

# What is Strategy?

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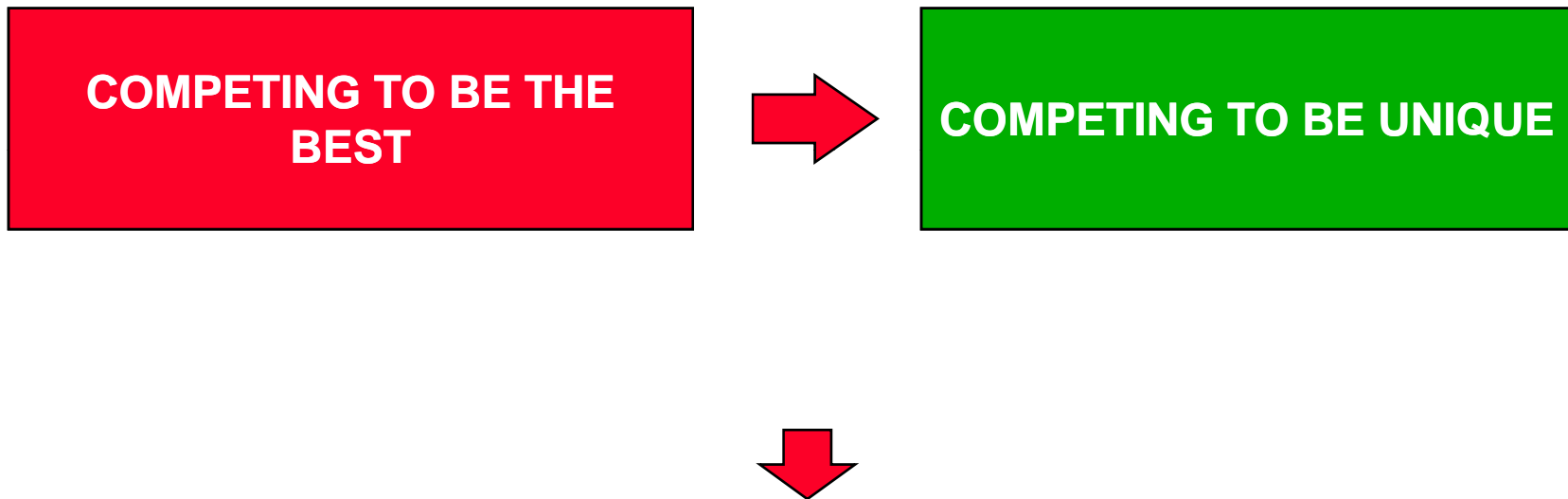
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This presentation draws on ideas from Professor Porter's books and articles, in particular, *Competitive Strategy* (The Free Press, 1980); *Competitive Advantage* (The Free Press, 1985); "What is Strategy?" (*Harvard Business Review*, Nov/Dec 1996); "Strategy and the Internet" (*Harvard Business Review*, March 2001); and a forthcoming book. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of Michael E. Porter. Additional information may be found at the website of the Institute for Strategy and Competitiveness, [www.isc.hbs.edu](http://www.isc.hbs.edu). Version: May 20, 2pm

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# How Managers Think About Competition



- The worst error in strategy is to compete with rivals on the **same dimensions**

# Flawed Concepts of Strategy

- Strategy as **action**
  - “Our strategy is to merge...”
  - “... internationalize...”
  - “... consolidate the industry...”
  - “... outsource...”
  - “...double our R&D budget...”
- Strategy as **aspiration**
  - “Our strategy is to be #1 or #2...”
  - “Our strategy is to grow...”
  - “Our strategy is to be the world leader...”
  - “Our strategy is to provide superior returns to our shareholders...”
- Strategy as **vision**
  - “Our strategy is to best understand and satisfy our customers’ needs...”
  - “... provide superior products and services...”
  - “...to advance technology for mankind...”

# Setting the Right Goals

- The fundamental goal of a company is **superior long-term return on investment**
- Growth is good only if superiority in ROIC is **achieved and sustained**
  - ROIC threshold
- Profitability must be measured realistically, capturing the **actual profits** on the **full investment**

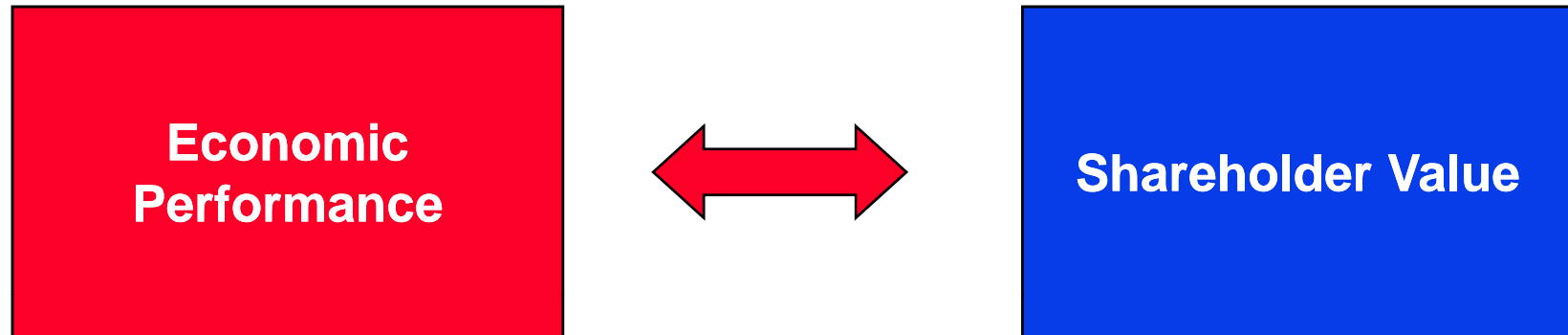
• Profitability metrics besides ROIC (e.g., return on sales; ebitda margin; pro-forma earnings; and cash flow margin) are **risky for strategy**

• Prevalent **accounting adjustments** to reported profitability (e.g., writeoffs, restructuring charges) can obscure true economic performance and lead to bad competitive choices

• Goodwill must be treated as **part of investment**

- Setting **unrealistic profitability** or **growth targets** can undermine strategy

# Economic Performance versus Shareholder Value



- Sustained ROIC
- Sustainable Revenue Growth

- Stock Price
- EPS
- EPS Growth

- Shareholder value is the **result** of creating real economic value
- Pleasing today's shareholders is **not** the goal

