Business Policy & Strategy

Block

2

Strategic Analysis and Strategy Formulation

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Ref. No. BPS-SLM-IFHE – 042022 B2

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BLOCK 2: STRATEGIC ANALYSIS AND STRATEGY FORMULATION

The second block of the course on Business Policy & Strategy deals with strategic analysis and strategy formulation. The block contains five units. The first and the second units discuss the external environment analysis and internal environment analysis, respectively. The third unit discusses the concept of objectives, grand strategies, and functional strategies. The fourth unit discusses the generic competitive strategies. The fifth unit discusses strategic analysis and choice.

The first unit, *External Environment Analysis*, discusses the remote and operating environments of business. It also discusses the Porter's five forces model. The unit ends with a discussion on the implications of industry structure analysis for competitive strategy.

The second unit, *Internal Environment Analysis,* discusses the relationship between strategy and internal analysis. The unit describes how to analyze the various departments and functions, management, and culture of an organization. The unit ends with a discussion on the concept of value chain analysis.

The third unit, *Objectives, Grand Strategies, and Functional Strategies*, discusses objectives and their hierarchy. The unit also discusses grand strategies and their major classifications. The unit ends with a discussion on functional strategies and their application in some of the functions of an organization.

The fourth unit, *Generic Competitive Strategies*, discusses the generic competitive strategies of overall cost leadership, differentiation, and focus. We shall then move on to discuss how to choose a generic strategy, and the pitfalls of generic strategies. The unit also discusses the concept of strategic lock-in. The unit ends with a discussion on the competitive strategies used in different types of industries.

The fifth unit, *Strategic Analysis and Choice,* discusses the criteria for evaluating strategic alternatives. We shall then move on to discuss techniques like BCG Growth-Share matrix and GE Nine Cell Planning Grid for conducting strategic analysis at the corporate level. The unit also discusses techniques like BCG Growth-Share matrix and GE Nine Cell Planning Grid for conducting strategic analysis at the corporate level. The unit ends with a discussion on the various behavioral factors influencing strategic choice, and the contingency approach to strategic choice.

Unit 4

External Environment Analysis

Structure

"The essence of formulating strategy is relating a company to its environment".

- Michael Porter

4.1 Introduction

Here, Michael Porter stressing the significance of relating the strategy formulation to its surrounding environment. For this, the companies have to analyse the environmental factors influencing business or company's operation. As a strategy, provides the course of action(s) to get the desired result, strategist must not ignore the prevailing conditions of environment while formulating strategy.

In the last unit of the previous block, we have discussed about vision, mission, and social responsibility. In this unit, we shall discuss about external environment analysis.

The main purpose of any business firm is to earn profits. These come from the products they produce and the services they render to their customers. Environmental scanning involves capturing information about the firm's external environment in terms of opportunities and threats. It is a proactive exercise to ensure that changes in the external environment do not take the firm by surprise. It makes use of both formal and informal methods of information capturing.

The importance of environmental scanning depends on the volatility of the firm's environment and the resource dependencies which exist for the firm. The greater the volatility, the higher will be the importance of environmental scanning for the firm. Similarly, personal factors such as the scanner’s knowledge or cognitive style influence the nature of environmental scanning.

Some of the environmental factors such as competition, political, economic, and legal factors, and government rules and regulations influence the firm’s choice of direction and action and also affect the internal environment of the organization. We can broadly categorize this environment into two types: remote environment and operating environment.

This unit will first discuss the remote environment of business, and then move on to discuss the operating environment. We shall also discuss the Porter’s five forces model. Finally, we shall discuss the implications of industry structure analysis for competitive strategy.

4.2 Objectives

By the end of this unit, students should be able to:

- Discuss the remote environment and operating environment for a business.
- Analyze the industry structure using Michael Porter’s Five Forces model.
- Explain the implications of industry structure analysis for competitive strategy.

4.3 The Remote Environment

The remote environment consists of a set of forces that originate beyond a firm’s operating situation. These comprise political, economic, social, technological, and legal forces which create opportunities, threats, and constraints for the firm.

4.3.1 Social Environment

The social environment of a business refers to the values, beliefs, attitudes, opinions, and lifestyles in a society. Its impact on the business is immense. The changes in the social forces create new opportunities for business firms and provide them with opportunities to grow. The cultural, demographic, religious, educational, and ethnic conditioning of individuals in society affects the social environment.

One of the important social changes which has taken place across the world is the increasing number of women in the workforce. This has resulted in the creation of demand for a wide range of products and services which include convenience foods, microwave ovens, children’s day care centers, and cosmetics.

Demographic changes are a part of society and refer to ageing profiles, ethnic origin, race, and social class. Better healthcare facilities have led to longer life spans, which in turn, have led to the demand for certain products for elderly people, like sugar free biscuits. Thus societal forces have a significant impact on the business environment.

Activity 4.1

Healthy food, a multinational company engaged in producing ready-to-eat food products, is planning to enter the Indian market. What are the socio-cultural issues that the company has to address?

Answer:

4.3.2 Political and Legal Environment

Political forces influence the legislations and government rules and regulations under which the firm operates. Laws and regulations govern the activities of every firm and they may come in a variety of forms. In India, till the late 1980s, licensing was prevalent and a firm could not enter a business line without having a license for it. A global firm had to procure a license before it could set up operations in India. This ‘protectionist environment’ favored local players. Any change in the policy orientation of a country has a profound impact on the businesses operating in that country and on their ability to survive. Some of the political and legal aspects which a firm is faced with relate to wage legislation, anti-trust laws, pollution policies, and patent laws. For example, if a country has weak patent laws, a firm engaged in high-end research will be adversely affected as competitors will imitate all of its new products without any difficulty and the advantage of creating new products would be lost. On the other hand, a strong patent policy will protect the firm engaged in high-end research and it will be in an advantageous position over its rivals.

Example

In 2017, after the diplomatic boycott by Saudi Arabia, UAE, Bahrain, and Egypt with Qatar accused for supporting terrorism, Abu Issa Holdings, a leading distributor and retailer of supermarket goods in Qatar, doubled its import of Turkish brands to about 25 per cent of its portfolio from about 10 per cent before the boycott. Ashraf Abu Issa (CEO) said. “We will continue with Turkey for sure. They are not a replacement. This should have happened a long time ago — we discovered some amazing products and the quality is superior.” He further added, “Will stick with Turkish brands even if the boycott is lifted despite higher shipping costs.” The above situation pointed out the political aspect of remote environment.

Source: ICFAI Research Center

4.3.3 Economic Environment

Economic environment forces have a direct bearing on a firm's performance. The growth rate of the economy, interest rates, currency exchange rates, and inflation rates are the important forces which need careful monitoring and responding to. The economic growth rate is important as a surge in it leads to increased customer expenditure and to competitive pressures being eased. On the other hand, when the economic growth starts declining, it translates into less spending by customers and leads to increased competition. Interest rates are relevant when customers borrow to finance their spending. Increased interest rates will adversely affect the demand for a firm's products, (automobiles, homes, etc.) as customers, who will have to pay high interest rates on borrowing, will reduce their spending. Currency exchange rates influence the demand in the global marketplace. If the value of the domestic currency, say the Indian Rupee, falls compared to, say the US Dollar, then products made in India will become cheap as compared to those in the US and Indian exports will do well.

Free Trade Agreements, economic communities, and economic blocs like the European Economic Community have a direct impact on the business environment.

Activity 4.2

Political forces influence legislations and government rules and regulations under which the firm operates. Every company faces political constraints in the form of antitrust laws, fair trade decisions, tax programs, minimum usage legislation, pollution and pricing policies, administrative activities, and many other actions. When the government uses them to protect consumers and local industries, it greatly affects businesses. So, the government's actions are of great concern to every firm. Describe an incident where government interfered with the working of an industry quoting customer welfare, and how it affected the industry.

Answer:

<u>Check Your Progress - 1</u>

1. Which of the following is **not** a factor coming under the remote environment?
   a. Social
   b. Political
   c. Customer
   d. Legal

2. Which of the following environments of an organization is constituted by the values, beliefs, attitudes, opinions, and lifestyles in society?
   a. Economic environment
   b. Social environment
   c. Political environment
   d. Legal environment

4.4 The Operating Environment

The operating environment involves factors that provide many of the challenges a particular firm faces when attempting to attract or acquire essential resources or when striving to profitably market its goods and services in the immediate competitive situation. The operating environment, which has a direct impact on the operations of a firm, includes all factors which a firm faces while sourcing its inputs and while marketing and selling its outputs. The competitors, customers, suppliers, and the labor market constitute the operating environment. It is also known as the competitive environment.

4.4.1 Competitive Position

The competitive position of a firm provides an insight on the firm's performance vis-à-vis its competitors. It is determined in terms of a wide range of parameters which includes market share enjoyed by the firm, the breadth of the product line, relative product quality, and price competitiveness. The factors to be taken into account will vary from industry to industry, depending on the specific attributes of the industry being considered.

To arrive at the competitive position of the firm, factors relevant to the industry are listed out and weights between 0 and 1 assigned to each factor, depending on their impact on the competitive position of the firm. Ratings are then assigned based on how the firm is performing against each factor, on a scale of 1 (very weak competitive position) to 5 (very strong competitive position).

The weighted values and the rankings are multiplied by each other and the resulting weighted scores are added to yield a numerical profile of the firm's competitive position. If the firm's numerical score is close to 5, then it can be considered to be enjoying a strong competitive position.

4.4.2 Customer Profile

The customer profile is built based on the information relating to the demographic, geographic, psychographic, and the buying profiles of the customer. The ability of the firm to survive depends on how well it is able to address the customer profile with its products and services. The objective of developing a customer profile is to ensure that the customers stay loyal to the firm's products and do not switch to competitors' products.

The geographic profile indicates where the firm's customers are located and the firm accordingly manages its reach to serve the customers. The demographic profile would be in terms of age, sex, marital status, income, and occupation. The psychographic profile would be in terms of values, attitudes, and lifestyles of consumers. Similarly, buying behavior or patterns are taken into account to sell more to the customers by increasing usage rates.

Example

In 2019, Clinique, a US-based multinational cosmetic brand looks to sell products in smaller sachets in India. The company realized that what works for others won't necessarily work for the Indian consumer. The brand's global president, Jane Lauder said, "Many of our markets prefer larger sizes of products. They want jumbo sizes. Yet, in India, they want the smaller sachets and one-use sizes." So, the company created more of single-use sachets for the Indian market to be able to cater to the preferences of customers in India. . Clinique's case of selling products in smaller sachets in India as per the customer's requirements represents buying behavior aspect of customer profile.

Source: ICFAI Research Center

4.4.3 Suppliers and Creditors

Suppliers and creditors play a crucial role in the ability of the firm to operate in the industry. A firm depends on its suppliers for its inputs. The quality of the inputs, the pricing of the inputs, the timeliness of the delivery of the inputs, the credit terms, and the replacement policy of the suppliers have a direct impact on the firm's performance. It is of crucial importance that the firm builds good relations with its creditors in order to perform well in the industry. If the suppliers are not reliable, then the firm will not be able to serve its customers appropriately and this may result in its failure.

The creditors lend money to the firm to meet its working capital needs and long-term funding needs in the form of plant and machinery, etc. Accordingly, the creditors of the firm will have an impact on its operations as they will determine whether the firm's stock is acceptable as collateral and whether the firm is creditworthy. The terms of credit offered by the creditors in terms of interest rates to be charged and the period of credit offered will have a direct impact on the firm's profitability.

4.4.4 Nature of the Labor Market

The nature of the labor market has a direct bearing on the firm in terms of the quality of manpower available to the firm. In a labor market, where there is a paucity of skilled manpower, as for example in the computer software industry, attrition rates need to be managed well by a firm. The firm should also evoke a good image in the minds of the employees as well as the talent pool in the labor market. Otherwise, it will not be able to attract and employ qualified and good talent.

4.5 Porter's Five Forces Model

Michael E. Porter of Harvard Business School developed a framework for industry analysis. The framework draws upon five forces that determine the competitive intensity and the attractiveness of the market. These five forces are: the bargaining power of the buyers, the bargaining power of the suppliers, the threat of new entrants, the threat of substitute products, and the intensity of rivalry amongst existing firms. These five forces constitute the micro environment of the firm and any change in them directly affects the firm and its performance. The stronger the impact of the five forces is, the lower will be the combined profitability of the firms in an industry and vice-versa. However, this does not necessarily imply that all the firms in the industry would have low profitability.

4.5.1 Threat of New Entrants

Firms operating outside an industry are lured by the attractiveness of an industry to enter that industry. When they enter the industry, new production capacity is created and competitive pressures are built up to capture market share. This leads to creating more supply and in price wars which result in falling returns for all the players in the industry. The threat of new entrants is a factor of six barriers to entry, which are as follows: economies of scale, product differentiation, capital requirements, cost disadvantages independent of size, access to distribution channels, and government policy.

Economies of scale

Economies of scale emerge from large-scale production. Firms already present in an industry enjoy this advantage as they are able to manufacture at a lower average cost as compared to the new entrants.

Product differentiation

New firms also evaluate the amount of money required for product differentiation. Existing firms have built brand identification and loyalty through first mover advantages. The amount of money required to build differentiation acts as a deterrent to a new firm planning to enter a market.

Capital requirements

The capital requirements of a new entrant also act as a barrier to its entry into an industry. A firm needs capital for research and development, inventories, customer credit, etc., and this limits the number of firms which can enter the industry.

Cost disadvantages independent of size

The learning curve and the experience curve effects provide advantages to the existing firms in the market place which are not available to the new entrants. As and when the firm gains experience in the field, its efficiency increases. This relationship between cumulative experience and efficiency forms the experience curve. Further, proprietary technology, access to the best sources of raw material, assets purchased at lower prices, government subsidies, and favorable locations serve as advantages to the existing firms.

Access to distribution channels

Existing firms may have access to distribution channels, which may be exclusive in nature and therefore the new entrants will face difficulties in distributing their products. For the products of a new entrant to replace those of an existing player, the new entrant may have to offer price breaks, promotions, and intense salesmanship.

Government policy

The government policy can create barriers to entry for a new firm by imposing controls, licensing requirements, and limiting access to raw materials. Similarly, when the government imposes pollution standards and product safety and efficacy norms, it is increasing the barriers to entry for a new firm as the capital requirements might be high for such technology and equipment.

4.5.2 Intensity of Rivalry among Existing Competitors

The rivalry among existing competitors has a direct bearing on the ability of the firm to survive in the marketplace. Rivalry is considered to be intense when there is a price war among the existing players and one or more players are trying to increase their market share. Competitors may also engage in launching new products, advertising battles, and increased customer services and warranties. The intensity of rivalry will make an industry attractive or unattractive. It is dependent upon certain factors as given here.

Rivalry is usually intense when the competitors are of similar size and there is not much of a differentiation between the products and services they offer. Slowdowns in industrial growth also make firms keen to grab each other’s market share. The absence of switching costs can also lead to an unstable marketplace.

Activity 4.3

According to Porter, if the rivalry among the firms is weak, the companies raise the prices and can earn great profits and if it is strong, there will be a price war or price competition. Discuss, with the help of a suitable example, how competition among the firms leads to price wars.

Answer:

4.5.3 The Bargaining Power of Buyers

A firm manufactures its products for its buyers. Its relationship with the buyer can be strong or weak. When the firm is in a strong position, it is able to dominate and dictate terms to the buyer. For example, the price at which the product will be sold, the replacement terms, the credit terms, etc., are all set by the firm. On the other hand, when the firm is in a weak position, the buyer will dominate the terms set for sale. The ability of the firm to earn profits (and its quantum) is therefore dependent on the bargaining power of the buyers. According to Porter, buyers would be powerful under the following circumstances:

- When the suppliers are many and the buyers are few and large.
- When the buyers purchase in large quantities.
- When the supplier's industry depends on the buyers for a large percentage of its total orders.
- When the buyers can switch orders between supply companies at a low cost, thereby playing companies off against each other to force down prices.
- When it is economically feasible for the buyers to purchase the input from several companies at a time.
- When the buyers can use the threat to provide for their own needs through vertical integration as a device for forcing down prices.

Example

In 2019, Kia Motor, a popular Korean car maker planned to make an entry in the Indian automobile market. The four-wheeler automobile market in India is a unique market where about 68 per cent market share is captured by top two (Maruti Suzuki and Hyundai Motor) of the total 16 car makers. Seven PV (Passenger Vehicle) makers, mostly foreign manufacturers, have one or less than one per cent market share despite being in the market for over a decade. Arvind Saxena (Former President and MD, General Motors) said the new car-makers should make the right product that distinguishes itself from existing ones. This is the only reason why Hyundai has been successful and others aren't. They haven't focused on product development from Indian market point of view. Arvind pointed out the product differentiation - a barrier to new entrant.

Source: ICFAI Research Center

4.5.4 The Bargaining Power of Suppliers

Suppliers are an important component of a firm's competitive environment. The quality of the suppliers in terms of their reliability to supply inputs of appropriate specifications at the right time determines the ability of the firm to compete in the market. Further, the strength of the suppliers vis-à-vis the firm determines the ability of the firm to generate profits. According to Porter, suppliers are powerful under the following circumstances:

- When the product that they sell has few substitutes and is important to the purchasing firm or buyer.
- When no single industry is a major customer for the suppliers.
- When products in the industry are differentiated to such an extent that they are not easily substitutable and it is costly for a buyer to switch from one supplier to another.
- When the supplier can use the threat of vertically integrating forward into the industry and competing directly with the buying firm to raise prices.
- When the buying companies cannot use the threat of vertically integrating backward and supplying their own needs as a means to reduce input prices.

4.5.5 The Threat of Substitute Products

Substitute products that can perform the same function impose limits on the price that a firm can charge for its products. The degree of similarity to which the function can be performed by the substitute will determine the threat of the substitute. The greater the similarity, the higher will be the threat and vice versa.

Coffee, tea, flavored milk, and other beverages all serve the consumer's need for refreshment. Due to the existence of substitutes, the prices charged by companies in the coffee industry are restricted. If coffee prices are hiked, customers have the option of switching over to tea, flavored milk, or other beverages, which are its substitutes.

Check Your Progress - 2

3. Which of the following environments involves factors that provide many challenges a particular firm faces when attempting to attract or acquire essential resources or when striving to profitably market its goods and services in the immediate competitive situation?
   a. Operating environment
   b. Remote environment
   c. Economic environment
   d. Social environment

4. The customer profile for an organization is built based on the information relating to:

    i. Demographic profile

    ii. Geographic profile

    iii. Psychographic profile

    iv. Buying profile

    a. Only i, ii, and iii

    b. Only i, ii, and iv

    c. Only i, iii, and iv

    d. i, ii, iii, and iv

5. Which of the following is **not** a barrier for a new entrant entering a particular industry?

    a. Market share

    b. Economies of scale

    c. Product differentiation

    d. Government policy

6. XYZ Ltd has been a soft drink major in northern India for the last two decades with four popular brands. No other soft drink giant has been able to make a dent in XYZ's market share. DEF Ltd is a multinational giant that has been given government subsidy to set up its unit here but is still not able to create a niche for itself. This is because along with distribution, production scale, and marketing, XYZ Ltd. has created entry barriers which are almost impenetrable through which of the following?

    a. Capital requirements

    b. Product differentiation

    c. Government policy

    d. Economies of scale

7. When switching costs are absent and there is a slowdown in industrial growth, what is the expected impact on the intensity of rivalry in the industry?

    a. Intensity of rivalry will increase.

    b. Intensity of rivalry will decrease.

    c. Intensity of rivalry will remain the same.

    d. Intensity of rivalry may either increase or decrease.

8. According to Michael Porter, buyers are powerful when

    i. There are many buyers but the suppliers are few and large.

    ii. They purchase in large quantities.

iii. The supplier's industry depends on the buyers for a large percentage of its total orders.

iv. It is economically feasible for the buyers to purchase the input from several companies at a time.

a. Only i, ii, and iii

b. Only i, ii, and iv

c. Only i,. iii, and iv

d. Only ii, iii, and iv

Activity 4.4

Glamorworld, a leading fashion store chain with stores in New Delhi and neighboring cities, now wishes to enter the major cities of South India. A consultancy firm has been hired to study the economic feasibility of the proposed venture. Discuss a few factors that the consultancy firm has to consider.

Answer:

4.6 Structural Analysis and Competitive Strategy

Competitive forces which include threat to entry, rivalry among existing players, bargaining powers of buyers, bargaining powers of suppliers, and threat from substitute products play a vital role in affecting the industry's environment. These forces can create threats and opportunities for the firm.

Once the forces affecting competition in an industry and their underlying causes have been diagnosed, the firm is in a position to analyze its strengths and weaknesses. The crucial strengths and weaknesses are a firm's posture vis-à-vis the underlying causes of each of the competitive forces. For example, where does the firm stand against substitutes, how can it erect entry barriers, and how well can it cope with rivalry from established competitors? This analysis helps a firm mold itself accordingly and formulate suitable strategies to exploit the opportunities created by these forces.

In order to create a favorable position against the five competitive forces, an effective competitive strategy takes offensive or defensive action. Broadly, this involves a number of possible approaches.

- Positioning the firm so that its capabilities provide the best defense against the existing array of competitive forces.

- Influencing the balance of forces through strategic moves, thereby improving the firm's relative position.
- Anticipating shifts in the factors underlying the forces and responding to them, thereby exploiting change by choosing a strategy appropriate to the next competitive balance before rivals recognize it.

4.6.1 Positioning

In the first approach, the industry structure is taken as given and the firm's strengths and weaknesses are mapped to it. This is a defensive approach and strategy is visualized as building defenses against the competitive forces or searching for and selecting positions where the competitive forces are the weakest.

Based on knowledge of the firm, it is analyzed whether the firm is in a position to face the competition, especially in the areas where the competitive forces are weak. If the competitive forces are too strong in particular areas, then it will be better for the firm to avoid that marketplace. So, accordingly, the firms should position themselves in the market.

Example

In February 2019, ACT Fibernet, a popular internet service provider in South India has partnered with Amazon to announce free Amazon Fire TV Stick with its select broadband plans. The move comes before the commercial launch of Jio GigaFiber which was expected to happen in March 2019 but now seems could be delayed further. ACT subscribers opting the valid plan will get an Amazon Fire TV Stick device for free with no additional cost involved. The offer is valid only with long-term broadband plans. ACT also offering a discount of up to 50 per cent on monthly tariff through a referral program if the user refers a friend to the network. However, the discount will be applicable only if the referred friend signs up for the network and completes the payment. ACT Fibernet adopted a defensive strategy (positioning) in advance to take on Jio GigaFiber.

Source: ICFAI Research Center

4.6.2 Influencing the Balance

The firm can devise a strategy that allows it to take the offensive. Innovation in marketing can raise brand identification or lead to differentiation of products being achieved.

In order to overcome the entry barriers, capital investments in large scale facilities or vertical integration are essential. The balance of forces is partly a result of external factors and partly within a firm's control. To identify the key factors driving competition in the particular industry, structural analysis is used.

