Strategic Logic
General Adviser:
Professor Christian Pinson, INSEAD
To Arantxa and Rosi
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If A equals B and B equals C, then A equals C. This is a typical precept of formal logic, upon which all reasoning is based. If somebody tried to explain something using statements that contradicted such a precept, we would take exception immediately: such an argument would be illogical.

Without logic there can be no science, for we cannot establish the correctness of a given argument. Logic is so important that we have it instilled into us from childhood, and we can say that a large part of our education consists precisely of this. Some psychologists go even further, stating, with solid reasons, that basic logic principles are innate: we come into this world with them, much as we come with the ability to hear or see.¹

The simplicity of these logical principles is a bit deceptive: they are simple, but without them we could not build more complex constructions. We could not answer the great questions that science and technology have been able to deal with. Physics, for instance, could not advance until Galileo had it enter the path of logic. Before him, each ‘scientist’ had his own ideas, used his own terminology, and put forward ad hoc arguments, that could never be generalized. Once the basic norms of logic were applied however, progress was rapid and Newton, a few years later, answered most of the problems that physics had been trying to solve for millennia. In 300 years we managed to go from magic and alchemy to quantum mechanics.

In the business world, we are not very far from the Middle Ages. If we ask a physicist what determines the speed of an object’s fall, we will get an answer that is both precise and identical to that given by any other physicist. If we ask an expert why a given company is profitable, or whether a given business looks promising, we will receive an answer that is in all likelihood essentially unique. It will not only be different from other answers in its results, but in its starting points, its parameters, its internal logic, even its terminology. Exactly like physicists in the Middle Ages; Aristotle said that things fell to the ground because ‘the centre of the earth
is their natural place’. This is not very different from saying that a company does well because it provides ‘value-added services’, or does badly because of ‘globalization’. It is clear that this kind of reasoning will not take us very far.

But progress we must. Every time a company fails, jobs are destroyed; every time a venture doesn’t work, capital is lost that could have been invested profitably to improve the future. These past few years in particular have been rich in serious strategic mistakes, from irrecoverable investments in mobile telephony licences to mega-mergers that destroy billions of equity and thousands of jobs.

The good news is that the world of business does have an internal, clear and precise system of logic that helps to prevent mistakes, if it is well applied. Obviously, we can’t expect, in something that touches the behaviour of human beings, mathematical precision. We can, however, demand analytical rigour, conceptual clarity and tight reasoning that will allow us to find certain solutions to complex problems. This book is dedicated to developing that logic.

As in any treatise on logic, we will start with very simple norms, which are foundational and absolutely necessary to the building of the system. To skip quickly over these norms, with the idea that they are already well known, is a serious mistake. For it is when the basic concepts are not totally mastered that ad hoc arguments develop, as do equivocal interpretations and justifications for almost anything, all under the gloss of an apparently sophisticated terminology. However, if bearing with me in these first steps, the reader will in the end have a clear idea of how to answer the complex problems posed by business strategy.

Specifically, we will analyse questions such as:

- Which company is more solid in the long term, a large or a small one? We read all the time (particularly after a large merger) how a company is going to be an ‘unbeatable juggernaut’ thanks to its size and sales leadership. But we also read frequently that when a large company is doing badly (which, unfortunately, happens very often) the reason must be found in its lack of agility; because it is a ‘dinosaur’, it is easy prey for smaller and therefore more nimble competitors. Which is true? On what does it depend?

- Something similar happens with integration: it is not unusual to hear as the explanation for the success (or failure!) of a company the fact that it ‘controls the whole value chain’. But it also seems reasonable when it is said that the success (or failure) is due to specialization in some ‘core activities’. 
Which is better for a company, to have 10% market share in four countries (of a similar size), or 40% market share in just one? This is not an academic question (although I like using it in my exams), because a company will make very different investments, presumably with very different results, depending on the answer.

Is it better to diversify risks or concentrate on core competences, as seems to be the fashion now?

It now seems quite clear that it is not true that ‘the Internet changes everything’. But does it change anything? If so, what?

What is the rate of growth that a company should strive for?

I repeat: these are fairly basic questions, but the answers given are often wrong. In many cases, there is no clear logic that leads to certain answers. To continue with our analogy, if we put the equivalent of these questions, in their field, to a group of biologists or chemists, we would get unanimous answers, for they are fairly basic. If we put these questions to businesspeople, we will get the most disparate answers, not only in their results but also in their perspectives and arguments, and we will quickly see that there is no overall internal logic in them.

Of course, logic does not mean determinism. The logic of the business world, which is the result of the interaction of thousands of human beings (employees, competitors, customers and so on), cannot pretend to the precision of natural sciences such as physics or chemistry which deal with inert materials. The number of variables that act upon the profitability of companies is enormous, and luck should not be ignored. Clear strategic logic, however, can still cast a clear light on business realities. Let us illustrate this with an example.

As everybody knows, Amazon.com is an Internet retailer that started as a bookshop and has been adding other lines. The company is famous for the huge market capitalization that it attained at its peak, $60 billion, double that of Tesco, Safeway and Sainsbury. After years of losses, it now seems to be breaking even. Of course, its market cap went down sharply once investors convinced themselves that, at best, Amazon’s profits will be those of a very successful book and electronics retailer and nothing else (today’s market cap is $3.8 billion, which is about 15 times less).

There is another Internet company, called eBay, which is an on-line auction facilitator. When somebody wants to sell something (from an old photographic camera to a collection of Beatles records), he or she can post it on eBay, which then allows bidders to send their bids, until a given date
and time. At closure, the highest bidder is awarded the object. What makes eBay interesting from a business point of view is that, contrary to most other Internet companies, it became profitable very quickly and its profitability has been increasing every year. Its competitive position grows stronger by the day and it has been able to push aside all competitors, including Amazon.com, which launched an unsuccessful auction site. Where is the difference? The answer is not complicated in the framework of our strategic logic.

The business of auctioning has an intrinsic characteristic: sellers are interested in posting their saleable items in the place that attracts most buyers. Buyers want to go and buy where they know they will find as large a variety of things on sale as possible. Thus all the actors involved (sellers and buyers) have a vested interest in going to the same auction house, whichever it is. As a result, the business of auctioning has a strong tendency to concentration and, in a short time, very few auction houses remain. New ones cannot set up shop successfully, for they cannot attract sellers given their lack of buyers and cannot attract buyers given their lack of sellers. This tendency to monopoly is so strong that eBay itself has failed in Japan, where another company (Yahoo! Japan) established itself first, and took the position that eBay has in the US. Everywhere, when an auction house achieves a meaningful market share, it tends to boom and become a quasi-monopoly, which can raise prices and enjoy excellent profitability (eBay not only grows in sales and profits, but its margins are larger every year).

Compare this to a bookshop. When buying a book, there is no value in buying it in the same place in which other people buy it. As long as the book is the one I want and the price is correct, I couldn’t care less if I am in fact the only customer. Of course, if there are more customers, the shop will be able to get its books at a lower price and offer better prices to its customers, but the difficulty of joining the business is less than for auction houses. In fact, the business of selling books is much less concentrated everywhere than the business of organizing auctions.

Without going any further with this example (we will analyse the structure of eBay’s business in Chapter 3, and the reasons why Amazon.com may indeed become fairly profitable when we discuss economies of scale), it seems clear that there is something intrinsic to the auction business that favours profitability. The key point is, this ‘something intrinsic’ can (must!) be analysed before getting into any of these businesses. That eBay would achieve profitability much more quickly than Amazon.com is something that the strategic logic we are developing could have shown. Of course, the quality of management also greatly affects the final results of specific
companies. But the truth is that some business models are more solid than others, independently of any other variable. That solidity, the ability to generate above-average profits, is what we will study in this book.

One thing we will not do is develop tools, or techniques for analysis. Henry Mintzberg, one of the best management writers, has defined those techniques as ‘something that saves us the effort of thinking’. What I would like to achieve with this book is exactly the opposite: I would like its readers to think hard. Even more, I would like to change their way of thinking, until they reason rigorously when analysing a strategic problem. If we achieve this lofty goal (it is a task for both of us), readers will be in a good position to:

■ Evaluate the strategic plans of a company, for instance as an outside investor or supplier.

■ Evaluate the strategic plans of their own company, as managers, and adjust them as necessary (that is, all the time).

■ Develop their creativity, as strategists or consultants in charge of helping to answer the very simple question: ‘And now what do we do?’

As indicated, this is an ambitious book. I want to explain why some companies are more profitable than others. I want us to reach a level of understanding that will let us foresee how that profitability will be affected by changes in the environment or inside the companies themselves. I want, in essence, to develop a ‘theory of profitability’. The theory has to be simple enough to be easily applicable everywhere, and robust enough to explain situations of great complexity and rapid change.

And there is no question that this theory is needed. Take the merger of Daimler and Chrysler, or AOL and Time Warner. At the time, they were heralded as brilliant strokes of business genius that would create unbeatable companies. Not much later, people find it hard to believe the amount of value destruction brought about. But in both cases, strategic logic could have explained that those combinations did not make sense. Paying attention to it would have saved investors billions of dollars and society thousands of jobs.

But this is not a ‘solutions’ book. The lack of strategic logic is, in my opinion, the source of the constant stream of books that promise to turn lead into gold if only … whatever the new fashionable concept is. The profitability of a company is something complex, subject to dozens of variables and very hard to improve, whatever consultants who promise easy solutions say. In fact, while the avalanche of gurus and consultants
that we have suffered in the past few decades has not produced an appreciable increase in the health of companies, rigorous medicine, for its part, has contributed to a documented lengthening of life expectancy. We are going to develop a logic, a way of thinking, full of rigour, step by step, without promising intellectual or practical short cuts. In many cases, readers will take from this book mostly the conclusion that many things they thought were good ideas are very probably wrong. This is an important achievement, since it focuses attention on what can be useful.

**Plan of the Book**

The book is divided into three parts: the essential elements of strategic logic; an analysis of company development; and the logic in action. The sense of these parts is clear. We start with the explanation of strategic logic’s simplest elements, then turn to see how that logic applies to the basic decisions that make for the development of a company, and finish by applying the whole framework to the task of creating a strategy for a company.

In the first chapter, we establish the fundamental basis for strategic logic: a company can make money only if it is able to do something that the market wants and that its competitors cannot imitate; or if it is able to do the same things its competitors do, but more cheaply; or both.

Stated like this, it sounds trivial. But the analysis of why a company may be able to do something that cannot be copied is a complex one, and requires a deep understanding of a series of mechanisms that operate in very different ways. Competitors are there to compete, and reality is full of very innovative or highly efficient companies that have nevertheless had serious profitability problems because competitors have quickly pushed margins down. From personal computers to telecommunications to home delivered pizzas, most companies have a difficult time keeping the good times going, even when they get them started.

But it is not always like this. Some companies are able to stay atop of their pedestal year after year, apparently immune to competition. In the last analysis, all strategic logic consists of is understanding in which cases competitors can imitate the innovation (whether product innovation or cost innovation) and in which cases they cannot.

In Chapter 2, we analyse the company, in the original sense of the term: we break it down into its constituent parts, from a strategic point of view. We will see how profitability usually originates in a few very specific aspects of the company and not in its entirety, as is normally assumed to be the case. This chapter also explains why most of the
strategic analysis techniques that have become popular in the past few years don’t usually yield useful analyses in practice, in spite of their theoretical solidity. This is a chapter in which many a reader will be surprised by the consequences of the application of strategic logic. Many ideas that once seemed obvious will probably appear as serious mistakes.

The first two chapters present the basic strategic concepts in a static mode, not allowing for the fact that things evolve. This is done to facilitate a rigorous comprehension of the intellectual building blocks. To be useful, however, our logic must be applicable to real-life situations and these change all the time. In Chapter 3, we study business evolution, providing the essential dynamic perspective to our basic concepts. We will see how a well-applied strategic logic can cast a bright light on technology or regulation as drivers of industry evolution.

Once the basic principles have been established, both statically and dynamically, we pass to the second part of the book. In it, we study the three dimensions along which companies grow and how strategic logic can be applied to this growth to ensure its profitability. Essentially, we show that companies determine their actual strategic position vis-à-vis three axes: product/market (what they do); geographic (where they do it); and vertical integration (which specific activities are actually carried out in the company and which are sourced outside). Companies don’t apply abstract strategies, they make decisions along these axes, thus configuring the real strategy of the company.

Chapter 4 starts this analysis by trying, in the simplest possible way, to provide the necessary logic to correctly answer the question: ‘do we do it ourselves, or do we buy it?’. As we shall see, this is possibly the decision with the most important impact on the long-term profitability of a company, yet it is often made lightly. The advantages and disadvantages of vertical integration and outsourcing, of strategic alliances and partnering will be discussed in detail, with clear rules to analyse the best solution, given specific circumstances.

Chapter 5 studies the current globalization process and how it impacts strategy. As we shall see, there is less globalization than meets the eye, and it is no coincidence that many companies never achieve the same profitability abroad as they achieve in their domestic operations. In many sectors, from banking to meat packing, the most profitable companies are those that eschew international expansion and stay close to their geographical roots.

Chapter 6 deals with the logic of diversification: when a company should stick to its knitting, and when it makes sense to launch into new ventures and under what circumstances. Again, this is a decision that is
being constantly taken in companies, for rare is the company that does not introduce new products, attack new markets and so on. We will show what rules must be followed so that this strategy makes sense, and not only preserves but even increases profitability.

The third and last part of the book, ‘Logic in Action’, has two chapters of a practical bent, where we show how the previously discussed principles apply to the reality of strategy making. Chapter 7 is devoted to mergers and acquisitions, which are, in practice, how companies implement the expansion already discussed: vertical integration, diversification, internationalization. Although it is well known that a large majority of mergers fail to produce anything close to the expected results, the reality is that this activity grows practically every year. It is therefore important to understand the reason for this growth and why there are so many failures.

The last chapter studies the actual determination of strategy inside a company: once all the principles of strategic logic have been assimilated, what do we do? As we have said before, this book does not offer tools to generate, more or less automatically, a solid strategy. But we do provide some working models that facilitate a way of thinking which could be both creative and rigorously logical.

As the reader will see immediately, the book is full of examples and it is rare that concepts are not analysed by starting with a specific case. Although readers tend to appreciate this, it has a downside: in some cases, the examples are very detailed and we get into the technical details of the business. However, it is in the technical details that the difference often lies (perhaps that’s why consultants are frequently accused of presenting brilliant analyses that don’t work. The difference between a brilliant and a useful analysis is that the latter includes all the relevant details of the business which the consultant sometimes ignores).

To study a book on logic or mathematics does not, of course, allow the reader to immediately understand Einstein’s theories, much less to improve on the relativity theory. But that study would be a necessary prerequisite. This book, in the same vein, cannot be a handbook of recipes or anything like that. However, it will provide the reader with a rigorous starting point for understanding business strategy and evaluating decisions which end up having a huge impact on the profitability of the company and, therefore, on the jobs and wealth created by society. This is particularly pressing, for the modern economy, with its technological change, regulatory rewriting (privatizations, deregulations) and globalization, favours the emergence of complex, not well-understood business phenomena. A large proportion of the most successful companies in the past few years, as well as some of the worst failures, are not only new, they do new things or do things differently.
We need a strong logic to guide us through all this innovation.

As we have already said, the world of business is affected by many variables. That is why its rules of logic, in many cases, do not produce results immediately. It may even be possible to show counterexamples: sometimes, companies may seem to defy the rules. It is important, in these cases, to take one of two attitudes: try harder to understand how the company’s success does indeed follow strategic logic, or wait for the failure that will inevitably come (unlike the law of gravity, strategic logic sometimes takes some time to act but, like the law of gravity, it always acts). Unfortunately, the past few years have given us abundant examples of companies that have grown in clear defiance of the rules of logic, from the ‘dot.coms’ to Enron to mergers of the Vivendi/Universal kind, which have always finished badly: logic asserts itself in the end. The fact that a situation may be complex does not mean it is incomprehensible: even the most complicated phenomena in physics follow the rules of logic. As we will see in these chapters, every strategy that seems to work against the rules of logic is simply profiting from the ignorance or greed of markets, but logic wins in the end. In this sense, the reader must be warned: all announcements of a ‘new economy’ are deeply suspect, not because innovation isn’t constant in the business world, which it is, but because the rules of the game never change. The prophets of the new rules are either self-interested (which consultant or professor does not like to say that the rules of the game have changed and immediately offers himself or herself to explain them?) or, more likely, just ignorant.

Frequently, readers of management books look for new ideas. This book is based on fairly old ones, essentially those derived from the advances in microeconomics in the past 50 years. However, it offers something that is often missing: a way of thinking that is simple and solid, that helps avoid frequent strategic mistakes. That many of the principles explained in the book are simple, as in the case of formal logic, does not detract from their usefulness. The difference, of course, is that formal logic is fairly well anchored in managers’ minds, but strategic logic has a much more tenuous grip. That is why a book that carefully explains principles that are perhaps not new, is useful nonetheless: these principles are not new but they are not well understood, yet they are essential for reasoning solidly in strategic terms.

For years I have had the opportunity to ‘talk strategy’ with literally thousands of managers of companies, large and small, on all the continents. Systematically, I have found intelligent and motivated people, willing to make the right decisions. But all too often the needed clarity of ideas was missing. This book derives from my efforts over the years to make strategic
logic ever more understandable. The problem is not very complicated, and I am sure that the reader is intelligent. All that is asked is that he or she reads the chapters carefully, trying to get rid of preconceived ideas. My experience over the years is that when the argument is followed step by step, clarity emerges and a clear grasp of strategic reasoning is achieved. It is my hope that readers will obtain the same result.

A last point: the variables that, in fact, determine the success or failure of a company are innumerable and span many fields outside strategy, from the leadership of its managers to pure luck. In this book I do not maintain that the only reasons that explain a company’s degree of success are those we discuss here: there are many others and they are very important. But the principles explained here form a framework that is essential to understand reality, and to ignore them, because ‘there are many other things’, cannot but lead to serious mistakes. Conversely, to incorporate these principles into one’s way of thinking and decision making has a clear long-term impact on profitability.

