It may also be useful to have students justify why the trends they have identified are major trends and not minor trends. And you can ask students to classify their chosen trends as threats or opportunities. If students have focused on one, say, opportunity, then ask them to consider threats.

As for sources of information, there are many good sources from the government. Try the census department, the Bureau of Economic Analysis, Department of Commerce, Department of Labor, and the Central Intelligence Agency. Many of these sources are freely available directly from the government or through libraries. Some libraries of institutions of higher education subscribe to industry analysts reports, which often include analyses of the business environment. In addition, company websites often include information about potential market size and trends, although note that company websites are inherently a biased source of information.

2. Analyze movements across the strategic groups in the U.S. retail industry. How do these movements within this industry change the nature of competition?

Response:

We suggest following these five steps. First, develop a list of retailers. The list may include only local retailers that the students are familiar with, or the stores within a local mall or shopping area, or even a comprehensive list of all retailers in the region.

Second, choose two dimensions for mapping the firms. Depending on the type of stores chosen, we suggest breadth of product line, degree of vertical integration, average store size, pricing strategy, or target market (broad versus niche).

Third, for each store assign a value for each dimension and plot it on the strategic group space. For example, Wal-Mart would have a broad product line, high vertical integration (it often buys directly from suppliers, not wholesalers), large size, low pricing, and broad target market. These assessments will determine its location on the two chosen dimensions. In addition, for at least one firm get a sense of how it has changed in the past year or so.

Fourth, after putting your firms on the strategic group space, look for clusters and spaces between clusters. Evaluate each cluster. Ask students which clusters would be more profitable and which less so. And most important, ask why. Students should be able to articulate the desirability of each cluster, and link their reasoning to the dimensions used for mapping the firms. For the spaces, ask students if any of the spaces would be desirable places. Often, the groupings do not make sense. If that were the case, then challenge students to come up with dimensions that do make sense. You should help students to understand that they have control over how the strategic space is defined.

Fifth, for the firm that has changed in the past year, chart that movement on the strategic group space. No matter what dimensions you use, this firm will be moving away from some competitors and toward others. Ask students how this movement affects the competition between this firm and others. The purpose of the discussion is to get students to appreciate that increasing distance associates with less competition and decreasing distance between firms represents a threat.

3. What are the major trends in the general environment that have impacted the U.S. pharmaceutical industry?

Response:

The U.S. pharmaceutical industry consists of firms that manufacture and market medicines for people. All segments impact this industry. The demographic segment affects demand, as the aging baby-boomers require age-specific medicines and marketing approaches. Also, older people tend to require more medicines than younger people, so market demand in the U.S. is growing. The sociocultural segment affects medicinal preferences. People value their health and trust their doctors rather than use traditional medicines.

The political/legal segment is extremely important due to the regulatory approval process for new medicines, intellectual property right protection, government insurance programs, and price controls. Regulatory approval of new medicines is extremely rigorous and costly. To recoup the costs of obtaining approval, pharmaceutical firms exploit their monopoly power that stems from the patents and trademarks on the medicines. And this monopoly power enables pharmaceutical companies to charge high prices. The recent trend in government support for prescription drugs through Medicare, and the recent and ongoing implementation of near-universal health care and prescription programs has two impacts: 1) more patients will be getting prescriptions, which increases revenues, and 2) more patients will be covered by insurance, which will increase buyer power and decrease revenue to pharmaceutical companies.

The technological segment affects the new product development process. Biotechnology involves the use of living organisms to develop new drugs and has created an explosion in potential new medicines. Other technologies developed by these companies are the ability to test thousands of substances at a time and to map the human genome, which helps us to understand the causes and potential cures of many ailments.

The economic segment affects the industry, as general economic growth affects market potential. The recent recession has therefore hurt the industry. In addition, expected interest rates affect the financial prospects of many biotech firms. These firms often take decades to develop new drugs and bring them to the market. Lower interest rates enable them to make their investors' capital last longer. The global segment affects the industry in a number of ways. Foreign markets offer sales opportunities. Foreign labs are effective partners for collaboration. However, foreign countries often put price controls on medicines, which limit profit potential from foreign sales. And foreign competitors often do not respect the intellectual property of U.S. firms, giving rise to loss through piracy.

4. Go to the Internet and look up www.kroger.com. What are some of the five forces driving industry competition that are affecting the profitability of this firm?

Response:

A couple of clicks first to the "about the Kroger company" at the bottom of the home page, then to the Kroger Fact Books on the right side of the page will get you to the fact books. These include information on the following topics.

The first step is to define Kroger's industry. While Kroger does have jewelry stores and houseware stores, its primary activity is in supermarkets. We will focus on supermarkets.

For the threat of new entrants, this force is weak. Kroger notes that the industry is consolidating. There are very large barriers to entry due to capital requirements and economies of scale. The bargaining power of buyers is weak. The buyers are the general public, which is an aggregation of very small customers. No customer is a very large part of the market, and customers will not have an information advantage over Kroger. The primary source of buyer power is the ability of customers to shop at the competition. The bargaining power of suppliers is moderate. Some of Kroger's stated competitive advantages stem from the brand equity of suppliers' products, such as Kitchen Aid, Levis, Dockers, and Nikon. However, Kroger counters supplier power by developing a series of corporate brands, and by backwards integrating into the suppliers' industries. The threat of substitute products and services is limited, as customers have developed a habit of doing most of their food shopping at supermarkets as opposed to farmers' markets, convenience stores, or general stores (although students may note the growing food offerings at retailers such as Wal-Mart or Target). And note that Kroger includes a number of other types of store formats, like marketplace stores and convenience stores, to compete in substitute industries. Alternatives do not have a very high market share. The intensity of rivalry among competitors in the industry is very strong. Kroger competes with Wal-Mart, Meijer, and other chains of supermarkets in every part of the country. These competitors are large, successful, and aggressive. Kroger limits rivalry by acquiring smaller stores and chains where possible. One of Kroger's strategies for dealing with rivalry is to encourage customer loyalty through various programs such as shopper cards and a customer relations management system in conjunction with London-based dunnhumby.

Ethic Questions

1. What are some of the legal and ethical issues involved in collecting competitor intelligence in the following situations?

a. Hotel A sends an employee posing as a potential client to Hotel B to find out who Hotel B's major corporate customers are.

Response:

The scheme risks exposure. Hotel B might find out who the employee is and find out that he or she represents Hotel A. Hotel B's list of major corporate customers is likely to be a trade secret, and Hotel A's use of fraud to gain the trade secret is, depending on state law and the specific circumstances, likely to be a crime.

It is likely that Hotel B will share this information with the press, trade publications, or other media. It is also possible that Hotel B will use this information to tarnish Hotel A's reputation. Hotel A's business could be affected and shareholders embarrassed. The cost to Hotel A of overcoming these shortcomings is likely to exceed whatever gain was possible.

b. A firm hires an MBA student to collect information directly from a competitor while claiming the information is for a course project.

Response:

It is possible that this action would be a crime, although doubtful. The competitor is not likely to share trade secrets, because the course project is not likely to be kept confidential, but that depends on the circumstances.

However, the scheme is certainly fraudulent and therefore unethical. The firm is using the MBA student as a spy, which is abusive to the MBA student. The student's college or university, though perhaps not directly involved, will have its name associated with the scheme.

In addition, the competitor can use the scheme to discredit the firm and embarrass its shareholders.

c. A firm advertises a nonexistent position and interviews a rival's employees with the intention of obtaining competitor information.

Response:

The scheme is fraudulent. Advertising a position without an intention of hiring is unethical. If the scheme succeeds in obtaining trade secrets, then it is probably a violation of law. And the coercive treatment of the rival's employees is a problem.

The possibility of criminal violations occurs within the purview of many states' trade secret laws. If any individual suffers any harm, then civil damages are possible.

But the unethical nature of this scheme is likely to be the largest problem. The rival can use the firm's actions to discredit the firm and embarrass its shareholders.

2. What are some of the ethical implications that arise when a firm tries to exploit its power over a supplier?

Response:

A monopsonist, or a firm that is the only buyer in a market, has great power over suppliers. It might try to exploit this power by forcing the supplier to reduce prices or provide extra services. In the extreme, suppliers will be forced to cut costs, lay off employees, cut salaries, and forego investments in new technologies or capabilities. The downside of these actions is that the supplier is less capable of contributing to industry development by infusing it with innovations.

CONNECT RESOURCES

Case Exercises and Case Analysis interactive questions.
Video: Analyzing Industry Forces
Video: Analyzing the Macro-Environment

Teaching Note: Case 3 – McDonald's

Case Objectives

1. To investigate the key external environmental issues that can affect a firm's strategy.
2. To examine how a reevaluation of strategy involves assessment of internal activities and resources.

See the table below to determine where to use this case:
NOTE: There are both PRIMARY and Secondary chapters that can be used for this case. The Teaching Note gives guidance for the PRIMARY use chapters, and provides suggestions if the instructor wants to use the case to illustrate concepts from the optional Secondary chapters.

Chapter Use	Key Concepts	Additional Readings or Exercises
PRIMARY CONCEPTS 2: External Environment	External environmental forces; Porter's five forces model	Visit investor commentary on MCD, see **VIDEO** links re customer response; read about healthy foods controversy, watch **video** re SuperSize Me, FastFoodNation
3: Internal Analysis	Value chain; tangible vs. intangible resources; VRIN analysis	See **VIDEO** links re value chain challenges
5: Business-Level Strategy	Generic strategies	
SECONDARY CONCEPTS 1: Strategy Concept	Strategic management; vision, mission, strategic objectives	Visit McDonald's website to evaluate its mission. See an embedded **video** of a 1967 McDonald's TV commercial.
4: Intellectual Assets	Human capital; intellectual capital	
6: Corporate-Level Strategy	Corporate strategy; diversification; synergy; acquisition	
7: International Strategy	International expansion	

Case Synopsis

McDonald's had announced on January 28, 2015, that Don Thompson would retire as president and chief executive at the end of February. He would be replaced by Steve Easterbrook, the firm's chief branding officer. The abrupt exit came after the world's largest restaurant chain posted one of its worst financial performances in years.

This was frustrating to many analysts, because McDonald's had managed to show consistent growth in performance up to 2013, riding a surge in operating profits and stock price for almost a decade. Most of this could be attributed to the "Plan to Win," which was first outlined by James R. Cantalupo, who had come out of retirement to guide McDonald's after overexpansion had caused the chain to lose focus. The core of the plan was to increase sales at existing locations by improving the menu, refurbishing the outlets, and extending hours.