# Levels of Strategy

**Competitive or  
Business Strategy**

- How to compete in each **distinct business or industry**



**Group or Corporate Strategy**

- The **company's mix of businesses** and the way that business unit **strategies are integrated**

# Economic Foundations of Competition

- The fundamental unit of strategic analysis is the **business** or **industry**
  - Defining the **relevant** industry is important to strategy
- Company economic performance results from **two** distinct causes



- *Overall Rules of Competition*

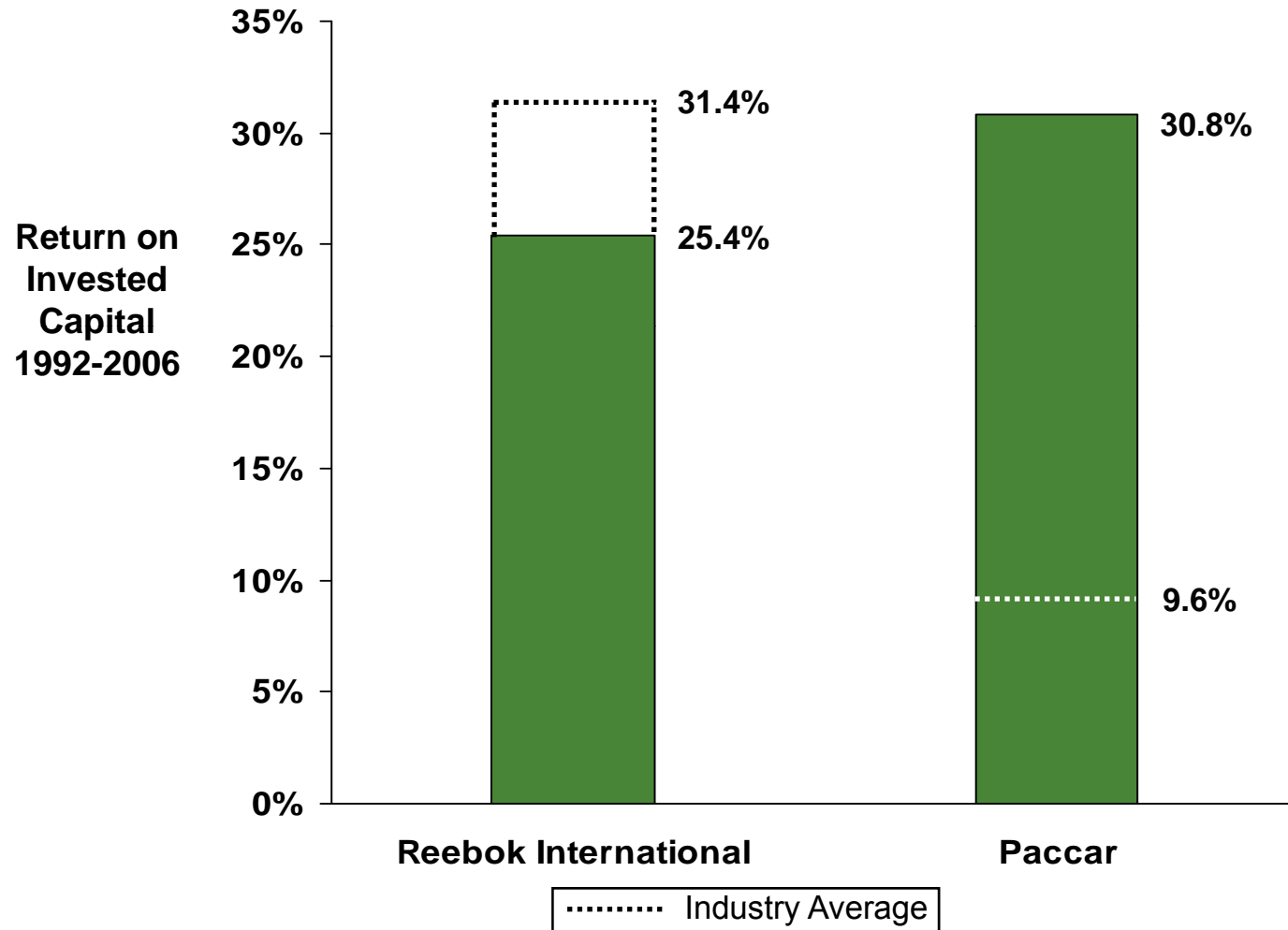


- *Sources of Competitive Advantage*



- Strategic thinking must encompass **both**

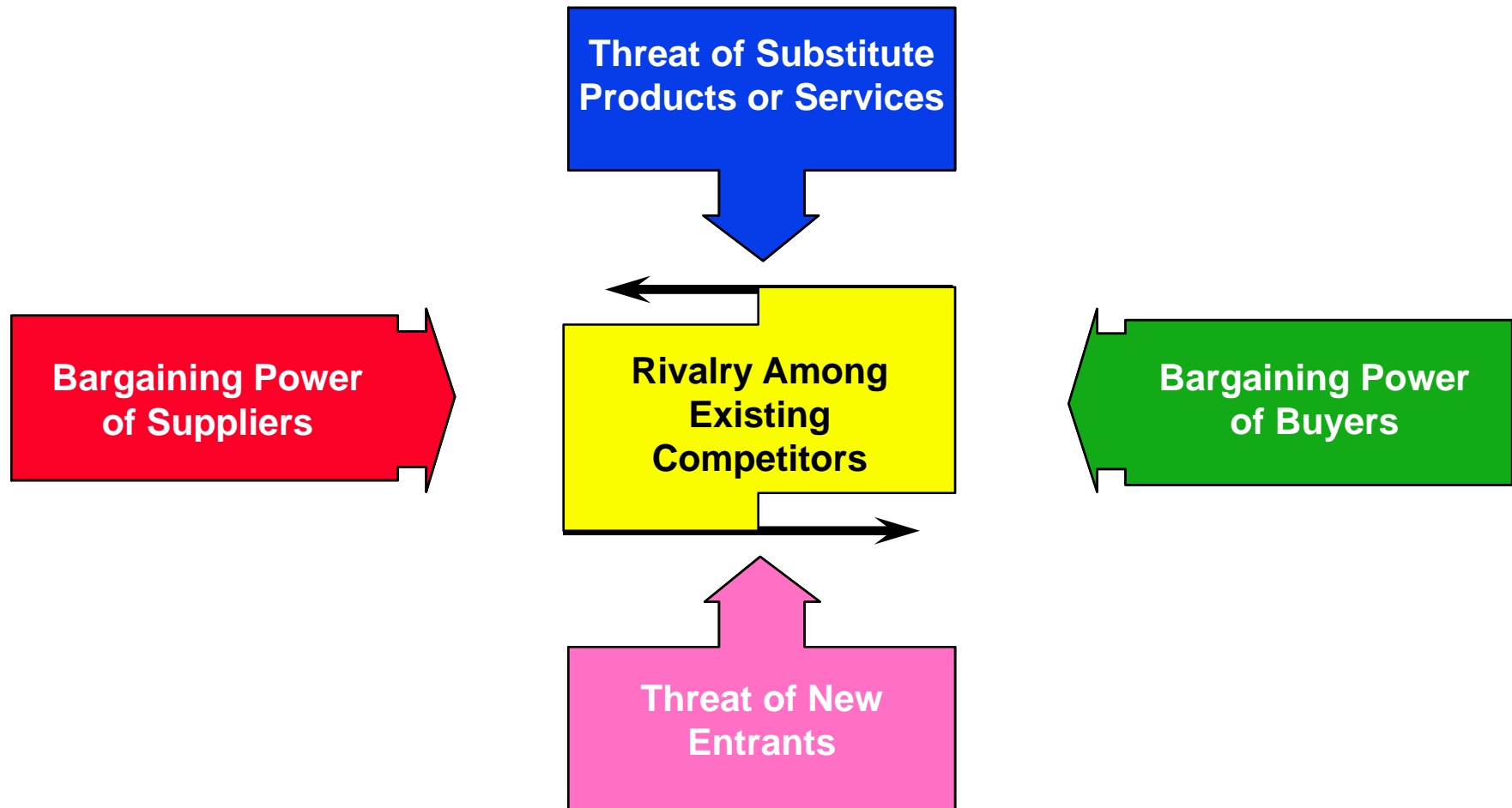
# Disaggregating Economic Performance: Industry vs. Position



Note: 'Invested capital less excess cash' is the average of the beginning period and the ending period values. Excess cash is calculated by subtracting cash in excess of 10% of annual revenue.