Notes
PART I

The Essential Elements of Strategic Logic
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To start our journey to discover the basic rules that make up strategic logic, we can start simply by looking at the very different levels of profitability that different businesses show over the years. For instance, the automobile sector has not provided a good return to its shareholders over the past ten years, whereas most mobile phone companies have been making money right from day one.

A first inspection of numbers shows that differences start with margins. In the pharmaceutical industry, for instance, the average margin, that is, the difference between what it costs them to make and sell their products (research, financing, manufacturing, marketing and so on) and what they charge for them stays around 10% of sales. In the steel industry, that margin rarely goes above 1%. Why? Obviously, the products from both sectors are necessary, and it is not reasonable to think that, in a systematic way, managers in the steel industry are less capable than those in the pharmaceutical industry. If that were the problem, it would be enough for the owners of the steel companies to hire a bunch of pharmaceutical managers to see how their profits exploded: if the margins of Corus had been as good as those of Novartis, Corus would have earned in the past five years almost £3 billion more than it actually did – enough to pay the best managers in the world.

Whatever the reasons for these differences, they cannot be easy to change, for they have existed for years, in every country. If we accept that a difference in the quality of management cannot explain these systematic differences, we will have to start looking for something related directly to the characteristics of the business, and it is this that we are going to investigate.¹
The Balance of Supply and Demand (or Why Some Companies can Hardly Find Clients and Others Cannot Produce Fast Enough)

Something that separates some businesses from others is the abundance of supply: in some cases, it is easy for the buyer to get his or her goods or services from many different suppliers, but in some cases, it is not. For instance, it is easy to buy shirts, as they are available in many shops from many different suppliers. That’s not the case, however, with other products. To go back to a previous example: if a company develops a medicine that is clearly superior to any other for treating a given condition, buyers can only get it from that company, for there is a patent system that makes it illegal for any other company to produce it. In a way, the company has a monopoly over the drug. This lets it set the price it wants (within limits, of course), and buyers cannot go elsewhere, for there is no real competition.

However, most businesses are not like this. As soon as somebody has a good idea and launches a product that sells well, imitators spring up. When this happens, competition pushes prices down. We are going to study this process with a detailed example. Its simplicity should not lead the reader to skip over it, for in order to build up our system of logic we must start with solid, self-evident propositions, before we embark on complex situations, as we will do later on.

Think of the business of renting videotapes to watch at home. If the example looks too simple, the reader can substitute ‘alternative telecoms companies’ for ‘video rental shops’: it is the same argument, only the technology is a bit more complicated. About 15 years ago, when VCR players started becoming popular in Europe, it was clear that renting tapes would be an interesting business. Sales of machines were growing and demand for the tapes could only go up (in fact, subsequent developments have proved this vision right). Some alert entrepreneurs then launched the first video rental shops.

Results came quickly: customers did show up and profits materialized as expected. What happened shortly thereafter? Other people, wishing to start their own businesses and seeing how well video shops were doing, opened theirs. This did not necessarily imply a drop in the profitability of those already open: it is perfectly possible that the market is in fact large enough to support several neighbouring shops working at maximum capacity. However, the supply of people looking for an opportunity is large, so more shops open up and this continues until a new owner finds that there are fewer customers than expected and results do not match expectations. Why are there fewer clients than expected? Because all
demand is being satisfied by those shops already open. What do shop owners do in these circumstances? They normally lower prices to try to attract more custom. As soon as it is known that the new shop is charging less (or perhaps offering three tapes for the price of two, or something like that), customers do show up.

The opening of new shops and the lowering of prices forces the old shops to lower their own prices, otherwise they will lose their customers. This does not imply a complete destruction of the business’s profitability: it is possible that it was so high that a lowering of prices still leaves a substantial margin. But if the business is still profitable, we can be sure that new shops will open and the increase in competition, with its attendant drop in prices (remember, all demand is basically satisfied) will continue.

What is the end of this process? There is a point where prices have dropped so much that they barely cover costs. Normally, there are competitors with higher costs than others, either because they are inefficient, they have rented very expensive premises or some other reason. There are also competitors with higher opportunity costs: people who, instead of running the shop, could be drawing a good salary working for a company. Shop owners with the highest costs will realize that the business is no longer interesting, as they could make more money by putting the money in the bank and spending their time working for a company. These competitors will start closing their shops, which will improve the situation for the remaining shops, as there is less competition for the same number of customers. This improvement may even attract some new competitors, but it is clear that, in the medium term, the process of entry and exit, and falling and rising of prices, reaches a ‘point of equilibrium’. This is when the profits obtained equal what the owner would make by putting the money in the bank, plus the salary she could earn elsewhere, plus a bit more to compensate for the risk and preoccupation of running her own business.

If the owner of a business knows she can get a 5% return on the investment just by buying government bonds, she will not go to the effort and uncertainty of launching a business to make 7%. At least, she’ll demand 10% or 15%. Generalizing, we can say that any return below 10–15% is not a real return: if the business yields slightly more than government bonds, the owner is not really creating value as an entrepreneur, but just as an investor. The same results would be obtained by putting the money in the bank and going to the beach. From now on, in this book, whenever we say ‘profitability’, we will mean profitability above that opportunity cost of capital. A company such as AT&T, with a return on investment, over the past five years, of 3%, is not really making
money, but destroying value, because its equity, invested in the bank with far less risk, would yield more.

We can summarize these pages with a statement that is the foundation of strategic logic: if supply can easily follow demand, profitability will be minimal, because competitors, in their desire to capture a demand that’s already satisfied, will lower their prices until they reach that equilibrium point where they just cover their opportunity costs. In fact, we can estimate a priori what a video shop makes. It can’t be much more than the salary that the owner would make working for a company (anybody with the level of responsibility and self-motivation required to run a video shop successfully has a market price), plus probably a bit more, to allow for the investment and the uncertainty. If profits were higher than that, we can be sure that new shops would open, lowering them. If profits were lower, some would go to actually earn that salary, thus improving profitability for those left. We see that strategic logic allows us to estimate the profitability of a business without knowing much about it. It is enough, in this particular case, that it is easy to open or close one. We will see how this simple reasoning can be applied to much more complex businesses.

But the ease with which supply can follow demand is not the same in all industries. One of the key points of this book is that the speed with which supply can follow demand in a given business (and therefore, the level of profits) stems from a series of objective, industry-specific reasons, that can be studied a priori. Or, in other words: it is possible to predict the profitability of a business even before knowing its financial situation. It is on this possibility that we are going to build the strategic logic that, in the end, will just be a series of rules that will allow us to understand the ability that a business has, in reality, to achieve and sustain high margins. Without these rules, we will have to explain profitability by using concepts as hard to quantify or even rigorously analyse as ‘leadership’ or ‘creativity’. Such analyses, although partially correct when describing the success of a given company, are useless for the manager trying to make decisions that will affect the future of her company.

**Why Supply Sometimes Cannot Follow Demand**

In most cases, supply can and does follow demand, as we have seen in the video shop example. In fact, the normal situation in an open economy is that, given a desire, the market takes care of it. But it is not always like that. There are many reasons why a company may find itself in the wonderful position of selling something for which there is plenty of
demand but cannot be sold by anybody else. In fact, we have already seen one of the reasons: patents. If a company develops a product that is clearly more desirable than its substitutes, because customers prefer it, and gets a patent on it, it gains a monopoly position. Of course, this is only possible in some industries, where patents are possible, but not in most.

There are many other reasons, such as reputation or brand name, why a company may be protected by a de facto quasi-monopoly. Thus, for many people, it is not the same to buy a Coca-Cola as a similar product that is not ‘the real thing’. Furthermore, if the buyer is really looking for a given brand, for reasons we shall see, it is obvious that only one company, the owner of the brand, can legally supply it.

In addition to the impossibility, legal or practical, of copying a successful product, there are other reasons why supply cannot, in practice, follow demand. In many cases, supply can be augmented, but at prohibitively high costs. Thus, the petrol we buy for our cars leaves a generous margin for the oil companies, but this does not imply a drastic increase in the number of oil companies (rather the opposite is happening right now, for reasons we shall see in Chapter 7 on mergers and acquisitions). The reason for this difference from the video shops, where supply grew to annul profits, is probably not the brand (who, actually, has a strongly preferred brand of petrol?) or the patents (there aren’t any). Furthermore, anybody can explore for oil, extract it, refine, transport and sell it, and customers will be there to buy it, if the price is right. The problem is that the amount of money necessary to carry out these activities is enormous, as is the scale on which these activities must be carried out to obtain costs comparable to those of the current competitors. As we will see later on, this restricts the number of companies in fact interested in the business, which gives the incumbents the chance to charge prices above the opportunity costs, thus making real profits.

What we are finally saying is that in some businesses, an evident chance for profits (substantial margins, a clear signal of a small supply for the existing demand) does not produce an increase in supply, because there are difficulties in making this happen. These difficulties can be summarized as either the impossibility of actually supplying the demanded product (patents, registered brands) or the difficulty of doing so at a cost that would make the effort worthwhile for a new competitor, given the current market price. These difficulties are objective, in the sense that they don’t depend on the effort of the managers involved (everybody would love to have protected margins), but on the intrinsic characteristics of the business.2

The factors that, on a permanent basis, hinder the entry of new competitors into a profitable business (and therefore make that profitability
possible in the first place) have been known since 1956 as ‘barriers to entry’, following an influential book by Joe Bain, a Harvard professor.\(^3\) In the following pages we are going to analyse, in a systematic way, what those barriers are, how they act and why. We are not going to provide the reader with a ‘list of barriers’, for reality offers an almost infinite number of possibilities. What matters is understanding the concept of barriers and how they act, so that they can then be discovered in practice. They can be grouped into two large ‘families’, related to the issues we’ve already discussed: barriers that prevent competitors from making a similar product, and those that make it difficult to make a similar product at similar costs.

## When the Product (or Service) is Truly Unique

It is clear that the first family of barriers consists of the different reasons that truly prevent entry to businesses. We’ve already seen the case of patents, but there are many others. Here are the most important ones.

1. **The brand**
   In many industries, competitors appreciate brands. This may be due to several reasons. Perhaps the brand identifies a truly unique product, whose singularity is protected by secret or difficult-to-copy processes, as may be the case of Nescafé. Or the brand represents a status symbol that the buyer wants to appropriate, as in many fashion and luxury products. Or it is simply a guarantee of quality: buyers know that, by buying a product of a given brand, its quality is assured. In many cases, buyers prefer to pay a little more for the branded article to be sure they are not making a mistake.\(^4\)

2. **Reputation**
   Imagine a product (or service) with the following characteristics:
   
   - It is technically complex, so the buyer cannot really appreciate the quality of the different offerings
   - It is critical to the buyer, in that if the quality turns out to be bad, the buyer sustains a serious loss
   - The product’s cost to the buyer is not very high compared to his or her total costs.

   An example might be sophisticated professional services, such as strategy consulting or legal advice on mergers and acquisitions. In a completely different industry, supplies to ‘clean rooms’ in semiconductor factories
(clothing and paper that produce no lint or dust whatsoever) would fall into this category. In these cases, a rational buyer does not make life difficult for himself or herself by shopping around too much: he or she simply buys the service with the reputation of being ‘the best’. As long as the products or services of that supplier continue to provide good quality, its reputation will grow, and will make entry very difficult for a potential competitor. Even if this potential competitor had a comparable (or even better) quality product, getting the order will not be easy, for the buyer cannot judge that quality and is seriously risk averse (remember, the product is critical and not too expensive anyway). Lowering the price, therefore, will not be a way to enter, for buyers will simply not try it. But if they never try it, the potential competitor will never develop the necessary reputation.5

Again, we see that barriers to entry are ‘objective’ or ‘structural’, that is, they do not depend on the manager’s will. Whether a product is complex or not, critical or not, or an important part of the buyer’s costs is something given. Managers in a company producing petrol cannot do much to make reputation play a role: if a competitor shows up with a lower price, many buyers will buy it, even if only to try. The same managers, working for a prestigious investment bank, will see that they can ask for a higher price for their services compared to banks with no reputation in the field, for no client risks putting his or her company’s defence in a hostile takeover in the hands of an inexperienced advisor, no matter how low the fee quoted.

The criticality of a product is not homogeneous for all buyers. Thus, for a weekend cyclist, having a punctured tyre is inconvenient, but not serious. A professional will pay whatever it takes to avoid such a fate in a race against the clock. This heterogeneity is the basis for marketing segmentation, and supports the strategy of differentiation: whatever our company does, there will (almost) always be some customer more interested (ready to pay a bit more) than the others, as we will see in Chapter 8.

Evidently, a way to make a product or service unique is to make sure it includes a desirable component whose supply is limited. This is the case for many food producers bent on using denominations of origin. If they manage to give value to the denomination, they create a barrier, for, by law, not everybody can sell Bordeaux wine or Parma ham.

The story of Californian wine is illustrative. When Californian wine growers decided to go for high quality wines, they found the reputation of French wines acting as a barrier to selling expensive wines. This is a barrier that cannot be attacked directly: whatever they did, their wines would never be French. Their brilliant idea was to adapt the best French
varieties of grapes and put their name on the bottles (Cabernet Sauvignon, Merlot, Chardonnay and so on), sending out the message that the quality of French wines did not come from them being French, but from using certain varieties of grapes. The conclusion is evident: once these grapes were successfully grown in California, there was nothing to differentiate these wines from the best in the world.

The long-term problem, of course, is that everybody can use those varieties. Once the differentiation is not based on the growing area, but on the grape, in principle, nothing prevents other growers in the US, Chile, Australia or wherever else from making wines as reputable as those from California. It is ironic, but consistent with our strategic logic, that many Californian growers now insist that while the variety of grape is important, so is the quality of the soil and Napa Valley has some geological and meteorological qualities unique in the world.

3. Governments
Governments can certainly intervene directly or indirectly to protect a market. Thus they can (explicitly or not) decide to buy only from local suppliers, thus making entry to foreign competitors impossible. Or they may favour some companies over others in a variety of ways, as many European countries prevent, informally but effectively, takeovers of local banks by foreign ones, thus protecting ‘local champions’.

Furthermore, governments can also intervene directly. For decades, the airline business was completely regulated and governments prevented the entry of new competitors. Today, governments limit the amount of licenses to compete in mobile telephony, which is a very profitable business because the number of competitors is limited by law.

4. Network effect
Finally, there is a phenomenon known as the ‘network effect’, that favours enormously high market-share companies in some industries. This is because, in some cases, everybody is interested in buying the same product the others are buying, for instance to make sure it is compatible, as is the case with personal computers. In these cases, the market gravitates quickly towards a single supplier (Microsoft), whose product nobody can really compete against, even if their product is technically superior (Apple), because it is not compatible with those used by most buyers. Of course, in most cases compatibility is worthless (I can wear the shirt I like, regardless of how many people buy the same brand), but where it matters, it matters a lot. We will develop this point in more detail in Chapter 3, when we talk about the new economy.
Differentiation and Sustainable Profits

Figure 1.1 shows how differentiation, that is, selling a product that nobody can copy, allows companies to make real profits.

Let’s imagine, to simplify the discussion, that Coca-Cola has such a reputation that it can charge somewhat more for its products than an unknown competitor. Or, in other words, for the same price most people would invariably choose Coke. Coca-Cola can, therefore, charge a bit more and still preserve a large market share. For our example, let’s say that this ‘bit more’ is 20%: for a competitor to start snatching sales away from Coke, it must sell 20% cheaper. We can say that the brand is ‘worth’ 20% of the price.

As unquestionable leader, Coca-Cola can set the price it pleases. But if the price is 60, as shown on the left side of Figure 1.1, it will find that its competitors, even selling for 20% less, can make money. In normal conditions, these competitors will enter and start reducing Coca-Cola’s market share. Evidently this is not good for Coke: even if the margin is good, volume decreases and with it overall profits.

But Coca-Cola can play the game differently: it can price its product at 50. In this case, potential competitors cannot enter, for they cannot cover costs selling 20% cheaper than that price. Coca-Cola can, therefore, make real profits (in costs we include everything, even normal returns on capital) and its competitors cannot do anything about it. But no more than the 20% premium. To try to earn more than that by raising prices would be
counterproductive, for it will simply open the door to competitors. If Coca-Cola really wants to make more money than that, it must improve its premium, that is, the amount of extra money buyers are ready to pay to drink the real thing. There is another possibility, of course, which is to lower costs. In this example we have considered that Coca-Cola’s and its competitors’ costs are the same. This is not realistic, as we will see later, but it shows that, even with the same costs as everybody else, a company that has something unique, for which its customers are ready to pay, can make real money, in a sustainable way.

That, to make money, one has to have something unique is so well accepted today that general opinion has gone a step further and maintains that a commodity cannot be profitable. Thus a product completely undifferentiated, always identical to itself, such as gold, a variety of wheat or a grade of oil, cannot justify any price premium, for buyers do not really care who the supplier is. But the examples should already indicate that the statement that commodities cannot be profitable does not really bear scrutiny: both gold and oil have been profitable things to sell for years (wheat less so). The reason is that, as we saw earlier, there are two reasons that prevent entry to a business. The first is the impossibility of actually making the product. The second is the impossibility of making the product on a cost-competitive basis.

Cost Differences

We saw how, in the video-rental business, all competitors (both actual and potential) have very similar costs. It is very difficult to make money in these circumstances: since the offer is essentially identical, the only way to attract customers is with a low price. But in a highly competitive market, there is always someone ready to keep lowering the price until opportunity costs are reached, as we have seen. And if those opportunity costs are the same for everybody, nobody earns much.