In spite of management changes, McDonald's had remained committed to pushing on various aspects of this plan. The chain had continued to expand its menu over the years, with more sandwiches and salads. It also started to add snacks and drinks, two of the few areas where restaurant sales had still been growing in spite of the economic downturn. Its addition of specialty coffee, ice-cold frappes, and fruit smoothies in its newly added McCafes had helped boost the average spent by each customer and lured customers to its outlets for snacks during slower parts of the day.

Nevertheless, McDonald's was aware that it was facing a rapidly fragmenting market, where consumers were looking for healthier and even more exotic foods. The chain was facing tougher competition from Burger King and Wendy's, both of which had been adding to their menus and remodeling their outlets. McDonald's had also lost ground with Millennials who were increasingly drawn to new designer burger outlets such as Five Guys and Shake Shack. At the same time, McDonald's was also losing customers to fast-casual chains, such as Chipotle Mexican Grill and Panera Bread, which offered customized ordering and fresh ingredients. Many analysts therefore believed that the chain had to continue to work on its turnaround strategy in order to meet these challenges.

The prevailing belief was that when restaurants started to slide, it really took a lot to turn them around. Would McDonald's be the exception? With the recent addition of the McCafe coffee line, fruit-based smoothies, and healthier offerings across the menu, McDonald's was stretching its brand beyond its traditional money making burgers and fries. Would this allow McDonald's to successfully compete against all of its rivals, since, especially in America, people just love their burgers?

Teaching Plan

This is a case that is well suited for a full investigation of strategic analysis and formulation. Especially since most students are well aware of McDonald's strategic challenges, the case can be placed in the course at the point where the instructor is ready to lead into a discussion of strategy formulation. By building a sound foundation in external and internal environmental analysis, a discussion of McDonald's can provide an intro for the challenges of competition in a changing environment. As such, this case is best positioned mid-way through the course, after students have had an introduction to the concepts of strategy analysis and formulation.

Regarding a competitive strategy, McDonald's has now moved into the drinks segment (with McCafe coffee and smoothies), which pits it against the likes of Starbucks and Jamba Juice. The instructor might want to assign the Jamba Juice case as well to provide another view of this part of the industry.

ICEBREAKER

This case can start with an ***icebreaker***. Starting from the perspective of a customer may make it easier for students to transition to a strategic analysis.

Have you ever eaten at McDonalds? Over the last few years, have you seen any changes in either the menu or the restaurant décor? What do you think of these changes?

It is safe to say that McDonald’s is an American icon. Chances are that almost every student has visited McDonald’s at least once. A good way to start the discussion of this case is to ask students about their experiences with McDonald’s. Those who had visited McDonald’s as little kids could share their experience about what McDonald’s meant to them as kids and how their perception of the restaurant changed as they grew older. This may lead to a discussion of the quality of food and service, and how this compares with choices at other places.

The instructor may want to put a chart on the board: what students *Like*, what they *Don’t Like* about McDonald’s and then what they think McDonald’s should *Do Differently*. There may be some disagreements about the likes and dislikes: some people really like the taste of the fries, while others dislike the unhealthy nature of the food; some people like the “fast-food” part – preferring the drive-in – while others prefer to be able to sit down and share food with their friends. If there are international students in the class, it’s also fun to have them share both the décor/service and menu differences between international and U.S. McDonald’s restaurants. These differences could also be put on the board. If there is diversity among responses, it may make it easier for the instructor to then ask: so if you were McDonald’s CEO, how would you respond to these diverse opinions from your customers? What strategic issues do you need to consider? This flows straight into a discussion of mission and the external environment.

Before engaging in discussion, you might want to test student’s basic knowledge regarding the case and the major concepts. Here are some multiple-choice questions to use. (This will get the student’s attention – they can’t answer these if they haven’t read the case!)

Which of these statements is the truest?

a. Millennials are defecting from McDonald’s to traditional competitors like Burger King and Wendy’s.
b. McDonalds’s dollar menu has worked well.
c. McDonald’s doesn’t have to worry about restaurants like Panera Bread, since these kinds of fast-casual dining destinations don’t draw the same customers as McDonald’s does.
d. Because of its bulk purchasing agreements, McDonald’s never has to worry about running out of French fries.

ANSWER: a
Changing tastes has customers, especially millennials, more likely to go to new designer burger outlets such as Five Guys and Shake Shack, and even traditional competitors such as Burger King and Wendy’s. McDonald’s tweaked its “dollar menu,” replacing it with “dollar value and more” and raising the prices of many items as part of a bid to get each customer to spend more.

Over the previous five years, about 15 percent of the chain's sales had come from its dollar menu, on which everything cost a dollar. Changing tastes were responsible for the loss of customers who were lining up at fast-casual chains such as Panera Bread, which offered customized ordering and fresh ingredients. McDonald's had to face shortages of French fries in several markets because of a slowdown at the port in Los Angeles.

In recent years, the only fast-food burger chain with consistent growth has been Wendy's.

a. Yes
b. No

ANSWER: b See Exhibit 4. Five Guys is the only fast-food burger chain to have seen consistent growth since 2010.

Summary of Discussion Questions
Here is a list of the suggested discussion questions. You can decide which questions to assign, and also which additional readings or exercises to include to augment each discussion. Refer back to the Case Objectives Table to identify any additional readings and/or exercises so they can be assigned in advance.

Discussion Questions:

1. What are the current forces in the external environment that might affect McDonald's strategy?
2. What source of competitive advantage does McDonald's have, and is that position supported by its value chain and other internal resources?
3. OPTIONAL QUESTION: What other strategies could McDonald's formulate to achieve a competitive advantage?

Discussion Questions and Responses

1. ***What are the current forces in the external environment that might affect McDonald's strategy?***

Referencing Chapter 2: Analyzing the External Environment

Organizational leaders must become aware of factors in the overall environment that might affect their ability to create a competitive advantage. So how do managers become environmentally aware? By doing scanning, monitoring, and gathering competitive intelligence, and using these inputs to develop forecasts. This prepares the firm to do more extensive analysis of the forces in the general environment and the industry or competitive environment.

Environmental scanning involves surveillance of a firm's external environment to predict environmental changes and detect changes already under way. It is a BIG PICTURE viewpoint of the industry/competition, looking for key indicators of emerging trends – What catches your eye? This alerts the firm to critical trends before changes have developed a discernible pattern and before competitors recognize them. Environmental monitoring is a firm's analysis of the external environment that tracks the evolution of environmental trends, sequences of events, or streams of activities. Leaders need to monitor the trends that have the potential to change the competitive landscape – What do you want to track? Firms need to CHOOSE the trends identified via the scanning activity, and regularly monitor or track these specific trends to evaluate the impact of these trends on their strategy process.

What factors or trends might be most important to McDonald's? To assess how the *external environment* might affect McDonald's strategy, it's necessary to take a look at the factors in the *general external environment*. McDonald's must consider the political/legal, economic and global, sociocultural and demographic, and technological forces that might affect the ability of the firm to deliver its services and sustain its business. See which factors in the ***general environment*** students might pick that have a significant impact on the fast food industry. Students might respond as follows:

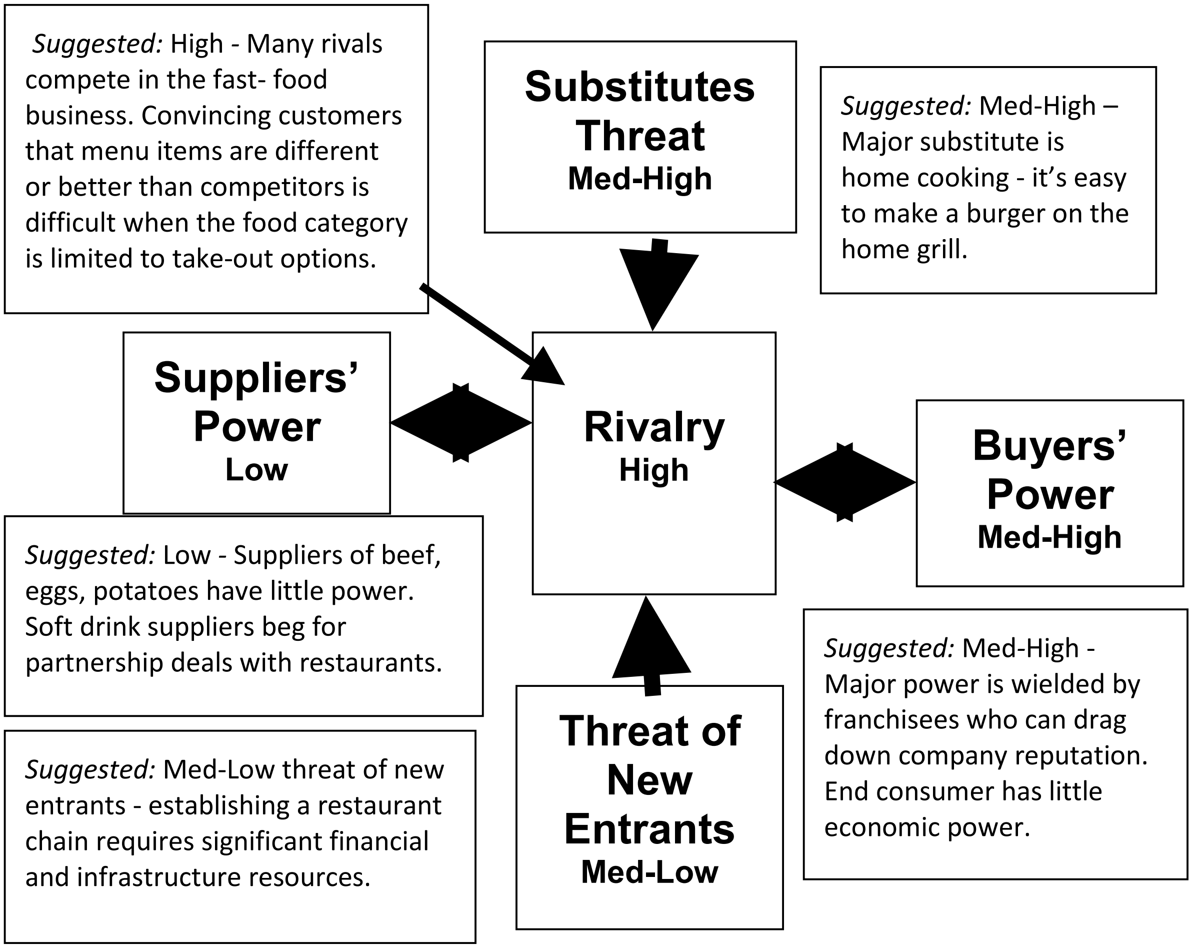
Demographic - customers are now working around the clock, expecting 24-hour access to fast food. How to please the range of customers from kids to contractors?