Source: Compustat (2007), author's analysis

# Determinants of Industry Profitability



# Strategic Implications of Industry Structure

## Positioning to Mute the Five Forces

### Heavy Truck Industry

#### Threat of Substitute Products or Services

- Railroads
- Water transportation

#### Bargaining Power of Suppliers

- Large independent suppliers of engines and drive train components

#### Rivalry Among Existing Competitors

- Heavy price competition on standardized models

#### Bargaining Power of Buyers

- Large fleets
- Leasing companies
- Small fleets and owner operators

#### Threat of New Entrants

- Many truck producers are assemblers

# Paccar Competitive Positioning

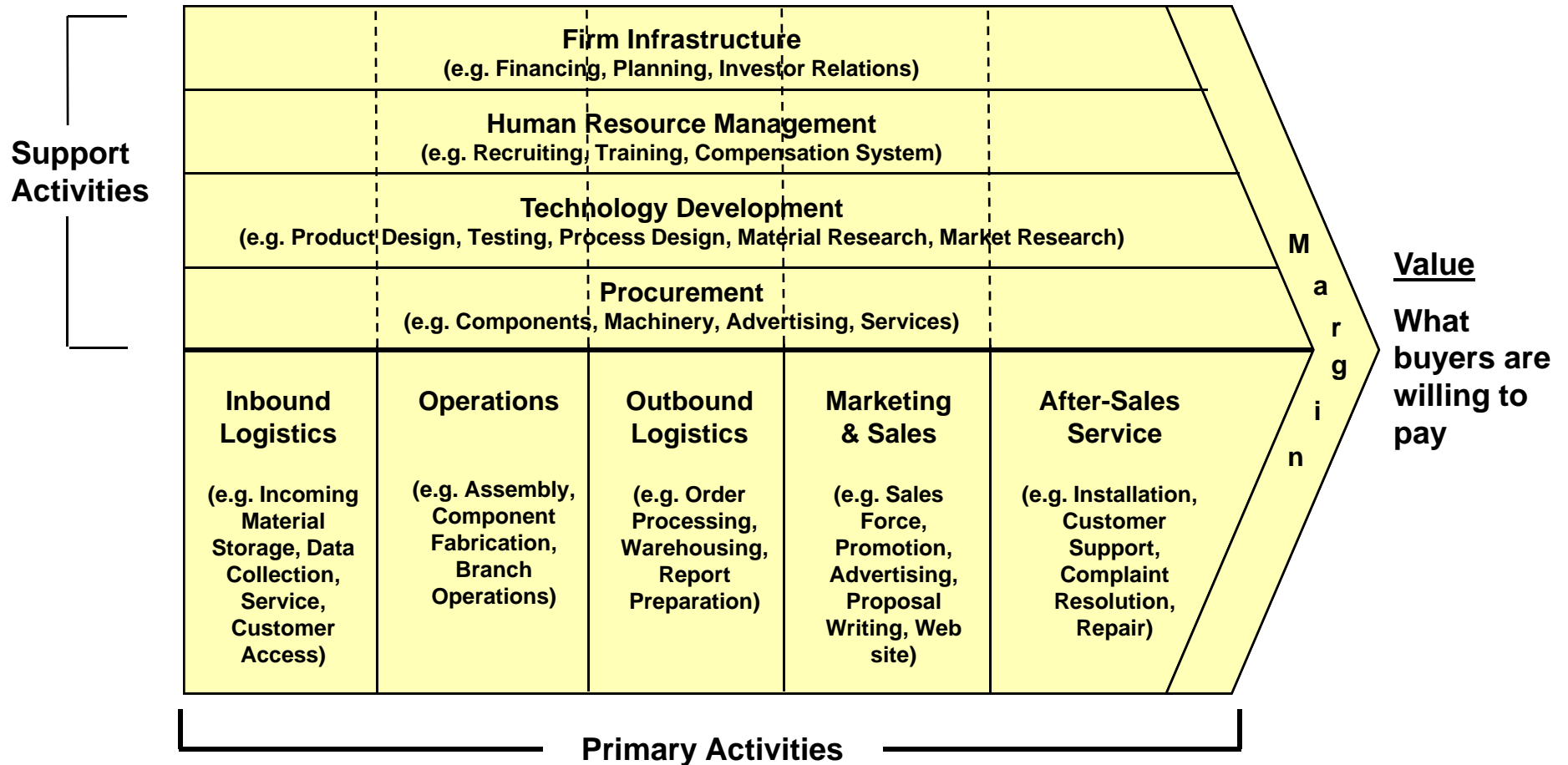
- Focus on owner-operators
- Design trucks with special features and amenities
- Customization and build-to-order
- Achieve low truck operating costs
- Offer extensive roadside assistance to truckers