4.6.3 Exploiting Change

Industrial evolution is important strategically, because evolution brings changes in the structural sources of competition. For example, the iTunes Music Store of Apple, Inc. created a new business model for online music retailing. In this evolved business model, the company was able to erect entry barriers and suppress the bargaining power of buyers as well as suppliers. Thus the company created a paradigm shift in the industry and exploited the changed situation to its advantage.

Check Your Progress - 3

9. To create a favorable position against the five competitive forces, an effective competitive strategy takes offensive or defensive action. This involves:
   i. Anticipating shifts in the factors underlying the forces and responding to them.
   ii. Positioning the firm so that its capabilities provide the best defense against the existing array of competitive forces.
   iii. Ignoring the balance of competitive forces that affect the firm's relative position.

   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii

10. Which of the following helps to achieve differentiation in products?
    a. Brand loyalty
    b. Product promotion
    c. Innovation
    d. Product distribution

4.7 Summary

- Environmental scanning involves capturing information about the firm's external environment -- either remote or operating -- in terms of opportunities and threats.
- The remote environment consists of a set of forces that originate beyond a firm's operating situation. These comprise political, economic, social, technological, and legal forces which create opportunities, threats, and constraints for the firm.

- The operating environment includes all factors -- such as competitors, customers, suppliers, and the labor market -- which a firm faces while sourcing its inputs and while marketing and selling its outputs. It has a direct impact on the operations of a firm.
- The Five Forces model is a framework for industry analysis. The five forces that determine the competitive intensity and the attractiveness of a market are: the bargaining power of the buyers, the bargaining power of the suppliers, the threat of new entrants, the threat of substitute products, and the intensity of rivalry amongst existing firms.
- In order to create a favorable position against the five competitive forces, an effective competitive strategy takes offensive or defensive action, such as: positioning the firm so that its capabilities provide the best defense against the existing array of competitive forces; influencing the balance of forces through strategic moves, thereby improving the firm's relative position; or anticipating shifts in the factors underlying the forces and responding to them, thereby exploiting change by choosing a strategy appropriate to the next competitive balance before rivals recognize it.

4.8 Glossary

External environment: The external environment of a company comprises forces and conditions over which the firm has little or no control, and they exert an influence on the company's strategic options as well as on its competitive position. The external environment is of two types, the operating environment and the remote environment. The operating environment has a direct bearing on the firm's performance and includes variables like competitors, consumers, and vendors. The remote environment includes political, social, economic, and demographic variables.

Political environment: Political forces influence the legislations and government rules and regulations under which the firm operates. An environment that constitutes these political forces is called political environment.

Porter's Five Forces Model: Developed by Michael E. Porter, the five forces model draws upon five forces that determine the competitive intensity and the attractiveness of the market. These five forces are -- the bargaining power of the buyers, the bargaining power of the suppliers, the threat of new entrants, the threat of substitute products, and the intensity of rivalry amongst existing firms.

Social environment: The social environment of a business refers to the values, beliefs, attitudes, opinions, and lifestyles in a society. Its impact on the business is immense. The changes in the social forces create new opportunities for business firms and provide them with opportunities to grow. The cultural, demographic, religious, educational, and ethnic conditioning of individuals in society affects the social environment.

4.9 Self- Assessment Test

1. Explain the remote environment and operating environment for a business. What are their constituents?
2. Discuss the five forces model proposed by Michael Porter. How can this model be used to analyze the industry structure?
3. In what way can an organization use the industry structure analysis to design a competitive strategy?

4.10 Suggested Readings/Reference Material

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5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
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4.11 Answers to Check Your Progress Questions

1. (c) Customer

The remote environment consists of a set of forces that originate beyond a firm's operating situation. These forces comprise political, economic, social, technological, and industrial forces which create opportunities, threats, and constraints to the firm. The **customer**, on the other hand, is **an operating environment factor**. The operating environment involves factors that provide many challenges that a particular firm faces when attempting to attract or acquire essential resources or when striving to profitably market its goods and services in the immediate competitive situation.

2. (b) **Social environment**

The social environment of an organization is constituted by the values, beliefs, attitudes, opinions, and lifestyles in society. For a company to grow, it is necessary to take advantage of societal changes. The cultural, demographic, religious, educational, and ethnic conditioning of individuals in society affects the social environment.

3. (a) **Operating environment**

The operating environment involves factors that provide many of the challenges a particular firm faces when attempting to attract or acquire essential resources or when striving to profitably market its goods and services in the immediate competitive situation. The factors that are considered in this environment are competitive position, customer profile, reputation among suppliers and creditors, and accessible labor market. The remote environment consists of a set of forces that originate beyond a firm's operating situation. Prime interest rates, inflation rates, the general availability of credit, the level of disposable income, and the propensity to spend at the national and international levels influence the strategic planning of the organization and they constitute the economic environment of the organization. The social environment of an organization constitutes the values, beliefs, attitudes, opinions, and lifestyles in society.

4. (d) **i, ii, iii, and iv**

The geographic profile indicates where the firm's customers are located, and the firm accordingly manages its reach to serve the customers. The demographic profile would be in terms of age, sex, marital status, income, and occupation. The psychographic profile would be in terms of values, attitudes, and lifestyles of consumers. Buying behavior or patterns are taken into account to sell more to the customers by increasing usage rates.

5. (a) **Market share**

The willingness and ability of firms to enter a particular industry depends on the barriers to entry. There are six such barriers — economies of scale, product differentiation, capital requirements, cost disadvantages independent of size, access to distribution channels, and government policy. By assessing market share of existing competitors, the firm is able to decide the positioning of various competitors in the market and form a strategy accordingly before entering the market. As it is a new entrant and its market share is nil, it has everything to gain and hence market share does not act as a barrier for new entrants.

6. (b) Product differentiation

Product differentiation is the process of distinguishing one's product from competitors' products available in the market. It helps in making the product more attractive for customers, leading to an increase in market share. It also becomes difficult for the competitors to increase their market share and hence product differentiation becomes a barrier for any new entrants. In the given example, DEF Ltd is a multinational giant and is not short of capital. It can easily create economies of scale, besides which the government has given a subsidy. Hence, these are not the barriers faced by the company.

7. (a) Intensity of rivalry will increase.

Rivalry is usually intense when there are many competitors of similar size; there is a slowdown in industrial growth which makes firms keen to grab each other's market share; and there is a lack of differentiation among the products of the players. Other reasons for increased rivalry are absence of switching costs; exit barriers like fixed investments in land, plant, and equipments; and loyalty of old players to the industry despite low returns. So, intensity of rivalry is expected to increase in the given situation.

8. (d) Only ii, iii, and iv

According to Porter, the buyers are powerful under the following circumstances: when the suppliers are many and the buyers are few and large; when the buyers purchase in large quantities; when the supplier's industry depends on the buyers for a large percentage of its total orders; when the buyers can switch orders between supply companies at a low cost, thereby playing companies off against each other to force down prices; when it is economically feasible for the buyers to purchase the input from several companies at a time; and when the buyers can use the threat to provide for their own needs through vertical integration as a device for forcing down prices.

9. (a) Only i and ii

In order to create a favorable position against the five competitive forces, an effective competitive strategy takes offensive or defensive action. This involves a number of possible approaches including positioning the firm so that its capabilities provide the best defense against the existing array of competitive forces; **influencing** the balance of forces through strategic moves, thereby **improving** the firm's relative position; and anticipating shifts in the factors underlying the forces and responding to them, thereby exploiting change by choosing a strategy appropriate to the new competitive balance before rivals recognize it.

10. (c) Innovation

Innovation can raise the differentiation in products. It involves the use of a new idea or method which would differentiate a firm's products from those of its competitors. A firm which brings out an innovative product usually enjoys the 'first mover' advantage. Brand loyalty is the allegiance which customers have toward a particular brand; it is the result of differentiation and not a cause for differentiation. Promotion of the product through various marketing strategies like advertisements and discounts is called product promotion. Product distribution aims at increasing the reach of the product in terms of geographical coverage.

Unit 5

Internal Environment Analysis

Structure

Ask those responsible for each activity to identify how other activities within the company improve or detract from their performance. Second, are there ways to strengthen how activities and groups of activities reinforce one another? Finally, could changes in one activity eliminate the need to perform others?

- Michael Porter

5.1 Introduction

Internal environment deals with the company's inside operations, people, policies, practices, activities, etc. Here, Michael Porter has emphasized how a company can reduce the number of operational activities wherein it incurs cost on each activity. On the other side, Porter also highlighted analysing the internal environment could lead to the increase in productivity in operational activities.

In the previous unit, we have discussed about external environment analysis. In this unit, we shall discuss internal environment analysis.

The internal analysis of an organization is basic to the study of strategic management. For a strategy to succeed, it should be based on a realistic assessment of the firm's internal resources and capabilities. An internal analysis provides the means to identify the strengths to build on and the weaknesses to overcome when formulating strategies. An analysis of internal resources will reveal what the organization is capable of doing in view of the resources profile.

This unit will first discuss the relationship between strategy and internal analysis. We shall then move on to understand how to analyze the various departments and functions, management, and culture of an organization. Finally, we shall discuss the concept of value chain analysis.

5.2 Objectives

By the end of this unit, students should be able to:

- Formulate the relationship between strategy and internal analysis.
- Find out how to analyze the various departments and functions, management, and culture of an organization.
- Explain the concept of value chain analysis.

5.3 Strategy and Internal Analysis

According to the resource-based view (RBV) of the firm, a firm which strategizes on the basis of the capabilities it possesses will enjoy clear advantages in terms of speed, agility, acuity, consistency, and innovativeness. To provide superior value to the customer and achieve competitive success, a firm should convert its key processes into strategic capabilities. These capabilities, along with valuable assets -- tangible and/or intangible -- that can provide a competitive advantage, are together referred to as 'resources'.

For a resource to be valuable and provide a competitive advantage to the firm, the market demand for the resource should be high, market availability should be low, and the firm should have the bargaining power to capture the value that is created by the resource. Further, such resources should be durable, superior to similar resources possessed by competitors, and difficult to imitate/copy or substitute.

When evaluating or developing a strategy, the starting point is the organization's present strategy and the resources it has or may acquire. The internal analysis process considers the firm's resources; the business the firm is in; its objectives, policies, and plans; and how well they were achieved. The important questions that are answered by the process of internal analysis are: 'Is the strategy being pursued consistent with the various resources of the enterprise?' and 'Are the available resources appropriate for any changes in strategy or new strategies?'

The results and conclusions of the analysis are crucial ingredients in determining what the future strategy might be or can be. The internal analysis not only indicates what the firm's resources are but also judges how well the assets have been used by the management.

Although the internal analysis is a very important element of the strategy formulation and evaluation process, it is one element and only a part of the overall analysis of the organization. It initiates the analysis by clarifying what an organization is capable of doing in light of the resources profiles. Thus, internal analysis requires the analyst to appraise the management's utilization of resources, formation, and implementation of strategy, and performance by the various functions required by the strategy.

5.4 Analyzing Departments and Functions

All organizations irrespective of their size, nature, and scope of business perform the functions of marketing, production and operations, finance and accounting, research and development, and human resource management. For efficient strategic management, careful planning, execution, and coordination of these functions is highly essential. Each of the functional areas has strengths or weaknesses depending on how the function is being managed. Managers should understand the interrelationships among these functions to formulate effective strategies.

5.4.1 Marketing

The marketing function is the interface point between the firm and its customers. The strength of the firm in terms of its ability to outperform its competitors is reflected in the marketing function. Marketing includes selling products/services, pricing, marketing research, distribution, customer analysis, product and service planning, and opportunity analysis. The marketing strengths or weaknesses get reflected in customer loyalty, which in turn depends on the customer profile and its interrelationship with other marketing variables like pricing and distribution. The market share gain or loss is a reflection of the marketing department's strength or weakness. Marketing is responsible for generating revenues and is also the vital communication link between the organization and its customers.

Further, marketing interfaces with the R&D and production functions. Inputs are provided by the marketing function on the changing trends in the marketplace for production and R&D teams to develop and produce new products to meet the competition. The quality of this interface determines the ability of the firm to outperform its competitors.

The effectiveness and efficiency of the marketing team get reflected as the strengths or weaknesses of the organization. Certain parameters like the ability to introduce new products quickly, a strong distribution network, above average credit terms, and appropriate marketing communications, are the strengths which a firm may enjoy.

5.4.2 Production and Operations

The basic objective of the production and operations function is to ensure that the outputs produced have a value that exceeds the combined costs of the inputs and the transformation process. An analysis of the production function will determine the speed of the production cycle, that is, the time it takes to convert inputs into finished goods. It will also determine the wastages and spoilages that take place during the production process. The ability to ensure a smooth flow of inputs in the production chain reflects the operations capability of the firm. The capability of the firm in these areas will reflect its strength or weakness vis-à-vis the competition.

The reliability of the vendors in terms of the quality of inputs being supplied (rejected versus accepted), the time within which the inputs are supplied (stock-outs versus no stock-outs), and the credit terms being received from the vendors reflect the operational strengths and weaknesses of the firm. The same applies to the distribution network, wherein if the dispatch of the firm's finished products is synchronized in terms of quantity and product portfolio with that of the customer requirements, it will be treated as a strength. Otherwise it would be a weakness. The effectiveness of inventory control and quality control policies and procedures will be reflected as a strength or weakness of the firm.

Example

In June 2019, Chennai faced water crisis due to a rainfall deficit of 41 per cent in Tamil Nadu, which impacted production industries. To combat, tyre companies started working on processing blue (surface water), green (rain water) and grey (polluted water) water to harvest, reuse and cut down overall water consumption at their factories in and around Chennai. For instance, JK Tyre cut water consumption at its Chennai plant bringing its average consumption from 3.32 liter/kg (2014-15) to 1.64 liter/kg (2018-19) — one of the world's lowest consumers of water per ton for manufacturing radial tyres. The company said in a statement, "As an innovative step traditional internal cure media (traditional process of tyre curing) has been changed, thereby eliminating water usage. Result: 24% daily reduction in water used for boiler make up. The company also found that fresh water consumption in cooling towers creates high water consumption. The sewage is an alternative fresh water resource if treated properly." JK Tyres analyzed its production and operational function to eliminate water wastage.

Source: ICFAI Research Center

5.4.3 Finance and Accounting

The finance function deals with scanning for funds, securing funds, and using funds. The accounting function reports all financial transactions and their consequent results to stakeholders. The financial information of a firm provides an insight into its strengths and weaknesses. The balance sheet of the firm provides details on the wealth position of the firm at a given point of time while the profit and loss account provides details of the results of operations over a period of time. When read jointly over a period of time, the two statements provide a clear insight into the financial position of the firm. The financial statements should, however, be read carefully in light of accounting principles to arrive at the true picture of the financial health of the firm.

Specifically speaking, the firm's ability to raise short-term and long-term capital is seen as its strength or weakness. The adequacy of working capital, quality of the capital budgeting procedures, and the dividend payout policies are reflected as the strength or weakness of the firm. The level of expertise in financial management will also translate to the firm's strength or weakness.

Financial analysis

One of the most important tools for assessing the strength of an organization within its industry is financial analysis. A financial analysis measures how a firm is doing in comparison with its performance during past years and its competitors in the industry. There are four basic groups of financial ratios -- liquidity ratio, leverage ratio, activity ratio, and profitability ratio.

Liquidity ratio: A firm's ability to meet its imminent financial obligation is known as liquidity. Liquidity ratios are used as indicators of a firm's ability to meet its short-term obligations. Two widely used liquidity ratios are:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

The quick ratio recognizes that inventory is usually less liquid than other current assets. In the case of long production processes, inventory may not provide much liquidity because it cannot be turned into cash.

Leverage ratio: The leverage ratios identify the source of a firm's capital, that is, owners or outside creditors. The various types of leverage ratios are:

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

$$\text{Debt on equity} = \frac{\text{Total liabilities}}{\text{Total common equity}}$$

$$\text{Times interest earned} = \frac{\text{Earnings before interest and tax (EBIT)}}{\text{Interest expense}}$$

$$\text{Fixed charged coverage} = \frac{\text{EBIT} + \text{interest expenses} + \text{lease obligations}}{\text{Interest expense} + \text{lease obligations}}$$

The debt ratio is the most commonly used ratio.

Activity ratio: In general, activity ratios measure a firm's efficiency in generating sales and making collections. The various activity ratios are:

$$\text{Inventory turnover} = \frac{\text{Sales}}{\text{Inventory}}$$

$$\text{Average collection period} = \frac{\text{Accounts receivable}}{\text{Sales per day}}$$

$$\text{Total asset turnover} = \frac{\text{Sales}}{\text{Total Assets}}$$

$$\text{Fixed asset turnover} = \frac{\text{Sales}}{\text{Net fixed assets}}$$

Other things being equal, a low inventory is more efficient because it indicates that the firm does not have many assets tied up in inventory. Total asset turnover and fixed asset turnover measure the firm's ability to generate sales for a given level of assets. A higher ratio indicates a more efficient firm.

Profitability ratios: Profits are the net result of a large number of policies and decisions chosen by the firm's management. Profitability ratios indicate how effectively the firm is being managed. Some important profitability ratios are:

$$\text{Profit margin} = \frac{\text{Net income}}{\text{Sales}}$$

$$\text{Return on assets} = \frac{\text{Net income}}{\text{Total assets}}$$

$$\text{Return on equity} = \frac{\text{Net income}}{\text{Total common equity}}$$

For profit margin and return on assets, high ratios are superior to low ratios; but with return on equity, a high value may indicate a higher level of financial leverage than of managerial efficiency. Also, a high degree of financial risk may accompany a high return on equity.

Financial analysis is not a standardized or mechanical process. It is the means for analysis and must always be directed toward the needs of a specific situation. Financial analysis, if approached in a proper manner, can be a productive starting point for assessing financial strengths and weaknesses and other attributes of a firm, based on past performance.

Information in financial statements is historical and often derived from a relatively distant past. The data shows what has happened and what the situation was in the past. Future trends can be predicted but the basic assumption that conditions will remain similar enough to extrapolate data seldom proves accurate.

Financial data can provide an insight into the future when analyzed properly in a strategic context.

Regardless of the type of institution, the finance function must be examined in order to gain some insight into its health. Even non-profit institutions must pay their bills on time to continue operations. Even though profit is not an objective of non-profit organizations, an excess of income over expenses allows them to grow larger and stronger to accomplish their service objectives.

A review of the financial conditions provides information about the organization and the management. It also reveals whether revenues have been increasing profitability. A financial analysis identifies the financial resources of the firm and how well they have been and are being utilized. All of this is important when considering the appropriateness and implementation of past, present, and future strategies.

5.4.4 Research and Development

A major functional area of any organization is research and development (R&D). The importance of R&D varies with the nature of the organization. In certain circumstances, the R&D function is of minor importance (e.g., retailing operations). The R&D function either supplements a product-oriented effort or improves the production processes. Although many firms develop new products, those with technically oriented products are most involved in R&D. In such organizations, R&D is accomplished at great expense, and it is vital if the firm is to prosper or even survive. Many non-profit organizations such as hospitals and universities also engage in R&D. Such organizations spend large sums to support medical education, staff, and equipment to improve their products, services, and contributions to society.

The two areas of R&D are product R&D and process R&D. Product R&D is concerned with innovations/implementations in the firm's products. Process R&D attempts to reduce the costs of operations and seeks constant improvement in quality through more efficient processes. Business units that adopt low-cost strategies emphasize process R&D, whereas businesses that adopt differentiation strategies emphasize product R&D.

The strength or weakness of the R&D function will get reflected in terms of the qualifications of the R&D staff, whether communication lines between R&D function and other departments exist, and whether adequate R&D facilities have been established.

R&D strengths are essential in industries like pharmaceuticals and consumer electronics.

5.4.5 Human Resource Management

The human element permeates all segments and units within an organization. The human resources are the most important resources an organization possesses.

Ironically, they are also the most mobile of the firm's resources. The human resource function of an organization deals with designing and analyzing jobs, handling recruitment, and selecting and employing people. The function also deals with training the employees and managing their compensation and benefits. Human resource managers, along with the line managers, take care of performance management, career management, and management development.

The ability of the human resource function to create a conducive work environment and build a high quality of work life will translate into strength for the firm. The strength also gets reflected in managing to achieve attrition rates below the industry rates. The strength or weakness of the human resource function is reflected in the employee morale, whether the organization structure is appropriate, employee turnover rate and absenteeism, and whether the job descriptions and specifications are clear.

5.4.6 Integrating the Functional Areas

Though an organization is divided into different functional areas, each with its own focus, it is essential that all of them act in an integrated and cohesive manner. They are sub-systems of the organization and hence their joint performance will have a direct bearing on the firm's performance. When all the functional areas are aligned and are working synchronously, the following benefits will accrue:

Superior product design and quality

Designing a superior product involves not only the contributions from the production department, but also those from the marketing and costing departments. Superior service when combined with superior product design and quality helps the firm gain an advantage over its competitors.

Superior customer service

Developing and maintaining quality customer service is more challenging than improving product quality. Companies that provide premium services can command premium prices for their products. An important method for providing superior quality service is by giving personal attention to the customers. All functional areas must work together like a team to provide qualitative service to the customer, before and after sales.

Superior speed

Speed in developing, producing, distributing products, and providing services will give the organization and the business a significant competitive advantage.

Overall strategic success depends on the tight integration of all the functional areas, and business organizations can achieve competitive advantage by accomplishing full functional integration.

Strategists examine a firm's past performance to isolate key internal contributions to favorable (or unfavorable) results. Analysis of past trends in a firm's sales, costs, and profitability is very important for identifying its strategic internal factors. The identification of strategic internal factors requires an external focus. Strategists' efforts to isolate key internal factors are assisted by the analysis of industry conditions and trends, and by comparisons with competitors. Thus, by adopting the functional approach, managers focus on basic business functions, thus leading to a more objective, relevant internal analysis that enhances strategic decision-making. Whether looking at attributes of marketing, production, finance, or research and development, the functional approach structures managers' thinking in a focused and potentially objective manner.

Activity 5.1
Discuss, with the help of an example, how activities pertaining to R&D, and marketing and sales help in creating value. **Answer:**

<u>Check Your Progress - 1</u>

1. Which of the following analyses is an important tool used to assess the strength of an organization within its industry and to measure its performance in comparison with past years and its competitors in the industry?
   a. Gap analysis
   b. Financial analysis
   c. Internal analysis
   d. Value chain analysis
2. Which of the following ratios are used as indicators of a firm's ability to meet its short-term financial obligations?
   a. Liquidity ratios
   b. Leverage ratios
   c. Activity ratios
   d. Profitability ratios

3. Which of the following ratios indicates the proportion of a firm's capital being contributed by owners and outside creditors?
   a. leverage ratio
   b. activity ratio
   c. liquidity ratio
   d. profitability ratio
4. Which of the following statements is **false**?
   a. Financial analysis is a standardized or mechanical process.
   b. Financial data can provide an insight into the future when analyzed properly in a strategic context.
   c. Even non-profit institutions must pay their bills on time to continue operations.
   d. Information in financial statements is historical and often derived from a relatively distant past.
5. Which of the following functions either supplements a product-oriented effort or improves the production processes?
   a. production
   b. marketing
   c. research and development
   d. accounting
6. The human resource management function includes major responsibilities like:
   i. designing and analyzing jobs.
   ii. management development.
   iii. managing employee compensation and benefits.
   iv. career management.
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. i, ii, iii, and iv

5.5 Analyzing Management

Within a strategic framework, the internal analysis of an organization begins and ends with the management of the organization. Everything else is dependent on the actions of the firm's management group. The management can be evaluated on the basis of the organizational profile of strengths and weaknesses in light of what it has or has not done, or what it has or has not achieved. If more than one group of managers is involved, each group should be evaluated in view of its accomplishments during a particular time. Moreover, individuals and groups within the management may be evaluated separately. In diversified organizations, the management of each subunit is assessed individually.