Sociocultural - customers preferences have changed to more exotic foods, healthier food with better taste, attention paid to sustainable solutions for the food chain, i.e. cage-free eggs. However the growth in fast-food burger places such as Five Guys shows that customers will ignore healthy as long as the food tastes really good – people still like a juicy, good tasting hamburger.

Economic – the current economic downturn means customers might be trading down to McDonald's if they want to eat out. However, this means that the fast-food meals must be perceived as worth the prices paid, meaning costs still need to be low enough to charge comparably low prices.

Global - boundaries are disappearing, travelers are more open to global consistency in food offerings - Golden Arches are accepted, and expected, everywhere. Geography does matter – given that people will be seeking out inexpensive yet good food, it doesn't matter the brand. Whichever burger chain is closest will get the business.

To answer the question about the *current forces in the general and fast-food industry environments* that affect McDonald's ongoing strategy, it's necessary to assess the segments of the external competitive environment that include competitors, customers, and suppliers, substitutes and new entrants. Porter's *five forces model* allows strategists to anticipate where the industry might be most vulnerable. Help students apply Porter's Five Forces of competition by drawing a diagram on the board similar to the following and having students fill in the details. Based on the external environmental industry analysis, the fast-food business is not an attractive industry, with many competitors trying to carve out a piece of the "profit" pie.


Suggested: High - Many rivals compete in the fast- food business. Convincing customers that menu items are different or better than competitors is difficult when the food category is limited to take-out options.
Substitutes Threat
Med-High
Suggested: Med-High – Major substitute is home cooking - it's easy to make a burger on the home grill.
Suppliers' Power
Low
Rivalry
High
Buyers' Power
Med-High
Suggested: Low - Suppliers of beef, eggs, potatoes have little power. Soft drink suppliers beg for partnership deals with restaurants.
Suggested: Med-High - Major power is wielded by franchisees who can drag down company reputation. End consumer has little economic power.
Suggested: Med-Low threat of new entrants - establishing a restaurant chain requires significant financial and infrastructure resources.
Threat of New Entrants
Med-Low

NOTE - ADDITIONAL EXERCISES, VIDEO VIEWING:

One interesting way to evaluate the competitiveness in the industry is to look at comparative financial performance from the perspective of an investor. Since McDonald's (MCD) is a publicly traded firm, take a look at http://finance.yahoo.com/q/co?s=MCD to see how it compares with its peers. Regarding MCD's performance over the last nine years, see the following:

After James Cantalupo charted the "Plan to Win" strategy, some argued that McDonald's stock was potentially a good investment: In April of 2007, McDonald's had made some changes, and still came out on top http://www.fool.com/investing/high-growth/2007/04/20/mcdonalds-still-going-strong.aspx?terms=mcdonalds&vstest=search_042607_linkdefault, and then impressed based on its global sustainability strategy http://www.fool.com/investing/general/2007/04/25/mcdonalds-making-money-making-a-difference.aspx?terms=mcdonalds&vstest=search_042607_linkdefault and strategy for global expansion http://www.fool.com/investing/general/2007/08/22/monsieur-mcdonald-charms-the-continent.aspx.

In October of 2007 McDonald's increased its focus on diversifying its menu offerings by confirming that it would compete with Starbucks for the specialty coffee market by 2008 http://www.fool.com/investing/general/2007/10/03/mcdonalds-head-of-steam.aspx?terms=mcdonalds&vstest=search_042607_linkdefault, and in December 2007, it had outperformed its direct competitors and looked poised to weather the forecasted economic downturn in 2008 in good shape, thanks in part to its overseas expansion plans: http://www.fool.com/investing/general/2007/12/31/best-stock-for-2008-mcdonalds.aspx?terms=mcdonalds&vstest=search_042607_linkdefault.

As MDC announced details of its coffee roll out in 2008, some wondered if this was the right time for such an expansion, especially because Starbucks was seeing a decline in business as more consumers brewed coffee at home, and it would cost the franchisees an average of $100,000 per location to do the needed remodeling: http://online.wsj.com/article/SB122506692561270623.html

Information from McDonald's history, and interviews with its franchisees, details MCD's turnaround strategy in this article: http://www.nytimes.com/2009/01/11/business/11burger.html?_r=1. Especially noteworthy was MCD's performance outside the U.S. (See http://www.nytimes.com/imagepages/2009/01/10/business/20090111_BURGER_GRAPHIC.html for graphs and commentary on MCD's international performance.) For current information on the company, see http://topics.nytimes.com/top/news/business/companies/mcdonalds_corporation/index.html

In 2011 analysts recommended McDonald's as "a solid defensive stock. It's a lean, mean competitive machine, focusing entirely on its core strengths." http://www.fool.com/investing/general/2011/01/24/mcdonalds-gets-defensive.aspx?source=isesitlnk0000001&mrr=0.33

And in 2013, after MCD announced disappointing quarterly results, in the wake of aggressive competition from Wendy's and Burger King and the continued economic troubles in Europe, one analyst pointed out another "challenge for McDonald's is the growing number of chains that offer quick, better quality food at higher prices, including Chipotle, Noodles & Company, Panera Bread and others. Those chains are reshaping expectations when people go out to eat." The question was whether Thompson, who took over in 2012, "will be able to keep McDonald's image up to date as it struggles though the tough economic climate":
http://finance.yahoo.com/news/mcdonalds-predicts-tough-despite-items-132325729.html

In 2015, after Easterbrook's promotion to CEO, traffic was down in all market segments, and was trying new menu combinations to appeal to millennials. See **VIDEO**
https://www.youtube.com/watch?v=vBnS4E4KhAw
And in 2016 news was good as MCD had its best quarter in nearly four years, by trying to appeal to millennials with, for instance, the customizable kiosk. See **VIDEO**
https://www.youtube.com/watch?v=A9ofHCPYC-A
In 2017 Easterbrook talks about growth based on what customers want: value and speed, but has also been forced to respond to quality and cleaning up the supply chain, i.e. cage free eggs. He also notes that consumer economic confidence is what ultimately drives customer visits. See **video** https://www.youtube.com/watch?v=xfn-D654m7s

Based on the information provided there, and from other analysts, would you be willing to invest in McDonald's stock today? Why or why not?

McDonald's was criticized in some quarters for providing unhealthy food that contributes to an obesity epidemic in the United States, most notably in the documentary film "Super-Size Me" and in the book and movie *Fast Food Nation*. Watch the **video** trailers here:
Super-Size Me: http://www.youtube.com/watch?v=I1Lkyb6SU5U Fast Food Nation: http://www.youtube.com/watch?v=zc_z623Wsro Read commentary on How McDonald's reacted, compared to Burger King's ad campaign:
http://www.prophet.com/blog/aakeronbrands/26-did-burger-king-panic

See McDonald's nutritional information from their website https://www.mcdonalds.com/ca/en-ca/about-our-food/nutrition-calculator.html What is McDonald's core position about the role of its food in a healthy diet? Do you agree or disagree with the company's view?

Another sociocultural trend worldwide, touched on in *Fast Food Nation*, is focused on the treatment of animals used for food. The Humane Society of the U.S. has challenged McDonald's to get its eggs from free-range chickens rather than cage-bound layers. In Britain, the company already does this, but it has been slow to make the switch in the U.S. MCD uses upwards of 3 billion eggs a year. See the strategy here:
http://www.guardian.co.uk/business/2009/may/24/mcdonalds-us-free-range-eggs-trial
Then in 2015 McDonald's announced it will be transitioning, and that within 10 years all of its American and Canadian egg suppliers will be cage-free. http://www.npr.org/sections/thesalt/2015/09/10/438934607/the-latest-scramble-in-the-egg-industry-mcdonalds-is-going-cage-free

In 2017 this shift is underway, although not all suppliers are ready to comply. Next on the strategic agenda is sustainable beef.

2. ***What source of competitive advantage does McDonald's have, and is that position supported by its value chain and other internal resources?***

Referencing Chapter 5: Formulating Business-Level Strategies

In order to achieve a sustainable competitive advantage, McDonald's has to assess its ability to contend with other fast-food restaurants. The question of how to compete in a given business to attain competitive advantage requires an assessment of the types of *competitive strategies*, including the three *generic strategies* that are used to overcome the five forces and achieve a competitive advantage:

- Overall cost leadership
    - Low-cost-position relative to a firm's peers
    - Manage relationships throughout the entire value chain
- Differentiation
    - Create products and/or services that are unique and valued
    - Non-price attributes for which customers will pay a premium
- Focus strategy
    - Narrow product lines, buyer segments, or targeted geographic markets
    - Attain advantages either through differentiation or cost leadership

Ask the students which strategy they think McDonald's should pursue, and why. Their answers may include some of the following points:

Cost leadership has been the traditional strategy for the fast-food industry, but McDonald's kept costs under control in order to achieve parity with competitors. McDonald's tried to develop a *differentiation* advantage while keeping costs at a reasonable level. Differentiation requires the creation of something that is perceived industry wide as unique and valued by customers. Differentiation is achieved by a firm configuring its value chain activities to support its position so customers are willing to pay a premium for something unique - could McDonald's do this effectively?

Referencing Chapter 3: Analyzing the Internal Environment

To answer the question of whether McDonald's differentiation strategy is adequately *supported by its value chain and other internal resources,* McDonald's must assess the relationships between the elements in its *value chain*. Every activity should add value. Take a look at Chapter 3, Exhibit 3.1 to see the value chain activities. Here is what an assessment of this might look like for McDonald's:

Value chain activity	How does McDonald's create value for the "customer"? What challenges does McDonald's have in its value chain?
Primary:	
Inbound logistics (food & supply deliveries)	Assumed adequate.

Operations (efficient processing of orders, quality control systems)	Strived for consistency across the chain, with differing results. Refurbishing of restaurants, change in hours may help draw customers.
Outbound logistics (distribution to customers)	Assumed adequate.
Marketing and Sales (motivated employees, innovative advertising & promotion)	Many product innovations failed, $1 menu didn't go well with franchisees. I'm Loving It campaign was an attempt to reach all customers, and had been successful for many years.
Service (ability to solicit feedback & respond to customer issues)	Assumed adequate.
Secondary (or support):	
Procurement (relationships with suppliers for procurement of raw materials and supplies)	Assumed adequate.
Technology development (state of the art equipment & software)	Adoption of expensive cooking processes failed to generate desired results. Premium salads take advantage of technology.
Human resource management (effective recruitment, incentive & retention mechanisms)	Lower standards for hiring, less time for training led to deterioration of service.
General Administration (effective planning systems to establish goals, access to operating capital, effective top mgmt communication, relationships with diverse stakeholders)	Top-down decision making, lack of involvement in changes caused franchisee complaints, especially when profits went down. Franchise training program may help.

