MODULE 1

Analyze your firm’s internal fit
Defining Strategy and Introduction to Internal Fit
Three types of fit to evaluate a strategy

**Content:** Positioning, Activities, Capabilities …

**Process:** Incentives, Org structure …

**External**

- Industry, Competition, Regulation …

**Dynamic fit**

- Competitor reactions, Technological change, Demand changes …

**Internal**

- Strategic, Organizational, Functional …
Strategy Audit

Tools

- Industry Analysis
- Scenarios
- Drivers of Cost and WTP
- Strategic Positioning
- Value Chain
- Activity System

Industry Background

Firm Positioning

Activities, Resources, Capabilities

Strategic Initiatives
The elements of a strategy

Strategy = Distinctive array of interdependent choices that address:

- A desired outcome
- Where to compete (market positioning)
  - Product
  - Customers
  - Geography
- Value proposition
- Source of CA (strategic positioning)
  - High-level (cost vs. differentiation)
  - Detailed level (activities, resources, capabilities)
Strategy: Intended versus Emergent

“Let chaos reign, then rein in chaos—repeatedly.” (Andy Grove)
Internal Fit

• Focus on one particular tool: mapping an activity system (system of interdependent choices)

• Two motivations
  • Creates clarity around the source and sustainability of competitive advantage
  • Helps with change initiatives
Difference between OE and SP
What does it mean to have a CA?

\[ \text{CA } \propto (P - C) \]

Can you achieve this by imitating what other firms do?
No, but…. 

- What about 
  - TQM 
  - JIT 
  - Six sigma 
  - Benchmarking 
  - Best practices
Operational Effectiveness ≠ Strategy

Operational Effectiveness
- Achieving and extending best practice

Strategic Positioning
- Creating a unique and sustainable competitive position

Determinants of company performance

- Improving operational effectiveness is necessary to achieving superior profitability, but it is **not sufficient**
  - Absolute but not relative improvement
  - Competitive convergence due to imitation

Many things vs single advantage
OK, we need to do something different…

- In order to make our competitive advantage sustainable, i.e., to make it more difficult for others to imitate us, should we do
  - one thing differently?
  - many things differently?
“Many things” sounds intuitive, but….

What about

- Core competence
- Key success factors
- Critical resources ????
In general

- “Silver bullet” strategies tend to be very fragile
  - Everyone knows your source of competitive advantage, thereby focusing imitation attempts
  - Environmental shifts may make your key success factor not as important anymore
“One” might be enough if...

- Legally protected (patent)
- It has major beneficial (for you) impact on industry structure
  - Huge investment
  - Entry deterring
  - Commitment (specialized, durable, non-tradable)
Companies are collections of discrete activities, in which competitive advantage resides.

Production Possibilities Frontier
Operational Effectiveness vs. Strategic Positioning

What is Strategy?

Strategy is a race to one ideal position

Strategy is the creation of a unique and valuable position, involving a different set of activities
Non-linearity and Example: Southwest Airlines
Non-linearity

- If competitors copy 70% of your activities
  - and they get 70% of the benefits => bad news
  - and they get <70% of the benefits => better news
  - and they get -10% to 10% of the benefits => good news

- Interactions among activities create such non-linearities
What is the source of Southwest Airlines’ Competitive Advantage?

Core Competency Perspective

- Ability to turn planes around quickly
  - Incentive systems
  - Flexible union contracts
Limited Passenger Service
- Short-haul, point-to-point routes between medium-sized cities and secondary airports
- Very Low Ticket Prices
- Limited use of travel agents
- Standardized fleet of 737 aircraft
- Automatic Ticketing Machines

Lean, Highly Productive Ground and Gate Crews
- Frequent, Reliable Departures
- 15-Minute Gate Turns
- High employee compensation
- Flexible union contracts
- High employee stock ownership

High Aircraft Utilization
- 15-Minute Gate Turns
- High employee compensation
- Flexible union contracts
- High employee stock ownership