# Determinants of Relative Performance



# Foundations of Economic Performance

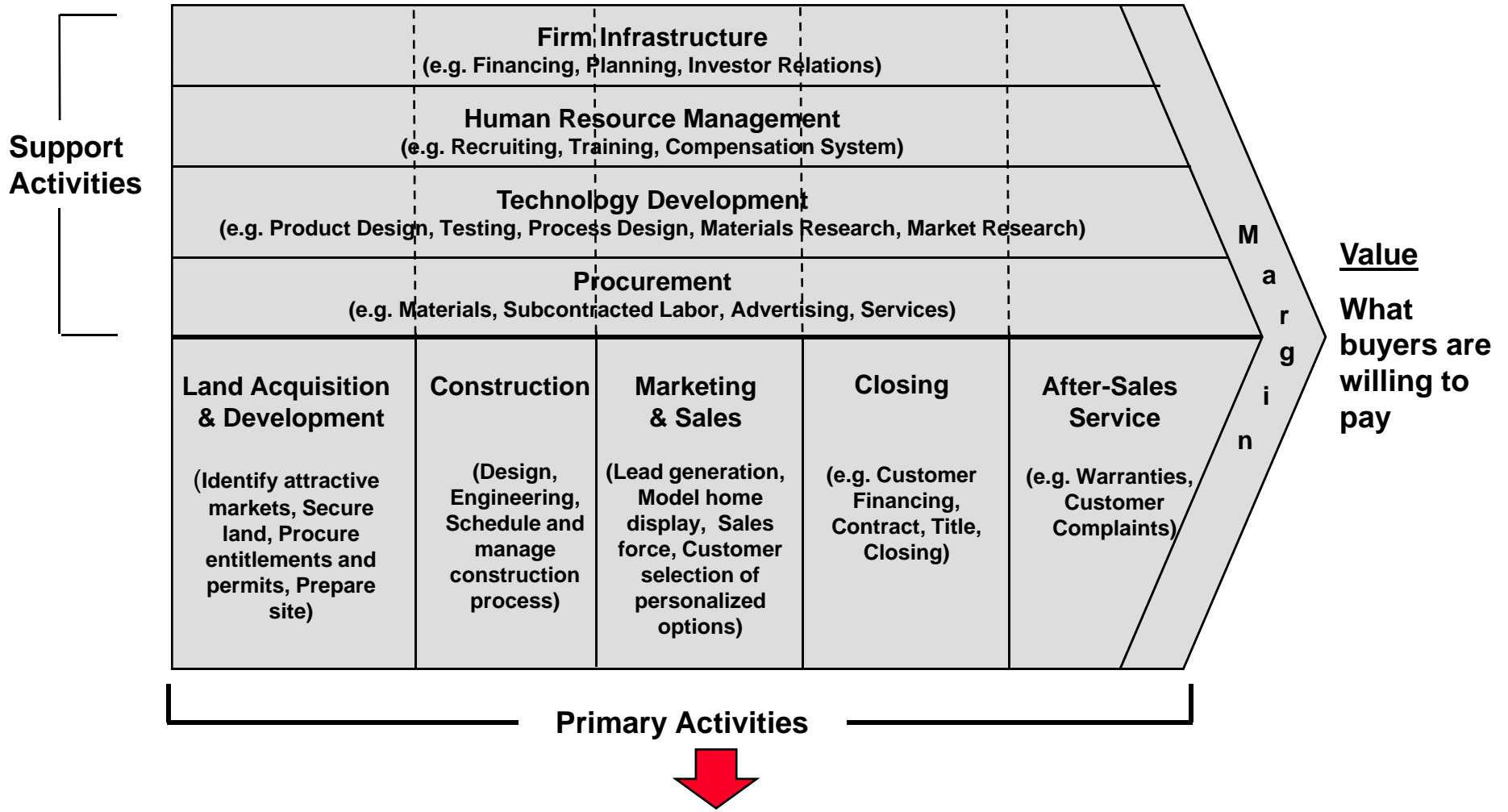
## The Value Chain



- Competing in a business involves performing a set of discrete **activities**, in which **competitive advantage resides**

