



Chapter

2

STRATEGY ANALYSIS

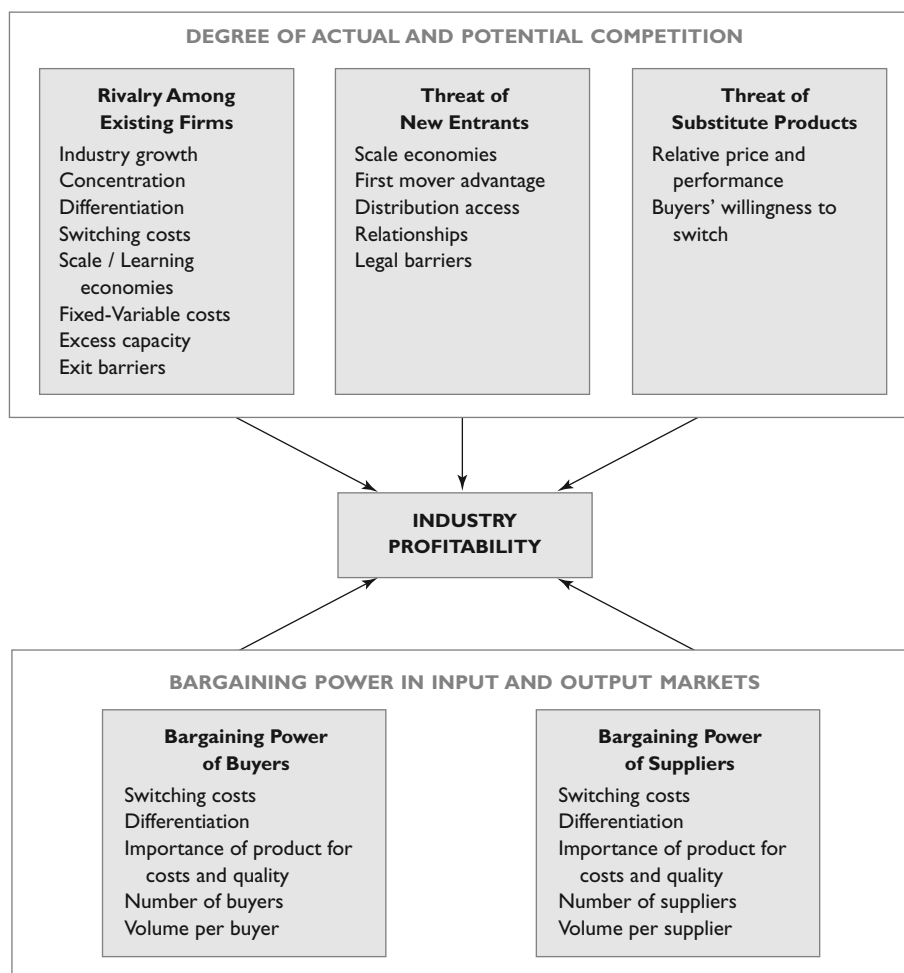
Strategy analysis is an important starting point for the analysis of financial statements. Strategy analysis allows the analyst to probe the economics of a firm at a qualitative level so that the subsequent accounting and financial analysis is grounded in business reality. Strategy analysis also allows the identification of the firm's profit drivers and key risks. This in turn enables the analyst to assess the sustainability of the firm's current performance and make realistic forecasts of future performance.

A firm's value is determined by its ability to earn a return on its capital in excess of the cost of capital. What determines whether or not a firm is able to accomplish this goal? While a firm's cost of capital is determined by the capital markets, its profit potential is determined by its own strategic choices: (1) the choice of an industry or a set of industries in which the firm operates (industry choice), (2) the manner in which the firm intends to compete with other firms in its chosen industry or industries (competitive positioning), and (3) the way in which the firm expects to create and exploit synergies across the range of businesses in which it operates (corporate strategy). Strategy analysis, therefore, involves industry analysis, competitive strategy analysis, and corporate strategy analysis.¹ In this chapter, we will briefly discuss these three steps and use the U.S. retail department store industry, Nordstrom Inc., and the Tata Group, respectively, to illustrate the application of the steps.

INDUSTRY ANALYSIS

In analyzing a firm's profit potential, an analyst has to first assess the profit potential of each of the industries in which the firm is competing. While specific industry profitability can change over time as the industry evolves, in general the profitability across industries has tended to differ systematically. For example, an analysis of financial results of all U.S.-based companies between 1991 and 2009 shows a ratio of earnings before interest and taxes to the book value of assets of 4.9 percent. However, the average returns varied widely across specific industries: for example, the passenger airline industry group (SIC code 4512), which has struggled with intense competition and low profitability since deregulation in the late 1970s, has seen a 1.8 percent return over the study period. In contrast, the pharmaceutical preparations industry group (SIC code 2834) returned 14.6 percent on average over the period.² These are illustrative—there are even more extreme examples. What causes these profitability differences?

There is a vast body of research in industrial organization on the influence of industry structure on profitability.³ Relying on this research, strategy literature suggests that the

FIGURE 2-1 Industry Structure and Profitability

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average profitability of an industry is influenced by the “five forces” shown in Figure 2-1.⁴ According to this framework, the intensity of competition determines the potential for creating abnormal profits by the firms in an industry. Whether or not the potential profits are kept by the industry is determined by the relative bargaining power of the firms in the industry and their customers and suppliers. We will discuss each of these industry profit drivers in more detail below.

Degree of Actual and Potential Competition

At the most basic level, the profits in an industry are a function of the maximum price that customers are willing to pay for the industry’s product or service. One of the key determinants of the price is the degree to which there is competition among suppliers of the same or similar products. At one extreme, if there is a state of perfect competition in the industry, micro-economic theory predicts that prices will be equal to marginal cost, and there will be few opportunities to earn supernormal profits. At the other extreme, if the industry is dominated by a single firm, there will be potential to earn

monopoly profits. In reality, the degree of competition in most industries is somewhere in between perfect competition and monopoly.

There are three potential sources of competition in an industry: (1) rivalry between existing firms, (2) threat of entry of new firms, and (3) threat of substitute products or services. We discuss each of these competitive forces in the following paragraphs.

Competitive Force 1: Rivalry among Existing Firms

In most industries the average level of profitability is primarily influenced by the nature of rivalry among existing firms in the industry. In some industries firms compete aggressively, pushing prices close to (and sometimes below) the marginal cost. In other industries firms do not compete aggressively on price. Instead, they find ways to coordinate their pricing, or compete on non-price dimensions such as innovation or brand image. Several factors determine the intensity of competition among existing players in an industry:

Industry Growth Rate If an industry is growing very rapidly, incumbent firms need not grab market share from each other to grow. In contrast, in stagnant industries the only way existing firms can grow is by taking share away from the other players. In this situation one can expect price wars among firms in the industry.

Concentration and Balance of Competitors The number of firms in an industry and their relative sizes determine the degree of concentration in an industry.⁵ The degree of concentration influences the extent to which firms in an industry can coordinate their pricing and other competitive moves. For example, if there is one dominant firm in an industry (such as Microsoft or Intel in the 1990s), it can set and enforce the rules of competition. Similarly, if there are only two or three similarly sized players (such as Coca-Cola and Pepsi in the U.S. soft drink industry), they can implicitly cooperate with each other to avoid destructive price competition. If an industry is fragmented, price competition is likely to be severe, as can be seen in the hotel/motel and construction industries.

Degree of Differentiation and Switching Costs The extent to which firms in an industry can avoid head-on competition depends on the extent to which they can differentiate their products and services. If the products in an industry are very similar, customers are ready to switch from one competitor to another purely on the basis of price. Switching costs also determine customers' propensity to move from one product to another. When switching costs are low, there is a greater incentive for firms in an industry to engage in price competition. The PC industry, where the standardization of the software and microprocessor has led to relatively low switching costs, is extremely price competitive.

