2 Strategic Frames of Reference: The Key Tools of Strategy Determination, their Principles, and How they Interact

Mintzberg demonstrated in a number of case studies that top managers cannot be strategic, all-knowing planners as well as organizers, coordinators, and controllers all at once – they do not have the time. They should instead share information and build up an overall picture in order to make the right strategic decisions.[12] This overall picture and the information required to develop it can be analyzed and evaluated with tools from the sphere of strategy content research. This chapter presents the key tools of strategy determination. They are also known as frames of references, since their job is to prompt you to think and to make it easier for you to know where to start when analyzing strategies. There is also the field of strategy process research, upon which we will touch only briefly, since the strategic planning approach presented previously lies at the heart of this.

The primary goal of Anglo-American-style strategy content research is practical relevance. It aims to make practice-oriented tools available to those who need them in their work. Here, performance (the result) is taken as the empirical measure of strategy. Viewed retrospectively, superior returns indicate a good strategy. So if a company in a certain industry permanently achieves higher returns than its competitors, it has chosen the right strategy. The research analyzes the company's past in a bid to pick out patterns from which to derive strategies and tools. This section is therefore not about prescriptive planning but about descriptive analysis of strategic perspectives.

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[12] See Mintzberg H., "The Manager's Job: Folklore and Fact" in: Harvard Business Review, July-Aug. 1975, pp. 49–61.

P. Kotler, R. Berger, N. Bickhoff, *The Quintessence of Strategic Management*,
DOI 10.1007/978-3-642-14544-5_2, © Springer-Verlag Berlin Heidelberg 2010

2.1 Why it is Important to Structure the Market, the Competition, and Your Own Company Properly

Against the backdrop of a constantly rising flood of information and the increasingly dynamic international markets, it is becoming ever more difficult for companies to formulate the "right" strategy. As we already demonstrated, strategic planning may be suitable as a thought process to integrate and provide an organized representation of all of the management steps. But it does not give any indication of the extent of the potential success of the chosen strategy – it suggests a certainty to decision makers but it does not guarantee success. Consequently, if they want to get any closer to the issue of a strategy's success, decision makers first need to adopt a diverse range of perspectives by applying strategy tools. Only then will they have an understanding of all of the layers of a strategy, providing them with an overall qualitative assessment of the situation and an essentially objective decision aid for strategy selection.

2.1.1 Interdependencies Between the Key Approaches

Figure 9 presents the most important frames of reference and how they interact. Practitioners should at least be aware of these approaches as well as the concepts behind them, what they entail, and the amount of information they potentially offer. The SWOT analysis provides the basis of data for all subsequent steps – the other frames of reference will not be any use at all unless this analysis is executed in a precise and exhaustive manner. The next step is to examine both the corporate strategy and the business strategy based on the SWOT findings. These two strategic issues subdivide into numerous perspectives, developed using seven different tools, to which the rest of this section is dedicated. In relation to the strategic management process, these frames of reference are applied in the sphere of strategic analysis and planning: they consequently depict the whole of the content side of strategy determination.

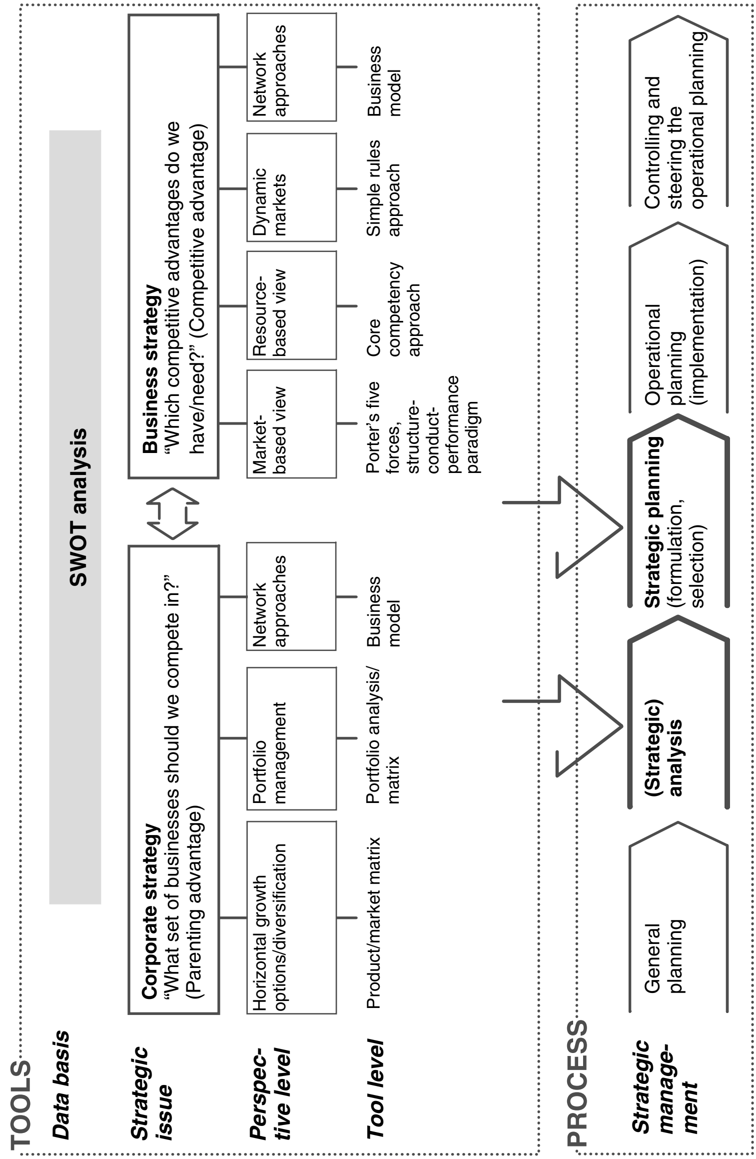

Fig. 9: Frames of reference for considering strategic options

2.1.2 The Harvard Business School SWOT Analysis – The Data Basis for all Interpretive Tools of Strategy Determination

In any attempt to determine a strategy you need to start by gathering and analyzing all of the necessary information. Given the much-cited flood of information with which we are faced, this is something of a never-ending task: the Internet, libraries, corporate PR departments, and a flood of internal documents quickly cause you to lose track and forget what you were really looking for in the first place. The frame of reference constituted by the SWOT analysis represents the basic analytical framework for strategy research. It was developed in the 1960s at Harvard Business School,[13] and today Henry Mintzberg sees "*... SWOT as underlying all attempts to formalize the strategy making process.*"[14]

This frame of reference breaks down the available information into four areas: **S**trengths, **W**eaknesses, **O**pportunities, and **T**hreats. According to this, a strategy is the result of the opportunities and threats of the technological and economic environment and the strengths and weaknesses of the company.[15] Whereas the strengths and weaknesses constitute the internal analysis of the company, the opportunities and threats represent the external analysis of the relevant market. In the first instance, you as a practitioner are therefore required to do no more than sort all of the information gathered into these four areas. The deeper analysis and interpretation is done later with other tools that draw on this preliminary work.