What happens, however, if somebody has lower costs than the rest? Imagine a situation where a competitor has costs that are, consistently, 10% lower than those of the others. This competitor, whom we will call the cost leader, will always be able to earn real profits, for its competitors cannot sell forever below their own costs. Figure 1.2 shows how the cost leader has a ‘guaranteed’ profit equal to the difference between its own costs and those of the competitor with the lowest costs (after the leader’s), for this second competitor cannot sell, long term, below its own costs.
But why would a competitor have a consistent cost advantage that the others cannot copy? A new technology, for instance, can lower production costs, but as long as that technology is embedded in machines that anybody can buy, it is not going to be the basis for a sustainable cost differential. As a matter of fact, the seller of the machines will make sure that all potential users realize how essential it is that they buy the new technology, lest they allow a competitor to have lower costs. A real cost advantage must be based on a unique factor to be the basis for long-term profits.

This is very important. Very often we find companies basing their hopes for profitability on the adoption of new production techniques, distribution channels or process re-engineering. All these actions, designed to lower costs, may be necessary. But they are not sufficient to make money. If all competitors can copy them, they will (if they are effective, of course), with larger margins, be ready to lower their prices a bit to gain market share. However, margins will go back pretty quickly to where they were before the cost reduction programmes started.

Therefore, we must find factors that may lower the costs for one company (or just a few) in a unique way, to really understand where sustainable profitability comes from.

**Figure 1.2** Cost leaders enjoy profits at least as large as the difference between their own costs and those of the next competitor.
1. *Economies of scale*

The first of those factors is known as ‘economies of scale’. As (almost) everybody knows, there are economies of scale when the unit cost of a product goes down as the volume of production goes up. Therefore, it is cheaper to make cars in factories that produce 300,000 cars per year than make them in factories that produce 2,000, and this is true even if the cars are basically identical.

The causes of this phenomenon are multiple and can be found in every one of the company’s activities. Thus, R&D expenses are independent of production volume and therefore go down (per unit) as volume goes up. It is also often the case that prices paid for raw materials are lower if the amounts purchased are larger. The same frequently applies to distribution costs, for it is not the same to transport a few units considerable distances as full trucks or even entire trains worth of the finished product. Indeed all functions in a company can give rise to economies of scale, as shown by some examples in Table 1.1.

Figure 1.3 shows a typical cost curve. It shows that as volume goes up (moves to the right), unit costs go down (move towards the bottom of the graph).

However, this is not necessarily the case. Some industries do not have economies of scale at all. For instance, to paint somebody’s house takes x kilos of paint and x hours of labour. Painting two houses will require exactly twice as much paint and time. There are no savings to be gained with growth: there are no economies of scale.7

Figure 1.4 shows that there is a point (a company size), called MES, that is the ideal one: a smaller company has higher costs, while a bigger company does not have lower costs and ends up having higher costs, too. This ideal size is known as the ‘minimum efficient scale’ (or ‘minimum efficient size’)

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<th>Table 1.1 Possible economies of scale in the different functions of a company</th>
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or ‘critical mass’, and is the minimum size that a company must reach to be really cost-efficient.

The specific shape of the curve for each particular business tells us what the ideal size for that business is. And this shape depends on the specific technology used in the business. Let’s go back to the example of house-painting. The current technology implies that the best (cheapest)
way to paint a house is for a painter to take his brush and can of paint and start covering the walls. And this means a specific level of costs, in labour and paint. Now imagine that somebody invents a robot that can go around the house spraying a thin yet regular coat of a special paint that produces excellent results (this is not as stupid as it seems: that is how cars are painted today). Imagine, too, that the robot costs €1 million. If it could paint 10 houses per day, it would be cost-efficient, provided the company can paint 2,000 houses per year. In this case, it could be amortized over five years, and still achieve a cost per house of €100, well below what it would cost to paint it by hand. If this were to happen, we would see traditional, manual painters being displaced by larger companies, able to paint at least 2,000 houses per year. Indeed, this is what has been happening since the beginning of the Industrial Revolution in industry after industry, starting with textiles, continuing with steel, cars, services and so on. Technology, in other words, finds ways to do things at a lower cost, but often with the demand of a larger volume.

But, in spite this general trend, there are businesses like painting, dentistry or house-building, where technological advances that imply economies of scale have not happened. In fact, some businesses go in the other direction: technology may push the cost curve to the left, that is, may make the minimum efficient scale smaller. According to many experts, for instance, natural gas-fired electric generation turbines are becoming so much smaller and cheaper that it may well happen that in a few years it will be cost-efficient for a small building (a hospital, say, or a block of houses) to generate its own electricity on the spot. Today, economies of scale in production dictate that electricity must be generated in large factories and then transported (at great cost) to the final user. Electricity utilities are, therefore, large companies able to finance and run these large facilities. But if self-production becomes cheaper than the current system, we will see the large electrical utilities of today lose market share, lose profitability and eventually disappear. This, which today may seem like ‘strategy-fiction’, is exactly what happened with large computers. Few people remember that, 20 years ago, the industry was dominated by IBM, Burroughs, Sperry, Univac, NCR and Honeywell in the US, plus Bull, ICL and Siemens in Europe, and Hitachi and Fujitsu in Japan. Most of these companies have disappeared, or have gone through drastic restructuring, because their competitive positions were radically altered by new technologies. Today, the number of computer makers is far larger, for the minimum efficient scale is lower (which, in part, explains why most of those manufacturers are not very profitable, as we will see in the following chapter).
In the end, economies of scale determine how many competitors can survive in a given industry. To see how, let us go back to the car industry. If, according to the experts, the minimum efficient scale is around three million cars per year, and the European market fluctuates below the 15 million cars/year mark, it is evident that there cannot be more than four competitors in the long term, otherwise some would be below the MES. This situation may be viable for a time, particularly if demand is strong and prices relatively high. But the companies that are below the MES earn little or no money (as their costs are too high). They start putting off the introduction of new models, which is a very expensive activity, and spend less on advertising, thus getting into a downward spiral. In fact, the situation in Europe illustrates this problem exactly: from a relatively large number of competitors we are down to six or seven groups, some of which are not very profitable and spend a lot of time talking about mergers. In the medium term, we can expect the current policy of hidden mergers, whereby competitors jointly develop new components or even whole models, to go on to full mergers (as I write this, Fiat seems to be the closest candidate among the large producers to be bought by GM and merged into Opel).

We can translate all this by a relatively simple formula: if we divide the total market (say, 14 million cars/year) by the minimum efficient scale (around 3 million/year), we obtain the maximum number of competitors that can survive profitably in the industry, which is four, as we have seen.

\[
\frac{\text{Total market size}}{\text{Minimum efficient size}} = \text{maximum number of competitors}
\]

This formula shows how the presence of important economies of scale can generate a monopoly. Take the case of aeroplanes. It is well known that for the last 30 years only one company, Boeing, has been offering a truly large plane, the 747 jumbo jet with more than 400 seats. The price of one such aeroplane is around $150 million. But the remarkable thing is the margin, which, according to analysts, is around $100 million. This huge margin can only be explained, of course, by the monopoly position that the company enjoys in planes with these characteristics. But strategic logic forces us to immediately pose the question, why are there no competitors to push down the margins? Why, after 30 years, has nobody copied Boeing?

Evidently, Airbus does not lack the necessary technology to develop such a plane, nor the production or financial capabilities. Moreover, it is in
Airbus’s evident strategic interest to launch a competitor to the 747, for Boeing uses its huge margins on them to cross-subsidize the smaller planes, in which they compete with Airbus. Yet Airbus has taken more than 20 years to seriously consider launching a competing model (which it will apparently do in a few more years time). Why? What is the barrier?

To develop a plane of jumbo jet characteristics costs some $10 billion. This is what Airbus would have to spend to enter the business and what Boeing paid many years ago. The total annual market amounts to 30 planes. If Airbus were to spend the $10 billion, it would have to earn $1.5 billion a year, once the plane was on the market, to justify the investment. But at a price of $150 million per plane, it would need about half the market to earn that amount of money (for making each plane also costs money, obviously). And this does not take into account the possibility that Boeing may lower the price, which it can do, thanks to its huge margin.¹⁰

In the end, the problem is that the market is big enough for only one competitor (minimum efficient size is as big as the total market), and the competitor who enters it first obtains an unassailable competitive position.

Economies of scale, when they are important, determine that only a handful of companies can survive in a given market and act as barriers to entry, which allows incumbent competitors to enjoy good margins. They are also relatively permanent. Until somebody invents a different way to make a product or deliver a service efficiently at a lower volume, the maximum number of competitors is predetermined and fixed.

As we have shown in Table 1.1, economies of scale can arise in any activity: from purchasing (which explains the concentration of many retail markets) to marketing, for only large companies can afford TV advertising campaigns.

Nevertheless, we must not forget diseconomies of scale. Every large company is less efficient than a small one, for its coordination and management costs are higher. If economies of scale in a given business are important, a few large companies will dominate it. If not, these large companies will find themselves under attack from leaner, smaller competitors. In Chapter 3 we will discuss in detail the situation when a new technology (in the broad sense of the word, it may just be a new way of doing business) changes the shape of the cost curve.

2. The concept of market niche: what matters is relative size, not absolute size
Take a company like Shimano, manufacturers of gear systems for mountain bikes. It is certainly a relatively small company (2001 sales $300 million) compared to Boeing (2001 sales $58 billion). But it has more than 90% market share. Is it then a small or a large company? Its market domi-
nance creates great profits but where does the protection come from? There are other companies in the bicycle industry (Peugeot, for instance) with more than enough resources to develop products as good as Shimano’s and take market share (and profits) away from them. Why don’t they do it?

The answer, of course, is identical to the one we gave when discussing Airbus’s ‘failure’ to introduce a jumbo jet for more than 20 years. The company can do it, but it is not in its interest to do it, for the size of the market does not justify the necessary investment, even assuming success. In the end, what determines the number of competitors is the ratio between the size of the market and the minimum efficient scale. The number of zeros in the numerator and the denominator does not change the result. Shimano is as well protected as Boeing has been. And this is the essence of a ‘market niche’. Of course, this protection is only real if the minimum efficient scale is truly independent of other products. If designing and building cars were to help Peugeot build better and cheaper gear systems for bicycles (through the use of common elements, for instance), then Shimano would quickly be driven out of business. A given business is not a niche because the company decides to define it as such, but because its cost curve is thoroughly independent of any other. Otherwise, it is not really a different business, no matter how much the company wants it to be so.

This niche characteristic of many businesses explains why, in the real world, real profitability often accrues to little known companies, far from the fashionable industries. An interesting example is provided by one of Tyco’s businesses. Tyco is a large American conglomerate (much maligned nowadays, as we will see in Chapter 6), present in many high-tech businesses. But one of its most profitable ones is to make the plastic hangers that garment makers include when shipping their products. Volume (in dollars) is not enormous, but there are important economies of scale when making these hangers. Through acquisitions, Tyco has developed a monopoly position in the business and nobody can enter it now, for the volume necessary to have costs as low as Tyco’s is simply too large for the size of the market. If economies of scale were not that important, nothing would prevent a competitor entering the business, even if Tyco had a monopoly position, and start eroding Tyco’s profitability.

3. Other sustainable cost advantages
It is possible to enjoy sustainable cost advantages even in the absence of economies of scale. For instance, it is common in the chemical industry to be able to patent a process, not just a product. Thus, if a company
discovers a cheaper way to produce a commodity, it can have sustainably lower costs than its competitors (in the real world, the inventor tends to license the technology to its competitors, but this still gives it a cost advantage, for the competitors must pay for the licence, while the investor is paid for the licence).

A company may enjoy a privileged access to cheaper (or better) raw materials, as oil companies do when they operate in Saudi Arabia instead of operating in the North Sea. Or, when transportation costs are very important for a product, the manufacturer who is close to consumers enjoys a cost advantage over those who are far away. This is obviously only sustainable if the distant producers cannot open a closer factory, for reasons such as economies of scale (minimum plant size much larger than the local market), legal impediments and so on.

Companies sometimes develop business practices that lower costs which, while not being proprietary, are very difficult to imitate. Thus Toyota introduced a wide array of management techniques that allowed it to offer a much better quality/price ratio than its competitors could. Of course, these techniques could be copied, and they have been to a large extent, after 20 years of trying. Large, unionized companies are hard to change, which gives a sustainable advantage to the company that introduces these new methods.

Something similar can be said of the so-called low-cost airlines, such as Southwest Airlines in the US or Ryanair and easyJet in Europe. Much like Toyota, these companies have developed ways of operating that are at the same time much more efficient than the traditional ones, but also very difficult to imitate by those traditional airlines, bound by culture, commitments and so on. Of course, these advantages will end up disappearing (they can be easily adopted by new low-cost airlines), but they can sustain above-average profitability for many years.

Finally, a company may enjoy what has been called ‘shared costs’. Imagine a company that wants to compete in the yogurt business, for it has detected that the main incumbents are very profitable. Among the most important cost items in this business are marketing and distribution. To compete with the likes of Danone and Nestlé, which already have excellent brands and good distribution networks, is not easy, for these companies can amortize their marketing and distribution costs over many other products. This is the rigorous meaning of ‘synergy’ that we will discuss in detail in Chapter 6, when we discuss diversification strategies.

Although these other sources of cost advantages are different from economies of scale, in reality, economies of scale are almost always present
because, once the company has an advantage, it tends to grow faster than its competitors, thus obtaining some fresh advantages thanks to its size.

Of course, sustainable cost advantages facilitate the earning of extraordinary profits, as does having a unique product. Figure 1.5 shows a situation parallel to that of Figure 1.1. The difference here is that companies now sell at the same price, for they are not differentiated, but one has lower costs than the others. If this company does not set too high a price, it will maintain a level of profits well above opportunity costs, without potential competitors being able to enter the market. Of course, a company that has both a differentiation premium and lower costs (as is the case with Coca-Cola, which enjoys an excellent brand and enormous economies of scale) will be particularly profitable.

A False Dichotomy

The idea has been generalized that a company can either obtain a unique product or be a cost leader, but that these two things are incompatible. Although true in some cases, this is very superficial. In fact, as we are seeing, there are factors that prevent imitation, but those factors are not a strategy. In the real world, it is almost impossible to find a successful company that does not profit from several of the factors we are discussing. Thus, it is very frequent, in industrial products, that the largest supplier is also the one with the best reputation and it enjoys the corresponding
lowest costs and highest prices. If a company develops a patented product that is so superior that it becomes a necessity (think of Tetra-Pak), it will be able to sell at a higher price and in larger volumes (it is a must for its customers). But its volume and high prices will give it a profitability that will sustain continuous reinvestment in R&D (thus increasing differentiation and prices), while its volume ensures economies of scale.

To go back to some of the examples we have discussed, this time in consumer products, we can say that Coca-Cola derives an important part of its profitability from its brand. But we can’t forget that this brand recognition is largely due to enormous expenditures on advertising that are, nonetheless, lower than those of its competitors, on a unit basis, given Coca-Cola’s huge volume. This volume also lowers its logistics costs (a crucial component of costs in soft drinks) and purchasing costs: Coca-Cola does not pay the same price for its cans or sugar as its smaller competitors. Thus it can charge more, at the same time as having lower costs.

In fact, it often happens that companies start their success by doing something unique and their success provides them with economies of scale, which protect them when competitors start copying their uniqueness. The case of The Body Shop is instructive. This company, founded by Anita Roddick in 1976, made a big splash with its line of natural cosmetics, made out of non-contaminating products and not tested in animals. This progressive approach struck a chord, and sales went up like foam. At the time this was a unique approach, but hardly sustainable: nothing prevents its competitors from developing green cosmetics lines.

However, this copying takes time and, in the meantime, The Body Shop’s uniqueness may allow it to gain size and exploit economies of scale in logistics, distribution, systems, marketing and so on. If it really can develop these advantages, it may become a long-term profitable company, even if the initial uniqueness is copiable. But if the company believes that its progressive image is enough to ensure profitability in the future, it is making a serious mistake: that image cannot be unique, even if it is profitable, in the long term. In fact, the company has had problems, as competition in its segment has appeared from other entrants and, particularly, from established competitors that have launched their green, progressive brands. It is difficult for a company to evolve from an organization that fights a political, social battle to one that fights a logistics battle. But this is the only way to ensure long-term success.

Strategy should not be trivialized, by pretending that there are generic strategies: strategies are always complex, even if the logic behind them is simple. But simple does not mean simplistic. We must start by understanding why the possibility exists to earn returns above opportunity
costs, in a sustainable way. In Chapter 8, we will see how this logic can be used in the development of a (necessarily tailor-made) strategy for a real company.

The Entry-deterring Price

Figures 1.1, 1.2 and 1.5 have shown how a company that has a brand premium and/or costs advantages can earn money above opportunity costs in a sustainable way. However, these figures also show that the amount of money to be earned is limited, and limited precisely by the importance of these advantages: a company cannot earn more than it ‘deserves’. A company, no matter how leading, that sets too high a price (in the figures, 60) will not earn more, but less, because too high a price will simply invite competitors, helping them to enter the business profitably, in spite of their disadvantages. Of course, the leader may think that if there is entry, it will confront it, for it has the best margins, thus being able to do more advertising, more product development and, in the end, lower its prices, but this is rarely a sound strategy. If the company attracts too many competitors, the market will fragment and volumes will diminish, even for the leading company, perhaps hurting its cost position. Moreover, as we will see later in detail, some businesses are hard to leave. Thus new competitors will stay, even if they are not as competitive as the leaders and their results are bad. The best way to avoid competition is to try to prevent entry, not to try to expel competitors from the market. And the best way to prevent entry is to set a price that, from the beginning, makes it clear to potential entrants that they will never be able to obtain a decent return on their investment. This price, know to economists as the ‘entry-deterring price’ is more of a concept than a reality, as knowing it would imply, among other things, knowing the costs of all our potential competitors. But it is a useful concept: every good manager knows that, above a certain price, competitors will surely enter, and that below another level, they are highly unlikely to do so. To ignore this is to waste the opportunity to really profit from an advantage that, well managed, can even be increased over the long term.