Scale/Learning Economies and the Ratio of Fixed to Variable Costs If there is a steep learning curve or there are other types of scale economies in an industry, size becomes an important factor for firms in the industry. In such situations, there are incentives to engage in aggressive competition for market share. Similarly, if the ratio of fixed to variable costs is high, firms have an incentive to reduce prices to utilize installed capacity. The airline industry, where price wars are quite common, is an example of this type of situation.

Excess Capacity and Exit Barriers If capacity in an industry is larger than customer demand, there is a strong incentive for firms to cut prices to fill capacity. The problem of excess capacity is likely to be exacerbated if there are significant barriers for firms to exit the industry. Exit barriers are high when the assets are specialized or if there are regulations which make exit costly. The competitive dynamics of the global automotive industry demonstrates these forces at play.

Competitive Force 2: Threat of New Entrants

The potential for earning abnormal profits will attract new entrants to an industry. The very threat of new firms entering an industry potentially constrains the pricing of existing firms within it. Therefore, the ease with which a new firm can enter an industry is a key determinant of its profitability. Several factors determine the height of barriers to entry in an industry:

Economies of Scale When there are large economies of scale, new entrants face the choice of having either to invest in large capacity which might not be utilized right away, or to enter with less than the optimum capacity. Either way, new entrants will at least initially suffer from a cost disadvantage in competing with existing firms. Economies of scale might arise from large investments in research and development (the pharmaceutical or jet engine industries), in brand advertising (soft drink industry), or in physical plant and equipment (telecommunications industry).

First Mover Advantage Early entrants in an industry may deter future entrants if there are first mover advantages. For example, first movers might be able to set industry standards or enter into exclusive arrangements with suppliers of cheap raw materials. They may also acquire scarce government licenses to operate in regulated industries. Finally, if there are learning economies, early firms will have an absolute cost advantage over new entrants. First mover advantages are also likely to be large when there are significant switching costs for customers once they start using existing products. For example, switching costs faced by the users of Microsoft's Windows operating system make it difficult for software companies to market a new operating system.

Access to Channels of Distribution and Relationships Limited capacity in the existing distribution channels and high costs of developing new channels can act as powerful barriers to entry. For example, a new entrant into the domestic auto industry in the United States is likely to face formidable barriers because of the difficulty of developing a dealer network. Tesla Motors, the California-based electric automobile manufacturer that has gained a lot of positive press for its sporty electric roadster, called out this risk in its 2010 pre-IPO S1 filing with the SEC.⁶ In addition, its 2010 strategic partnership with Toyota has been seen by many as a way to leap this barrier by gaining access to Toyota's extensive dealer network. Existing relationships between firms and customers in an industry are another barrier that can make it difficult for new firms to enter an industry. Examples of industries where this is a factor include auditing and investment banking.

Legal Barriers There are many industries in which legal barriers such as patents and copyrights in research-intensive industries limit entry. Similarly, licensing regulations limit entry into taxi services, medical services, broadcasting, and telecommunications industries.

Competitive Force 3: Threat of Substitute Products

The third dimension of competition in an industry is the threat of substitute products or services. Relevant substitutes are not necessarily those that have the same form as the existing products but those that perform the same function. For example, airlines and car rental services might be substitutes for each other when it comes to travel over medium distances. Similarly, plastic bottles and metal cans substitute for each other as packaging in the beverage industry. In some cases, threat of substitution comes not from customers' switching to another product but from utilizing technologies that allow them to do without, or use less of, the existing products. For example, energy-conserving technologies allow customers to reduce their consumption of electricity and fossil fuels.

The threat of substitutes depends on the relative price and performance of the competing products or services and on customers' willingness to substitute. Customers' perception of whether two products are substitutes depends to some extent on whether they perform the same function for a similar price. If two products perform an identical function, then it would be difficult for them to differ from each other in price. However, customers' willingness to switch is often the critical factor in making this competitive dynamic work. For example, even when tap water and bottled water serve the same function, many customers may be unwilling to substitute the former for the latter, enabling bottlers to charge a price premium. Similarly, designer label clothing commands a price premium even if it is not superior in terms of basic functionality because customers place a value on the image or style offered by designer labels.

Bargaining Power in Input and Output Markets

While the degree of competition in an industry determines whether there is *potential* to earn abnormal profits, the *actual profits* are influenced by the industry's bargaining power with its suppliers and customers. On the input side, firms enter into transactions with suppliers of labor, raw materials and components, and finances. On the output side, firms either sell directly to the final customers or enter into contracts with intermediaries in the distribution chain. In all these transactions, the relative economic power of the two sides is important to the overall profitability of the industry firms.

Competitive Force 4: Bargaining Power of Buyers

Two factors determine the power of buyers: price sensitivity and relative bargaining power. Price sensitivity determines the extent to which buyers care to bargain on price; relative bargaining power determines the extent to which they will succeed in forcing the price down.⁷

Price Sensitivity Buyers are more price sensitive when the product is undifferentiated and there are few switching costs. For example, Windows-based personal computers are seen by customers as close substitutes of each other, and hence purchasing decisions among different brands of PCs is heavily influenced by price. The sensitivity of buyers to price also depends on the importance of the product to their own cost structure. When the product represents a large fraction of the buyers' cost (for example, the packaging material for soft drink producers), the buyer is likely to expend the resources necessary to shop for a lower cost alternative. In contrast, if the product is a small fraction of the buyers' cost (for example, windshield wipers for automobile manufacturers), it may not pay to expend resources to search for lower-cost alternatives. Further, the importance of the product to the buyers' own product quality also determines whether or not price becomes the most important determinant of the buying decision. The explosion in compensation paid to marquee sports figures can be seen as an example of this type of phenomenon because these players are viewed by teams as critical to their fan appeal and success as a franchise.

Relative Bargaining Power Even if buyers are price sensitive, they may not be able to achieve low prices unless they have a strong bargaining position. Relative bargaining power in a transaction depends, ultimately, on the cost to each party of not doing business with the other party. The buyers' bargaining power is determined by the number of buyers relative to the number of suppliers, volume of purchases by a single buyer, number of alternative products available to the buyer, buyers' costs of switching from one product to another, and the threat of backward integration by the buyers. For example, in the automobile industry, car manufacturers have considerable power over component

manufacturers because auto companies are large buyers with several alternative suppliers to choose from, and switching costs are relatively low. In contrast, in the personal computer industry, computer makers have low bargaining power relative to the operating system software producers because of high switching costs.

Competitive Force 5: Bargaining Power of Suppliers

The analysis of the relative power of suppliers is a mirror image of the analysis of the buyer's power in an industry. Suppliers are powerful when there are only a few companies and few substitutes available to their customers. For example, in the soft drink industry, Coke and Pepsi are very powerful relative to the bottlers. In contrast, metal can suppliers to the soft drink industry are not very powerful because of intense competition among can producers and the threat of substitution by plastic bottles. Suppliers also have a great deal of power over buyers when the suppliers' product or service is critical to buyers' business. Microsoft's power in the personal computer industry is a good example of this. Suppliers also tend to be powerful when they pose a credible threat of forward integration. For example, IBM is powerful relative to mainframe computer leasing companies because of its unique position as a mainframe supplier and its own presence in the computer leasing business.

APPLYING INDUSTRY ANALYSIS: THE U.S. RETAIL DEPARTMENT STORE INDUSTRY

Let us consider the above concepts of industry analysis in the context of the U.S. retail department store industry. The growth of cities and mass production techniques spurred the emergence of retail clothing stores in the late 1800s. The rapid expansion of the market in the twentieth century fostered the development of regional and national chains that gave the industry its concentrated profile we see today. While the major players originally located in stand-alone flagship locations in urban centers, the population migration out of cities and the rise of the suburban shopping mall in the mid-twentieth century resulted in these players positioning themselves as "anchor stores"—large department stores selling a wide range of apparel, accessories, and other related goods that "anchored" the broader shopping mall and its selection of smaller specialty stores.

