# chapter 1

# Fundamentals of Strategic Management

What do Circuit City, Washington Mutual, Saab, Blockbuster, and Borders have in common? All of these recognized companies filed for bankruptcy during the past several years. While the situation surrounding each firm is different, all of them failed to meet various strategic challenges. Put another way, organizations typically do not succeed or fail randomly. Some plan, prepare, and execute more effectively than others.

Today's business world is global, Internet-driven, and obsessed with speed. The challenges it creates for strategic managers are often complex, ambiguous, and unstructured. Add to this the incessant allegations of top management wrongdoings, economic stagnation, and increasing executive compensation, and it is easy to see why firm leaders are under great pressure to respond to strategic problems quickly, decisively, and responsibly. Indeed, the need for effective **strategic management** has never been more pronounced. This text presents a framework for addressing today's strategic challenges.

This chapter introduces the notion of strategic management, highlights its importance, and presents a five-step process for strategically analyzing an organization. The remaining chapters expand on the various steps in the process with special emphasis on their application to ongoing enterprises.

## What Is Strategic Management?

Organizations exist for a purpose. The **mission** is articulated in a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to affected groups and entities. Most organizations of a significant size or stature have developed a formal mission statement, a concept discussed further in Chapter 5.

**Strategy** refers to top management's plans to develop and sustain **competitive advantage**—a state whereby a firm's successful strategies cannot be easily duplicated by its

competitors[1]—so that the organization's mission is fulfilled.[2] Following this definition, it is assumed that an organization has a plan, its competitive advantage is understood, and its members understand the reason for its existence. These assumptions may appear self-evident, but many strategic problems can be traced to fundamental misunderstandings associated with defining the strategy. Debates over the nature of the organization's competitive advantage, its mission, and whether or not a strategic plan is really needed can be widespread.[3] As such, comments such as "We're too busy to focus on developing a strategy" or "I'm not exactly sure what my company is really trying to accomplish" can be overheard in many organizations.

Strategic management is a broader term than *strategy* and is a process that includes top management's analysis of the environment in which the organization operates prior to formulating a strategy, as well as the plan for implementation and control of the strategy. The difference between a strategy and the strategic management process is that the latter includes considering what must be done before a strategy is formulated through assessing whether or not the success of an implemented strategy was successful. The strategic management process can be summarized in five steps, each of which is discussed in greater detail in subsequent chapters of the book (see Figure 1.1):[4]

1. *External Analysis:* Analyze the opportunities and threats, or constraints, that exist in the organization's external environment, including industry and forces in the external environment.
2. *Internal Analysis:* Analyze the organization's strengths and weaknesses in its internal environment. Consider the context of managerial ethics and corporate social responsibility.
3. *Strategy Formulation:* Formulate strategies that build and sustain competitive advantage by matching the organization's strengths and weaknesses with the environment's opportunities and threats.
4. *Strategy Execution:* Implement the strategies that have been developed.
5. *Strategic Control:* Measure success and make corrections when the strategies are not producing the desired outcomes.

The sequential order of the steps is logical. A thorough understanding of the organization and its environment is essential if the appropriate strategy is to be developed, put into action, and controlled. One could transpose the first two steps and analyze the internal environment before the external environment—the logic being that comprehending the organization informs the strategic assessment of factors outside of the firm. The external environment is analyzed before the internal environment in Figure 1.1, however, because internal goals, resources, and competencies are viewed in a relative fashion to some extent and are understood within the context of the industry and the factors that drive it. This dilemma resembles the *chicken and egg* argument; in a practical sense, external and internal analysis often occurs simultaneously.

A distinction between outside and inside perspectives on strategy is also relevant. *Outsiders* analyzing a firm should apply a systematic approach that progresses through these steps in order. Doing so develops a holistic understanding of the firm, its industry, and its strategic challenges.

Inside organizations, strategies are being formulated, implemented, and controlled simultaneously while external and internal factors are continually reassessed. In addition, changes in one stage of the strategic management process will inevitably affect other stages as well. After a planned strategy is implemented, it often requires modification as conditions change. Hence, because these steps are so tightly intertwined, *insiders* tend to treat all of the steps as a single integrated, ongoing process.[5]

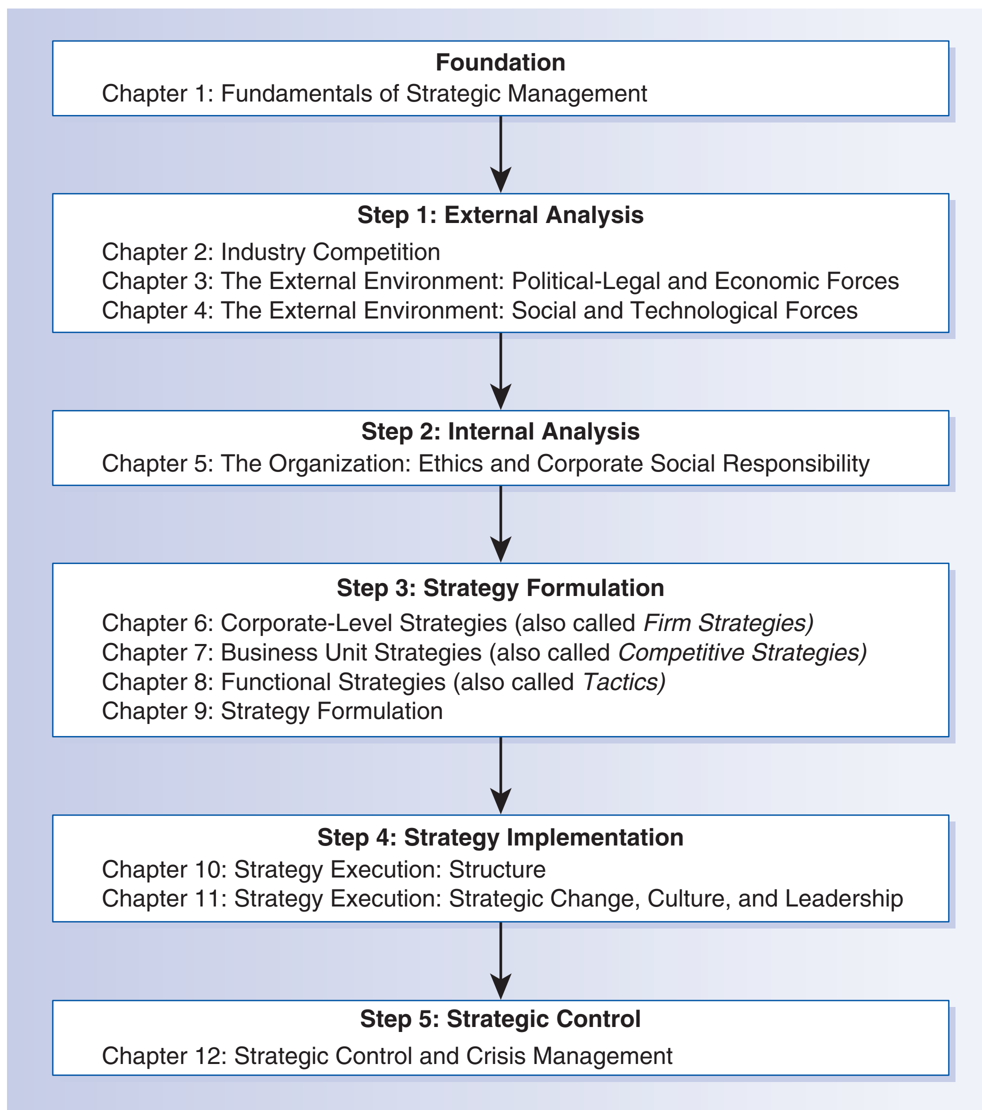


**Figure 1.1** Organization of the Book.

Consider the strategic management process at a fast-food restaurant chain. At any given time, top managers are likely assessing changes in consumer taste preferences and food preparation, analyzing the activities of competitors, working to overcome firm weaknesses, controlling remnants of a strategy implemented several years ago, implementing a strategy crafted months earlier, and formulating strategic plans for the future. Although each of these activities can be linked to a distinct stage in the strategic management process, they occur simultaneously.