CEO Easterbrook realized that basic changes in McDonald's' value chain needed to be made to get the company back on track. Menu changes and franchisee relationships were key factors that had been addressed. His moves seem to have paid off in that McDonald's' financial performance improved, but fundamental issues still remained - would the customizable "kiosks" and "healthier" menu dilute the traditional brand image, confuse customers, and harm McDonald's reputation for value and speed?

To further answer the question of how to support a competitive strategy, it's important to consider the concept of the *resource-based view of the firm*, and the three key types of resources: tangible resources, intangible resources, and organizational capabilities. Determining whether the internal resources are valuable, rare, difficult to imitate, or difficult to substitute (*VRIN*) can help a firm sustain a competitive advantage. See Chapter 3, Exhibit 3.6. McDonald's profile might look like this:

Tangible Resources:

Financial - McDonald's appears to have managed its finances well, currently has adequate cash on hand.
Physical - has significant physical assets in the restaurants.
Technological - has kept up with current technology.

Intangible Resources:

Organizational - franchise model is a weakness unless strong quality controls are in place
Human - training of staff is critical, could be a problem.
Innovation - this is a current strength, but needs to be managed in the right direction - choice of innovation is key.
Reputation - McDonald's brand is its most significant strength - this should be protected at all costs.

Organizational Capabilities: Easterbrook's leadership and willingness to extend Cantalupo's and Skinner's vision of excitement to all stakeholders may be key.

Applying the VRIN analysis, McDonald's doesn't appear to have any resources that are clearly valuable, rare, in-imitable, or non-substitutable. This indicates that McDonald's may have a major challenge sustaining a competitive advantage, especially since any strategy it implements can be quickly imitated by competitors. However, McDonald's *core capability* appears to be its operations focus on the original vision and mission. This has allowed its brand reputation to remain solid over the years.

NOTE - ADDITIONAL VIDEO VIEWING:

In 2017 Easterbrook talks about growth based on what customers want: value and speed, but has also been forced to respond to quality and cleaning up the supply chain, i.e. cage free eggs. He also notes that consumer economic confidence is what ultimately drives customer visits. See **video** https://www.youtube.com/watch?v=xfn-D654m7s

3. ***OPTIONAL QUESTION: What other strategies could McDonald's formulate to achieve a competitive advantage?***
   NOTE: There are no PowerPoint slides to accompany the following.

Referencing Chapter 1: Introduction and Analyzing Goals and Objectives

Strategy is all about the ideas, decisions, and actions that enable a firm to succeed. See Chapter 1, Exhibit 01: *Strategic management consists of the analyses, decisions, and actions an organization undertakes in order to create and sustain competitive advantages:*

a. strategy directs the organization toward overall goals and objectives;
b. includes multiple stakeholders in decision making;
c. incorporates both short-term and long-term perspectives;
d. recognizes trade-offs between efficiency and effectiveness.

Leaders face a large number of complex challenges. Leaders must be proactive, anticipate change, and continually refine changes to their strategies. This requires a certain level of "ambidextrous behavior," where leaders are alert to opportunities beyond the confines of their own jobs, and are also cooperative and seek out opportunities to combine their efforts with others. Leaders must make strategic management both a process and a way of thinking throughout the organization.

See Chapter 1, Exhibit 06: *The primary role of the organizational leader is to articulate vision, mission, and strategic objectives*. Leaders must communicate their initial *vision* of the organization's purpose. Should McDonald's evaluate its initial *vision*? What was the original goal that *evoked a powerful and compelling mental image of a shared future,* one that was massively inspiring, overarching, and long-term, that represented a destination that is driven by and evokes passion?

Is the original vision still applicable given the present circumstances?

McDonald's organizational mission needs to be considered: a *mission* encompasses both *the purpose of the company as well as the basis for competition and competitive advantages.* In writing a mission statement, it is important to understand the definition of the business by answering these questions: 1) Who are its customers? 2) What customer need is the organization trying to fulfill? and 3) How does the business create and deliver value to customers and satisfy their needs?

Organizations must respond to multiple constituencies if they are to survive and prosper, and the mission provides a means of communicating to diverse organizational stakeholders. Although vision statements tend to be quite enduring and seldom change, a firm's mission can and should change when competitive conditions dramatically change or the firm is faced with new threats or opportunities.

Anticipating that things might change, McDonald's leadership must establish *strategic objectives* to operationalize the mission statement with specific yardsticks. That is, objectives help *to provide guidance on how the organization can fulfill or move toward the "higher goals" in the goal hierarchy* – the mission and vision.

McDonald's original vision was to provide local customers with a quality meal at a fair price through a quick and convenient service delivery. McDonald's mission became to deliver this service consistently, providing an all-around enjoyable experience for the whole family. CEO Cantalupo's objective was to inspire employees and franchisees to "put the smile back into the McDonald's experience." External forces had begun pushing for healthier forms of food. Company-owned and franchisee restaurants had inconsistency in service and décor. New menu items had to be accepted by loyal customers. Skinner appeared to have continued with the original vision & mission. Should Easterbrook do the same?

McDonald's provides an interesting example of a firm that did very well for decades with a clear strategy and then stumbled as it tried to reevaluate what it wanted to do. It is clear from the case that McDonald's had been tremendously successful primarily as a fast-food chain, with particular emphasis on hamburgers. Should Easterbrook rethink strategy as a result of factors in the environment?

See Chapter 1, Exhibit 1.3 for a depiction of the strategic management process. During *strategic analysis*, the leader does "advance work" to anticipate unforeseen environmental developments, identify unanticipated resource constraints, assess changes in his or her preferences for how to manage. During *strategy formulation,* the organization addresses the issue of how to compete in a given business to attain competitive advantage. Strategies are formulated at the business, corporate, and international levels. Entrepreneurial initiatives may also play a role.

In *strategy implementation*, depending on the type of organization structure, the leader might include key individuals in a discussion around selecting which strategies might be best to implement at which level within the organization. The leader must ensure proper strategic controls and organizational design, and establish effective means to coordinate and integrate activities within the firm as well as with suppliers, customers, and possible alliance partners. Leaders should also be committed to excellence and ethical behavior while promoting learning and continuous improvement. Here's where innovation is important.

The basic question strategic management tries to answer is: *How can we create competitive advantages in the marketplace that are not only unique and valuable but also difficult for competitors to copy or substitute?*

NOTE - ADDITIONAL EXERCISES AND VIDEO VIEWING:

As stated, in writing a mission statement, it is important to understand the definition of the business by answering these questions: 1) Who are its customers? 2) What customer need is the organization trying to fulfill? and 3) How does the business create and deliver value to customers and satisfy their needs? Visit McDonald's corporate web site to research its mission and vision at:
http://www.aboutmcdonalds.com/mcd/our_company/mcd_faq/student_research.html?DCSext.destination=http://www.aboutmcdonalds.com/mcd/our_company/mcd_faq/student_research.html#1
Based on your visit to this website, how do you feel about McDonald's mission and what its current priorities seem to be?

Here's a McDonald's **television** advertisement from 1967: http://www.youtube.com/watch?v=RFEkfipbI3Q&feature=related. Compare McDonald's positioning of itself within the restaurant industry in 1967 to its positioning today. What are the similarities and differences? Which one seems truest to the original vision and mission of the company?

Referencing Chapter 4: Assessing Intellectual Capital

Consider the concepts of *intellectual capital* and *human capital*, both of which are intangible assets that a company such as McDonald's needs to have in order to compete successfully. Intellectual capital is a measure of the value of a firm's intangible assets, its reputation, employee loyalty and commitment, customer relationships, company values, brand names, and the experience and skills of employees. Human capital involves the individual capabilities, knowledge, skills, and experience of the company's employees and managers. McDonald's has some valuable intangible assets to help it carry out its mission, but these need to be further developed, especially now that the company has transitioned to a more franchise-based model. Easterbrook's leadership is necessary. Given McDonald's challenges both internally and externally, he must make some good choices about how to compete going forward.

Regarding the *steps Easterbrook could take to fix the problems McDonald's faced,* McDonald's should review the components of the strategic management process.

Remember our previous discussion. See Chapter 1, Exhibit 1.3 for a depiction of the strategic management process. During *strategic analysis*, the leader does "advance work" to anticipate unforeseen environmental developments, identify unanticipated resource constraints, assess changes in his or her preferences for how to manage. During *strategy formulation,* the organization addresses the issue of how to compete in a given business to attain competitive advantage. Strategies are formulated at the business, corporate, and international levels. Entrepreneurial initiatives may also play a role.

In *strategy implementation*, depending on the type of organization structure, the leader might include key individuals in a discussion around selecting which strategies might be best to implement at which level within the organization. The leader must ensure proper strategic controls and organizational design, and establish effective means to coordinate and integrate activities within the firm, as well as with suppliers, customers and possible alliance partners. Leaders should also be committed to excellence and ethical behavior while promoting learning and continuous improvement. Here's where innovation is important.

Once again, the basic question strategic management tries to answer is: *How can we create a sustainable competitive advantage in the marketplace that is not only unique and valuable but also difficult for competitors to copy or substitute?*

McDonald's CEO Skinner had continued the tough "up or out" grading system for franchisees that identified underperforming units. He introduced new products such as McGriddles breakfast sandwich; added healthier items; created a new promotion, "I'm loving it"; refurbished restaurants, making them more comfortable, providing TVs and wireless access; allowed franchisees to experiment and make changes to fit their local community; moved toward 24/7 all-hour customer access; innovated by incorporating McCafe concept to appeal to another type of customer.

McDonalds's had already experienced a relatively unprecedented comeback, but were things different now? The prevailing belief was that when restaurants started to slide, it really took a lot to turn them around. Would McDonald's be the exception? Will CEO Easterbrook guide McDonald's to be able to successfully compete against all of its rivals? Who's willing to bet yes?

Referencing Chapter 6: Formulating Corporate-Level Strategies

Corporate strategy focuses discussion on the questions of what businesses a corporation should compete in, and how the businesses should be managed so they can create "synergy" – creating value through entering new markets or developing new technologies, either through related or unrelated diversification.

Diversification is the process of firms expanding their operations by entering new businesses. In related diversification, a firm enters a different business in which it can benefit from leveraging core competencies, sharing activities, or building market power. Some possibilities include:

- Mergers and acquisitions
- Strategic alliances
- Joint ventures
- Internal development

Whatever the choice, it should create value for all stakeholders – employees, suppliers, distributors, and the organization's owners themselves. The choice of diversification strategy should create *synergy* so that all parties gain something they would not have had on their own.

