

What Is Strategy?

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- LO 1-3** Assess the relationship between stakeholder strategy and sustainable competitive advantage.
- LO 1-4** Conduct a stakeholder impact analysis.
- LO 1-5** Apply the Analysis, Formulation, Implementation (AFI) Strategy Framework.

Tesla: The Trillion-Dollar Tech Titan

Tesla, Inc., an American manufacturer of all-electric cars, had a market capitalization¹ of greater than \$1 trillion in 2022, an appreciation of 50,000% over its initial public offering in 2010. Only five other tech companies—Alphabet, Amazon, Apple, Meta Platforms (formerly Facebook), and Microsoft—are in the elite trillion-dollar club.² A mere 18 years after its founding, Tesla is the youngest company to reach this important milestone. Moreover, the Austin, Texas-based electric vehicle company is almost twice as valuable as five major car companies combined: Ford, GM, Stellantis (formerly Fiat Chrysler), Toyota, and Volkswagen (VW).

How did Tesla transform from a fledgling startup to a trillion-dollar tech titan? The answer: Tesla's strategy. In a 2006 blog entry, Elon Musk, Tesla's co-founder and chief executive officer (CEO), explained the startup's master plan:³

1. Build sports car.
2. Use that money to build an affordable car.
3. Use *that* money to build an even more affordable car.
4. While doing above, also provide zero-emission electric power generation options.

Did Tesla stick to its strategy? In 2008, Tesla introduced its first car: the Roadster, a \$110,000 sports coupe with faster acceleration than a Porsche or a Ferrari. The Roadster served as a prototype to demonstrate that electric vehicles (EVs) can be more than mere golf carts. Tesla thus completed Step 1 of its master plan.

In Step 2, after selling 2,500 Roadsters, Tesla stopped producing them in 2012 to focus on its next car: the Model S, a four-door family sedan with an initial base price of \$73,500. The Model S, which appeals to a somewhat broader market and thus allows for larger production runs to drive down unit costs, received an outstanding market

reception. It was named the Motor Trend Car of the Year and received the highest score of any car ever tested by Consumer Reports (99/100). The refreshed Tesla Model S Plaid, introduced in 2022, is the world's fastest mass-production car; it accelerates from 0 mph to 60 mph in two seconds. Tesla has sold more than 300,000 Model S cars worldwide.

Tesla also completed Step 3 of its master plan. In 2016, it unveiled the Model 3, an all-electric compact luxury sedan with a starting price of \$35,000. Many people who wanted the new Model 3 stood in line overnight, eagerly waiting for Tesla stores to open so they could pay their \$1,000 deposit and secure a spot on the waiting list for a car they had never seen, let alone taken for a test drive. As a result of this consumer enthusiasm, Tesla received more than 500,000 preorders for the Model 3, for a total of \$500 million in interest-free loans. Despite Tesla's initial difficulties in scaling up production, Model 3 deliveries began in 2017. In 2019, Tesla launched the Model Y, a compact SUV with the entry version starting at \$39,000 (and a range of 230 miles) and the high-end performance version starting at \$60,000 (and a range of 280 miles).



Elon Musk introduced the Cybertruck in 2019, with mass production of the futuristic truck in 2023.

Frederic J. Brown/AFP/Getty Images

The two lower-priced Models 3 and Y were critical for Tesla to break into the mass market. In 2021, Tesla sold close to 1 million vehicles worldwide, with Models 3/Y accounting for 97% of sales. With upgrade options, the average selling price in 2021 was \$54,000 for the Model 3 and \$68,000 for the Model Y. Despite its higher price, the Model Y is the most popular Tesla vehicle globally, and Tesla continuously works on ramping up production volume to drive down costs further.

Step 4 of Musk's master plan for Tesla aims to provide zero-emission electric power generation options. To achieve this goal, Tesla acquired SolarCity, a solar energy company, for more than \$2 billion in 2016. The integration of Tesla and SolarCity, which resulted in the first fully integrated clean-tech energy company that combines solar power, power storage, and transportation, marks the completion of Step 4 in Tesla's master plan.

In 2016, 10 years after creating Tesla's initial master plan, Elon Musk unveiled the second part of his strategy to

continue the pursuit of Tesla’s vision “to accelerate the advent of sustainable energy.”⁴ Again, CEO Musk detailed a set of stretch goals:

1. Create stunning solar roofs with seamlessly integrated battery storage.
2. Expand the EV product line to address all major segments.
3. Develop a self-driving capability that is 10 times safer than manual via massive fleet learning.
4. Enable your car to make money for you when you aren’t using it.

In the updated strategy, Step 1 leverages the integration of SolarCity. Tesla is now a fully integrated sustainable energy company, combining energy generation and storage. It provides energy generation via solar roofs that look like regular roofing shingles but last longer and cost less, all things considered. Tesla also offers its Powerwall to residential consumers, making it possible to store solar energy captured on the roof of their house for later use. Energy generation therefore becomes decentralized. Thanks to the Powerwall, consumers can generate and use energy without being dependent on a utility company and can sell their excess energy to utility providers. Indeed, consumers can generate enough energy to power not only their Tesla cars but also their entire house. Should there be a power outage in the

central utility grid, the Powerwall provides electricity to a home for one week.

In Step 2, Tesla is planning to expand the EV lineup to address all major market segments. Elon Musk excels in product development, and Tesla has introduced several new vehicles, including a futuristic pickup truck (the Cybertruck, with production in 2023) and a heavy-duty semitruck.

In Step 3, Tesla is developing its vehicles’ self-driving capabilities. The goal is to make self-driving vehicles 10 times safer than cars driven manually, thus increasing the demand for fully autonomous cars. Many industry observers expect commercial trucks to be the first fully autonomous vehicles, especially on interstate highways. Self-driving large trucks can be on the road 24/7 and need to stop only to recharge their batteries.

Fully self-driving capabilities are required for Tesla to fulfill Step 4 of the new master plan: Turn your car into an income-generating asset. The idea is to offer an Uber-like service composed of Tesla vehicles but without drivers. On average, cars are in use for less than three hours a day. The idea is that your self-driving Tesla will be part of a shared vehicle fleet when you are not using it. This new business model drastically reduces the total cost of ownership of a Tesla vehicle. It also allows anyone to ride in a Tesla due to the sharing economy.⁵

Part II of this ChapterCase appears in Section 1.4.



Why is Tesla so successful? In contrast to Tesla’s success, the big three U.S. automakers—Ford, GM, and Chrysler (now Stellantis)—struggled during the first decade of the 21st century, with both GM and Chrysler filing for bankruptcy protection.

Why are some companies successful while others fail? And what, as a strategic leader, can you do about it? These are the big questions that define strategic management. Answering these questions requires integrating the knowledge you’ve obtained in your studies of various business disciplines to understand what leads to superior performance and how you can help your organization achieve it.

Strategic management is the integrative management field that combines *analysis, formulation, and implementation* in the quest for competitive advantage. Mastery of strategic management enables you to view a firm or a nonprofit organization in its entirety. It also allows you to think like a general manager to help your organization achieve superior performance. The *AFI Strategy Framework* embodies this view of strategic management. It will guide our exploration of strategic management throughout this book.

In this chapter, we lay the groundwork for the study of strategic management. First, we introduce foundational ideas about strategy and competitive advantage. We move beyond thinking about competitive advantage solely as superior financial performance and

strategic management

An integrative management field that combines analysis, formulation, and implementation in the quest for competitive advantage.

introduce the concept of stakeholder strategy. Understanding stakeholder strategy allows us to appreciate the role of business in society more broadly. We then examine the components of the AFI framework and provide an overview of the entire strategic management process. We conclude this introductory chapter, as we conclude all other chapters in this text, with a section titled *Implications for Strategic Leaders*, which provides practical applications and considerations of the material developed in the chapter. Let's begin the exciting journey that ends with a deep understanding of strategic management and competitive advantage.

1.1 What Strategy Is: Gaining and Sustaining Competitive Advantage

Strategy is a set of goal-directed and integrated actions a firm takes to gain and sustain superior performance *relative* to competitors.⁶ Strategy is the outcome of the strategic management process. To achieve superior performance, companies compete for resources: New ventures compete for financial and human capital, existing companies compete for profitable growth, charities compete for donations, universities compete for the best students and professors, sports teams compete for championships, and celebrities compete for endorsements. As highlighted in the ChapterCase, Tesla, a new entrant in the automotive industry, is competing for customers with established U.S. companies such as GM and Ford, and with foreign automakers Toyota, Honda, Nissan, Hyundai, VW, Audi, Porsche, Mercedes, and BMW, among others.

A **good strategy** enables a firm to achieve superior performance and sustainable competitive advantage relative to its competitors in any competitive situation. A good strategy consists of three key elements that make up the strategic management process:

1. A *diagnosis* to identify the competitive challenge. Diagnosis includes analyzing the firm's external and internal environments (Part 1 of the AFI framework: *Analysis*).
2. A *guiding policy* to address the competitive challenge through strategy formulation. The guiding policy lays the foundation to craft a firm's corporate, business, and functional strategies (Part 2 of the AFI framework: *Formulation*).
3. A set of *coherent actions* to implement the firm's guiding policy (Part 3 of the AFI framework: *Implementation*).

CRAFTING AND IMPLEMENTING STRATEGY AT TESLA

Let's revisit ChapterCase 1 to see whether Tesla pursues a good strategy. Tesla is performing quite well in terms of indicators such as stock appreciation, where it outperforms its competitors by a wide margin. The appreciation of Tesla stock after its initial public offering (IPO) points to investors' expectations of future growth. By other measures, such as generating profits, Tesla underperforms compared to established car companies. Early on, startups expect losses, especially if the business requires significant upfront investments such as building new manufacturing facilities and retooling existing factories, which Tesla was required to do. Since 2020, Tesla has been generating positive and increasing net income. What we can say at this point is that Tesla seems to be starting with a promising strategy and is in the process of achieving superior performance relative to its competitors. But can Tesla sustain this outstanding performance over time? Let's use the three elements of a good strategy to explore this question.