An effective strategy is built on the foundation of the organization's **business model**, the mechanism whereby the organization seeks to earn a profit by selling its goods or services. While all firms seek to produce a product or service and sell it at a price higher than its production and overhead costs, a business model is stated in greater detail. For example, a magazine publisher might adopt a *subscription model,* an *advertising model,* or perhaps some combination of the two. Profits would be generated primarily from readers under the subscription model but from advertisers under the advertising model. As we can see, identifying a firm's business model can become more complex when intricate details are considered. Progressive firms often devise innovative business models that extract revenue—and ultimately profits—from sources not identified by competitors.

Consider the *razor and blades* business model invented by Gillette. A company gives away or deeply discounts a product—the razor—while planning to profit from future sales of required replacement or complementary products—the blades. Cell phones are often given to customers willing to sign a 2-year service contract. Computer printers are typically sold below production cost, but customers must periodically replace the ink cartridges, which are high-margin items. This model is not foolproof, however. In a competitive marketplace, customers may be able to purchase the required complementary products at lower prices from rivals not under pressure to recoup initial losses.

Successful business models can change over time. Since the early 2000s, a number of authors have strayed from the traditional business model whereby book publishers offer contracts and pay royalties of 10% to 15%. Leveraging advances in publishing software, social media, and a strong online retail book market, they have opted for a self-publishing model. Enterprising authors who publish their own work also shoulder the initial risk but can net as much as a 70% return on e-book sales from companies such as Amazon.com. The total print book and e-book output of self-publishers in the United States rose from about 50,000 titles in 2006 to over 125,000 in 2010.[6]

While a successful strategy is built on the firm's business model, crafting one can be a challenge. Realistically, a number of factors are typically associated with successful strategies. Some of these factors including the following:

1. The organization's competitive environment is well understood, in detail.
2. Strengths and weaknesses are assessed in a thorough and realistic manner.
3. The strategy is consistent with the mission and goals of the organization.
4. Plans for putting the strategy into action are designed with specificity before it is implemented.
5. Possible future changes in the proposed strategy—a process called strategic control—are evaluated before the strategy is adopted.

Careful consideration of these factors reinforces the interrelatedness of the steps in the strategic management process. Each factor is most closely associated with one of the five steps, yet they fit together like pieces of a puzzle. The details associated with the success factors—and others—will be discussed in greater detail in subsequent chapters.

While some of these success factors are associated with the competitive environment in profit-seeking firms, strategic management is not limited to for-profit organizations. Top managers of any organization, regardless of profit or nonprofit status, must understand the organization's environment and its capabilities and develop strategies to assist the enterprise in attaining its goals. Former Drexel University president Constantine Papadakis, for example, was widely considered to be a leading strategic thinker among university top executives. The innovative Greek immigrant promoted Drexel through aggressive marketing, while campaigning for an all-digital library without books. In many respects, he managed the university in the same way that other executives manage profit-seeking enterprises. His annual salary was close to $1,000,000 in the years preceding his death in 2009, making him one of the highest paid university presidents in the country.[7]

## Intended and Realized Strategies

One of the most critical challenges facing organizations is the reality that strategies are not always implemented as originally planned. Sometimes strategic decisions seem to evolve. In this respect, strategy formulation can be seen as an iterative process where decision

makers take actions, make sense of those actions afterward, and then decide how to proceed.

Henry Mintzberg introduced two terms to help clarify the shift that often occurs between the time a strategy is formulated and the time it is implemented. An **intended strategy** (i.e., what management originally planned) may be realized just as it was planned, in a modified form, or even in an entirely different form. Occasionally, the strategy that management intends is actually realized, but the intended strategy and the **realized strategy**—what management actually implements—usually differ.[8] Hence, the original strategy may be realized with desirable or undesirable results, or it may be modified as changes in the firm or the environment become known.

The gap between the intended and realized strategies usually results from unforeseen environmental or organizational events, better information that was not available when the strategy was formulated, or an improvement in top management's ability to assess its environment. Although it is important for managers to formulate responsible strategies based on a realistic and thorough assessment of the firm and its environment, things invariably change along the way. Hence, it is common for such a gap to exist, creating the need for constant strategic action if a firm is to stay on course. Instead of resisting modest strategic changes when new information is discovered, managers should search for new information and be willing to make such changes when necessary. This activity is part of strategic control—the final step in the strategic management process.

## Scientific and Artistic Perspectives on Strategic Management

There are two different perspectives on the approach that top executives should take to strategic management. Most strategy scholars have endorsed a *scientific perspective*, whereby strategic managers are encouraged to systematically assess the firm's external environment and evaluate the pros and cons of myriad alternatives before formulating strategy. The business environment is seen as largely objective, analyzable, and largely predictable. As such, strategic managers should follow a systematic process of environmental, competitive, and internal analysis and build the organization's strategy on this foundation.

According to this perspective, strategic managers should be trained, highly skilled analytical thinkers capable of digesting a myriad of objective data and translating it into a desired direction for the firm. *Strategy scientists* tend to minimize or reject altogether the role of imagination and creativity in the strategy process and are not generally receptive to alternatives that emerge from any process other than a comprehensive, analytical approach.

Others have a different view. According to the *artistic perspective* on strategy, the lack of environmental predictability and the fast pace of change render elaborate strategy planning as suspect at best. Instead, strategists should incorporate large doses of creativity and intuition in order to design a comprehensive strategy for the firm.[9] Henry Mintzberg's notion of a craftsman—encompassing individual skill, dedication, and perfection through mastery of detail—embodies the artistic model. The strategy artist senses the state of the organization, interprets its subtleties, and seeks to mold its strategy like a potter molds clay. The artist visualizes the outcomes associated with various alternatives and ultimately charts a course based on holistic thinking, intuition, and imagination.[10] Strategy artists may even view strategic planning exercises as time poorly spent and may not be as likely as those in the science school to make the effort necessary to maximize the value of a formal planning process.[11]

This text acknowledges the artistic perspective but emphasizes the science view. Creativity and innovation are important and encouraged but are most likely to translate into organizational success when they occur as part of a comprehensive, systematic approach to strategic management. Nonetheless, the type of formal strategic planning proposed in this text is not without its

critics. Some charge that such models are too complex or that they apply only to businesses in highly certain environments.[12] Others emphasize that the stages in the process are so closely interrelated and that considering them as independent steps may be counterproductive. Still others, such as Mintzberg, argue that planning models stifle the creativity and imagination that is central to formulating an effective strategy.[13] Although these views have merit, the comprehensive, systematic model proposed herein is presented as a proper foundation for understanding the strategic management process. It does not, however, preclude the application of other approaches.

## Influence on Strategic Management

The roots of the strategic management field can be traced to the 1950s when the discipline was originally called "business policy." Today, strategic management is an eclectic field, drawing upon a variety of theoretical frameworks. Three prominent perspectives are summarized in Table 1.1 and discussed next. There are a number of other influences as well, but these three illustrate how competing viewpoints have coalesced into an overarching discipline.

| Theoretical Perspective | Primary Influence on Firm Performance | How Perspective is Applied to the Case Analysis |
|---|---|---|
| Industrial organization (IO) theory | Structure of the industry | Industry analysis portion of the external environment |
| Resource-based theory | Firm's unique combination of strategic resources | Analysis of internal strengths and weaknesses |
| Contingency theory | Fit between the firm and its external environment | SWOT (strengths, weaknesses, opportunities, and threats) analysis and SW/OT matrix |

**Table 1.1** Theoretical Perspectives on Firm Performance

**Industrial organization (IO)**, a branch of microeconomics, emphasizes the *influence of the industry environment* upon the firm. The central tenet of IO theory is the notion that a firm must adapt to influences in its industry to survive and prosper; thus, its financial performance is primarily determined by the success of the industry in which it competes. Industries with favorable structures offer the greatest opportunity for firm profitability.[14] Following this perspective, it is more important for a firm to choose the correct industry within which to compete than to determine *how* to compete within a given industry. Recent research has supported the notion that industry factors tend to play a dominant role in the performance of most firms, except for those that are the notable industry leaders or losers.[15]

IO assumes that an organization's performance and ultimate survival depend on its ability to *adapt* to industry forces over which it has little or no control. According to IO, strategic managers should seek to understand the nature of the industry and formulate strategies that feed off the industry's characteristics.[16] Because IO focuses on industry, forces, strategies, resources, and competencies are assumed to be fairly similar among competitors within a given industry. If one

firm deviates from the industry norm and implements a new, successful strategy, other firms will rapidly mimic the higher-performing firm by purchasing the resources, competencies, or management talent that have made the leading firm so profitable. Hence, although the IO perspective emphasizes the industry's influence on individual firms, it is also possible for firms to influence the strategy of rivals and in some cases even modify the structure of the industry.[17]

Perhaps the opposite of the IO perspective, **resource-based theory** views performance primarily as a function of a firm's ability to utilize its resources.[18] Although environmental opportunities and threats are important, a firm's unique resources comprise the key variables that allow it to develop a **distinctive competence**, enabling the firm to distinguish itself from its rivals and create competitive advantage. Resources include all of a firm's tangible and intangible assets, such as capital, equipment, employees, knowledge, and information.[19] An organization's resources are directly linked to its capabilities, which can create value and ultimately lead to profitability for the firm.[20] Resource-based theory focuses primarily on individual firms rather than on the competitive environment.