When achieving synergy through diversification, a firm has two choices: *related diversification* through horizontal relationships with related businesses, sharing tangible and intangible resources, and leveraging core competencies; and *unrelated diversification* though hierarchical relationships with unrelated business. In this case, value creation derives from the corporate office by leveraging support activities.

McDonald's has pursued related diversification through its relationships with franchisees.

Acquisition is the incorporation of one firm into another through purchase. It can be a means of obtaining valuable resources that can help an organization expand its product offerings and services. Acquisition can lead to consolidation within an industry and can force other players to merge. Corporations can also enter new market segments by way of acquisitions.

McDonald's tried acquisition of Chipotle Mexican Grill and Boston Market. Cantalupo divested these acquisitions - they did not add enough value to McDonald's portfolio - were not related enough to McDonald's *core capabilities*. CEO Skinner continued to pursue internal development. Perhaps Easterbrook will do the same.

Referencing Chapter 7: International Strategy: Creating Value in Global Markets

International expansion is a viable diversification strategy; however, before pursuing this, a firm needs to determine why an industry in a given country is more (or less) successful than the same industry in another country. When choosing a country to expand into, firms must assess the degree of consumer demand, the degree to which resources such as skilled labor and other supplier or supporting infrastructure are developed and available, the speed with which such resources can be deployed, the extent of political and economic risk and corruption, the access to qualified management.

McDonald's has now had enough experience internationally to learn what works and what doesn't. Asia Pacific and Europe appeared to be growing. Growth was slower in the Americas. *International expansion* and *internal development* in partnership with franchisees appear to be the best choices for future growth.

Teaching Note: Case 1 – Robin Hood

Case Objectives

1. To provide an introduction to the conceptual framework of strategic management using a non-business situation.
2. To introduce students to the process of problem identification and potential solution analysis that will be used in case discussions throughout the semester.

See the table below to determine where to use this case:

Chapter Use	Key Concepts
1: Strategy Concept	Leadership for strategic management; sustainable competitive advantage; vision, mission, strategic objectives; external environment; internal environment; efficiency vs. effectiveness; stakeholder management

Case Synopsis

Robin Hood and his Merry Men are now in trouble because wealthy travelers (their source of revenue) are avoiding the forest. As is often common in an entrepreneurial organization, the Merry Men were highly motivated by Robin Hood's leadership. Therefore, Robin had previously relied on informal communication to organize and implement operations. Robin is pleased with the growing size and influence of his organization. However, growth has meant that specialized duties have begun taking up most of the men's time, leaving a command vacuum between Robin and the first line recruits. In addition, they are now all located in a large encampment that can be seen for miles. This creates the probability of a surprise attack on their position. Growth has also put great pressures on resources, so now they must harvest the forest more thoroughly. Where will additional revenue come from? Rich travelers are avoiding the forest, so in desperation Robin is considering robbing the poorer travelers, which means his lieutenants must now tell their men to rob their brothers and fathers. What started as a rebellion is in danger of being routinized into banditry. Robin must therefore begin to evaluate the Merry Men's mission in view of the changing environment. Should it still be an extension of his private grudges and aspirations? Has the organization acquired a new mission, if so what is it? Who are the key stakeholders here? On whose behalf should the organization formulate its mission?!

Teaching Plan

Most students are familiar with the Robin Hood story, so it's possible to ask them to read this short case in class during the 1st or 2nd class meeting. Either use the PowerPoint slides or ask the discussion questions directly. As students respond, either write answers on the board or refer to the PowerPoint slide answers.

It's up to the instructor whether or not to assign Chapter 1 prior to discussing the case. If the case is read before the chapter is read, then the instructor has the option to ask students, when they do read the chapter, to identify the concepts in the chapter that they recognize from the case discussion and come to the next class prepared to share what they recognized. If the case is discussed after students have read Chapter 1, the instructor can ask students to identify what concepts apply from the chapter.

Summary of Discussion Questions
Below is a list of the suggested discussion questions. You can decide which questions to assign and which additional readings or exercises to include to augment each discussion. Refer back to the Case Objectives Table to identify any additional readings and/or exercises so they can be assigned in advance.

1. What is the purpose of strategy?

2. What strategic problems does Robin Hood have?

3. What is the role of the organizational leader as strategist and articulator of global goals?

4. What are some issues in this organization's external environment?

5. What is the relationship of the organization's internal structure to its environment?

6. How do stakeholder values or culture influence strategy making?

7. What strategy can Robin Hood implement?

Discussion Questions and Responses

Chapter 1: Introduction and Analyzing Goals and Objectives

1. ***What is the purpose of strategy?***

Strategy is all about the ideas, decisions, and actions that enable a firm to succeed. See Chapter 1, Exhibit 01: *Strategic management consists of the analyses, decisions, and actions an organization undertakes in order to create and sustain competitive advantages:*

- strategy directs the organization toward overall goals and objectives;
- includes multiple stakeholders in decision making;
- incorporates both short-term and long-term perspectives;
- recognizes trade-offs between efficiency and effectiveness.

Strategic management involves

- *Analysis* of strategic goals (vision, mission, strategic objectives), and of the internal and external environment;
- *Decisions - Formulation* about what industries to compete in and how to compete in those industries; and
- *Actions - Implementation* to allocate necessary resources and design the organization to bring intended strategies to reality.

An interesting question that the instructor can ask at this point is: *What business is Robin Hood's organization in?* Some students might say philanthropy, some might say robbery. The answers to this question will help students understand the importance of vision and mission: the leader must have a clear idea of the purpose of the business, and with whom it competes, in order to craft strategy. If the business is robbery, there are different competitors, like highwaymen.

2. What strategic problems does Robin Hood have?

If strategy is all about the ideas, decisions, and actions that enable a firm to succeed, what might Robin Hood need to assess as he ponders his likelihood of future success? As Robin Hood's organization has grown, food resources are becoming scarce and it has encountered a profit squeeze: revenue is down and costs are rising. In addition, there are cracks in the culture of the organization; as the organizational membership has increased, discipline problems have emerged. The original business model of "robbing the rich and giving to the poor" appears to be no longer viable, and the "competition" from the Sheriff is growing stronger as the Sheriff increasingly uses his "alliances" and connections with Prince John to get better organized. In addition, "new entrants" into the Sherwood Forest environment, the barons, are proposing that Robin join with them to restore King Richard. If this happens, Robin Hood's mission may no longer be relevant because the need to restore "justice" may no longer exist.

Issues that need to be addressed include:

- Has Sherwood Forest become too small to sustain operations?
- How to avoid detection of the now "major encampment"?
- What to do about the growing strength of the Sheriff's forces?
- How to address organizational communications and redefine the leadership focus?

Decisions that need to be made include:

- Should Robin Hood impose a fixed transit tax in order to increase revenue?
- Should Robin Hood kill the Sheriff?
- Should Robin Hood accept the barons' offer to join in freeing King Richard?

Consequences to be considered include:

- What might happen if Robin expanded operations beyond Sherwood Forest?
- Does the change in the external environment mean that the original mission is no longer valid?
- If Robin Hood decides to kill the Sheriff, accept the barons' offer or impose a tax on travelers, how do each of those actions link to the original mission?

- If the mission changes, to what degree does Robin Hood have to worry about the loyalty of stakeholders?

If Robin Hood expands operations beyond Sherwood Forest, that may solve his revenue and resource problems, but it will create issues with organizational communications – he can't keep track of his men now, so what will happen if the physical environment changes even further? Would his existing organizational structure still work with a larger group? It appears as if the changing conditions might also mean a shift in the original mission, especially if Robin decides to impose a fixed transit tax. Killing the Sheriff might satisfy Robin's "personal thirst for revenge," but it wouldn't improve the situation, especially since someone else might take up the Sheriff's role. Likewise, if Robin decided to align with the barons, his group would have to accept amnesty, and how many of his "men" would feel good about this? There was no assurance that the barons' plan would work, plus this would require a real shift in overall mission from banditry to court political intrigue, and multiple stakeholders might object (how would the poor people feel?).

The major issue concerns the rapid growth of the organization and the changing external environmental conditions. In the space of two years the organization grew from fragmentation and obscurity to a strong regional presence. Competitive strategy is about *sustaining* a position in the industry. Growth implies that strategy has to be flexible enough to adapt. Does Robin have a *sustainable* strategy?

3. ***What is the role of the organizational leader as strategist and articulator of global goals?***

Leaders face a large number of complex challenges. Leaders must be proactive, anticipate change and continually refine changes to their strategies. This requires a certain level of "ambidextrous behavior", where leaders are alert to opportunities beyond the confines of their own jobs, and are also cooperative and seek out opportunities to combine their efforts with others. Leaders must make strategic management both a process and a way of thinking throughout the organization.

See Chapter 1, Exhibit 06. The primary role of the organizational leader is to articulate vision, mission, and strategic objectives. Robin Hood needs to evaluate his initial *vision* of the organization's purpose: what was the original goal that *evokes a powerful and compelling mental image of a shared future,* one that would be massively inspiring, overarching, and long-term, that represented a destination that is driven by and evokes passion? Is the original vision irreconcilable with the present circumstances?

Robin Hood's organizational mission may have to change: a *mission* encompasses both *the purpose of the company as well as the basis for competition and competitive advantages.* Organizations must respond to multiple constituencies – multiple stakeholders – if they are to survive and prosper, and the mission provides a means of communicating to these diverse organizational stakeholders.

If the vision and mission have to change, Robin Hood must establish *strategic objectives* to operationalize the mission statement. That is, objectives help *to operationalize the mission statement with specific yardsticks*, and they provide guidance on how the organization can fulfill or move toward the "higher goals" in the goal hierarchy—the mission and vision.

Therefore, Robin Hood needs to redefine the organizational vision and mission since it may have changed - rebellion may have become routinized into banditry. He must also identify the key stakeholders, broadening his focus beyond his own private grudge to include the needs of the district, the region, or the nation. And he must establish new goals and strategic objectives. Depending on the stakeholders, these new goals may include replacing the Sheriff or changing the political order. Robin should remember that short-term objectives can become essential components of a firm's "action plan" and therefore can be critical in implementing the firm's chosen strategy.

4. ***What are some issues in this organization's external environment?***

Strategy analysis is the first step in the strategic management process. It precedes effective formulation and implementation of strategies, involves careful analysis of the overarching goals of the organization, and requires a thorough analysis of the organization's external and internal environment. To begin with, Robin must take a look at the issues in the organization's external environment.