You should bear in mind that the SWOT analysis remains highly abstract in practice, since its findings are purely descriptive and it

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[13] For a detailed view see Andrews K. R., The Concept of Corporate Strategy (2nd ed.), Homewood et al. 1980.

[14] See Mintzberg H., The Rise and Fall of Strategic Planning, Hemel et al. 1994.

[15] The interests of management and the requirements of society are sometimes explicitly incorporated in the consideration as well. But we will leave these aspects aside here.

does not make any recommendations or set any priorities.[16] Nor does it need to; its job is merely to present a structured, and therefore reusable, depiction of the situation for which a decision is required.

The example in figure 10 illustrates the point: a company produces an extremely high-end product and is faced with enormous demand. It is unable to satisfy this demand due to capacity problems in production operations. The threat is that new competitors entering the market may lead to the development of overcapacities, which would put pressure on volumes and prices. This sample situation, effectively reduced to four pieces of information, demonstrates the potential of the SWOT analysis: the structure is there, but there is nothing to help make a decision. Whether the company should expand capacity, running the risk of new suppliers causing overcapacities, or keep its capacity tight, with the danger of customers switching to other suppliers, is a decision that can only be made with the help of additional tools. However, structuring countless pieces of information at the same level of abstraction is only the first, albeit very important, step in understanding and describing the complex situation in rough.

[16] For additional points see Hill T./Westbrook R., "SWOT analysis: It's time for a product recall" in: Long Range Planning, Vol. 30 (1997), No. 1, pp. 46–52.

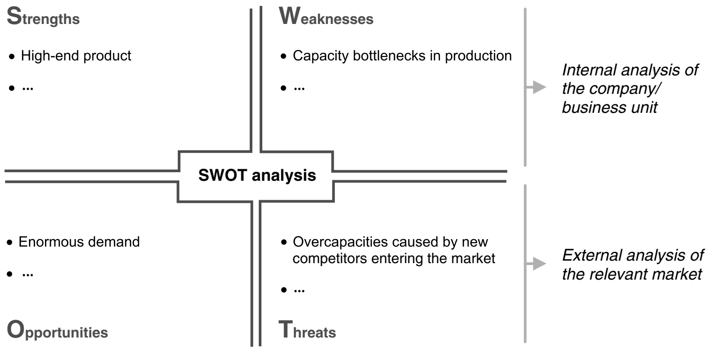

Fig. 10: Sample SWOT analysis

When you apply this method in practice, it is essential to bear the following points in mind, otherwise the frames of reference for strategic planning cannot be applied or exploited to the full – this is definitely a case in which thoroughness takes precedence over speed:

- Keep the statements descriptive. It is very hard to avoid jumping straight to interpretation when you are condensing all of the information down to a few points, but such evaluation should be left to the tools at the perspective level.
- Certain points cannot always be assigned unambiguously. A statement saying that 30% of US households have a broadband connection could be an opportunity (70% market potential remaining) or a threat (limited acceptance). Since you should not be interpreting the points during the SWOT analysis, you need to list the statement as both an opportunity and a threat.

- Concentrate on information for the external analysis. Most companies remain on the level of internal analysis, taking an inside-out perspective, because there are naturally a lot of internal documents available on this aspect, and every employee has an opinion on the company's strengths and weaknesses. The act of gathering external information on the market through anything other than the online channel is regularly less than successful: the people tasked with the job are often afraid to call competitors, industry associations, or other entities under a clever pretense (such as researching for an academic paper) to ask for information that is not in the public domain. Yet this is the very information that determines the quality of an external analysis.
- Keep a sharp distinction between internal and external analysis. Many practitioners will let themselves be taken in by the obvious notion that weaknesses also represent opportunities, and will thus mix internal and external points.[17] This must not be allowed to happen – "external" really does mean the pure market perspective.

[17] It is quite astonishing, in fact, that this happens time and again. Even the dictum of "the crisis as an opportunity" derives solely from the fact that external threats or changes lead to corporate crises, which then lead to weaknesses and present the opportunity to make a new start. Thus, there is an indirect connection at most.

2.2 Analyzing Corporate Strategies

Corporate strategy is also known as enterprise strategy and it addresses the strategic question, “What set of businesses should we compete in?” This means it examines and clarifies at the group level which businesses should be operated overall. The best example of this are the conglomerates, such as General Electric and Siemens, which bring a wide range of very diverse businesses – from power plant construction to fridge manufacture – under one roof. In the case of legally independent integrated companies, there are also parent companies, each of which has a number of subsidiaries, which, in turn, all operate different businesses. For a parent company to justify its existence economically, it must offer its subsidiaries a parenting advantage. Such parenting advantages may be benefits arising from a common umbrella brand, from having management structures and systems consolidated at a single point instead of present in each company, from value-oriented portfolio management, and from other economies of scope. If the parent company does not provide this advantage, its role as a strategic holding company must be questioned. In this case it can either be interpreted as a financial holding company or, if the subsidiaries are large and independent (for the most part listed or listable corporations), it can be disestablished. So there is no parenting advantage unless the company as a whole is worth more than the sum of the individual, independent companies within it.

2.2.1 Horizontal Growth Options: Ansoff's Product/Market Matrix

Igor Ansoff first published his deliberations on the product/market matrix in 1957.[18] In a bid to address the corporate strategy of the future, his approach delivers the perspective of growth options on the horizontal (group) level and introduces the possibility of diversification. The first starting point of Ansoff's deliberations was the fact that companies need to grow fast in order to improve their position among the competition. The second starting point was the assumption that there could be uncertainties in the existing businesses, which would mean that it might make sense, in the context of growth, to spread the risk (for instance if the markets are subject to seasonal cycles).

Building on these two notions and utilizing empirical data, Ansoff developed his generic product/market matrix. Based on the fundamental question, "Which products should be supplied in which markets?" this frame of reference depicts the four general growth options for a company's horizontal strategy. In order to substantiate this "set of businesses," a distinction is made between existing products and new products as well as existing markets and new markets:

[18] See Ansoff I., "Strategies for diversification" in: Harvard Business Review, pp. 113–124 (1957) and also Ansoff I., Corporate Strategy, New York 1965.