If resources are to be used for **sustained competitive advantage**—a firm's ability to enjoy strategic benefits over an extended period of time—those resources must be valuable, rare, not subject to perfect imitation, and without strategically relevant substitutes.[21] Valuable resources are those that contribute significantly to the firm's effectiveness and efficiency. Rare resources are possessed by only a few competitors, and imperfectly imitable resources cannot be fully duplicated by rivals. Resources that have no strategically relevant substitutes enable the firm to operate in a manner that cannot be effectively imitated by others and thereby sustain high performance.

According to the third perspective, **contingency theory**, the most profitable firms develop *beneficial fits* with their environments. In other words, a strategy is most likely to be successful when it is consistent with the organization's mission, its competitive environment, and its resources. Contingency theory represents a *middle ground* perspective that views organizational performance as the joint outcome of environmental forces and the firm's strategic actions. Firms can become proactive by choosing to operate in environments where opportunities and threats match the firms' strengths and weaknesses.[22] Should the industry environment change in a way that is unfavorable to the firm, its top managers should consider leaving that industry and reallocating its resources to other, more favorable industries.

Differences aside, each perspective has merit and has been incorporated into the strategic management process laid out in this text. The IO view is seen in the industry analysis phase, most directly in Michael Porter's *five forces* model. Resource-based theory is applied directly to the internal analysis phase and the effort to identify an organization's resources that could lead to sustained competitive advantage. Contingency theory is seen in the strategic alternative generation phase, where alternatives are developed to improve the organization's fit with its environment. Hence, multiple perspectives are critical to a holistic understanding of strategic management.[23]

## Corporate Governance and Boards of Directors

A small business is often governed by one or several individuals well known to everyone in the organization. Ownership is often *privately held* and may rest with a single person, a family, or a few business partners. Because more resources are needed, many midsize and large organizations are *publicly held*, with shares of stock available for purchase on exchanges such as the New York Stock Exchange. In public corporations, shareholders—the owners of the firm—are represented by an elected board of directors legally authorized to monitor firm activities as well as the selection, evaluation, and compensation of top managers. Strategic

decision making in these firms is more complex because the ownership is widely dispersed and often changes frequently.

**Corporate governance** refers to the board of directors, institutional investors (e.g., pension and retirement funds, mutual funds, banks, insurance companies, among other money managers), and large shareholders known as **blockholders** who monitor firm strategies to ensure effective management. Boards of directors and institutional investors—representatives of pension and retirement funds, mutual funds, and financial institutions—are generally the most influential in the governance systems. Because institutional investors own more than half of all shares of publicly traded firms, they tend to wield substantial influence. Blockholders tend to hold less than 20% of the shares, so their influence is proportionally less than that of institutional investors.[24]

Boards of directors often include both inside (i.e., firm executives) and outside directors. Insiders bring company-specific knowledge to the board whereas outsiders bring independence and an external perspective. Over the past several decades, the composition of the typical board has shifted from one controlled by insiders to one controlled by outsiders. This increase in outside influence often allows board members to oversee managerial decisions more effectively.[25] Moreover, when additional outsiders are added to insider-dominated boards, dismissal of the chief executive officer (CEO) is more likely when corporate performance declines[26] and outsiders are more likely to pressure for corporate restructuring.[27]

A number of companies became concerned about both potential conflicts of interest and the amount of time a board member who sits on multiple boards can spend with the affairs of each company. As a result, many companies have begun to limit the number of board memberships their own board members may hold. Approximately two-thirds of corporate board members at the largest 1,500 U.S. companies do not hold seats on other boards. The average director's direct compensation ranged from $90,775 at firms with revenues between $50 million and $500 million to $228,058 at the 200 largest firms in the Standard & Poor's 500 based on revenue.[28]

The **Sarbanes-Oxley Act**, which was passed in 2002, requires firms to include more independent directors on their boards and make disclosures on internal controls, ethics codes, and the composition of their audit committees on annual reports. The act requires that both the CEO and the chief financial officer (CFO) certify every report that contains company financial statements. It restricts membership of the firm's audit committee—the formal group charged with reporting oversight—to outsiders (i.e., board members who are not managers). Sarbanes-Oxley also prohibits firms from extending personal loans to board members or executives.

Even with new disclosure regulations, however, it can be difficult to determine precisely what top executives earn at public companies. A number of analysts have noted positive changes among boards as a result of this legislation in terms of both independence and expertise, while others contend that government regulations like Sarbanes-Oxley have merely added more costly paperwork.[29]A record number of public firms went private in the mid-2000s primarily due to investor and management frustration with the legislation. Evidence also suggests that many CEOs have become more reluctant to sit on boards of publicly held companies. Increased liability on the part of board members and recent policy changes that often restrict the number of outside boards on which a CEO may serve have also contributed to this change.[30]

Boards of directors are responsible for monitoring activities in the organization, evaluating top management's strategic proposals, and establishing the broad strategic direction for the firm. As such, boards select and terminate the CEO, establish his or her compensation package, advise top management on strategic issues, and monitor managerial and company performance as representatives of the shareholders. Critics charge that board members do not always fulfill their legal roles.[31] One reason is that they are nominated by the CEO, who expects them to

support his or her strategic initiatives. The generous compensation they often receive is also a key issue.[32]

When insiders control a board, a *rubber stamp* mentality can develop, whereby directors do not aggressively challenge executive decisions as they should. This is particularly true when the CEO also serves as chair of the board, a phenomenon known as **CEO duality**.[33] Insider board members may be less willing to exert control when the CEO is also the chair of the board because present rewards and future career prospects within the firm are largely determined by the CEO. In the absence of CEO duality, however, insiders may be more likely to contribute to board control, often in subtle and indirect ways so as not to document any opposition to the decisions of the CEO. For example, the insiders may ostensibly present both sides of various issues while carefully framing the alternatives in favor of one that may be in opposition to the wishes of the CEO.

Activist shareholders can significantly influence a firm's operations. Target, for example, suffered the effects of the recession and experienced sluggish sales in the late 2000s. Investor activist William Ackman challenged Target to address the recession more aggressively. Ackman's Pershing Square Capital Management **hedge fund**—an investment fund open to only a small number of investors but permitted by regulators to undertake riskier and more speculative investments—is Target's sixth largest shareholder and has actively supported dissident nominees for board slots. In response to Ackman, Target expanded its fresh foods and other "recession-proof" offerings in many of its stores.[34]

Pressure on directors to acknowledge shareholder concerns has continued into the 2010s. The major source of pressure in recent years has come from institutional investors, owners of large chunks of most publicly traded companies via retirement or mutual funds. By virtue of the size of their investments, they wield considerable power and are more willing to use it than ever before (see Strategy at Work 1.1).

### Strategy at Work 1.1. The Growing Responsiveness of Corporate Boards[35]

There is an adage on Wall Street: "If you don't like the stock, sell it." Over the past decade, however, a number of dismayed investors have decided to challenge the board instead. Many corporate boards have historically functioned as rubber stamps for top executives. Nonetheless, the directors of many prominent corporations have become increasingly responsible to shareholder interests, thanks in part to the increased influence of institutional shareholders. These large investment firms control substantial numbers of shares in widely held firms and have the clout necessary to pressure board members for change when needed.