# Defining the Value Chain

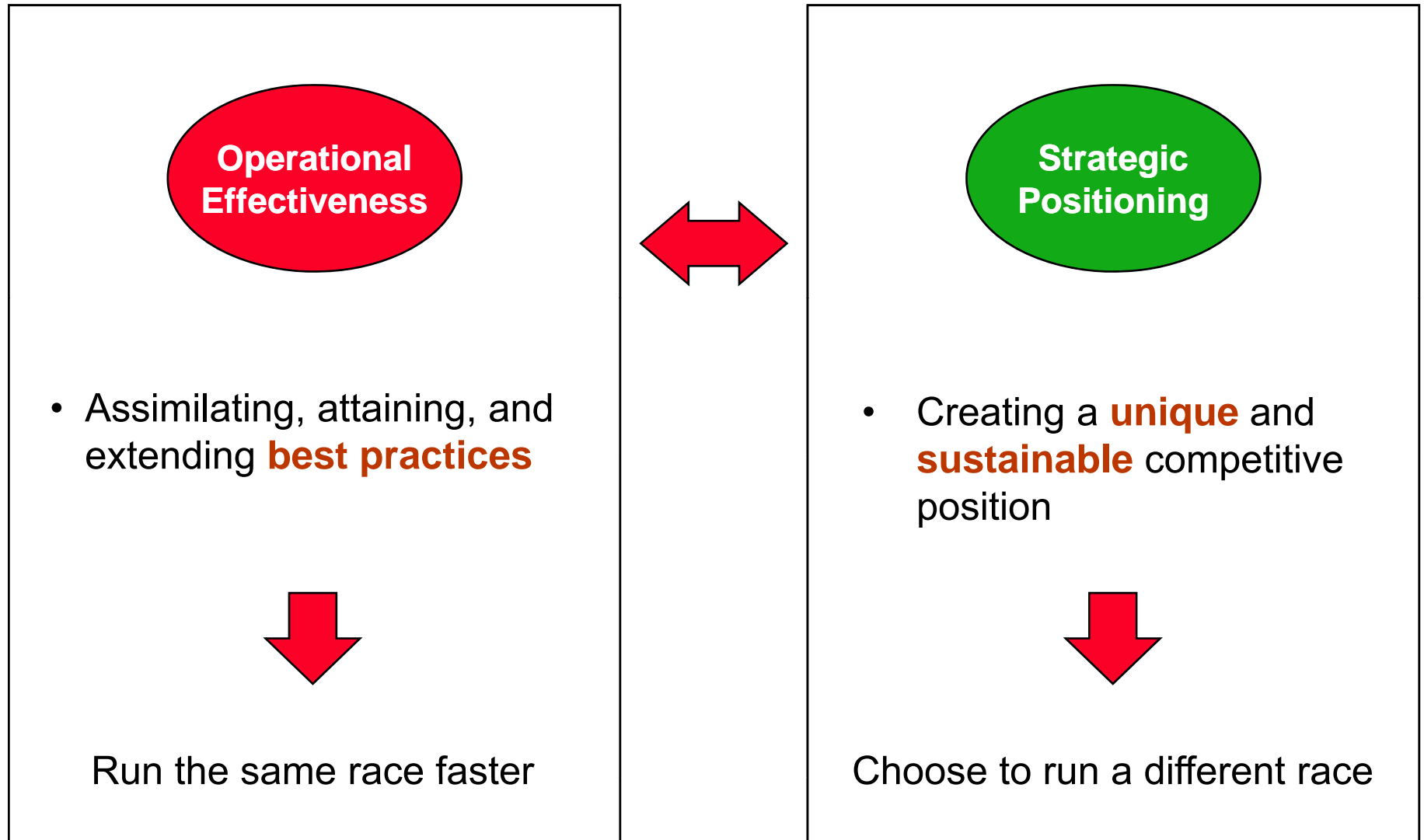
## Homebuilding



- There can be **different ways of configuring** the value chain in the same industry

# Achieving Superior Performance

## Operational Effectiveness is Not Strategy



# Five Tests of a Good Strategy

- A **unique value proposition** compared to other organizations
- A **different**, tailored value chain
- Clear tradeoffs, and choosing what **not** to do
- Activities that **fit** together and reinforce each other
- **Strategic continuity** with continual improvement in realizing the strategy

# Strategic Positioning

## Enterprise Rent-A-Car

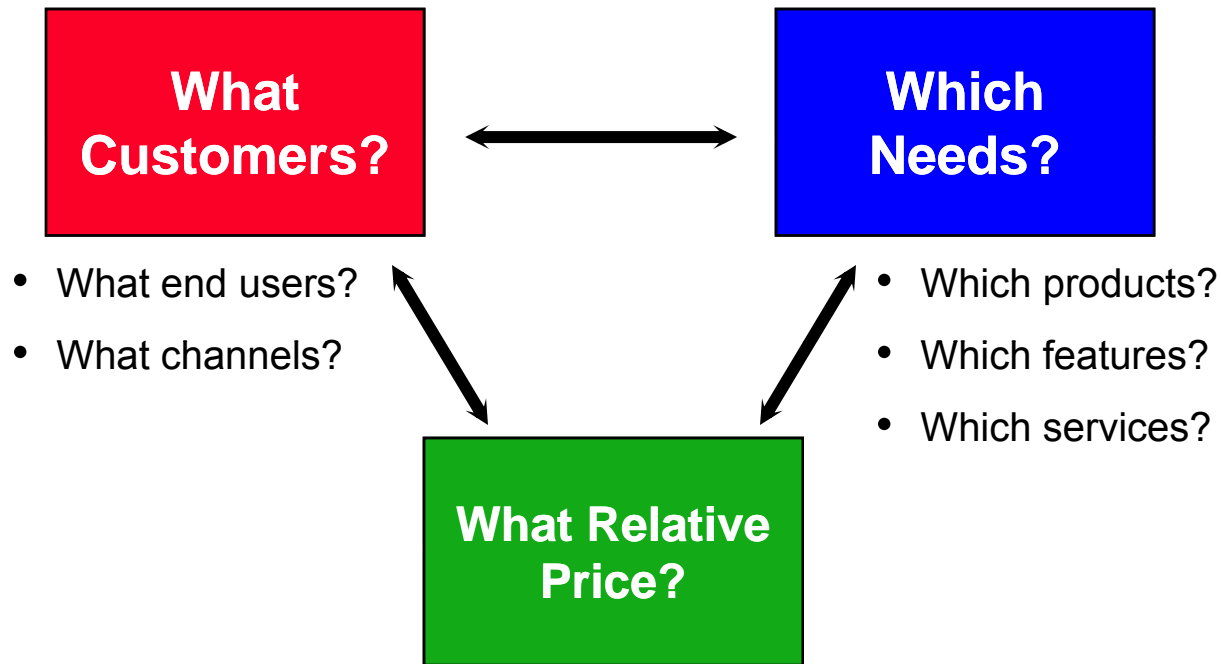
### Value Proposition

- Home-city replacement cars for drivers whose cars are being repaired or who need an extra vehicle, at low rates (30% below airport rates)

### Distinctive Activities

- Numerous, small, inexpensive offices in each metropolitan area, including on-premises offices at major accounts
- Open during daylight hours
- Deliver cars to customers' homes or rental sites, or deliver customers to cars
- Acquire new and older cars, favoring soon-to-be discontinued older models
- Keep cars six months longer than other major rental companies
- In-house reservations
- Grassroots marketing with limited television
- Cultivate strong relationships with auto dealerships, body shops, and insurance adjusters
- Hire extroverted college graduates to encourage community interaction and customer service
- Employ a highly sophisticated computer network to track the fleet

# Defining the Value Proposition



- A novel value proposition can grow the pie/expand the industry

# Strategic Positioning

## IKEA, Sweden

### Value Proposition

- Young, first time, or price-sensitive buyers who want stylish, space efficient and scalable furniture and accessories at very low price points.