LO 1-1

Explain the role of strategy in a firm's quest for competitive advantage.

strategy The set of goal-directed and integrated actions a firm takes to gain and sustain superior performance relative to competitors.

good strategy Enables a firm to achieve superior performance and sustainable competitive advantage relative to its competitors. It is the outcome of a strategic management process that consists of three elements: (1) a diagnosis of the competitive challenge; (2) a guiding policy to address the competitive challenge; and (3) a set of coherent actions to implement a firm's guiding policy.

DIAGNOSIS OF THE COMPETITIVE CHALLENGE. A good strategy needs to start with a precise and critical diagnosis of the competitive challenge. Elon Musk, Tesla's co-founder and CEO, describes himself as an "engineer and entrepreneur who builds and operates companies to solve environmental, social, and economic challenges."⁷ Tesla was founded with the vision to "accelerate the world's transition to sustainable transport."⁸

To accomplish this mission, Tesla must build zero-emission electric vehicles that are attractive and affordable. Beyond achieving a competitive advantage for Tesla, Musk is working hard to set a new standard in automotive technology. He hopes that zero-emission electric vehicles will one day replace gasoline-powered cars.

Tesla's competitive challenge is sizable. To succeed, it must use its new technology to manufacture attractive and affordable vehicles, which will compete with cars running on gasoline. To overcome "range anxiety,"⁹ Tesla has installed a charging station network. At this point, mass-market EVs cannot drive as far on one charge as gasoline-powered cars with a tank of gas. Gas stations are pretty much on every corner in cities and every couple of miles on highways.¹⁰

A GUIDING POLICY. After diagnosing the competitive challenge, strategic leaders must formulate an effective guiding policy in response. The developed strategy needs to be consistent over the long term, and it is often backed up with strategic commitments. A *strategic commitment*, for instance, is a sizable investment or a change to an organization's incentive and reward system. Strategic commitments (such as Tesla's Gigafactories) are significant investments resulting in fundamental changes to the organization's structure. In general, strategic commitments are significant changes that are difficult and costly to reverse.

Without consistency in a firm's guiding policy, it can create confusion among employees about which priorities to address. An inconsistent policy, therefore, negatively impacts effective day-to-day decisions that support the overall strategy. Moreover, other stakeholders, including investors and customers, become frustrated if the firm does not have a consistent and coherent strategy over time.

Tesla's guiding policy is to build cost-competitive mass-market vehicles such as Models 3/Y. Its formulated strategy is consistent with its mission and the competitive challenge identified. This strategy required significant strategic commitments, as demonstrated by Tesla's \$5 billion investment in a new lithium-ion battery plant in Nevada, the so-called Gigafactory or Giga Nevada. Batteries are the most critical component of electric vehicles. To build the battery manufacturing component of the Gigafactory, Tesla partnered with Panasonic of Japan, a world leader in battery technology.

To expand global production capacity rapidly and drive down costs, Tesla invested billions in several electric vehicle manufacturing plants across the globe. In 2019, it completed a production facility in Shanghai, China. Giga Shanghai is a vast factory, equal in size to the Tesla car manufacturing facility in Fremont, California, combined with its Gigafactory in Nevada. The goal is to produce batteries and cars on a large scale and in the same location. Large scale and co-location of critical tasks allow Tesla to further lower the price of Models 3/Y. The completion of Giga Shanghai in a record time of less than one year was a turning point for Tesla because the company was facing bankruptcy in 2018. The development and manufacturing costs of the luxury Models S/X were much higher than anticipated, leading to huge losses.

Giga Shanghai services the European market and the Chinese market, which is the largest electric vehicle market globally. The cost of Models 3/Y at Giga Shanghai is an estimated 40% lower than the costs when they are made in the United States, with no loss in quality. To further expand production capacity, in 2022 Tesla opened Giga Berlin, a \$7 billion factory, and Giga Texas (near Austin), a \$10 billion investment. Although such significant up-front investments frequently lead to early-year losses, they also represent a solid and credible commitment to becoming a viable competitor in the mass automobile market. Moreover, they deter entry by other potential newcomers to the EV industry.

COHERENT ACTIONS. Strategic leaders implement a guiding policy through coherent actions. Tesla's strategic leaders implement the formulated strategy with activities consistent with their diagnosis of the competitive challenge. To make a cost-competitive mass-market vehicle, Tesla must benefit from *economies of scale*, decreasing the cost per vehicle as output increases. To reap critical cost reductions, Tesla must ramp up its production volume. Tesla's retooling of its manufacturing facility in Fremont, California, to rely more heavily on cutting-edge robotics as well as its multibillion-dollar investment to secure an uninterrupted supply of lithium-ion batteries, exemplify actions coherent with Tesla's formulated strategy. So do its investments in Gigafactories in Austin, Berlin, and Shanghai.

Another set of coherent actions are those focused on Tesla's best-selling vehicles, Models 3/Y. In 2021, the EV maker doubled its production volume to close to 1 million cars compared to 2020. Thus, since 2015, Tesla has achieved a 20-fold increase in production volume from 50,000 cars built per year. Tesla's focus on Models 3/Y explains why they made up 97% of Tesla's vehicle deliveries in 2021. In addition, to ramp up production and drive down costs even further, Elon Musk announced, in 2022, that Tesla will not introduce any new vehicles for the time being. Moreover, he pushed back the mass production date for the much-anticipated Cybertruck to 2023.

At the same time, Tesla is expanding its network of charging stations across North America, Europe, and Asia. To fund this initiative and to avoid bottlenecks, Tesla announced that it will no longer provide new owners free use of the company's charging network. In addition, to accomplish the lofty goal of making zero-emission electric motors rather than internal combustion engines the new standard in automotive technology, Tesla decided to make some of its proprietary technology available to the public. Musk hopes that sharing Tesla's patents will expand the overall market size for electric vehicles as other manufacturers use Tesla's technology. This set of coherent actions shows that Tesla is dedicated to achieving its mission of accelerating the transition to sustainable transportation.

In review, to craft a good strategy, three steps are crucial in the strategic management process:

- A good strategy must define an organization's competitive challenge through a critical and honest assessment of the status quo.
- A good strategy provides a game plan for dealing with the competitive challenge identified. The firm needs a guiding policy that provides clear guidance for all employees.
- A good strategy requires effective implementation through a coherent and consistent set of actions.

Strategy Highlight 1.1 examines Twitter and asks whether the social media company has a strategy.

Strategy Highlight 1.1

Twitter Needs a Strategy

In late 2021, Jack Dorsey, Twitter’s co-founder, was ousted as CEO for the second time. Dorsey had led Twitter from its founding in 2006 until 2008, and then returned as CEO for a second stint from 2015 until 2021. Despite its prominent role in public discourse, Twitter has failed to live up to expectations. In comparing normalized stock appreciation between Twitter’s initial public offering (IPO) in 2013 and 2022, we see that Twitter’s market cap increased by a mere 25%. Over the same period, the market cap of Meta (formerly Facebook) increased by over 620%. What went wrong? Despite churning through five CEOs in its short history, Twitter did not have a strategy!



Jack Dorsey co-founded Twitter in 2006. He served as CEO from 2006 to 2008 and 2015–2021.

Burston/Bloomberg/Getty Images

Twitter is an online news and social networking site that allows its users to send short messages (“tweets”) of up to 280 characters to their followers. People who follow one another on Twitter can see tweets in each others’ feeds. Users with the most followers include former President Barack Obama with 131 million, Justin Bieber (114 million), Katy Perry (109 million), and Rihanna (104 million). Many politicians, such as U.S. Senate and House Representatives and world leaders such as India’s Prime Minister Narendra Modi (75 million followers), use Twitter to communicate directly with the public, allowing them to bypass traditional media outlets. While famous for its newsy and gossipy content, Twitter’s cultural significance has resulted from its pivotal role during the Arab Spring

(2010–2012), in the Black Lives Matter movement (founded in 2013), and in its real-time coverage of breaking news, such as the raid on Osama bin Laden’s compound in Pakistan (2011) and the killing of George Floyd (2020).

To bolster the assertion that Twitter did not have a strategy, let’s apply the three critical elements of a good strategy: *diagnose the competitive challenge*, *formulate a guiding policy*, and *implement a coherent set of actions*.

DIAGNOSIS OF THE COMPETITIVE CHALLENGE

Twitter is a two-sided platform business, matching users with advertisers. Twitter’s goal is to grow its user base and foster engagement. Capturing a large number of users and their attention allows Twitter to develop fine-grained profiles for each user, which in turn allows it to sell targeted advertising matched to each user’s unique profile. Gaining market share in the digital ad space is critical for Twitter to drive future revenue growth, which is needed to fund continued innovation in product features and services. In 2022, the digital ad spending globally was a whopping \$525 billion.

But compare Twitter’s user base with that of another social media platform, Facebook. Twitter has 210 million daily users compared to Facebook’s 2 billion daily users. Given Twitter’s much smaller user base, advertisers view it as a niche application and thus channel the bulk of their digital ad dollars to three dominant digital ad platforms: Facebook (part of Meta Platforms), Google (part of Alphabet), and Amazon. These digital ad platforms allow advertisers to target their ads with great precision. The dominant ad platforms feed their artificial intelligence (AI) algorithms with data such as the user’s location, browsing history, and demographic information (birth year, university affiliation, network of friends, interests, etc.) thus allowing for precisely targeted ads.

At the same time, Twitter also lost out on the digital ad bonanza during the Covid-19 pandemic. Advertisers poured billions into the digital ad space to reach consumers staying at home during the pandemic. Twitter fell further behind the digital ad giants and younger competitors in the digital ad space, such as Snap and TikTok. The newer entrants doubled their digital revenue during the pandemic.

A GUIDING POLICY Twitter’s guiding policy is “to have the largest audience in the world,”¹¹ which is not a

good strategy. Indeed, it is no strategy at all. Instead, it is a mere statement of desire.