Consider the case of Nell Minow. A principal at activist money-management firm Lens Inc., Minow searches for companies with strong products and underlying values that appear to be underperforming. After identifying a target, Minow purchases a substantial number of shares in the company and then advises the CEO of her ownership position. She requests a meeting with the CEO and/or the board to discuss changes that could improve the performance of the firm. Activist owners like Minow have sent a message to both top executives and boards that poor performance is not unlikely to go unchallenged.

However, a number of analysts and executives believe that further change to the system is needed. According to David Leighton, former chairman of the board at Nabisco Brands, Ltd., companies should seek out more independent and qualified board members who will consider the strategic direction of the firm more aggressively.

Criticism notwithstanding, some board members have played effective stewardship roles. Many directors promote strongly the best interests of the firm's shareholders and various other stakeholder groups as well. Research indicates, for instance, that board members are often invaluable sources of environmental and competitive information.[36] By conscientiously carrying out their duties, directors can ensure that management remains focused on company performance.[37]

A number of recommendations have been made on how to promote an effective governance system. For example, it has been suggested that outside directors be the only ones to evaluate the performance of top managers against the established mission and goals, that all outside board members should meet alone at least once annually, and that boards of directors should establish appropriate qualifications for board membership and communicate these qualifications to shareholders. For institutional shareholders, it is recommended that institutions and other shareholders act as owners and not just investors,[38] that they not interfere with day-to-day managerial decisions, that they evaluate the performance of the board of directors regularly,[39] and that they should recognize that the prosperity of the firm benefits all shareholders.

## Strategic Decisions

How does one think and act strategically, and who makes the strategic decisions? The answers to these questions vary across firms and may also be influenced by ownership and other issues related to corporate governance. It is also important to distinguish between strategic decisions and common management decisions. In general, strategic decisions are marked by four key distinctions:

1. They are based on a systematic, comprehensive analysis of internal attributes and factors external to the organization. Decisions that address only part of the organization—perhaps a single functional area—are usually not considered to be strategic decisions.
2. They are long-term and future-oriented but are built on knowledge about the past and present. Scholars and managers do not always agree on what constitutes the *long term,* but most agree that it can range anywhere from several years in duration to more than a decade.
3. They seek to capitalize on favorable situations outside the organization. In general, this means taking advantage of opportunities that exist for the firm, but it also includes taking measures to minimize the effects of external threats as well.
4. They involve choices. Although making *win-win* strategic decisions may be possible, most involve some degree of trade-off between alternatives—at least in the short run. For example, raising salaries to retain a skilled workforce can increase wages and adding product features or enhancing quality can increase the cost of production. However, such trade-offs may diminish in the long run, as a more skilled, higher paid workforce may be more productive than a typical workforce, and sales of a higher-quality product may increase, thereby raising sales and potentially profits. Decision makers must understand these complex relationships across the business spectrum.

Because of these distinctions, strategic decision making is generally reserved for the top executive and members of his or her **top management team**. The CEO is the individual ultimately responsible (and generally *held responsible*) for the organization's strategic management, but he or she rarely acts alone. Except in the smallest companies, he or she relies on a *team* of top-level executives—including members of the board of directors, vice presidents, and even various line and staff managers in some instances—all of whom play

instrumental roles in strategically managing the firm. Generally speaking, the quality of strategic decisions improves dramatically when more than one capable executive participates in the process.[40]

The size of the team on which the top executive relies for strategic input and support can vary from firm to firm. Companies organized around functions such as marketing and production generally involve the heads of the functional departments in strategic decisions. Very large organizations often employ corporate-level–strategic-planning staffs and outside consultants to assist top executives in the process. The degree of involvement of top and middle managers in the strategic management process also depends on the personal philosophy of the CEO.[41] Some CEOs are known for making quick decisions whereas others have a reputation for involving a large number of top managers and others in the process.

Input to strategic decisions, however, need not be limited to members of the top management team. To the contrary, obtaining input from others throughout the organization, either directly or indirectly, can be quite beneficial. In fact, most strategic decisions result from the streams of inputs, decisions, and actions of many people. The top management team might create the context for strategic decisions by establishing rules and procedures and by influencing the informal means through which things are accomplished in the organization. Strategic decisions do not necessarily start with top management action, however, but instead can bubble up from a series of lower level decisions throughout the firm. For example, an employee in a company's research and development department may attend a trade show where a new product or production process idea that seems relevant to the company is discussed. The employee may relate the idea to his or her manager, who, in turn, may modify and pass it along to his or her manager. Eventually, a version of the idea may be discussed with the organization's marketing and production managers and later presented to top management. Ultimately, the CEO will decide whether or not to incorporate the idea into the ongoing strategic planning process. This example illustrates the indirect involvement of individuals throughout the organization in the prison strategic management process. Top management is ultimately responsible for the final decision, but its decision is based on a culmination of the ideas, creativity, information, and analyses of others[42] (see Strategy at Work 1.1).

While participation can be healthy, most firms place significant limits of the say that their managers have in strategic decisions. There are a few exceptions, however. At Ternary Software, for example, all of its 13 employees must agree before a strategic decision can be implemented. Such democracy is easier to implement in larger organizations, but even large companies like Google have taken steps to create an egalitarian culture for decision making.[43]

The corporate boardroom is often a place where decisions that have already been made in a less formal setting are confirmed. A formal, systematic decision-making process is often applied as a means of confirming what top executives already see as the appropriate course of action. A danger associated with this type of approach is that it tends to jump straight to a proposed solution without considering how a decision should be made. Although there are no guarantees, top management teams that circumvent a logical decision-making approach are more susceptible to mistakes. For example, when a systematic cost-benefit analysis is not employed, leaders may confuse actual costs of a decision with sunk costs—those already expended—which is a common error that distorts decision making and can lead to an escalation of commitment to a failed strategy.[44]

## The Global Imperative

Most business organizations buy, sell, or trade across borders whether they have a physical presence in other countries or sell a significant amount of imported merchandise. Although firms typically concentrate on serving local or domestic markets before expanding internationally, many must interact with entities in other nations as a means of survival. For example, virtually all of Japan's industries would grind to a halt if imports of raw materials from other nations ceased because the nation is small and isolated, and its natural resources are quite limited. In larger nations like the United States, most manufacturers utilize components from abroad in their production process while most retailers sell products that were produced abroad. Hence, strategic management is—by definition—a global undertaking. For this reason, examples from concepts, industries, and firms outside of the United States are integrated into each of the chapters.

The high degree of global interconnectedness common in many enterprises today emanates from the economic concept of **comparative advantage**—the idea that certain products may be produced more cheaply or at a higher quality in particular countries due to advantages in labor costs or technology. For this reason, many manufacturers in the United States and other developed nations have shifted their production to Asia and other parts of the world. Firms do not always engage in production only in areas where they are most efficient for several reasons, however. The cost of transporting raw materials or goods from one nation to another can exceed the potential cost savings. Political turmoil or trade restrictions can also create a barrier. Moreover, even if one nation enjoys an absolute advantage over another in most areas, the weaker nation must participate in some forms of business to maintain economic viability and employ its citizens. Firms in these nations tend to produce in areas where the absolute advantage is lowest. Put another way, even firms in less developed nations lack a comparative advantage; they tend to produce in areas where their inefficiencies are less pronounced while their counterparts in developed nations concentrate in more vital industries. All nations benefit economically from such an arrangement.

The notion of comparative advantage is fluent, as nations enjoying a form of comparative advantage at one period may not enjoy it in a future period. Chinese manufacturers enjoyed some of the lowest global labor rates for unskilled or semiskilled production in the 2000s. Worker skills and production quality has increased in the rapidly developing nation, making Chinese labor the third most expensive in Asia in 2011—well ahead of nations like India, Pakistan, Indonesia, Cambodia, and Vietnam.[45]

While comparative advantage is a key consideration for international operations, it is not the only one. Global involvement may also provide advantages to a firm not directly related to costs. For political reasons, a firm often needs to establish operations in other countries, especially if a substantial proportion of sales is derived abroad. Doing so can also provide managers with a critical understanding of local markets. For example, Ford operates a number of plants in Western Europe, where manufacturing has helped Ford's engineers design windshield wipers for cars engaged in high-speed driving on the German autobahns[46] (see Case Analysis 1.1).