	Existing products	New products
Existing markets	***Market penetration*** Intensifying market development, relaunching products, imitation, cutting costs and prices, unbundling (Market leadership)	***Product development*** New products, new product lines, new services and/or problem and system solutions (Extending the value chain)
New markets	***Market development*** Expanding the market, new customer strata, new distribution channels, new uses for the products (Realizing economies of scale)	***Diversification*** New products for new markets – Vertical – Horizontal – Lateral (Additional mainstay, risk balancing)

Fig. 11: The product/market matrix

The box at top left describes the status quo at the company. In line with this frame of reference, it incorporates the four principal, horizontal growth options of market penetration, market development, product development, and diversification. All of the descriptive results of the SWOT analysis are needed here as the options are evaluated and a prospective corporate strategy developed. If, for instance, there are virtually no opportunities in other markets and the company's in-house product expertise is limited, a strategy of market penetration would seem appropriate. This entails no expansion of business activities; instead the company should develop the status quo more intensively in order to attain or defend a position of market leadership through relaunches, price cuts, etc.

If, on the other hand, opportunities for the existing products in other markets are good, the group should develop the market. This generally involves penetrating new customer groups in the same geographic market, although it can also mean expanding the current market geographically. In either case, the group supplies its existing products in these new markets, for instance by establishing or buying a foreign subsidiary. The objective is to realize scale economies[19] by achieving better utilization of existing production capacities through market extension and the acquisition of new customer strata, and by bringing fixed costs down as a result.

Where the opportunities in other markets are not good but the in-house product expertise can be expanded, the company should pursue a strategy of product development: offering existing customers or geographic markets either a brand-new set of products (generally achieved by buying up a subsidiary) or new product lines or system solutions building on the current product and service spectrum. With this strategy, growth centers on extending the value chain, in other words on upstream or downstream integration.

If the SWOT analysis shows that the company faces substantial threats to its existing businesses (for instance seasonal or cyclic fluctuations), diversification may be a suitable growth strategy. Here, the aim is to offset the threats present in the current markets by establishing an additional mainstay of the business to balance the risk at the group level. Lateral diversification[20] entails a complete departure from any prior expertise, with the company supplying brand-new products in brand-new markets. The above-mentioned conglomerates are examples of companies that follow this principle: a fridge and a power plant have nothing in common on the product or the market side – except the parent company.

Self-evidently, any synergies within a group's existing business diminish the further the strategy moves away from the status quo. With lateral diversification, there is no synergy between the businesses, so the success of this strategy is much more risky – but on the other hand, it is the best way of spreading the risk. What this means for conglomerates is that they must manage their individual subsidiaries very strictly, since there is no mutual support between them. General Electric, for instance, lives this principle by stipulating

[19] Also known as economies of scale.

[20] We will not address the other two forms of diversification (vertical and horizontal) in any more detail here.

that any subsidiary is only kept in the portfolio if it is sustainably the number one or the number two in the market. Where this is not (or no longer) the case, the subsidiary is divested. This strategy of market leadership on the part of all of its subsidiaries is what made the General Electric conglomerate one of the five most valuable companies in the world and is indeed what keeps it in that position.[21]

2.2.2 Portfolio Management: Portfolio Analysis (Matrix)

Complementing Ansoff's perspective of growth options, the portfolio analysis offers a perspective for the active evaluation and management of the existing portfolio. These two frames of reference are used in parallel and together they produce a suggestion as to the right corporate strategy for the company concerned.

The portfolio analysis considers all of the group's strategic business segments and subsidiaries from the corporate perspective, evaluates all aspects of them, and takes this as a basis to plan the allocation of resources and, with it, the corporate strategy. It has its origins in Markowitz's financial portfolio analysis (1952), the aim of which is to achieve an optimal return. The objective of portfolio analysis is, therefore, to realize as high a return as possible while incurring as little risk as possible and to operate or establish such strategic business segments as are necessary to achieve this. The process turns the parent company into an investor with a medium to long-term orientation, holding individual shares or subsidiaries in its portfolio in line with its return/risk preferences in much the same way as a shareholder would do.

The analysis is mapped onto a portfolio matrix, which, in most cases, contrasts the strengths and weakness with the opportunities and threats. As such, all of the descriptive findings of the SWOT analysis flow directly into the portfolio matrix. Generally speaking, the matrix combines attributes that describe the strength of a market (and also

[21] In fact, GE is often the most valuable company in the world, but – depending on oil prices or technological innovations – is continually superseded by either Microsoft or Exxon.

the strength of the competition) with attributes that express the market's attractiveness to arrive at four (or more) generic strategies. With a strategic portfolio matrix you should always ensure that one of the axes depicts internal criteria while the other portrays external criteria. Only then are the attributes completely independent, and the whole of the portfolio matrix can be utilized or filled. Time and again, we come across portfolios that use mutually dependent axis criteria (namely both external or both internal attributes). The interdependency results in automatic regression – the portfolio matrix cannot fully be utilized and its strategic significance is dramatically impaired.

Bruce Henderson developed the best-known portfolio matrix, the BCG matrix, in the late 1960s.[22] It is based on three theoretical fundamentals, which afford it significant relevance at the strategic level (as long as those who use it are aware of these fundamentals).[23]

Henderson studied the semiconductor industry in the U.S. in the course of his work. In the context of quantitative-empirical research, he discovered the following law, which we now know as the experience curve: each time the relative market share doubles, the relative costs decline by at least 20 percent. The relative market share is calculated as a ratio consisting of a company's own market share and the market share of the biggest competitor – an increase in this ratio signifies a dramatic rise in the cumulative production volume and, thus, the emergence of learning effects in the conduct of business operations, which bring corresponding cost benefits. Since Henderson discovered the experience curve, it has been demonstrated in countless works pertaining to an extremely diverse range of industries, and as a result it now counts as a widely accepted

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[22] BCG stands for Boston Consulting Group, the company Henderson founded.

[23] With regard to the following remarks see Henderson B., The Experience Curve Reviewed – How Does it Work?, Boston 1974, and Henderson B., Henderson on Corporate Strategy, Cambridge 1979, and Henderson B., The Logic of Business Strategy, Cambridge 1984.

economic law.[24] It represents the first theoretical fundamental of the BCG matrix. The attribute that the relative market share reflects in this matrix is a company's market power, which equates to the internal analysis of strengths and weaknesses. The better a company's position here, the greater its cost and margin benefits, the greater its market power.