Rivalry

Barriers to entry are a necessary condition for long-term profitability: without them, competitors will erode margins. But they are not a sufficient condition. In many industries, competitors will do anything to snatch a
customer, while in other industries we can observe much more oligopo-
listic behaviour, where competitors don’t really attack each other very
seriously. The difference in the degree of rivalry among industries (and
inversely, in their profitability) is not a random phenomenon. It is directly
determined by the structural characteristics of the business, much as the
height of the barriers to entry is. It is the market imperfections, those char-
acteristics that separate it from a perfectly competitive market where
anybody can enter and exit, that influence the degree of rivalry of comp-
panies already inside. Let us see which factors influence that rivalry.

1. Number of competitors
We have already seen how the relationship between the minimum efficient
size and the total size of the market determines how many competitors fit
into an industry. It is clear that a business with few competitors (in the
extreme, one or two) will be more profitable than one with 20, all other
things being equal.

2. Switching costs
In some businesses, clients incur heavy costs if they decide to switch
suppliers. Thus, mainframe computers can often only run their software
under brand-specific operating systems. If a Unisys user wants to switch to
IBM, it must rewrite the programs. This has a prohibitive cost, which
allows the current supplier to charge high prices (and enjoy good margins)
without competitors being able to compete those margins away. Compet-
itors, of course, are in a symmetric position: they cannot snatch customers
away, but they cannot lose them either. In such a situation, it is not difficult
for competitors to reach tacit agreements, which maintain high margins.
IBM enjoys huge margins on its mainframes, and barely makes money on
PCs. The enormous difference can be explained by the existence of high
switching costs in the former, and the almost total absence in the latter.

A similar example is provided by mobile telephony. If mobile phone
numbers are not portable, that is, switching service suppliers implies
changing the phone number, many customers will stay with their current
supplier, even if another one offers lower prices, to avoid the hassle. As a
result, there is no real competition, for changing phone numbers can have
huge costs: think of a company, with hundreds of salespeople who their
customers call on their mobile phones. That is why the European Commiss-
ion has imposed number portability, over the strong protests of the oper-
ators, in an attempt to lower sky-high tariffs.

In general, whenever there are switching costs there is a profit oppor-
tunity, for buyers will be willing to pay extra to their current supplier to
avoid the switching costs. Of course, that profit opportunity will be proportional to the importance of the switching costs. Thus, if those costs amount to, say, 20% of the product’s price, that will be the excess margin that the seller can reap, above opportunity costs.

3. High proportion of fixed costs
It is common to find adverts for airline tickets at prices lower than half the normal tariff, but it is very uncommon to see such an offer from a restaurant. Why? Most costs in an airline are fixed. Once the plane is ready to leave, costs will be the same whether the plane is full or not. The airline must fill its planes, for it is the only way to make them profitable. Since adding a passenger does not add any costs, it will be tempted, if demand is weak, to offer a deal to get those extra customers. In fact, once the plane is ready to leave, any deal will be better for the airline that letting seats fly empty. The problem gets ugly if there is another plane, from another airline, going to the same destination, also with empty seats. The battle for the additional customers will turn into a Dutch auction, with the sellers lowering their prices in turns to get the business. In general, when a business has mostly fixed costs and variable demand, there will be price wars. A restaurant does not get into those wars, for an important part of its costs is variable: if it cannot sell the steak tonight, it will try to sell it tomorrow, something an airline, or a hotel, cannot do with its empty seats or rooms.

4. Great jumps in production capacity
Something similar happens in those businesses where each new factory represents a large addition to total capacity. When all available capacity is being used, because demand has increased, competitors will naturally expand. But if each expansion is very important, in relative terms compared to the total market, because minimum scale considerations so demand it, the net result will be an important excess of installed capacity. If many costs are fixed, as we saw in the previous point, the stage is set for a protracted price war that will not disappear until demand grows to use up the new capacity. Once this occurs, prices firm and profitability returns to the market, until capacity scarcity (and the new-found riches) push the companies to expand again. This cycle can be found in industries such as glass containers and paper, where demand is fairly stable, but profitability is very cyclical.

5. Barriers to exit
In the video rental example, and in its generalization to all perfect competition business, we have seen that companies could not make money
(above opportunity costs), but they didn’t lose money either. As soon as a competitor realized that the business was not worth it, that is, better returns could be had elsewhere, it acted accordingly. Thus, it does not lose money (at least not for a long time), and it lets the profitability of those who stay improve (at least to the level of opportunity costs). But this does not happen in all businesses, because in some it is impossible to leave. If those competitors that lose money cannot quit, everybody will lose money, as there will be excess capacity and desperate competitors selling at any price, for they will stay in business anyway.

Why would a company stay in a money-losing operation? There are many reasons. In some cases, shutting down a factory may be difficult for political reasons, for the company is perhaps the only provider of jobs in a large area. This is one of the key reasons for the low profitability of the steel and ship-building industries. Or, there are very specialized assets that cannot be deployed in another business, but whose lease must be paid over the years. In these circumstances, a company may prefer to continue losing money, but generating some cash, rather than not generating any cash. This is a typical problem in the airline industry: if there are too many planes, margins will suffer, but the planes will continue to fly, as long as prices generate some cash after paying for fuel. This is aggravated by constant government intervention (for the first reason given above) subsidizing inefficient companies so that they can continue flying, depressing profits for everybody.

The specialization of the assets (and how long they last) is an important barrier to exit. We see it now with the fibreoptic networks that have been laid by alternative telecommunications companies. Once they are laid, these networks are going to stay operational for a long time. Since all costs are fixed, it pays to accept traffic at extremely low prices, rather than having no income. The original company will surely go bankrupt, but somebody will buy the heavily discounted network and keep taking business away from the other competitors. It is hard to see how this can be a profitable business for long. When it eventually gets to that point, somebody will start laying new fibreoptics, launching new satellites or generally deploying whatever technology promises new business.

These two kinds of problem (political pressures to stay, plus asset specialization) go a long way to explain the very low profitability achieved by the automobile industry in the last decade, as shown by Figure 1.6. The reason is that plants are becoming ever more productive, so that real installed capacity is growing. In addition, governments subsidize foreign manufacturers to install new plants in depressed regions, thus increasing capacity even more. At the same time, they (or trade unions) make it diffi-
cult for companies to shut down old plants. If the market does not grow, overcapacity will be a fact of life.

Generalizing, we can say that a company cannot make money in a business where some competitors are ready to lose it, for they will always lower their prices until they can snatch customers away. That’s why a company must consider the situation carefully before entering a market with high barriers to exit, even if it has serious reasons to consider itself the most competitive firm in the business. It can find itself surrounded by companies that are less efficient, but able to steal customers nonetheless, as they will stay in business even while losing money.

Putting together all the preceding ideas, we can establish a simple matrix, represented in Figure 1.7, which relates industries to the nature of their barriers to entry and their barriers to exit.

In the first quarter, we have low barriers to entry and low barriers to exit. This is the case of all perfectly competitive markets, from video shops to language schools. In the second, barriers to entry are high and barriers to exit are low. This is an excellent business for those who are already in: competitors cannot enter but if they try, they give up quickly. It may be the case of consulting companies, such as McKinsey or the Boston Consulting Group. In the case of both high entry and exit barriers, we find all the big industrial sectors, such as automobiles or semiconductors. These businesses should be profitable, for barriers to entry are high, but if there is excess capacity, for any reason, profitability may deteriorate for a
long time. Finally, there are businesses where barriers to entry are low, but barriers to exit are high. These industries are real ‘traps’. They seem easy to enter, and in fact they are, but profitability is elusive, for there is chronic overcapacity. In my opinion, airlines and telecommunications may fall into this quarter.\textsuperscript{12}

In the end, we see how market imperfections not only create barriers to entry, thus determining how many competitors there will be, but also the degree of rivalry in the industry.

## Conclusion

In a perfectly competitive market, companies cannot make money long term, beyond the opportunity costs of the investment, adjusted by risk. Thus the first necessary condition to earn extra returns is that the business has some imperfections and that the company may be able to profit from them. And those imperfections, which are numerous, can be grouped into two families; which are that a company may be able to make something better or cheaper, and in a sustainable way.

This is the only foundation for long-term profitability. Profitability does not come from making great products at a low cost. It comes from making better products at a lower cost. And this, in many cases, is simply impossible. Netscape created, to a large extent, the whole Internet phenomenon with its ‘navigator’. But it was built on open standard (the

**Figure 1.7** Classification of industries according to barriers to entry/exit
essence of the Internet) and Microsoft had no problem in quickly putting out a program that did exactly the same thing. I repeat, profitability does not come from creating value, but from capturing a chunk of the value that has been created.

This leads us to some non-obvious conclusions. For instance, the fact that the prices of raw materials go up or down does not affect an industry’s margins in the long term. Of course, in the short term, margins are the difference between the price and the cost. But what determines how high the margins are, are the barriers to entry. If barriers to entry don’t change, margins will not change, no matter how much costs go up or down: prices will simply reflect the new level of costs.

In essence, strategy is about finding ways to make something better and/or cheaper than competitors, in a sustainable way. Everything a manager can do, from hiring people to firing them, internationalizing operations or merging them with another company’s, is only useful in as much as it lets the company raise its prices (do something better) or lower its costs. Throughout this book, we will explain this logic step by step. But it is important to establish this basic principle. These past few years have seen far too many bad decisions that have destroyed value, from the dot.com bubble to many senseless mergers. Although most people now admit those mistakes, some mental habits are still there. There is still too much reasoning in terms of growth, industry leadership, globalization, and so on, without paying attention to the basic tenets of strategic logic. And not following this logic can only result in a loss of profitability.

Notes

1. Evidently, the previous lines do not imply that the quality of a company’s management does not matter: it matters a lot, and it explains in many cases the differences in profitability among companies in the same industry. But it cannot explain the systematic differences among whole sectors, throughout the world. In Chapter 8 we will come back to the relationship between strategy, management and profitability.

2. As we will see in the following chapters, the behaviour of managers does sometimes affect this ‘protection’. But even in these cases, the effect is caused through some objective mechanisms, external to the managers’ will.


4. Of course, many articles are sold under a brand (again think of petrol), but the brand does not enter into the purchasing decision (buyers don’t really care). In these cases, although present, the brand does not really act as a barrier to entry. We can say that, in strategic terms, the brand does not have much value.

5. An old story illustrates this point well. A person who has finished his training as a sports parachutist decides to go to a specialist shop to buy his parachute. The seller offers two options: one, sold for a long time and widely used, costs €10,000. The other comes from
a developing country, is said to be as good as the previous one and, as an introductory offer, costs only €2,000. Which parachute will most people buy?

6. There is an exception that we will analyse later on, when we talk about barriers to exit. When these are high, competitors can go on selling below costs for a long time.

7. In fact, there are no large companies active in just painting houses. The reasons are that, in practice, some costs go up with size, such as coordination and organization costs. A large multinational company has much higher management costs than a small family company, where everybody knows everybody else, and control can be carried out in an intuitive and efficient way. If there are economies of scale that justify those added costs which come with size, companies will tend to grow. Otherwise, growth implies a decrease in profitability, as we will see in detail in Chapters 4 to 6.


9. For the reader interested in technical precision we must add that a market only finds real equilibrium when the minimum efficient scale is a fairly exact divisor of the equilibrium point between supply and demand: if cars were more expensive, companies could survive selling fewer cars (à la Porsche), but the total amount of units sold would also be much lower.

10. In fact, Airbus’s strategy has consisted of developing ever larger planes from a single design, using many common elements. In addition to offering large savings to their customers in fleet management, this has allowed Airbus to spread the design costs over many planes and many years, so that a large part of the necessary investment for its jumbo, the Airbus 380, has already been done and paid for (through the margins of the smaller planes). It has taken a long time to get to this point, however, which has allowed Boeing to reap enormous amounts of monopoly profits.


12. The fact that an individual competitor may sell its planes and ‘get out’ is not a solution: for every seller there is a buyer, and the overcapacity situation continues. Only the scrapping of planes (or parking them in the Mojave desert, as some owners do when the situation is desperate) reduces capacity.

13. There is an exception: if costs go up a lot, total demand may go down, for the price becomes too expensive for many consumers (or vice versa). But, in itself, the level of costs has nothing to do with profitability. This is determined by the height of the barriers to entry.
The previous chapter established the foundation for strategic logic: a business is profitable as long as it is not exposed to perfect competition, that is, while it can benefit from sustainable singularity, because competitors, for some reason, either cannot offer the same (or something truly equivalent) to their clients, or they can only do it by incurring higher costs. Therefore, we have been able to establish that the potential profitability of a business depends on the entry barriers to it, barriers that depend in turn on the structural characteristics of the business. This principle is the basis on which we have to construct our understanding of managerial reality.

However, although the preceding chapter is full of examples that try to clarify the concepts explained, and show how these are applied in practice; the truth is, that in real life, this application is not easy. In my experience, in the real world, most attempts to carry out a ‘competitive analysis of the sector’ do not work, in spite of the popularity of the technique in question (the bestseller by Michael Porter, *Competitive Analysis*, published in 1980, has various chapters and appendices that indicate explicitly how to make such an analysis). The reason, in my opinion, is not that the basic ideas are wrong (in essence, we discussed the gist of them in the preceding chapter), but rather that strategic logic is applied to a terrain for which it does not work. In this chapter, we will see why and develop the next step that we need to establish a strategic logic which permits us to understand what really happens. In this sense, this is an absolutely essential chapter of the book in order to be able to develop a strategic logic that is both theoretically solid and absolutely practical.
When a Sector is Not a Sector

After analysing the last chapter, which resulted in the conclusion that the only way to earn money in the medium term is to have something that is sustainably unique, it could be demoralizing to look at a real company. Almost everything a company does can also be done by others. Anyone can set up a factory, buy the best machines, contract the best consultants to implant the latest productivity techniques or the most brilliant advertising agencies to improve their marketing. Not only are most things buyable, but the fact that outsourcing is becoming widespread in many areas, as we will see in detail in Chapter 4, shows that a company can eliminate many of the things that it does, and nothing happens (at least in principle). That is, almost all a company does can either be copied (because the assets and the necessary methodologies to do it efficiently are for sale) or subcontracted (something that the competitors can also do). In short, there is no authentic singularity, much less is it sustainable.

This negative appraisal is, essentially, correct. Even in the most profitable companies, the majority of the things that they do are not singular. Consequently, profitability comes only from a few things (in some cases, just one) that are done inside the company, and the rest only wrap up these profitable activities, in many cases reducing profitability. Let us return to the automobile sector, since we mentioned it briefly in the previous chapter, to understand how this happens.

As we saw, the minimum efficient size in the automobile sector is, according to the experts, around 3 million vehicles per year. The main cause for this volume is the cost of developing a new model. This cost is currently estimated at about €4 billion. Taking into account that the models have to be changed every five years, at least, so that they continue being attractive to the market, we realize that a minimum of 500,000 per year must be manufactured so that the cost of the design does not exceed €1,000 or €1,500, which is the maximum that the market is willing to pay (taking into account the variable cost of producing and selling the automobile). Since the company must have a complete series of at least five models to be able to make a profit from its distribution network, it is clear that they need to manufacture and sell at least 3 million vehicles a year. Evidently, selling more would be good, but the gain in costs would be marginal, and the company would have to sell many units of the same model, something that is not easy, since not all clients want to buy the same car.

The preceding argument, however, does not refer at all to economies of scale in manufacturing, only in design. The minimum efficient size that we just discussed does not affect the manufacture of automobiles, just their
design. In fact, all the automobile companies of a certain size have various production plants and, normally, just one design centre. That is, economies of scale (or any other entry barrier) do not apply to the sector in its entirety, but rather to some of its activities. Or, put another way, the minimum efficient size of designing automobiles is different from the minimum efficient size of assembling them.

In the first chapter, we insisted that long-term profitability can only come from a certain ‘protection’ of the margins, based on the entry barriers. The implication of the previous paragraph is that the level of this protection is very different for the different activities that the company carries out. Consequently, the concept of ‘profitability of a sector’ is intrinsically erroneous, since this profitability is only the sum of the profitability of the different activities within the sector.

Thus, the fundamental principle which supports strategic logic is applied in reality to the activities within the sector, not the sectors themselves. The reason is that the imperfections of the market based on the entry barriers (economies of scale, patents and so on) are not applied to the business, but to the activity. To lose sight of this makes the analysis of profitability impossible, since we would be trying to apply concepts of strategic logic to realities to which these concepts do not apply: entry barriers do not make entry to an industry difficult, but rather to some of the distinct activities within the industry, and in a very different manner for each one of these activities.

Take another, very clear example: the patents that protect the singularity, and with it the profitability, of the pharmaceutical industry. These patents do not protect (that is, they do not permit its sustained profitability) the pharmaceutical industry in general, but rather the activity that consists of developing a new drug. Its manufacture and distribution are different activities, whose profitability depends on their own imperfections. A company that manufactures for another company (something that is frequent in this sector) will be profitable according to the strategic characteristics of the business of manufacturing drugs (Are there economies of scale? Is the manufacturing technology complicated? In other words, is there much competition in offering the service of manufacturing to someone else?) and not according to the pharmaceutical industry, which is mainly based on patents. In fact, the pharmaceutical sector offers a very interesting example, since it is usual for one company to develop the basic formula; another, generally larger and with more financial resources, is assigned the costly process of getting the approval of the product; another is assigned to manufacture it; and, lastly, another is in charge of distributing it in those countries in which the protagonists are not present. The
profitability of each one of these companies is very different, and depends on the structural characteristics of each one of these activities (development, approval, manufacturing, distribution and marketing) which are, logically, very different. From a logical point of view, the fact that these activities are executed by different companies, or by the same company, does not alter at all the intrinsic profitability of each of them. The only practical difference is that if they are all carried out by the same company, it might be very difficult to have data on the profitability of each one of the activities, since it is normal for the accounting system of the company to show aggregate results. But this does not mean that the profitability is different. In the next chapter, we will see some of the practical implications of this situation.