### Case Analysis 1.1 — Step 1: Introduction of the Organization

The first step in analyzing a firm is to develop familiarity with the organization. Analyzing an ongoing enterprise begins with a general introduction and understanding of the firm. When was the organization founded, why, and by whom? Is any unusual history associated with the organization? Is it privately or publicly held? What is the company's mission? Has the mission changed since its inception?

It is also important at this point to identify the business model on which the organization's success is predicated. In other words, what is the profit-generating idea behind the company? Determining this information is simple for some companies (Ford, for example, hopes to sell cars and offer consumer financing at a profit) but may be complicated for others where revenue streams and competitive advantage are more difficult to identify.

## Summary

Top managers face more complex strategic challenges today than ever before. Strategic management involves analysis of an organization's external and internal environments, formulation and implementation of its strategic plan, and strategic control. These steps in the process are interrelated and typically done simultaneously in many firms.

A firm's intended strategy often requires modification before it has been fully implemented due to changes in environmental and/or organizational conditions. Because these changes are often difficult to predict, substantial changes in the environment may transform an organization's realized strategy into one that is quite different from its intended strategy.

The strategic management field has been influenced by such perspectives as IO theory, resource-based theory, and contingency theory. Although they are based on widely varied assumptions about what leads to high performance, each of these perspectives has merit and contributes to an overall understanding of the field.

Strategy formulation is the direct responsibility of the CEO, but he or she relies on a team of other individuals as well, including the board of directors, vice presidents, and other various managers. In its final form, a strategic decision is crafted from the streams of input, decisions, and actions of the entire top management team.

## Key Terms

**Blockholders:** Large shareholders who monitor firm strategies to ensure effective management.

**Business Model:** The economic mechanism by which a business hopes to sell its goods or services and generate a profit.

**CEO Duality:** A situation in which the CEO also serves as the chair of the board.

**Comparative Advantage:** The idea that certain products may be produced more cheaply or at a higher quality in particular countries due to advantages in labor costs or technology.

**Competitive Advantage:** A state whereby a business unit's successful strategies cannot be easily duplicated by its competitors.

**Contingency Theory:** A view that states the most profitable firms are likely to be the ones that develop the best fit with their environment.

**Corporate Governance:** The board of directors, institutional investors, and blockholders who monitor firm strategies to ensure managerial responsiveness.

**Distinctive Competence:** Unique resources, skills, and capabilities that enable a firm to distinguish itself from its competitors and create competitive advantage.

**Hedge Fund:** An investment fund open to only a small number of investors but permitted by regulators to undertake riskier and more speculative investments.

**Industrial Organization (IO):** A view based in microeconomic theory that states firm profitability is most closely associated with industry structure.

**Intended Strategy:** The original strategy top management plans and intends to implement.

**Mission:** The reason for an organization's existence. The mission statement is a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to affected groups (i.e., stakeholders, as defined later in the book).

**Realized Strategy:** The strategy top management actually implements.

**Resource-Based Theory:** The perspective that views performance primarily as a function of a firm's ability to utilize its resources.

**Sarbanes-Oxley Act:** Legislation passed in 2002 that created more detailed reporting requirements for boards and executives in public U.S. companies and accounting firms.

**Strategic Management:** The continuous process of determining the mission and goals of an organization within the context of its external environment and its internal strengths and weaknesses, formulating and implementing strategies, and exerting strategic control to ensure that the organization's strategies are successful in attaining its goals.

**Strategy:** Top management's plans to attain outcomes consistent with the organization's mission and goals.

**Sustained Competitive Advantage:** A firm's ability to enjoy strategic benefits over an extended period of time.

**Top Management Team:** A team of top-level executives—headed by the CEO—all of whom play instrumental roles in the strategic management process.

## Review Questions and Exercises

1. Identify a company with a published mission statement on its website. Evaluate its mission statement along each of the following criteria:
   a. Is the mission statement comprehensive? Is it concise?
   b. Does the mission statement delineate in broad terms what products or services the firm is to offer?
   c. Is the mission statement consistent with the company's actual activities and competitive prospects?
2. Is it necessary that the five steps in the strategic management process be performed sequentially? Why or why not?
3. What is the difference between an intended strategy and a realized strategy? Why is this distinction important?
4. How have outside perspectives influenced the development of the strategic management field?
5. Does the CEO *alone* make the strategic decisions for an organization? Explain.

## Practice Quiz

### True or False?

1. A strategy seeks to develop and sustain competitive advantage.
2. Strategic management refers to formulating successful strategies for an organization.
3. Each step in the strategic management process is independent so that changes in one step will not substantially affect other steps.
4. The intended strategy and the realized strategy can never be the same.

5. Whereas IO theory emphasizes the influence of industry factors of firm performance, resource-based theory emphasizes the role of firm factors.
6. Strategic decisions are made solely by and are ultimately the responsibility of the CEO alone.

## Multiple Choice

7. Strategies are formulated in the strategic management stage that occurs immediately after __________.
   A. the assessment of internal strengths and weaknesses
   B. implementation of the strategy
   C. control of the strategy
   D. none of the above
8. The strategy originally planned by top management is called __________.
   A. grand strategy
   B. realized strategy
   C. emergent strategy
   D. none of the above
9. The notion that successful firms tend to be the ones that adapt to influences in their industries is based on __________.
   A. IO theory
   B. resource-based theory
   C. contingency theory
   D. none of the above
10. The notion of distinctive competence is consistent with __________.
    A. IO theory
    B. resource-based theory
    C. contingency theory
    D. none of the above
11. In order to contribute to sustained competitive advantage, firm resources should be __________.
    A. valuable and rare
    B. not subject to perfect imitation
    C. without strategically relevant resources
    D. all of the above
12. Which of the following is not a characteristic of strategic decisions?
    A. They are long term in nature.
    B. They involve choices.
    C. They do not involve trade-offs.
    D. All of the above are characteristics of strategic decisions.

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**Strategy + Business Reading**

# The China Challenge

**For global companies, ignoring China is not an option. But they must adapt their strategies to the country's changing markets, increased competition, and shifting government priorities.**

by Edward Tse

In 2006, the IBM Corporation uprooted the main offices for its global procurement services. It transferred them from Somers, N.Y., 20 miles north of corporate headquarters at Armonk, to Shenzhen in south China's Pearl River Delta, just across from Hong Kong. It was a notable moment: the first time one of IBM's most critical departments had moved its center from the United States. And it marked a significant milestone along the road toward making IBM a "globally integrated enterprise" running "truly global systems of production," as its CEO, Sam Palmisano, had written in *Foreign Affairs* the same year.

IBM's executives knew, from many years of firsthand experience, that this region in southern China had become home to one of the biggest pools of procurement talent in the world. The company had arrived in 1993, manufacturing personal computers—a business it eventually sold in 2005, to Lenovo, a Chinese company. Over the years IBM had produced servers, retail store systems, storage devices, and printers in Shenzhen: first for overseas markets, and later, increasingly for the Chinese market. It had seen massive supply networks develop in the Pearl River Delta. Some suppliers made parts for toys, sports shoes, and other low-end products; others made components for sophisticated computing and telecommunications equipment. Still others provided logistics and supporting technology. IBM had also seen the Chinese government invest in business-friendly infrastructure: economic zones, industrial parks, highways and container ports, universities and training colleges. By locating its global procurement headquarters in Shenzhen, IBM was not only strengthening its own supply base, but better positioning one of its core businesses: helping clients strengthen their supply chains.

The company has also invested in R&D in China. Its China Research Laboratory, one of eight flagship IBM labs around the world, is located in Zhongguancun Software Park, next to Beijing's main university district. Most of its more than 150 researchers hold doctorates or master's degrees from Beijing, Tsinghua, or other leading Chinese universities. The lab specializes in speech and language technologies, cross-border e-business solutions, and pervasive computing, which is the embedding of microprocessors in everyday objects. IBM opened another lab in Shanghai in 2008. In consulting, despite the global economic slowdown, IBM has been on a growth trajectory, doubling its business in 2009 because of Chinese demand. It plans to open four new offices in China, taking its total presence from six to 10. Moreover, IBM runs all its global growth businesses from Shanghai. This includes its businesses in Asia, Latin America, Russia, eastern Europe, the Middle East, and Africa.