COHERENT ACTIONS As Twitter attempts to attract more users, it encounters trade-offs that are hard, perhaps even impossible, to reconcile. Core users' needs differ from those of casual visitors or passive viewers. To narrow these gaps, Twitter has attempted to be everything to everybody, resulting in strategic confusion. One result was increased frustration among managers and engineers, which led to the turnover of key personnel. Low employee morale and inferior products and services resulted in a competitive disadvantage. Internal turmoil was further stoked by Jack Dorsey's personnel decisions, such as promoting close personal friends into important positions.

GOODBYE @JACK, HELLO @PARAGA Since the company's inception, Twitter's culture has been shaped by infighting and its leaders' public intrigues. Twitter insiders and analysts also charged that Jack Dorsey was "missing in action" as CEO because he focused on his fintech company Square (now Block) and spent little time on Twitter. Things came to a head when Dorsey announced shortly before the Covid-19 pandemic that he would move to Africa. The turmoil at Twitter led Elliott Management, an activist investor, to take a 9% stake in the company. Threatening an ugly proxy fight at the next shareholder meeting, Elliott presented Twitter's board of directors with a list of demands, including Dorsey giving up the CEO role and leaving Twitter.



Parag Agrawal became the CEO of Twitter in November 2021. At 37, A native of India, Agrawal is a computer engineer and scientist who graduated from the prestigious Indian Institute of Technology (IIT). He holds a master's and doctoral degrees from Stanford University. Before being appointed CEO, Agrawal served as Twitter's Chief Technology Officer. When Musk took over Twitter, he fired the company's top management team, including Parag Agrawal.

ZUMA Press, Inc./Alamy Stock Photo

Parag Agrawal, formerly Twitter's Chief Technology Officer, was appointed CEO in late 2021. Under his leadership, Twitter has successfully implemented several strategic initiatives. For example, Twitter decided to shut down its custom-built technology infrastructure (which regularly encountered security, reliability, and scaling issues) and moved its back-end computing needs to Amazon Web Services (AWS), the largest provider of cloud computing. Using AWS allows Twitter to be more innovative and to introduce new features and services faster. Jack Dorsey himself called Twitter "slow" and "not innovative."¹² Agrawal has also focused on fine-tuning Twitter's ad platform, allowing it to serve ads to its users with higher accuracy.

One thorny problem in growing its user base is that Twitter is a text-based SMS service, whereas newer competitors such as Instagram and TikTok are photo and video based. The vast majority of people are visual and not textual. Moreover, pictures and videos allow users to relax, which facilitates online shopping; Twitter is, by its nature, combative. However, Twitter is the forum where news breaks, is shaped, and is battled over, which means that new services will find it hard to dislodge Twitter.

While Twitter's impact on social and cultural life is tremendous, its ability to make money appears limited, given the nature of its product. One option for increasing revenue is to apply AI to Twitter's vast amount of real-time information, and license these data insights to stockbrokers, investment banks, hedge funds, media companies, other Fortune 500 companies, and governments. In 2021, revenues from licensing data to enterprise customers were less than 15% of Twitter's revenues. So, there appears to be room for growth.

Rather than limiting the company to the tactical changes Agrawal spearheaded, the new CEO needed a strategy! As Twitter's market cap continued to decline (from a peak of \$62 billion in March 2021 down to \$29 billion in early 2022—a loss of more than 50%), it became a takeover target.

Elon Musk felt the same way because he revealed (in spring 2022) that he had taken a 9% stake in Twitter, making him the single largest shareholder. Musk has been concerned with Twitter's commitment to free speech. After buying his stake in Twitter, Musk tweeted to his over 100 million followers: "Free speech is essential to a functioning democracy. Do you believe Twitter rigorously adheres to this principle?" He added in a follow-up tweet: "The consequences of this poll will be important. Please vote

(Continued)

carefully.” More than 70% of his followers that responded to the poll voted no. A few weeks later, Musk made an offer to buy Twitter for \$44 billion, taking the company private. He announced sweeping changes in strategy. The new Twitter owner wants less reliance on advertising. Rather, he wants to implement a subscription-based model. Musk also indicated that all human users should be verified and that bots, spam, and scams need to be removed more aggressively. He also advocated for less content moderation as he sees free speech as “the bedrock of a functioning democracy, and Twitter is the digital town square where matters vital to the future of humanity are debated.”

In the summer of 2022, Musk announced that he would walk away from the deal to buy Twitter, arguing that the social message company has not been forthcoming enough in providing him with appropriate data to assess the problem of fake accounts and bots on the site. Twitter’s board responded that they will insist that the agreement will be consummated. Twitter sued Musk to fulfill his commitment to acquiring Twitter at the price premium he originally offered. After some back-and-forth, the acquisition closed in the fall of 2022. Twitter became a private company owned by Elon Musk, who is implementing a new strategy. His first action at Twitter was to fire a slew of senior executives, including the CEO, Parag Agrawal.¹³

LO 1-2

Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

competitive advantage

Superior performance relative to other competitors in the same industry or the industry average.

sustainable competitive advantage

Outperforming competitors or the industry average over a prolonged period of time.

competitive disadvantage

Underperformance relative to other competitors in the same industry or the industry average.

competitive parity

Performance of two or more firms at the same level.

WHAT IS COMPETITIVE ADVANTAGE?

A firm with superior performance relative to competitors in the same industry or the industry average has a **competitive advantage**.¹⁴ Competitive advantage is always *relative*, not absolute. To assess competitive advantage, we compare firm performance to a *benchmark*—either the performance of other firms in the same industry or an industry average. Tesla’s stock market valuation has increased much more in recent years than the market valuation of the major carmakers combined and thus has a competitive advantage, at least on this dimension.

A firm that can outperform its competitors or the industry average over a prolonged period has a **sustainable competitive advantage**. Apple, for example, has enjoyed a sustainable competitive advantage over Samsung in the smartphone industry since introducing the iPhone in 2007. Brands with smaller market share include HTC (Google Pixel phones), LG, and Motorola/Lenovo. Other phone makers, such as Microsoft (which purchased Nokia) and BlackBerry, have exited the smartphone market, while new entrants such as Oppo, Xiaomi, and ZTE of China are gaining traction.

If a firm underperforms its rivals or the industry average, it has a **competitive disadvantage**. For example, a 15% return on invested capital may sound like superior firm performance. In the consulting industry, though, where the average return on invested capital is often above 20%, such a return puts a firm at a competitive disadvantage. In contrast, if a firm’s return on invested capital is 2% in a declining industry such as newspaper publishing, where the industry average has been -5% for the past few years, then the firm has a competitive advantage. When two or more firms perform at the same level, they have **competitive parity**. In Chapter 5, we discuss in greater depth how to evaluate and assess competitive advantage and firm performance.

Two distinct strategies form the basis for competitive advantage:

- A firm provides goods or services that consumers *value more* than its competitors’ offerings, but at a *similar cost* (a *differentiation* strategy), or
- the firm furnishes goods and services *similar* to those of competitors but at a *lower cost* (a *cost leadership* strategy).

The rewards of superior value creation and capture are higher profitability and increased market share. For example, Elon Musk, who is motivated to address climate change, formed

Tesla to build electric vehicles with zero emissions. Sara Blakely, founder and CEO of Spanx, the global leader in the shapewear industry, is motivated to promote confidence in people. In creating Walmart, now the world's largest retailer, Sam Walton was driven to offer acceptable value at a lower cost than his competitors. Successful companies fill a need and provide a product, service, or experience that consumers want at a price they can afford while still making a profit. For Musk, Blakely, Walton, and numerous other entrepreneurs and businesspeople, creating shareholder value and making money is the *consequence* of being purpose-driven.¹⁵

The critical point here is that a good strategy delivers superior value while managing the costs of creating it or by offering similar value at a lower cost. Managers achieve these combinations of value and cost through *strategic positioning*. They stake out a unique position that allows the firm to provide value to customers while controlling costs. The larger the difference between value creation and cost, the greater the firm's *economic contribution* and the greater the likelihood of gaining a competitive advantage.

Strategic positioning requires *trade-offs*, however. Walmart has a clear strategic profile and serves a specific market segment as a low-cost retailer. Upscale retailer Nordstrom has also built a clear strategic profile, but it is almost the opposite of Walmart's: Nordstrom provides superior customer service to a high-end, luxury market segment. Although these companies are in the same industry, they are not direct competitors because their customer segments have very little overlap. Walmart and Nordstrom have chosen distinct but different strategic positions: cost leadership for Walmart, differentiation for Nordstrom. Their strategic leaders make conscious trade-offs that help each company strive for competitive advantage in the retail industry. Walmart provides acceptable service in a big-box retail outlet offering "everyday low prices," while Nordstrom offers a superior customer experience by hiring professional salespeople and offering a luxury setting.

Each retailer's clear strategic profile—which specifies its level of product differentiation, customer service, and cost structure—allows it to meet specific customer needs. The goal is to create value for customers (in this example, through lower prices or better service and selection). Even though Walmart and Nordstrom compete in the same industry, both can win if they achieve a clear strategic position through a well-executed competitive strategy. Strategy, therefore, is not a zero-sum game.

The key to a successful strategy is to combine activities to stake out a *unique strategic position* in an industry. Competitive advantage comes from performing different activities or performing the same activities differently from rivals. Ideally, consistent and coherent activities reinforce one another rather than create trade-offs. For instance, Walmart's strategic decisions work together to strengthen its position as a cost leader. Key components of Walmart's success include its big retail stores in rural locations, extremely high purchasing power, sophisticated IT systems, large regional distribution centers, low corporate overhead, decent base wages (well above the federal minimum) and salaries, employee profit-sharing, and a highly effective website (walmart.com) that provides an omnichannel experience (in-store/curbside pick-up or delivery).

Because precise strategic positioning requires trade-offs, strategy is as much about deciding what *not* to do as it is about deciding what to do.¹⁶ Because resources are limited, decision-makers must carefully consider their strategic choices in the quest for competitive advantage. Trying to be everything to everybody will likely result in inferior performance.