The second theoretical fundamental of the BCG matrix is the four-phase lifecycle concept: young markets grow very fast and thus demand substantial investment in research & development, in building up capacities, in branding, in human resources, and so on. Mature and saturated markets grow slower and tend to require lower investments to sustain the business. In the BCG matrix the growth of the market reflects the attractiveness of the relevant market as an attribute, which equates to the external analysis of opportunities and threats. According to this, young markets are theoretically more attractive, but they necessitate a great deal of investment, making them prone to risk as well.

The third and crucial theoretical fundamental of the BCG matrix is the use of free cashflow (FCF) as one of the target criteria in the portfolio. It is not profit but freely available liquid funds that need to be optimized: FCF is defined as cashflow less maintenance capex,[25] and it represents the liquidity available in excess of that needed to operate the business in line with the market. This liquidity can be distributed in the form of dividends, for example, or used for diversification, acquisition, etc. In the BCG matrix, free cashflow is

[24] Experience curve effects relate unit costs to cumulative volume; economies of scale relate unit costs to units of volume per unit of time. This is an important difference, because it means that experience curve effects are even available to small firms that have been active in the market a long time – for instance the local shoemaker. Economies of scale, on the other hand, can be experienced by large companies only – those that make better use of their production capacities, for instance. This, of course, means that these larger companies also feel experience curve effects.

[25] For a first approximation you can quickly calculate cashflow from the following figures in the profit and loss statement: annual profit plus depreciation and amortization.

calculated by looking at the relative market share, which determines how much cash is freed up, and the growth of the market, which determines how much cash is consumed (in other words, maintenance capex).

A diversified company can use the BCG portfolio to analyze its portfolio of activities in great detail and to plan the allocation of investments to the most productive areas of business. The following standard matrix serves to illustrate the ensuing description:

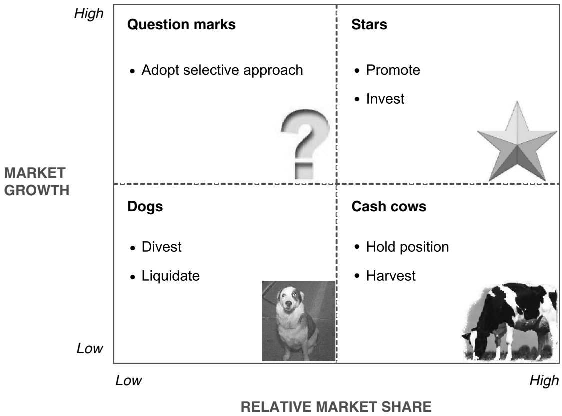

Fig. 12: The Boston Consulting Group portfolio matrix

A "cash cow" has a high relative market share in a mature market. This means it frees up more cash than it consumes. Accordingly, the company should hold this business segment in its current position by making maintenance investments so that the cash can be "harvested."

"Stars" also have a high relative market share but operate in a market that is still growing fast. Consequently, the amount of cash freed up is offset by the amount consumed. Companies should definitely promote stars with the funds at their disposal because such investments can help stars become cash cows in time.

A high level of market growth means that business segments in the “Question mark” quadrant use up more cash than they can generate with their relatively low market share. A selective approach is called for with these businesses: depending on the future prospects, the division should either be promoted or divested. Question marks are, in any case, the areas in which the company must make a decision and take action the fastest, since they consume cash.

“Dogs” have a low relative market share in a mature market. Therefore, they neither consume nor free up much cash, and they also tie up management resources at the parent company or group level. The preferable course of action for these business units is thus to divest them, or sell them to other companies. If this is not possible, they should be liquidated, in other words closed down.

A company should have a balanced portfolio. In order to achieve this, it needs to employ scoring models or direct measurement to assess where on the axes a business segment is positioned, between low and high. The coordinates determined on both axes enable the firm to mark the division’s position as a dot in the portfolio. Once all business units have been marked on the matrix, the portfolio of the company as a whole can be evaluated and developed. A balanced portfolio encompasses a few cash cows and strong stars as well as some question marks with potential, while also exhibiting a positive free cashflow overall. The cash cows release cash that can be used to promote the stars and question marks. The rest of the free cashflow can be put to good use promoting certain areas of the business more strongly or building up other high-potential business segments (mostly question marks).

Their respective lifecycles mean that all three types are needed for a portfolio to be balanced: cash cows tend to degenerate and stars become cash cows as their lifecycle progresses. And only question marks with potential can develop into stars over time. If a company has only cash cows, it will generate a lot of cash but will have no future-proof business activities – the firm should put the funds at its disposal to use creating a balanced portfolio by developing or acquiring question marks and stars. Dogs have no place in a balanced portfolio: even if they are cash-neutral, they tie up management capacity and can lead, among other things, to image problems for the parent company.

At a single glance, the portfolio matrix makes it possible to draw conclusions about a company's situation and to see where action needs to be taken. If the company does not have a balanced portfolio for want of stars, it can formulate a corporate strategy by integrating considerations from Ansoff's product/market matrix: What horizontal strategy will balance the portfolio by creating question marks with potential or stars – or, to rephrase the question, "What set of businesses should we compete in?"

2.3 Analyzing Business Strategies

Business strategies are concerned with establishing competitive advantages in each of the strategic business segments. They endeavor to answer the question, “Which competitive advantages do we need or do we have?”

A company can develop the crucial competitive advantages by looking to the market, on the one hand. In this case the firm employs what is known as the market-based view (MBV). This is all about the opportunities and threats in the markets, which means that only these descriptive results of the SWOT analysis flow into the considerations. In other words, the approach takes an outside-in perspective: a company’s position in the market or competitive environment is the crucial determinant of its success (the concept of “*strategy as positioning*”[26]). The focus lies on the customer, the market, or the industry, and the key questions are: What do I need to offer in order to be successful? What competitive advantages do I need in order to do this? In this view, the firm’s existing competencies are not decisive factors.

On the other hand, a company can develop the crucial competitive advantages by looking at resources. Otherwise known as the resource-based view (RBV), this approach considers only the firm’s strengths and weaknesses and the descriptive results of the SWOT analysis upon whose basis these are assessed. An inside-out perspective like this sets out – based on the specific company’s resources – to find the markets in which the highest returns can be achieved with these competencies. The key question here is: What competitive advantages do I have? Opportunities outside of the company’s own world are not taken into account. This perspective finds consideration in the concept of “*strategy as stretch and leverage*”, which involves setting barely attainable targets (stretch) to be achieved through the innovative use of resources (leverage).[27]

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[26] See, among others, Brews P. J., op. cit.
[27] See, among others, Brews P. J., op. cit.

We will now take a look at the MBV with reference to the structure-conduct-performance paradigm and Porter's five forces. The core competency approach subsequently serves to explain the RBV.