In short, IBM's presence in China is very different from what might have been envisioned a few years ago. It is defined not by an expanding consumer population or by low-wage labor, but by the integration of Chinese activity with its worldwide enterprise. Like a growing number of other companies—Coca-Cola, Honeywell, KFC, and Goodyear among the most prominent—IBM has a "one world"–oriented strategy for its operations in China. In addition to sourcing products in China and seeking out Chinese markets, it is investing dramatically in operations there and integrating them with the rest of IBM's global enterprise.

The benefits of a one-world strategy in China have become obvious, and a growing number of multinational companies—or "foreign" companies, as the Chinese think of them—are ready to increase their presence. They may already market to some Chinese consumers, or draw from the country's labor pool, or outsource manufacturing there, but now they want more. China's rapid recovery from the global recession, bolstered by its reorganized banking sector and its emerging middle class, has attracted many companies to the Chinese economy.

As *Financial Times* columnist Martin Wolf wrote on September 13, 2009, the West's "reputation for financial and economic competence is in tatters, while that of China has soared." Moreover, profitability is rising for global companies in China. A 2009 study by the American Chamber of Commerce in Beijing noted that in 1999, only 13 percent of companies reported margins in China that were higher than their worldwide averages; in mid-2008 (before the onset of the global financial crisis), this figure reached 50 percent. Moreover, a large number of multinational executives feel that they have gained enough experience in China to expect a relatively coherent, expanding future for their Chinese operations.

But the challenge of doing business in China has increased during the past few years. Most businesses, even many that are currently successful, will find themselves inadequately prepared for the turmoil and dynamism to come. Not only could they miss out on the opportunities in this economy; they could be pushed aside by rivals, old and new, that use China to transform their competitive positions.

In 2005, I wrote in this magazine that in the world's fastest-growing economy, the experience of the last 10 years will not be the best guide to the next 10 years. This statement has even more truth, and even greater urgency, in 2010. Business leaders around the world who want to be successful will need to take on a challenge with four components: the growing complexity of the Chinese market, the new sophistication of Chinese competitors, the evolving interests of the Chinese government, and their own entrenched assumptions about global business.

## The Complexity of Open China

Only 30 years after it began to open and liberalize its economy, China offers its consumers an extraordinary range of brands and products that no other country, even the wealthy consumer markets of Japan, Europe, and the United States, can match. In any convenience store in Shanghai or Dalian, you can find Western beverages such as Coke, Pepsi, and Schweppes; Japanese soft drinks made by Suntory, Kirin, and Sapporo; Taiwanese flavors under the Uni-President label; Hong Kong brands such as Vitasoy; and local teas, coffees, soy milks, and fruit drinks. Chinese companies make their own versions of every international flavor, and many flavors that are not produced elsewhere.

Outside, on the newsstands, are Chinese magazines and Chinese editions of such familiar global titles as *Cosmopolitan*, *Vogue*, and *Elle*. Driving on the streets are locally manufactured vehicles from almost every global carmaker—General Motors and Ford, Toyota and Honda, Volkswagen and its subsidiary Audi, BMW and Mercedes, Citroën and Hyundai—plus a host of local auto brands, including Chery, Geely, Brilliance, and Great Wall Motor. Step inside a department store and you will see a similar proliferation of labels and choices. For most of the local patrons in cities such as Shenyang, Wuhan, and Changsha, this is a remarkable change from the sparsely stocked, dour shops that they patronized just a decade ago.

The shift in population from predominantly rural to predominantly urban is having an impact on almost every aspect of Chinese life. Millions of people are being lifted from poverty, probably far more in the next few years than in the past few decades. Since the start of the 1990s, annual retail sales in China have increased more than 15-fold, from around US$100 billion to more than $1.6 trillion by the end of 2008. (The 2008 figure is about one-third of the retail sales in the United States during the same year.) The Chinese middle class, although new, will not be a short-lived phenomenon; it is here to stay.

At first glance, for global consumer-oriented companies, this situation would seem to be the realization of a dream. For years, they have looked forward to the rise of the mythical "land of 1 billion–plus consumers"—eager for new products, ready to be sold to. A company with a product or service well targeted for a market category or consumer segment—perhaps a packaged good aimed at newly urbanized, frugal, demanding consumers—can expect to find hundreds of thousands of potential customers in China. This consumer market represents the largest "niche play" opportunity in the history of world commerce.

Yet this market is far more complex than many outsiders realize. The expansion of Chinese markets is accompanied by phenomenal competition, as well as abrupt rises and falls in market share for both new and established products. Most importantly, although China's markets are open to global products, they are also extraordinarily local, rooted in traditional customs and tastes, with extreme variations from one region to the next.

The methods that most global marketers have used in China so far will not be effective in the future. Most multinationals have concentrated their Chinese marketing in relatively small parts of the country, targeting only a fraction of the potential consumer population. Global companies are most familiar with the "big three" clusters: the Yangtze River Delta region around Shanghai, the Pearl River Delta region running from Hong Kong to Guangzhou, and the region around Beijing and its neighbor Tianjin. These three areas account for almost half of China's GDP and have relatively high per capita GDP, about $5,000 to $6,500. But the rest of China represents a yet more promising market, with a higher urbanization rate, new transportation and communications links, and many cities with populations of more than 1 million. (See Exhibit 1.)

The differences within regions are also enormous. Even in the wealthiest provinces, such as the coastal parts of Guangdong or Zhejiang, you need travel only a short distance inland and incomes fall abruptly. The gap between rural and urban residents splits the nation; the divide between permanent residents and migrant workers splits many cities.

A growing number of cities in China, including many outside the "big three" clusters, are rapidly becoming vibrant consumer markets, but are still relatively ignored by global multinationals.

**Exhibit 1** Emerging Cities in China, Present and Future

*Source:* Edward Tse, *The China Strategy: Hamessing the Power of the World's Fastest-Growing Economy* (Basic Books, 2010)

And although the middle class is large, it is also unpredictable. The rapid pace of economic growth in China has disrupted traditional patterns of consumer development that build commitment to a product over time. People who were living in frugal, company-assigned, company-owned apartments a decade ago now have their own homes, an array of possessions, and possibly a car. With little or no history of consumption, these consumers tend to be difficult for marketers to reach: They are fickle and demanding, often shopping on price alone. Brand loyalty is a new notion to them. At the same time, a rapidly growing group of people at the high end are very brand conscious and interested in showing off their wealth as they acquire known products. With markets and tastes continuing to change, it is difficult to predict what kind of path China's consumers will follow. They cannot be taken for granted.

One company that understands the complexity of Chinese consumer markets is KFC, the most successful restaurant chain, foreign or domestic, in the country. Since arriving in China in 1987, this American fried chicken specialist has set up more than 2,900 restaurants in 450 cities, with about 300 outlets opening every year.

KFC spent nearly a decade figuring out its business model for China, even though it was led by a group of executives who knew the country well. Many of them, including the head of China operations, Sam Su, had been raised in Taiwan. Su's team began by looking at the whole range of the company's operations, from its menu offerings to its supply chain. Their first conclusion: Food, not systems, was the most important thing to get right. They gradually extended the menu, experimenting with different items, often making them available for just a limited period. They invested in ovens so they could offer more than fried food, and began selling juices, salads, and congee, a Chinese rice porridge. Rather than rapidly bringing in menus and practices from elsewhere without carefully assessing their merit, they built the KFC business model slowly and fit their approach to China's diverse conditions.

## The Sophistication of Entrepreneurial China

As Chinese companies become more successful, they are becoming global competitors. Some of them, like Huawei—the world's third-largest maker of mobile-infrastructure equipment and the fifth-largest telecommunications manufacturer overall—are having a dramatic impact on their industries. Huawei played a major role in forcing a global industry restructuring in which Siemens and Nokia merged their network infrastructure divisions and Alcatel acquired Lucent.