5.5.1 Assessing Top Management

The assessment of the top management of the organization is a major reason for the internal analysis of an organization. Top management, in this context, refers to those primarily responsible for organizational strategy. These are the managers who guide the overall destiny and operations of the organization. The important questions to be asked here by the analyst are: ‘How has the organization been managed in the past?’, ‘How is it being managed now?’, and ‘How well is the firm prepared to face the future?’

Top management can be analyzed and evaluated in depth by pulling together the separate areas into an overall profile or analysis of the entire organization. The analyst should make statements about the firm as a whole, its top management, and the strategies of the past, present, and future. When formulating business strategy, conclusions and decisions should be based on information, as comprehensive as can be obtained, within a reasonable time and at a reasonable cost.

5.5.2 Using Results to Analyze Management

A variable input involved in the analysis of management is results. The various types of results could be in the areas of -- production/manufacturing, marketing, human resources, research and development, and finance. With respect to results, the most important questions are:

- Were objectives established and measures developed against which to compare with the results?
- Were planned results accomplished in all the important areas within the organization?
- How well did the management assess its position, plan for change, and carry out change?
- Was a strategy developed and implemented?
- Were objectives articulated, communicated, and understood by those responsible for implementing them?
- Have decisions been made by one person or by a group?
- Have the top level managers been open to and initiated change readily?

The answers to such questions say a lot about the future possibilities of the organization as well as about its present condition. Thus, a thorough look at results in profits, sales, cost reduction, research and development, building of plants, morale, social contribution, and other areas will reveal a lot about the quality of both the organization and its management. Generally, good performance in the functional areas will lead to good overall results.

5.5.3 Stockholders and Directors

The stockholders of a business organization have the basic rights of ownership, unless management overlaps heavily with ownership. The management should act in the best interests of the stockholders. It should take decisions that would clearly benefit the stockholders over the long run. If the directors do not consider the interests of stockholders, they fail in one of the basic responsibilities of management, that is, to protect and enhance the investment of the firm's owners. Regarding stockholders, the analyst should explore the following questions:

- How do stockholders collectively make themselves heard?
- What is the stockholders' representation on the board of directors?
- Is the board active or inactive?
- Does the board of directors have a voice in the determination of strategy?
- Is the composition of the board logical considering the nature of the organization and its business?
- Has the board of directors exercised its powers in setting the basic objectives of the organization?

5.6 Culture

The seven S's are the organization's strategic levers -- structure, strategy, systems, skills, style, staff, and shared values. According to the McKinsey 7-S framework, an organization's culture (shared values) should have a good fit with its strategy and other factors such as structure, systems, management style, and human resources (staff and their skills).

Understanding the culture of an organization helps the management to predict whether the existing culture would be suitable for some/all of the various strategic alternatives that the firm has to choose from. If the existing culture will not be suitable for a desired strategic alternative, the management has to decide whether it will be feasible to change the culture, and how much time and other resources would be required to achieve this culture change.

If required, minor modifications may be made to the strategy or execution plan to overcome the associated challenges of a cultural misfit. For example, a company that chooses to explore a new market that requires a different organization culture, may start a new subsidiary or division which is reasonably insulated from the culture in the rest of the organization.

Example

In June 2019, Tata Motors has decided to cut periodic production at its passenger-car plants and focus on retail sales to prop up dealerships amid an industrywide slowdown in passenger vehicle sales. Mayank Pareek, President of Tata Motors' passenger vehicle division, said that the company has also increased dealer margins to about 5.8%—which is about 200 basis points higher than the industry average— to ensure its channel remains healthy. He further added, "We're changing our focus from wholesale to retail. The wholesale dispatch is not a real reflection of the demand in the market place. Retail is the real sale." The case represented a strategic lever of McKinsey 7-S framework where Tata Motors decided to cut periodic production and started pushing retail sales.

Source: ICFAI Research Center

5.7 Value Chain Analysis

Value chain analysis is based on the assumption that a business's basic purpose is to create value for its users and its products or services. In this method of analysis, strengths and weaknesses are assessed by dividing a business into a number of linked activities, each of which may produce value for the customer. In value chain analysis, managers divide the activities of their firms into sets of separate activities that add value. To do so, the activities of the organization (such as raw material procurement, logistics, operations, sales, marketing, technology development, and firm infrastructure) have to be identified and examined by managers. Managers thus acquire an in-depth understanding of their firm's capabilities, its cost structure, and how these create a competitive advantage or disadvantage.

Value chain analysis divides a firm's activities into two major categories -- primary and support activities. Primary activities are those activities that are involved in the physical creation of the product, marketing, and after-sales support. Support activities assist the primary activities by providing infrastructure that allows them to take place on an ongoing basis.

Example

Walmart-owned Flipkart moved a substantial proportion of its manufacturing and sourcing for its private brands from China and Malaysia to India over the last year, helping to cut costs and comply with the government's Make in India initiative. That has helped Flipkart reduce prices of private label products sold across 300 categories on its platform. Flipkart's private brands include MarQ,

Contd….

Perfect Homes, Billion and Smart-Buy, which contribute about 8% to the company's overall sales. In June 2019, Adarsh Menon, (Head of private label business at Flipkart) said, "About two years back, almost 100% of our electronics came from China. Today (2019), that number would be less than 50%." Flipkart substantially moved their sourcing from China to India, which depicts inbound logistics of value chain.

Source: ICFAI Research Center

The value chain includes a profit margin. Each of the primary and support activities can be further divided for a thorough internal analysis. Table 1 provides a summary of some important factors to consider when evaluating primary activities and Table 2 summarizes some important factors to consider when evaluating support activities.

Table 1: The Primary Activities and Factors for Assessment

Primary Activity	**Factors of Assessment**
Inbound logistics	• Soundness of material and inventory control system • Efficiency of raw material warehousing activities
Operations	• Productivity of equipment compared to that of key competitors • Appropriate automation of production processes • Effectiveness of production control systems to improve quality and reduce cost • Efficiency of plant layout and work-flow design
Outbound logistics	• Timeliness and efficiency of delivery of finished goods and services • Efficiency of finished goods warehousing activities
Marketing and sales	• Effectiveness of market research to identify customer segments and needs • Innovation in sales promotion and advertising • Evaluation of alternate distribution channels • Motivation and competence of sales force • Development of an image of quality and a favorable reputation • Extent of brand loyalty among customers • Extent of market dominance within the market segment or overall market

Contd….

Primary Activity	Factors of Assessment
Customer service	• Means to solicit customer input for product improvements • Promptness of attention to customer complaints • Appropriate of warranty and guarantee policies • Quality of customer education and training • Ability to provide replacement parts and repair services

Adapted from Porter, Michael E. Competitive Advantage: Creating and Sustaining Superior Performance. Simon & Schuster; Export edition, 2004.

Table 2: The Support Activities and Factors for Assessment

Support Activity	Factors of Assessment
Firm infrastructure	• Capability to identify new-product market opportunities and potential environmental threats • Quality of the strategic planning system to achieve corporate objectives • Coordination and integration of all value chain activities among organizational subunits • Ability to obtain relatively low-cost funds for capital expenditures and working capital • Level of information systems support in making strategic and routine decisions • Timely and accurate management information on general and competitive environments • Relationships with public policy makers and interest groups • Public image and corporate citizenship
Human resource management	• Effective of procedures for recruiting, training, and promoting all levels of employees • Appropriateness of reward systems for motivating and challenging employees • A work environment that minimizes absenteeism and keeps turnover at desirable levels • Relations with trade unions • Active participation by managers and technical personnel in professional organizations • Levels of employee motivation and job satisfaction.

Contd….

Support Activity	Factors of Assessment
Technology development	• Success of research and development activities in leading to product and process innovations • Quality of working relationships between R&D personnel and other departments • Timeliness of technology development activities in meeting critical deadlines • Quality of laboratories and other facilities • Qualification and experience of laboratory technicians and scientists • Ability of work environment to encourage creativity and innovation
Procurement	• Development of alternate sources for nipple to minimize dependence on a single supplier • Procurement of raw materials (1) on a timely basis, (2) at lowest possible cost, and (3) at acceptable levels of quality • Procedures for procurement of plant, machinery, and buildings • Development of criteria for lease-versus-purchase decisions • Good, long-term relationships with reliable suppliers

Adapted from Porter, Michael E. Competitive Advantage: Creating and Sustaining Superior Performance. Simon & Schuster; Export edition, 2004.

5.7.1 Conducting a Value Chain Analysis

In the initial step of a value chain analysis, a firm's operations are divided into specific activities or business processes. The next step is to attempt to attach costs to each discrete activity (Activity-based costing). If managers assign costs and assets to each and every activity, managing internal strengths and weaknesses would be much easier and simpler.

Once the firm's value chain has been documented and costs determined, managers need to identify the activities that are crucial to customer satisfaction and market success. The following considerations are essential at this stage: the manager's choice of activities has to be influenced by the firm's basic mission, and the manager must take into consideration the nature of value chains and the relative importance of the activities since they vary by industry.

Value chain analysis also requires a meaningful comparison to use for evaluating the role of an activity as a strength or a weakness. The framework of the value chain analysis has certain strengths. First, it clearly highlights the importance of customer value. Second, it provides a sense of direction to managers by offering a generic checklist of what to analyze when assessing a firm. Last, it indicates that everything an organization does can be managed to improve the firm's overall ability to create value. Thus, the value chain framework is useful for organizations in general and to managers in particular. However, the framework suffers from certain limitations. It does not provide a sense of how various activities interact or relate to one another.

Check Your Progress - 2

7. In value chain analysis, which of the following are assessed by dividing a business into a number of linked activities, each of which may produce value for the customer?
   a. Strengths, weaknesses
   b. Opportunities, threats
   c. Opportunities, weaknesses
   d. Strengths, threats
8. Which of the following options is **not** a primary activity in a value chain?
   a. Operations
   b. General administration
   c. Outbound logistics
   d. Inbound logistics
9. The value chain framework is useful for managers in particular because:
   i. It clearly highlights the importance of customer value.
   ii. It provides a sense of direction to managers by offering a generic checklist of what to analyze when assessing a firm.
   iii. It indicates that everything an organization does cannot be managed to improve the firm's overall ability to create value.

   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii
10. Which of the following is **not** a factor of assessment of marketing and sales activity?
   a. Development of an image of quality and a favorable reputation
   b. Extent of brand loyalty among customers
   c. Extent of market dominance within the market segment or overall market
   d. Ability to provide replacement parts and repair services

11. The factors of assessment of the marketing and sales function include:
    i. Innovation in sales promotion and advertising.
    ii. Promptness of attention to customer complaints.
    iii. Evaluation of alternate distribution channels.
    iv. Motivation and competence of the sales force.
    a. Only i, ii, and iii
    b. Only i, ii, and iv
    c. Only i, iii, and iv
    d. Only ii, iii, and iv
12. Which of the following statements is **false**?
    a. Timeliness and efficiency of delivery of finished goods and services is a factor of assessment of outbound logistics.
    b. The efficiency of finished goods warehousing activities is a factor of assessment of operations.
    c. A factor for assessment of marketing and sales activity is the effectiveness of market research to identify customer segments and needs.
    d. The ability to provide replacement parts and repair services is a factor of assessment of customer service.
13. The factors of assessment of operations activity are:
    i. Efficiency of plant layout and work-flow design.
    ii. Effectiveness of production control systems to improve quality and reduce cost.
    iii. Appropriate automation of production processes.
    iv. Soundness of material and inventory control systems.
    a. Only i, ii, and iii
    b. Only i, ii, and iv
    c. Only i, iii, and iv
    d. Only ii, iii, and iv
14. Which of the following are the factors of assessment of human resource management?
    i. Effectiveness of procedures for recruiting, training, and promoting all levels of employees
    ii. Appropriateness of reward systems for motivating and challenging employees

iii. Quality of laboratories and other facilities

iv. Levels of employee motivation and job satisfaction

a. Only i, ii, and iii

b. Only i, ii, and iv

c. Only i, iii, and iv

d. Only ii, iii, and iv

15. Which of the following is **not** a factor of assessment of technology development?
    a. Quality of working relationships between R&D personnel and other departments
    b. Qualification and experience of laboratory technicians and scientists
    c. Relationships with public policy makers and interest groups
    d. Ability of the work environment to encourage creativity and innovation

Activity 5.2

A value chain is a linked set of value - creating activities, beginning with basic raw materials coming from suppliers, moving on to a series of value-added activities involved in producing and marketing a product or service, and ending with the distributors supplying the final goods to the ultimate consumer. Elaborate, with the help of an example, how service and support activities help in adding value to the product or service.

Answer:

5.8 Summary

- For a strategy to succeed, it should be based on a realistic assessment of the firm's internal resources and capabilities.
- An internal analysis provides the means to identify the strengths to build on and the weaknesses to overcome when formulating strategies. The internal analysis process considers the firm's resources; the business the firm is in; its objectives, policies, and plans; and how well they were achieved.

- For efficient strategic management, careful planning, execution, and coordination of various functions -- marketing, production and operations, finance and accounting, research and development, and human resource management -- is highly essential. Each of the functional areas has strengths or weaknesses depending on how the function is being managed. The joint performance of these functions will have a direct bearing on the firm's performance in terms of superior product design and quality, superior customer service, and superior speed.
- The management can be evaluated on the basis of the organizational profile of strengths and weaknesses in light of what it has or has not done, or what it has or has not achieved. Similarly, the role of the board of directors should also be analyzed.
- An organization's culture (shared values) should have a good fit with its strategy and other factors such as structure, systems, management style, and human resources (staff and their skills).
- Value chain analysis divides a firm's activities into two major categories -- primary and support activities. Primary activities are those involved in the physical creation of the product (inbound logistics, operations, and outbound logistics), marketing and sales, and after-sales support. Firm infrastructure, human resource management, technology development, and procurement are the support activities.

5.9 Glossary

Activity ratio: In general, activity ratios measure a firm's efficiency in generating sales and making collections.

Financial analysis: It measures how a firm is doing in comparison with its performance during past years and its competitors in the industry.

Leverage ratio: The leverage ratios identify the source of a firm's capital, that is, owners or outside creditors.

Liquidity ratio: A firm's ability to meet its imminent financial obligation is known as liquidity. Liquidity ratios are used as indicators of a firm's ability to meet its short-term obligations. Two widely used liquidity ratios are: current ratio and quick ratio.

Primary activities: Value chain analysis divides a firm's activities into two major categories -- primary and support activities. Primary activities are those activities that are involved in the physical creation of the product, marketing, and after-sales support.

Profitability ratios: Profits are the net result of a large number of policies and decisions chosen by the firm's management. Profitability ratios indicate how effectively the firm is being managed.

Support activities: Value chain analysis divides a firm's activities into two major categories -- primary and support activities. Support activities -- such as technology development, human resource management, procurement, and firm infrastructure -- assist the primary activities by providing support that allows them to take place on an ongoing basis.

Value chain: A value chain is a linked set of value-creating activities that begins with the purchase of basic raw materials from suppliers, and ends with distribution of a product or service. A value chain analysis evaluates the firm in the context of its value-creating activities.

5.10 Self-Assessment Test

1. In what way are strategy and internal analysis related to one other?
2. How can an organization analyze the various departments and functions, management, and culture of an organization?
3. Explain the concept of value chain analysis.

5.11 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

5.12 Answers to Check Your Progress Questions

1. (b) Financial analysis

Financial analysis is a tool that measures how a company is doing compared to past years and its competitors in the industry. It is one of the most important tools for assessing the strength of an organization within its industry. Gap analysis is the analysis of the gap between where the firm is today and where it wants to reach in terms of goals and aspirations. Value chain analysis is based on the assumption that a business's basic purpose is to create value for its users and its products or services. Internal analysis aims at identifying the strengths and weaknesses of the organization. It does not provide an insight into a competitor's strengths or weaknesses.

2. (a) **Liquidity ratios**

   A company's ability to meet its imminent financial obligations is known as liquidity. Liquidity ratios are used as indicators of a firm's ability to meet its short-term obligations. Two widely used liquidity ratios are current ratio and quick ratio. Leverage ratios identify the source of a firm's capital, i.e., owners or outside creditors, and the extent of their contribution to the firm's capital. Activity ratios measure a firm's efficiency in generating sales and making collections. Profitability ratios indicate how effectively a firm is being managed in terms of its ability to generate profits.

3. (a) **Leverage ratio**

   Leverage ratios identify the source of a firm's capital, i.e., owners or outside creditors. Activity ratios measure a firm's efficiency in generating sales and making collections. Liquidity ratios are used as indicators of a firm's ability to meet its short-term obligations, and profitability ratios indicate how effectively a firm is being managed.

4. (a) **Financial analysis is a standardized or mechanical process.**

   Financial analysis is not a standardized or mechanical process. It requires an application of skill and judgment to arrive at conclusions about the financial health of an organization. Financial data can provide an insight into the future when analyzed properly in a strategic context. Even non-profit institutions must pay their bills on time to continue operations. Information in financial statements is historical and often derived from a relatively distant past.

5. (c) **Research and development**

   The research and development (R&D) function either supplements a product-oriented effort or improves the production processes. For example, the R&D function of Sony has developed cordless earphones for its Walkman. This is an example of a product-oriented effort in which a new improved feature is added to an existing product. The process R&D effort may look at improving its production process to reduce wastages from 2% to 1%.

6. (d) **i, ii, iii, and iv**

   The responsibilities of the human resource management function include, but are not limited to, the four responsibilities listed in the question.

7. (a) Strengths, weaknesses

Value chain analysis is based on the assumption that the basic purpose of a business is to create value for its users and its products or services. In this method of analysis, strengths and weaknesses are assessed by dividing a business into a number of linked activities, each of which may produce value for the customer. For example, the production and selling activities of a firm manufacturing gas stoves are called primary activities and are assessed separately from human resource and general administration activities which are seen as secondary or support activities. Threats and opportunities are thrown up by the environment and the value chain analysis does not take them into consideration.

8. (b) General administration

Primary activities in a value chain are those activities that are involved in the physical creation of the product, marketing, and after-sales support. They can be divided into operations, outbound logistics, purchased supplies, inbound logistics, sales, marketing, and services. General administration provides support to all the functional divisions of an organization and is not a primary activity in the value chain.

9. (a) Only i and ii

The framework of the value chain analysis has certain strengths. First, it clearly highlights the importance of customer value. Second, it provides a sense of direction to the managers by offering a generic checklist of what to analyze when assessing a firm. Last, it indicates that everything an organization does can be managed to improve the firm's overall ability to create value. It stresses those factors which are predominantly internal to the firm, over which the firm has a high degree of control. Thus, the value chain framework is useful for organizations in general and to managers in particular.

10. (d) Ability to provide replacement parts and repair services

Factors of assessment of marketing and sales activity are effectiveness of market research to identify customer segments and needs; innovation in sales promotion and advertising; evaluation of alternate distribution channels; development of an image of quality and a favorable reputation; extent of brand loyalty among customers; extent of market dominance within the market segment or overall market; and motivation and competence of the sales force. The ability to provide replacement parts and repair services is a factor of assessment of customer service.

11. (c) Only i, iii, and iv

The factors of assessment of the marketing and sales activity are innovation in sales promotion and advertising, evaluation of alternate distribution channels, and the motivation and competence of the sales force. Promptness of attention to customer complaints is a factor of assessment of customer service and not of the marketing and sales function.

12. (a) The efficiency of finished goods warehousing activities is a factor of assessment of operations.

The efficiency of finished goods warehousing activities, and the timeliness and efficiency of the delivery of finished goods and services are factors of assessment of **outbound logistics**, and not of operations. The effectiveness of market research in identifying customer segments and needs is a factor of assessment of the marketing and sales activity. The ability to provide replacement parts and repair services is a factor of assessment of customer service.

13. (a) Only i, ii, and iii

The efficiency of plant layout and work-flow design, the effectiveness of production control systems to improve quality and reduce cost, the appropriate automation of production processes, and productivity of equipment compared to that of key competitors are factors of assessment of the operations activity. Soundness of material and inventory control systems is a factor of assessment of **inbound logistics**.

14. (b) Only i, ii, and iv

The factors of assessment of human resource management include: effectiveness of procedures for recruiting, training, and promoting all levels of employees; appropriateness of reward systems for motivating and challenging employees; and levels of employee motivation and job satisfaction, among others. The quality of laboratories and other facilities is the factor of assessment of **technology development**.

15. (c) Relationships with public policy makers and interest groups

The factors of assessment of technology development are quality of working relationships between R&D personnel and other departments; qualification and experience of laboratory technicians and scientists; and the ability of the work environment to encourage creativity and innovation. Relationships with public policy makers and interest groups are a factor of assessment of **firm infrastructure**.

Unit 6

Objectives, Grand Strategies, and Functional Strategies

Structure

"If your goal is anything but profitability - if it's to be big, or to grow fast, or to become a technology leader - you'll hit problems".

- Michael Porter

6.1 Introduction

Here, Michael Porter says companies who set their goal such as to expand their operations or entering new markets, or deploying new innovative technology, with an aim to gain profits, there are many forces or problems that companies would encounter in framing and executing grand and functional strategies to attain the goals.

In the previous unit, we have discussed about internal environment analysis. In this unit, we shall discuss about objectives, grand strategies, and functional strategies.

No business or enterprise activity can function effectively unless there is a purpose, aim, or objective to be reached. The activity of planning starts when the objectives are defined. Objectives are a vital prerequisite to successful operation of an organization. They are a must in any organization if it has to utilize the resources relative to its opportunities and if the organization is to be well managed strategically.

Once managers have determined their organization's mission, the next step is to establish how that mission is to be accomplished. The managers do this by formulating a set of objectives. Objectives are the concrete, specific aims that management seeks to achieve for the organization, often within a stated time period. The formulation of appropriate objectives is crucial to an organization's success in accomplishing its mission, since these objectives form the basis for planning, policymaking, and setting performance standards. From a strategy perspective, organizations formulate grand strategies, generic competitive strategies, and functional strategies as means for achieving organizational objectives.

This unit will first define objectives, and explain their hierarchy. We shall then move on to discuss grand strategies and their major classifications. Finally, we shall discuss about functional strategies and their application in some of the functions of an organization.

6.2 Objectives

By the end of this unit, students should be able to:

- Define objectives and their hierarchy.
- Explain grand strategies and their major classifications --- growth strategies and retrenchment (defensive) strategies.
- Discuss the concept of functional strategies and its application in select functions of an organization.