2.3.1 The Market-Based View: The Structure-Conduct-Performance Paradigm and Porter's Five Forces

Thoughts around the MBV are based on the structure-conduct-performance paradigm from the field of industrial economics.[28] The paradigm states that the industry and its structure are decisive factors in the behavior of market players and in the market's potential (see Fig. 13). Oligopolistic market structures thus induce different behavior than those in a polypoly because oligopolies have the chance to secure high returns by means of adapted behaviors. Polypolistic structures, on the other hand, exhibit very intense competition and result in lower returns. Of course, there are recursive processes, which is to say that high returns increase the probability of new providers entering the market, thereby changing the market structures and consequently changing the behaviors in the market as well as other market results.

[28] See, among others, Scherer F., Industrial Market Structure and Economic Performance (2nd ed.), Chicago 1980, or Bain J., Barriers to New Competition, Cambridge (MA) 1956.

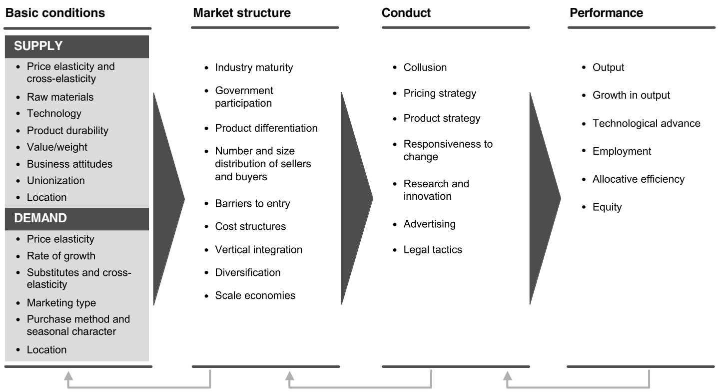

Fig. 13: The structure-conduct-performance paradigm from the field of industrial economics[29]

"Tell me what industry you're in and I'll tell you what you earn." This sentence aptly paraphrases the fundamental thought behind this frame of reference. In the early 1990s the steel industry was marked by low demand and high capacities – the returns were correspondingly poor. Only when there was a demand shock from India and China did the market structures change to such an extent that high returns can now be realized once again. By the same token, international oil companies have for decades been generating outstanding returns in their oligopoly, whose substantial startup investments afford it excellent protection from the incursion of new competitors. Accordingly, the MBV demands that individual companies take a good look at the markets and choose the ones that offer the best returns. Based on the structure-conduct-performance paradigm, Michael Porter presents this process of selection in a structured manner in his "five forces" approach in the interest of

[29] Scherer F., op. cit.

showing companies exactly what positioning options and strategies are open to them in the context of the opportunities and threats present in a given market.

Porter takes competitive intensity as a criterion and applies it to five fundamental competitive forces that shape the market and its environment.[30] The more intense the combined competitive strength in these areas of an industry, the lower the potential for profit (and vice-versa). The five forces are:

- Rivalry among existing competitors
- Bargaining power of suppliers
- Bargaining power of buyers
- Threat of new entrants
- Threat of substitute products

With the aid of these forces, a company can perfectly structure and analyze its value chain and its external environment or potential market. The following figure[31] illustrates Porter's typical presentation of the model and also depicts the key determinants or criteria that can be used to analyze and evaluate competitive intensity.

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[30] With regard to this section see Porter M., Competitive strategy, New York 1980, and Porter M., "Towards a dynamic theory of strategy" in: Strategic Management Journal 12 (1991), pp. 95–117.

[31] Hutzschenreuter T., Wachstumsstrategien [Growth strategies], Wiesbaden 2001, p. 137.

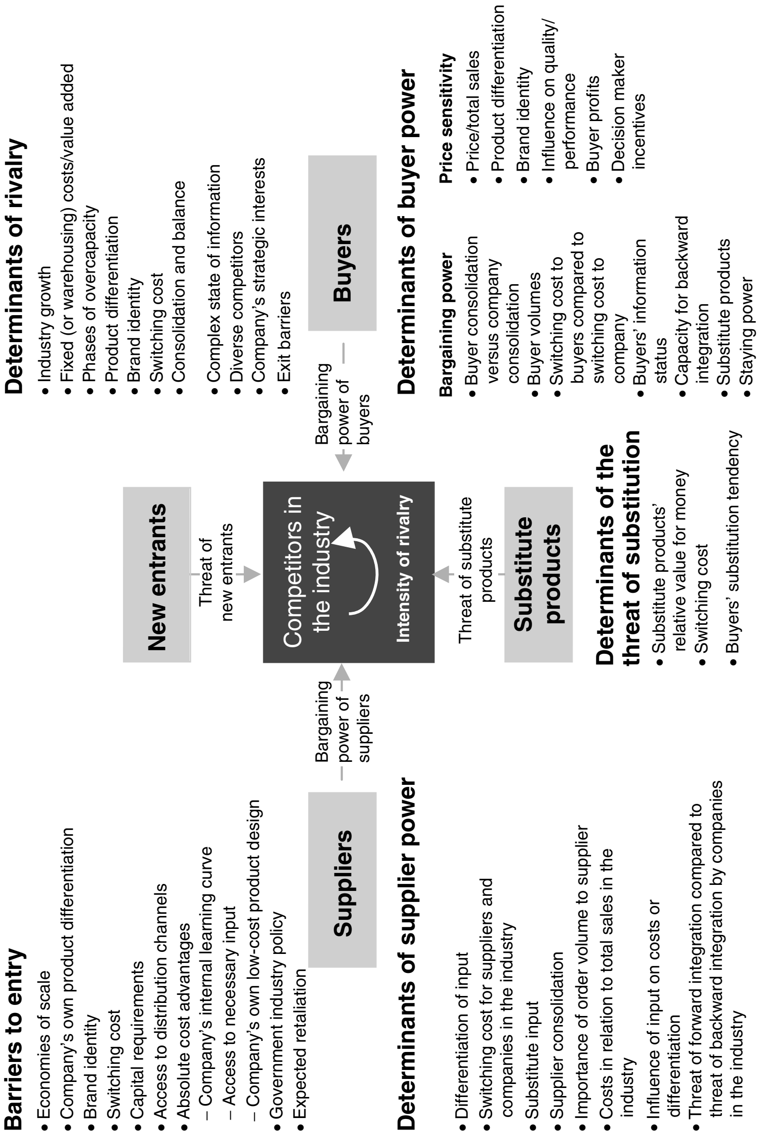

Fig. 14: Porter's five forces model for analyzing an industry's structure

The descriptive results concerning the external opportunities and threats as identified in the SWOT analysis are applied to the five forces using Porter's system in order to evaluate the intensity of the competition. This involves individually examining and conducting a qualitative assessment of the separate determinants or criteria by placing them in relation to one another with statements in the form of "The [more/less] …, the …." Below are a few examples for the different quadrants:

- The stronger the industry growth, the lower the competition and the competitive intensity.
- The lower the capital requirements, the greater the market entry opportunities and the competitive intensity.
- The greater the supplier concentration, the greater the supplier dependency and the competitive intensity.
- The lower the customer volume, the lower the customer dependency and the competitive intensity.
- The higher the switching costs, the lower the threat of substitution and the lower the competitive intensity.