In general, the 2008 global economic crisis enhanced the position of Chinese companies and their relationships with overseas enterprises, making them much stronger—and presenting a new sort of challenge to other global companies. The reasons for this robust recovery have to do with fundamentals. Besides fostering its emerging consumer base, China had rid itself of most of the structural rigidities inherited from socialism during the 2000s; its national productivity rose steadily through the decade. The government's economic stimulus, which began to take effect early in 2009, was designed to reinforce these fundamentals and improve the prospects for Chinese businesses. The recession also forced the country's overheated real estate and construction sectors to slow down, consolidate, and shed some of the extra capacity that had built up during the manic years of growth from the late 1990s to early 2008.

The next five to 10 years will see the emergence of a new generation of Chinese companies, bigger but leaner, better able to compete, and prepared to operate on a global basis. For example, over the next five years, while American automakers are focused on their problems at home, some of China's car companies will expand overseas. Similarly, while American and European banks are sorting out the consequences of a financial morass of their own making, some of China's leading financial institutions will have growth strategies built on international expansion. Not every Chinese company will thrive, but many are in strong positions to take advantage of the recession. For instance, they will exploit major declines in corporate valuations in Europe and North America to buy companies headquartered on those continents.

The new wave of Chinese entrepreneurship represents a change in business models—away from a dependence on rapid, low-cost production and copycat R&D, and toward effective long-term management—and it will take some time to develop. Chinese producers are still prone to the vicious circle of commoditization; its relentless focus on cost reduction heightens price competition, which leads to more cost reductions. And most Chinese

companies are still relatively unskilled in the kinds of management methods and knowledge that a global company needs.

But the stronger companies in China are making themselves leaner, with larger market shares and better positions on their industry value chains. They will increasingly make overseas acquisitions that enhance their technological assets, marketing reach, and managerial expertise. These companies will continue to pursue ways of producing goods more cheaply; that cost pressure will remain. But they will also figure out ways of producing and marketing goods more effectively by applying and reapplying the lessons they have learned. Witness the success of Haier, which sells specialized appliances like wine-cooling refrigerators in developed markets, and Fuyao Glass, a maker of glass for the automotive industry, which has made itself a supplier to many China-based car producers.

Or consider the game-changing potential of the Chinese aircraft manufacturing sector. At first glance, this technologically complex, capital-intensive industry would seem like a big leap for a developing nation's economy. But it is official government policy to develop large passenger aircraft and eventually compete with Boeing and Airbus. Given China's record over the last couple of decades of establishing a presence in industries previously deemed too technologically advanced for developing countries, the aircraft initiative could well be successful. And it could happen within a few years—far less time than the two decades it took Airbus to launch its first commercial aircraft.

Chinese manufacturers are entering this market in the same way they develop their presence in every other industry. First they make components; then they sell them at low prices to claim market share; then they expand through acquisitions. This gives them access to further know-how and expertise, allowing them to move up the value chain and build out the range of components they produce, eventually getting to a point where they can make entire products. In 2007, Airbus sourced $60 million worth of components from China; by 2015, it expects that value to have risen to $400 million. In the city of Tianjin, the company's A320 aircraft are being assembled; the first one was completed in June 2009. A separate runway has been built at the city's airport specifically to handle test flights for the aircraft.

China's aircraft manufacturers could have a natural advantage within the burgeoning Chinese airline industry, particularly if the market for air travel within China grows as anticipated. The industry is currently expected to need 3,000 passenger and freight aircraft in the years up to 2025, with an estimated value of just under $290 billion. Like automobile and telecommunications companies before them, aircraft makers will discover that they cannot avoid building production facilities in China because of the combination of lower costs and better access to China's markets.

The challenge for global companies facing this sort of emergent Chinese competition is to get the balance right: They must position themselves for maximum gain while minimizing risk and maintaining their own distinctive edge. This objective is best accomplished by tailoring products for the Chinese market—often with sophisticated support and services that other companies cannot match.

## The Trajectory of Official China

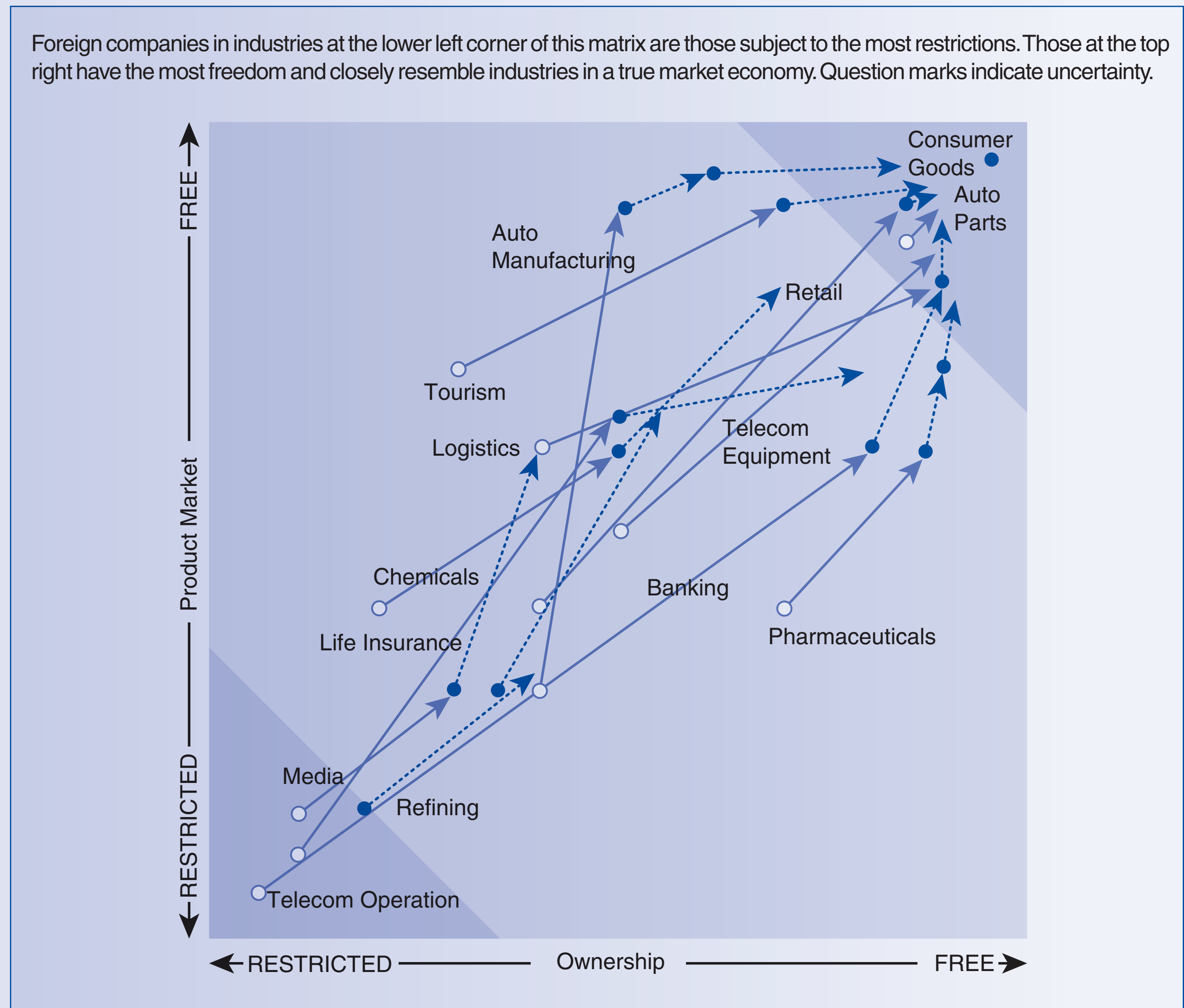
To many observers, especially Westerners, China's embrace of a market-based economy seems to have made the country capitalist in all but name. They assume that in a country with economic freedoms and a rapidly growing middle class, democracy and political freedom will inevitably follow.

But thus far, that assumption has been wrong. Under every plausible scenario, China's government will continue to be authoritarian for the foreseeable future. The Chinese Communist Party (CCP) may be less controlling than it was in the past, but its more than 70 million members continue to dominate every level of government and society—and they are deeply committed to remaining the country's sole holders of political power. Moreover, they (and many of their country's citizens) believe that China's development, both socially and economically, can be achieved for now only under the auspices of the CCP.