Therefore, we should not speak of the profitability of an industry, but of the profitability of the distinct activities that make up the industry. In fact, the concept itself of ‘industry’ is, at the same time, very useful and absolutely erroneous. It is useful because it allows us to realize quickly that the profitability of an activity is in the characteristics themselves of the activity. It is nevertheless erroneous because, normally, by ‘industry’ we understand a reality that is excessively aggregated to allow a rigorous strategic analysis. To be able to understand this point and develop all the logical and practical implications, we will once again turn to a real-life case: the personal computer sector. This industry is particularly suitable for this analysis, since it has a certain concentration (some manufacturers are large and well known) and is at the same time varied: there are many competitors who are very different from one another. It is also an industry that advances rapidly and thus the impact of strategic decisions is soon observed. Moreover, their products are probably well known to most readers of this book. After the analysis of this industry, we will lay the foundations for the methodology of the practical application of strategic logic that we will use in the rest of the book to solve more and more complex questions.

**An Example: The Activities of the Personal Computer Sector**

If we ask ourselves if the personal computer sector has significant entry barriers, we will find various possible answers. On the one hand, there are companies, right at the heart of the business, like Intel or Microsoft, which are extraordinarily profitable (and, therefore, according to our logic, with some type of singularity protected by entry barriers). However, there are many other manufacturers that have lost money or even disappeared
(Olivetti, Commodore, Tulip, Borland, Lotus), and many of the current leaders leave much to be desired in terms of profitability (Compaq, the PC division of IBM, Corel). In fact, the appearance of a phenomenon such as that of the ‘clones’ points to a certain lack of entry barriers.

All this shows that it is impossible, in reality, to make a general statement on the height of the entry barriers to an industry: the only rigorous answer is that ‘it depends’. There are parts of the sector with high barriers and parts with no barriers. In order to be useful, however, our logic has to give us answers of general use, ‘it depends’ will just not do. Therefore we need a methodology that identifies, a priori, which parts of an industry will have high entry barriers (and consequently could be profitable) and which don’t. To do this, in the following pages we will actually analyse the sector, that is, divide it into its constituent parts.

For a customer to be able to acquire a personal computer, many things had to have happened first: someone had to design it; someone had to buy the components (that had to be designed and manufactured); someone had to assemble it; the product had to be distributed, advertised and finally sold (probably through wholesalers and retailers, or perhaps directly by telephone or through the Internet). The basic software (at least the operating system) has to have been developed and installed in the computer, the manuals printed and everything put in boxes and so on. If all these activities have been carried out in a correct and coordinated fashion (we will come back to this), the user can finally buy a computer and we can finally say that the industry exists, although a financial director will say, reasonably enough, that the process is not finished until the computer is paid for, so perhaps activities such as financing the purchase and collecting the payment must be included. It can also be said that after-sales services and consultancy and training form part of the business, since many people would not buy the computer if these services did not exist in some form.

It is not difficult to conclude intuitively that the intrinsic profitability of each of the activities we have just mentioned is different, as are the entry barriers to each of them. It is clear that the same company volume is not necessary to manufacture successfully microprocessors, whose technology requires factories that cost billions of dollars, as those required to manufacture keyboards, inject plastic boxes or even assemble the components. If we do not take into account this intrinsic difference between the different activities, we cannot really say anything from a strategic point of view with even a minimum of rigour. This is because the concepts of strategic logic, based on the technical characteristics of the production of goods or services, as we saw in the previous chapter, can only be applied to homogeneous realities, and the technical characteristics of manufac-
turing microprocessors and those of manufacturing keyboards are completely different.

In fact, the breakdown into activities can and should go quite far. Take the example of the microprocessor. It is clear that there are at least two very different sub-activities within the microprocessor sub-industry: designing them and manufacturing them. One key factor in the profitability of the processor comes from design (for example if it is compatible with the most widespread operating systems). It is from this that the possible differentiation will come (the design will determine whether the client will buy an Intel processor or a Motorola processor, since the former allows the use of all the programs compatible with Windows and the latter does not). And this design is protected by copyright laws: one cannot freely copy the design of an Intel processor. Technically, Motorola could do it without much difficulty, but the law does not permit this. The manufacturing of the processors, on the other hand, is a much more standard process: both the cost as well as the speed of the processors of the different manufacturers are quite similar. There are, in fact, microprocessor companies that do not manufacture, but rather subcontract the manufacturing of their designs. There are others that simply manufacture for third parties (do not design). Lastly, there are others that do both. For a serious strategic analysis, we have to understand these sub-activities as distinct businesses, as we have seen briefly in the example of the pharmaceutical industry, if we want to understand which are truly profitable, that is, which are protected by entry barriers and which are not. Put another way, the profitability of one company that designs and manufactures microprocessors is not a strategically useful concept. The reality is that the profitability of that company is the sum of the profitability of two distinct businesses: the manufacturing and the design of microprocessors. The profitability of the company in its entirety cannot be analysed a priori, since we cannot say anything about the entry barriers to the business. We have to study the profitability of each activity, which can indeed be estimated a priori, since the technical characteristics of each activity are clear, as well as their strategic implications. Of course, we can speak of the profitability of Intel or Glaxo, but it would be very difficult, without going into the different activities, to understand fully where this profitability comes from. As we will see below, the lack of a deep understanding of the source of profitability of a company can lead to seriously erroneous decisions.

How far do we take this ‘division’? The theoretical answer would be that where there is a ‘separable’ economic activity, we should distinguish it from the rest. This would lead us to say that, in the computer sector, there are hundreds and hundreds of different activities, but this is not very useful
for strategic analysis. The practical answer, therefore, is that we take into account those activities that have a certain economic importance and, later, see if there are, within them, sub-activities that explain the competitive advantages. That is, if we observe a very profitable activity (for example the manufacturing of microprocessors), it is essential then to analyse it, to see on what its profitability really depends, that is, its ‘uncopyable singularity’, since that will be the ultimate cause of the profitability. In many cases, this may not be evident, as we will soon see.

In order to continue developing our case, let’s return to the personal computer sector. In the first analysis, which is extraordinarily simplified, we can distinguish the activities, shown in Figure 2.1. Evidently, within each one of these activities there are many companies (in some more than in others) and some earn more money than others. Now we can apply the type of logic developed in the previous chapter, and try to understand what the potential for profitability is for each one of these activities, based on the entry barriers that do or do not protect them.

Let’s carry out an analysis, necessarily brief and superficial, but illustrative of the entry barriers to each one of these activities.

**Microprocessor:** VERY HIGH. Difficult to manufacture (economies of scale) but, above all, need for the design to be compatible with the most used software. Main competitors: Intel (historically very profitable), AMD

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**Figure 2.1** Main activities of the personal computer sector
(much less profitable, although improving lately), plus others that have been left standing as niche players. Very concentrated business.

*Operating system:* EXTREMELY HIGH. The main entry barrier is the network effect, briefly mentioned in the previous chapter and which we will develop in detail in the next chapter. This effect causes almost all users to converge in a relatively rapid and automatic way on one supplier, who develops an unassailable position as ‘standard’. Main competitors: Microsoft (extraordinarily profitable), Apple (far behind), some scarcely successful challengers (Linux, Sun). The business is so concentrated in the hands of Microsoft that the United States Government has formally accused the company of being a monopoly and constantly tries (unsuccessfully) to curb its power.

*RAM:* MEDIUM. On the one hand, the manufacture of memory chips is complex and requires very expensive factories. On the other hand, the minimum efficient size is not enormous (there are more than a dozen manufacturers in the world) and the product is intrinsically undifferentiated: all the memories work the same way and are basically interchangeable. This makes the business very cyclical: when the demand is high, the prices go up, since it takes time to build new production units. When demand is low, however, prices fall sharply, since the costs of the factories are basically fixed, and the competition for filling the capacity is ferocious, since there is no differentiation possible. This business also has certain exit barriers, since there are many governments that see the national manufacturing of chips as an investment in the future, and subsidize companies that, in economic logic, should close.

*Screen:* HIGH. There are two types of screens: the flat ones and the television type. Both have a high efficient size in relation to the entire market, which is why there are few manufacturers, and an acceptable profitability. In the case of flat screens, the technology is still advancing and the difficulties of design and manufacturing are important. Consequently, very few manufacturers (for years, only two) are capable of producing them with competitive costs. Logically, their profitability is very high.

*Hard disk:* MEDIUM. There are plenty of manufacturers for a product with little differentiation. The manufacturer that has the technology to produce the latest model can charge a certain premium, until the others imitate him. IBM, thanks to proprietary technology and volume, has obtained a strong position, selling a good part of its production of disks to other computer manufacturers. Nevertheless, the profitability of the unit leaves much to be desired.
Keyboard: LOW. A keyboard cannot be differentiated (by definition, it has to be quite standard) and its construction is simple, without great economies of scale.

Case: LOW. These cannot be differentiated either, at least not in a sustainable way: a prettier design can be made, but this can be copied in the short term, if it is truly successful. Neither are there economies of scale or other complex characteristics of production.

We could add here all the other necessary parts, from screws to some very sophisticated chips that facilitate the connection of the computer to a wireless network, to cables that, inside the computer, connect the different electronic parts. Of course, entry barriers to each one of these activities are completely different, depending on their own manufacturing characteristics, and the profitability varies from nothing to excellent.

Assembly: LOW. In the world of computers, it is not easy to assemble better than the rest, since it is done by robots, in the same way for all. Neither are economies of scale important in the process. There are economies of scale in purchasing, of course, but the most expensive parts (microprocessors and screens) are in the hands of oligopolistic suppliers, and it is not easy to obtain large discounts for quantity. It is a fragmented market with frequent bankruptcies. Dell is prevailing with a very special strategy, which we will discuss at the end of this chapter, but most competitors have, at best, a marginal profitability.

Programs: VARIABLE. Some programs generate switching costs (who wants to learn all over again how to use another spreadsheet?) or network economies (if we all use PowerPoint, it is easy to pass presentations around). These will be profitable for the companies that are well positioned. There are economies of scale for the more complex programs, since designing the modern word processing programs or database management applications literally requires thousands of man-years of work, which must be amortized over a wide client base.

Distribution: LOW. It is difficult to establish a defensible position. In addition, the large manufacturers try to distribute directly to their important clients.

Marketing: LOW. Today the value of the brand is not very important. It used to be, when personal computers were still seen as a novelty and buying IBM was a guarantee of quality for which the client was willing to pay something (remember the discussion in Chapter 1 about when reputation matters). However, when users understood that there were no
significant differences between computers, the differentiation premium practically disappeared.

Retail selling: LOW. The profitability of the business is also poor because the necessary inventories are constantly devalued by the rapid technical advances typical of this sector.

In short, as we said before, we observe that each of the activities of the sector is, from any point of view, a very distinct business. And it is very important to understand this, since not doing so explains the failure of many strategic analyses conducted in the past few years. The fact that a company performs two activities, or that all the companies in the industry perform them and do not consider them distinct businesses, does not mean that they are not, in fact, different businesses. This point is so important that we are going to develop it in more detail.

Finding the Sources of Profitability Inside the Company

Take the very simple example of a restaurant. Imagine a restaurant manager, who actually owns the property from which the business is run. At first glance, we could say that there is a single activity: the restaurant business. But in reality there are two: the restaurant and the property. This is not an ‘academic’ distinction. It can happen that a restaurant is profitable only thanks to the fantastic situation in which it is located. Imagine that such a restaurant, very well situated, generates net profits for the owner of €20,000 a month. This is, apparently, an excellent income for a small individual owner. But if the success of the restaurant is due above all to its location, it is very possible that our owner could rent the premises to another business (perhaps another restaurant) for a good amount. If it turns out that the market value of renting is more than €20,000 a month, we find that the reality is very different from what our restaurateur thought. In reality, he does not have a restaurant that yields him €20,000, but rather a property investment that yields €25,000, and a restaurant that loses €5,000. Any attempt to expand what he believes to be a profitable business (managing restaurants) to another place, will only increase his losses. In fact, I knew a restaurateur who had two restaurants, one in a property which he owned and the other in rented premises. He told me that he earned money in the former and lost money in the latter. He had concluded that he should save money to buy the rented property and in this way he would earn money from both restaurants.
This erroneous thinking arises because, very often, companies do not separate the distinct economic activities that make them up, whether conceptually or from an accounting point of view (a restaurateur who owns his own property does not normally charge himself rent). But not doing so makes it completely impossible to apply the strategic logic that we developed in the previous chapter, since it considers as one business what are in reality various businesses. To return to our example (simplistic, but authentic), our restaurant owner does not know where he earns money or where he loses it and therefore runs the risk of making erroneous decisions. Below we will see some spectacular mistakes made by large companies, whose internal logic is identical to that of the restaurant owner who did not know that he earned a living thanks to his investments in property and not his gastronomic prowess.

In short, the golden rule of analysis is that any economic activity that is conceptually separable from the rest (such as owning a property and managing a restaurant on it) is in fact a distinct business. Furthermore, it is a distinct business in the strongest sense of the word, for it has a profitability structure that is distinct, as distinct will be the appropriate strategy to earn money at it.

The decision of ‘configuration’, that is, the decision as to which activities a company will perform and which activities it will leave to others, is possibly the most important a manager can make, since it consists, in short, of deciding in which business the company is going to be and, therefore, what is, a priori, its profit potential. As we will soon see, a company can make a serious mistake and decide to keep those activities without a good profit potential and subcontract those that in the long term will be more profitable. However, these decisions are very often made either implicitly (that is, they are not made but are fallen into) or they are made by treating them as a cost problem: which is less expensive, making our own microprocessors or giving them to someone to make according to our design? In reality the problem is deeper, since the decision implies the type of company that we are going to have. Making the decision on a pure cost analysis is not taking into account its long-term implications. Not making the decision, because the different activities are not seen as independent businesses, can lead to monumental errors. This point, apparently simple, is extraordinarily important in understanding the real profitability of a company and is crucial when designing its strategy. If a company does not distinguish its different activities internally and is not aware that, in essence, it is not in a single business, but owns a diversified portfolio, it can make very serious mistakes. The history of Apple Computer dramatically illustrates this point.
At the beginning of the 1980s, Apple Computer, the first unquestionable leader in the PC industry, realized that IBM, supported by its enormous reputation in the business world and with a good quality product, was taking over the leading position very rapidly with its new PC. To counteract this advance, Steve Jobs, the charismatic founder of the company, decided to launch a computer much superior to any then known. This was the origin of the ‘Macintosh project’. After several years’ work, in 1984 Apple introduced a computer that was extraordinarily better than those of the competition. To understand this advance, the reader who presently uses a computer has only to recall the great difficulty that existed in using a typical computer during the 1980s, based on complex commands that were difficult to master. The advance represented by the Macintosh was truly important.

However, a few years later, the company was marginalized, had lost almost all its market share and began a long process of fighting against being consigned to oblivion, from which it still has not completely freed itself. Why would a company with a product so extraordinarily superior to that of the competition, which held this superiority for almost ten years (Microsoft Windows 3.1 did not come out until 1993), fail financially? In my opinion, we have to look for the explanation in the mistake that a company makes when it sees itself in a business and not in a collection of activities, each one of which is a distinct business. Let’s apply the strategic logic we are developing to this case.

The reason why Apple lost its market share to the point of becoming a marginal competitor is that, as we saw in the previous chapter, most users prefer to use the same operating system. We call this the ‘network effect’: an operating system, even if it is not very sophisticated, is better if most people use it, since thanks to it we can use popular programs and interchange data with others. Although the Macintosh operating system was infinitely better than that of IBM (MS-DOS, from Microsoft), the importance of IBM in the world of computers and the fact that Apple decided to sell its computers at substantially higher prices made the MS-DOS system grow rapidly. Once a standard clearly surpasses another, as we know now, it is natural for the whole market to go to it. This we know today, but there are reasons to think that Apple could have acted very differently, if it had understood its business (‘the manufacture and sale of computers’) as various different businesses (‘design and sell operating systems’, ‘design computers’, ‘assemble computers’ and ‘sell computers’). We will see how.

When Apple spent a good deal of money (around $400 million) developing the Macintosh, it did it to surpass IBM and offer a better computer.
In reality, however, most of its effort, the true innovation of the computer, was the operating system, not the machine itself, which was quite normal: it had a standard keyboard, a normal screen, a typical processor, regular memory and so on. Apple, in fact, designed an excellent operating system and it said to the public: ‘if you like our operating system, which enormously facilitates working with a computer, you will also have to buy the machine from us, not just the software’. Personally, I have used Apple computers for years, and each time I bought one I had to pay an average of about €500 more than I would have paid if I had bought an equivalent IBM-compatible computer. Twenty-five million Apple users did the same thing. But all those users were willing to pay €500 ‘extra’ for the operating system, not for the keyboard or the processor. In fact, if they had sold us the system on a ‘diskette’, as Microsoft does, to be used in an IBM-compatible computer, for less than €500, we would have been glad to buy it. And Apple would have earned much more money, for it is more profitable to sell diskettes at €400 (with practically no variable manufacturing costs) than to sell full-price computers, where it does not achieve this margin.

This leads us to what should have been Apple’s strategy. Let’s imagine that once the Macintosh operating system was developed, instead of ‘putting it’ in a computer to favour the sale of the machines, it had done the following: visited IBM and offered it, free, the operating system for use in its computers. The deal would have been the following: IBM can include the operating system freely in all its computers, as long as it permits Apple to sell it to other manufacturers, exactly as Microsoft did (and does, although it charges IBM).

If IBM had accepted the deal (difficult to reject: an excellent free product, while it had to pay for the one from Microsoft, much worse at that time), it is not difficult to imagine how the sector would have evolved: the ‘compatibles’ would have continued taking the market share from IBM, Apple would not sell a computer (why buy expensive Apple machines when you could have all the good things from them in a cheap computer?) and the richest man in the world would not be Bill Gates, founder of Microsoft, but Steve Jobs, founder of Apple.