As many of the determinants as possible should be examined and evaluated using this method. The information from the SWOT analysis is not always available in a comprehensive form, so it may not be possible to use certain criteria. Having carried out the evaluation, the company will know which areas and forces drive the competition in particular and how high the competitive forces and therefore the profit potential in the industry is overall.

If the company decides, on the basis of this potential, to remain in or to enter an industry, it can use the individual determinants to identify which competitive advantages are necessary in the industry concerned. Porter also refers to this as competitive strategy and offers two alternatives: in the defensive alternative, the company's establishment of the necessary competitive advantages enables it to find a position in the existing market in which it can shield itself optimally against the competitive forces. In the offensive alternative, however, the firm attempts to influence the balance of forces in the existing market or to exploit a change in the competitive fundamentals to create new competitive advantages for the industry and to establish itself there.

In the interest of enabling firms to successfully grapple with the five competitive forces and implement a competitive strategy, Porter cites three generic strategy types for both alternatives. According to these, companies should strive for a position in the market either through cost leadership, through differentiation, or by focusing on niches in the market. A strategy between cost leadership and differentiation is stuck in the middle and cannot be successful in the long run.

2.3.2 The Resource-Based View: The Core Competency Approach

10 years on from Porter's five forces, the opposite perspective was presented in the core competency approach,[32] which is at the center of the notion of the RBV. This frame of reference analyzes the strengths and weaknesses of a company and states that there are certain core competencies that constitute competitive edge. These core competencies may be resources, skills, or general assets, and a company must look for the markets in which it can achieve the highest returns on the basis of these core competencies. A core competency must meet certain requirements:

- It must be valuable – in other words scarce and non-substitutable.
- It must be heterogeneous and immovable – in other words differentiating and non-transferable.
- It must be accessible to the company – in other words the company cannot be denied the use of it.
- It must not be imitable – in other words it must be genuinely unique.

[32] See Prahalad C./Hamel G., "The core competence of the corporation" in: Harvard Business Review, May-June 1990, pp. 79–91.

The core competency approach attracted a large following in the 1990s, and even today the concept of core competency is still firmly established in the management and consulting arenas. However, the practical relevance of the approach has been markedly qualified in the field of strategy research. The notion of the "causal ambiguity of competitive advantages" conceals the following thought: if a company, a consultant, or an academic were to succeed in precisely identifying one of a company's core competencies, it would only be for the purposes of employing this core competency more widely. Yet this would infringe on the inimitability requirement, and competitors would be able to build up the apparent core competency themselves. In practice it is therefore better to speak of strategic competencies that constitute competitive advantages for the company and that meet some but not all of the requirements of a core competency. This is not to imply that there are no such things as core competencies: the strength of this frame of reference lies in illustrating that there are, for example, certain organizational capabilities on the part of a company that give it competitive edge. What is important is that, though they exist, these advantages cannot be perceived and reproduced in detail. If it plans to adopt a resource-based view, a company should therefore examine its own strengths and weaknesses as depicted in the SWOT analysis against the four attributes of a core competency in order to identify its strategic competencies: if one or two or even several of the conditions are met, the competency at hand is indeed a strategic one, which holds a competitive advantage.

2.3.3 Dynamic Markets: The Simple Rules Approach

The MBV and RBV were developed against the background of "traditional" markets. In light of the growing dynamism of the markets and environments in an era of increasing technological progress and networking, the two perspectives and their recommended strategies became ever less relevant; they were too slow to build up competitive advantages in fast moving markets. Kathleen Eisenhardt carried out a number of extensive case studies in the late 1990s and discovered that successful companies in fast moving markets work not with complex strategy tools, but with simple rules and few core processes. These simple rules can be split into five categories:[33]

1. *How-to rules* define how a company should carry out its core processes and how it can make them unique.
2. *Boundary rules* set guidelines concerning which business opportunities managers should pursue and which they should not.
3. *Priority rules* help managers rank the perceived business opportunities.
4. *Timing rules* synchronize the dynamics of markets and business opportunities with internal processes such as product development.
5. *Exit rules* discipline managers to get out of obsolete business opportunities at the right time.

The simple rules approach therefore offers a special frame of reference, which builds neither on positioning nor on resource aspects, but places the focus firmly on seizing, implementing, and exiting short-term business opportunities. The opportunities and threats as well as the strengths and weaknesses identified in the SWOT analysis are all used and are interpreted with regard to the market dynamism and the internal processes and rules. The figure below illustrates how this approach differs from the other two and enables all three approaches to be defined on the basis of eight criteria:

[33] See Eisenhardt K./Sull D., "Strategy as simple rules" in: Harvard Business Review, January 2001, pp. 107–116.

	Positions	Resources	Simple rules
Strategic logic	• Establish position	• Leverage resources	• Pursue opportunities
Strategic steps	• Identify an attractive market • Locate a defensible position • Fortify and defend	• Establish a vision • Build resources • Leverage across markets	• Jump into the confusion • Keep moving • Seize opportunities • Finish strong
Strategic question	• Where should we be?	What should we be?	• How should we proceed?
Source of advantage	• Unique, valuable position with tightly integrated activity system	• Unique, valuable, inimitable resources	• Key processes and unique simple rules
Works best in	• Slowly changing, well-structured markets	• Moderately changing, well-structured markets	• Rapidly changing, ambiguous markets
Duration of advantage	• Sustained	• Sustained	• Unpredictable
Risk	• It will be too difficult to alter position as conditions change	• Company will be too slow to build new resources as conditions change	• Managers will be too tentative in acting on promising opportunities
Performance goal	• Profitability	• Long-term dominance	• Growth

Fig. 15: Comparing the MBV, RBV, and simple rules approach[34]

Whereas the MBV and RBV pursue sustained strategies and competitive advantages in slower markets – in line with their underlying concepts as presented above – the simple rules approach adopts a very short-term orientation, engaging in a permanent search for the best opportunities and exits. All three approaches exhibit the same risk typology, however: once successful, the organization or the management will find it difficult to adapt to the new conditions or even to exit the markets. The fact that success can make you lazy therefore applies irrespective of what strategic perspective you adopt or what the market dynamics are like.