### Distinctive Activities

- Modular, ready-to-assemble, easy to package designs
- In-house design of all products
- Wide range of styles displayed in huge warehouse stores with large on-site inventories
- Self-selection
- Extensive customer information in the form of catalogs, explanatory ticketing, do-it-yourself videos, and assembly instructions
- Ikea designer names attached to products to inform coordinated purchases
- Long hours of operation
- Suburban locations with large parking lots
- On-site, low-cost, restaurants
- Child care provided in the store
- Self-delivery by most customers

# Strategic Positioning

## Whole Foods Markets

### Value Proposition

- Natural, fresh, organic, and prepared foods and health items with excellent service at premium prices
- Educated, middle class, and affluent customers passionate about food as a part of a healthy lifestyle

### Distinctive Activities

- Well-lit, inviting supermarket store formats with appealing displays and extensive prepared foods sections
- Produce section as “theater”
- Café-style seating areas with wireless internet for meetings and meals
- Each store carries local produce and has the authority to contract with the local farmers
- Information and education provided to shoppers along with products
- High touch in-store customer service via knowledgeable, non-unionized, highly motivated personnel
- Egalitarian compensation structure
- Own seafood procurement and processing facilities to control quality (and price) from the boat to the counter
- Donates 5% of profits to non-profits
- Each store has “green projects,” directed by employees, to improve environmental performance

# Strategic Positioning

## BMW

### Value Proposition

- Superior-engineered, high performance, sporty, customized automobiles at a premium price

### Distinctive Activities

- “Active driving” design philosophy
- Highly unique product and engine performance
- Centralized engineering
- Design department with high degree of autonomy to encourage creativity
- Factories configured for customization
- High craft labor input in production with selective automation
- High vertical integration to achieve proprietary components
- One global brand
- Limited dealer system
- Non-traditional, brand-focused marketing
- BMW-sponsored race team

Source: Draws on research conducted by Harvard Business School students M. Collardin, F. Cueto, J. Encinar, A. Gonzalez, A. Kulyk, and D. Smith, April 1997

# Making Strategic Tradeoffs

- Tradeoffs occur when strategic positions are **incompatible**
  - The need for a **choice**

## Sources of Tradeoffs

- Incompatible product / service features or attributes
  - Differences in the best configuration of activities in the value chain to deliver the chosen value proposition
  - Inconsistencies in image or reputation across positions
  - Limits on internal coordination, measurement, motivation, and control
- Tradeoffs make a strategy **sustainable** against imitation by established rivals



- An essential part of strategy is choosing what **not** to do

# Strategic Tradeoffs

## Neutrogena Soap (1990)

- Forgo cleaning, skin softening, and deodorizing features
- Choose higher costs through the configuration of:
  - packaging
  - manufacturing
  - detailing
  - medical advertising
  - skin research
- Give up the ability to reach customers via:
  - promotions
  - television
  - some distribution channels

# Strategic Tradeoffs

## IKEA, Sweden

### IKEA

#### Product

- Low-priced, modular, ready-to-assemble designs
- No custom options
- Furniture design driven by cost, manufacturing simplicity, and style

#### Value Chain

- Centralized, in-house design of all products
- All styles on display in huge warehouse stores
- Large on-site inventories
- Limited sales help, but extensive customer information
- Long hours of operation

### Typical Furniture Retailer

#### Product

- Higher priced, fully assembled products
- Customization of fabrics, colors, finishes, and sizes
- Design driven by image, materials, varieties

#### Value Chain

- Source some or all lines from outside suppliers
- Medium sized showrooms with limited portion of available models on display
- Limited inventories / order with lead time
- Extensive sales assistance
- Traditional retail hours

# Typical Thinking on the Sources of Competitive Advantage

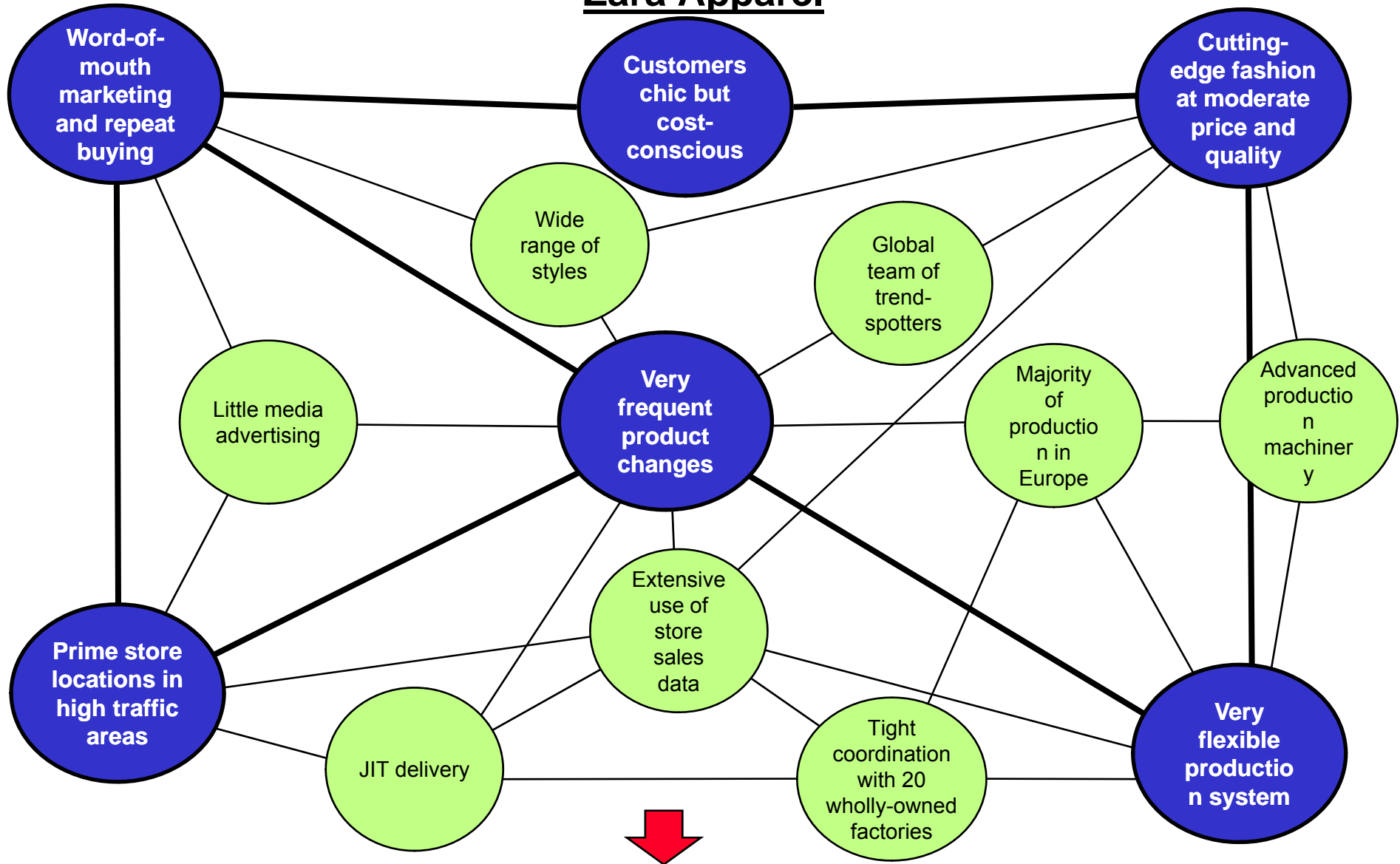
- “Key” Success Factors
- “Core” Competencies
- “Critical” Resources