Frequent, Reliable Departures
- High employee compensation
- Flexible union contracts
- High employee stock ownership

Southwest Airlines Activity System

## Continental Airlines: “Continental Lite”

### Activities Matching Southwest on a Subset of Routes

<table>
<thead>
<tr>
<th>Activities Matching Southwest on a Subset of Routes</th>
<th>Activities Changed Across the Board</th>
<th>Activities Left Unchanged</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Point-to-point route network within Continental’s hub-and-spoke system</td>
<td>• Reduced commissions to travel agents</td>
<td>• Maintained position as full-service airline</td>
</tr>
<tr>
<td>• First class service eliminated</td>
<td>• Ended upgrades and promotions on frequent-flier program</td>
<td>• Continued use of existing hub-and-spoke system</td>
</tr>
<tr>
<td>• Meals on Lite flights eliminated</td>
<td>• Overhaul of fare structure for short flights</td>
<td>• Maintain fleet of several types of aircraft</td>
</tr>
<tr>
<td>• Fares lowered</td>
<td>• Focus 75% of advertising budget on Lite service</td>
<td>• Interline baggage checking and seat assignments</td>
</tr>
<tr>
<td>• Quickened turnaround time at gate</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Continental Lite: Outcome

- Severe operating problems including delays and cancellations
- Alienated passengers, frequent fliers, corporate clients and travel agents
  - 1,000 complaints a day, customer defections to other airlines
- Customer confusion about Continental service
- Overcapacity: mimicking Southwest led to frequent departures to cities that did not need the service

- Matched Southwest’s prices without matching its low costs
- Lost hundreds of millions of dollars
- CEO was fired
Tradeoffs and IKEA example
Fighting imitation

- Interactions drive both complexity and tradeoffs

- The role of complexity
  - Increases the difficulty of wholesale imitation
  - Decreases the value of partial imitation

- The role of tradeoffs
  - Decreases the desirability of imitation
  - Deters straddling, because straddling is costly
    - Inconsistencies in reputation
    - Different set of optimal activities
    - Limits on internal coordination and control

- The choice of what not to do is a central part of strategy
  - This is not easy to do; “Failure to choose”
  - Most common problem: Growth trap
<table>
<thead>
<tr>
<th>IKEA</th>
<th>Typical Furniture Retailer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited variety, no custom options</td>
<td>Extensive variety, customization of fabrics, colors, finishes</td>
</tr>
<tr>
<td>Centralized, in-house design of all products</td>
<td>Purchase from the lines of outside suppliers</td>
</tr>
<tr>
<td>Furniture design and manufacture heavily influenced by cost</td>
<td>Design and manufacturing heavily influenced by image/style/materials</td>
</tr>
<tr>
<td>Huge warehouse stores to display entire line</td>
<td>Stores display partial line</td>
</tr>
<tr>
<td>Self-selection. Information in the form of catalogs, do-it-yourself videos, explanatory ticketing</td>
<td>Extensive sales assistance</td>
</tr>
<tr>
<td>Large on-site inventories</td>
<td>Low inventories/order with lead time</td>
</tr>
<tr>
<td>Childcare provided in the store</td>
<td>No arrangements for children</td>
</tr>
<tr>
<td>Long hours of operation</td>
<td>Traditional retail hours</td>
</tr>
<tr>
<td>Suburban locations with large parking lots</td>
<td>Urban/suburban locations</td>
</tr>
<tr>
<td>Assembly by customers</td>
<td>Fully assembled furniture</td>
</tr>
<tr>
<td>Self delivery by customers</td>
<td>Provide delivery</td>
</tr>
</tbody>
</table>
Self-Selection by Customer

Limited Customer Service

Manufacturing Cost

Low

Modular furniture Design

Limited Sales Staffing

Increased likelihood of follow-on purchase

In-house design focused on cost of manufacturing

Year-round stocking

Most items in inventory

Ample inventory on site

High traffic store layout

Suburban locations with ample parking

Self-transport by customers

Explanatory catalogues, informative displays and labels

Ease of transport and assembly

'Search-down' kit packaging

Self-assembly by customers

High variety with ease of manufacturing

Limited Items in Inventory

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Limited Items in Inventory

Summary: NUMMI Example and Intel’s Copy Exactly Method
Summary: NUMMI Example and Intel’s Copy Exactly Method