[34] Eisenhardt K./Sull D., op. cit., p. 109.

2.4 Network Approaches: The Business Model – An Integrative Frame of Reference for Describing a Strategy

“Nobody really knows what strategy is!” – Can the opening quote of this book be refuted based on the frames of reference presented thus far? To put it another way, do we now know what strategy is? Mintzberg cites the following aspects, among others, with respect to the definition of strategy[35] – they summarize some of the thoughts behind the frames of reference:

- Strategy is an action plan – this reflects the action-based principle of “strategy as formal planning.”
- Strategy is a pattern of consistent actions – this is the descriptive view of American-style strategy research.
- Strategy is a position in the competitive hierarchy – this statement expresses the concept of the MBV.
- Strategy is a perspective (from the inside out) – this is fundamentally true of all frames of reference but can be taken as a particular expression of the RBV.

In summary, therefore, we can say that the frames of reference presented so far have given us various tools and processes with which to formulate a strategy, but have not brought “enlightenment” concerning what strategy is. The business model frame of reference attempts to close this gap by integrating aspects of corporate and business strategy and complementing them with certain additional issues.

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[35] See Mintzberg H., op. cit.

2.4.1 From Old to New Business Models

The business model approach emerged in the mid-1990s and was driven by the topics in and around the net economy, namely the technological progress that the Internet brought, and also the general globalization of companies and economic processes. Crucial to this development is the fact that these issues transformed economic activities from bilateral processes of exchange into multilateral, interconnected relationships of exchange:

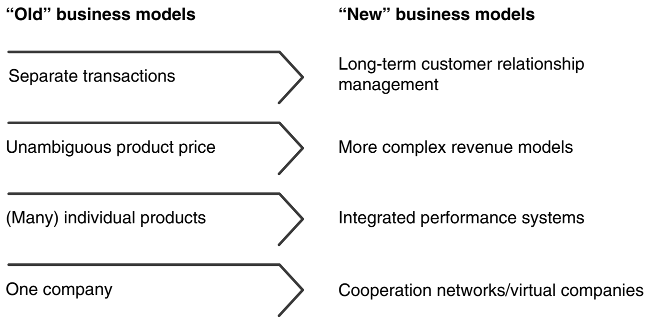

Fig. 16: The transformation from old to new business models

The concept of the business model was developed to describe this heightened complexity. It is, first and foremost, a model (for describing complexity) with which a company should do business (in other words make a profit). It features three components through which to structure the complexity of the interconnected world:

1. The choice of product/market combinations
2. The determination of the revenue mechanism
3. The configuration and execution of value adding activities

A differentiating feature by virtue of being new, the revenue mechanism aspect had played a secondary role in strategies up to this point. But the all-round networking and advances in technology created a need to properly plan the different types of revenue streams because – as we will see below – they have a decisive influence on the corporate system and therefore on strategy. A business model is a fairly recent attempt to formulate a simplified description of a company's strategy and is therefore the tool for the perspective level of the network approaches, which are found in both the corporate and the business strategy (see Fig. 9). The business model draws upon many of the tools presented above as well as all of the results of the SWOT analysis. It is therefore the approach that takes us the closest to answering the question of what strategy is.

2.4.2 The Three Components of a Business Model

The choice of product/market combinations is based on Ansoff's deliberations as presented above as well as his product/market matrix. According to these, the business model is a means of describing the products with which the company (or the group) currently operates in which markets and whether it plans to expand this field of activity for the purposes of growth. These statements produce the three central parameters of a strategy: the sphere of activity, the target markets/groups relevant to this sphere, and the economic logic of the choice (spreading the risk vs. exploiting the synergies).

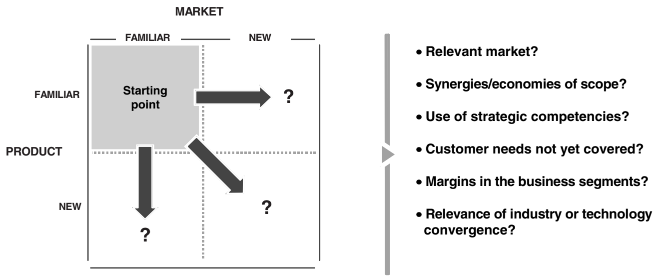

Fig. 17: Alternatives and criteria in the choice of product/market combinations

In accordance with the findings on the networked economy, the market dimension was subdivided into target groups to make the specification of the strategic choice even clearer. Using a nine-box matrix (see Fig. 18) the market strategy can be explained in much greater depth in a business model than with the previously conventional split between consumer goods and industrial commodities. B2C, B2B, and the like are now common parlance and provide a straightforward explanation of what type of customer is being served by what type of provider.

		Customers of the service		
		Consumer	*Business*	*Administration*
Providers of the service	*Consumer*	**Consumer-to-consumer** e.g. online classifieds market	**Consumer-to-business** e.g. job boards with ads from job seekers	**Consumer-to-administration** e.g. taxation procedure for private individuals (income tax, etc.)
	Business	**Business-to-consumer** e.g. a customer's order in an online shopping mall	**Business-to-business** e.g. a company's order from a supplier via EDI	**Business-to-administration** e.g. taxation procedure for companies (sales tax, corporation tax, etc.)
	Administration	**Administration-to-consumer** e.g. processing benefits (welfare, unemployment compensation, etc.)	**Administration-to-business** e.g. public institutions' procurement activities in the domestic and international markets	**Administration-to-administration** e.g. transactions between public institutions in the domestic and international markets

Fig. 18: The nine-box matrix for specifying the market strategy[36]

The second component of a business model concerns the determination of the revenue mechanism. Before this aspect became the subject of more intense interest, relationships of exchange were, from a corporate perspective, based on the bilateral approach under which price multiplied by quantity equals sales. As mentioned, the planning of revenue streams has since become considerably more complex. For a start, it is important to note that business models can theoretically be based on usage-independent and usage-dependent revenues:

[36] Zu Knyphausen-Aufsess D./Meinhardt Y., "Revisiting Strategy: Ein Ansatz zur Systematisierung von Geschäftsmodellen" [Revisiting strategy: An approach for systemizing business models] in: Zukünftige Geschäftsmodelle [Future business models], T. Bieger et al. (ed.), Berlin et al. 2002, p. 69.