6.3 Definition of Objectives

In management literature, there are various definitions for objective(s) such as:

- The goals, aims, and purposes that organization wishes to achieve over varying periods of time.
- The intended goal that prescribes definite scope and suggests direction of efforts of managers.
- A term commonly used to indicate the end point of a management program.
- A desired state of affairs which the organization attempts to realize.

The planning process is considered as one of the prime functions of management. Also, the inseparability of objectives and planning has brought much attention to the setting of objectives as a major managerial task. Several forces influence the selection of basic objectives. They include the external environment, the internal resources of the firm, the personal values of major decision makers, and management's perceptions of its societal obligations.

The factors stated above must be analyzed as part of the strategic planning process. Also, objectives specify the desired end results in addition to providing the original impetus and direction for coordinated action. Examples of objectives could be: the company will ensure 35% rate of return on investment; the company will obtain 50% share for its products in the market; the company will ensure superior product with competitive price; and the company will enter into foreign markets within 3 years.

All these are overall objectives at the topmost level and will be time bound. The establishment of objectives is necessary in the management of any enterprise, whether that enterprise is a profit-making business or nonprofit organization. To those who would understand business strategy, understanding the many roles of objectives in organizations is critical.

6.3.1 The Need for Objectives

Organizations come into being for some purpose or purposes. The purpose/purposes of an organization’s existence should be clarified, articulated, and defined by the management. This is done through the establishment of objectives, which pervades the managerial process. An organization not guided by objectives is an organization not being managed properly. There are hardly any organizations with no purpose and no direction. Without objectives, an organization may continue to exist, but it cannot be considered to be under the control of management. The need of objectives can be understood from the following.

Objectives provide direction

As the beacon of a lighthouse guides ship captains to safety, objectives direct the efforts of managers into certain channels in the pursuit of these objectives. Therefore, clearly defined objectives specify an end result for the organization.

Objectives serve as standards

Objectives serve as standards for the manager. Without clearly defined objectives, managers possess no tools for evaluating performance. Without objectives there are no means of deciding whether work is satisfactory or acceptable.

Objectives serve as motivators

Objectives encourage workers to put forth their best efforts to achieve the end goals. For example, employees who understand the objective of profitability and their role in generating profits may be motivated to work harder or more efficiently under a bonus or other profit-sharing program.

Therefore, objectives improve the effectiveness of an organization by producing three major benefits: providing direction, serving as standards for evaluating performance, and motivating members of the organization.

6.3.2 The Nature of Objectives

1. Objectives are the goals set by the enterprise, which have to be reached.
2. Objectives are the most essential part of a plan and relate to the future.

3. They give direction to all functions and plans of an organization. They will have a bearing on policies, staffing, directing and of course, control.
4. Objectives are not sacrosanct in the sense that a change in situation will have a bearing on these and they may be changed.
5. They come in various garbs, viz., primary and secondary, general and specific, long term and short term, and few to many in number.
6. There is always a hierarchy of objectives.
7. All objectives of the enterprise at all levels are inter-connected and inter-related because their original source is one. They form a network of objectives.

The strategic managers must ensure that objectives are communicated to all members of the organization. Each employee should understand how his/her individual work objectives relate to the overall organizational objectives. As the organization and the environment in which it operates change, objectives may require adjustments to reflect these changes.

6.3.3 Levels of Objectives: Strategic to Operating

Companies have specific planning goals in areas such as production, marketing, and finance, but these derive from broader and more abstract, basic objectives. The functional objectives are based upon personal needs, values and goals of individuals and groups that are within or that influence the organization. Also, the degree of abstraction is the key to understanding organizational objectives. Objectives vary by nature in the level of precision with which they are described, in the breadth of their coverage within an organization, and in periods during which they are applicable. Moreover, objectives deal with specific decisions, performance and expected results. They are needed because managers must be able to measure their progress towards achievements and attainments especially in areas critical to organizational survival and success. Specific objectives are dependent upon the establishment of broader objectives. This is because they state more clearly the short-term, measurable goals that are to be achieved if attainment of broader strategic objectives is to become a reality for the organization. The strategic management process requires that managers at all levels of an organization become involved in a process of formulating objectives that are consistently linked. Failure to achieve this consistency linkage results in sub-optimization.

6.3.4 The Hierarchy of Objectives

Objectives state end results and overall objectives need to be supported by sub-objectives. Thus, objectives form a hierarchy.

At the zenith of the hierarchy are the socio economic objectives, such as requiring the organization to contribute to the welfare of the people by providing goods and services at reasonable cost. The next level consists of the mission of the organization. At the third level are the overall objectives and strategies (such as designing, producing, and marketing reliable, low-cost products).

The next level of the hierarchy contains more specific objectives called *Key Result Areas* (KRAs). These are the areas in which performance is essential for the success of the enterprise. The KRAs have to be watched very carefully. The objectives have to be further translated into division, department and unit objectives down to the lowest level of the organization. The accomplishment of each subsidiary objective should contribute to the achievement of its respective superior objective.

Descending the hierarchy, objectives become less abstract, less enduring and less encompassing in the total organizational context. The objectives at the lower level of hierarchy require fewer resources, involve commitment from fewer organizational members, and are more readily measurable. Viewing the hierarchy of objectives, one can picture the roles of various levels of management.

Thus, the concept of hierarchy helps to clarify the nature of objectives, particularly strategic objectives. The concept not only shows that it is not useful to consider only a single objective for any institution, but also it demonstrates that a multiplicity of objectives must be articulated if organizational direction is to be clearly understood. Moreover, this concept places objectives into an orderly and logical framework. With this framework, the nature of objectives can be more readily described, analyzed, and understood.

Check Your Progress - 1

1. Which of the following are important for an organization as they provide direction, serve as standards, and also serve as motivators?
   a. Objectives
   b. Mission statements
   c. Grand strategies
   d. Functional strategies
2. Which of the following statements with reference to objectives is **true?**
   a. Strategic managers must ensure that objectives are communicated to all members of the organization.
   b. Each employee needs to understand only his/her individual objectives. How they relate to the overall objectives is not his/her concern.
   c. Objectives do not require changes even if the organization and the environment in which a firm operates change.
   d. Objectives can relate either to the past or to the future.

6.4 Grand Strategies

Grand strategies (or master or business strategies) provide basic direction for strategic actions. A grand strategy is a strategy that provides the basic strategic direction at the corporate level. They are the basis of coordinated and sustained efforts directed towards achieving long-term business objectives. Also, they indicate the time period over which objectives are to be achieved. Thus, a grand strategy can be defined as a comprehensive general approach that guides a firm's major actions. The two major classifications of grand strategies are growth strategies and retrenchment (defensive) strategies.

6.4.1 Growth Strategies

The growth strategies are adopted when firms remarkably broaden the scope of their customer groups, customer functions and alternative technologies singly or in combination with each other. They involve a significant increase in performance objectives. Thus, growth strategies are those grand strategies that involve organizational expansion along some major dimension. In business organizations, growth typically means increasing sales and earnings. Though other criteria such as increase in number of geographic locations and clients served may also be the criteria for growth.

Organizational growth may be achieved by following organic and/or inorganic growth strategies. In organic growth, the firm focuses on developing new products, entering new geographic areas, and penetrating existing markets more effectively. In inorganic growth, the firm acquires companies, business units, or brands.

The major growth strategies are market penetration, market development, product development, forward integration, backward integration, horizontal integration, concentric diversification, conglomerate diversification, and horizontal diversification.

Market penetration or concentration strategy

Market penetration is a strategy wherein a firm seeks to increase its market share for present products and services in its present markets through increased marketing efforts. The main rationale for this approach is that the firm thoroughly develops and exploits its expertise in a delimited competitive arena.

The major characteristics of a concentrated growth strategy are the ability to assess market needs, knowledge of buyer behavior, customer price sensitivity, and effectiveness of promotion. Vigorous marketing efforts are made by augmenting the sales force, increased advertising, improved sales promotion, etc.

A firm pursuing market penetration strategies has many strategic alternatives to choose from. It could focus on its existing customers by increasing usage by present customers, increasing purchase size or frequency, improving product location, expanding product line (sizes, options, styles), and expanding shelf space. Or it could attract competitor's customers through increased promotional efforts, aggressive price cuts, and discounts. A third alternative is to attract non-users within the target segment of the product by promoting new uses of the product, offering special prices for sample packs, etc. A fourth alternative is to focus on the product by enhancing product differentiation and quality, launching more variants of the same product, developing new uses for the product, providing better after-sales service, etc.

Market penetration is pursued as a strategy when:

- Present markets are not saturated with present products.
- Usage rates of the present products can be increased sufficiently to justify the increase in marketing expenditure.
- Overall industry sales are witnessing an increase but that of the competitors are declining.
- Correlation between the sales revenues and marketing expenses has been high.
- Economies of scale exist and they provide a significant competitive advantage.

Risks and rewards of concentrated growth: Under stable conditions, market penetration poses less risk than any other grand strategy. But in a changing environment, concentrating in a single product market makes a firm vulnerable to changes in that segment. Also, it is difficult for an organization to attempt sudden changes if its product is threatened by near-term obsolescence, changes in customer needs, new substitutes or changes in technology. In the case of market penetration, over commitment to a specific technology and product market can hinder a firm's ability to enter a new or growing product market that offers more attractive cost-benefit trade-offs. Also, organizations following this strategy incur high opportunity costs that result from remaining in a specific product market and ignoring other options that could employ the firm's resources more profitably.

A major misconception about the market penetration strategy is that the firm practicing it will settle for little or no growth. A firm adopting this strategy grows by building on its competencies. By this, the firm achieves a competitive edge by concentrating in the product-market segment it knows best. The firm that chooses this strategy directs its resources to the profitable growth of a narrowly defined product and market, focusing on a dominant technology. Therefore, the success of this strategy is founded on the firm's use of superior insights into its technology, product and customer to obtain a sustainable competitive advantage.

Activity 6.1

A grand strategy is a statement of means that indicates the methods to be used to achieve the company's objectives. This is a unique package of long-term strategies. The grand strategy provides the framework for the entire business of the firm. Describe, with an example, why firms formulate grand strategies and how they operate according to them.

Answer:

Market development

The strategy of market development involves marketing present products in new geographical areas. This may involve adding channels of distribution, or modifying the existing products marginally, etc.

Market development allows firms to practice a form of concentrated growth by identifying new uses for existing products and new demographically, psychographically and geographically defined markets. Changes in media selection, promotional appeals, and distribution are used to initiate the approach of market development.

Market development is followed when there are untapped or unsaturated markets and channels of distribution available to tap these markets. This strategy is followed when excess production capacity exists to serve the untapped markets.

Example

Mexican movie theatre chain Cinepolis was aiming to capture a good slice of the Indian market. In July 2019, Devang Sampat (Director-Strategic Initiatives, Cinepolis India) said, the Mexican movie theatre chain which has 374 screens across the country, aims to capture a bigger market share of the exhibition business by opening 40 screens every year in new geographical areas. The strategy of Cinepolis depicts market development growth strategy.

Source: ICFAI Research Center

Product development

The product development strategy involves modifying the existing products to seek increased sales volume. This strategy requires relying on research and development efforts. It aims to attract satisfied customers of old products to new products. It involves utilizing the established channels of distribution for marketing the new products.

Product development is usually pursued when the firm's competitors offer better quality products, or it is operating in an industry characterized by high growth or frequent changes in technology. The firm should have competence in product research and development in order to successfully pursue this strategy.

Vertical integration

Vertical integration involves effecting growth through the production of inputs previously provided by suppliers or through the replacement of a customer role by consuming one's own outputs. In other words, in vertical integration, new products and/or services, which are complementary to the existing product and/or service lines, are added. Vertical integration is characterized by the extension of the firm's definition in two directions from the existing business -- forward integration and backward integration.

Forward integration: Forward integration involves encompassing a role previously executed by a customer. It is followed to get closer to the customer /consumer and have a greater degree of control over the interactions with the customer. Specific advantages of forward integration are:

- Greater acquisition of control over sales prices and level of output.
- Greater predictability of demand
- Firms can improve their competitive position.
- Firms can develop their own network for consumer feedback.
- Firms can have their own facilities for providing pre-sales and post-sales service/feedback.

Sometimes, firms face financial problems when this strategy demands large-scale operations at retail level requiring greater financial investments and managerial attention.

Forward integration should be followed when:

- The distributors are expensive, unreliable, and their availability is limited.
- The firm has the resources required to manage the forward integration.
- The present distributors have high profit margins.
- The firm's industry is growing and is expected to grow more, and the organization stands to gain by being able to predict the demand for its products with greater accuracy.

Backward integration: Backward integration involves encompassing a role previously executed by a supplier. It is followed to have a greater degree of control over the supplies. A shoe manufacturer setting up or acquiring leather tanneries is an example of backward integration. The advantages of backward integration strategy are:

- The firm can have a regular and uninterrupted supply of raw materials, components and other inputs.
- The firm can enjoy economies of large-scale operations.
- Quality control of raw materials, components, and parts is ensured.
- The firm can increase its power of negotiation with other suppliers in view of access to information on costs, facilities, earning potential, etc.

One drawback of this strategy is that technological upgradation in one of the acquired firms necessarily forces the management to upgrade the technology of the remaining firms. This process demands heavy financial investment that may not be feasible in short-term. Also, adverse economic conditions in the main firm may affect the firm supplying raw materials or components.

Backward integration should be followed when:

- The organization's suppliers are expensive or unreliable.
- The number of suppliers of the organization is small.
- The suppliers have a high profit margin.
- The organization has the resources to pursue a backward integration strategy.
- The industry in which the organization operates is growing and is likely to keep growing rapidly.

Horizontal integration

Horizontal integration involves seeking ownership or increased control over a firm's competitors. It involves acquiring one or more similar firms operating at the same stage of the production-marketing chain. The various reasons as to why firms take up the strategy of horizontal integration are:

- To increase the market share
- To reduce the cost of operations per unit of business through the large scale economies
- To have greater access to channels of distribution
- To get greater leverage to deal with the customers and suppliers
- To enjoy increased operational flexibility
- To promote the products and services more efficiently to a larger audience
- To take the advantage of the benefits of synergy

The horizontal integration for a firm may range from full to partial ownership to long-term contracts.

Activity 6.2 Vertical integration involves effecting growth through the production of inputs previously provided by suppliers or through the replacement of a customer role by disposing of one's own outputs. Examine the circumstances under which a firm would pursue such a strategy. **Answer:**

Concentric diversification

Concentric diversification takes place when a firm adds new but related products or services. The relatedness may be in terms of technology, markets, or products. In concentric diversification, the selected businesses possess a high degree of compatibility with the firm's current businesses.

Conglomerate diversification

Conglomerate diversification is diversification into a new business area that has no obvious connection with any of the firm's existing areas. It is also called unrelated diversification. Organizations that adopt this diversification strategy are often referred to as conglomerates. The benefits of this strategy are:

- Reduction of risks, particularly for businesses that operate in industries subject to rapid technological change.
- Economies of large-scale operation.
- Financial stability and increased profits.

The principal difference between the two types of diversification is that concentric diversification emphasizes some commonality in markets, products or technology. And conglomerate diversification is based principally on profit considerations.

Horizontal diversification

The horizontal diversification strategy involves adding new, unrelated products or services for present customers. This strategy is considered to be less risky than conglomerate diversification because the firm is dealing with existing customers.

Refer to Table 2 for details of the desired conditions for adopting each of the diversification strategies.

Table 2: Diversification Strategies - Suitable Conditions for Adoption

Type of Diversification	Suitable Conditions for Adoption
Concentric diversification	• The firm's industry is (almost) stagnating. • The firm has the capability to offer related products at highly competitive prices. • The firm can offer related products that can either augment the sales of existing products or smoothen out the seasonality in sales revenues from the existing products. • The firm's products are in the decline stage of the product life cycle
Conglomerate diversification	• The firm finds an investment opportunity that promises a good rate of return, and it has the resources to take advantage of this opportunity. • The firm's industry is facing a decline with saturation in markets.
Horizontal diversification	• The firm's revenues will increase substantially on the introduction of new products or services. • The firm competes in a no growth industry or a highly competitive industry. • The firm can leverage on existing channels to distribute new products to its current customers.

Adapted from David, Fred R. and David, Forest R. "Strategic Management: Concepts and Cases." Fifteenth ed. Delhi: Pearson Education, 2015.

Activity 6.3

Diversification is an approach by which a company looks to grow through the development of new areas that are clearly distinct from current businesses. Organizations, also often diversify to reduce the risk associated with single product or industry operations. With the help of an example, explain why and how firms choose this long-term strategy.

Answer:

6.4.2 Retrenchment Strategies

A firm pursues retrenchment strategies when it has a weak competitive position in some or all of its product lines, thus resulting in poor performance. Retrenchment strategies, also known as defensive strategies, are adopted when the firm's survival is at stake. These strategies impose a great deal of pressure on the workforce to improve performance. This strategy would be followed when:

- The organization's position in its industry is very weak and it is more vulnerable to the threats facing the industry participants. There is an overall failure in strategy formulation and execution.
- The organization has a distinctive competence but the competence has not translated into achievement of performance objectives. The organization does not meet shareholder expectations on profitability and/or efficiency.
- The organization has grown so rapidly that it requires a period of consolidation and cost-cutting.

Depending on the nature of the threat faced by the organization, retrenchment strategies may involve initiatives for asset reduction and cost reduction, and may even result in divestiture or liquidation.

Divestiture

A divestiture strategy involves the sale of a firm or a major component of a firm. This strategy is adopted if the firm is unable either to pull itself up or to find a customer to whom it can become a captive unit. There are three approaches of divestiture. Firms can select any approach depending upon the need for adopting this strategy. They are:

- Divestiture strategy can be pursued by spinning off a part of the business as an independent entity.
- Firms can sell a business unit to another firm
- Another form of this strategy is simply closing down a portion of the firm's operations.

The causes for adopting divestment strategy could be:

- When a firm's market share is negligible or when the market size is small to earn desired profit.
- Often, limited resources force firms to divest from less profitable business to more profitable business.
- Parts of businesses are divested when they do not fit in the original business of the firm.
- If cash outflows are more than cash inflows, in any unit, then the firm is forced to divest that unit.

- Firm's inability to meet the competition.
- The technological changes and the inability of the firm to invest additional financial resources.
- Divestment of unprofitable units becomes necessary to allow the remaining businesses to survive.

Thus, divestiture strategy is used when the firm wants to increase the efficiency of a strategic business unit or major operating division or product line that has failed to achieve the desired results.

Liquidation

The liquidation strategy involves closing down a business organization and selling its assets. This strategy is adopted when the industry has become unattractive and the firm too weak to be sold as a going concern. In liquidation, management converts as many saleable assets as possible to cash, which is then distributed to the shareholders after all obligations are paid. This is the last alternative strategy, as its consequences are severe. The various reasons for adoption of liquidation strategy could be:

- Small businesses and partnership firms liquidate when one or more partners want to withdraw from the business.
- When a sole proprietor wants to retire or take up another job, he/she has to liquidate the business.
- The liquidation strategy is essential when one of the partners has to withdraw and all other partners express their inability to buy the withdrawing partner's share.
- Liquidation occurs when the value of assets of the firm are more worthwhile than the rate of return earned by the firm.
- Sometimes, owners adopt the liquidation strategy when they receive a highly attractive offer and they may feel that liquidating the business is more worthwhile.

The consequences of liquidation would include:

- Liquidation leads to a closure of an agency performing economic functions. Therefore, government does not encourage liquidation, unless it is warranted.
- Employees and trade unions do not welcome this strategy because the jobs of the employees will be terminated.
- The stakeholders (creditors, dealers, financial companies, banks, customers, suppliers) do not prefer this strategy because the obligations of the firm towards them will be fully or partially unmet.
- It would be difficult to find a buyer, as it involves large amount of finance.

In view of the consequences stated above, firms should adopt this strategy in a planned way and very carefully. Liquidation strategy should be adopted when it enables the firm to get maximum proceeds by selling the assets and meet the obligations of various stakeholders.

Example

On August 27, 2018, Lanco Infratech, the flagship company of the Lanco Group was posted for bankruptcy by the Hyderabad bench of the National Company Law Tribunal (NCLT). The company was once among the larger private players in the field of power and infrastructure Engineering, Procurement and Construction (EPC). The bankruptcy of Lanco Infratech came as no surprise to any stakeholders who had been tracking the fate of EPC companies under the Insolvency and Bankruptcy Code, 2016. The case of Lanco Infratech pointed out liquidation – retrenchment strategy.

Source: ICFAI Research Center

Check Your Progress - 2

3. The _______________ is a strategy that provides the basic strategic direction at the corporate level.
   a. Grand strategy
   b. Functional strategy
   c. Business level strategy
   d. Operating strategy
4. Which of the following allows firms to practice a form of concentrated growth by identifying new uses for existing products and new demographically, psychographically, and geographically defined markets?
   a. Market development
   b. Product development
   c. Forward integration
   d. Horizontal integration
5. Which of the following integrations takes place when a firm takes up a function previously provided by a supplier?
   a. Forward integration
   b. Vertical integration
   c. Backward integration
   d. Horizontal integration

6. For which of the following strategies, divestiture and liquidation are examples?
   a. Growth
   b. Retrenchment
   c. Diversification
   d. Integration

6.5 Functional Strategies

A functional strategy is a short-term game plan for a key functional area within a firm. Functional strategies clarify the grand strategy and provide specific details about the management of key functional areas in the near future.

Functional strategies must be consistent with long-term objectives and the grand strategy. They enable the grand strategy to be pursued in terms of daily activities. Functional strategies help in the implementation of the grand strategy by organizing and activating specific subunits (marketing, finance, production, etc.) of the firm.

Example

In August 2019, the face-off between restaurant companies and aggregators escalated in which more than 1200 restaurants in several major Indian cities began delisting themselves from the dine-in programs service. These restaurants exited from the platforms including Zomato, EazyDiner, Nearbuy, MagicPin and Gourmet Passport under a #Logout campaign, claiming that "unsustainable" deep discounting offered by the aggregators and table reservation services was hurting their business models. The given case of restaurants where they are delisting themselves from the aggregators' platform highlighted a functional strategy.

Source: ICFAI Research Center

6.5.1 Differences between Grand and Functional Strategies

There are three basic characteristics -- time horizon covered, specificity, and participation in their development -- differentiate functional strategies from grand strategies.

Time horizon

For a functional strategy, the time horizon is usually short. For example, a consumer durables marketer might prefer a marketing strategy of increasing price discounts and sales bonuses in its appliance division to reduce excess appliance inventory over the next year. This functional strategy is designed to achieve an annual objective but it should also ultimately contribute to the firm's grand strategy (say, market penetration) in its retail division over the next five years.

Specificity

A functional strategy is more specific than a grand strategy. Functional strategies are restricted to the firm's subunits, which carry out certain functional activities in key areas in order to implement the grand strategy. The general direction is provided by the grand strategy. Functional strategies give specific guidance to managers responsible for completing the objectives successfully. Such strategies are meant to ensure that managers meet their objectives in the best possible way. The willingness and ability of operating managers to implement strategic decisions can be improved by specific functional strategies, particularly when those decisions represent major changes in the current strategy of the firm.