NUMMI example
Intel copy exactly
Strategic continuity

- **Strategic continuity** over sustained periods contributes strongly to sustainable competitive advantage
  - Reinforces identity with customers and channels
  - Builds truly unique capabilities and skills
  - Sharpens understanding of tradeoffs
  - Extends and strengthens the fit among activities
  - Saves costs and confusion associated with frequent shifts in positioning

- Strategic continuity must be combined with continuous improvement in operational effectiveness

- There is a tension between achieving sustainable advantage and maintaining the flexibility to respond to any conceivable environmental change
In sum

- Positions built on activity systems are far more sustainable than those built on individual activities
  - Harder for a rival to match the whole system than to imitate one feature, product or service
  - Difficult to discern relevant parts from outside the company (but sometimes also within)

- Incompatible activity systems, because of tradeoffs, are what underlie the most viable strategic positions

- Interaction among activities is fundamental both to competitive advantage and sustainability
Use of Activity Systems for Organizational Change
Use of Activity Systems

- Consistency check of present implementation of positioning
- Uniqueness check (What are the roots of our competitive advantage?)
Another example: Case facts

- Setting: U.S., early 1990s
- Firm: very successful women’s fashion apparel manufacturer

- Low cost due to pioneering production in Far East
- Many small suppliers; little technology (on both sides)
- Mix-and-match design
- Design and presentation of clothes as “collections”
- Support/training for floor presentation

- Long lead times between design and delivery
- Late presentations
- No-cancellation policy; no-reordering
- Six design cycles (six seasons)
- Focus on large department stores
- No sales force; sell only in NY
Need to adapt

• Up to now, the firm was able to shift inventory onto customers
• Now, customers demand re-ordering
  – shift of product range
  – customer cash constraints
  – competitors
• What to do?
Liz Claiborne’s Activity System (1980s)

**Product Portfolio**
- Liz&Co
- LizWear
- LizSport
- Dana Buchman
- Elizabeth
- Accessories

**Fashion apparel for the professional woman**

**Production and Distribution**
- No reordering
- No production to order
- Long lead times
- Small suppliers
- Overseas suppliers
- Six collections
- No cancellation policy
- No splashy advertising
- Low design technology
- Stylish yet conservative design
- Mix-and-match design
- Consistency of color
- Late presentation and delivery
- Low spending on information systems and distribution
- Underproduction

**Marketing**
- Image of friend
- No splashy advertising
- Stylish yet conservative design
- Mix-and-match design
- Consistency of color
- Low spending on information systems and distribution

**Design**
- Claibords
- Presentation as collection
- Sales consultants
- Retail associates
- Concept shops
- LizWeek presentations
- Underproduction

**Presentation**
- Accessory concept shops
- Concept shops
- LizWeek presentations

**Selling Process**
- Excellent sales force
- Selling entire groups only
- Sales only in NY
- Focus on large customers
- Underproduction

Lower total cost to customers (price, search, lifetime)
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**Presentation**
- Accessory concept shops
- Concept shops
- Liz Week presentations
- Sales consultants
- Retail associates
Choices in 1997

Product Portfolio
- Apparel for women at every price point
  - moderate: First Issue, The Villager
  - better: Liz Casual
  - bridge: Dana Buchman
  - better: Liz Claiborne Collection
  - upper moderate: Emma James
- accessories

Marketing
- rejuvenating image
  - Niki Taylor
  - NY flagship

Design
- Consistency of color
- Mix-and-match design and mix-and-match across divisions
- Close design coordination
- Partial production to order

Production and Distribution
- Reordering for certain styles
- increased spending on IT systems and distribution
- Reduced lead times
- shift towards western hemisphere suppliers
- four collections