- Competitive advantage is seen as **concentrated in a few parts** of the value chain

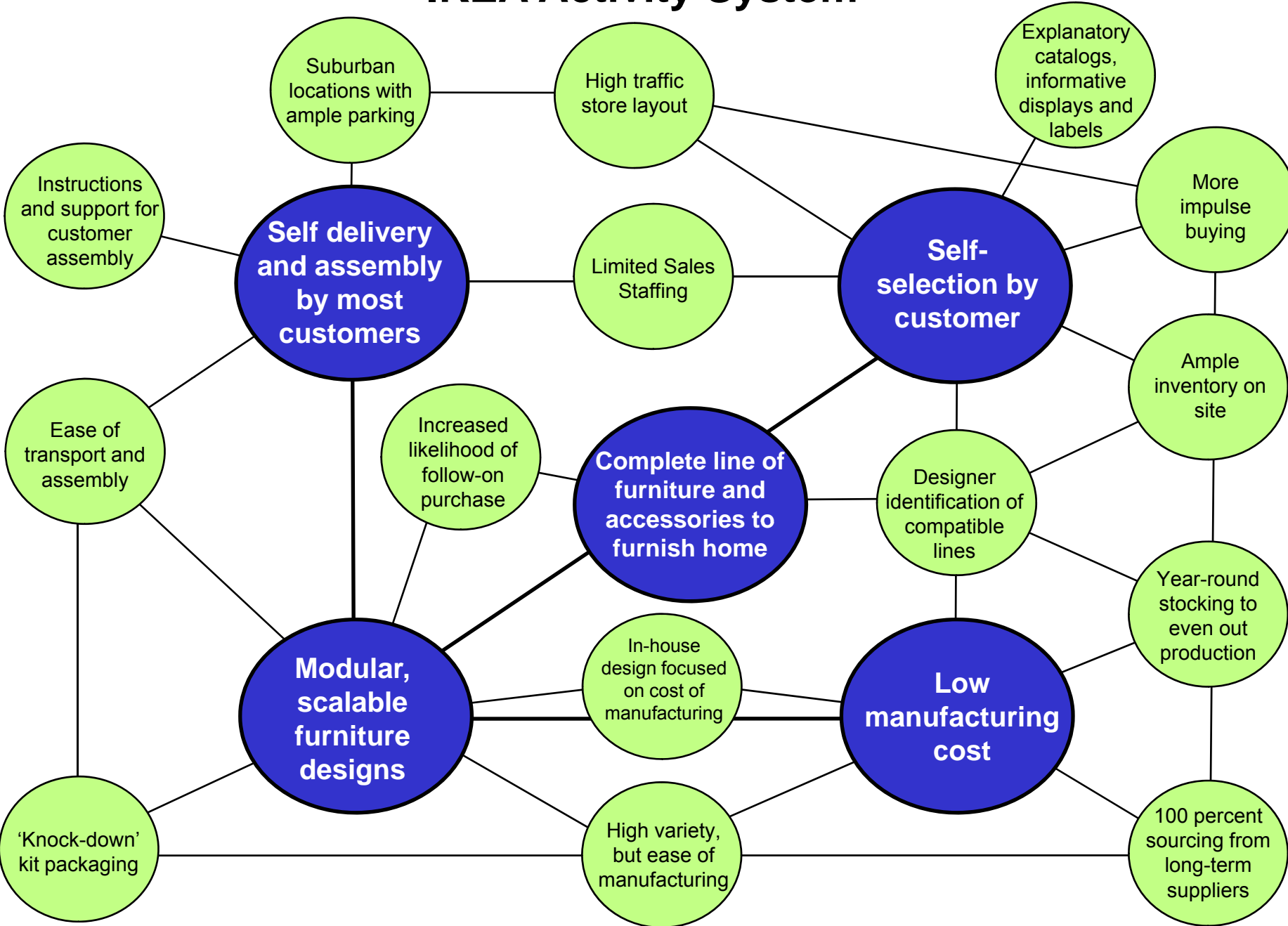
# Mutually Reinforcing Activities

## Zara Apparel



- Fit is leveraging what is different to be **more** different

# IKEA Activity System



# Strategic Continuity

- **Continuity of strategy** is fundamental to sustainable competitive advantage
  - e.g., allowing the organization to **understand the strategy**
  - building truly **unique skills** and **assets** related to the strategy
  - establishing a clear **identity** with customers, channels, and other outside entities
  - strengthening **fit** across the value chain
- **Reinvention** and **frequent shifts in direction** are costly and confuse the customer, the industry, and the organization



- Maintain continuity in the **value proposition**
- **Continuously improve** ways to realize the value proposition
  - Strategic continuity and continuous change should occur **simultaneously**. They are not inconsistent
- Continuity of strategy allows learning and change to be **faster** and **more effective**

# Barriers to Strategy

## Flawed Management Concepts

- **Misunderstanding** of strategy itself
- Poor **industry definition**

## Industry Convergence Pressures

- **Industry conventional wisdom** leads all companies to follow common practices
- **Labor agreements** limit ways of configuring activities
- **Regulation** constrains price, product, service or process alternatives
- **Customers** ask for incompatible features or request new products or services that do not fit the strategy