Broadly stated, the industry can be segmented into high-end, middle market, and discount department stores. Table 2-1 shows profitability of select competitors in these three segments. The overall department store industry has historically earned higher than average returns when compared to all U.S. industries (analysis described above), with the high-end and discount segments outperforming the middle market. What has accounted for this above average industry return? Looking forward, what is the department store industry's future profit potential?

Competition in the U.S. Retail Department Store Industry

Industry analysis can help to explain the above average profitability seen in the department store industry. Key elements of industry structure:

- The industry is concentrated, with the four largest players accounting for over 75 percent of the industry revenue in 2009.⁸
- Consumer demand grew along with the growth in U.S. affluence for most of the twentieth and early twenty-first century. This has meant that department stores have typically experienced growth without having to resort to high levels of price competition in an effort to steal market share from competitors.

TABLE 2-1

Retail Department store pre-tax profitability—select competitors 1991–2009

Company	EBIT/Net Assets
Neiman-Marcus Group, Inc. ^a	11.8%
Saks Inc / Saks Holdings, Inc.	5.2%
Nordstrom Inc.	<u>13.8%</u>
High-end segment average	10.3%
Sears Roebuck & Co / Sears Holding Group ^b	6.3%
Dillard's Inc.	6.4%
R H Macy & Co / Macy's Inc. ^c	7.0%
J C Penney Co.	<u>7.9%</u>
Middle market segment average	6.8%
Wal-Mart Stores, Inc.	12.4%
Target Corp	11.3%
TJX Companies Inc.	<u>22.1%</u>
Discount segment average	12.5%
Average of all retail department store segments	9.9% ^d
Average of all U.S. companies	4.9%

Source: Financial statement data for noted companies, industry, and all publicly traded U.S.-based companies from 1991–2009, listed in Research Insight. Analysis completed November, 2011.

^aNeiman-Marcus was taken private in 2006—results shown are through 2005.

^bIncludes Kmart beginning 2005 when the companies merged to form Sears Holding Group.

^cIncludes Bloomingdales, other brands, which make up about 10 percent of total revenues.

^dAverage of SIC codes 5311, 5331, and 5651 data 1991–2009. The representative group of competitors shown above mirrors the overall results of the department store industry with a return of 10.0 percent over the period.

- Competitors such as Nordstrom, Saks Fifth Avenue, and Neiman Marcus have successfully differentiated themselves on non-price parameters such as superior customer service, a differentiated product offering through the use of private label lines and exclusive designer relationships, loyalty programs, and an upscale shopping experience—all of which are designed to build customer loyalty and thus increase switching costs.
- There are significant economies of scale available to larger competitors, who have more power to obtain lower prices from their suppliers, to invest in sophisticated IT infrastructure to better understand customer needs and manage inventory, and to conduct national advertising campaigns. These economies of scale have been critical to the success of competitors pursuing a cost-leadership strategy (Wal-Mart, Target, TJX), who have been ruthless in streamlining their operations, reducing their cost from suppliers, and otherwise driving down their cost to bring product to market.
- Established competitors have strong brand recognition earned through years of effort, while a new competitor is faced with the need to expend large amounts of capital in order to gain this brand equity. This first mover advantage holds true not only in traditional physical stores but also in the realm of the Internet where consumers, lacking the ability to measure the quality of a store or product

by experiencing it firsthand, have tended to gravitate to established, “trusted” name brands.

- A new competitor in the industry would typically face a distribution constraint when seeking a prime retail location as established competitors have better access to prime retail locations and favorable terms since they are viewed as valuable “anchor” tenants that can ensure success of an entire development. With the increased use of the online channel, this barrier has been eased somewhat as a competitive factor in the industry.
- The rise of the online shopping channel as represented by online-only competitors such as Amazon.com has resulted in a large and growing threat of substitution for the traditional “bricks and mortar” stores. Competitors such as Nordstrom have aggressively developed their own online presence in an attempt to reduce this threat, while at the same time working to integrate their online and physical channels in order to leverage their physical presence to their advantage.

The Power of Buyers and Suppliers

Suppliers and buyers have limited power over firms in the industry for these reasons:

- Generally, buyers tend to have relatively low bargaining power with department stores—there is little or no “haggling” over price. Given the relative number of individual buyers to providers (high), buyers mainly are able to exert their ability to switch providers rather than to exert any relative strength in bargaining power.
- Suppliers to department stores also have low relative power due to their small size as compared to their clients. The expansion of the private label lines has also established a credible alternative to the designer lines, further reducing supplier power. Competitors in all segments of the department store industry have focused on building their power over suppliers. As an example, TJX added approximately 2,000 new suppliers in 2010 bringing their total global count to over 14,000.⁹ Also, Nordstrom has no guaranteed supply arrangements with its vendors,¹⁰ which allows it to maintain flexibility to adjust their products to meet current demand.

In recent years, industry dynamics have been shifting. First, growth in consumer demand slowed significantly during the recent global economic crisis, and there is speculation that it may not return to pre-crisis levels at least in the short term.¹¹ Also, the emergence of the Internet channel has begun to change consumer shopping behavior both online and off. The availability of price and product information has increased substitution as the consumer is able to make more informed buying decisions. The ease of shopping across multiple online outlets has reduced switching costs, and perhaps has served to reduce the value of the broad product offering of the retail department store model. In a similar offline shift, the rise of “lifestyle centers,” which emphasize smaller specialty retailers clustered in an attractive center, has de-emphasized the role of the anchor store. In general, the trend toward specialization would seem to be against the department store model.¹²

While it is not clear what additional structural changes will take place in the industry, what is clear is that the competitors who adapt will be the ones to survive and thrive. Nordstrom’s aggressive push to expand its online presence, TJX working to expand its global supplier base while pursuing a specialized offering strategy (Home Goods, Marshalls / TJ Maxx), and Wal-Mart’s push into China and other high growth potential emerging markets are examples of actions competitors are taking to adapt to the changing dynamics of the marketplace.

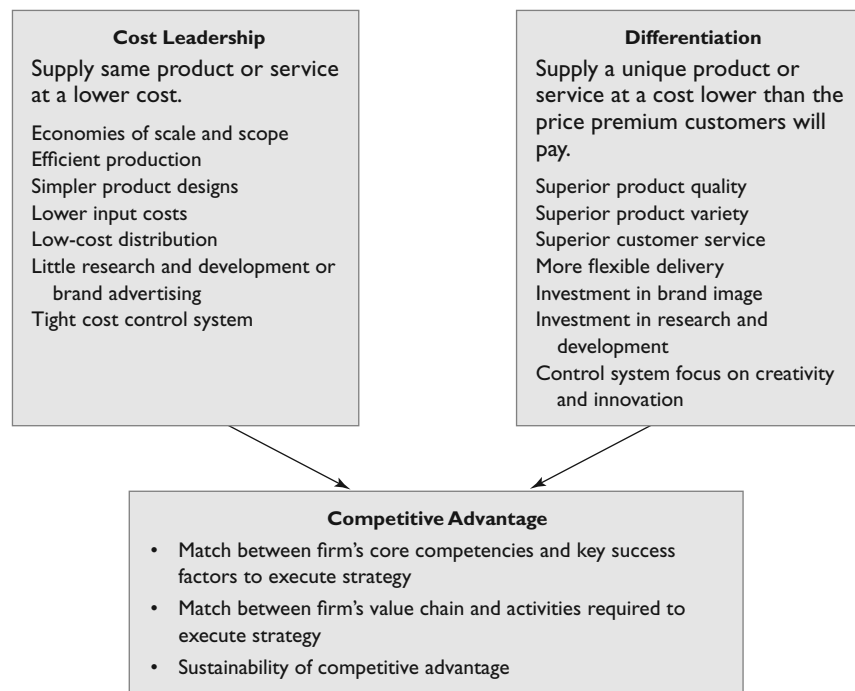
Limitations of Industry Analysis

A potential limitation of the industry analysis framework discussed in this chapter is the assumption that industries have clear boundaries. In reality, it is often not easy to demarcate industry boundaries. For example, in analyzing Nordstrom's industry, should one limit the analysis to large department store competitors, or also include smaller specialty retailers which compete with Nordstrom for market share? With the rise of the discount and off-price retailers, should one include Wal-Mart and TJX? Where do online retailers such as Amazon.com fit? Inappropriate industry definition will result in incomplete analysis and inaccurate forecasts, and thus it is important to correctly scope the industry segment to be considered.