As a striking example, the Sears department store chain was founded in 1886 and long hailed as an innovator. For instance, Sears pioneered its iconic mail-order catalog, which allowed customers in rural and remote areas of the United States to shop like city dwellers. The Sears catalog was an early version of Amazon.com, albeit with a smaller selection and slower delivery time. However, as time progressed and Sears failed to adapt to new

competitive challenges, it lost its competitive advantage. In recent years, Sears did not have a clear strategic position and tried to be too many things for too many types of customers. Consequently, after more than 130 years in business, Sears filed for bankruptcy in 2018.

It is also important to note that operational effectiveness, marketing skills, and other functional expertise can strengthen a unique strategic position. However, those capabilities do not substitute for competitive strategy. Competing to be similar to but just a bit better than your competitor is likely a recipe for cutthroat competition and low profits. Let's examine this idea further with a quick thought experiment: If all firms in the same industry pursue a low-cost position through the application of competitive benchmarking, then all firms will have an identical cost structure. None could gain a competitive advantage. Everyone would be running faster, but nothing would change in relative strategic positions.

Red Queen effect

A situation in which everyone runs faster but there are no changes in relative strategic positions.

THE RED QUEEN EFFECT IN BUSINESS COMPETITION. The **Red Queen effect**¹⁷ refers to a situation in which everyone runs faster but there are no changes in relative strategic positions. That is, studying and copying the competition results in unsuccessful efforts to gain a competitive advantage. The metaphor of the Red Queen comes from Lewis Carroll's novel *Through the Looking Glass*, in which the Red Queen informs Alice, "Here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!"¹⁸

Applying the idea of the Red Queen effect to business competition implies that when competitors copy one another, everyone will run faster, but their relative strategic positions may not change. The result is zero-sum competition in which a firm can gain market share only at a competitor's expense. As the Red Queen effect plays out, there is little value creation for customers because companies have no resources to invest in product and process improvements. Moreover, the least-efficient firms will be driven out of business, thus reducing customer choice.

To gain a deeper understanding of what strategy is, it is therefore helpful to think about what strategy is *not*.¹⁹ Be on the lookout for the following red flags of what strategy is *not*:

Grandiose Statements Are Not Strategy. You may hear leaders say, "Our strategy is to win" or "We will be No. 1." Twitter, for example, declared its "ambition is to have the largest audience in the world."²⁰ These statements of desire, on their own, are not strategies. They provide little managerial guidance and often lead to goal conflict and confusion. Moreover, this type of wishful thinking frequently fails to address the economic fundamentals of *value creation* and *cost*. A compelling vision and mission *can* lay the foundation for crafting a good strategy; however, strategic actions and commitments based on economic fundamentals must address the competitive challenge identified.

A Failure to Face a Competitive Challenge Is Not Strategy. If a firm's leaders do not define a clear competitive challenge, employees have no way of assessing whether they are making progress in addressing it. For example, strategic leaders at the now-defunct video rental chain Blockbuster failed to address the competitive challenges posed by new players, including Netflix and Redbox. Likewise, Blackberry RIM did not address the competitive challenge posed by Apple's iPhone. Microsoft initially failed to address the shift to mobile computing pioneered by Google's Android and Apple's iOS.

Operational Effectiveness, Competitive Benchmarking, and Other Tactical Tools Are Not Strategy. People casually refer to a host of different policies and initiatives as "strategy": pricing strategy, internet strategy, alliance strategy, operations strategy, AI strategy, brand strategy, marketing strategy, HR strategy, China strategy, Covid-19 strategy, and so on. These elements may be a *necessary* part of a firm's functional and global initiatives to

support its competitive strategy. However, they are *not sufficient* to achieve a competitive advantage. We reserve the term *strategy* for describing the firm's overall efforts to *gain and sustain a competitive advantage*.

1.2 Stakeholder Strategy and Competitive Advantage

VALUE CREATION

Companies with a good strategy generate value for society. When firms compete in their self-interest while obeying the law and acting ethically, they ultimately create value. **Value creation** occurs because companies with a good strategy can provide products or services to consumers at a price point that they can afford while keeping costs under control, thus making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created. As a result, society is better off.²¹

Thus value creation lays the foundation for the societal benefits that successful economies can provide: education, infrastructure, public safety, health care, clean water, and clean air, among others. Superior performance allows a firm to reinvest some of its profits and grow, providing more employment and career opportunities to the workforce. Google started as a research project in graduate school by Larry Page and Sergey Brin. Some 25 years later, it became one of the most valuable companies globally, with \$2 trillion in market capitalization and 160,000 employees. Moreover, billions of people worldwide rely on Google for information gathering, a free service for the end user.²²

In contrast, strategic failure can be expensive. Once a leading technology company, Hewlett-Packard was known for innovation that resulted in superior products. The “HP way of management” included lifetime employment, generous benefits, work/life balance, and freedom to explore ideas.²³ However, HP has not been able to address the competitive challenges of cloud and mobile computing, AI, and virtual and augmented reality, and HP's strategic mishaps destroyed significant shareholder value. The company also had to lay off tens of thousands of employees. Its customers no longer received the innovative products and services that made HP famous. The contrasting examples of Google and HP illustrate the relationship between individual firms, competitive advantage, and society. Successful firms ultimately create value for society.

The goals of a good strategy are to create value and to capture some of it. Thus a good strategy creates a direct link between business and society. All organizations are embedded in a network of exchange relationships. Therefore, to manage a multifaceted and diverse set of relationships effectively, all organizations need a stakeholder strategy.²⁴

STAKEHOLDER STRATEGY. **Stakeholders** are organizations, groups, and individuals that can affect or be affected by a firm's actions. They have a vested claim or interest in the firm's performance and continued survival.²⁵ Stakeholders make specific contributions to a firm, providing different types of benefits to various stakeholders:

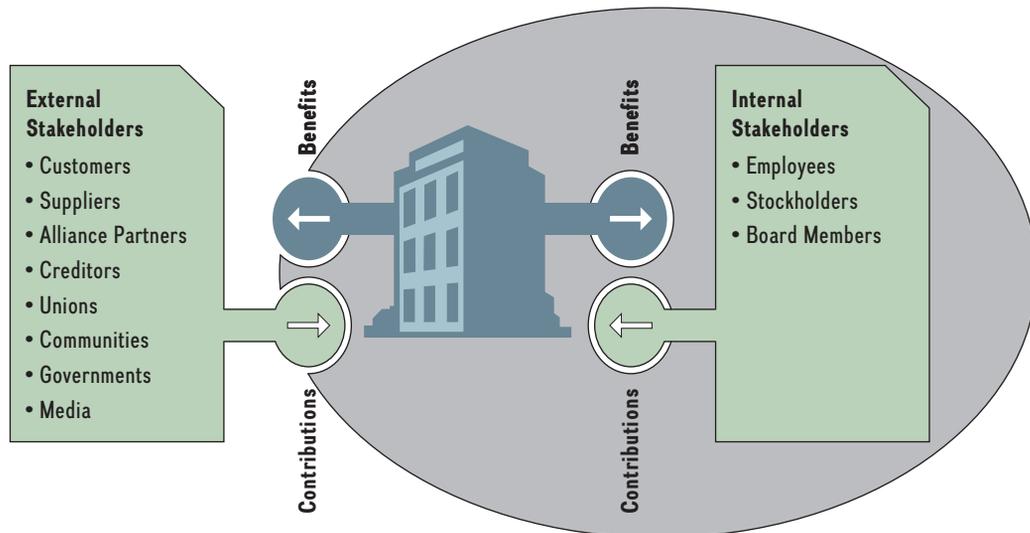
- Shareholders provide capital with the expectation that they will receive a return on their investment in stock appreciation and dividend payments.
- Creditors such as debt holders provide financing for the firm.
- Employees contribute their time and talents to the firm, receiving wages and salaries in exchange.
- Communities furnish real estate, infrastructure, and public safety.

LO 1-3

Assess the relationship between stakeholder strategy and sustainable competitive advantage.

value creation Occurs when companies with a good strategy are able to provide products or services to consumers at a price point that they can afford while keeping their costs in check, thus making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created.

stakeholders Organizations, groups, and individuals that can affect or are affected by a firm's actions.

EXHIBIT 1.1 Internal and External Stakeholders in an Exchange Relationship with the Firm

In return for their various contributions, stakeholders expect companies to pay competitive salaries, provide health insurance, pay their fair share of taxes, provide safe employment, and not pollute the environment. The firm, therefore, is embedded in a *network of exchange relationships* with a diverse set of internal and external stakeholders. As shown in Exhibit 1.1, *internal stakeholders* include employees (executives, managers, and workers), stockholders, and board members. *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media. If any stakeholder withholds participation in the firm's exchange relationships, it can negatively affect firm performance.

stakeholder strategy

An approach to strategy formulation that considers all of the company's stakeholders, not just its shareholders. A core tenet of stakeholder strategy is that a single-minded focus on shareholders exposes a firm to undue risks.

A core tenet of **stakeholder strategy** is that a single-minded focus on shareholders exposes a firm to undue risks. Putting shareholder interest above all else can undermine the company's economic performance and even threaten its very survival. Therefore, strategic leaders must understand the complex web of exchange relationships among different stakeholders. Based on that understanding, the firm can proactively shape the various associations to maximize the joint value created and manage the distribution of this larger pie fairly and transparently. Effective stakeholder management exemplifies how strategic leaders can improve the firm's performance, thereby enhancing its competitive advantage and increasing the likelihood of its continued survival.²⁶

Strategy scholars have provided several arguments as to why effective stakeholder management can increase firm performance:²⁷

- Satisfied stakeholders are more cooperative and thus more likely to reveal information that can further increase the firm's value creation or lower its costs.
- Increased trust lowers the costs of firms' business transactions.
- Effective management of the complex web of stakeholders can lead to greater organizational adaptability and flexibility.
- The likelihood of adverse outcomes can be reduced, creating more predictable and stable returns.
- Firms can build strong reputations that are rewarded by business partners, employees, and customers. Most strategic leaders care about the firm's public perception, and they

celebrate and publicize their inclusion in high-profile rankings such as *Fortune*'s "World's Most Admired Companies," which is published annually.²⁸ In 2021, the top five companies in this ranking were Apple, Amazon, Microsoft, Disney, and Starbucks. Because of its continued innovation in products, services, and delivery, Apple has been ranked as the world's most admired company by *Fortune* for the past 14 years.