For example, the grand strategy of a movie production firm indicates the direction that its films division should follow in order to capture the market. Its marketing strategies give specific direction to managers on the type of movies (action, horror, comedy, family oriented, etc.) they should show and the pricing strategy (competitive in the local area) they should follow.

Specificity in functional strategies contributes to the successful implementation of plans in several ways. First, it adds substance, completeness, and meaning to what a specific subunit of the business must do. The functional strategies ensure that managers know what needs to be done and can focus on achieving the results. Second, specific functional strategies clarify for the top management how functional managers intend to implement the grand strategy successfully. This increases the top management's confidence in the grand strategy. Third, the coordination between operating units within the firm is facilitated since areas of interdependence and potential conflict are clarified by specific functional strategies.

Participation

Various people at the functional and business levels participate in both functional and business strategy formulation. Business strategy is the responsibility of the general manager of the business unit. The manager of each business unit relies on his/her subordinates for the design and implementation of the functional strategies. Functional managers establish annual objectives and operating strategies meant for their department.

6.5.2 Functional Strategies in Select Functions

It is difficult to generalize about the development of strategies across functional areas because of the difference in the key variables in marketing, finance, production, etc. Further, within each functional area, the importance of key variables varies across business situations. Refer to Table 3 for various functional strategies in respective functional areas.

Table 3: Functional Strategies in Various Functional Areas

Key Functional Strategies	Key Considerations
Marketing	
Product	Type of product; Key contributors to profitability; Product image; Consumer need; Changes that influence customers
Price	Price as the basis of competition; Price modifications through discounts; Uniformity in pricing policies; Target segments / Market share; Gross profit margin
Place	Level of market coverage; Priority geographic areas; Key distribution channels; Channel objectives, structure, and management; Change in marketing mix; Sales force organization (based on territory, market, product)
Promotion	Key promotion priorities and approaches; Advertising and communication priorities; Media
Finance	
Capital acquisition	Cost of capital; Proportion of short and long-term debt; Balance between internal and external funding; Appropriate risk and ownership; Level and forms of leasing
Capital allocation	Priorities in allocation to projects; Basis of final selection of projects; Capital allocation authority
Dividend and working capital management	Dividend-payout ratio; Stability of dividends; Cash flow requirements; Credit policies; Credit limits, terms of repayment, and collection procedures; Payment timing and procedure
Research & Development	
Basic research versus commercial development	Extent of innovation vis-à-vis product development, refinement, and modification; New projects that support growth
Time horizon	Emphasis on short term or long term
Organization fit	Nature of research (in-house or contracted); Departmental structure (centralized or decentralized); Relations with other departments
Basic R&D posture	Offensive or defensive

Key Functional Strategies	Key Considerations
Production and Operations	
Facilities and equipment	Importance of facilities; Extent of integration of processes; Size and capacity
Purchasing	Sources; Selection of suppliers and managing relations; Acceptable forward buying level
Operations planning and control	Level of inventory; Inventory use; Key control efforts; Nature of maintenance (preventive or market-oriented); Job specialization; Plant safety

Marketing

The marketing function of a firm deals with fulfilling customer needs and wants through its products and services. It involves developing marketing strategies which determine who will sell what, where, when, to whom, in what quantity, and how. Marketing strategies identify the correct time, place, and seller for the product.

Marketing strategies ensure that the products and services of a firm are available to customers wherever and whenever they need it. This is achieved by the distribution strategy which includes strategizing for warehousing, distribution channels and coverage, inventory levels, and transportation carriers.

Marketing strategy defines how a firm can communicate with the market efficiently in order to sell its products and services. To achieve this, marketing strategies deal with advertising, sales promotion, personal selling, and customer and dealer relations.

Product and services planning is another area of marketing which involves strategizing for product lines, product features, new product development, test marketing, product and brand positioning, devising warranties, packaging, phasing out of old products, and providing for customer service.

Pricing the products and services is an essential component of marketing. The price influences demand and supply, profitability, and consumer perception. There are various policies of pricing from which a firm can choose, like cost-plus pricing, market-based pricing, and competition-oriented pricing. Pricing decisions are centered on total cost with an acceptable markup or target price ranges, under a cost-oriented approach. When the approach is market-oriented, pricing is based on consumer demand. With the competition-oriented approach, pricing decisions center around those of the firm’s competitors.

Finance

Financial strategies deal with three broad aspects, the financing decision, the investment decision, and the dividend decision. The financing strategies deal with acquisition of funds to run the business. The strategy on acquisition of capital should take into account the desired level of debt and equity, and the internal long-term financing of business activities. The strategy on investment decision or allocation decision involves investing in numerous alternative areas for investment, such as in facilities, projects, and acquisitions, or on augmenting the workforce. The dividend strategy deals with the quantum of earnings to be paid to shareholders, the stability of dividend paid over time, and repurchase or issuance of stock.

The financial strategy of the firm should be aligned with firm performance. If the firm's business is facing a downturn, then the investment strategy should permit it to exit from certain business areas and enter high growth areas. Similarly, if the firm's business is witnessing growth, it should be supported by the investment strategy. The financing strategy should be aligned with the investment strategy.

The dividend strategy determines the earnings payout ratio to the shareholders. A high payout ratio may lead to higher stock prices but lower internal funding of investment projects and the firm will have to borrow more for its investment projects. A low payout ratio may lead to lower stock prices but higher internal funding of investment projects.

Research and development

The research and development (R&D) strategy of a firm could be focused either on developing new products or at improving the production and manufacturing processes to reduce costs. The strategy relating to R&D might be to outsource the R&D activity to an external source. The strategy will address issues like whether R&D activity should be decentralized or centralized. The R&D strategy of a firm plays a significant role in positioning the firm's products and services in the minds of the customer.

An offensive R&D strategy is focused on developing technological innovations and new product development for the firm's success. This strategy has high risks associated with it since it is not known whether the customer will accept the new product. A defensive strategy is one in which the focus is on the ability to copy or imitate to maintain the firm's position in the industry. A firm may follow both the offensive and defensive strategies.

Production and operations

The production and operations management (POM) strategy deals with the processes and activities related to conversion of inputs into outputs. The production and operations strategies deal with basic input-output relationships and their optimization; and factors relating to location, facilities, design and process planning, equipment replacement, and plant size.

The POM strategy also deals with the purchase and inventory activity. The strategy followed should ensure that policies exist for selecting a vendor, that there is an adequate number of vendors, that criteria for payment have been developed, and that the volume and delivery requirements have been well defined. The strategy should also ensure that appropriate inventory levels are defined, the linkages between inventory and purchase are synchronized, and quality control levels established.

The strategy has to determine the appropriate level of trade-off between cost and quality in production/operations. It should also spell out clearly the criteria for adding or reducing equipment, facilities, shifts, and people.

If the demand is less cyclical, a firm might maintain a uniform level of production and inventories. Many firms subcontract production in order to handle sudden increases in demand, without having to face the problems of idle capacity in slack periods and high capital investment. If a firm is to succeed, POM strategies must be coordinated with marketing strategy, financial strategy, and human resources strategy.

Human resources

The human resource strategy should address the following issues: employee recruitment, selection, and orientation; career development and counseling, performance evaluation, and training and development; compensation; labor/union relations; and discipline and control.

By focusing on these issues, human resource management contributes to the successful implementation of the grand strategy of the firm by nurturing managerial talent, managing compensation, and motivating employees.

Thus, on the whole, functional strategies are considered to be important because they provide specific guidelines to enable each major sub-activity to contribute to the implementation and accomplishment of the grand strategy.

Activity 6.2

A functional strategy is usually a short-term plan for a key functional area within a company. Such strategies clarify grand strategy and provide more specific details about how key functional areas are to be managed in the near future. Explain this strategy by giving a suitable example from the marketing and business development aspects.

Answer:

Check Your Progress - 3

7. Which of the following aspects of strategy clarify the grand strategy and provide specific details about the management of key functional areas in the near future?
   a. Functional strategies
   b. Critical success factors
   c. Corporate strategies
   d. Mission and vision
8. Which of the following statements is/are **false**?
   i. Specificity in functional strategies adds substance, completeness, and meaning to what a specific subunit of the business must do.
   ii. Functional strategies clarify for the top management how functional managers intend to implement the grand strategy successfully.
   iii. Due to specificity in the functional strategy, the coordination between operating units is hindered.
   a. Only ii
   b. Only iii
   c. Only i and ii
   d. Only i and iii
9. Which of the following aspects are dealt with the product strategy of the marketing function in a firm?
   a. gross profit margin, media, and level of market coverage.
   b. key distribution channels, key promotion priorities and approaches, and priority geographic areas.
   c. key contributors to profitability, product image, and consumer need.
   d. sales force organization
10. In which of the following strategies of the marketing function in a firm, gross profit margin is a key consideration?
   a. product
   b. price
   c. place
   d. promotion
11. Which of the following statements are true?
   i. A high dividend payout ratio may lead to lower stock prices.
   ii. Lower dividends to the shareholders lead to higher internal financing.

iii. Lower dividends to the shareholders lead to lower internal financing.

iv. Higher dividends to the shareholders lead to lower internal financing.

a. Only i and ii

b. Only i and iii

c. Only i and iv

d. Only ii and iv

12. Which of the following research and development strategies emphasizes technological innovations and new product development as the basis for the firm's success?

a. offensive

b. defensive

c. intended

d. realized

6.6 Summary

- Objectives are the concrete, specific aims that management seeks to achieve for the organization, often within a stated time period. They provide direction, and serve as standards and motivators.
- A grand strategy is a strategy that provides the basic strategic direction at the corporate level. The two major classifications of grand strategies are growth strategies and retrenchment (defensive) strategies.
- The major growth strategies are: market penetration, market development, product development, forward integration, backward integration, horizontal integration, concentric diversification, conglomerate diversification, and horizontal diversification.
- Retrenchment strategies are adopted when the firm's survival is at stake. Depending on the nature of the threat faced by the organization, retrenchment strategies may involve initiatives for asset reduction and cost reduction, and may even result in divestiture or liquidation.
- A functional strategy is a short-term game plan for a key functional area within a firm. Functional strategies clarify the grand strategy and provide specific details about the management of key functional areas in the near future.
- Functional strategies must be consistent with long-term objectives and the grand strategy. When compared to grand strategies, functional strategies have a shorter time horizon, greater specificity, and greater level of participation in their formulation.

- Functional strategies help in the implementation of the grand strategy by organizing and activating specific subunits (marketing, finance, production and operations, research and development, human resources, etc.) of the firm.

6.7 Glossary

Backward integration: Backward integration is a growth strategy that involves encompassing a role previously executed by a supplier. It is followed to have a greater degree of control over the supplies.

Concentric diversification: A growth strategy that takes place when a firm adds new but related products or services. The relatedness may be in terms of technology, markets, or products. In concentric diversification, the selected businesses possess a high degree of compatibility with the firm's current businesses.

Conglomerate diversification: A growth strategy that involves diversification into a new business area that has no obvious connection with any of the firm's existing areas. It is also called unrelated diversification. Organizations that adopt this diversification strategy are often referred to as conglomerates.

Conglomerate merger: A merger of two firms from unrelated business activities. Conglomerate mergers can be categorized into product extension merger (merger between two firms in a related business activity), geographic extension merger (merger between two firms operating in non-overlapping geographic areas), and pure conglomerate merger (merger between two firms from unrelated business activities).

Divestiture: The sale of a segment of a company (assets, a product line, a subsidiary) to a third party for cash and/or securities. Firms often divest themselves of businesses which are not of strategic importance and which do not contribute much to their total revenues, and to focus completely on their core businesses.

Forward integration: A growth strategy that involves encompassing a role previously executed by a customer. It is followed to get closer to the customer /consumer and have a greater degree of control over the interactions with the customer.

Functional strategies: A short-term game plan for a key functional area within a firm. Functional strategies clarify the grand strategy and provide specific details about the management of key functional areas in the near future. They must be consistent with long-term objectives and the grand strategy. They enable the grand strategy to be pursued in terms of daily activities. Functional strategies help in the implementation of the grand strategy by organizing and activating specific subunits (marketing, finance, production, etc.) of the firm.

Grand strategy: A statement of means that indicates the methods to be used to achieve the firm's objectives. This strategy is a unique package of long-term strategies, and provides the framework for the entire business of the firm. Grand strategies include the following strategies: market penetration, market development, product development, horizontal integration, vertical integration (forward and backward integration), concentric diversification, conglomerate diversification, horizontal diversification, retrenchment, divestiture, and liquidation.

Horizontal diversification: A growth strategy that involves adding new, unrelated products or services for present customers. Horizontal diversification strategy is considered to be less risky than conglomerate diversification because the firm is dealing with existing customers.

Horizontal integration: A growth strategy that involves seeking ownership or increased control over a firm's competitors by acquiring one or more similar firms operating at the same stage of the production-marketing chain.

Market development: A growth strategy that involves marketing present products in new geographical areas. Market development allows firms to practice a form of concentrated growth by identifying new uses for existing products and new demographically, psychographically, and geographically defined markets. This may involve adding channels of distribution, modifying the existing products marginally, etc.

Market penetration (Concentration): A growth strategy wherein a firm seeks to increase its market share for present products and services in its present markets through increased marketing efforts.

Objectives: The goals, aims, and purposes that an organization wishes to achieve over varying periods of time.

Product development: A growth strategy that involves modifying the existing products to seek increased sales volume. This strategy requires relying on research and development efforts. It aims to attract satisfied customers of old products to new products.

Retrenchment strategies: A firm pursues retrenchment strategies when it has a weak competitive position in some or all of its product lines, thus resulting in poor performance. Retrenchment strategies, also known as defensive strategies, are adopted when the firm's survival is at stake. Depending on the nature of the threat faced by the organization, retrenchment strategies may involve initiatives for asset reduction and cost reduction, and may even result in divestiture or liquidation.

Vertical integration: A growth strategy that involves effecting growth through the production of inputs previously provided by suppliers or through the replacement of a customer role by consuming one's own outputs. Vertical integration is characterized by the extension of the firm's definition in two directions from the existing business -- forward integration and backward integration.

6.8 Self-Assessment Test

1. Define objectives. Explain the need and nature of objectives. What are the various levels and hierarchy of objectives?
2. Explain grand strategies. What are the various classifications of grand strategies?
3. Discuss the concept of functional strategies. How can these strategies be applied to select functions of an organization?

6.9 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

6.10 Answers to Check Your Progress Questions

1. (a) Objectives

An objective is a concrete, specific aim that the management seeks to achieve for the organization, often within a stated time. For example, the marketing objectives of a firm might be to increase the market share from 15% to 18% in the quarter October to December 2009. They provide direction, serve as standards, and also serve as motivators.

2. (a) Strategic managers must ensure that objectives are communicated to all members of the organization.

For a firm to be successful, employees should understand how his or her individual objectives relate to the organizational objectives. Objectives should be flexible in nature and not sacrosanct. A change in the situation or environment has a bearing on them and they should undergo a change if the environment warrants it. It is true that strategic managers need to ensure that the objectives are clearly communicated to all the organizational members. Otherwise, there will be a misdirection of efforts and no yardstick to measure individual and group performance. Objectives are related to plans and to the future (and not the past).

3. (a) Grand strategy

The grand strategy provides the basic strategic direction for the firm at the corporate level. For example, the grand strategy of a firm might be to grow using the acquisition route. The firm's resources and actions are directed in synchronization with this strategy. Business level strategy is the strategy devised and adopted by the heads of the strategic business units for their respective business units. Functional strategy is the strategy designed and followed by the various functional heads for their respective functional domains in an organization. Operating strategy is an operational strategy adopted at the lower levels of management.

4. (a) Market development

Market development allows firms to practice a form of concentrated growth by identifying new uses for existing products and new demographically, psychographically, and geographically defined markets. For example, when Harvest Gold, a bread manufacturer and seller in Delhi, enters the Mumbai market, it is following the market development strategy. Similarly, when Parlé launches a biscuit which is sugar-free for the diabetic segment, then the firm has identified a new unexplored market segment.

5. (c) Backward integration

Backward integration takes place when a firm assumes a function previously fulfilled by a supplier. For example, when a garment manufacturer sets up or buys yarn spinning mills to have better control over its raw materials, it is called backward integration. This strategy requires investments and the firm should have substantial resources at its disposal to take it up. It also increases the element of risk faced by a firm if the finished product's market declines and the raw materials into which the firm had backward integrated have no alternative use.

6. (b) Retrenchment

Divestiture and liquidation are examples of retrenchment strategies. Such strategies are adopted when the firm's survival is at stake.

7. (a) Functional strategies

Functional strategies clarify the grand strategy and provide specific details about the management of key functional areas in the near future. Functional strategies must be consistent with long-term objectives and the grand strategy. They help in the implementation of the grand strategy.

8. (b) Only iii

Specificity in functional areas adds substance, completeness, and meaning to what a specific subunit of the business must do. Functional strategies clarify for the top management how functional managers intend to implement the grand strategy successfully. Due to specificity in functional strategy, the coordination between operating units is **facilitated** since areas of interdependence and potential conflict are clarified.

9. (c) Key contributors to profitability, product image, and consumer need.

Key contributors to profitability, type of product, product image, and consumer need are the considerations which influence the product strategy of the marketing function; hence option (c) is correct.

10. (b) Price

Among the functional strategies in marketing, gross profit margin is a key consideration for the price strategy.

11. (d) Only ii and iv

A high dividend payout ratio may lead to high stock prices. Hence statement (i) is not correct. Lower dividends to the shareholders lead to higher internal financing and vice versa. This is so because, out of the total profits earned, the firm has to decide how much to retain for internal financing and how much to pay as dividend. The greater the amount of dividend paid, lesser will be the amount left for internal financing and vice-versa. Hence, statements (ii) and (iv) are correct and statement (iii) is not correct.

12. (a) Offensive

An offensive research and development strategy emphasizes technological innovations and new product development as the basis for the firm's success. In the electronics industry, Sony is known for its offensive research and development strategy.

Unit 7

Generic Competitive Strategies

Structure

"Strategy is about making choices, trade-offs; it's about deliberately choosing to be different".

- Michael Porter

7.1 Introduction

Michael Porter reveals the essence of strategy in the competitive market – Differentiation.

In the previous unit, we have discussed about objectives, grand strategies, and functional strategies. In this unit, we shall discuss generic competitive strategies.

A firm, in order to stay competitive, can pursue any of the three generic strategies proposed by Michael E. Porter (Porter), namely, 'overall cost leadership', 'differentiation', and 'focus'. These generic strategies leverage a firm's capabilities and enable it to cope with the five forces model as well. Generally, firms pursue only one of these generic strategies. However, some firms make an effort to pursue more than one strategy at a time by bringing out a differentiated product at low cost. Though approaches like these are successful in the short term, they are hardly sustainable in the long term. If firms try to maintain cost leadership as well as differentiation at the same time, they may fail on both fronts.

This unit will first discuss the generic competitive strategies of overall cost leadership, differentiation, and focus. Then we shall move on to discuss how to choose a generic strategy, and the pitfalls of generic strategies. We shall also discuss about the concept of strategic lock-in. Finally, we shall discuss about the competitive strategies used in different types of industries.

7.2 Objectives

By the end of this unit, students should be able to:

- Explain the generic competitive strategies of overall cost leadership, differentiation, and focus.
- Find out how to choose a generic strategy, and the pitfalls of generic strategies.
- Discuss the concept of strategic lock-in.
- Identify the competitive strategies used in different types of industries.

7.3 Overall Cost Leadership

Porter proposed the overall cost leadership strategy as a mechanism for a firm to sustain its competitive position in the industry. In this strategy, a firm makes sustained efforts to reduce costs in all areas of business without compromising on the quality of its products and services. This yields a cost structure for the firm which would be lower than that of its competitors. The firm can then either price the product at the same level as a competitor’s pricing and earn higher profits due to its lower costs or it can reduce its prices to build volumes and emerge as the market leader.

Cost leadership demands construction of efficient-scale facilities, tight cost and overhead controls, avoidance of small customer accounts, and minimization of costs in areas such as service, advertising, research and development, and sales force.

By pursuing this strategy, an organization can hope to reap above average returns even in a competitive industry. The low cost position also provides the required cushion for changes in input costs and serves as an entry barrier as well. A low cost position presents the organization in a better light vis-à-vis firms with substitute products, in terms of pricing of the products. Thus, the firm can protect itself from the influence of the five forces in the industry.

Overall cost leadership is a function of large market share, exclusive access to cheap raw materials, access to technology for manufacturing products efficiently, a wide line of products to spread costs, and/or access to all major customer groups.

A firm’s ability to achieve overall cost leadership may be dependent on high investment in plant and machinery and aggressive pricing. Once the low cost position is achieved, it may be maintained easily on account of economies of scale.

Example

Redbox which is into DVD rentals is headquartered in Oakbrook Terrace in Chicago. In an interview to Chicago Tribune on 12th July 2017, the CEO, Galen Smith said, "Redbox focuses on low-cost provider strategy. Redbox offers unparalleled levels of low price and high convenience when compared with other firms that rent actual DVDs. We use vending machines placed outside grocery stores and other retail outlets to rent DVDs of movies for $1. In the year 2017, we added 1,500 rental kiosks. Typically, each kiosk offers 150 to 200 different titles. At $1.50 a night for DVDs, Redbox rentals are generally cheaper than digital video on demand that costs $5.99/$6.99 for one movie streaming. An average kiosk in a year does $50,000, $60,000 in revenue. Thus, our focus is really on driving profitability and cash flow, and to do so, we continue to install kiosks in more locations which would be just 11 minutes away from a consumer's house. This method has significantly helped in boosting the company's profitability besides making us the choice of the millennials as they see us as a great access point to watch new release movies at a low cost. This low-cost advantage has enabled the company to achieve quicker rates of growth by using price to draw customers away from rivals". In the instance case, Redbox`s cost effective model of DVD rentals through kiosks is a cut above when compared to digital video market which is costly for customers.

Source: ICFAI Research Center

7.4 Differentiation

Porter propagated differentiation as a strategy through which a firm can create sustainable success for itself. The differentiation strategy aims at creating products and services that are perceived by the customers and consumers as distinct and unique from its competitor's products and services. A product can be differentiated on the basis of one/more attributes to build a distinct brand image.

The differentiation strategy aims at creating customer loyalty for the company's products and services by developing a positive association in the mind of the customer. This enables a firm to deal with the five forces effectively. It leads to above average returns as it enables the firm to price its products higher than those of its competitors. The loyalty of the customers to a firm's products acts as a barrier for other players to enter the firm's industry. The bargaining power of the buyers is limited as the products of the firm are seen as unique. Differentiation requires a firm to invest in research and development, make use of high quality inputs, and build an intensive customer support system.

The pricing strategy of the firm pursuing a differentiation strategy determines whether the firm will become a market leader or not. If the firm pursuing differentiation prices its products close to those of its competitors, then the firm will emerge as the market leader, because the customers will switch to the differentiated products. The ability of the firm to price the products close to those of its competitors will depend on the cost effectiveness of achieving the differentiation and the ability of the competitor to imitate the differentiation characteristics.