COMPETITIVE STRATEGY ANALYSIS

The profitability of a firm is influenced not only by its industry structure but also by the strategic choices it makes in positioning itself in the industry. While there are many ways to characterize a firm's business strategy, research has traditionally identified two generic competitive strategies, (1) cost leadership and (2) differentiation, that can potentially allow a firm to build a sustainable competitive advantage.¹³ These strategies (shown in Figure 2-2) have broadly been seen as mutually exclusive—firms that straddle the two strategies are said to be “stuck in the middle” and expected to earn low profitability (the middle market department store competitors described in the last section are a good example of this).¹⁴ These firms, the thinking goes, run the risk of not being able to attract price-conscious customers because their costs are too high; they are also unable to provide adequate differentiation to attract premium price customers.

FIGURE 2-2 Strategies for Creating Competitive Advantage



Source: © Cengage Learning

Additional research has attempted to explain the apparent exception of certain competitors, for instance, the Japanese automotive industry, which for many years offered both higher quality and lower cost than its competitors in the United States and Europe. Generally, though, this ability to compete successfully from the “middle” has been attributed to a focus on operational effectiveness—not strategy—that has allowed them to continuously push the “productivity frontier” ahead of their competitors. This advantage is only expected to be sustainable if it could not eventually be duplicated allowing competitors to “catch up.”¹⁵

Sources of Competitive Advantage

Cost leadership enables a firm to supply the same product or service offered by its competitors at a lower cost. Differentiation strategy involves providing a product or service that is distinct in some important respect valued by the customer. We will illustrate both of these strategies using two companies in the U.S. retail department store industry. TJX Companies, Inc. (parent to stores such as T.J. Maxx and Marshalls) has been highly successful competing purely on a low-cost basis. Nordstrom, in contrast, has succeeded on the basis of differentiation by emphasizing exceptionally high customer service and broad, differentiated merchandise selection.

Competitive Strategy 1: Cost Leadership

Cost leadership is often the clearest way to achieve competitive advantage. In industries where the basic product or service is a commodity, cost leadership might be the only way to achieve superior performance. There are many ways to achieve cost leadership, including economies of scale and scope, economies of learning, efficient production, simpler product design, better sourcing and lower input costs, and efficient organizational processes. If a firm can achieve cost leadership, then it will be able to earn above-average profitability by merely charging the same price as its rivals. Conversely, a cost leader can force its competitors to cut prices and accept lower returns or to exit the industry.

Firms that achieve cost leadership focus on tight cost controls. They make investments in efficient scale plants, focus on product designs that reduce manufacturing costs, minimize overhead costs, capitalize on global sourcing opportunities, make little investment in risky research and development, and avoid serving marginal customers. They have organizational structures and control systems that focus on cost control.

Competitive Strategy 2: Differentiation

A firm following the differentiation strategy seeks to be unique in its industry along some dimension that is highly valued by customers. For differentiation to be successful, the firm has to accomplish three things. First, it needs to identify one or more attributes of a product or service that customers value. Second, it has to position itself to meet the chosen customer need in a unique manner. Finally, the firm has to achieve differentiation at a cost that is lower than the price the customer is willing to pay for the differentiated product or service.

Drivers of differentiation include providing superior intrinsic value via product quality, product variety, bundled services, or delivery timing. Differentiation can also be achieved by investing in signals of value such as brand image, product appearance, or reputation. Differentiated strategies require investments in research and development, engineering skills, and marketing capabilities. The organizational structures and control systems in firms with differentiation strategies need to foster creativity and innovation.

While successful firms choose between cost leadership and differentiation, they cannot completely ignore the dimension on which they are not primarily competing. Firms that target differentiation still need to focus on costs so that the differentiation can be achieved at an acceptable cost. Similarly, cost leaders cannot compete unless they achieve at least a minimum level on key dimensions on which competitors might differentiate, such as quality and service.

Achieving Competitive Advantage

The choice of competitive strategy does not automatically lead to the achievement of competitive advantage. To achieve competitive advantage, the firm has to have the capabilities needed to implement and sustain the chosen strategy. Both cost leadership and differentiation strategy require that the firm make the necessary commitments to acquire the core competencies needed and structure its value chain in an appropriate way. Core competencies are the economic assets that the firm possesses, whereas the value chain is the set of activities that the firm performs to convert inputs into outputs.

To evaluate whether a firm is likely to achieve its intended competitive advantage, the analyst should ask the following questions:

- What is the customer need that the company is focusing on?
- How does the company distinguish its customer value proposition from the alternative propositions available to the customers from its competitors?
- Does the firm currently have the key capabilities and processes to deliver its value proposition?

Sustaining Competitive Advantage

The uniqueness of a firm's core competencies and its value chain and the extent to which it is difficult for competitors to imitate them determine the sustainability of a firm's competitive advantage.¹⁶ Very few companies are able to sustain their competitive advantage over a long period of time. There are a number of reasons for this. First, successful strategies are often copied by competitors. This can only be prevented or delayed if there are explicit barriers such as patents or other legal protections, or implicit barriers such as customer switching costs or first mover advantages. The second reason why firms lose their competitive advantage is due to changes in the environment. New technologies, changes in regulation, changes in customer requirements make current value propositions obsolete or enable creation of new, substitute propositions that might be more attractive for customers. As industries and markets evolve over time, it is critical that a firm's strategy evolve as well in response. The competitors who will win over time will be the ones who will continually be alert to the need to adapt to changing industry dynamics.

To evaluate whether or not a firm is likely to sustain its competitive advantage, an analyst should ask the following questions:

- Are there any barriers to imitation in this company's strategy? If so, what are they? How long are they likely to last?
- Are there any changes that potentially affect this company's industry and its strategic position in that industry? What are they? In what way are these changes likely to lead to changes in the competitive dynamics in this industry?
- What actions, if any, can this company take to address these changes, and renew its competitive advantage? How likely is it that the company will be able to renew itself successfully?

Applying Competitive Strategy Analysis

Let us consider the concepts of competitive strategy analysis in the context of TJX and Nordstrom.

The TJX Companies, Inc.