There are obvious resource constraints. Sherwood Forest has finite resources: the inputs into the organization (travelers to rob) have dwindled, especially since the rich travelers have started avoiding it. Robin Hood's band are spending past gains on present problems in the assumption that future revenues will continue to grow at the same pace as in the past. This assumption, one that is often pervasive in successful organizations, may be unwarranted. The Merry Men are reduced to robbing poorer travelers. The poor travelers are their mainstay of political support. Here is a common pitfall of success, the tendency of organizations to take their best and most important customers for granted, to extract from them the highest return for least effort in the belief that they have no practical alternative. In addition, trained manpower is scarce.

Regarding the physical environment, the current growth of the organization has created a large encampment that can be seen for miles, and is therefore now a target for attack. The nature of the Merry Men's environment and operations requires stealth and flexibility. The current physical facility does not provide for this.

5. ***What is the relationship of the organization's internal structure to its environment?***

See the Chapter discussion of the *trade-offs between effectiveness and efficiency*. Given the growth of the operation and other changes in the external environment, Robin Hood's previous structure may no longer be effective. He may no longer be able to achieve the goals of the organization. He might need to make trade-offs.

His current structure is functional, with each lieutenant a specialist. Communication has been informal, and Robin currently has no direct link to his first line recruits. This structure performed well in the early days of the band. However, with the growth of the organization, this has become problematic, resulting in lack of coordination.

Robin might want to consider a possible new structure: his lieutenants could do double time as staff and line personnel, fulfilling their staff duties in off-peak periods, but available for line duty during field operations. Robin might also want to consider creating a decentralized regional operation, with sub-bands who can operate out of smaller regional headquarters and better coordinate movements. This will increase flexibility of the total organization by moving the organizing of operations closer to those who undertake them. This will also reduce the chance of attack because then only part of the band might be detected and surprised. Decentralization also pushes food gathering down the line, thereby eliminating food distribution problems. Small-scale operations can be carried out with greater economy.

6. ***How do stakeholder values or culture influence strategy making?***

During strategic analysis, the leader does "advance work" to anticipate unforeseen environmental developments, identify unanticipated resource constraints, assess changes in his or her preferences for how to manage. During strategy formation, depending on the type of organization structure, the leader might include key individuals in a discussion around selecting which strategies might be best to implement at which level within the organization. In strategy implementation, the leader must ensure proper strategic controls and organizational design, and establish effective means to coordinate and integrate activities within the firm, as well as with suppliers, customers and alliance partners.

Therefore, leaders must pay attention to all stakeholder needs, including the group's values and the organizational culture. See Chapter 1, Exhibit 05 for *the diverse stakeholder groups and the claims they make on the organization.*

Regarding the organizational culture, it was based on founding values that embraced a missionary outreach to the community. The original purpose created unity and a spirit of daring among the Merry Men. Robin is considering abandoning the higher (more affluent) segment of his market for a deeper exploitation of a very large segment with limited resources. Here he runs up against organizational traditions and values. If Robin pursues profit maximization now (robbing all travelers, including the poor), the group will become thieves. Group members will resist stealing from their brothers and fathers. The larger community of poor people, who originally supported the Merry Men, will now feel abandoned. Loyalty will be eroded. Robin needs to restore the group members' and larger stakeholders' need for order and purpose. The Merry Men might need to feel that their participation is quasi-voluntary. They may need to feel more involved in strategic decision making so they can see shared value in the organizational efforts.

7. ***What strategy can Robin Hood implement?***

The basic question strategic management tries to answer is: *How can we create competitive advantages in the marketplace that are not only unique and valuable but also difficult for competitors to copy or substitute?* Robin Hood must assess how functional areas and activities "fit together" to achieve goals and objectives.

If the organization is still Robin's extension of a personal grudge, then displacing the Sheriff should be the primary mission of the Merry Men. If the organization is acting on behalf of the district then replacing the Sheriff with a more benign administration should be the priority. If however the Merry Men's existence is an expression of widespread dissatisfaction with the present political order, then Robin should consider his potential contributions on a national scale. An analysis of the options confronting Robin ought to lead the students to question the criteria by which strategy is judged. Who is the actor in strategy? The chief executive officer? Top management? A coalition of stakeholders? There is clearly no theoretical answer to these questions. A discussion ought to set the ground for an appreciation of the political and structural forces under which strategy emerges.

Robin should have a meeting with the Merry Men to explain the strategic dilemma and long-term issues. He needs to increase organizational discipline, which could be done by creating a clearer organizational structure with strategic controls that enforce the mission. To do this, he needs to recruit qualified leaders for the new decentralized structure, and involve lieutenants in the solution. It is always an issue – which functions should be decentralized and which retained at the corporate level. In this case intelligence gathering and finance should probably be kept centralized.

It is crucial for the students to appreciate the contradictory pressures that implementation generates. The new decentralized structure will call for more intricate communication and command systems. It increases flexibility but also increases the probability of breakdown and mismanagement. In this case runners must keep the various sub-bands in communication. This is a primitive technology that may be insufficient to ensure coordination. An opportunity exists here for the students to appreciate to what extent sophisticated *organizational forms* are made possible by modern technologies, which are ordinarily taken for granted.

While restructuring is going on, Robin must begin to consider other aspects of his strategy. He should examine the possibility of diversifying beyond the confines of his traditional forest territory. This is viable if he is decentralized. Operations can be carried on in the countryside by the autonomous sub-bands. He must also resolve the issue of the proposed transit tax. What should be his relationship to the local population? Should he increase their burden of taxation, or not?

Robin must also prepare for the possibility of ceasing operations by providing outplacement training. He should pursue alliances beyond the current band of Merry

Men, negotiating a possible change in the political order, negotiating amnesty, returning the band to legality. He should probably avoid contact with the Sheriff!

Finally, Robin should recognize that mistakes will occur. Therefore he should anticipate the costs of implementation, especially the problems of extended communication. Robin must familiarize his lieutenants with his intentions and the projected problems. They must actively become involved in the evolving implementation.

Ultimately, however, Robin Hood must consider the long-term course of action. If the Merry Men were a profit-maximizing organization in the classic sense they would be satisfied with keeping the Sheriff off balance; or perhaps work toward his replacement with a more inexperienced man. They are however a missionary organization. To pursue profit maximizing would sooner or later lead them to thievery, pure and simple. It would also undermine their unity and spirit of daring. Robin Hood has little choice but to increase his involvement in issues that lie beyond his immediate task environment.

Teaching Note: Case 2 – The Global Casino Industry

Case Objectives

1. To examine industry dynamics and how the structure of an industry has implications for competition.

See the table below to determine where to use this case:

Chapter Use	Key Concepts	Additional Readings or Exercises
2: External Environment	Porter's five forces model; strategic groups	**NOTE** additional web linked reading, view embedded **videos** about the current state of the industry.

Case Synopsis

For well over fifty years the casino business has been on a roll, on its way to becoming a $150 billion–a-year global industry. For much of that period, the United States has been leading the charge, accounting for nearly half the global gambling revenues as recently as 2010. Most of these revenues have come from Las Vegas and Atlantic City, magnets for gamblers from around the world. However, Las Vegas and Atlantic City have had to deal with increased competition from other locales, including waterfront casinos in over a dozen states, Native American gambling locations, and, most recently, overseas casino development in places like Macau, Singapore, Malaysia, Philippines, South Korea, and Australia. Other sites in Asia, such as Japan, Vietnam, Taiwan, and Sri Lanka, were in development as well.

In the U.S. there was a growing tendency to regard casino gambling as an acceptable form of entertainment for a night out. A large part of the growth in casino revenues came from the growing popularity of slot machines, yet facilities in Las Vegas, especially, had spent billions on extravagant and luxurious properties meant to attract the "high rollers" who came often and spent large amounts of money. Las Vegas casinos had tried to move beyond gambling and offer visitors many choices for fine dining, great shopping, and top-notch entertainment. This allowed higher-end casinos to generate revenues from activities other than gambling. Las Vegas, the city, was trying to brand itself as a tourist destination, but would that be enough to stem the flow of Chinese high rollers to Asian destinations? U.S. casino operators were expanding to open facilities in Asia or engage in mergers and acquisitions in an attempt to cash in on this local business, but would it be enough to return significant revenue to U.S. firms? Was there enough demand to go around?

Teaching Plan

Most students know what a casino is, and they probably haven't thought much about the industry beyond the glitz and the gambling. Therefore, this case becomes a good way to introduce the importance of defining the industry, and examining the dynamics of competition in the industry from the point of view of certain clusters of companies – companies that are part of "strategic groups" who compete in the same way for the same customers. The structure of the casino industry has changed in recent years due to new forms of competition and the presence of substitutes. Students may have not considered this. Therefore, this case can be positioned early in the course, right after discussion of the strategic concept, to alert students to these issues. Since companies are not passive as far as industry structure goes, but can take steps to influence the structure to their advantage, this case can be reintroduced during the discussion of competitive strategy, later in the course, to remind students how external environmental analysis is very relevant to strategic formulation.

ICEBREAKER

This case can start with an ***icebreaker***. Starting from the perspective of a customer may make it easier for students to transition to a strategic analysis.

Have you ever visited a casino? If so, where was it located, and what type of casino was it? Why were you there? What did you think of the casino experience?

It is possible that some students may have visited a Las Vegas or an Atlantic City casino, perhaps on a family vacation. Others may have been to a riverboat or Native American casino venue. It might be interesting to see students' responses regarding the purpose of their visit to a casino location – it might not have been for gambling purposes. Reasons for the visit might include the following: because it was part of my vacation trip; because a convention was held there; to see a sports event; to eat out; to see a show; just to see it, period! The casino industry competes for the family entertainment dollar. If so, it competes with a family trip to, say, Disneyworld. Are the two experiences the same? Might some conservative families not even consider Las Vegas or Atlantic City as a vacation place for their family, because of the gaming or risqué entertainment elements?

The instructor may want to put a chart on the board: *Where* the casino was, and *Why* the visit was made. If there is diversity among responses, it may make it easier for the instructor to then ask: so if you were the owner of a casino, how would you respond to these diverse reasons for visiting? What strategic issues do you need to consider? Who is competing against whom? This flows straight into a discussion of the external environment.

Before engaging in discussion, you might want to ***test students' basic knowledge*** regarding the case and the major concepts. Here are some multiple-choice questions to use. (This will get the student's attention – they can't answer these if they haven't read the case!)