Example

IKEA is a global brand in the home furnishing market with hundreds of stores across the world. The major target market of IKEA comprises the middle class and the young buyers of the world who are in search of affordable and stylishly designed fashionable furniture and household accessories. IKEA has maintained the style of Swedish furniture in its products. The growth of IKEA is majorly attributed to the style and design of products it offers and the buying inclinations of the customers. IKEA's concept of "one suits all" is the basis for the design through which it reinforced the notion that the expectations of this class is the same universally and incorporated minor changes in the basic design to suit the local tastes and needs of the nation they are serving. Further, instead of relying primarily on third party manufacturers, IKEA's engineers design / create modular furniture ready for assembly by customers on their own. Thus, its products became flexible and also the core idea of uniqueness was still kept in tact. This same approach was adopted by IKEA while entering other markets, resulting in international acceptance of the store and its products. This makes customers and consumers perceive IKEA products and services as distinct from that of its competitors. In the instance case, IKEA's differentiation strategy is evident from its "one suits all" strategy. With the concept of customization & 'assemble yourself' idea, IKEA stood different from other players in the market.

Source: ICFAI Research Center

Activity 7.1

There are many approaches to pursuing a differentiation strategy. With an example, discuss how a company differentiated its products from competition, and how it benefited by adopting the strategy.

Answer:

On the other hand, if the firm prices its products higher than those of its competitors, then the firm will not become a market leader but will still enjoy a higher than average returns.

Check Your Progress - 1

1. In the overall cost leadership strategy, a firm makes sustained efforts to reduce costs in all areas of business without compromising on the quality of its products and services. From the following options, identify the benefits of successfully adopting the overall cost leadership strategy.
   i. The cost structure for the firm would be lower than that of its competitors.
   ii. The firm can price the product at the same level as a competitor and earn higher profits due to its lower costs.
   iii. The firm can reduce its prices to build volumes and emerge as the market leader.
   iv. The firm's products and services are perceived by the customers and consumers as distinct and unique from its competitor's products and services.
   a. Only i and iii
   b. Only i, ii, and iii
   c. Only ii, iii, and iv
   d. i, ii, iii, and iv
2. Which of the following is **not** one of the methods in which firms control costs when they adopt the overall cost leadership strategy?
   a. Tight control of overhead costs and expenditure in service, advertising, research and development, and sales force
   b. Focus on small customer accounts
   c. Exclusive access to cheap raw materials and a wide line of products to spread costs
   d. High investment in plant and machinery and construction of efficient-scale facilities
3. Which of the following is **not** an advantage of adopting the differentiation strategy?
   a. Creates customer loyalty for the firm's products and services
   b. Allows the firm to price its products higher than those of its competitors
   c. Increases the bargaining power of the buyers
   d. Creates a perception of uniqueness about the firm's products and services

4. What are the implications of a firm with a well-differentiated product portfolio pricing its products significantly higher than those of its competitors?
   a. The firm will not become the market leader; it will enjoy a higher than average return.
   b. The firm will become the market leader; it will enjoy a higher than average return.
   c. The firm will not become the market leader; it will enjoy a lower than average return.
   d. The firm will become the market leader; it will enjoy a lower than average return.

7.5 Focus

A firm pursuing the focus strategy aims at segmenting the market and identifying the market segment which will be served by its products and services. The idea behind a focus strategy is to concentrate efforts on a specific market segment and serve it well to achieve success. It assumes that by focusing on a specific market segment, it can serve it better than the competitors who are serving the entire market. A focus strategy selects target markets where the firm is the least vulnerable to substitutes or where competitors are the weakest.

Activity 7.2

With the entry of foreign players, Indian insurance industry has become highly competitive. Analysts feel that, to remain profitable, insurance companies can use the generic strategies of cost leadership, differentiation, and focus. Discuss how insurance companies can use the three generic strategies.

Answer:

7.6 Choice of a Generic Strategy

In order to succeed in the industry, a firm can adopt and pursue any of the three strategies discussed here. If a firm attempts to adopt two strategies at the same time, there is a probability that it will fail. For example, a firm which is pursuing overall cost leadership will be cutting costs in all areas including research and development. If such a firm decides to adopt differentiation, it will not succeed because new product development would not have been carried out due to its efforts at cost minimization. Porter addresses this as “Getting stuck in the middle”. Such a firm will have to re-orient itself and adopt a unique generic strategy to focus upon. However, there are organizations which have combined two strategies effectively.

Example

SIMPLE is an American direct bank (branchless / virtual / online bank) based in Portland, Oregon that provides FDIC-(Federal Deposit Insurance Corporation insured checking accounts to US citizens through a partnership with The Bancorp and BBVA USA). Since 2014, SIMPLE has been part of the BBVA Group, one of the largest banks in Europe and is part of the STAR network (a full-service debit payment network in accessing cash, and paying in-person across America or online - at anytime) for surcharge-free access to around 55,000 ATMs. While traditional banks have many branches they were slow to create easy to use mobile apps. "Simple" has no branches yet they focused on their great mobile app at a time when most banks' apps were clunky and cumbersome. While traditional customers valued services such as home loans, CDs, and bank tellers, SIMPLE created the first 21st-century bank concentrating online banking services that are targeted at the younger tech savvy customers. In the instance case, SIMPLE bank focused purely on online consumer banking specifically targeted to serve the younger generation.

Source: ICFAI Research Center

7.7 Pitfalls of Generic Strategies

The pitfalls relating to the adoption of generic strategies are twofold. First is an implementation issue, wherein the firm may fail to successfully adopt, implement, and sustain a strategy. The second is related to the firm's industry and its evolution which may render the strategic advantage provided by the strategy redundant.

7.7.1 Risks of Cost Leadership

A firm pursuing cost leadership has to make heavy investments in a state-of-the-art plant and machinery, avoid product line extensions, and continuously upgrade technology. This it has to do to achieve economies of scale. There are certain risks associated with this strategy, which are listed in Table 2.

Table 2: Risk Events of Cost Leadership

Event	Risk
Technological change	Makes past investments and learning redundant
Imitation	Late entrants achieve the advantage of low cost learning and investing in modern R&D facilities
Inadequate customer orientation	Ignoring customer needs due to excessive obsession with cost minimization
Unexpected inflation in costs	Inability to offset differentiation through cost leadership

Adapted from Porter, Michael E. "Competitive Strategy: Techniques for Analyzing Industries and Competitors." Simon & Schuster; Export edition, 2004.

7.7.2 Risks of Differentiation

A differentiation strategy is vulnerable to the following risks:

- An increased cost differential between low cost producers and the differentiating firm will motivate brand loyal customers to switch brands. Thus, buyers will sacrifice some additional features and image for the huge savings in cost.
- Imitation might narrow down the perceived difference.
- If a differentiating firm lags behind too much, a low cost firm may take over the market of the differentiating firm.

Activity 7.3

A firm can differentiate itself from other firms by providing something unique. But if the differentiation strategy is not properly executed, it may lead to severe losses for the company. With the help of an example, explain how a differentiation strategy not properly executed can erode the competitive position of a firm.

Answer:

7.7.3 Risks of Focus

A focus strategy is vulnerable to the following risks:

- An increasing cost differential between broad-range competitors and the focus firm might offset the differentiation achieved through focus, and turn the customers toward firms that offer a broad range of products.
- Perceived or actual differences between products and services might disappear.
- Other firms might find submarkets within the target market of the focus firm and outfocus the focuser.

7.8 Strategic Lock-In

An approach to overcome the pitfalls of the generic strategies is the concept of strategic lock-in. Competition based upon the product alone misses out entirely on a primary force driving profitability. Instead, customer bonding should be established, with an unbreakable link, deep knowledge, and close relationship with the customer. In the application of this concept, bonding emerges as the central force in shaping strategy.

If the firm is able to create a strategic lock-in, it achieves a proprietary position in its industry. For example, Intel became almost the standard microprocessor for all desktops, and desktops without Intel were often considered to be inferior.

Lock-in means that other businesses have to conform to or relate to that standard in order to prosper, and the architecture of the industry is built around the dominant player. The achievement of lock-in is dependent on:

- *Extent of market dominance*: The extent of lock-in depends on the extent to which the firm is dominating the market in which it operates. Other firms will not seek to conform to certain standards unless they perceive the organization that promotes those standards as dominant in its market.
- *Self-reinforcing commitment*: When a few firms conform to the standards, others are also obliged to and this sets in motion a process whereby the lock-in becomes firm.
- *Timing of dominance*: The lock-in is likely to come in more easily in the early stages of a market life cycle as compared to mature markets.

Example

Apple’s iTunes music is the only music player that an iPod or iPhone could access and upload music files. American media company CNET estimated that 90% of iPhone buyers intend to repurchase iPhone as they are 'hooked' to the iTunes and also avoid the potential hassle as moving off from Apple's proprietary platforms is inevitably a hassle as those products / services don't work on any other platforms. Thus, Apple continues to hook all its customers into more of its services and makes them buy Apple's new range of own brand Connected Home products. As these products emerge, users / customers find it increasingly hard to wean themselves off their Apple habit whether they like it or not. Similarly, while vendors like IBM, Oracle, Cisco and HP embraced open standards and open source technologies such as OpenStack, Cloud Foundry or Linux, Apple has adopted the opposite stance creating proprietary hardware and platforms that firmly hook the user / customer into their ecosystem. This is one of the reasons despite falling market share, Apple remains one of the world's most profitable companies. In the instance case of Apple, this is achieved through its proprietary hardware and platforms which make it difficult to the users / customers to seek an alternative phone and media provider.

Source: ICFAI Research Center

Check Your Progress - 2

5. With reference to Michael Porter's generic competitive strategies, in which of the following cases is a 'stuck in the middle' situation likely to occur?
   a. A firm pursues cost leadership strategy.
   b. A firm pursues differentiation strategy.
   c. A firm simultaneously attempts both cost leadership and differentiation.
   d. A firm pursues focus strategy.
6. For a firm that pursues the cost leadership strategy, the risk of 'redundancy of past investments and learning' is associated with which of the following events?
   a. Technological change
   b. Imitation
   c. Excessive obsession with cost minimization
   d. Unexpected inflation in costs
7. To overcome the pitfalls of generic strategies, a firm can create a strategic lock-in, that is, achieve a proprietary position in its industry. Identify the statement that is **false** with respect to strategic lock-in.
   a. Lock-in means that other businesses have to conform to or relate to that standard in order to prosper, and the architecture of the industry is built around the dominant player.
   b. The lock-in is likely to come in more easily in the maturity stage of a market life cycle.
   c. The extent of lock-in depends on the extent to which the firm is dominating the market in which it operates.
   d. When a few firms conform to the standards, others are also obliged to do so and this sets in motion a process whereby the lock-in becomes firm.

7.9 Competitive Strategies in Different Types of Industries

Industries can be divided into: Fragmented industries, Emerging industries, Maturing industries, and Declining industries. The intensity of competition in the industry also depends on these dimensions. Hence, there is a need to consider these dimensions when formulating strategy.

7.9.1 Fragmented Industries

In fragmented industries, no firm has a significant market share. However, the majority of firms can strongly influence the outcome of the industry. These industries contain privately owned small- and medium-sized companies. Such industries can be found in service, retailing, distribution, wood and metal fabrications, agricultural products, and creative business sectors.

Example

Quiznos, a sub-shop chain about 15% of Subway's size, has directly aimed some of its advertising campaigns at Subway, including one portraying a fictional sub-shop called "Wrong Way" that had a powerful similarity to Subway. When Subway provided $5-foot-long subs and Quiznos also offered items matching the same price. Quiznos later intensified its effort to attract budget-minded customers by presenting a flatbread sandwich costing just $2. While price jockeying delighted customers, Quizno’s idea lowered the industry's price and profit margins. As a result, Subway was compelled to anticipate not only how fellow restaurant giants like McDonald's and Burger King will react, but also how smaller sub-shop chains like Quiznos will react when selecting strategic movements. This shows that only a tiny percentage of the industry is controlled by the biggest competitors and a big number of companies are significant participants. The instance case of Subway and Quiznos show that fragmented industry is controlled by the biggest competitors and a big number of companies are significant participants.

Source: ICFAI Research Center

Reasons for industry fragmentation

Reasons for fragmentation vary from the historical to the economical. Some of the reasons for fragmentation are discussed here.

Low overall entry barriers: Fragmented industries consist of many small firms because of low entry barriers. However, fragmentation can occur only when various other factors act in tandem.

Absence of economies of scale or experience curve: Fragmented industries are formed when there is a lack of significant economies of scale in the activities of firms in areas such as manufacturing, marketing, distribution, and research and development. Simple processes, straight forward warehousing operations, high labor content, high personal service content, and intrinsic impossibility to mechanize or standardize operations are reasons for the lack of economies of scale. For example, in industries like lobster fishing, each individual boat is a unit of production. Employing a large number of boats does not reduce fishing costs as the boats are fishing in the same waters and each boat has an equal chance of catching fish. Thus, all the players incur almost the same costs for producing and transporting the goods to market.

High transportation costs: High transportation costs are crucial to decision making as these can influence the size and location of a plant irrespective of the presence of economies of scale. Hence, these costs determine the extent of a firm's operations. For example, these costs are high in cement and caustic chemicals industries. Similarly, high costs are common in service industries since the service is either produced at the customer's location or is available only at the supplier's location.

High inventory costs or erratic sales fluctuations: High inventory costs influence the efficiency of operations. Sometimes they even nullify the implicit economies of scale. This makes the construction of large-scale, capital-intensive facilities, their operation, and maintenance impossible. Erratic sales fluctuations thus leave no incentive for firms with large-scale facilities compared to small-scale facilities. Small firms can adapt to changes in output more easily than specialized firms.

No advantages of size in dealing with buyers or suppliers: The firm might operate in industries in which size does not affect the bargaining power of companies. For example, even large firms will not have any advantage in bargaining with suppliers if there are a large number of buyers in an industry. Suppliers may also limit their dependence on a particular buyer by spreading their business across multiple buyers in the same industry or in different industries where the same inputs are required.

Diseconomies of scale in some important aspect: Diseconomies of scale are caused by various factors. For example, rapid product changes or style changes require a quick response and strong coordination among employees. A large firm may be at a disadvantage if these rapid changes permit only short lead times. A small firm may be more effective in situations such as this. Such rapid changes occur in women's wear, where style plays a major role in gaining competitive advantage.

Low overheads: Low overheads can be an important factor in determining a firm's success. A firm managed by an owner-manager has an advantage in a situation where low overheads are crucial. This type of firm will not have to deal with issues like pension plans, and will not be closely scrutinized by regulatory institutions.

Highly diverse product line: A highly diverse product line also tends to favor small firms because such a line requires customization and a user-manufacturer interface to meet the needs of individual users.

A high level of creative content: Likewise, if a business demands a high level of creative content, then a very large firm will have no distinct advantage. This is the reason why one hardly finds dominant firms in industries such as interior design and advertising. Also, if close local control, local image, and local contacts are prerequisites for success in the marketplace, then too, small firms tend to gain.

Diverse market needs: In some industries, buyers' tastes may be fragmented and the demand for any particular variety may be small and discourage standardization. For example, home needs with respect to furniture are different and hence fragmentation takes place in the home furniture industry.

High product differentiation, particularly if based on image: When product differentiation based on image is required, large firms are at a disadvantage since customers do not associate exclusivity with such firms. In addition, key suppliers prefer exclusive channels for the distribution of their products and services. For example, performing artists sometimes prefer dealing with a small booking agency or record label to create the image they desire.

Exit barriers: Exit barriers limit consolidation by preventing firms from leaving the market. The result: marginal players survive and operate in the industry. Firms operate in the industry without profit-orientation.

Local regulation: Local regulations might force a firm to comply with specific standards. However, complying with such regulations might limit the size of a firm. Certain industries, like the liquor retailing industry, have not been able to grow because of local regulation.

Newness: Industries such as solar heating and fiber optics are fragmented because none of the firms in these industries have acquired the skills and resources to command a significant market share.

The presence of any or a combination of the factors discussed here leads to fragmentation in the industry.

Formulating strategies in fragmented industries

Strategy formulation in this type of industry involves outlining a broad analytical framework. Step one is to conduct an industry-wide analysis. This analysis comprises identifying: where the competition takes shape; industry structure; and position of the competitors in the industry. Step two involves identifying what causes fragmentation in the industry. This identification of causes has to be comprehensive and include their relationship to the economics of the industry. Step three is to study in detail the causes of fragmentation and look for ways to overcome fragmentation. Step four is to assess future benefits of the new structure that emerges once the industry overcomes fragmentation. The fifth step is to locate a defendable position to take advantage of the industry consolidation.

7.9.2 Emerging Industries

Emerging industries are created by technological innovations, emergence of new consumer needs, or shifts in relative cost relationships. In these industries, the fundamental rules of the competition change due to changes in the environment. The primary characteristic of this type of industry from the point of view of formulating strategies is that there are no rules. This situation offers both risks and opportunities. Formulating a strategy in this type of industry involves identifying early buyers or early adopters because early adopters influence the industry development, and the way in which industry designs, produces, delivers, and markets its product.

Formulating strategies in an emerging industry

Strategy formulation in this phase of industry involves uncertainty and risk. At this stage, the rules of competition are not clear, the structure of the industry is still emerging, and the identification of competitors is incomplete. Yet, this is the stage in which the strategic degree of freedom is at its highest and hence the firm has a great opportunity to leverage itself by making the right strategic choices.

Shaping industry structure: In emerging industries, a firm can set the rules for competition in areas like product policy, pricing strategy, and marketing approach. The firm should make an effort to determine the rules in the industry, in a manner that would ensure a strong position for itself in the long run.

Externalities in industry development: In emerging industries, maintaining the right balance between industry advocacy and self-interest is a major concern for firms. As such industries are beset with problems such as an unclear industry image, confusion of buyers, and credibility of sellers, the firms are partly dependent on other players in the industry for their success. Industry conferences and associations help solve some of the problems these firms face. This need for cooperation creates conflict in firms angling for a market position to the detriment of the industry. A firm may be tempted to block the standardization of products (necessary to solve repair problems and promote customer confidence) because it wants to project a unique image in the market and is interested in promoting its products as the industry standard.

Changing role of suppliers and channels: Firms in emerging industries should be prepared to adapt to the changing orientation of suppliers and distribution channels as the industry grows. Suppliers might show an interest in meeting the special needs of the industry in terms of variety, service, and delivery. Likewise, distribution channels may prefer investing in facilities, and advertising in association with firms. The prudent exploitation of these changes can be a source of strategic leverage.

Shifting mobility barriers: Early entry barriers might not last long in emerging industries, and new barriers might emerge as innovations in technology wane. Therefore, firms must not depend solely on proprietary technology and unique product variety to defend their position. Large firms might enter the industry, and scale and marketing clout might become the new mobility barriers. Firms must, therefore, forecast the nature of potential entrants on the basis of their evaluation of present and future barriers, industry attractiveness, and the ability of existing firms to ward off competitors.

7.9.3 Maturing Industries

Industries in which the growth rates are reaching saturation stage are called maturing industries. This maturity stage is not reached at a fixed point in time, and can be delayed by innovations and other events that fuel continuous growth for industry players. Strategic breakthroughs may also cause mature industries to regain their rapid growth.

Example

P&G's Olay skin-care business was almost given up by P&G due to its growth rate, which reached a saturation stage. P&G had no other option except to innovate its Olay products. The business was rejuvenated based on the "one big concept"- preventing the signs of aging on women's' faces. The company searched for and found the needed technology (outside P&G) and re-launched the business with multiple new products: Regenerist, Definity, Professional, and others. As of June 2017, Olay did over $2 billion in sales annually. The instance case of P & G's Olay skin-care business growth reflects on the process innovation that it followed to sustain in the matured industry market.

Source: ICFAI Research Center

Formulating strategies in maturing industries

The transition to maturity can lead to changes in the basic structure of the industry. Elements of the industry such as mobility barriers, significance of various barriers, and the intensity of rivalry change continuously. Firms should respond strategically to structural changes in the industry.

Rapid growth tends to hide the strategic mistakes committed by firms. In the growth stage, strategic experimentation is high, and a wide variety of strategies are deployed at the same time. However, industry maturity reveals this strategic sloppiness and forces firms to choose from among three generic strategies. Some steps involved in strategy formulation are:

Sophisticated cost analysis: Cost analysis helps firms rationalize the product mix and price products correctly. This process is very important in a maturing industry.

Rationalizing the product mix: A broad product line and frequent introduction of new varieties and options is no longer appropriate in a mature setting. Cost competition and the fight for market share are major concerns in a maturing industry. Hence, focusing attention on items with distinct advantages is essential. This need to rationalize the product line creates the need for computerized costing systems.

Correct pricing: A change in pricing methodology is necessary in maturing industries. Average cost pricing and pricing the line as a whole are the common methods followed during the growth phase. However, maturity in the industry demands an accurate measure of costs on individual items along with the right prices. This method of measuring costs is useful as it brings out the implicit cross-subsidization within the product line. Cross-subsidization is undesirable because products with low demand are supported by profits earned from successful products.

Process innovation and design for manufacture: Process innovation assumes significance in a maturing industry. Production and delivery systems that ensure low manufacturing costs get first preference in this stage of the industry.

Buyer selection: In an industry characterized by knowledgeable buyers and increasing competitive pressures, buyer selection can be a source of continued profitability. Buyers tend to use their bargaining power when the industry matures. Hence, identifying "good" buyers and "locking them in" becomes crucial.

Competing internationally: A firm can escape the effects of industry maturity by entering international markets where the industry is more favorably structured. The industry in international markets can have less sophisticated and powerful buyers, fewer competitors, and so on. Moreover, some equipment that is outdated in the home market could be used effectively in international markets.

7.9.4 Declining Industries

Declining industries are industries that have experienced a sustained, absolute decline in unit sales over a long period. This decline cannot be attributed to one single business cycle, or strikes, or material shortages. These declines are typical situations. The decline in these industries results due to slower economic growth, product substitution, and continued technological changes in areas such as electronics, computers, and chemicals. However, the decline can be reversed sometimes through innovations, cost reduction, and changes in other circumstances.

Formulating strategies in declining industries

Strategies in declining industries can be classified into four categories.

Leadership: This strategy aims at taking advantage of the declining industry by maintaining leadership vis-à-vis competitors. The key assumption underlying this strategy is that above-average profits can be earned in a declining industry. In this strategy, a firm makes an effort to be the only firm or one of the few firms in the industry. Once this position is attained, the firm continues either to hold or harvest its position in the industry.

Niche: This strategy involves identifying a segment of the declining industry that will not only offer a stable market but also high returns. A firm following this strategy will invest in building its position in this segment.

Harvest: A firm following this strategy makes an effort to optimize its cashflow from the business. The firm severely curtails new investment, minimizes expenditure on the maintenance of facilities, and makes an effort to take advantage of its residual strengths. The tactics employed in the harvest strategy include reducing the diversity of the product line, reducing the number of channels employed, eliminating small customers, and reducing the quality of service in terms of delivery time, speed of repair, or sales assistance.

Quick divestment: This strategy concentrates on maximizing the recovery of investment by selling the business early in decline. Selling the business early brings the highest value the firm can realize. In some cases, it may be prudent for the firm to divest itself of the business before the industry decline starts, because once such a decline begins, buyers for assets (both inside and outside) in the industry will have stronger bargaining positions.