In the early 2000s, party leaders directed several research institutes to study examples from other nations, including the collapse of socialist rule in the Soviet Union and the continued success of Singapore's People's Action Party. They concluded that even China's powerful rate of economic growth was not sufficient for stability. They would have to create, as party chief (and current president) Hu Jintao called it, a "harmonious society," reducing inequalities that might lead to social unrest, maintaining openness to the rest of the world, embracing environmental

responsibility, and spending more on education and health care. They would also maintain close control over the business sector, even while fostering more of the entrepreneurial activity that had produced so much success.

For businesses, the result has been a complex and ever-changing set of rules and government practices that determine what a multinational company may or may not be able to achieve in China. At the same time, the general policy of liberalization continues, toward fewer restrictions on ownership (including the right of non-Chinese




Foreign companies in industries at the lower left corner of this matrix are those subject to the most restrictions. Those at the top right have the most freedom and closely resemble industries in a true market economy. Question marks indicate uncertainty.

**Exhibit 2** The Product Market Freedom Matrix

*Source:* Edward Tse, *The China Strategy: Harnessing the Power of the World's Fastest-Growing Economy* (Basic Books, 2010)

companies to own all or part of Chinese subsidiaries) and higher levels of "product market freedom": the ability to make business decisions without government restrictions. (See Exhibit 2.)

But some industries are liberalizing further and faster than others. Consumer goods have had high ownership freedom and high product market freedom for years, because Beijing decided in the early 1990s that the consumer goods industry was not strategic. Telecommunications service companies, by contrast, have had little ownership freedom and little product market freedom. In the early to mid-1990s, many of the world's leading telecom operators

established some kind of presence in China. They all hoped to gain entry when telecom services were liberalized. Yet today, the industry remains entirely in the hands of state-owned companies, with their services strictly licensed, and it will almost certainly stay that way. Consequently, nearly all the foreign operators have packed their bags and left.

Between those extremes, some industries have relatively liberal ownership regulations, but strict controls over what kinds of products and services can be offered. For example, since late 2006, a foreign institution in the banking sector has been able to own up to 20 percent of any Chinese bank, as long as the total stake held by foreign institutions in a Chinese bank does not exceed 25 percent. But credit cards can be offered only via a joint venture with a Chinese bank. And new products are often subject to long delays before approval; it would be very unlikely for a foreign bank to be permitted to introduce an investment innovation before its Chinese counterparts could.

In other sectors, ownership freedom is relatively limited, but product freedom is high. No foreign company can own more than 50 percent of a Chinese motor vehicle maker, for example, but there are few constraints on what kinds of cars the foreign companies make or how they sell them.

In the more-restricted industries—those that the government has deemed strategic—foreign companies have to deal with numerous regulations whose interpretation can vary according to official whim or sentiment. As a result, most or all companies operating within these spheres are state owned or controlled. In the less-restricted industries, multinational companies find themselves facing a proliferation of competitors, often from all corners of the world, quite likely with a surfeit of productive capacity and downward pressure on pricing.

The dynamics of government restriction can be surprisingly complex. For example, since the early 1990s, the soft drinks sector has been open to companies from any country, with almost no oversight from the government. However, when Coca-Cola attempted to buy China's biggest juice maker, Huiyuan Juice, in 2008, it ran into official resistance. The Ministry of Commerce rejected the bid in 2009, citing China's new anti-monopoly law. (Public opinion, which mounted against the deal on blogs and in online forums, did not help Coca-Cola's cause.)

Anticipating the impact of potential changes is not easy. Some sectors, possibly including telecommunications and media, may even become more restricted for some periods. Acknowledging that such changes may happen is essential for a company if it is to be ready to move quickly when events shift in its favor. For some industries, this means maintaining an office in Beijing that can interact with the relevant ministry or other official body. This degree of readiness requires a strong grasp of China's official strategic agenda, and it means having access to the best possible sources of information on government thinking.

## The Mind-set of "One World" Companies

To meet the Chinese challenge, some multinational companies are rethinking the way they do business. The only companies that can take advantage of the massive opportunities are those that place their China activities in a global context as part of an integrated web of capabilities, including manufacturing, marketing and sales, innovation, new business model incubation, and talent development. And that is the fourth component of the challenge: Their own assumptions must change.

For example, global companies will need to become more adept at integrating their Chinese operations into their global value chains. They will need to use their Chinese expansion to significantly improve their global scale and their leverage in sourcing, and to apply superior product designs and standards from elsewhere to the Chinese market. As IBM and Coca-Cola have done, they will need to integrate their upstream activities, such as R&D and product development, into their Chinese operations. And they will need to build marketing platforms that combine local consumer insights with global brands and platforms.

This could involve moving some key elements of their global business into China, including core practices previously maintained at headquarters—just as IBM did with procurement. Nokia, Samsung, and Nike have also started down this path. China is Nokia's leading production center, a major market for its phones, and a primary source of new technological developments. Samsung set aside $1 billion in Chinese investments in 2009 to develop more low- to mid-tier products and to give itself broader market coverage, and Nike built its biggest Asian logistics center in the eastern Chinese province of Jiangsu.

A fully integrated enterprise might also tap into China's research and development skills by establishing new innovation centers, or forming partnerships with Chinese firms or research institutes. So far, many of the new R&D facilities in China conduct little genuine research; their main focus is product localization and testing. But they help companies draw on the most advanced research being done in China, especially in industries the government is prioritizing, such as aerospace, agriculture, and communications technology.

Multinational companies that want to succeed in China will also need to develop better knowledge of Chinese local markets and government priorities. Some of this knowledge can be bought directly from sector consultancies, or, better yet, developed through relationships with government officials. The National Bureau of Statistics of China, the government's main agency responsible for collecting and collating economic and other data, has a long history of collaboration with organizations from overseas. Local Chinese companies can also be a rich source of market understanding in the regions where they operate. Most useful, however, is the knowledge acquired through experience, the kind that comes from building out an operation product by product, city by city, province by province.

In many companies, these sorts of choices will be the subject of continued discussion between the company's world headquarters and China operations. Indeed, a key element in executing global strategy will be the maintenance and management of communication between the two. Keeping headquarters informed of what's happening in China can be a challenge, but when it is overlooked, headquarters executives often fail to understand developments in the country, and may find it difficult to react to possibilities and opportunities rapidly enough.

A related error is to maintain Chinese operations without benefit of the corporation's overall knowledge base; too few multinationals have brought the best practices of their global operations into the country. Without good communication, some companies may find their burgeoning business in China causing disruptions in parts of the enterprise that are thousands of miles away.

Finally, the development of a China-conscious talent strategy, particularly for executives, is crucial. Some multinational companies have a relatively high turnover rate for executives in their Chinese operations. They bring in senior people from elsewhere, people who don't understand the local context, on short-term, rotation-style assignments to "bring them up to speed" in China. This has left these companies with little institutional memory of their hard-learned experiences. Conversely, the multinationals that have performed well in China have tended to leave people in place in the country for years. They look for executives who combine facility in the Chinese language with a global perspective, who make a relatively long-term commitment to their position, and who develop an extremely valuable base of experience over time.

The Chinese themselves have only just started digesting the implications of the changes they are going through. And most multinational companies still have a lot to learn about doing business in China. The transition to being a one-world company will feel unfamiliar and challenging for them, because this type of company is new on the world scene.

And so is the Chinese context: its diverse markets and demographics, policies and regulations, cultures and tastes. Corporate leaders who see China as a large but still-emerging market must now regard it as a diverse and immense group of global consumers. Those who see Chinese companies as partners in joint ventures must come to see those companies as active, highly capable global competitors. And those who see the Chinese government as simultaneously welcoming and opaque must recognize it as an active, increasingly open player on the global stage. In other words, leaders of businesses around the world must see this country in the same way that the corporate leaders of the late 19th century saw the still-emerging United States—and change their strategies accordingly.

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- This article was adapted from Tse's *The China Strategy: Harnessing the Power of the World's Fastest-Growing Economy* (Basic Books, 2010).

## Chapter Outline

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