This is clear today, looking back. Why did someone as intelligent and with such deep knowledge of the market as Steve Jobs not see it? In fact, if someone had suggested to Jobs that Apple gave the Macintosh operating system to IBM, Jobs would have responded that the operating system was precisely Apple’s competitive advantage over IBM which was going to help sell computers. **And there is the essence of the problem:** Jobs wanted
Strategic Logic

to sell computers, without realizing that the profitability is not in selling computers, but rather in some of the individual activities of the industry. And by selling computers, he spurned the opportunity to have the most profitable company in the world. If he had separated the activities, it is very possible that Apple today would not sell many computers but it would earn a huge amount of money and dominate the sector, instead of Microsoft.

Of course, this is not an exclusive error of Apple. Imagine a meat products company that reaches the conclusion that the quality of its products and the manufacturing costs are influenced by the characteristics of the pigs that it uses: their constitution, the proportion and distribution of fat and so on. Imagine also that, after years of investing in research, it obtains, through careful selection, a genetic variety of pig that produces meat of a superior quality at a lower cost. Imagine, finally, that this variety of animal is difficult to copy by any competitor who does not spend several years and many millions on research.

In real life, the tendency of the managers of this company will be to say: we have finally found a competitive advantage! In effect, the business is difficult, since there are many competitors and the average profitability is low. What will never occur to them is to sell (under license, of course) to all their competitors the formula for obtaining the pigs in question. Doing this would not favour the manufacturing activity, but they would earn much more money in the genetics business. If they decide not to sell the formula, they will be sacrificing the genetics business in order to support a not very profitable business, exactly as Apple did. In addition, if they refuse to sell the formula to their competitors, who see that having it is very profitable, they will work until they achieve something similar, thus diluting the profitability of that activity. That is what Microsoft did; in short, it worked until it had a more or less comparable operating system.

Managers tend to sacrifice a good business for the sake of another which is not so good for two reasons. On the one hand, in the short term, the factories are there and the only way not to lose money is to keep them busy: everything that helps to sell the product is considered good. On the other hand, there is an ‘implicit definition of the business’, in industry terms (computers, meat packing), that prevents analysing the profitability of each of the activities separately, and possibly comes from the company culture that was developed over the years.

A company can, nevertheless, understand that various activities are indeed distinct and carry out a correct analysis. As a result, it can decide to keep those activities that have a potential for low benefits, having had the
option of keeping more profitable activities: this is what IBM did when it
decided to launch its PC computer, using an operating system purchased
from the outside (MS-DOS, from Microsoft), without bothering to acquire
exclusive rights. Evidently, it did not think of this activity as a business in
itself, with intrinsic characteristics that would lead it, in due time, to
become the most profitable activity of the industry. This also occurs in
companies of the old economy. Many companies today prefer lowering
their risks and investments, turning to what is called ‘co-packing’ which is,
simply, subcontracting the manufacturing of the product, while keeping
the design, quality control and marketing. But manufacturing a product
can have high, medium-term profitability, if it is difficult to do, if there are
economies of scale and, above all, if there are ‘economies of learning’: only those who have done it for years can do it efficiently. In this case, the
company is giving away a potentially profitable business in the medium
term to a subcontractor who, if it really develops a unique capacity in
production, will end up taking its share of the profits.

How to Make a Correct Competitive Analysis

Of course, there are companies that do make the right decisions, after
analysing the sector. In this sense, the history of Dolby is interesting.
Dolby is a company of which all the readers of this book are clients: prac-
tically all the tape recorders in the world, and now the DVD players, use
its technology. The cassette player in your car has, almost certainly a
small logo, with a ‘D’, which indicates it. The reason is the following. In
the 1960s, Ray Dolby invented a procedure, relatively simple but inge-
nious, to improve the sound of a tape recording and obtained a solid
patent to protect it. At that time, to simplify matters, he had two options:
begin to manufacture tape recorders objectively better than all the others;
or sell his technology to any manufacturer who wanted to improve the
sound of its products. Dolby opted for the second, avoiding the problems
of diseconomies of scale, lack of brand and so on that manufacturing
would have entailed. In addition, if the price charged for the technology is
below the entry-deterring price, as we saw in the previous chapter,
competitors will prefer to buy it from him rather than develop their own
technology. Forty years later, Dolby is a much smaller company, but
much more profitable, than Philips or Sony. It seems clear, however, that
if Dolby had already been a manufacturer of equipment, he would have
possibly fallen into Apple’s trap, using his technology to defend a manu-
facturing activity that perhaps is not very profitable. This would have
been a mistake because, in the long term, a mediocre activity does not survive, and the truly profitable activity is asphyxiated.

Many other companies have preferred to concentrate on their profitable activity, and not give exclusive rights over it to their non-profitable ones. This is especially important when the profitable activity needs a large volume to be successful, whether for economies of scale (in maintaining a high level of research), or for the network effect. For example, Sony designed its Betamax video system, of great quality, and decided to sell the system exclusively. Matsushita decided to give licenses of his VHS system to any manufacturer of video players. The result, very similar to that of Apple, is that Sony sold their devices exclusively, and more expensively, while the market became inundated with players based on the VHS system and manufactured by many distinct companies. As there is a certain network effect (the people buy devices for which there are tapes, and the video rental companies buy tapes with the most common format), VHS replaced Betamax in a short time. It is true that Matsushita left the manufacturing and sale of a good number of devices to its competitors, but that is not a very profitable business, since there are no entry barriers. But each VHS video player produced by any manufacturer carries reading heads from Matsushita that are necessary to be able to read the standard VHS, and which are highly profitable since only Matsushita has the patents to manufacture them.

Along similar lines, IBM has recently decided to sell its enormous technological capacity to whoever wants to buy it, competitor or not. From integrated circuits with unique speed characteristics, to high-capacity hard disks, to flat screens, any component where IBM is unique is being exploited. Its profitability has gone up in the past few years, although its market share in computers has gone down.

From all that has been said in this and the previous chapter, we can now deduce how a correct industry analysis should be made. Essentially, it has four steps, which are not strictly linear but iterative:

1. Determination of the basic activities.
2. Analysis of each one of those activities.
3. Positioning of the different actors.
4. Possible evolution of the activities.

We have dealt in depth with the first point in this chapter. One must take the sector and see what are the key activities, understanding all those
economic activities that must be carried out so that the sector exists, and which can (at least conceptually) be carried out by independent companies. Thus, manufacturing is an activity independent of design in almost all cases, since it can be conceived (and in fact it usually occurs) that one company designs the product and another manufactures it, either because the designer subcontracts the manufacturing, or the other way around. In a normal sector, we will not consider the management of human resources as an independent activity, since it is something that is intrinsically included in each of the other activities. Of course, it is very possible that the human resources department of a manufacturer uses a management search company, which implies externalizing an activity, but it is very unlikely that this externalization is important in the analysis of the sector.

This gives us a clue of up to what point to carry the analysis, that is, the separation into activities. First, we should take the obvious ones: design, manufacturing, components, distribution and so on. Then we should observe each one of these in order to subdivide the ones that are more important in terms of economic volume.

Once this is done, we go on to the second point: analysis of the activities. This involves all the concepts of Chapter 1, and simply tries to answer the question: ‘What is the potential profitability of this activity?’ Now we know the answer depends on the possibility of carrying out the activity better than the rest, or at lower costs than the others, and in a sustainable fashion. An activity that cannot be done better (so that the buyers are willing to pay a premium), or that cannot be done with lower costs, cannot have high, medium-term profitability. But an activity that can be done better may be very profitable, although it may not be there yet. For example, most users find that the batteries of laptops do not last long enough, and those who travel frequently would be willing to pay more for a battery that lasted longer. A company that develops a technology, which can be patented or is difficult to copy, to provide longer battery life will be a company with a good opportunity for profitability. And this would be true, even though no company were doing it: the activity is potentially profitable.

A correct execution of point 2 can take us back to point 1: by studying the potential of an activity, we can perhaps realize that, in it, there are potentially very profitable sub-activities and others that are less so. Perhaps subdividing the activity would be a good idea. That is why we said it is an iterative process.

The final result of repeating steps 1 and 2 as many times as necessary will be a map of the territory of the industry, with all the activities that are critical to understanding its profitability. Step 3 consists of drawing on
this map the positions that the different competitors occupy: some will be in many of the activities, others only in some of them, while some competitors will be very specialized. If we are capable of estimating the potential profitability of the distinct activities, we can understand the profitability of the different competitors and some of their probable next actions: a competitor that is in a profitable activity (that is, protected by entry barriers), but as a secondary player, will soon have to make an in-depth strategic re-examination.

Finally, in step 4, we should study how the potential profitability of the different activities is going to change, since strategic analysis is important for decisions for the future, not just to understand the past. The next chapter is entirely dedicated to this dynamic analysis, so we will not go into it now. Listing these steps, however, indicates to us how to approach the analysis, that is, how we can apply strategic logic to the constituent units of a sector.

**Another Source of Profitability: Reorganization of the Industry**

We have seen how profitability lies in the activities and not in the sector or the company: what are profitable (or not) are the individual activities. The sectors (and the companies) are collections of activities, whose final profitability is just the sum of the profitability of the activities.

But the fact that the activities are really *distinct* businesses does not mean that they are *separate* businesses. To return to our example, in order for a personal computer to be sold to the public, it is not enough that the activities are carried out, in general: it is necessary that they be carried out in a coordinated fashion. Someone has to make sure that as many microprocessors are manufactured as keyboards (since you need one for each computer), without surplus or shortages. Logistics is important; assembling is distinct from manufacturing components, but they are two activities united in practice: in order for the assembling to be efficient, the factory has to receive the right components at the right moment.

In Chapter 4 we will analyse in detail the consequences of organizing the activities in one way or another, but here we can advance the following: a company that is capable of organizing the activities in a more efficient way than others, and in a non-copiable way, will obtain an extraordinary profitability, even if the profitability of the activities themselves is the same. Let us see this through with an example.

Dell is a manufacturer of personal computers. Within the business system, it is basically dedicated to the assembly and marketing/distribution
of computers. In this, it is practically identical to Compaq, Hewlett-Packard or IBM (although these companies do other things in other businesses). The only important difference is profitability: as we show in Figure 2.2, Dell’s is much better than its competitors’, and its growth is faster. What is at the root of this sustained success? After all, Dell is present in the same activities as its competitors, and besides, they are not very profitable activities.

Dell, of course, does things differently. Its main feature is that it sells directly to the final consumer, by telephone or, more and more, through the Internet. When the buyer wants a computer, she accesses Dell’s Internet site, where she sees all the models and options, and as she goes along designs the computer that she wants. Dell communicates the price and the buyer gives her credit card number. And it is at this moment that Dell begins to manufacture the computer. That is, the computers are manufactured only after they are sold. Dell’s competitors use the traditional system: they manufacture without firm orders, based on sales predictions. The computers manufactured in this way are sold to distributors, who do not have firm orders either, but rather their own forecasts. Finally, the distributors try to sell them to the final consumer (or to some intermediary).

The ‘Dell system’ is much more profitable than the usual system for the following reason. A typical feature of the most expensive components

![Figure 2.2 Profitability and growth of Dell and its main competitors](source: Annual reports)
of the computer (the microprocessor, the hard disk and, in lesser measure, the flat screen) is that the technology advances very rapidly, so prices go down constantly. This makes having inventories of these components (as components or already assembled in a computer) prohibitively expensive: on average, the components of a computer depreciate 1% weekly (besides the usual cost of maintaining inventories, of course).

A traditional production system, which works on sales forecasts, cannot shorten the process, from the manufacturing of the processor or hard disk until the final client pays (the complete cycle), to less than 12–15 weeks: the parts have to be received, assembled, sent to the distributors, who send them to the retailers, who try to sell them. But this implies depreciation, as we have seen, of over 10%. If all the competitors did the same, this would not be serious, as the final price would reflect it.

This is where Dell intervenes with its manufacturing system under firm order. As it only manufactures computers that are already paid for, the time that passes between the manufacturing of the components and the payment collection for the computer is a week: five days for the components and two days for the assembly (delivery, two or three more days, does not count, as the computer is already paid for). The difference in total costs (more than 10%) is superior to the typical margin of the sector, which permits Dell to earn money at prices that are leading its competitors to bankruptcy.

But this story does not explain in reality the profitability of Dell: it explains only that it is better at doing things one way than another. What is the sustainable advantage? If we cannot respond to this question, as we saw in Chapter 1, we cannot say that we understand the root of profitability, since the essence of profitability is that the advantage cannot be copied. In principle, everyone could do what Dell does, much as everyone can do what Compaq does. Where is the problem?

The problem, for an established competitor, is that shifting to a direct sales method implies the immediate emnity of all its distributors. All manufacturers have tried it timidly, and have had to back off, after the immediate lowering of sales in the traditional channel. Although they are convinced that the final situation of going to direct sales would be better than the present situation, they cannot permit themselves the luxury of losing current, immediate sales and, little by little, recuperating them, perhaps, in the direct channel (if Dell permits it, since, let us remember, Dell is already there, with important cost advantages).

In addition, competitive advantages tend to reinforce themselves: once Dell begins to achieve volume thanks to its low prices, it skims the few economies of scale to be found in the assembly business (purchase of
components) and marketing (advertising). All this means that, after a few years, its situation will be impregnable. It is interesting to observe, however, that its profitability does not come from the activities themselves, but rather from the way of organizing them. In fact, it is more expensive to assemble to order than to assemble a long series of identical computers, as the rest do. But there are other advantages that more than compensate for that excess cost.

We have talked in some detail about Dell, as it is a truly noteworthy and recent example. But there are others similar to it. Ikea has drastically reorganized the furniture business, by emphasizing design, obtaining economies of scale in production and having the customer do the assembly. The reason here is that the basic cost of a cheap piece of furniture is, again, storage, not because of devaluation, as with computers, but because of its volume. A store that wants to have a large range of furniture ready to carry out would have to be simply enormous, with all the expenses that this implies. The idea of transporting and selling flat-pack furniture radically changes the economic equation and permits much lower prices.

The sustainability here is not as clear as in the case of Dell, and Ikea does not have the same profitability or market share. But the economies of scale in design, production, logistics and marketing are important, and most competitors cannot really imitate these. Although similar companies will appear eventually (in fact, they already have), the business is already more concentrated than before.

We could continue with other examples, such as McDonald’s in the restaurant business, but the important point is that, from time to time, a company can find a different way of organizing the activities of the sector that is, at the same time, better and difficult to copy. In these cases, the company will be profitable thanks to its business formula. This profitability will nevertheless be eroded, of course, as competitors (slowly, if it is difficult) start imitating it.

**Conclusion**

The breakdown of industries into the activities that constitute them is absolutely essential in order to apply rigorous strategic logic: if the profits come from sustainable singularity, we must be able to find it. Moreover, as we said at the beginning of this chapter, it is usually found only in some very specific parts of what a company does. This breakdown helps us understand why, for example, football clubs can never be a good business,
in spite of the millions that they charge television stations to transmit their games. The reason is that the players have the authentic singularity. As soon as legislation let them auction their services to the highest bidder, all the profits of the sector drifted towards the only activity that has real singularity (in fact, some clubs also have it, since they are very appreciated brands, but the strength of the players is such that they end up taking all the money: no matter how strong the brand, if a club does not win championships, and for this it needs the best players, it ends up losing income). This indicates, in addition, that the solution to the economic problems of the clubs is not to charge television stations more. In fact, they already charge much more than a few years ago and they continue to lose money (and the stations continue to go bankrupt). Profitability is determined by the capacity for singularity of the different activities, and an increase or decrease in prices/costs, as we saw in Chapter 1, does not affect in the medium term the margins of each activity. If the clubs bring in more money, the stars will ask for more. The only solution is that all the clubs come to an agreement, like the American professional leagues do, to form an oligopoly and limit payments to the players. In the absence of this (in Europe, illegal) solution, it is hard to see how a professional sports club can ever be a profitable business.

The industry analysis we propose in this chapter is also absolutely necessary to understand the more complex topics we will deal with in the next chapters: industry evolution, vertical integration, diversification and globalization. Each of these complex phenomena affects very differently the different activities of an industry, and no discussion can therefore be logical without proceeding to the appropriate separation.

Notes

1. ‘Clones’ are those computers that were functionally identical to the IBM PCs, capable of using the same software and the same peripherals. Built in many cases by unknown companies, who limit themselves to assembling standard pieces according to a standard design, they came out on the market with a very low price and were responsible, as we will see, for the progressive lowering of profitability of very important parts of the sector.
3. Chapter 3 explains in detail the concept of ‘network economics’.
4. To alleviate this problem, accounting based on activities has been developed (activity-based accounting). But the strategic validity of the data supplied by such accounting will depend, obviously, on the good or bad division of activities, which is not obvious, and of the understanding that the managers have of their strategic implications.
5. There is a technical consideration to make here, and that is that Apple uses a microprocessor from Motorola, and not from Intel, and so the Macintosh operating system cannot be used directly in an IBM or IBM-compatible computer. But the ‘translation’ is
possible, and in fact Apple has done it, although it never dared to market it, for reasons that are explained in the text.

6. In its article entitled simply ‘Football Clubs’, the *Financial Times* of September 9, 2001 analysed the sharp decline in the stock market of all the teams that had issued stock to the public, showing the intrinsic problem that we have mentioned: the players take all the money collected for television rights and even more, leading the club to the peculiar situation of bringing in more and more money, and at the same time getting closer to bankruptcy.
CHAPTER 3

Industry Evolution

The preceding chapters have laid the foundations of strategic logic. As we said in the Introduction, many of its elements may have seemed fairly basic to the reader, even downright simplistic. The elements making up all logic, however, are simple and precisely from that fact comes their explicative power.