# Barriers to Strategy

## Internal Practices

- Inappropriate **goals** and **performance metrics** bias strategy choices
  - Size over profitability
  - Short time horizon
- **Rapid turnover of leadership** undermines strategic direction to achieve short-term performance benefits
- A desire for **consensus** blurs strategic tradeoffs
- **Inappropriate cost allocation** leads to too many products, services, or customers
- **Outsourcing** makes activities homogenous and less distinctive

# Barriers to Strategy

## Capital Market Biases

- Strong pressure for **short-term “surprises”** in earnings or revenue
- Strong pressure to **grow faster** than the industry
- Industry-wide **analyst metrics** are misaligned with true value and drive **strategic convergence**
- Strong pressures to **emulate** currently “successful” peers
- A strong bias for “**doing deals**” (M&A)



- Over-weighting of **equity-based management compensation** amplifies such unhealthy pressures

# Defining the Relevant Industry

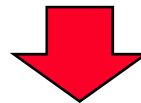
## Foodservice Distribution

### Broadline Distribution

- Customers are **independent** restaurants and institutions
- The product line consists of **well over 10,000** SKUs
- Sales and service activities are carried out by **local** sales reps
- Value-added services, credit terms, and distributors' private-label products are valued and allow support product/service **differentiation**
- Logistical activities are heavily **local** in nature (local warehouses and trucks)

### Systems Distribution

- Customers are **national** chains
- The product line consists of **several hundred** SKUs
- Customer relationships and services are **specified by national contracts**
- **Price** is the key basis for selection; customers do not purchase value-added services or private-label products
- A **national** distribution and warehousing network is required



- Tools for industry definition: the 5 Forces and the Value Chain

# Finding a Unique Strategic Position

<p><b><u>Segmenting the Industry</u></b> <b><u>(not just the Market)</u></b></p> <ul style="list-style-type: none"><li>• Creatively <b>segmenting</b> product varieties, customer groups, and purchase occasions</li></ul>	<p><b><u>Exploiting Tradeoffs</u></b></p> <ul style="list-style-type: none"><li>• Identifying <b>tradeoffs</b> in the value proposition or in the value chain</li></ul>
<p><b><u>Leveraging Unique Activities</u></b></p> <ul style="list-style-type: none"><li>• Building <b>off activities</b> with true uniqueness</li><li>• Looking for <b>new activity configurations</b> and <b>combinations</b></li></ul>	<p><b><u>Capitalizing on Industry Dynamics</u></b></p> <ul style="list-style-type: none"><li>• Identifying strategic positions opened up by <b>industry structural changes</b></li></ul>



- **Migrate** toward the chosen strategic position
- Focus incremental investments on **reinforcing** the chosen strategy

# Segmentation and Strategic Positioning

## Automobile Insurance

### Progressive

#### Customer Group

- High-risk drivers shunned by standard automobile insurers

#### Set of Activities

- Distribution primarily through independent agents
- Sales force that educates independent agents in complex information gathering techniques
- 30-year database on high-risk drivers
- Complex rating scheme
- 14,000 different prices
- 50-300% premium pricing over standard segment
- Adjusters work from offices on wheels to provide immediate response. Adjusters trained and empowered to write out check at scene of accident
- Steep incentives to make a 4% underwriting profit
- Conservative, liquid investment portfolio

### Geico

#### Customer Group

- “Preferred”, lowest risk drivers

#### Set of Activities

- Direct customer interaction through direct mail, telephone, and the Internet
- Sophisticated direct mail targeting low risk households
- 35+ year database and modeling utilities on preferred drivers
- Complex rating and pricing system
- Heavy advertising to drive requests for rate quotes (“I’ve got good news.”)
- Quote rates to only 50% of customers who inquire about coverage
- 15-20% lower prices than competition
- Network of insurance adjusters with cell phones working out of own vehicles for immediate response
- 24-hour customer service to handle sales, policy inquires, and claims
- Conservative, liquid investment portfolio

# Growing Strategically

1. Make the strategy even **more distinctive**
  - Introduce new technologies, features, products or services that are **tailored to the strategy** and which **leverage other distinctive activities** within the value chain
2. **Deepen** the strategic position (rather than broaden it)
  - Raise the penetration of chosen customers / needs
3. **Expand geographically** to tap new regions or countries using the **same positioning**
  - **Aggressively reposition** foreign acquisitions around the company's strategy
4. **Expand the market** for what the company can uniquely deliver
  - Find other customers and segments that **value the strategy**



- It is an **illusion** that growth (and especially profitability) are easier to achieve in untapped or growth segments
- It is difficult, and often dangerous, to try to **grow faster than the underlying market** for an extended period.
- Industry leaders should concentrate as much, or more, on **growing the category** as on growing share
- In many cases, shareholders are best served by **earning a high return and returning capital, especially via dividends**

# Strategy

## What **Is** a Strategy?

- A **unique value proposition** compared to other organizations
- A **different**, tailored value chain
- Clear tradeoffs, and choosing what **not** to do
- Activities that **fit** together and reinforce each other
- **Strategic continuity** with continual improvement in realizing the strategy

## What is **Not** a Strategy?

- Best practice improvement
- Execution
- Aspirations
- A vision
- Learning
- Agility
- Flexibility
- Innovation
- The Internet (or any technology)
- Downsizing
- Restructuring
- Mergers / Consolidation
- Alliances / Partnering
- Outsourcing
- Internationalizing

# The Role of Leaders in Strategy

- Drive **operational improvement** but clearly distinguish it from **strategy**
  - Lead the **process of choosing** the company's unique position
    - The CEO is the chief strategist
    - The choice of strategy **cannot** be entirely democratic
  - **Communicate** the strategy relentlessly to all constituencies
    - Harness the **moral purpose** of strategy
  - Maintain **discipline** around the strategy, in the face of many distractions.
  - Decide **which** industry changes, technologies, and customer needs to respond to, and how the response can be **tailored** to the company's strategy
  - **Measure progress** against the strategy using tailored metrics that capture the implications of the strategy for serving customers and performing particular activities
  - Sell the company's strategy and how to evaluate progress against the strategy to the **financial markets**
- 
- Commitment to strategy is **tested every day**