TJX is the leading off-price apparel and home fashions retailer in the United States and worldwide. At the beginning of 2011, the company operated over 2,700 retail outlets through its T.J. Maxx, Marshalls, and HomeGoods brands in the United States; its Winners, Marshalls and HomeSense brands in Canada; and its T.K. Maxx and HomeSense brands in Europe.¹⁷

TJX pursues a cost leadership strategy, offering its customers a “rapidly changing assortment of quality, brand-name and designer merchandise at prices generally 20% to 60% below department and specialty store regular prices, every day.”¹⁸ In order to execute that strategy, the company has developed a low-cost, flexible business model that has at its core a focus on opportunistic buying of merchandise. Since TJX’s philosophy of presenting its customers with a “treasure hunt atmosphere” is not dependent on offering complete product lines, having all sizes available, or presenting a set mix of merchandise, it has the ability to buy partial lots, discontinued items, or cancelled orders. This opportunistic positioning allows TJX to purchase very late in the merchandising cycle, enabling it to react quickly to market trends, to negotiate the best deals, and to adjust pricing to maintain its margin.¹⁹ Key elements of this business model:

- Open store concept: The lack of set departments in its stores allows TJX to maintain an opportunistic product mix that targets current consumer tastes.²⁰
- Global sourcing network: In order to source product opportunistically with maximum effectiveness, TJX maintains a global sourcing network, which in 2011 consisted of 700 buyers managing 14,000 vendors across 60 countries. As TJX noted in its 2009 Annual Report, “One way to think about our business model is as more of a sourcing machine than most other retailers.”²¹
- Significant buying power: TJX quotes its “\$20 billion buying pencil”²² to describe the buying power its large scale gives it with vendors.
- Focus on efficient inventory management: True to its positioning as a low-cost competitor, TJX has an ongoing focus on increasing the efficiency of its supply chain.²³

TJX sees itself as well positioned to take advantage of what it sees as a permanent shift in consumer spending behavior as a result of the global financial crisis: “We believe that there has been a paradigm shift among consumers to value and that our new customers will continue to be attracted to our great values even as the recession abates.... What sets this recession apart from previous ones is that we have seen positive business trends accelerate during the recession, underscoring our belief that there has been a fundamental shift in the consumer psyche toward value.”²⁴

During fiscal year 2010 (ending January 29, 2011), TJX results seemed to bear out management’s viewpoint. Despite a challenging retail climate, sales increased by 8 percent to \$21.9 billion, with same store sales increasing by 4 percent. Cost of sales fell, reflecting improved merchandise margins and increased cost leverage. Overall, net income grew 11 percent to \$1.3 billion.²⁵ However, while TJX seemed to be executing its cost leadership strategy successfully, changes in the industry structure and moves by competitors had begun to raise questions about the long term sustainability of TJX’s competitive position. Key questions:

- **Will there be enough merchandise available to purchase?** As competitors such as Nordstrom and Saks Fifth Avenue rapidly expand their own off-price chains, an

ever-growing TJX could eventually face merchandise sourcing constraints as competitors increasingly retain product for their own off-price channels. TJX is cognizant of this potential issue and views its extensive global sourcing network and strong supplier relationships as key to its success in product procurement going forward.²⁶

- **Can TJX expand successfully outside of the United States?** TJX views continued expansion as key to maintaining its low-cost position over the long term by ever-increasing purchasing and operational leverage. However, as it increasingly looks outside the United States for growth, it remains to be seen whether it can achieve the same success internationally.
- **Is the shift to value permanent?** It remains to be seen whether this consumer shift that TJX sees is permanent. TJX has undertaken a program of store remodeling and has made additional advertising expenditures in order to capitalize on this shift.²⁷ It is an open question whether this expenditure will result in a permanent increase in market share.
- **What about the Internet?** As of 2011, TJX had almost no online presence. While it is not clear at this point what threat online retailing represents to the TJX “treasure hunt” model, moves by competitors, such as the recent purchase of HauteLook (an online apparel auction site) by Nordstrom and the increasing ubiquity of online retailing, raises the question of what TJX will need to do to defend itself against this substitute channel.

Nordstrom, Inc.

Nordstrom is a high-end department store offering a wide variety of apparel, shoes, and accessories. Founded as a shoe store in Seattle, Washington, in 1901, the company quickly became known for its broad selection of high-quality merchandise coupled with exceptional customer service. By 2011 the company had grown to be a leading retailer, operating 207 stores located in 28 states (both full-line Nordstrom and discount Nordstrom Rack stores) as well as a growing online presence. The company also offered a variety of private label credit and debit card products through Nordstrom fsb, its wholly-owned bank. The company posted 2010 annual earnings of \$613 million against annual revenues of \$9.7 billion.²⁸

Nordstrom’s success has historically been based on a competitive strategy of differentiation that has sought to build loyalty in consumers who have many retail purchase options. The key elements of that strategy:

- *Providing exceptional customer service:* From the beginning, Nordstrom has sought to differentiate itself in the market by providing exceptional customer service. A quote from the 2009 annual report sums up this customer-centric philosophy: “We follow, first and foremost, a customer strategy at Nordstrom—not a price, brand, technology or any other corporate strategy.”²⁹
- *Offering a broad selection of high-end, differentiated merchandise closely targeted to local tastes:* Nordstrom has sought to differentiate itself from competitors by low product overlap, which it has achieved with exclusive agreements with designers as well as by the development of an extensive private label line. In addition, Nordstrom prides itself on making buying decisions with local customer input, thus maximizing merchandizing success and minimizing inventory investments.

While the above broad strategic elements have served it well for much of its 110-year history, in recent years Nordstrom has recognized that the rapid expansion of the online channel and the rise of the discount retail model represent shifts in the market that could threaten the long-term sustainability of its differentiation strategy. As such,

Nordstrom's current strategy is to stay true to its original precepts of superior customer service and product selection, while adding additional initiatives that it views as critical to remaining competitive in an evolving marketplace. Key initiatives being undertaken in response to this market shift:

- *Diversification into the discount segment*—In response to the market shift towards the discount segment, Nordstrom has rapidly expanded its Nordstrom Rack division of off-price stores. This has served several purposes. First, in establishing its own discount entrant, it has “created its own substitute” for customers that would otherwise potentially be lost to a TJX or other discount retailer. Also, the Rack division gives Nordstrom a channel to move slow-selling inventory from its full-line stores without needing to resort to more frequent sales or markdowns that might erode the brand. Finally, given that the discount segment tends to perform better in poor economic times, this can be seen as adding counter-cyclical balance to the full-line store segment.
- *Expansion and integration of a multichannel presence*—Responding to the changing shopping habits of consumers, Nordstrom has recently undertaken a number of initiatives designed to expand its online presence and fully integrate its systems across all channels. In 2010 the company launched a new version of the Nordstrom.com website designed to more effectively serve the online shopper. The integration of inventory systems across channels has enabled seamless multichannel customer services such as “Buy Online, Pick Up in Store” and rapid fulfillment of online orders from local stores. Recent initiatives designed to further enhance the multichannel offering include the addition of Wi-Fi to its full-line stores, development of mobile checkout, and the acquisition of online retailer HauteLook, Inc.—a provider of online private sales.³⁰ In general, Nordstrom views the development of a seamless multichannel shopping experience as an extension of its focus on providing superior customer service and as critical to its continued ability to compete successfully in an evolving marketplace.

As the United States slowly began to emerge from the deep downturn that began in 2008, Nordstrom was a company taking steps to adapt to changing industry dynamics. In early 2011, analysts seemed to think that it was on the right track:

“JWN remains one of our top picks in the department store space.... We believe Nordstrom is the most technologically savvy of the large cap department stores. The acquisition of HauteLook not only introduces a new revenue stream, but should help the company further expand its internet marketing capabilities and monetize the multichannel customer (who spends 3-4x more than the store only customer).”³¹

“From its move in 2009/2010 to integrate its in-store and online inventory to its announcement yesterday of an acquisition of HauteLook, a leading online closeout channel, the Company remains well ahead of competitors in its online presence. Moreover, we think that this helps provide a long-term roadmap for growth...”³²

“We continue to believe Nordstrom is a longer term share winner...”³³

Analysts' opinions aside, it remains to be seen whether Nordstrom can maintain its superior competitive position going forward in the rapidly evolving industry landscape.

CORPORATE STRATEGY ANALYSIS

So far in this chapter we have focused on strategies at the individual business level. While some companies focus on only one business, many companies operate in multiple businesses. For example, the average number of business segments operated by the top

500 U.S. companies in 1992 was eleven industries.³⁴ In recent years, there has been an attempt by U.S. companies to reduce the diversity of their operations and focus on a relatively few “core” businesses. However, multi-business organizations continue to dominate the economic activity in most countries in the world.