STAKEHOLDER IMPACT ANALYSIS

The critical challenge in the pursuit of stakeholder strategy is to effectively balance the needs of various stakeholders. Some of these needs may be in conflict. Strategic leaders need to ensure that their shareholders achieve their desired return on investments. At the same time, the firm needs to recognize and address the concerns of other stakeholders—employees, suppliers, customers, and communities—ethically and fairly so that they too are satisfied. Approaching stakeholder strategy in this manner sounds good in theory, but how can strategic leaders go about it in practice?

Stakeholder impact analysis provides a decision tool that helps strategic leaders recognize, prioritize, and address the needs of different stakeholders. It helps the firm achieve a competitive advantage while being a good corporate citizen. Stakeholder impact analysis takes strategic leaders through a five-step process to recognize and evaluate stakeholders' claims. Each step must pay attention to three crucial stakeholder attributes: *power*, *legitimacy*, and *urgency*.²⁹

- A stakeholder has *power* over a company when it can get the firm to do something that it would not otherwise do.
- When a stakeholder's claim is perceived as legally valid or otherwise appropriate, that stakeholder has a *legitimate claim*.
- A stakeholder has an *urgent claim* when it requires a company's immediate attention and response.

Exhibit 1.2 depicts the five steps in stakeholder impact analysis and the corresponding critical question. Let's look at each step in detail.



LO 1-4

Conduct a stakeholder impact analysis.

stakeholder impact analysis A decision tool with which managers can recognize, prioritize, and address the needs of different stakeholders, enabling the firm to achieve competitive advantage while acting as a good corporate citizen.

EXHIBIT 1.2

Stakeholder Impact Analysis

STEP 1: IDENTIFY STAKEHOLDERS. In Step 1, strategic leaders ask, “Who are our stakeholders?” In this step, the strategic leaders focus on stakeholders that currently have or potentially can have a material effect on the company. This prioritization identifies the most powerful internal and external stakeholders and their needs. For public-stock companies, key stakeholders are the shareholders and other capital providers. If shareholders are not satisfied with investment returns, they will sell their stock, leading to a decrease in its market value. If this process continues, the company may become a takeover target or get stuck in a vicious cycle of continuous decline.

The second group of stakeholders includes customers, suppliers, and unions. Local communities and the media are also influential stakeholders that can affect the smooth operation of the firm. If their needs are not met, any of these groups can materially affect the firm’s operations.

STEP 2: IDENTIFY STAKEHOLDERS’ INTERESTS. In Step 2, strategic leaders ask, “What are our stakeholders’ interests and claims?” Their goal is to specify and assess the interests and claims of the pertinent stakeholders using the power, legitimacy, and urgency criteria introduced earlier.

As the legal owners of a firm, shareholders have the most legitimate claim on a company’s profits. However, the wall separating the claims of ownership (by shareholders) and the claims of management (by employees) has been eroding. Many companies incentivize top executives by paying part of their overall compensation with stock options. They also turn employees into shareholders through *employee stock ownership plans (ESOPs)*, which allow employees to purchase stock at a discounted rate or use company stock as an investment vehicle for retirement savings. For example, Alphabet, Coca-Cola, Meta (Facebook’s parent), Microsoft, Southwest Airlines, Starbucks, and Walmart offer ESOPs. The claims and interests of stakeholders who are employed by the company and who depend on the company for salary, wages, and other benefits such as health care will be somewhat different from those of stakeholders who merely own stock. The latter are investors primarily interested in dividend payments and increasing the value of their stock holdings. Employees tend to be more interested in career opportunities, job security, employer-provided health care, paid vacation time, and other perks.

Even within stakeholder groups, there can be significant variation in the power of individual stakeholders. For example, public companies pay more attention to large investors than to millions of smaller, individual investors. *Shareholder activists* such as hedge funds and individuals such as Elliott Management, Bill Ackman (Pershing Square), Carl Icahn, Daniel Loeb (Third Point), and Nelson Peltz (Trian) buy equity stakes in corporations they view as underperforming. Then they pressure a company to change its strategy, for example through a media campaign and shareholder resolutions at annual meetings. Examples of activist activities include the takeover battle at Dell Computer (which founder Michael Dell subsequently took private before taking the company public again a few years later), the pressure on PepsiCo to spin off its Frito-Lay brand, and the pressure on Yahoo to sell itself to Verizon, which it did. Even top-performing companies are not immune to pressure from shareholder activists.³⁰ As a result of a sustained competitive advantage over the last decade, Apple became the first company to be valued above \$1 trillion (in 2018), amassing \$200 billion in cash in the process. Apple CEO Tim Cook faced significant pressure from Carl Icahn, who held roughly \$4 billion worth of Apple stock, to buy back more of its shares and thus to raise Apple’s share price further. Cook obliged, and Apple bought back a significant amount of stock, using its cash to bolster its share price.

Although individual and activist investors may claim the same legitimacy as stockholders, shareholder activists have more power over a firm. They can buy and sell a large number

of shares at once or exercise block-voting rights in the *corporate governance process* (which we discuss in detail in Chapter 12). Shareholder activists frequently also demand seats on the company's board to influence its corporate governance and strategy more directly. For instance, Jack Dorsey's ouster as CEO of Twitter (Strategy Highlight 1.1) was initiated by activist investors Elliott Management and Silver Lake. Owning \$2 billion combined in Twitter stock, the activist investors also each secured a seat on Twitter's board of directors and with it a direct influence over CEO appointments and the firm's strategy. These abilities make activist investors influential stakeholders with urgent and legitimate claims.

STEP 3: IDENTIFY OPPORTUNITIES AND THREATS. In Step 3, strategic leaders ask, "What opportunities and threats do our stakeholders present?"

Consumer boycotts, for example, can be a powerful threat or force affecting a company's behavior. For instance:

- BP faced a boycott for its role in the 2010 Gulf of Mexico oil spill, which resulted in environmental damage.
- Consumers boycotted Nestlé in response to its aggressive marketing of infant formula in developing countries. Specifically, boycotters noted that some of these countries lack dependable sources of clean water, which must be mixed with the formula; the polluted water led to high infant mortality. Boycotters also criticized the high price of the formula, which could consume up to 30% of a family's disposable income.
- PETA³¹ called for a boycott of McDonald's due to alleged animal-rights abuses.

In the best-case scenario, strategic leaders transform such threats into opportunities. Sony Corp. of Japan did just that.³² During one holiday season, the Dutch government blocked Sony's entire holiday-season shipment of PlayStation game systems, valued at roughly \$500 million, into the European Union because of a small but legally unacceptable amount of toxic cadmium discovered in one of the system's cables. This incident led to an 18-month investigation in which Sony inspected over 6,000 supplier factories worldwide to track down the source of the problem. The findings allowed Sony to redesign and develop a cutting-edge supplier management system that adheres to stringent standards.

STEP 4: IDENTIFY SOCIAL RESPONSIBILITIES. In Step 4, strategic leaders ask, "What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?" To identify these responsibilities more effectively, scholars have advanced the notion of **corporate social responsibility (CSR)** to help firms recognize and meet society's expectations of the business enterprise.³³ According to the CSR perspective, strategic leaders need to realize that society grants shareholders the right and privilege to create a publicly traded company. Therefore, the firm owes something to the community.³⁴ CSR provides strategic leaders with a conceptual model that helps them identify society's expectations and guides strategic decision making. CSR has four components:

- Economic responsibilities
- Legal responsibilities
- Ethical responsibilities
- Philanthropic responsibilities³⁵

Economic Responsibilities. According to the CSR perspective, a business enterprise is first and foremost an economic institution. Investors expect an adequate return for the risks they take. Creditors expect the firm to repay its debts with interest. Consumers expect safe products and services at reasonable prices and acceptable quality. Suppliers expect to be

corporate social responsibility (CSR) A framework that helps firms recognize and address the economic, legal, social, and philanthropic expectations that society has of the business enterprise at a given point in time.

paid in full and on time. Governments expect the firm to pay its fair share of taxes and manage natural resources such as air and water. To meet all these expectations, firms must obey the law and act ethically in their quest to gain and sustain competitive advantage.

Legal Responsibilities. Laws and regulations embody a society's notions of right and wrong. They also establish the rules of the game. For example, businesses can function because property rights exist and contracts can be enforced in courts of law. Strategic leaders must ensure that their firms obey all laws and regulations, including but not limited to labor, consumer protection, and environmental laws.

One far-reaching piece of U.S. legislation in terms of business impact is the Patient Protection and Affordable Care Act (PPACA), more commonly known as the Affordable Care Act (ACA, passed in 2010). One key provision of the ACA is that health insurance providers are not allowed to deny coverage based on preexisting medical conditions. As a consequence, health care premiums, whose cost is frequently shared by employers and employees, have been rising because the people insured are now less healthy as a group.³⁶

Ethical Responsibilities. Legal responsibilities often define only the minimum acceptable standards for firm behavior. Frequently, strategic leaders are called upon to go beyond minimum legal requirements. The letter of the law cannot address or anticipate all possible business situations and newly emerging concerns, such as internet privacy or advances in artificial intelligence, DNA testing, genetic engineering, and stem cell research. A firm's ethical responsibilities, therefore, go beyond its legal responsibilities to reflect the full scope of stakeholders' expectations, norms, and values. Strategic leaders are called upon to do what society deems just and fair.