Which statement is most true?

a. A large part of growth in casino revenues comes from slot machines.
b. In the U.S., Las Vegas and Atlantic City casinos generate more revenue than all other gambling locations combined.
c. Macau, the gambling "capital" of Asia, is located in Malaysia.

d. At some Las Vegas casinos, revenue from non-gaming activities could account for over 70 percent of net revenues.

ANSWER: a. A large part of the growth in casino revenues came from the growing popularity of slot machines. Coin-operated slot machines typically accounted for almost two-thirds of all casino gaming revenues. When combined with Native American casinos, gambling revenues in other parts of the U.S. now exceed the amount that is generated by casinos in Las Vegas and Atlantic City. Macau is a former Portuguese colony, a special administrative region of China, currently under autonomous rule, similar to Hong Kong prior to 1997. Non-gaming activity at MGM Mirage in recent years accounted for almost 60 percent of net revenue.

Worldwide, the U.S. generates more casino revenue than anywhere else.

a. Yes
b. No

ANSWER: b. At over $30 billion, Macau generates six times more casino revenue than the U.S. Las Vegas strip. Also see Exhibit 1.

Summary of Discussion Questions

Here is a list of the suggested discussion questions. You can decide which questions to assign, and which additional readings or exercises to include to augment each discussion. Refer back to the Case Objectives Table to identify any additional readings and/or exercises so they can be assigned in advance.

Discussion Questions:

1. Examine the structure of the casino industry. What has been the effect of the changing industry structure on U.S. casinos?

Discussion Questions and Responses

1. ***Examine the structure of the casino industry.***

Referencing Chapter 2: Analyzing the External Environment of the Firm

If you recall, strategy is all about the ideas, decisions, and actions that enable a firm to succeed. See Chapter 1, Exhibit 01: *Strategic management consists of the analyses, decisions, and actions an organization undertakes in order to create and sustain competitive advantages:*

- strategy directs the organization toward overall goals and objectives;
- includes multiple stakeholders in decision making;
- incorporates both short-term and long-term perspectives;
- recognizes trade-offs between efficiency and effectiveness.

The basic question strategic management tries to answer is: *How can we create a sustainable competitive advantage in the marketplace that is not only unique and valuable but also difficult for competitors to copy or substitute?*

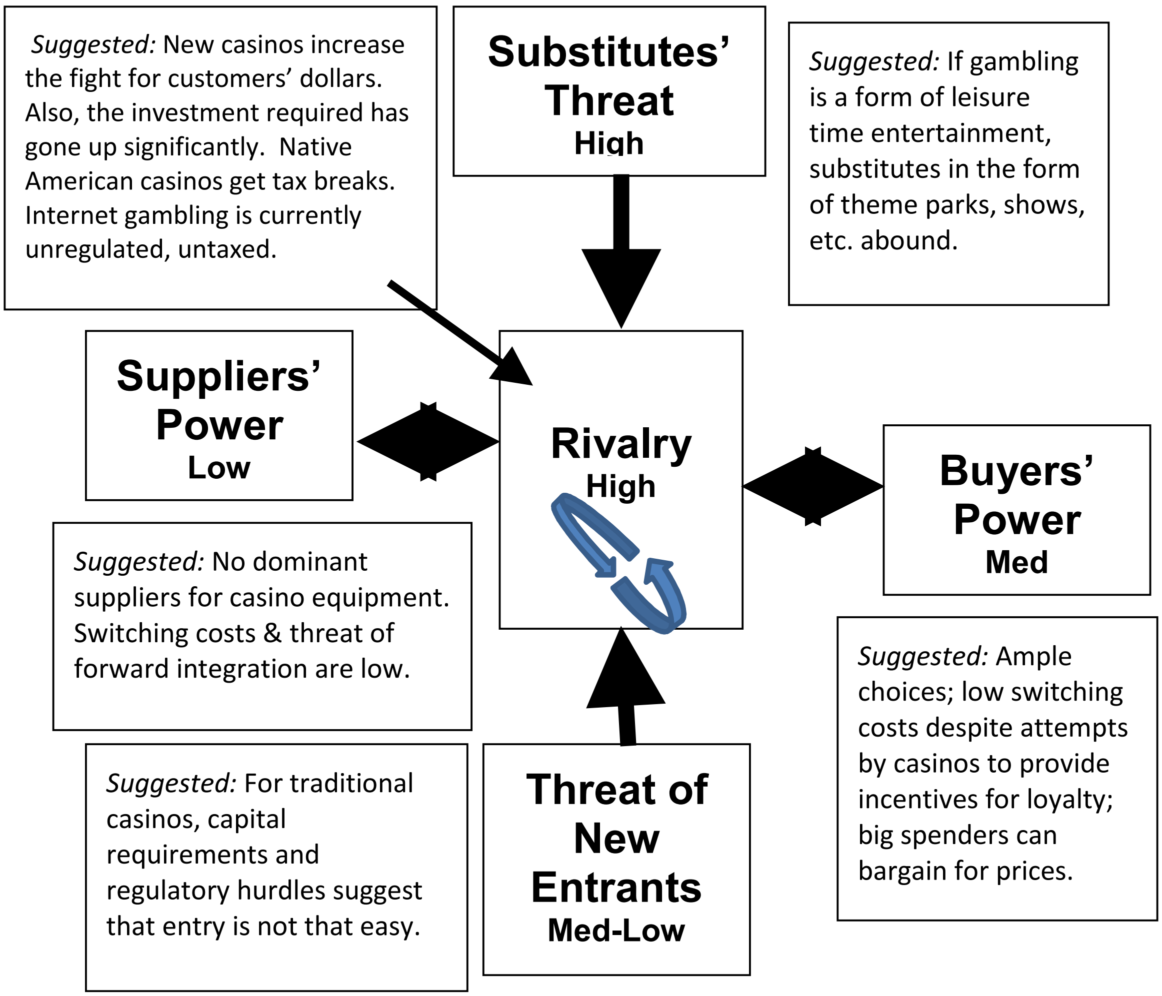
However, an interesting and fundamental question is *How do we define the "marketplace"? Just what business are we in?* Ask students to fill in the blank: *Casinos are in the* ________________ *industry.* Some students may say "gambling," but some may also say "entertainment." The various answers to this question will help students understand that a firm must have a clear idea of the purpose of its business, and who it competes with, in order to craft strategy.

During *strategic analysis*, the firm does "advance work" through *external scanning* and *monitoring* of the external environment to anticipate unforeseen environmental developments, identify unanticipated resource constraints, assess changes in his or her preferences for how to manage. Evaluating the evolution of environmental trends may be critical to crafting a strategic response.

In order to formulate a competitive strategy**,** it's necessary to assess the segments of the external competitive environment that include competitors, customers or buyers, and suppliers, substitutes and new entrants. Porter's *five forces model* allows strategists to anticipate where the industry might be most vulnerable to competition. The model also helps decide where profits might be best made, or whether there is any chance of further dividing up the profit pie: how attractive *is* this industry?

To answer this question, it is very important to correctly define the industry even further. If we define the casino industry broadly to include any organization that allows people to wager money on events of chance, then we must include Native American casinos, waterborne casinos, and Internet gambling places as incumbents in the industry along with casinos in Las Vegas and Atlantic City. However, if we define it narrowly to include traditional casinos in Las Vegas and Atlantic City, those that also provide enhanced entertainment, then most Native American casinos, etc. would be substitutes. Either way, the five forces model will capture the impact of all these gambling establishments.

Help students apply Porter's ***Five Forces of competition*** by drawing a diagram on the board similar to the following, and having students fill in the details:



The following key points emerge from a structural analysis of the casino industry:

- There was industry growth in the U.S. up until 2010. This should typically ***decrease*** the intensity of rivalry as the potential profit pie grows larger. However, intensity of rivalry had increased due to new investment by industry players – the entrance of Native American gambling resorts and waterborne casinos – as well as the overseas development of casinos in places such as Macau. There were more players to compete for the bigger pie.
- Industry players realized that, typically, customer switching cost was low, in that a gambler could switch from one casino to another and shop for the "best" deal. This would typically ***increase*** the intensity of rivalry. However, casinos tried to maintain the business of customers by providing complimentary rooms, food, beverage, shows, and other perks. Loyalty programs also provided a means to hold on to gamblers.

- Native American casinos had a distinct advantage over traditional casinos in that they were exempt from federal taxes, even though they paid a percentage of their winnings to the state in which they were located. These casinos generated a large share of total gaming revenues – certainly a major threat for traditional casinos. Particularly for Atlantic City, the two big Native American casinos in Connecticut generated substantial business.
- Internet gambling was a growing major threat because it was a low-cost business model and therefore did not face the same entry barriers as traditional casinos did. In addition, it was unregulated, untaxed, and not legalized. Racetrack casinos were also low-cost because there was little overhead when only slot machines were involved.
- Waterborne casinos provided significant competition in the regions where they were located. They received the benefit of legislative protection after Hurricane Katrina, and the watery venue might just have been unique enough to entice and retain local customers.
- The international rivalry from places such as Macau was muted among the big players such as MGM and Wynn, as they used this as an opportunity for international expansion. A good deal of consolidation was also occurring in the industry among these big players as they pursued acquisition targets.
- All of Asia-Pacific was under development, with multiple firms hoping to grab a share of the gambling revenues worldwide.

Based on the external environmental factor analysis, the casino business is not that attractive an industry, although opportunities for diversification into other forms of entertainment and tourism may be a way to increase profits among the larger players.

NOTE - ADDITIONAL READING, VIDEO VIEWING:

Regarding sociocultural and demographic trends affecting the industry, read this article about the "what happens here" advertising campaign for Las Vegas, first launched in 2003:
http://www.usatoday.com/money/advertising/adtrack/2005-04-11-track-vegas_x.htm
What are the positives and negatives of the campaign for Las Vegas casinos? If you were the manager of a Las Vegas casino, would you be in favor of the campaign? Why or why not?

Gaming continues to be big business, as explained in a report from the American Gaming Association: a 2014 study measures the economic impact of every facet of the casino gaming industry – commercial casinos and manufacturers and Native American casinos – as well as the industry's significant ripple effect on the supply chain, including local businesses. The Oxford Economics' study found that the U.S. gaming industry:

- Contributes **$240 billion** – nearly a quarter-trillion – to the U.S. economy, which is equivalent to the total state budgets of New York and Texas combined;
- Supports more than **1.7 million jobs** – more than double Washington, D.C.'s total employment – and nearly **$74 billion in income;**
- Generates **$38 billion in tax revenues** to local, state and federal governments – enough to pay more than half-a-million teachers' salaries.