When analyzing a multi-business organization, an analyst has to evaluate not only the industries and strategies of the individual business units but also the economic consequences—either positive or negative—of managing all the different businesses under one corporate umbrella. Some companies have viewed this multibusiness structure as a source of strength and have embraced it, while others have seen it as distracting and value dilutive and have moved to narrow their business focus. For example, General Electric has been very successful in creating significant value by managing a highly diversified set of businesses ranging from aircraft engines to light bulbs. In contrast, starting in 2000, the Swiss pharmaceutical giant Roche sold off its flavors and fragrances, vitamins, and fine chemicals businesses to focus on oncology and diagnostics.³⁵

Sources of Value Creation at the Corporate Level

Economists and strategy researchers have identified several factors that influence an organization’s ability to create value through a broad corporate scope. Economic theory suggests that the optimal scope of activity of a firm depends on the relative transaction cost of performing a set of activities inside the firm versus using the market mechanism.³⁶ Transaction cost economics implies that the multiproduct firm is an efficient choice of organizational form when coordination among independent, focused firms is costly due to market transaction costs.

Transaction costs can arise out of several sources. They may arise if the production process involves specialized assets such as human capital skills, proprietary technology, or other organizational know-how that is not easily available in the marketplace. Transaction costs also may arise from market imperfections such as information and incentive problems. If buyers and sellers cannot solve these problems through standard mechanisms such as enforceable contracts, it will be costly to conduct transactions through market mechanisms.

For example, as discussed in Chapter 1, capital markets may not work well when there are significant information and incentive problems, making it difficult for entrepreneurs to raise capital from investors. Similarly, if buyers cannot ascertain the quality of products being sold because of lack of information, or cannot enforce warranties because of poor legal infrastructure, entrepreneurs will find it difficult to break into new markets. Finally, if employers cannot assess the quality of applicants for new positions, they will have to rely more on internal promotions rather than external recruiting to fill higher positions in an organization. Emerging economies often suffer from these types of transaction costs because of poorly developed intermediation infrastructure.³⁷ Even in many advanced economies, examples of high transaction costs can be found. For example, in most countries other than the United States, the venture capital industry is not highly developed, making it costly for new businesses in high technology industries to attract financing. Even in the United States, transaction costs may vary across economic sectors. For example, electronic commerce continues to be hampered by consumer concerns regarding the security of credit card information sent over the Internet.³⁸

Transactions inside an organization may be less costly than market-based transactions for several reasons. First, communication costs inside an organization are reduced because confidentiality can be protected and credibility can be assured through internal mechanisms. Second, the head office can play a critical role in reducing costs of enforcing agreements between organizational subunits. Third, organizational subunits can

share valuable non-tradable assets (such as organizational skills, systems, and processes) or non-divisible assets (such as brand names, distribution channels, and reputation).

There are also forces that increase transaction costs inside organizations. Top management of an organization may lack the specialized information and skills necessary to manage businesses across several different industries. This lack of expertise reduces the possibility of actually realizing economies of scope, even when there is potential for such economies. This problem can be remedied by creating a decentralized organization, hiring specialist managers to run each business unit, and providing these managers with proper incentives. However, decentralization will also potentially decrease goal congruence among subunit managers, making it difficult to realize economies of scope.

Whether or not a multibusiness organization creates more value than a comparable collection of focused firms is, therefore, context dependent.³⁹ Analysts should ask the following questions to assess whether an organization's corporate strategy has the potential to create value:

- Are there significant imperfections in the product, labor, or financial markets in the industries (or countries) in which a company is operating? Is it likely that transaction costs in these markets are higher than the costs of similar activities inside a well-managed organization?
- Does the organization have special resources such as brand names, proprietary know-how, access to scarce distribution channels, and special organizational processes that have the potential to create economies of scope?
- Is there a good fit between the company's specialized resources and the portfolio of businesses in which the company is operating?
- Does the company allocate decision rights between the headquarters office and the business units optimally to realize all the potential economies of scope?
- Does the company have internal measurement, information, and incentive systems to reduce agency costs and increase coordination across business units?

Empirical evidence suggests that creating value through a multibusiness corporate strategy is difficult in practice. Several researchers have documented that diversified U.S. companies trade at a discount in the stock market relative to a comparable portfolio of focused companies.⁴⁰ Studies also show that acquisitions of one company by another, especially when the two are in unrelated businesses, often fail to create value for the acquiring companies.⁴¹ Finally, there is considerable evidence that value is created when multibusiness companies increase corporate focus through divisional spin-offs and asset sales.⁴²

There are several potential explanations for this diversification discount. First, managers' decisions to diversify and expand are frequently driven by a desire to maximize the size of their organization rather than to maximize shareholder value. Second, diversified companies often suffer from incentive misalignment problems leading to suboptimal investment decisions and poor operating performance. Third, capital markets find it difficult to monitor and value multibusiness organizations because of inadequate disclosure about the performance of individual business segments.

In summary, while companies can theoretically create value through innovative corporate strategies, there are many ways in which this potential fails to get realized in practice. Therefore, it pays to be skeptical when evaluating companies' corporate strategies.

Applying Corporate Strategy Analysis

Let's apply the concepts of corporate strategy analysis to the Tata Group, a diversified global company headquartered in India. Tata traces its beginnings to the founding of a private trading firm in 1868. In 2009-2010 the company reported revenues of

\$67.4 billion, employed almost 400,000 people, and had operations in over 80 countries.⁴³ Its structure as a diversified conglomerate reflects its Indian roots as a legacy of the British colonial managing agency system, and also in the need to provide its own intermediary infrastructure in the absence of that infrastructure in the emerging Indian market.⁴⁴ Chairman Ratan Tata has worked since his appointment in 1991 to turn what was then a collection of highly independent companies spread across disparate industries into a modern global enterprise able to harness the value of multicompany synergy to successfully compete in India and beyond.

At the end of 2010, the Tata Group was organized into seven business sectors:⁴⁵

- *Information Technology and Communications:* In 2009-2010 this sector represented about 16 percent of Tata's revenues. Tata Consultancy Services is India's most valuable IT company and its over 140,000 consultants provide IT services, business solutions, and outsourcing across 42 countries. This sector also includes companies engaged in product design and technology development services, interactive learning development, business support services, and telecommunications.
- *Engineering products and services:* This sector represented about 33 percent of Tata's revenues. Tata Motors, producer of the Nano, the world's least expensive car, is India's largest automobile company, and is also a significant player globally, being the world's fourth-largest truck manufacturer, the second-largest bus manufacturer, and the owner (since 2008) of Jaguar Land Rover. Other companies in this sector provide automotive, construction, and engineering products and services.
- *Materials:* Materials represented about 32 percent of Tata's revenues. Tata Steel, a Fortune Global 500 company in its own right,⁴⁶ employs over 80,000 people in nearly 50 countries. Other companies in the sector provide a wide range of materials production and services.
- *Services:* Services represented about 4 percent of Tata's revenues. The Taj Hotels Resorts and Palaces group offers 66 hotels across India as well as 16 international locations, while related companies provide additional real-estate-focused services. Tata AIG Life Insurance Company and Tata AIG General Insurance Company provide insurance solutions to individuals and businesses. Additional companies provide asset management, management consulting, and other services.
- *Energy:* Energy represented about 6 percent of Tata's revenues. Tata Power is India's largest private-sector-integrated power utility. Tata BP Solar is the largest Indian maker of solar photovoltaic and solar water heating products.
- *Consumer Products:* Consumer products represented about 4 percent of Tata's revenues. Tata Beverage Group markets brands such as Tata Tea, Tata Coffee, Tetley (the leading UK market brand), Eight O'Clock Coffee, and Mount Everest Mineral Water. Other companies in the sector own retail stores, and also produce and market watches, jewelry, and eyewear.
- *Chemicals:* Chemicals represented about 3 percent of Tata's revenues. Tata Chemicals is the world's second largest producer of soda ash, and produces a variety of chemicals for the consumer, industrial, and farm sectors. Other companies in the sector pursue drug discovery and development and produce agrochemicals.