Presentation
- accessory concept shops
- LizEdge
- LizView
- Presentation as collection
- Sales associates
- Liz & Learn

Selling Process
- Selling entire groups only
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Lower total cost to customers
- Price
- Search Cost
- Time Value

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Lower total cost to customers
- Price
- Search Cost
- Time Value
Use of Activity Systems

- Consistency check of present implementation of positioning
- Uniqueness check (What are the roots of our added value?)
- Consistency check for future expansions
- Guide for changes to system (What can stay constant? What has to change?)
Interactions
Definition 1: Two choices/activities A and B are complementary if doing more of activity A increases the marginal benefit of B, and vice versa.

For the engineers watching: If $\Pi(x_1, x_2, \ldots)$ is our profit function, then the cross partial derivative $\frac{\partial^2 \Pi}{\partial x_1 \partial x_2}$ is positive.

For those of us who don’t have an intuitive feeling for cross-partial derivatives, we need a different thought experiment…
Test for complementarities

Pick one variable set it at a low value, ask what is the marginal benefit of increasing the other variable...

Example: product variety and flexibility of machinery

Example: product variety and investment in inventory management system
Summary: Central Questions of Strategy
Central Questions

- What are the explicit tradeoffs underlying our strategy?
- Which of our activities are best practices (operational effectiveness); which of our activities strengthen our strategic positioning? => Where is the source of our sustainable CA?
Strategy, Operational Effectiveness, Best Practices

• Thought Experiment: If my competitor were to imitate activity/choice A would they get the same benefit from it as I do?
  – Yes = industry best practice => probably not a source for sustainable CA
  – No, I get more benefit from it because the way it is embedded in my system of choices = firm/strategy-specific (good/best) practice

• Each strategic positioning has its own set of activities that yield maximal operational effectiveness, so strategy and OE go hand in hand, but…
• How do we strengthen, protect, extend these activities?

• What are the implications for our existing AS when we add new activities (when we expand)?
Describe the value chain of your organization.

1. Change the labels on the various activity “buckets” if necessary.

2. For each stage of the value chain, list the key activities that your firm is engaged in.

3. Ask yourself which activities are particularly distinct, i.e., different from those of your competitors.
Mapping your Company’s Activity System

Assignment

Please draw your firm’s System of Interdependent Choices (refer back to the value chain that you have drawn in Assignment 1)

Identify which choices are best practices, vs which choices are truly enhancing your distinctiveness. (Fill out the following worksheet)
Mapping Activity Systems

- Identify overarching positioning choices
- Identify activities/choices (value chain analysis)
- Relate activities to positioning
- Examine pairwise reinforcement
- Look for choices that have many interconnections
  - other core choices than those already identified?
- Sketch an activity map
Example: Vanguard

- First stab at overarching positioning choices:
  - Focus on low cost
  - Focus on conservatively managed funds
  - Focus on long-term performance
  - Mutual structure
Example: Vanguard
Value Chain of Typical Mutual Fund Provider

Organizational Structure

Human Resource Practices

Asset Management
Account Management
Selling & Marketing
Information & Customer Service

Product Portfolio
Vanguard’s Selling and Marketing Choices
What they do/What they don’t do

- Direct distribution, 1-800 (toll-free) number; internet
- No-load
- No retail branches
- Little advertising
- Decline assets if considered “hot” money
Assume our competitor were to duplicate our activity/choice A. Would they get the same benefit from it as we do (= OE)? Would we get a higher benefit from it, given the way A is embedded in our activity system (= SP)?

<table>
<thead>
<tr>
<th>Activity/Choice</th>
<th>OE or SP</th>
<th>Why?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most refined pricing system</td>
<td>SP</td>
<td>Higher benefit due to more heterogeneous customers</td>
</tr>
</tbody>
</table>
Choices and Tradeoffs Assignment

What do we NOT do?
What do we do differently?
What are the tradeoffs arising from our choices?
How do we communicate these tradeoffs, these choices within our firm? How do we make sure people know what NOT to do?