In the following chapters we are going to apply strategic logic to complex problems of the managerial world, and we will see how the results are very enlightening, for in many cases they will go against generalized opinions. The first complex element that we are going to introduce is the dynamic aspect of competition. The dynamic application of our basic concepts will allow us to answer questions such as:

- How have several Japanese car-makers been able to leap over the entry barriers that the sector had (and still has) to become leaders?
- Is it true that the Internet changes everything?
- Will Microsoft keep its dominance over the software sector, or will another company dethrone it?
- How will the new technologies affect the traditional business of the communication media?
- Why are the leading oil companies always the same while in software, with a few exceptions, they change constantly?
- What can be expected from the telecommunications sector?

Some of these questions do not have a clear answer if we make a purely static application of strategic concepts. An example of this is the success of some Japanese car-makers, especially Toyota. If we analyse the United
States automobile market, we will see that it is protected by an extensive series of entry barriers, in almost all of its activities: from economies of scale in design, production of components, assembly and distribution, to a strong brand differentiation. In fact, for decades General Motors was the largest company in the world and one of the most profitable. Economies of scale were so important that, over the years, a strong concentration resulted, leaving only three competitors in the sector. Then, a series of much smaller companies, with less technology, no brand reputation or distribution capacity, entered the market with such success that only the intervention of the government in the 1980s stopped them from literally throwing the American companies out of the market. In these pages we will try to see how this is possible, and also develop a methodology that even allows us to predict what is going to occur in some sectors that practically do not exist, such as those relating to the Internet or what has been called the ‘new economy’.

Most of the concepts that we have developed in the previous pages are, by their very nature, static. Economies of scale, for example, exist for certain activities and do not change. What makes them solid concepts is precisely this static nature, on which an entire logical development can be based: if the cost curve of a certain activity changed constantly, it could never be one of the criteria on which to base a strategy, which necessarily implies making decisions whose repercussions last a long time. In short, strategy (‘the art of earning money in a sustainable fashion’) is interested in the future, not the past; so strategic logic has to be able to predict. It must have the ability to anticipate the impact on industry profitability of all the changes that occur around it. In this chapter we will present a series of conceptual tools that will allow us to do just that: predict the impact of change, since the object of strategic analysis is to prepare to make decisions that ensure a profitable future for a company. In addition, these tools will let us, as we have said, understand better the phenomenon of emerging sectors, those that have not yet established clear entry barriers and, therefore, do not appear to lend themselves to an analysis of this type up until now. In short, it is not a question of ‘predicting what is going to happen’ because the future is unknowable. It is a question of analysing, by the application of strategic logic, what would be the strategic impact of a series of phenomena that could occur.

A Methodology of Predictive Analysis

The first step towards understanding what is going to happen in an industry in transformation (and this includes, sooner or later, all of them)
is to understand the present situation and how it has come about. For this, we must proceed according to the lines discussed in Chapter 2: divide the sector into its constituent activities and try to understand the competitive structure of each one of them, that is, the level of competition (and, therefore, profitability) in them. If competition is low (and profitability, therefore, is high), we must try to understand why: what are the market imperfections of that activity that make stronger competition difficult and permit the profitability of the businesses that perform it.

Once this is done, we must study what factors can modify the current profitability of each of the activities. As we know, the profitability of the activities is supported by some market imperfections. Hence, we must be capable of anticipating how these imperfections are going to change. For example, if an activity is profitable because the government maintains it as a monopoly or an oligopoly, it is evident that the future profitability will depend on the maintenance of that intervention. No one can know, of course, what the government will do in the future, but in many cases a trend can be detected.

A more frequent case is where profitability stems from some significant economies of scale. But economies of scale are always based on a specific technology, and technology changes. Once again, no one can know what technology will bring us, but the direction it is taking can be projected as well as the effects it will have on the cost curves: there are technological changes whose impact is such that the company should increase its size, and for others it is just the opposite.

Finally, it is not very difficult, in many cases, to foresee the impact that a change in demand characteristics is going to have on the different activities. Although, again, there are fashion trends that can surprise everyone, the truth is that most major changes in the market occur over a period of years and are relatively easy to discern, at least when they have already begun.

The three factors just mentioned (technology, governmental regulation and demand characteristics), which we will call ‘motors of change’, determine the evolution of the strategy, because they determine the conditions of sustainable singularization of the different activities. And this is the essential point to hold on to in our effort: any change affects the strategy, whenever it affects the characteristics that make an activity more or less singularizable, that is, those characteristics that make some competitors able to carry out the activity with costs sustainably lower or with some degree of differentiation. If the changes in the scene do not affect this ‘capacity of singularization’, they do not truly affect the strategy: although the change can produce short-term imbalances, the strategic equilibrium will reassert itself.
For example, a significant increase in oil prices, in itself, does not affect excessively the profitability characteristics of the oil business or the automobile industry. In the short term, it can signify an increase in the margins for the oil companies or a decrease in demand for the car-makers. If the change is transient, however, things will return to their level. So what happens if the change is permanent? The long-term profitability of the oil business will not be affected by the fact that oil is more expensive, since the extraordinary sustained margin in the oil business will see, in the medium term, the entry of new competitors, as we saw in Chapter 1, who will take the margin back to where it was, that is, to a profitability in accordance with the entry barriers (that were already certainly quite high). If the entry barriers do not change, the long-term profitability will not change either. In fact, if the price of oil went down, the same would occur: a certain lack of short-term profitability with a return to the usual profitability, with the less profitable oil companies abandoning the oil business (or merging with others, as has been happening lately, to withdraw capacity from the market).

In short, the change in profitability of a company occurs only when the ‘rules of the competition game’ change, not when the prices go up or down. And these changes in the rules of the game occur for many reasons, but there are three basic ‘motors of change’ that usually are behind the great competitive mutations. We are now going to see in detail how they function.

**Technological Change, the First Motor of Industry Change**

Technological change, as we have said, is only important from the strategic point of view when it changes the possibilities of singularization of the industry, and this can occur only when it alters the cost structure or the real possibilities for differentiating the product.

**Changes in the Cost Structure of the Business**

Take any activity. As we saw in Chapter 1, this activity has a given minimum efficient size, determined by its technology, that is, by the most economic way to carry it out. This efficient size then determines how many competitors fit into the sector, which normally influences the profitability of the activity. In principle, this is a structural, or permanent, reality. But, once in a while, someone invents a new way of doing things
that makes them cheaper. It could be a new machine that produces at a higher speed, a new formula or a new way of doing things in general. If this cheapening of the production is attainable by all competitors (for example because it consists of a new machine that is on sale to everyone), it will have no impact on the profitability of the sector: the rivalry between competitors will make the savings go directly to the clients. Profitability will continue to be as it was, since entry barriers have not changed. But if the new technology implies that the MES is greater, because it implies large investments and optimizes its costs at a higher level of output than the previous one, then it produces a phenomenon of concentration in the industry, as shown in Figure 3.1.

This has happened recently with several electronic products that have gone from analogue to digital technology. For example, in the 1970s, telephone exchanges were based on analogue technology. This technology determined the minimum efficient size of production (especially of design) of these exchanges. That size was such that the telecommunications market in each European country was sufficiently large to be able to support profitably one or two competitors, depending on the size of the country. Taking into account that at that time the buyer of these products was a state company (the telephone company of each country), the industry developed in a way that each country had its own national champions. In some cases (France, Spain or Germany, for example), the national champion was in reality a subsidiary of the multinational company (ITT), but it operated like a national company, since it performed

![Figure 3.1](image-url)  
**Figure 3.1** Two cost curves, the old one and the new one, where the new one has a higher MES, thus reducing the number of viable competitors
practically all the design and manufacturing in the country. The situation had remained stable almost from the beginning of the century until the early 1980s.

At that time, Ericsson of Sweden decided to invest heavily in a new technology. It consisted of approaching the design and construction of telephone exchanges from a digital point of view, as if they were simply computers specialized for a specific task: connecting different telephones together. The result was excellent, and the new digital exchanges were able to do things that the old analogue exchanges could not and with a better quality/price ratio. The basic technology, however, is very different, and the cost of designing each new generation of telephone exchange went from around €100 million for the analogue exchanges to €1,000 million for the digital ones. The immediate result was that to amortize the development costs, ten times the number of exchanges had to be sold (or the prices raised, which would not work, of course). As the market does not grow much, the competitive result is clear: too many competitors and so there must be a process of concentration. Twenty years later, no country can permit itself the luxury of having a national champion, designing telephone exchanges fit for the country, and the business has become much more international than it was (as we will see in Chapter 5, this story exemplifies one of the most frequent causes of globalization of industries).¹

Hence, a technological change that introduces a new way of doing things that is advantageous for the clients (and which, therefore, ends up prevailing) can also involve a change in the structure of the sector: by increasing the minimum efficient size without the market growing, the maximum number of competitors that can exist successfully decreases. Those companies that position themselves rapidly will survive and those that take longer to react find themselves on the wrong side of the new entry barriers. As we indicated in Chapter 1, the concentration of many sectors from the beginning of the Industrial Revolution follows this pattern.

Of course, there is also the opposite case, as shown in Figure 3.2. In Chapter 1 we advanced the (possible) case of gas mini-turbines, generators of electricity with a very competitive cost at a very low production volume compared to that of the traditional thermal plants. If this technology prevails (that is, if the manufacturers of mini-turbines produce a product that offers a better yield/price relationship), the electricity generating market will fragment. It will go from being dominated by a few competitors in each country to being distributed among many (that is, as long as the government permits it, since this is a very regulated market everywhere).
One last point on changes in cost structure. Even if the costs of producing a certain good do not change, changes in the transportation costs may make it possible to sell the product farther away in a competitive fashion, thus in fact altering the competitive equilibrium in favour of larger companies. In Chapter 4, we will see in detail how the decline in transportation and telecommunications costs can involve an increase in the effective minimum efficient size, generating concentration processes and internationalization.

**Figure 3.2** Decrease in the MES through change in the technological base

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**Modifications in the Intrinsic ‘Differentiability’ of the Product**

It is necessary to note that a technological change can also affect the competitive foundations of an industry without affecting its costs, but rather its capacity for differentiation. For example, before personal computers came out, all information systems professionals paid close attention to the choice of supplier, since, as we also saw in Chapter 1, the switching costs were enormous. In this context, differentiation was very important and IBM, as the leading company, could permit itself the luxury of charging a premium. When personal computers came onto the market, IBM continued charging this premium and a good number of clients continued accepting it: in short, the personal computer was a new product, not well proven, and it seemed better to continue with a reliable brand. Consequently, IBM had great initial success, both in volume (it became
the sales leader) as well as in price (since it sold an equivalent product more expensively than its competitors).

But the design itself of the IBM personal computer made this differentiation blur little by little: as long as a computer is an assembly of standard pieces, managed by a standard operating system, it is very difficult to maintain a price differential, even with the extraordinary IBM brand. In effect, the market did not take long to realize that, in fact, there was no real basis for that differentiation premium. As a result, the profitability of the operation has suffered since then (and the prices charged by the different competitors are much more similar than before).²

This phenomenon occurs frequently because when the intrinsic quality of the products improves, thanks to technological advances, the basis for differentiation becomes blurred. A mechanical watch is very dependent on the ability of the watchmaker and on a complex industrial infrastructure but a quartz watch is always precise and, therefore, no brand can demand a quality premium. Something similar happens with cars, where differences in quality have been reduced enormously in recent years, thanks to the adoption of electronic engine management, based on components which are identical for all brands.³

In short, forecasting industry evolution is a question of seeing whether the foreseeable technological changes in the way an activity is carried out will tend to reduce or increase competition in it, through a different minimum efficient size, or an increased (or decreased) capacity for differentiation. An important point must be repeated, already mentioned in Chapter 1: new technology that lowers production costs but is available to all competitors will not modify the profitability of the business. The constant reduction in costs to which many companies are dedicated can be a necessary condition for earning money, since they cannot have costs higher than those of their competitors, but it is not a sufficient condition: if costs go down by 10%, but those of the competitors also decrease, profits will not improve.

We can say formally that the capacity of singularization of a sector rests on the ‘variance’ that it provides between the quality and the costs of the participants. If the variance is very small (all have more or less the same costs and the same quality), profitability will be small, as we saw in the first chapter. If the variance is large, the potential for profits is much greater, since the buyers will be willing to pay more for what is objectively better, or a business will be able to have a margin protected by its cost advantage. Furthermore, the introduction of new technology affects variance, either increasing or reducing it.
Changes in Regulation

Of course, in those activities where government regulation is significant, that is, it is the basis of singularity, changes in regulation may have an impact on singularity. The examples of deregulation that sectors such as audiovisual, airlines and telecommunications have experienced are evident. But governments also affect profitability by favouring some companies over others when purchasing goods or services, or in providing certain inputs at a better price, or by raising or lowering exit barriers. All these actions have an enormous impact on the profitability of the affected activities and are to a great extent predictable.

Regulation’s impact can be very subtle, and it is essential to understand the mechanisms that facilitate the singularization in order to foresee the impact of a given regulatory change. For example, one of the key entry barriers to local telephony is the enormous cost of opening trenches to install new telephone cables, when a company wants to compete with the operator already installed. In most countries, the incumbent operator is the old state monopoly, which has been more or less partially privatized. At the time of privatization, the government can decide that the underground tubes through which phone cables pass continue to be public, privatizing only the cables themselves. In this case, a new competitor will be able to pass its cables through the tubes, and will enter the business at a cost that is more than ten times less than if it had to open trenches, because the government had also privatized the tubes. Or, as we saw in Chapter 1, the government can demand that the telephone companies accept that the client may change providers while keeping his phone number, in which case switching costs decrease and competition increases; or it may not do it, in which case the clients are tied to their provider, which may then charge them higher prices. We could say something similar about the airports and airlines. Today, the greatest entry barrier to the aviation business is that the most interesting airports are saturated and there are no slots (times for landing or taking off) available. While the government was for years the owner of the airports (in many countries it still is) and the main airline of the country also belonged to the state, it seemed logical that the slots were assigned freely to this dominant (or perhaps only) airline. Today, those slots are an authentic gift from the government and, in many cases, those governments, still favouring the old national champion, have been reluctant to arbitrate a fair division between those that are already there and the possible competitors. A real subsidy is then passed to the dominant national airlines that makes entry by new ones difficult and contributes to maintaining high prices.
The government also has a great impact on the entire financial sector, which is rigorously regulated. In Chapter 1 we saw how the switching costs from one supplier to another, when they are high, lower competition, as they make it difficult for clients to change suppliers. An interesting example is provided by the business of managing unit trusts in Spain, which is very profitable. There are various reasons that explain that profitability, which we are not going into now, but there is one, very subtle, that depends exclusively on the more or less arbitrary will of the government: according to current legislation, if an investor in a fund decides to take his savings from that fund (because it is poorly managed, for example, or he considers the commission too high) and places them in another, he must sell the first fund, liquidate the taxes due for the capital gains produced, and then invest what is left in the second fund. If the investor has obtained capital gains during the period of investment, this makes him very reluctant to change funds, although there are others better managed or with lower costs. A change in legislation that would permit switching funds without paying taxes would imply an immediate increase in competition, with the consequent lowering of profitability in the business.4

We could multiply the examples, since there are very few sectors in a modern economy in which regulations do not play an important role. The key, however, is to understand that, in the majority of cases, except for situations of an officially sanctioned monopoly, the influence of the government is subtle and indirect, altering the basis of singularization of the different activities.

Changes in Demand

Of course, many of the changes are not ‘endogenous’, such as those which correspond to the invention of a new technology, but ‘exogenous’, as long as they are driven by the final arbitrator, who is the client. In many cases, these changes can be relatively subtle, but the chain of causation can be established fairly well. Let us return to our example of an increase in oil prices.

We said before that a temporary increase in the price of oil (besides causing a good or bad year for some of the actors) does not have an impact on long-term profitability. In fact, not even a permanent increase will do that, since the level of competition will adjust according to the entry barriers. However, it could happen that the entry barriers to the automobile sector are modified as an indirect consequence of a variation in the price of
oil. It is even possible that profitability is affected in the opposite direction to what seems intuitive: probably, the more expensive the oil, the more profitable the sector will be in the long term. Let’s see why.

Imagine that the price of oil increases significantly and permanently. In itself, this does not affect the manufacturing of cars, but one thing seems clear: buyers of automobiles will pay more attention than in the past to fuel consumption. This is another way of saying that a car that consumes less energy will have better acceptance. Therefore, if anyone is capable of developing fuel-efficient engines, in a relatively unique way, it can charge a differentiation premium. Of course, this does not affect the business of assembling cars, but rather the activity of engine design and, perhaps, some components. Companies such as Bosch or Bendix, suppliers to the automobile industry, were the major beneficiaries from the switch from carburetors to electronic injection systems, which they manufacture under patent, a switch motivated by the need for greater efficiency in fuel consumption. We see again how strategic logic works: profitability goes to the company that has singularity. In the face of a change in the conditions of the environment (greater desire for efficiency in fuel consumption), profits will flow to the company that can provide this efficiency, in a relatively unique way.

In short, the reasoning is as follows: the higher oil price makes the buying criteria for automobiles change, rewarding fuel economy. As long as that fuel efficiency can be improved through technology, a possibility for differentiation is opened. In addition, investments in R&D can be so important that the minimum efficient size of the sector grows. In this case, it will reduce the number of competitors and, after a difficult period of adjustment, it is possible that a sector arises that is more profitable than the previous one, with higher entry barriers. As always, this affects certain activities but not others: a manufacturer that just assembles the parts bought from suppliers, and leaves to them to do the research to improve engine efficiency, will not see its profitability increase: only those who do the research and find defensible new ways of doing things (that is, take advantage of the new possibility for uniqueness) will see their profitability improve.

Let’s summarize, then, the impact over time on industry profitability of a change in demand characteristics. At first, the impact may be negative: as the price of oil goes up, the demand for automobiles goes down and the manufacturers lose money. But, as long as the new demand characteristics favour uniqueness, profitability will increase in the medium term, at least for those companies involved in the activities whose possibilities for uniqueness have been reinforced.