Given the conventional wisdom that multi-industry conglomerates will struggle to compete against their more-focused competitors, how has Tata managed to achieve its success thus far? The answer lies in the well-executed development of centralized functions applied across the group that support, connect, and elevate the individual companies on many different levels, while at the same time allowing them the independence to succeed on their own. Key elements of this model include:

- The primary connection between the Tata Group companies, and perhaps their biggest collective source of strength is the Tata Brand, which in 2011 was named one of the top 50 global brands by Brand Finance.⁴⁷ This recognition comes as the result of a well-planned and careful nurturing of the brand by Chairman Tata that began in 1995 when he introduced the Tata Brand Equity Scheme. This subscription plan establishes the criteria by which a subscriber company may use the Tata brand and also gain access to the resources of the broader group.⁴⁸ Subscribing companies sign the Brand Equity and Business Promotion (BEBP) agreement, which specifies a required code of conduct that helps to ensure high standards of quality and integrity across the company. A centralized organization, Tata Quality Management Services (TQMS), works to help Tata companies achieve their business objectives and meet the standards specified by the agreement. Companies who excel in quality management can be nominated for the JRD Quality Value Award, which is modeled after the Malcolm Baldrige Award.⁴⁹ Conversely, companies who fail to meet the standards set out in the BEBP agreement risk losing their right to use the Tata name. The value of the Tata brand is immense for a group company that is not well recognized in its market, and especially in emerging markets the brand can be a very powerful and important sign of quality and integrity.
- The Tata Group exploits its scale and the diversity of its collective companies in order to foster learning, leadership development, and the sharing of best practices across the group. Tata Administrative Services (TAS) coordinates a group-wide management recruitment and development program, recruiting at top Indian business schools and rotating new managers across group companies during a five-year development plan. The Tata Management Training Centre (TMTC) brings together senior executives, who share insights with their fellow executives from a huge diversity of industries.⁵⁰ The scale of the company is such that these programs can easily bring together 50 or more company CEOs, who share best practices, view problems from a multitude of perspectives, and build relationships that help facilitate cross-company communication and synergy.
- While Tata Group companies operate with a significant degree of independence, they have the financial, intellectual, and other resources of the broader group behind them. In many ways the central office acts as a venture capitalist—serving as a resource for investment funds, management expertise, and connections within the broader group, in industry, and in government. Much like venture capitalists, the Group Executive Office (GEO) members sit on the boards of Tata Group companies in order to facilitate communication between the central office and individual companies, and to bring the knowledge and experience of the broader group to each individual company.⁵¹ This support allows group companies to act like a much larger company in making acquisitions, investing in new technologies, and making other strategic moves. The power of this backing can be seen in the acquisitions of Tetley Tea by Tata Tea in 2000, Corus by Tata Steel in 2007, and Jaguar Land Rover by Tata Motors in 2008, all of which represented an acquisition of a company much larger than the Tata company which acquired it. This would not have been possible without the backing of the broader group.⁵²

As of 2010, almost 60 percent of Tata Group revenue came from outside the Indian market.⁵³ The increasingly global footprint of the company as well as the evolving global economy present several challenges to the effectiveness of its conglomerate model. First, the continued expansion into developed countries may reduce the importance of the internal intermediary infrastructure that Tata has worked to develop. Second, as the Indian economy continues to evolve, this same issue may eventually hold true in the home market.

Finally, the continued successful integration and coordination of the operating companies in a company with a strong tradition of independence will be made ever harder when spread across an increasingly broad geography. As the company works to identify a worthy successor to Ratan Tata (who is scheduled to retire in 2012),⁵⁴ how the Tata Group responds in the coming years to the challenges and opportunities presented by both globalization and the rapid development of its Indian home market will be closely watched as a test case for the viability of the multi-industry conglomerate in the modern global economy.

SUMMARY

Strategy analysis is an important starting point for the analysis of financial statements because it allows the analyst to probe the economics of the firm at a qualitative level. Strategy analysis also allows the identification of the firm's profit drivers and key risks, enabling the analyst to assess the sustainability of the firm's performance and make realistic forecasts of future performance.

Whether a firm is able to earn a return on its capital in excess of its cost of capital is determined by its own strategic choices: (1) the choice of an industry or a set of industries in which the firm operates (industry choice), (2) the manner in which the firm intends to compete with other firms in its chosen industry or industries (competitive positioning), and (3) the way in which the firm expects to create and exploit synergies across the range of businesses in which it operates (corporate strategy). Strategy analysis involves analyzing all three choices.

Industry analysis consists of identifying the economic factors which drive industry profitability. In general, an industry's average profit potential is influenced by the degree of rivalry among existing competitors, the ease with which new firms can enter the industry, the availability of substitute products, the power of buyers, and the power of suppliers. To perform industry analysis, the analyst has to assess the current strength of each of these forces in an industry and make forecasts of any likely future changes.

Competitive strategy analysis involves identifying the basis on which the firm intends to compete in its industry. In general, there are two potential strategies that could provide a firm with a competitive advantage: cost leadership and differentiation. Cost leadership involves offering at a lower cost the same product or service that other firms offer. Differentiation involves satisfying a chosen dimension of customer need better than the competition, at an incremental cost that is less than the price premium that customers are willing to pay. To perform strategy analysis, the analyst has to identify the firm's intended strategy, assess whether the firm possesses the competencies required to execute the strategy, and recognize the key risks that the firm has to guard against. The analyst also has to evaluate the sustainability of the firm's strategy.

Corporate strategy analysis involves examining whether a company is able to create value by being in multiple businesses at the same time. A well-crafted corporate strategy reduces costs or increases revenues from running several businesses in one firm relative to the same businesses operating independently and transacting with each other in the marketplace. These cost savings or revenue increases come from specialized resources that the firm has to exploit synergies across these businesses. For these resources to be valuable, they must be non-tradable, not easily imitated by competition, and non-divisible. Even when a firm has such resources, it can create value through a multibusiness organization only when it is managed so that the information and agency costs inside the organization are smaller than the market transaction costs.

The insights gained from strategy analysis can be useful in performing the remainder of the financial statement analysis. In accounting analysis, the analyst can examine

whether a firm's accounting policies and estimates are consistent with its stated strategy. For example, a firm's choice of functional currency in accounting for its international operations should be consistent with the level of integration between domestic and international operations that the business strategy calls for. Similarly, a firm that mainly sells housing to high-risk customers should have higher-than-average bad debts expenses and a higher-than-average allowance for loan losses.

Strategy analysis is also useful in guiding financial analysis. For example, in a cross-sectional analysis, the analyst should expect firms with cost leadership strategy to have lower gross margins and higher asset turnover than firms that follow differentiated strategies. In a time series analysis, the analyst should closely monitor any increases in expense ratios and asset turnover ratios for low-cost firms, and any decreases in investments critical to differentiation for firms that follow differentiation strategy.

Business strategy analysis also helps in prospective analysis and valuation. First, it allows the analyst to assess whether, and for how long, differences between the firm's performance and its industry's (or industries') performance are likely to persist. Second, strategy analysis facilitates forecasting investment outlays the firm has to make to maintain its competitive advantage.

DISCUSSION QUESTIONS

- Judith, an accounting major, states, "Strategy analysis seems to be an unnecessary detour in doing financial statement analysis. Why can't we just get straight to the accounting issues?" Explain to Judith why she might be wrong.
- What are the critical drivers of industry profitability?
- One of the fastest growing industries in the last 20 years is the memory chip industry, which supplies chips for personal computers and other electronic devices. Yet the average profitability for this industry has been very low. Using the industry analysis framework, list all the potential factors that might explain this apparent contradiction.
- Rate the pharmaceutical and lumber industries as high, medium, or low on the following dimensions of industry structure:

	Pharmaceutical Industry	Lumber Industry
--	-------------------------	-----------------

Rivalry		
Threat of new entrants		
Threat of substitute products		
Bargaining power of buyers		
Bargaining power of suppliers		

Given your ratings, which industry would you expect to earn the highest returns?