Consider a recent example. Starbucks received harsh criticism from multiple stakeholders (in 2018).³⁷ Calls to #BoycottStarbucks went viral on social media. The cause of the firestorm was the arrest of two Black men at one of its Philadelphia stores. Reports indicated that the two men had entered the Starbucks store and asked one of the employees to use the restroom. The employee refused permission because the men had not (yet) purchased anything. The men then sat down, stating they were meeting an associate for a business meeting and that they would order upon his arrival. Shortly after that, the two men were asked to leave the store. The store manager eventually called the police, who arrested them for alleged trespassing. A patron videotaped the entire scene and then posted it to Twitter; it has since been viewed more than 11 million times and retweeted more than 150,000 times. In the video, police officers are handcuffing the two men while a perplexed and upset bystander repeatedly asks the police, "But what did they do? What did they do? Someone tell me what they did."³⁸

In response to the public outcry over the store's actions and the grave concerns expressed by stakeholders, Starbucks then-CEO Kevin Johnson issued a formal apology in which he expressed regret over the situation's "reprehensible outcome" and stated that the actions of the employees were "not representative of ... Starbucks' mission and values."³⁹ A few weeks after the incident, Starbucks closed its more than 8,000 U.S. stores for a full day and dedicated the day to diversity training for all employees. Closing its stores to provide training was not an action Starbucks was legally required to do, and it cost the company an enormous amount of money, but Starbucks felt ethically obligated to do so.⁴⁰

Philanthropic Responsibilities. Philanthropic responsibilities are often subsumed under the idea of *corporate citizenship*, the idea that companies should voluntarily give back to society. Over the years, Microsoft's corporate philanthropy program has donated more than \$3 billion in cash and software to people without access to computer technology.⁴¹

The pyramid in Exhibit 1.3 summarizes the four components of corporate social responsibility.⁴² Economic responsibilities are the foundational building block, followed by legal,

**EXHIBIT 1.3**

The Pyramid of Corporate Social Responsibility

Source: Adapted from A. B. Carroll (1991, July–August), “The pyramid of corporate social responsibility: Toward the moral management of organizational stakeholders,” *Business Horizons*: 42.

ethical, and philanthropic responsibilities. Note that society and shareholders *require* economic and legal responsibilities. Ethical and philanthropic responsibilities result from a society’s expectations of business. The pyramid symbolizes the need for firms to balance their social responsibilities carefully. Doing so ensures not only effective strategy implementation but also long-term viability.

STEP 5: ADDRESS STAKEHOLDER CONCERNS. Finally, in Step 5, the firm asks, “What should we do to effectively address the stakeholder concerns?” In this last step in stakeholder impact analysis, strategic leaders need to decide the appropriate course of action for the firm, given all of the preceding factors. Thinking about power, legitimacy, and urgency attributes helps firms prioritize the legitimate claims and address them accordingly.

Strategy Highlight 1.2 describes Merck’s stakeholder strategy, which is anchored in ethical core values. It showcases how Merck considered and addressed various claims from a wide variety of stakeholders, among them the most disadvantaged patients who can’t afford to pay for medications. It also explains a major misstep on Merck’s part.

Strategy Highlight 1.2

Merck’s Stakeholder Strategy

Merck’s vision is to *preserve and improve human life*. The words of founder George W. Merck still form the basis of the company’s values today: *We try to never forget that medicine is for the people. It is not for profits. The profits follow, and if we have remembered that, they have never failed to appear.*⁴³

ENDING RIVER BLINDNESS Ray Vagelos, a former Merck scientist turned CEO, announced in 1987 that

the company would donate, free of charge, its recently developed drug Mectizan to treat river blindness. For centuries, river blindness—a parasitic disease that causes blindness—plagued remote communities in Africa and other parts of the world. Merck’s executives formed a novel private-public partnership, the Mectizan Donation Program (MDP), to distribute the drug in remote areas, where health services are often unavailable.

A 35-year-long effort, with some 120,000 communities served and more than 1 billion treatments administered,

(Continued)

effectively eradicated the disease. Kenneth Frazier, Merck's Executive Chairman, announced himself "humbled" by the result of the company's value-driven actions.⁴⁴



Kenneth Frazier is the Executive Chairman of Merck and served as its CEO from 2011 to 2021. *Time* magazine included him in its list of the world's most influential people in 2018 and 2021.

Stephanie Keith/Getty Images

WITHDRAWING VIOXX The MDP marked a high point in the public's perception of Merck. In contrast, its stakeholder strategy for Vioxx had a disastrous effect. Vioxx is a painkiller that Merck developed to produce fewer gastrointestinal side effects than aspirin or ibuprofen. After the Food and Drug Administration (FDA) approved the new drug in 1999, Merck engaged in typical Big Pharma promotional practices, including:

- Heavy direct-to-consumer advertising via TV and other media
- Luxury doctor inducements, including consulting contracts and free retreats at exotic resorts

Vioxx was a blockbuster, generating revenues of \$2.5 billion a year by 2002 and growing fast.

When evidence began to appear that Vioxx caused heart attacks and strokes, critics alleged that Merck had suppressed evidence from early clinical trials about Vioxx's dangerous side effects. In 2004, Merck voluntarily recalled the drug. Merck's CEO at the time, Raymond Gilmartin, framed the situation in terms of knowledge learned *after* the initial release. He said he received a phone call from the head of research: "He told me that our long-term safety study of Vioxx was showing an increased risk of cardiovascular events compared to placebo, and the trial was being discontinued After analyzing the data further and consulting with outside experts, the Merck scientists recommended that we voluntarily withdraw the drug."⁴⁵

The voluntary withdrawal reconfirmed Merck's core value that patients come before profits. Nonetheless, the Vioxx incident damaged Merck's reputation, and its stock fell almost 30%, eradicating \$27 billion in market value almost overnight. Moreover, Merck has been hit by Vioxx-related lawsuits ever since, and legal liabilities have cost the company up to \$30 billion thus far. Taken together, the value destruction of \$57 billion was much greater than the estimated net present value of Merck's profits from continued sales of Vioxx.

In addition, some corporate social responsibility experts argue that Merck should have never put Vioxx on the market in the first place or that it should have at least provided up-front a clear assessment of the risks associated with it.⁴⁶

LO 1-5

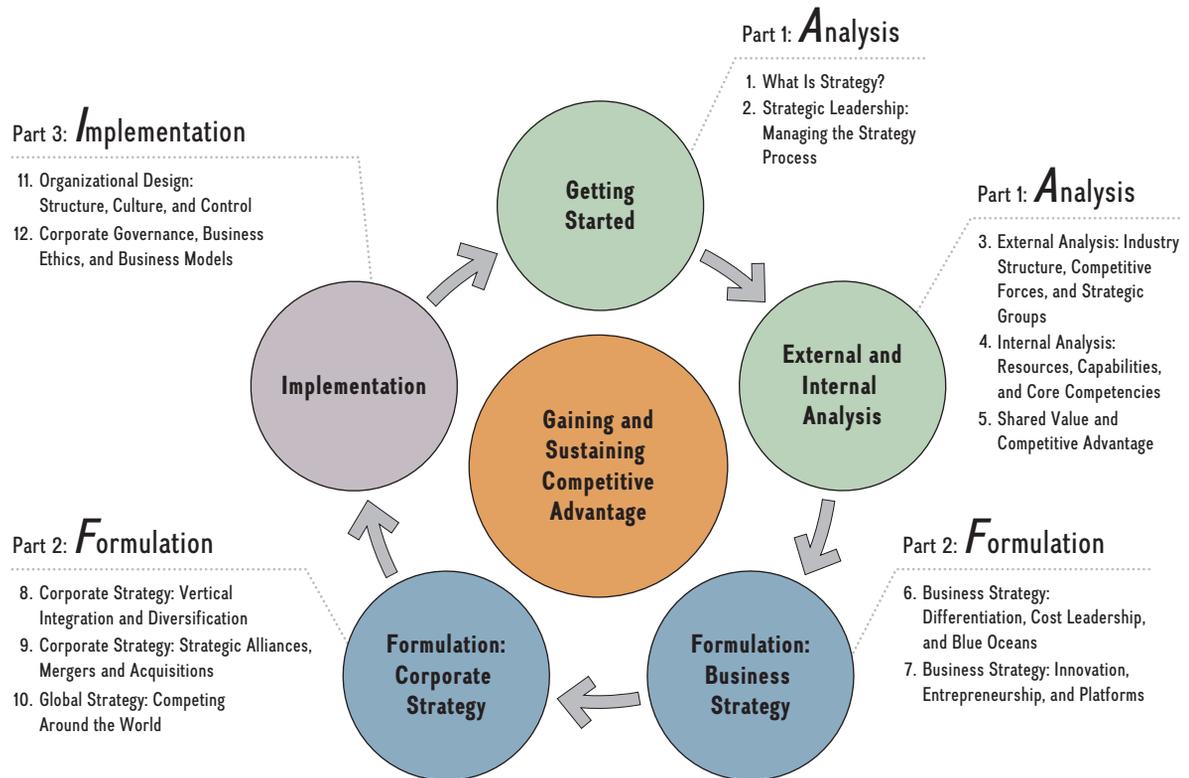
Apply the Analysis, Formulation, Implementation (AFI) Strategy Framework.

1.3 The Analysis, Formulation, Implementation (AFI) Strategy Framework

How do leaders craft and execute a strategy that enhances their chances of achieving superior performance? A successful strategy details a set of actions that managers take to gain and sustain a competitive advantage. Effectively managing the strategy process is the result of the following:

1. Analysis (A)
2. Formulation (F)
3. Implementation (I)

These three tasks are the pillars of research and knowledge of strategic management. Although we will study these tasks one at a time, they are highly interdependent and frequently occur simultaneously. Effective managers do not formulate a strategy without thinking about how to implement it. Likewise, while managers implement strategy, they also adjust to changing circumstances.