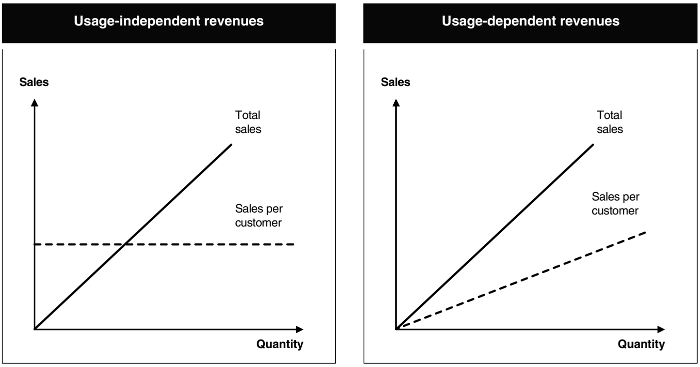

Fig. 19: Basic forms of revenue mechanism[37]

Usage-independent revenues come from basic charges, such as the TV licenses that are common throughout Europe, which are paid once per television receiver regardless of how much TV a household watches. Usage-dependent revenues, such as those from movie theater tickets, are generated with each visit (each use). And there are, of course, hybrid forms like telephone lines: in their most elementary version the provider levies a basic charge and the usage fees depend upon the actual calls made.

Whereas the first two, pure forms can be planned without any trouble whatsoever, the hybrid form is already indicative of the complexity of the subject of revenue streams. Telecommunications companies need to decide on a strategy for pricing their products and services within their businesses: how high is the basic charge and what are the secondary charges per network type as a function of and in relation to the basic charge, how many free minutes do customers get, how

[37] Zu Knyphausen-Aufsess D./Meinhardt Y., op. cit., p. 77.

much does a text message cost, is there a discount for customers who allow the provider to send advertising by text message, and so on? In this case the maximization of revenues is limited by the number of customers per revenue type and their price sensitivity. But there are other optimization problems with the revenue streams as well. Consider, for example, a company that sells a B2C product exclusively via its website. In this case the term “usage” is replaced by “transaction,” so there are transaction-dependent and transaction-independent revenues. As sales figures rise and the product becomes better known, more and more users visit the site. At some point this volume of “traffic” is so great that the operator is able to sell advertising banners and links on its homepage. What proportion of the homepage can be filled with advertising without the company’s own product fading into the background? The space on a homepage is limited, so there is an optimization problem for two fundamentally different revenue streams, which were brought together by a new technology and which were inconceivable in combination until the mid-1990s. Figure 20 illustrates the complexity of this decision and the associated assertion regarding the business model – and thus the choice of strategy.

Old economy

	Product/ service	Product + investment/operation
Usage-dependent	• Volume-dependent • Distance-dependent	• Pay on production • Operator model
Usage-independent	• Fixed per period • Fixed per order • Fixed per lifecycle	• Bonuses • Minimum revenues

New economy

	Direct revenue generation	Indirect revenue generation
Transaction-dependent	• Transaction revenues • Connection charges • Usage charges	• Commission
Transaction-independent	• Setup charges • Basic charges	• Banner advertising • Data mining revenues • Sponsorship

Fig. 20: Revenue possibilities in the old and new economies

So complex revenue streams exist not only in the new economy. In the old economy too, decision makers have numerous possible combinations at their disposal, some of which evolve around the product only, but often around the company's entire value creation too. Accordingly, globalization, networking, and advances in technology led to specialization and competitive pressure even in the old economy – creating, among other things, innovative pricing models and, hence, revenue models.

The configuration and execution of value adding activities is the third and final component of a business model for describing a strategy. Here too, influenced by the issues cited above, a broad spectrum of variants has established itself. The following four basic forms are the most important of these:

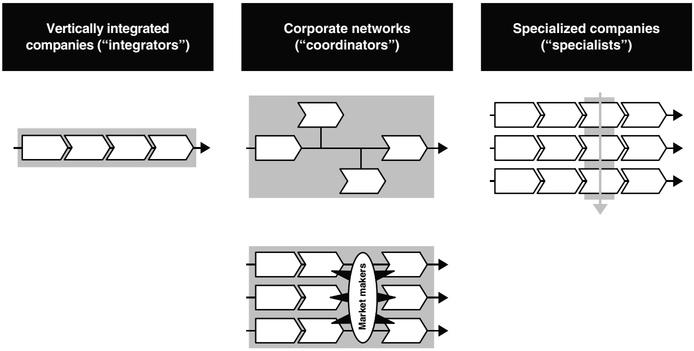

Fig. 21: A company's positioning options in the value chain[38]

Traditionally a company occupies a position in one or more of the links in an industry's value chain. The more links in the value chain it covers, the greater its degree of vertical integration. The oil industry, for instance, can be differentiated as follows: searching for and exploring crude oil, transporting crude oil to the refineries, processing crude oil into petroleum products in the refineries, transporting the petroleum products to the wholesalers/retailers, and selling the petroleum products. International oil companies like Exxon and Shell are integrated in the whole of the value chain, meaning that they operate in all of the links. But besides them there are other players like independent gas station operators, selling petroleum products only and therefore operating in just one of the links in the value chain.

Specialized companies emerged in substantial numbers in the late 1980s: they offer the same service across several industries, which is

[38] Zu Knyphausen-Aufsess D./Meinhardt Y., op. cit., p. 73.

why this strategy is also known as business migration. The gas station operator, for instance, migrated from a seller of gas to a store operator: specializing in sales, the operator is able to offer petroleum products, bakery goods, and general supermarket items – covering at least three normally separate industries.

The other two basic forms that originated in the sphere of corporate networks first attained significance with the advent of networking and technological progress. On the one hand there are business models in which providers from various industries come together for a limited period in order to offer the entire value chain for a given industry. Such forms are frequently referred to as virtual companies, and they are mostly small market players who use this method to offer and execute large single contracts. Examples include construction consortia and coalitions of service providers such as advertising agencies, IT consultants, and strategy consultants. On the other hand the Internet itself created the "market maker" model. This signifies companies that break up a traditional value chain and introduce a new link, sometimes even across several industries simultaneously. Internet trading platforms exemplify this model: eBay, Amazon, and countless online B2B platforms opened up new, previously non-existent marketplaces beyond traditional sales. Whereas Amazon put old sales channels online, B2B platforms that sell things like leftover warehouse stocks of screws or similar items from one company to another represent brand new links in the value chain given that the assets sold here were simply scrapped in the past.

A strategy must take numerous issues into account, and numerous decisions need to be made in the formulation of a strategy – the business model as the expression of a strategy represents the best attempt so far at describing strategies and their complexity. It does, however, remain at the level of description; even this does not irrefutably answer the question of what strategy is.

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