- Joe Smith argues, "Your analysis of the five forces that affect industry profitability is incomplete. For example, in the banking industry, I can think of at least three other factors that are also important; namely, government regulation, demographic trends, and cultural factors." His classmate Jane Brown disagrees and says, "These three factors are important only to the extent that they influence one of the five forces." Explain how, if at all, the three factors discussed by Joe affect the five forces in the banking industry.
- Coca-Cola and Pepsi are both very profitable soft drinks. Inputs for these products include corn syrup, bottles/cans, and soft drink syrup. Coca-Cola and Pepsi produce

the syrup themselves and purchase the other inputs. They then enter into exclusive contracts with independent bottlers to produce their products. Use the five forces framework and your knowledge of the soft drink industry to explain how Coca-Cola and Pepsi are able to retain most of the profits in this industry.

7. All major airlines offer frequent flier programs. Originally seen as a way to differentiate their providers in response to excess capacity in the industry, these programs have long since become ubiquitous. Many industry analysts believe that these programs have met with only mixed success in accomplishing their goal. Use the competitive advantage concepts to explain why.
8. What are the ways that a firm can create barriers to entry to deter competition in its business? What factors determine whether these barriers are likely to be enduring?
9. Explain why you agree or disagree with each of the following statements:
 - a. It is better to be a differentiator than a cost leader, since you can then charge premium prices.
 - b. It is more profitable to be in a high technology industry than a low technology one.
 - c. The reason industries with large investments have high barriers to entry is that it is costly to raise capital.
10. There are very few companies that are able to be both cost leaders and differentiators. Why? Can you think of a company that has been successful at both?
11. Many consultants are advising diversified companies in emerging markets such as India, South Korea, Mexico, and Turkey to adopt corporate strategies proven to be of value in advanced economies such as the United States and the United Kingdom. What are the pros and cons of this advice?

NOTES

1. The discussion presented here is intended to provide a basic background in strategy analysis. For a more complete discussion of the strategy concepts, see, for example, *Contemporary Strategy Analysis* by Robert M. Grant (Cambridge, MA: Blackwell Publishers, 1991); *Economics of Strategy* by David Besanko, David Dranove, and Mark Shanley (New York: John Wiley & Sons, 1996); *Strategy and the Business Landscape* by Pankaj Ghemawat (Reading, MA: Addison Wesley Longman, 1999); and *Corporate Strategy: Resources and the Scope of the Firm* by David J. Collis and Cynthia Montgomery (Burr Ridge, IL: Irwin/McGraw-Hill, 1997).
2. Standard & Poor's Compustat data via Research Insight, accessed November 2010. The analysis here owes its logic to that presented in A. M. McGahan, "Do Competitors Perform Better When They Pursue Different Strategies?" working paper, Harvard Business School, May 12, 1999).
3. For a summary of this research, see F. M. Scherer, *Industrial Market Structure and Economic Performance*, second edition (Chicago: Rand McNally College Publishing, 1980).
4. See M. E. Porter, *Competitive Strategy* (New York: The Free Press, 1980).
5. The U.S. Department of Justice and the Federal Trade Commission use the Herfindahl-Hirschman Index (HHI) to measure concentration when evaluating horizontal mergers. The HHI is calculated by summing the squares of the individual market shares of all the participants. The Department of Justice considers a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000 to 1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace. The four-firm concentration ratio is

another commonly used measure of industry concentration; it refers to the market share of the four largest firms in an industry.

6. Tesla Motors, Inc., Form S-1 (filed January 29, 2010), p. 17, <http://www.sec.gov/Archives/edgar/data/1318605/000119312510017054/ds1.htm>, accessed January, 2011.
7. While the discussion here uses *buyer* to connote industrial buyers, the same concepts also apply to buyers of consumer products. Throughout this chapter we use the terms *buyers* and *customers* interchangeably.
8. Standard & Poor's Compustat data via Research Insight, accessed April 2011. The department store industry is defined here as those firms contained in SIC codes 5311, 5331, and 5651.
9. The TJX Companies, Inc., 2010 Annual Report, via Thomson ONE, accessed August 2011.
10. Nordstrom, Inc., January 29, 2011, Form 10-K (filed March 18, 2011), p. 6, via Thomson ONE, accessed April 2011.
11. See for instance, C. Roche, P. Ducasse, C. Liao, and C. Grevler, "A New World Order of Consumption 2010 Report on Consumer Sentiment," The Boston Consulting Group, June 28, 2010, https://www.bcgperspectives.com/content/articles/consumer_products_retail_new_world_order_of_consumption/, accessed February 2011.
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13. For a more detailed discussion of these two sources of competitive advantage, see M. E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: The Free Press, 1985).
14. *Ibid.*
15. For a more detailed discussion of this theory, see Michael E. Porter, "What is Strategy," *Harvard Business Review* (November-December 1996).
16. See G. Hamel and C. K. Prahalad, *Competing for the Future* (Boston: Harvard Business School Press, 1994), for a more detailed discussion of the concept of core competencies and their critical role in corporate strategy.
17. The TJX Companies, Inc., January 29, 2011, Form 10-K (filed March 30, 2011), p. 2, via Morningstar Document Research, accessed February 2011.
18. *Ibid.*
19. *Ibid.*, p. 4.
20. *Ibid.*, p. 4.
21. The TJX Companies, Inc., 2009 Annual Report, p. 4, via Thomson ONE, accessed February 2011.
22. The TJX Companies, "Background Information 2010," The TJX Companies, Inc. website, http://www.tjx.com/files/pdf/TJXbackground_2011.pdf, accessed April 2011.
23. The TJX Companies, Inc., 2009 Annual Report, p. 6, via Thomson ONE, accessed February 2011.
24. *Ibid.*, pp. 2-3.
25. The TJX Companies, Inc., January 29, 2011, Form 10-K (filed March 30, 2011), p. 30, via Morningstar Document Research, accessed February 2011.
26. The TJX Companies, Inc., "Why We Always Have Product Availability," The TJX Companies, Inc. website, http://www.tjx.com/investor_2.asp, accessed February 2011.
27. The TJX Companies, Inc., 2009 Annual Report, p. 4, <http://thomson.mobular.net/thomson/7/2968/4250/>, accessed February 2011.

28. Nordstrom, Inc., January 29, 2011, Form 10-K (filed March 18, 2011), p. 16, via Thomson ONE, accessed April 2011.
29. Nordstrom, Inc., 2009 Annual Report, p. 3, via Thomson ONE, accessed April 2011.
30. Nordstrom, Inc., 2010 Annual Report, pp. 4–5, via Thomson ONE, accessed May 2011.
31. M. L. Clark and C. Cuomo, “Nordstrom Highlights from Dinner with Management; Reiterate Overweight Rating,” Morgan Stanley Research, March 16, 2011, via Thomson ONE, accessed April 2011.
32. E. Yruba and C. Sharma, “Nordstrom, Inc.: JWN: 4Q - Flow Through, Forward Thinking,” KeyBanc Capital Markets, February 18, 2011, via Thomson ONE, accessed April 2011.
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39. For an empirical study which illustrates this point, see T. Khanna and K. Palepu, “Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups,” *Journal of Finance* (April 2000): 867–891.
40. See L. Lang and R. Stulz, “Tobin’s q, diversification, and firm performance,” *Journal of Political Economy* 102 (1994): 1248–1280, and Phillip Berger and Eli Ofek, “Diversification’s Effect on Firm Value,” *Journal of Financial Economics* 37 (1994): 39–65.
41. See P. Healy, K. Palepu, and R. Ruback, “Which Takeovers Are Profitable: Strategic or Financial?” *Sloan Management Review* 38 (Summer 1997): 45–57.
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