Check Your Progress - 4

8. In which of the following industries, a firm has the opportunity to shape industry structure, maintain the right balance between industry advocacy and self-interest, and prudently exploit the changing role of suppliers and channel intermediaries?
   a. Fragmented
   b. Emerging
   c. Maturing
   d. Declining
9. In which of the following industries, the steps involved in strategy formulation often involve sophisticated cost analysis, rationalizing the product mix, correct pricing, process innovation and design for manufacture, buyer selection, and competing internationally.
   a. Fragmented
   b. Emerging
   c. Maturing
   d. Declining
10. In declining industries, a firm may severely curtail new investment, minimize expenditure on the maintenance of facilities, reduce the diversity of the product line, reduce the number of channels employed, eliminate small customers, and reduce the quality of service in terms of delivery time, speed of repair, or sales assistance. In this case, which of the following strategies is said to be adopted by the firm?
    a. Leadership
    b. Niche
    c. Harvest
    d. Quick divestment

Activity 7.4

Generic strategies -- overall cost leadership, differentiation, and focus – can provide competitive advantages to a firm. However, it is not essential that a firm following these strategies will always be successful. Elaborate with the help of an example.

Answer:

7.10 Summary

- Generic competitive strategies enable a firm to outperform competitors in the industry. According to Michael Porter' the three generic competitive strategies are overall cost leadership, differentiation, and focus.
- A firm following the cost leadership strategy needs to achieve the lowest cost of production per unit level in the industry.
- Differentiation strategies are aimed at maintaining the exclusivity of the product so that the perceived difference in the product serves as a competitive advantage to the firm.
- Using focus strategies, the firm tries to capture a particular buyer group, segment of the product line, or geographic market.
- Pitfalls of adopting a generic strategy can be avoided by creating a strategic lock-in by achieving a proprietary position in the industry.
- Industries in which firms operate can be classified into: fragmented industries; emerging industries; maturing industries; and declining industries.
- Strategy formulation in fragmented industries involves an analytical framework that identifies the causes of fragmentation, and looks for ways to overcome them and benefit from consolidation in the industry.
- Strategy formulation in emerging industries involves identifying early buyers or early adopters because early adopters influence the industry development, and the way in which industry designs, produces, delivers, and markets its product.
- During an industry's maturity phase, firms move away from strategic experimentation and choose between difficult strategic choices.
- Strategies in declining industries can be classified into leadership, niche, harvest, and quick divestment.

7.11 Glossary

Declining industries: Industries that have experienced a sustained, absolute decline in unit sales over a long period due to slower economic growth, product substitution, and continued technological changes. The decline can sometimes be reversed through innovations, cost reduction, and changes in other circumstances.

Differentiation strategy: A generic competitive strategy (as proposed by Michael E. Porter) through which a firm can create sustainable success for itself. The strategy aims at creating products and services that are perceived by the customers and consumers as distinct and unique from its competitor's products and services.

Emerging industries: Industries created by technological innovations, emergence of new consumer needs, or shifts in relative cost relationships. In emerging industries, the fundamental rules of the competition change due to changes in the environment.

Focus strategy: A generic competitive strategy (as proposed by Michael E. Porter) through which a firm can create sustainable success for itself. A firm pursuing the focus strategy aims at segmenting the market and identifying the market segment which will be served by its products and services. The idea behind a focus strategy is to concentrate efforts on a specific market segment and serve it well to achieve success. It assumes that by focusing on a specific market segment, it can serve it better than the competitors who are serving the entire market. A focus strategy selects target markets where the firm is the least vulnerable to substitutes or where competitors are the weakest.

Fragmented industries: Industries in which no firm has a significant market share. However, the majority of firms can strongly influence the outcome of the industry. These industries contain privately owned small- and medium-sized companies.

Generic competitive strategies: A firm, in order to stay competitive, can pursue any of the three generic strategies proposed by Michael Porter, namely, 'overall cost leadership', 'differentiation', and 'focus'. These generic strategies leverage a firm's capabilities and enable it to cope with the five forces model as well.

Maturing industries: Industries in which the growth rates are reaching saturation stage. This maturity stage is not reached at a fixed point in time, and can be delayed by innovations and other events that fuel continuous growth for industry players.

Overall cost leadership: A generic competitive strategy (as proposed by Michael E. Porter) through which a firm can create sustainable success for itself. In the overall cost leadership strategy, a firm makes sustained efforts to reduce costs in all areas of business without compromising on the quality of its products and services. This yields a cost structure for the firm which would be lower than that of its competitors. The firm can then either price the product at the same level as a competitor's pricing and earn higher profits due to its lower costs or it can reduce its prices to build volumes and emerge as the market leader.

7.12 Self- Assessment Test

1. What are the various generic competitive strategies? Explain them in detail.
2. How can an organization choose which generic strategy to follow? What are the pitfalls of adopting generic strategies? Explain the concept of strategic lock-in.
3. Explain the competitive strategies used in different types of industries.

7.13 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

7.14 Answers to Check Your Progress Questions

1. (b) Only i, ii, and iii

Statement iv is false as it is applicable to the differentiation strategy, and not to the overall cost leadership strategy.

2. (b) Focus on small customer accounts

Firms that adopt the overall cost leadership strategy seek a large market share, usually by pursuing large customer accounts and **avoiding** small customer accounts.

3. (c) Increases the bargaining power of the buyers

When a firm follows the differentiation strategy, its products and services are perceived as unique. This limits (and not increases) the bargaining power of the buyers and allows the firm to price its products higher than those of its competitors.

4. (a) The firm will not become the market leader; it will enjoy a higher than average return.

When the firm with a well-differentiated product portfolio prices its products significantly higher than those of its competitors, it loses the opportunity to become the market leader by volume. However, the higher price enables the firm to enjoy higher than average returns.

5. (c) A firm simultaneously attempts both cost leadership and differentiation.

If a firm attempts to adopt two strategies at the same time, there is a probability that it will fail. Porter refers to this phenomenon as "Getting stuck in the middle". For example, a firm which is pursuing overall cost leadership will be cutting costs in all areas including research and development. If such a firm decides to adopt differentiation, it will not succeed because new product development would not have been carried out due to its efforts at cost minimization.

6. (a) Technological change

Risk Events of Cost Leadership:

Event	**Risk**
Technological change	Makes past investments and learning redundant
Imitation	Late entrants achieve the advantage of low cost learning and investing in modern research and development facilities
Inadequate customer orientation	Ignoring customer needs due to excessive obsession with cost minimization
Unexpected inflation in costs	Inability to offset differentiation through cost leadership

7. (b) The lock-in is likely to come in more easily in the maturity stage of a market life cycle.

The timing of dominance is a crucial factor for a firm to achieve strategic lock-in. The lock-in is likely to come in more easily in the early stages of a market life cycle as compared to mature markets.

8. (b) Emerging

In emerging industries, the fundamental rules of the competition change due to environmental changes and industry evolution. This situation offers both risks and opportunities for firms and the strategic degree of freedom is at its highest.

9. (c) Maturing

In maturing industries, firms learn from the strategic mistakes committed in the growth stage and take corrective action. For such industries, the steps involved in strategy formulation often involve sophisticated cost analysis, rationalizing the product mix, correct pricing, process innovation and design for manufacture, buyer selection, and competing internationally.

10. (c) Harvest

In declining industries, the harvest strategy is followed in order to optimize the cash flows from the business.

Unit 8

Strategic Analysis and Choice

Structure

"If all you're trying to do is essentially the same thing as your rivals, then it's unlikely that you'll be very successful".

- Michael Porter

8.1 Introduction

Michael Porter is stressing the point of examining the competitors' strategy and not taking a similar footstep rather companies should make a strategic differentiation for sustainable competitive advantage.

In the previous unit, we have discussed the generic competitive strategies of overall cost leadership, differentiation, and focus. In this unit, we shall discuss about strategic analysis and choice.

A firm can grow in a variety of ways and by pursuing a diverse range of strategies. It might follow a combination of one or two given strategies at a time or a single strategy. Strategy selection and choice is both analytical and creative and is based on a rational-intuitive process. From one perspective, 'strategy is about choosing what not to do'. To select a strategy, other strategy alternatives have to be eliminated; this is done by a comparison of the strengths, weaknesses, risks, and tradeoffs of each alternative while keeping a possible future scenario in mind. Further, the risk propensity of owners and/or managers plays an important role in the analysis and selection of strategy by a firm.

This unit will first discuss the criteria for evaluating strategic alternatives. We shall then move on to discuss techniques like BCG Growth-Share matrix and GE Nine Cell Planning Grid for conducting strategic analysis at the corporate level. We shall also discuss the techniques like BCG Growth-Share matrix and GE Nine Cell Planning Grid for conducting strategic analysis at the corporate level. Finally, we shall discuss the various behavioral factors influencing strategic choice, and the contingency approach to strategic choice.

8.2 Objectives

By the end of this unit, students should be able to:

- Identify the criteria for evaluating strategic alternatives.
- Discuss techniques like BCG Growth-Share matrix and GE Nine Cell Planning Grid for conducting strategic analysis at the corporate level.
- Explain the technique of SWOT analysis for conducting strategic analysis at the business unit level.
- Identify the various behavioral factors influencing strategic choice.
- Discuss the contingency approach to strategic choice.

8.3 Criteria for Evaluating Strategic Alternatives

A number of criteria are available for evaluating strategic alternatives. In order to make the evaluation practically possible, the criteria can be classified into three groups, i.e., the criteria of suitability, feasibility, and acceptability.

8.3.1 Criteria of Suitability

The criteria for suitability attempt to measure the extent to which the proposed strategies fit the situation identified in the strategic analysis. The strategy to be selected should meet the following criteria:

- Can the strategy overcome the difficulties identified in the strategic analysis?
- To what extent can the strategy exploit the environmental opportunities by using the firm’s strengths?
- Do the firm’s objectives and values fit in with the strategy?

8.3.2 Criteria of Feasibility

The criteria of feasibility assess the practical implementation and working of strategy. In the evaluation stage, the following questions need to be assessed:

- Does the firm have sufficient financial resources to implement the strategy?
- Is the firm capable of performing at the required level?
- Can the necessary market position be achieved?

- Is the firm capable of coping with competition effectively?
- Will the technology be available to compete effectively?
- Can the firm ensure that the required managerial and operative skills will be available?
- Is the firm capable of procuring the necessary materials and services?

8.3.3 Criteria of Acceptability

The acceptability of the strategy is the third measurement. Acceptability involves not only the consequences of the strategy but also the personal considerations (e.g. values) of the strategy decision-makers, as they have to accept it. An analysis of the following factors will help in identifying the consequences of the strategy after its implementation.

- The financial position of the firm in terms of profitability
- Financial problems like liquidity: how will they be solved?
- Effect on capital structure
- The level of acceptability of cultural changes within the organization
- The nature of change in the firm's interactions with outside stakeholders
- The acceptability of the strategy by the firm's environment, as for example, by the local community.
- The proposed strategy's fit (or lack of fit) with the existing system.

Check Your Progress - 1

1. Which of the following is **not** a class of criteria for evaluating a strategic alternative?
   a. Criteria of suitability
   b. Criteria of feasibility
   c. Criteria of acceptability
   d. Criteria of excellence
2. Which of the following class of criteria attempts to measure the extent to which the proposed strategies fit the situation identified in the strategic analysis?
   a. Suitability
   b. Feasibility
   c. Acceptability
   d. Excellence

3. Which of the following class of criteria involves not only the consequences of the strategy but also the personal considerations of the strategy decision makers as they have to accept it?
    a. Suitability
    b. Feasibility
    c. Acceptability
    d. Excellence
4. The consequences of a strategy after its implementation can be identified by analyzing the following factors:
    i. The financial position of the firm in terms of profitability.
    ii. The critical success factors.
    iii. The effect on capital structure.
    iv. The level of acceptability of cultural changes within the organization.

    a. Only i, ii, and iii
    b. Only i, ii, and iv
    c. Only i, iii, and iv
    d. Only ii, iii, and iv

8.4 Strategic Analysis at the Corporate Level

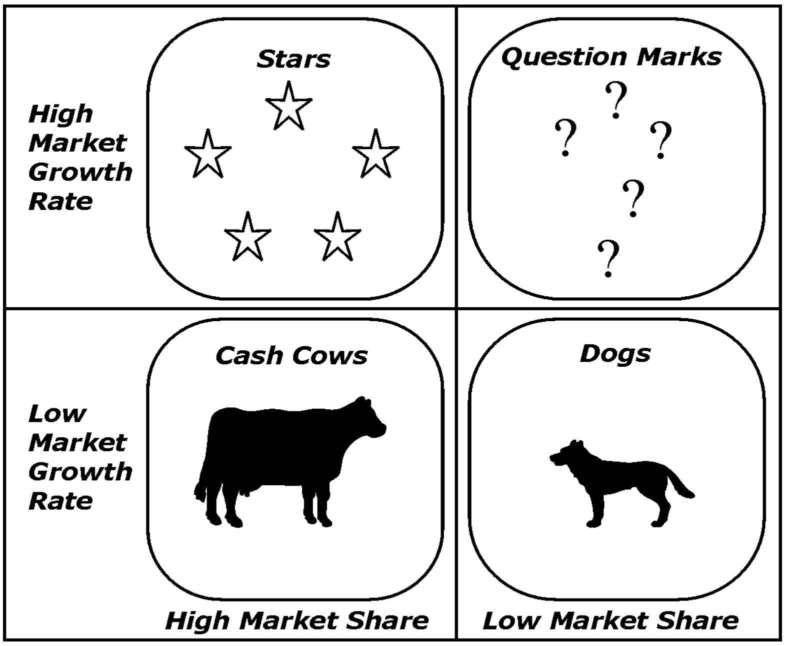
The resource allocation process in multi-business firms is done at the corporate level. In diversified, multi-industry companies, the fundamental method of corporate strategic analysis is the "business portfolio approach". In this approach, decisions on which product /service markets to compete in, diversification, and the geographic regions to operate in are made at the corporate level.

The matching stage of the analytical framework for strategy formulation is also called corporate portfolio analysis. This strategy has to be adaptable to multiproduct market firms in which each product/market is managed as a separate business or profit center because the firm is not dominated by one product/market. Moreover, each business is a separate entity and a contributor to the corporation's total portfolio of business. In such companies, the corporate strategic considerations are not separate and distinct from business-level considerations. The portfolio approach provides a simple way of identifying and evaluating alternative strategies for the generation and allocation of corporate resources.

Corporate strategic analysis maps out issues like: What business should the firm be in? How should the firm allocate its resources among existing businesses? Which businesses represent the firm's future? and How diversified should the corporation's business be?

8.4.1 BCG Matrix

Figure 1: BCG Product Portfolio Matrix



Source: ICFAI Research Center

The BCG Growth-Share matrix is widely used in corporate strategic analysis. In the early 1970s, the Boston Consulting Group developed a model for managing a portfolio of different business units (or major product lines). This matrix takes into consideration the growth rate of the market and the relative market share of the business unit. The market growth rate demands attention because it is an important factor that indicates whether the organization should stay in a particular industry or not. Rapid growth and maximum returns are possible for a firm only in booming industries. Hence, it is prudent for an organization to enter and continue to operate in a growing industry. A high market share benefits the organization by way of economies of scale and bargaining power in relations with buyers and sellers. The BCG growth-share matrix displays the positions of business units on a graph of the market growth rate against their market share relative to competitors. Refer to Figure 1 for the BCG matrix. Resources can be allocated to business units on the basis of their classification into categories. Business units are classified into four categories -- Cash Cows, Stars, Question Marks, and Dogs.

Cash Cows – These business units hold a large relative market share in a mature and slow-growing industry. These businesses have a strong business position and negligible investment requirements and hence the returns from them are often more than their investment requirements. Organizations often tap their 'cash cows' in order to draw out resources required elsewhere in the organization

Stars – These business units have a large relative market share in fast growing markets or industries. Firms need to invest in stars as the industry is still evolving and market share is also growing. Often the investment requirements of stars are greater than the revenues they generate. But once the industry reaches the stage of maturity, the stars need hardly any investment and become major sources of revenue for the firms.

Question Marks – These business units have a small relative market share in a high growth market. They demand significant investment because their cash needs are high, the norm in a growing industry. As the market is growing rapidly, acquiring market share is easier than in a mature market. However, the stage of growth in the industry is characterized by a lot of uncertainty that results from changes in technologies, distribution channels, and the players themselves. Hence, there are only a few question marks that are able to grow into stars.

Dogs – These business units have low relative market share in an intensely competitive mature industry characterized by low profits. A dog does not need much of an investment, but it ties up capital that could be invested in industries with better returns. Hence, organizations concentrate on recovering as much as possible from these units in terms of returns on investment and often undertake ruthless cost cutting. Unless there is a larger purpose in keeping such units, an organization should divest itself of dogs at the earliest.

However, recent research suggests that well-managed dogs can have a positive effect on the organization, and be highly reliable revenue generators. These well-managed dogs have a narrow business focus, concentrate on high product quality and moderate prices, have strong control over costs, and advertise only to a limited extent. Though these units can generate surplus returns, the possibility of their being transformed into cash cows does not exist.

Example

In 2019, the comparative sales growth for electric two-wheelers in India was 130 per cent year-on-year. In September 2019, Hero Electric, one of the largest electric scooter makers in India by sales, planned to double its production capacity over the next 12 months. Around 65,000 electric two-wheelers were sold in India in FY19, of which 37,000 were sold by Hero Electric alone. By September 2019, it had an annual capacity of 75,000 units at its Ludhiana facility, which will be increased to 150,000 annually. According to Sohinder Gill, CEO, Hero Electric will invest ₹ 700 crore over the next three to four years as capital expenditure. Of this, nearly ₹ 250-300 crore will go towards capacity addition. Gill said on the sidelines of the launch of its electric scooter range, “We can look at brownfield expansion at Ludhiana or go for a Greenfield unit down South. We are exploring all the five (Southern) States and a call on this will be taken soon.”

Contd….

Sohinder Gill, CEO further added, “We have seen sales nearly double over the last six months and we now have a 65 per cent market share.” The company is also eyeing an increase in dealerships. Hero Electric has large market share in the fast-growing industry i.e. e-vehicle. Hence, the case represented star category of business unit as per BCG matrix.

Source: ICFAI Research Center

Though the BCG matrix provides a framework for allocating resources among different business units and allows one to compare many business units, it is criticized for over-simplification. For example, the relation between relative market share and profitability is questionable, and the emphasis on improving relative market share may lead the organization in a direction which does not meet the objectives of the organization.

8.4.2 GE Nine Cell Planning Grid

McKinsey & Co., a leading management consultancy firm, developed a nine cell planning grid for the corporate portfolio analysis of General Electric Co. (GE), a diversified conglomerate.

The parameters used by the matrix are industry attractiveness and business strengths.

The various industry attractiveness factors taken into consideration by the grid are: market size and growth rate; intensity of competition; technological requirements; capital requirements; entry and exit barriers; emerging industry threats and opportunities; historical and projected industry profitability; and social, environmental, and regulatory influences.

The various business strength factors are: market share growth, size, and firm profitability; economies of scale; knowledge of customers and market; and caliber of management.

Example

Life’s Abundance is a US-based pet food manufacturing company established in 1999. As of 2018, it never had a product recalled, a record that made CEO Lester Thornhill, a native Trinidadian, proud. It relies on customers to market its products, as in multi-level marketing, but with a crucial difference: There are no quotas, and no one is required to buy or sell anything. That not only means a lot of repeat customers but also lets the company keep its goods out of big-box stores. Amazon, which is a matter of principle. Thornhill said that Life's Abundance manufactures in small batches and guarantee freshness and quality. The company is also listed under “The Best Small Companies of 2019” by Forbes. The list includes 25 companies, which are all privately owned firms.

Contd….

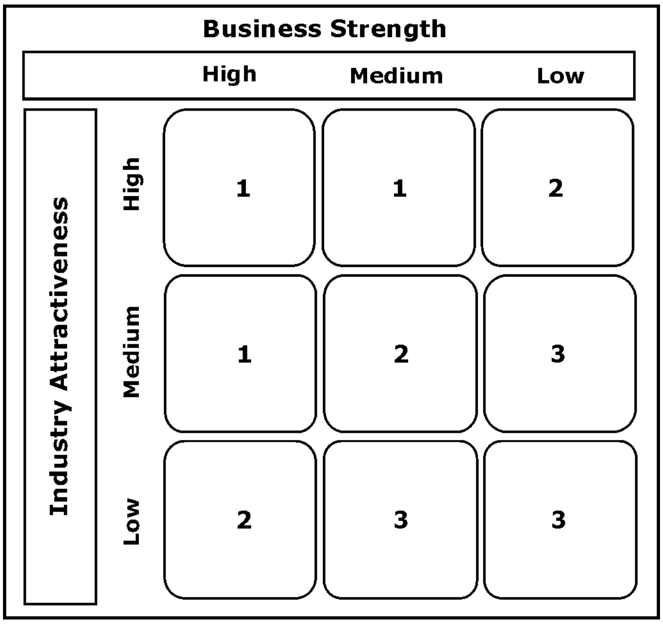
Forbes believes that these companies share a commitment to being the best at what they do, providing stellar service to customers, offering employees fulfilling, rewarding work and being vital members of their communities. Life's Abundance reflects the caliber of company's management.

Source: ICFAI Research Center

To plot business units on the GE Nine Cell Planning Grid, the following four steps need to be followed.

1. In the first step, a criterion is selected to rate the industry for each business unit. Then to each industry attractiveness factor, a weight is assigned that reflects its perceived importance to the other attractiveness factors). The business units are rated on a five-point scale from 1 (very unattractive) to 5 (very attractive).
2. In step two, the key factors needed for success in each business unit are selected. The business strength/competitive position for each business unit is assessed on a scale of 1 (very weak) to 5 (very strong).
3. Each business unit's current position is plotted on a matrix. This could be similar to the one depicted in Figure 2.

Figure 2: GE/McKinsey Matrix



Recommended strategies:

1 – Invest to grow

2 – Invest selectively or hold the investment

3 – Harvest or Divest

4. In the last step, the firm's future portfolio is plotted, assuming that present corporate and business strategies remain unchanged. Then, it has to be seen if any performance gap exists between the projected and desired portfolios. If any gap exists, it should serve as a stimulus to review the corporation's current mission, objectives, strategies, and policies.

Thus, the GE Nine Cell Planning Grid helps in placing a business unit in one of the nine cells of the matrix, based on its industry attractiveness and business strength scores.

The potential strengths of the grid are:

- It allows for intermediate ranking between high and low and between strong and weak.
- It incorporates a much wider variety of strategically relevant variables than the BCG matrix.
- It stresses the channeling of corporate resources to businesses with the greatest probability of achieving competitive advantage and superior performance.

Though the GE Nine Cell Planning Grid is better than the BCG matrix, it also suffers from some weaknesses.

- It is quite complicated and cumbersome.
- It cannot effectively depict the positions of business units in developing industries.

Overall, the GE Nine Cell Planning Grid is an improvement over the BCG matrix. The planning grid considers more variables and does not lead to simplistic conclusions.