EXHIBIT 1.4 The Analysis, Formulation, Implementation (AFI) Strategy Framework

We've captured these interdependent relationships in the **Analysis, Formulation, Implementation (AFI) Strategy Framework** shown in Exhibit 1.4. This framework

1. Explains and predicts differences in firm performance.
2. Helps leaders formulate and implement a strategy that can result in superior performance.

Each broad strategy task raises specific topics and questions that managers must address. These questions and topics are listed in this section. They are also addressed in the specific chapters listed in Exhibit 1.4. Chapters 1 to 5 (Part 1) address questions related to analysis, Chapters 6 to 10 (Part 2) cover formulation, and Chapters 11 and 12 (Part 3) cover implementation.

KEY TOPICS AND QUESTIONS OF THE AFI STRATEGY FRAMEWORK

Analysis (A)

- **Strategic Leadership and the Strategy Process.** *What roles do strategic leaders play, and how do they help shape a firm's vision, mission, and values? How does strategy come about, and what process for creating strategy should strategic leaders put in place?* (Chapter 2)
- **External Analysis.** *What effects do forces in the external environment have on the firm's potential to gain and sustain a competitive advantage? How should the firm deal with them?* (Chapter 3)

Analysis, Formulation, Implementation (AFI) Strategy Framework

A model that links three interdependent strategic management tasks—analyze, formulate, and implement—that, together, help managers plan and implement a strategy that can improve performance and result in competitive advantage.

- **Internal Analysis.** *How do internal resources, capabilities, and core competencies affect the firm's potential to gain and sustain a competitive advantage? How should the firm leverage them for competitive advantage?* (Chapter 4)
- **Shared Value and Competitive Advantage.** *How do we create shared value? What is the relationship between competitive advantage and firm performance?* (Chapter 5)

Formulation (F)

- **Business Strategy.** *How should the firm compete: cost leadership, differentiation, or value innovation?* (Chapters 6 and 7)
- **Corporate Strategy.** *Where should the firm compete in terms of industry, markets, and geography?* (Chapters 8 and 9)
- **Global Strategy.** *How and where should the firm compete: locally, regionally, nationally, or internationally?* (Chapter 10)

Implementation (I)

- **Organizational Design.** *How should the firm organize to translate the formulated strategy into action?* (Chapter 11)
- **Corporate Governance, Business Ethics, and Business Models.** *What type of corporate governance is most effective? How does the firm anchor strategic decisions in business ethics? Which business model should we use to execute strategy?* (Chapter 12)

The AFI Strategy Framework shown in Exhibit 1.4 is repeated at the beginning of each part of this text to help contextualize where we are in our study of the firm's quest to gain and sustain competitive advantage. In addition, the *AFI Strategic Management Process Map*, presented at the end of Chapter 1, illustrates the steps in the AFI framework in more detail. This strategic management process map highlights the key strategy concepts and frameworks we cover in each chapter. It also serves as a checklist for conducting a strategic management analysis.

We next turn to the *Implications for Strategic Leaders* to provide practical applications and considerations of the material discussed in this chapter.

1.4 Implications for Strategic Leaders

Strategy is the art and science of success and failure. The difference between success and failure lies in an organization's strategy. A good strategy is grounded in a strategic management process that defines the competitive challenge, provides a guiding policy, and is implemented by coherent actions. A good strategy enhances the chances of achieving a competitive advantage and superior performance. Strategic leaders appreciate the fact that competition is *everywhere*. Thus, they need a good strategy to deal with competition.

Strategic leaders are also mindful of the organization's internal and external *stakeholders* who have a vested claim or interest in the firm's performance and continued survival. Using a *stakeholder strategy approach* enables strategic leaders to manage a diverse set of stakeholders effectively in their quest to gain and sustain a competitive advantage.

Strategic leaders also realize that the principles of strategic management can be applied universally to all organizations. Strategy determines performance in organizations large and small, multinational Fortune 100 companies, and for-profit and nonprofit organizations; in the private sector and the public sector; and in developed economies as well as emerging

economies. A good strategy is more likely to result when strategic leaders apply the three key tasks of the AFI Strategy Framework:

1. Analysis of the external and internal environments
2. Formulation of an appropriate business and corporate strategy
3. Implementation of the formulated strategy through structure, culture, and controls

Keep in mind that strategic leaders are making decisions under conditions of uncertainty and complexity. They must carefully monitor and evaluate the progress toward key strategic objectives and make adjustments by fine-tuning any strategy as necessary. We discuss these topics in the next chapter, where we focus on strategic leaders and the strategic management process.

CHAPTERCASE 1 Part II

Despite Tesla's astronomical ascent, its market capitalization remains highly volatile, frequently fluctuating by hundreds of billions of dollars within a few days. Several factors explain why Tesla's future remains uncertain.

Transition to Electric Vehicles. Many observers wonder if and when a change to EVs will happen. In 2021, 14% of all new cars registered in Europe and 9% in China were EVs, but in the United States EVs made up a mere 4% of new car registrations. Consumers feel "range anxiety," worrying that EVs are limited in the number of miles they can be driven before requiring recharging. Moreover, EVs still sell at a premium over comparable internal combustion engine (ICE) cars, which are refilled easily at the many gas stations that dot the land.

Competition. Although Tesla enjoys a first-mover advantage, the legacy carmakers such as GM, Ford, and Volkswagen have committed billions of dollars to develop electric cars within the next decade. Tesla is also facing increasing competition from pure EV startups such as Rivian and Lucid in the United States and NIO, XPeng, and Li in China.

Global Scale. To continue to drive down the cost per car produced and to meet demand, which exceeds supply, Tesla must continue to ramp up its global scale. Tesla needs multiple factories across continents to make more than 1 million vehicles a year in each plant. In 2020, Tesla began producing cars at scale in Giga Shanghai, its most productive plant. In 2022, Tesla opened Gigafactories in Berlin, Germany, and Austin, Texas. Still, Tesla

needs a much larger production footprint to meet global demand.

Moreover, given the supply chain interruptions in the wake of the Covid-19 pandemic, the productivity of the Gigafactories has been negatively affected. For instance, a limited supply of batteries and computer chips has caused production slowdowns. Finally, the geopolitical tensions between the United States and China may put Tesla in the crosshairs, with potentially adverse consequences.

Succession. Although Elon Musk is a visionary leader who can produce tremendous results, many observers note that Tesla has no succession plan. They wonder what will happen to the company if its temperamental leader becomes unable or unwilling to lead Tesla. Insiders confirm that Musk's true love is his space exploration and transportation company, SpaceX, and running Tesla is needed to "pay the bills." Finally, although Musk likes to be in charge, he does not want to be CEO. Indeed, he changed his official title at Tesla to "Techno King" in a filing with the Securities and Exchange Commission.

Questions

1. Do you agree with the assessment that Elon Musk and Tesla successfully fulfilled the first master plan published in 2006? To answer this question, apply the three-step process for crafting a good strategy explained in Section 1.1 (*diagnose the competitive challenge, develop a guiding policy, and implement a set of coherent actions*).

2. Apply again the three-step process for crafting a *good strategy* (see Section 1.1), this time to each element of the new master plan. On which steps of the new master plan has Tesla made the most progress? Which actions will be the most difficult to accomplish? Why?
3. Overall, does Tesla have a *good strategy*? Why or why not? How do you know? Explain.
4. Of the threats listed in Part II of the ChapterCase, which do you consider the most significant? How would you recommend that Musk and Tesla address each of these challenges?

TAKE-AWAY CONCEPTS

This chapter introduced the concept of *strategy* and the key role it plays in an organization's success or failure. We learned that a *good strategy* results from a strategic management process that defines the competitive challenge, provides a guiding policy, and is implemented by coherent actions. A good strategy improves the chances of achieving a competitive advantage and superior performance. It also examines the relationship between *stakeholder strategy* and *sustainable competitive advantage*. Finally, this chapter set the stage for further study of strategic management by introducing the *AFI Strategy Framework*.

LO 1-1 / Explain the role of strategy in a firm's quest for competitive advantage.

- Strategy is the set of goal-directed actions that a firm takes to gain and sustain superior performance relative to competitors.
- A good strategy enables a firm to achieve superior performance. It results from three elements:
 1. A diagnosis of the competitive challenge
 2. A guiding policy to address the competitive challenge
 3. A set of coherent actions to implement the firm's guiding policy
- A successful strategy requires three integrative management tasks—analysis, formulation, and implementation.

LO 1-2 / Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

- Competitive advantage is always judged relative to other competitors or the industry average.

- To obtain a competitive advantage, a firm must either create more value for customers while keeping its cost comparable to competitors, or it must provide value equivalent to its competitors' but at a lower cost.
- A firm that is able to outperform competitors for prolonged periods of time has a sustained competitive advantage.
- A firm that continuously underperforms its rivals or the industry average has a competitive disadvantage.
- Two or more firms that perform at the same level have competitive parity.
- An effective strategy requires that strategic trade-offs be recognized and addressed—for example, the trade-off between value creation and the costs to create the value.

LO 1-3 / Assess the relationship between stakeholder strategy and sustainable competitive advantage.

- *Stakeholders* are individuals or groups that have a claim on or interest in the firm's performance and continued survival. They make specific contributions for which they expect rewards in return.
- *Internal stakeholders* include stockholders, employees (for instance, executives, managers, and workers), and board members.
- *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.
- The effective management of stakeholders is necessary to ensure the firm's continued survival and to sustain any competitive advantage. These goals are achieved through *stakeholder strategy*.

LO 1-4 / Conduct a stakeholder impact analysis.

- Stakeholder impact analysis considers the needs of different stakeholders, enabling the firm to perform optimally and to live up to the expectations of good citizenship.
- In a stakeholder impact analysis, managers pay particular attention to three important stakeholder attributes: power, legitimacy, and urgency.
- Stakeholder impact analysis is a five-step process that answers the following questions for the firm:
 1. Who are our stakeholders?
 2. What are our stakeholders' interests and claims?
 3. What opportunities and threats do our stakeholders present?
 4. What are our economic, legal, ethical, and philanthropic responsibilities to our stakeholders?