This research is being used to encourage policymakers to work with the industry as partners for more economic growth for all.
See http://www.gettoknowgaming.org/news/groundbreaking-new-research-reveals-impressive-magnitude-us-casino-gaming-industry

And consultants have suggestions for firms, from 2007:
http://urbino.net/bright.cfm?specificBright=Five%20Indomitable%20Trends%20for%20the%20Casino%20Industry%20%E2%80%93%202007%20and%20Beyond%2E
Increasingly, it appears that the industry doesn't get its revenue from gaming – much of industry revenue comes from non-gaming activity such as lodging, food, retail shopping, shows, spas. See a 2-minute **video** snapshot of the industry at https://www.youtube.com/watch?v=71oEugGTfVo
What implications might that have for the "players" in this industry? Where should they expect real profits to come from?

More information on the industry is available at https://www.americangaming.org/

With information from 2010, here's a 2-minute **video** naming Macau as the gaming capital of the world: https://www.youtube.com/watch?v=8pUDCXtop_k
And in 2014 a **video** report explains the macroeconomic environment of the Asia-Pacific gaming industry, and that although activity from China regarding anti-corruption efforts is reducing traffic in Macau, the environment remains supportive of the sector's growth and credit quality, underpinning a stable outlook on the sector: https://www.youtube.com/watch?v=ZpeKMZLnoPk

As of 2013 the biggest competitors, MGM, Wynn Resorts, and Sands, have all created very successful operations in Macau (Caesars did not enter the market initially, and has now been frozen out due to the lack of available gaming licenses). Although there are widespread allegations of fraud and connections to Chinese organized crime, the financial benefits from this global expansion means these major competitors won't back off. According to I. Nelson Rose, a professor at Whittier Law School in California who writes a blog called Gambling and the Law, "Macau forced the casinos to see that they could become like other large U.S. corporations: Set up their plants and operations in other nations and make far more than they can being stuck just in Las Vegas." Sheldon Adelson, CEO of Las Vegas Sands, has described Sands as "an Asian company" with a presence in America. He makes far more in China, where a culture in which notions of luck and fate play integral roles, than in Las Vegas. As MGM CEO Jim Murren points out, "The Macau market is now larger than the entire U.S. gaming market. Unfortunately for Atlantic City, it's gone the other way. It's smaller now than when we entered it. The fortunes of the two couldn't be more different." Las Vegas would have to attract six times more gamblers each year than it does now – essentially every adult in America – in order to match the amount of money being taken in via casinos in Macau. Based on estimated numbers from 2012, Wynn Resorts now makes nearly three-quarters of its revenue in Macau. Sands, which owns the Venetian and Palazzo, earns two-thirds of its revenue there. In the U.S., companies are tweaking their flagship Las Vegas casinos to look and operate more like Macau-style properties. This is because an increasing number of Asians come to Las Vegas, especially, because of the reduced tax on earnings compared to China. Asian visitors now account for 9 percent of tourists to Las Vegas, up from 2 percent in 2008. See the AP report, "Tiny Chinese enclave remakes gambling world, Vegas" by Hannah Dreier, July 8, 2013. http://lasvegassun.com/news/2013/jul/06/us-casinos-macau-headache-abridged/

How can you use the above information to do an analysis of the industry? If you were in the casino business, wouldn't you want to keep abreast of this kind of information?

1. ***Continued: What has been the effect of the changing industry structure on U.S. casinos?***

The concept of *Strategic Groups* involves two unassailable assumptions in industry analysis, based on the belief that no two firms are totally different, and no two firms are exactly the same. Strategic groups are clusters of firms that share similar strategies in their:

- Breadth of product and geographic scope
- Price/quality
- Degree of vertical integration
- Type of distribution system

The value of strategic groups as an analytical tool is that they identify barriers to mobility that protect a group from attacks by other groups; identify groups whose competitive position may be marginal or tenuous; chart the future direction of firms' strategies; and allow strategists to think through the implications of each industry trend for the strategic group as a whole.

The casino industry can be used to illustrate the existence of strategic groups. To begin with, casino firms that had a large presence in Las Vegas or Atlantic City were more likely to compete with each other. These firms operated larger resorts, which offered a broad range of entertainment that catered to customers from around the country and even other parts of the world. By contrast, the smaller casinos, such as those on the water and on Native American lands, were more focused on gambling and catered more to local and regional customers. As such, these were less likely to compete with the larger casinos that were based in Las Vegas and Atlantic City. Each of these – the LV and AC large resorts vs. the local waterborne and Native American casinos – could therefore be considered to fall into different strategic groups.

What might Las Vegas casinos do to craft a *sustainable competitive advantage*, given the industry they're in?

In general, the gambling companies in Las Vegas embarked on an aggressive strategy in light of the competition from various sources. They did a number of things:

- Promoted Las Vegas as the *destination* gambling city – in contrast to Atlantic City where gamblers made day trips from cities in the northeast. Las Vegas positioned itself as a magnet for both the overnight casino gambler, and weeklong vacationer, offering more than 130,000 hotel rooms, myriad dining choices, shopping, and top-notch entertainment. The infrastructure also helped in that Las Vegas was linked by air to major U.S. cities and also to countries outside the U.S.
- Casinos in Las Vegas positioned themselves as resorts for families by offering circus performances, etc. However, casinos in Las Vegas did continue to conform to their original "sinful" roots by offering adult-oriented entertainment, further differentiating Las Vegas casinos from casinos in other competing areas. This differentiation strategy was helped by the promotion slogan, "What happens in Vegas, stays in Vegas!"

- Las Vegas casinos constantly invested in refitting and renewal to continue to offer new attractions to customers. This meant that Las Vegas convention facilities competed successfully with Orlando and New York for the corporate meeting business. Las Vegas remained the top destination for overnight visitors looking for a casino experience.

By differentiating its properties, the Las Vegas casinos attracted visitors and retained their business.

On the other hand, casinos in Atlantic City played catch-up with Las Vegas casinos partly because LV had a head start – gambling was legalized in New Jersey a full 45 years *after* Nevada. From the start, Atlantic City casinos realized that they could not compete with Las Vegas's broad range of dining, shopping, and entertainment choices. In addition, AC's location in the Northeast highway corridor meant that the majority of customers could easily come as "day trippers." By promoting its proximity to the beach and the fact that most casinos were located on a boardwalk, AC was originally able to carve out a competitive position in the industry. However, that competitive position had eroded. Atlantic City casinos had tried to mimic their Las Vegas competitors by sprucing up their establishments. The city attempted a makeover, with the *Borgata* leading the charge. Casinos added wings to attract overnight customers, and some added outdoor bars to take advantage of the beachfront, but additional expansion was on hold during 2009 and most of 2010, waiting for a change in economic conditions. Then, reports of hurricane damage in 2012 kept visitors away. In short, Atlantic City casinos had been trying to move toward a strategy of differentiation by providing a more attractive ambience, but overall environmental conditions were making this difficult to achieve.

The main threats Atlantic City casinos faced (as did Las Vegas casinos) were Native American casinos, slot machines at local racetracks, and Internet gambling. Two of the biggest Native American casinos were in Connecticut, within driving distance of Atlantic City. In addition, several states had passed legislation allowing racetracks to provide slot machines for their visitors. Internet gambling had a cost advantage – operators did not have high infrastructure costs, and offshore websites were immune to legislation regulating their operation. In addition, competition had grown internationally, especially in the South China Sea city of Macau where casino developers had begun to grow their portfolios. To combat these threats, both Las Vegas and Atlantic City casinos had to continue to try to differentiate themselves. Many industry observers believed that the proliferation of local casinos and the availability of Internet gambling might even be an opportunity for LV and AC, since people who developed a taste for gambling at the local and home venue would probably want to visit LV or AC eventually, to experience the real thing!

There remain challenges AND opportunities for all major competitors. See the additional reading and updates below. The major question is which of these firms, and which of these locations or *strategic groups* do you believe is better positioned for the future?

NOTE – ADDITIONAL READING AND VIDEO VIEWING:

Wynn Resorts, Las Vegas Sands, and MGM are some of the major players mentioned. Does their diversification into Macao and other world markets give them an edge?

In addition, the move to legalize online gaming offers another challenge AND opportunity to the big casino competitors. Online gambling will be licensed state by state, with New Jersey one of the first to allow this in 2013. As one analyst reported, "Casinos are already positioned to capitalize on the industry's paradigm shift and face the least amount of red tape in doing so. It's not often that you hear the U.S. associated with any 'emerging' opportunity, but in fact this is how online gambling can be characterized. In Boyd Gaming's 2012 annual report, the company (which trades as BYD, and is part owner of Atlantic City's Borgata Hotel Casino) boasts of how it's well positioned to capitalize on the "emerging domestic online gaming industry." http://www.newstimes.com/business/fool/article/Why-Online-Gambling-Will-Crush-the-Candy-4480839.php
From 2015 here's a report and **video** about mobile gaming. Although not truly gambling, this is becoming a big business, with the heaviest users spending up to $400 per person per transaction on these online games: http://www.cnbc.com/2015/08/03/the-shocking-truth-about-mobile-gaming.html

Regarding the major competitors, on January 28, 2008, Harrah's Entertainment was acquired by affiliates of private-equity firms TPG Capital and Apollo Global Management. As the article below points out, this was a bad time to go private. Harrah's is now "drowning in debt": http://www.fool.com/investing/general/2009/06/24/for-casino-companies-this-is-no-panacea.aspx
Harrah's resurfaced as the public company Caesars Entertainment Group (CZR) in 2010. It operated over 47 casinos, hotels and 4 golf courses under several brands, and held rights to the World Series of Poker tournament activity. See more at http://caesarscorporate.com/about-caesars/

Compare the financial status of competitors MGM (MGM), Las Vegas Sands (LVS), Penn National Gaming (PENN), Wynn Resorts (WYNN), Boyd Gaming (BYD), and Caesar's Entertainment (CZR) using these links:
http://finance.yahoo.com/q?s=mgm
http://finance.yahoo.com/q?s=lvs
http://finance.yahoo.com/q?s=PENN
http://finance.yahoo.com/q?s=wynn
http://finance.yahoo.com/q?s=BYD
http://finance.yahoo.com/q?s=CZR&ql=0

In 2015 the 270 Nevada casinos generated a net loss of $661,779,138 from total revenues of $24,591,388,351. These results were improved compared to FY14 when the net loss was $743,688,008 and total revenues were $23,895,954,169. "Total revenue" is the money spent by patrons on gaming, rooms, food, beverage, and other attractions. "Net income/loss" is the money retained by casinos after expenses have been paid but prior to deducting federal income taxes and prior to accounting for extraordinary expenses. Data from the Nevada State Gaming Control Board at http://gaming.nv.gov/index.aspx?page=31&parent=4512