Thus, the portfolio approach is useful for examining alternative corporate-level strategies in multi-industry companies. Once portfolio strategies have been identified, business strategies must be determined. The portfolio approach helps in clarifying and determining the broad strategic intent, but this is not enough. The process of strategic analysis and choice is not completed by merely making decisions involving the allocation of corporate resources and the manner in which the business unit has to be managed. Each business unit must also examine and select a specific grand strategy to guide its pursuit of long-term objectives.

Example

During 2018, the air purifier market in India was estimated to be about ₹ 200-250 crore. Though it was growing year-on-year, air purifier companies were struggling to make place for themselves in the market.

Contd….

Some industry experts said that though the growth was impressive in percentage terms because of the low base, it should not be read as a sign that Indians are adapting to changes quickly. This was the situation despite halving of entry-level prices to about ₹ 8000. Senior executives at Blue Star, Eureka Forbes, Kent and Hicare said, “More than half of the purchases are still by institutional buyers such as the foreign embassies, luxury hotels and CXO chambers in large corporates.” Eureka Forbes CEO Marzin R Shroff said, “Creating the basic need for an air purifier is a big task which brands have not been able to do till now. It’s not just an Indian phenomenon, but global. When pollution comes down, sales fall drastically.” Mahesh Gupta (Chairman - Kent RO Systems) said, “there is no wider adoption since people feel they can still live without it.” In this case, the industry executives mentioned the social environmental factor – customer perception about the air purifier.

Source: ICFAI Research Center

Check Your Progress - 2

5. What provides the basis for comparing the relative strengths of different businesses in terms of the strength of their positions in their respective markets?
   a. The BCG matrix
   b. Value chain analysis
   c. The 7S Framework
   d. The Five Forces Model
6. With reference to the BCG matrix, which one of the following represents the best long-run opportunity in a firm’s portfolio?
   a. Cash cows
   b. Stars
   c. Question marks
   d. Dogs
7. Which of the following have a strong business position and negligible investment requirements and hence the returns from these businesses are often more than their investment requirements?
   a. Cash cows
   b. Stars
   c. Question marks
   d. Dogs

8. Which of the following have a large relative market share, and the firms need to invest in them as the industry is still evolving and the market share is also growing?

   a. Dogs

   b. Cash cows

   c. Question marks

   d. Stars

9. Which of the following have a small relative market share in a high growth market?

   a. Dogs

   b. Cash cows

   c. Stars

   d. Question marks

10. Which of the following have a low relative market share in an intensely competitive mature industry characterized by low profits?

    a. Dogs

    b. Cash cows

    c. Stars

    d. Question marks

11. Which tool of strategic analysis uses multiple factors to assess industry attractiveness and business strength?

    a. The GE grid

    b. The BCG matrix

    c. The turnaround strategy

    d. SWOT analysis

12. The various business strength factors taken into consideration by the GE grid are:

    i. Knowledge of customers and markets

    ii. Caliber of management

    iii. Emerging industry threats and opportunities

    iv. Economies of scale

    a. Only i and ii

    b. Only iii and iv

    c. Only i, ii, and iv

    d. Only ii, iii, and iv

13. What is the potential strength of the GE nine cell planning grid?
    i. It allows for intermediate ranking of business units, between high and low, and between strong and weak.
    ii. It is simple and easily manageable.
    iii. It incorporates a much wider variety of strategically relevant variables than the BCG matrix.
    iv. It stresses the channeling of corporate resources to businesses with the greatest probability of achieving competitive advantage and superior performance.
    a. Only i, ii, and iii
    b. Only i, ii, and iv
    c. Only i, iii, and iv
    d. Only ii, iii, and iv

Activity 8.1

A few years ago Raheja Fertilizers acquired a firm engaged in manufacturing fertilizers and other chemicals. Initially, the merged entity performed well. However, after a couple of years, Raheja Fertilizers recorded its first ever loss. The management decided to divest the chemical manufacturing units of the acquired entity. Discuss the possible reasons that could have prompted the divestiture.

Answer:

8.5 Strategic Analysis at the Business Unit Level

Business units are oriented toward a particular industry, product, or market. Each business unit will have its own competitors and its own unique strategy. Business unit level strategies are concerned with developing a distinctive and sustainable competitive advantage, identifying a product or service niche, and monitoring product or service markets so that the strategies conform to the market needs. SWOT analysis is a popular approach for making strategic choices at the business unit level.

8.5.1 SWOT Analysis

The process of strategy formulation begins with situation analysis, i.e., the process of finding a strategic fit between external opportunities and internal weaknesses. SWOT is an acronym for strengths, weaknesses, opportunities, and threats. It is a systematic study and identification of those aspects and strategies that best suit the individual firm's position in a given situation. The strategy should improve a firm's business strengths and make use of opportunities while at the same time reducing its weaknesses and counter threats.

Strengths

Strengths are the resources, skills, or other advantages the firm enjoys relative to its competitors. They are the distinctive competences that give the firm a comparative advantage in the marketplace. Some of the strengths that a firm may possess are:

- Distinct technical superiority with the best technical know-how
- Financial resources
- Skills of the people in the organization
- Goodwill and image in the market for goods and services
- Access to the best distribution network
- The discipline, morale, attitude, and manners of the employees
- Market leadership
- Good buyer/supplier relations

Weaknesses

A weakness is a limitation or deficiency in resources, skills, and capabilities that seriously impedes effective performance. It refers to a constraint that checks movement toward a distinct competitive advantage for the firm. Some sources of weakness could be limitations of -- facilities, financial resources, management capabilities, marketing skills, and brand image.

Corporate strength and weakness are a matter of interpretation. Understanding the key strengths and weaknesses of a firm helps in narrowing down the choice of alternative strategies. The study of internal strengths and weaknesses provides a useful framework for making the best strategic choice.

Opportunities

An opportunity refers to a very favorable situation in the firm's environment. An environmental opportunity is a situation which makes it possible for a particular firm to enjoy a competitive advantage. Some of these opportunities may be -- identification of a new market segment, favorable changes in the regulatory environment, favorable technological changes, and improved buyer or supplier relationships. For example, changes in the Export-Import Policy may bring new opportunities to some export-oriented companies.

Threats

A threat refers to an extremely unfavorable situation in the firm's environment. It is a challenge posed by an unavoidable trend that could lead, in the absence of purposeful action, to the erosion of the firm's position.

Some threats to a firm may be:

- Slow market growth
- Entry of resourceful multinational companies/competitors
- Increased bargaining power of key buyers or suppliers
- Quick rate of obsolescence due to major technological changes
- Adverse changes in government policies, rules, and regulations

Opportunities and threats are the external factors and forces in the business environment, which change from time to time. They affect organizations to a great extent because organizations operate in a business environment influenced by others. Understanding the key opportunities and threats to a firm helps its managers to identify realistic options from which to choose an appropriate strategy.

Businesses desire to be in a situation characterized by strong internal strengths and numerous environmental opportunities. If a business is in a less attractive situation characterized by strong internal strengths but faced with environmental threats, diversification may be considered as a strategic option. Businesses that suffer from critical internal weaknesses but have access to numerous environmental opportunities should pursue a turnaround strategy. Businesses faced with critical internal weaknesses and major environmental threats should pursue defensive strategies.

A SWOT analysis covers most aspects of a firm's situation and provides a dynamic and useful framework for choosing a strategy. However, SWOT analysis is a subjective exercise and the perceptions of managers may differ as to whether various aspects are threats or opportunities; this could be due to underlying considerations within the organization as well as differences in perspectives.

Check Your Progress - 2

14. Strengths are the resources, skills, or other advantages the firm enjoys relative to its competitors. Some of the strengths that a company may possess are:

    i. Goodwill and image in the market for goods and services.
    ii. Access to the best distribution network.
    iii. Increased bargaining power of key buyers or suppliers.
    iv. The discipline, morale, attitude, and manners of the employees.

a. Only i, ii, and iii
b. Only i, ii, and iv
c. Only i, iii, and iv
d. Only ii, iii, and iv

15. Which of the following is **not** a threat to a firm's environment?
    a. Entry of resourceful multinational companies/competitors
    b. Decreased bargaining power of key buyers or suppliers
    c. Quick rate of obsolescence due to major technological change
    d. Adverse changes in government policies, rules, and regulations

8.6 Behavioral Considerations Affecting Strategic Choice

Strategic choice refers to the decision to adopt any of the alternative strategies. The decision process is relatively simple if the analysis clearly identifies a superior strategy or if the current strategy clearly meets the firm's objectives into the future. If there is an overwhelmingly superior strategy, then decision making is easy. However, in reality, this clarity is an exception. When different alternatives promise similar payoffs, the decision-making process becomes judgmental and difficult because the strategic decision-makers are confronted with several viable alternatives rather than a clear-cut choice. Under such circumstances, various factors influence the choice. Some of these factors are described in Table 1.

Table 1: Behavioral Considerations Affecting Strategic Choice

Behavioral Consideration	Description
Role of current/past strategy	If a strategy has worked well for the firm in the past, there is a tendency to persist with it for the future. Often, the firm's strategists have also been the architects of strategies used earlier. Owing to their familiarity with and commitment to past strategy, both lower-level managers and top-level managers show an inclination toward continuity. The more successful the strategy becomes, the harder it is to replace it with a new one, even under changed circumstances.
Attitude toward risk	The attitude of managers (and owners) toward risk influences the strategic choices made by a firm. Risk-oriented managers tend to explore more choices and prefer offensive strategies based on innovation and the firm's strengths in order to maximize growth and

Behavioral Consideration	Description
	profitability. Risk-averse managers strategize in a conservative manner in order to maximize the probability of earning reasonable returns. They are drawn to incremental and defensive strategies that minimize the uncertainty associated with innovation-based strategies. Also, in highly volatile industries, or if a firm is in the early stages of product/market evolution, the owners and/or managers may be required to bear more risk.
Competitive reaction	Organizations have to take into consideration the reactions of competitors while making strategic choices. Before choosing a strategy, the capability of the competitor to react, the probability of reaction, and the impact of the reaction on the strategy chosen by the firm should be kept in mind.
Degree of firm's external dependence	When strategizing, the firm should pay considerable attention to its external environment which comprises customers, suppliers, competitors, unions, and government. If the influence of the external forces on a firm's performance is high, it will have fewer options to choose from.
Values and preferences	An important basis of strategy choice lies in the background, needs, desires, and values of the owners/managers. These factors have an impact even in large organizations, depending on the amount of actual control in the hands of one or a few individuals.
Internal politics	Power struggles and political considerations influence various stages in the process of making strategic choices.

Adapted from Pearce II, John A. and Richard B. Robinson Jr. "Strategic Management – Formulation, Implementation, and Control." New York: McGraw-Hill, Tenth Edition, 2007,

Example

In September 2019, Volkswagen, a popular German car maker again is in the process to reduce its dealer-partners in India to 50 from 60 as it seeks to improve their profitability. Steffen Knapp (head of VW Passenger Cars) said "We have higher digitisation in smaller showrooms than regular ones. The company is, therefore encouraging its existing dealer-partners to open more outlets called 'pop-up stores' that would be one-tenth the size of a regular showroom. The size of such stores would range between 2,000 square feet and 3,000 sq ft as against a regular showroom measuring 25,000-30,000 sq ft".

Contd….

Such compact stores would cost just ₹ 55 lakh as compared to ₹ 15-18 crore required for a regular metro store. With pop-up-stores, the dealer gets a bigger reach at a lesser expense and have more synergies and economies of scale. These dealers become more loyal because they have a larger exposure to Volkswagen. This strategy is planned to increase sales, leverage economies of scale and improve profitability. Knapp added, “We are going for less investors (dealers). When I started (in June 2017), we had 84 investors, now we have 60 and we will go down to 50.” Volkswagen’s decision to pursue reduction in dealer size is primarily due to the role of current/past strategy, which has proved to be successful.

Source: ICFAI Research Center

Activity 8.2

Once the forces affecting competition in an industry and their underlying causes are diagnosed, the firm is in a position to analyze its strengths and weaknesses. To create a defendable position against the five competitive forces, an effective competitive strategy takes offensive or defensive action. Discuss, with the help of a suitable example, how firms adopt offensive and defensive strategies.

Answer:

8.7 Contingency Approach to Strategic Choice

The ability of the strategy chosen by the firm to succeed is dependent to a certain extent on the future conditions to be faced by the firm. Contingency approach is a technique adopted by firms to address this issue. In this approach, the critical assumptions on which the success of the strategy depends are identified and a what-if analysis is carried out, especially with regard to those assumptions that might have a significant bearing on the future success of the firm. Some examples of contingencies: a downturn in the economy, a labor strike, a technological breakthrough, and a shortage of critical materials.

Once the negative conditions in the scenarios have been identified, managers should develop alternative contingency strategies for the firm. The contingency strategies can be either short term or long term in nature. Besides, they could be appropriate at the corporate, business, and/or functional levels.

Firms using the contingency approach identify the trigger points so that the management can be alerted to consider a contingency strategy. The trigger points are specific deviations in key forecasts of industry and are set to alert management. The management then needs to consider alternative strategies and allow sufficient lead time for implementation of the contingency approach.

Check Your Progress - 3

16. Which of the following statements is **false** regarding strategic choice?
    a. Attitudes toward risk exert considerable influence on strategic choice.
    b. When making a strategic choice, risk-oriented managers are attracted toward opportunistic strategies with higher payoffs.
    c. When making a strategic choice, risk-averse managers lean toward safe, conservative strategies with reasonable, highly probable returns.
    d. The greater the firm's dependence on external factors, the higher will be the range and flexibility of its strategic choice.

8.8 Summary

- For evaluating strategic alternatives, the criteria for suitability, feasibility, and acceptability should be considered.
- For multi-industry firms, strategic analysis begins at the corporate level. Corporate strategy is concerned with the generation and allocation of corporate resources.
- The portfolio analysis method is a technique of strategy examination at the corporate level. The BCG matrix and the GE nine cell planning grid are examples of how portfolio analysis can be done at the corporate level.
- Strategic analysis and choice do not end with corporate level strategy. The business unit level strategies must be examined in order to identify and evaluate the strategy options of each business unit.
- SWOT analysis is often used for making strategic choices at the business unit level.
- The behavioral considerations that influence strategic choice include: the impact of past strategy, managerial attitude toward risk, competitive reaction, degree of firm's external dependence, values and preferences of owners and/or managers, and internal politics.
- The contingency approach to strategic choice incorporates the flexibility to alter a chosen strategy if underlying assumptions change.

8.9 Glossary

BCG Growth-Share matrix: A strategic analysis tool developed by the Boston Consulting Group in the early 1970s for managing a portfolio of different business units (or major product lines). The BCG Growth-Share matrix considers the growth rate of the market and the relative market share of the business. It displays the positions of business units on a graph of the market growth rate against their market share relative to competitors.

GE Nine-Cell Planning Grid: McKinsey & Co., a leading management consultancy firm, developed a nine cell planning grid for the corporate portfolio analysis of General Electric Co. (GE), a diversified conglomerate. The parameters used by the matrix are industry attractiveness and business strength.

Strategic analysis: Strategic analysis is done at corporate and business unit levels. Tools such as BCG Growth-Share Matrix, and GE Nine-Cell planning Grid are used at corporate level to examine each business as a separate entity and as a contributor to the organization's total business portfolio. SWOT analysis is a popular tool used for strategic analysis at the business unit level.

SWOT analysis: SWOT is an acronym for strengths, weaknesses, opportunities, and threats. It is a systematic study and identification of those aspects and strategies that best suit the individual firm's position in a given situation. The strategy should improve a firm's business strengths and make use of opportunities while at the same time reducing its weaknesses and countering threats.

8.10 Self-Assessment Test

1. What are the criteria used for evaluating strategic alternatives?
2. Discuss the techniques like BCG Growth-Share matrix and GE Nine Cell Planning Grid for conducting strategic analysis at the corporate level.
3. Explain the technique of SWOT analysis for conducting strategic analysis at the business unit level.
4. What are the various behavioral factors influencing strategic choice?
5. Describe the contingency approach to strategic choice.

8.11 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press

4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

8.12 Answers to Check Your Progress Questions

1. (d) Criteria of excellence

For evaluating strategic alternatives, all criteria can be classified into three groups, i.e., the criteria of suitability, feasibility, and acceptability. The criterion of suitability attempts to measure the extent to which the proposed strategies fit the situation identified in the strategic analysis. The criterion of feasibility assesses the practical implementation and working of the strategy. The criterion of acceptability involves not only the consequences of the strategy but also the personal considerations of the strategy decision maker, as he/she has to accept it. Excellence is something for which a firm strives and is not a class of criteria for evaluating a strategic alternative.

2. (a) Suitability

The criteria of suitability attempts to measure the extent to which the proposed strategies fit the environmental situation identified in the strategic analysis. For example, a firm with a business line of pre-cooked convenience food, which is facing a mature market and is a market leader, is following the strategy of growth by spending huge amounts on market development and product development. Based on the criterion of suitability, it may be concluded that the firm is following the wrong strategy as the market is maturing, and that it should cut back on its spending on market development and product development as the market is at a mature stage and the firm is already the market leader.

3. (c) Acceptability

Acceptability involves not only the consequences of the strategy but also the personal considerations of the strategy decision makers, as they have to accept it. For example, the vice president marketing of a firm which intends to follow a concentration strategy can choose between market development and product development. The decision on the strategy chosen will also be influenced by the personal considerations of the vice president in terms of whether he/she is risk averse or a risk lover, and his/her past experiences in terms of whether he/she was more successful in using the market development or the product development strategy.

4. (c) Only i, iii, and iv

An analysis of the following factors will help in identifying the consequences of the strategy after its implementation: the financial position of the firm in terms of profitability; the effect on capital structure; and the level of acceptability of cultural changes within the organization. The critical success factors needed for success is **not** a factor based on which the consequences of the strategy are analyzed.

5. (a) The BCG matrix

The BCG matrix provides a framework for allocating resources among different business units and allows one to compare many business units. The BCG matrix evaluates the performance of a business unit on two parameters, namely relative market share and market growth rate. In value chain analysis, strengths and weaknesses are assessed by dividing a business into a number of linked activities, each of which may produce value for the customer. The 7S Framework comprises strategy, structure, systems, style, staff, skills, and shared values. The Five Forces Model evaluates the industry structure in terms of the threat of new entrants, the bargaining power of buyers, the bargaining power of suppliers, the rivalry among existing players, and the threat of substitute products.

6. (b) Stars

Stars are those business units that have a large relative market share in fast growing markets or industries. Firms need to invest in Stars as the industry is still emerging and the market share is also growing. Hence, they represent the best long-run opportunity in a firm's portfolio. For example, in a growing tobacco export market, if a firm's tobacco exports division records high market share, it will be treated as a Star business. Cash cows hold a large market share in a mature and slow-growing industry. These businesses have a strong business position and negligible investment requirements and hence the returns from these businesses are often more than their investment requirements. Question marks have a small relative market share in a high growth market. They demand significant investment because their cash needs are high, a norm in a growing industry. Dogs have low relative market share in an intensely competitive mature industry characterized by low profits. A Dog does not need much of investment, but it ties up capital that could be invested in industries with better returns.

7. (a) Cash cows

Cash cows have a strong business position and negligible investment requirements and hence the returns from these businesses are often more than their investment requirements. For example, if the home detergent industry in India grows at a slow pace and the home detergent powder division of Hindustan Unilever Limited enjoys the market leader position, it would be treated as a Cash cow. Firms need to invest in Stars as the industry is still emerging and market share is also growing. Often, the investment requirements of Stars are greater than the revenues they generate. Question marks demand significant investment because their cash needs are high, a norm in a growing industry. A Dog does not need much of an investment but it ties up capital that could be invested in industries with better returns.

8. (d) Stars

Stars have a large relative market share, and the firms need to invest in them as the industry is still emerging and the market share is also growing. For example, in the Indian mobile industry, Airtel is the Star business line for the Bharti group. This is because the Indian telecom industry has been growing at a good pace since its deregulation in the late 1990s. To expand its telecom business further and retain or increase its market share, Bharti needs to invest more in the near future.

9. (d) Question marks

Question marks have a small relative market share in a high growth market. However, because the market is growing at a high rate, they represent a good opportunity for investment. There is, however, no certainty that the high market growth rate will be sustained over a long period as the industry is still emerging. There is also a possibility that the firm may not be able to keep up with the growth rates of the market because the fund requirements are huge and the competitive pressures may also increase because the industry attracts new players due to high growth rates.

10. (a) Dogs

Dogs have a low relative market share in an intensely competitive mature industry characterized by low profits. Cash cows hold a large relative market share in a mature and slow-growing industry. Stars have a large relative market share in fast growing markets or industries. Question marks have a small relative market share in a high growth market.

11. (a) The GE grid

The GE nine cell model uses multiple factors to assess industry attractiveness and business strength. This model is a nine cell matrix and evaluates business entities on the parameters of industry attractiveness and business strength. The industry attractiveness is determined by the variables of market size and growth rate, industry profit margins, competitive intensity, seasonality, technology conditions, social, environmental, and legal and human impacts. The business strengths are determined by the firm's relative market share, its profit margins, its ability to compete on price and quality, its knowledge of the customer and market, competitive strengths and weaknesses, caliber of management, and technological capability.

12. (c) Only i, ii, and iv

The GE grid uses multiple factors to assess business strength. Some of the business strength factors taken into consideration are: knowledge of customers and markets, caliber of management, and the economies of scale which a firm enjoys. Emerging industry threats and opportunities is an industry attractiveness variable and not a business strength variable.

13. (c) Only i, iii, and iv

The GE nine cell planning grid helps in placing a business unit in one of the nine cells of the matrix, based on its industry attractiveness and business strength scores. The potential strengths of the grid are: it allows for intermediate ranking between high and low and between strong and weak; it incorporates a much wider variety of strategically relevant variables than the BCG matrix; and it stresses the channeling of corporate resources to businesses with the greatest probability of achieving competitive advantage and superior performance. The GE grid is a complicated and cumbersome process and not a simple and easily manageable process.

14. (b) Only i, ii, and iv

Strengths are the resources, skills, or other advantages the firm enjoys relative to its competitors. Some of the strengths that a company may possess are: goodwill and image in the market for goods and services; access to the best distribution network; the discipline, morale, attitude, and manners of the employees; and market leadership. Increased bargaining power of key buyers or suppliers is a threat for an organization and not strength.

15. (b) Decreased bargaining power of key buyers or suppliers

A threat refers to an extremely unfavorable situation in the firm's environment. Some threats to a firm may be: entry of resourceful multinational companies/competitors, **increased** bargaining power of key buyers or suppliers, a quick rate of obsolescence due to major technological changes, and adverse changes in government policies, rules, and regulations. The decreased bargaining power of key buyers or suppliers is an opportunity and not a threat.

16. (d) The greater the firm's dependence on external factors, the higher will be the range and flexibility of its strategic choice.

The greater the firm's dependence on external factors, the lower will be the range and flexibility of its strategic choice. For example, the Indian mobile industry in the initial stages was highly regulated, which reduced the range and flexibility of strategic choice which a firm could enjoy.

Business Policy & Strategy

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