5. What should we do to effectively address the stakeholder concerns?

LO 1-5 / Apply the Analysis, Formulation, Implementation (AFI) Strategy Framework.

- The Analysis, Formulation, Implementation (AFI) Strategy Framework (1) explains and predicts differences in firm performance, and (2) helps managers formulate and implement a strategy that can result in superior performance.
- Effectively managing the strategy process is the result of the following:
 1. Analysis (A)
 2. Formulation (F)
 3. Implementation (I)

KEY TERMS

Analysis, Formulation, Implementation (AFI) Strategy Framework (p. 23)

Competitive advantage (p. 12)

Competitive disadvantage (p. 12)

Competitive parity (p. 12)

Corporate social responsibility (CSR) (p. 19)

Good strategy (p. 7)

Red Queen effect (p. 14)

Stakeholder impact analysis (p. 17)

Stakeholder strategy (p. 16)

Stakeholders (p. 15)

Strategic management (p. 6)

Strategy (p. 7)

Sustainable competitive advantage (p. 12)

Value creation (p. 15)

ENDNOTES

1. Market capitalization (or, market cap) = Share price x Number of outstanding shares.
2. Globally, only one other firm (Saudi Aramco) is valued at more than \$1 trillion.
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Event," www.youtube.com/watch?v=llkm6xhrror4&t=4s [33:53 min].

6. This section draws on: McGrath, R.G. (2013), *The End of Competitive Advantage: How to Keep Your Strategy Moving as Fast as Your Business* (Boston: Harvard Business Review Press); Rumelt, R. (2011), *Good Strategy, Bad Strategy: The Difference and Why It Matters* (New York: Crown Business); Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*: 78–93; Porter, M.E. (1996, Nov.–Dec.), "What is strategy?" *Harvard Business Review*: 61–78; and

Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Competitors* (New York: The Free Press).

7. As quoted in: Rothaermel, F. T. (2017), "Tesla, Inc.," *McGraw-Hill Education Case Study MHE-FTR-032*.
8. Tesla's mission statement. Tesla, Inc.
9. Range anxiety denotes the concern that an electric vehicle has insufficient range to reach its destination on a single charge. Tesla's cars can go some 250 miles per charge. The lower cost Nissan Leaf (~\$30k) can go some 85 miles per charge, while GM's Chevy Bolt can

drive some 200 miles per charge, based on EPA estimates. The average American drives about 40 miles per day. <http://www.fueleconomy.gov/>

10. The discussion of Tesla throughout this chapter is based on Higgins, T. (2021), *Power Play: Tesla, Elon Musk, and the Bet of the Century* (New York: Doubleday); Tesla, Inc. annual reports (various years); Rothaermel, F.T. (2020), Tesla, Inc., McGraw-Hill Education Case Study MHE-FTR-067; Hoang, H., and F. T. Rothaermel (2016, Fall), "How to manage alliances strategically," *MIT Sloan Management Review*, 58(1): 69–76; Ramsey, M. (2016, Mar. 30), "A lot riding on Tesla's Model 3 unveiling," *The Wall Street Journal*; Ramsey, M., and C. Sweet (2016, Aug. 1), "Tesla and SolarCity agree to \$2.6 billion deal," *The Wall Street Journal*; Pulliam, S., M. Ramsey, and I.J. Dugan (2016, Aug. 15), "Elon Musk sets ambitious goals at Tesla—and often falls short," *The Wall Street Journal*; and Ramsey, M. (2014, Jun. 12), "Tesla Motors offers open licenses to its patents," *The Wall Street Journal*.
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13. Sources: Bilton, N. (2013), *Hatching Twitter: A True Story of Money, Power, Friendship, and Betrayal* (London, UK: Sceptre); "Twitter in retweet," *The Economist* (2016, Sep. 17); "New models for new media," *The Economist* (2017, Feb. 16); Conger, K. (2018, Oct. 25), "Twitter posts another profit as user numbers drop," *The New York Times*; Thompson, B. (2021, Nov. 30), "Twitter has a new CEO; what about a new business model?" *Stratechery*; "Jack Dorsey goes Square—leaving Twitter at a time of his choosing," *The Economist* (2021, Dec. 4); Needleman, S., and W. Feuer (2022, Apr. 4), "Musk acquires 9% stake in Twitter, becoming its top stockholder," *The Wall Street Journal*; Thomas, L., A. Corse (2022, Oct. 28), "Elon Musk Twitter deal completed, CEO and CFO immediately fired," *The Wall Street Journal*; and Twitter, Inc. annual reports (various years).
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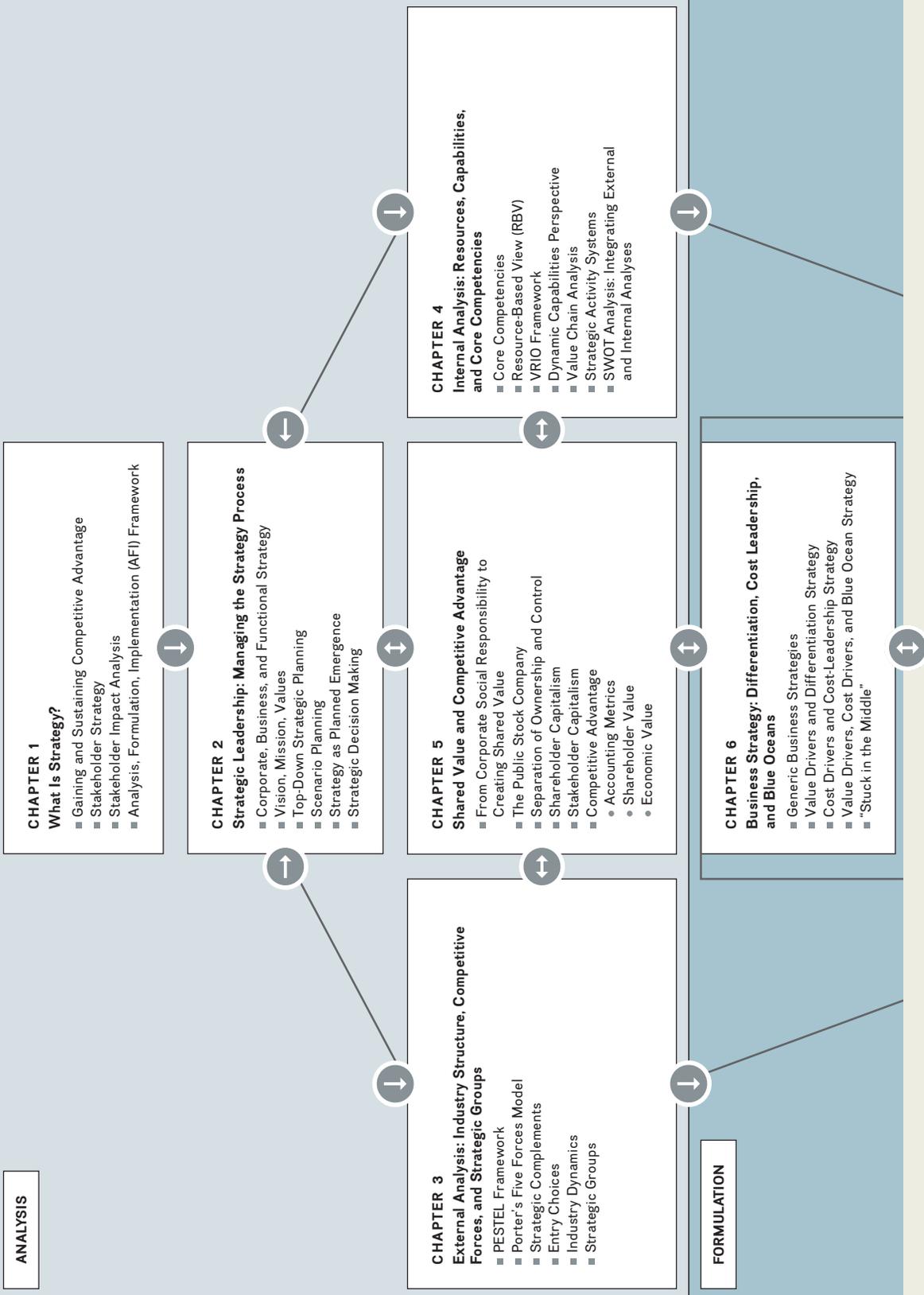
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The Strategic Management Process Map





CHAPTER 7
Business Strategy: Innovation, Entrepreneurship, and Platforms

- The 4 I's: Idea, Invention, Innovation, and Imitation
- Strategic and Social Entrepreneurship
- Innovation and the Industry Life Cycle
- Crossing the Chasm
- Technology and Markets: Types of Innovation
- Platform vs. Pipeline Business Models
- Platform Ecosystem



CHAPTER 8
Corporate Strategy: Vertical Integration and Diversification

- Boundaries of the Firm
- Vertical Integration along the Industry Value Chain
- Types of Corporate Diversification
- Core Competence-Market Matrix
- BCG Growth-Share Matrix



CHAPTER 9
Corporate Strategy: Strategic Alliances, and Mergers and Acquisitions

- Build-Borrow-Buy Framework
- Strategic Alliances
- Alliance Management Capability
- Mergers and Acquisitions (M&A)
- Horizontal Integration



CHAPTER 10
Global Strategy: Competing Around the World

- Globalization
- Going Global: Why?, Where?, and How?
- The CAGE Distance Framework
- The Cost-Responsiveness Framework
- Porter's Diamond of National Competitive Advantage



IMPLEMENTATION

CHAPTER 11
Organizational Design: Structure, Culture, and Control

- Simple Structure
- Functional Structure
- Multidivisional Structure
- Matrix Structure
- Open vs. Closed Innovation
- Organizational Culture
- Control and Reward Systems



CHAPTER 12
Corporate Governance, Business Ethics, and Business Models

- Agency Theory
- Board of Directors
- Other Governance Mechanisms
- Business Ethics and Sustainable Competitive Advantage
- Business Models