As we said before, there are changes in demand that cannot be foreseen (in fact, the first oil shock was unexpected), but many can be.
example, the ageing of populations in Western countries (and some Eastern countries like Japan and China) is an irrefutable fact. Its impact on strategy is not so much in its first obvious consequence: that we should prepare products adapted to older people. This will have to be done, of course, but nothing tells us that these products will be profitable. In fact, if they are not singularizable, they will not be, since we can be sure that all our competitors are thinking the same way and so there will be no lack of competition. But it is possible that some products are singularizable: for example in the area of food, there is much research to be done, much of it more or less patentable, to offer products truly adapted to the specific needs of the elderly. It seems clear that since the purchasing criteria of a 70-year-old person are very different from those of a 25-year-old, the possibilities for singularization of the different activities will change. Let me insist on a fundamental point: it is not a question simply of foreseeing that there will be more elderly people, since everyone knows that. The idea is not, therefore, to start developing products adapted to them, and nothing more. If these products are not singularizable, they will not be profitable in the medium term. It is a question of analysing how the changes in demand change the rules of the competitive game, that is, the possibilities for singularization. And this is the essence of the structural change in a sector: a sector changes structurally, that is, its sustainable profitability increases or decreases, as the reason that defines its possibilities for singularization changes. If singularization becomes more possible (because there are new demands that require R&D, and, consequently, greater volume; or because they change the technology of production and increase the minimum efficient size; or because new governmental standards make competition difficult; or for any other reason), the competitors that adapt well will be more profitable, at the expense of those who, not seeing the change in time, will have to disappear. If the singularization becomes more difficult (because common usage of new technology completely satisfies the clients; or because the minimum efficient size decreases; or switching costs disappear; or for whatever other reason), profitability will deteriorate inexorably, despite the efforts of the competitors. In fact, every improvement in efficiency that they obtain will not improve their profits. The improvement, obtained by everyone, will be passed on to the buyers in the form of lower prices.

One last point: sometimes the change does not occur in the direct demand for the product or service we are analysing, but rather in public opinion in general. Thus, it is possible that there are people willing to buy electrical energy produced in a nuclear plant, if the price is right; or to
consume genetically modified farm products. The pressure of public opinion against these products, however, is such that they are not viable. Again, it is difficult to predict exactly what public opinion will demand, but there are secular trends (indicated to a great extent by something as objective and predictable as demographics) that can be seen quite clearly.

Direct Change and Induced Change

It may well happen that changes in one activity affect the characteristics of other activities that have a relationship with the first one. We can then talk of ‘induced change’. Take, for example, the case of the development of the hypermarkets.

For a population that, on the whole, does not have automobiles, and in a country in which the highways are not good, the most efficient form of distributing food products is what the experts in retail commerce call the ‘proximity store’, that is, the neighbourhood grocery store. But if automobiles get cheaper, as a result of their own technological changes, and the economy of the country improves and good roads are built, we find that a business model consisting of opening very large stores on the outskirts of the cities, to which consumers go by automobile to do their shopping, becomes possible. The advantages in costs are clear, since each product does not have to be taken to each small neighbourhood store, in a small truck, in difficult traffic conditions. It is enough to send a large truck from the factory to the hypermarket. In fact, the consumer takes charge of the so-called ‘capillary distribution’.

This economic model, clearly superior in costs, becomes widespread, and so generates possibilities for economies of scale in purchasing: large hypermarkets can bargain for better prices from manufacturers. This reinforces the cost advantages of the model, which becomes established. Up to this point, everything is clear and quite straightforward, but consider the impact these changes have on the food manufacturing sector. In principle, nothing has changed in their business: the technology of preparing food remains the same and there are no legal changes or changes in demand characteristics. But the manufacturers must now face stronger and more sophisticated buyers, who can threaten to take away a very important sales channel, given the volume that the hypermarkets have acquired, if they do not offer better conditions. This inevitably causes a lowering of the margins of the more mediocre manufacturers, that is, those that have a weaker competitive position. In this situation, there are only two solutions: either obtain new unique and sustainable cost advantages (somewhat
difficult, if there is no drastic change in production technology), or
increase the differentiation of the product for the final consumer, who
would end up demanding it of the hypermarket (a European hypermarket
chain decided not to sell Coca-Cola, since the company did not give it the
discounts it demanded. A few weeks later it had to go back, since
customers went to another store to do their shopping, in order to find
Coca-Cola. Unfortunately for the manufacturers, there are few brands with
that strength).

In any case, it is not difficult to observe how the process of concentra-
tion of demand and its transformation in large self-service stores change
the rules of the game for the manufacturers, who have to invest more and
more in advertising and development of new products, in order to defend
their margins, which are under heavy pressure. The mergers between
production companies, together with the disappearance of marginal
competitors, are an indirect result of the changes in the technology of the
distribution of food products. In this new situation, the competitive advan-
tages are different and the need to adapt or die is evident.

In fact, it often happens that when a sector consolidates, for whatever
reason (generally, the appearance of a new technology that requires a
greater MES), the suppliers to this sector see themselves pushed towards a
certain consolidation, to withstand the pressure of stronger buyers, as well
as respond to the business opportunity to serve the larger clients, who
frequently require larger suppliers. As we will see in Chapter 6, it is very
frequent for the internationalization of a sector to carry with it the interna-
tionalization of its suppliers, since clients often value a supplier that can
serve their needs in every country where they operate.

Changes in a sector can also induce a fragmentation in another. If the
cause for a high MES disappears, we will observe a fragmentation of the
sector. For example, the ubiquity of the Internet, together with the appear-
ance of innumerable companies that produce ‘turnkey’ software, has made
the MES of fund management lower, at least from the point of view of the
necessary investments in information technology. For this reason (together
with deregulation), entry of new competitors into the sector is constant,
frequently with just a few employees.

New Technologies and Strategic Logic

It is evident that technological changes alter the world: we only need to
think of our lifestyle, and compare it to that of just 25 or 50 years ago.
These cause important changes in the profitability of companies too, as we
are seeing. Occasionally, the change is drastic: old leaders disappear and newcomers become dominant. But, in most cases, the impact of technological change on profitability is subtle and indirect, as we have seen.

Henry Ford could not possibly have foreseen the impact of his innovation in the assembly of automobiles. It dramatically lowered the price of cars, making them popular, and thus changed for ever the economics of hundreds of different businesses. A whole world of tourism, superstores, second homes and so on was born out of this technology. Think also of the impact of inventions, such as electricity, that ended up permitting things as far from the mind of the inventors as computers or telecommunication satellites.

Trying to forecast the impact of such technological development leads to serious mistakes. The opinion became widespread in the United States in the 1950s that, with the popularization of television, universities would change radically. Indeed, who would pay to go to a second-class university when she could receive, directly and in the comfort of her own home, classes taught at Harvard, and all at a very low cost? At first glance, the argument looked solid, but the world did not go that way, since the university experience is much more than passively receiving a series of lectures. When, supported by a simplistic forecast of this type, companies get involved in heavy investments, the risk of significant loss is evident. The popularization of the Internet offers us an example very close to our time.

At the end of the 1990s, as connection to the Internet spread exponentially, it became evident that a new form of communication, with very special characteristics, was developing. Given the explosive growth of the network, many saw a possibility of launching new businesses, or reformulating old ones. The fact that Microsoft (of which we will speak later in the chapter) had had a financial success of historic dimensions was more than enough to attract enormous amounts of investment to the sector (it seems incredible, but €1,000 invested in 1983 had turned into more than €600,000 by the year 2000, as shown in Figure 3.3).

Many of those new businesses, however, did not really try to solve a real problem, but just to take advantage of a new technology to do something. Many years of experience show that starting with a heap of money and a vague idea of what to do with it, then to look for products and clients, almost never produces results. A business normally starts small, by someone who has an idea and begins to put it into practice and, after various trials, when he detects that the market ‘pulls’, it begins to grow. The reason that as a general rule you cannot begin ‘pushing’ but rather you have to look for the ‘pull’ rests on the fact that, as we said earlier, it is
practically impossible for human beings to foresee the impact of new technologies on activities relatively far from their own. Thus, many people stated that the appearance of video-recording machines would mean the end of cinemas; but that was not taking into account that what people really looked for when going to the cinema was not only to see a film, but to get out of the house, to meet friends and so on.

Just as serious as a bad technology forecast is the mistake of not taking into account strategic logic. It tells us that the profitability of a company will not depend, in the medium term, on the demand for its products, but on the market imperfections that make it difficult to satisfy that demand by a more or less unlimited number of competitors. Thus, there are businesses that have enjoyed excellent demand, but have ended just the same in bankruptcy. Netscape, a company to which we owe, to a great extent, the current success of the Internet, offers a good example.

In 1993, Marc Andreesen wrote, as part of his work as a student in the University of Illinois, a computer program called Mosaic. It allowed people to connect themselves to the Internet in a user-friendly and simple way. When Andreesen saw the incipient success of the program, he left the university and launched the program commercially under the name of Netscape. Success was tremendous, users grew at the rate of several million monthly, and the company entered the stock market only two years later, valued at more than $2 billion. Andreesen, at the age of 25, had a fortune estimated at $100 million. Four years later, AOL absorbed the company for $400 million (in inflated AOL stock, not in cash). A few
years later, practically nothing is left of Andreessen’s innovation. How is such a fall possible in a company that really had made the ‘Internet revolution’ possible?

The explanation, of course, is that profitability stems from entry barriers, not from innovation per se and there were no entry barriers to a program that did what the Netscape Navigator did. The Internet is based on common standards, and anyone with some moderate technical skill can write a ‘navigator’. In addition, if this ‘anyone’ is Microsoft, who does not want a start-up threatening its territory, and is literally willing to give away the equivalent program, Internet Explorer, the result is that it is impossible to earn money, innovation or no innovation. In this sense, the investors who believed they saw in Netscape the ‘next Microsoft’, being willing to pay very high prices for its stock, showed a total ignorance of strategic logic: to be the next Microsoft, a good product in an enormous, fast-growing market was not enough. It must also be protected by barriers to entry.

Once again we see the dichotomy between the creation of value (enormous, by the inventor of the navigator) and the capturing of this value by him (nil, since there are no entry barriers). This reasoning is what has to guide us when analysing a new business: it is fundamental, of course, to ask if there will be a demand for the new product. It is fundamental, but insufficient. If there are no entry barriers, success will be ephemeral, since the competitors will take care of lowering the margins to the point where profits disappear, regardless of how valuable the product may be for the buyers.

![Figure 3.4 Changes in the prices of Netscape stock](image-url)
A really useful new product will naturally enjoy strong growth at the beginning, even with no entry barriers, since demand grows faster than supply. During this time, the business will be profitable (as were the first video rental shops). When the growth phase ends, however, or a massive entry of competitors occurs, and the supply and the demand become balanced, profitability will slowly drop. In some cases, the drop can be pretty sudden, as mobile telephony companies have discovered, once the market becomes saturated.

Often, the first problem for the entrepreneur who wants to introduce a new product is to know whether there will be a demand for it. After all, if the product has a potential for profitability, because it is well protected by entry barriers, but no one buys it, the entrepreneur will not earn much money either. How do we forecast the volume of demand?

Most new technologies do not create a new business, but rather a substitute for the old way of doing things. Thus, the strategic impact of a new technology will depend on how it affects the market imperfections that protected the older way of doing things. And this impact can be important. Take the case of photography, which is more and more turning to digital. You do not have to be a genius to realize that the traditional business of Kodak is in danger, since every time someone buys a digital photographic camera, he or she is renouncing the future purchase of photographic paper and the products necessary for development, products on which Kodak has a high margin, supported by its patents and economies of scale (in fact, there are only two important competitors in the world, Kodak and Fuji, along with a few secondary actors).

Facing this ‘announced death’ of its main business by the invasion of a new technology, Kodak seems to have a straightforward strategic solution: get more and more into digital photography. This is indeed what Kodak has been doing for more than ten years, investing the important cash flow produced by its traditional operations in the new digital technologies. However, profits are not arriving and, in my opinion, never will. The reason is that the competitive structure of traditional (chemical) photography and that of digital photography (electronic) are very different, the second being much less attractive than the first.\(^5\)

Traditional photography is based on a fairly specific chemical technology, on which Kodak has an important number of patents and specialized knowledge, accumulated over more than 100 years. Moreover, not only research but also most production processes are subject to important economies of scale. To round up the situation, Kodak’s brand, advertised for a century, and its worldwide distribution reach are two more barriers that protect the company’s profits. A further positive for the manufac-
turers is that the price of the cameras is relatively unimportant compared with that of the consumables, such as photographic paper and developing products. Each person who buys a camera, no matter how inexpensive, ends up leaving a lot of money in Kodak’s till. For all these reasons, the business has traditionally been very profitable, with very little competition. Little by little, Kodak has been able to push the rest (Agfa, Ilford) that did not have its competitive advantages from the market. The only exception has been Fuji, which played its cards right, and it shares the market with Kodak. It does not seem as if a competitor could enter this business now.

This competitive structure, however, has nothing to do with the business of digital photography. To start with, there are no significant consumables: digital photos are taken with a digital camera, which does not use rolls of film, and are seen on the computer screen, without consuming anything. Some, perhaps, are printed on the printer, on paper that is much more normal than photographic paper and is not protected by entry barriers.

The technology of the cameras is also different, based on electronic light sensors, produced by several companies: all those that have significant capability in photo-electronics can manufacture them, and there are many. Finally, because we are dealing with a digital product, company brands such as Sony, Panasonic, Hewlett-Packard and so on come into play, as they have credibility with consumers in this area. In short, we find a business that will be structurally less profitable than that of traditional photography, since its entry barriers are lower and the degree of competition, logically, is higher.

This is why Kodak’s effort to transform itself into a digital photography company is headed for failure. Even if it succeeds (something that is still to be seen, of course), it will find that the business is not as profitable as the traditional one. And there is not much that it can do about it: the shift from chemistry to electronics is a technological change that destroys the profitability of the traditional photography business, just as the microcomputer destroyed the profitability of large computers. If IBM has become profitable today, it is not by selling PCs, but by doing other very different things. In short, it is a question of accepting strategic logic: the profitability of a company depends in the first place on the possibilities of singularization that exist in its business, and if these change (to become higher or lower), then profitability will change (to become better or worse).  

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6 Strategic Logic
From Evolution to Creation: Application of Strategic Logic to New Businesses

As we saw, many new businesses are in reality substitutes for others that already exist. This allows us, up to a certain point, to foresee future demand, but how do we apply strategic logic when the business is really new? As we said before, it is very difficult, not to say impossible, to know what the real demand will be: the world is full of stories of products or services launched with a public or a use in mind and ending up becoming popular in a totally unforeseen way (for example think of text messaging by mobile telephones (SMS) that was included in the service because the technology was there, but without any idea of how it would be used but which, after several years, has become enormously successful with young people). In these cases, it is reasonable to adopt a wait and see attitude, and look for surprises, instead of trying to confirm one’s own forecasts.

Total novelty is rare; since, in reality, something new almost always comes to be a substitute for something else, although it may look like a very different product. A graphic form of saying this is that, from 1998 onwards, the television channel that American children watch most is Nintendo. Of course, Nintendo is a games console, not a television channel. But from the point of view of its functionality, spending an hour watching cartoons or playing ‘Super Mario’ on the video console is exactly the same and any advertiser will certainly consider it to be so.

It is clear that if the business is totally new, that is, if it responds to a new need using a new technology, it will be difficult to make an accurate projection: by definition, we do not know the true demand, since no one has seen the product or service, although in the majority of cases parallels can be found. For example, no one knew how successful e-commerce would really be, but we did know that selling by catalogue has never reached more than a few percentage points of total retail sales. If people, in general, prefer to buy directly, for whatever reason (desire to touch the merchandise, immediate delivery, social interaction and so on), and most did not want to buy by telephone, it is highly unlikely that they’ll suddenly turn to the Internet.

The conclusion seems to be that, faced with a business that is difficult to predict, perhaps the most sensible attitude would be to stay attentive to its development, get ready to enter, but commit no large investments. This pragmatic focus has been contradicted, however, in recent years by two great myths of the new economy strategy which we are going to discuss now in detail: the so-called ‘early mover advantages’ and the network effect.
Early Mover Advantages (and Disadvantages)

The key justification for the huge cash-burning exercise that we have seen in the past few years in Internet companies, but applicable to other areas, is based on a relatively simple notion: what matters is being first. The reasoning, with all the strategic verbiage in use, seemed sound: so sound that it convinced millions of investors to throw billions into the pot of being first. It is, therefore, important to analyse what economists call early mover advantages.

Imagine an industry in which the economies of scale are so important that there is room for very few competitors. As we already know, this is a sector that, in principle, without other problems, should be profitable eventually, for it will be concentrated in a few competitors. When the sector is new, the ‘chosen ones’ have not been decided yet, unlike the automobile industry, which already has as many competitors as it can hold profitably (and then some). The problem is that many people know about this, which ensures plenty of entrants to an unconsolidated industry, ready to end up as one of those who stay when the music stops. What is the best way to ensure that we are one of the chosen? If it is impossible to maintain the differentiation in the product or service, because it is relatively easy to copy, the idea is to grow as fast as possible, then ‘go down’ the cost curve that we saw in Chapter 1 more rapidly than the competitors, and thus obtain lower costs while the volume is increasing. This cost advantage can then be used to set lower prices, which would help us to grow even more, thus lowering costs again and so on, until all other competitors have to abandon the sector, incapable of competing with our very low costs, which are the fruits of our great volume.

The argument is so sound that, if true, it implies a single rational strategy: at the starting point of the sector, it is better to set the price as if the costs had already gone down, that is, well below the initial costs, in order to set the virtuous circle in play. The inevitable initial losses will only be, in the end, part of the necessary investment to become one of the leaders of the new, highly profitable sector. Doing the opposite, that is, pretending that prices cover costs from the beginning, is only a show of cowardice or of little strategic vision, doomed to failure, since with this policy it will never attain the necessary volume in order to lower costs and be able to lead the sector.

Unfortunately, almost all the companies that have followed this rational strategy have lost money. This is for two important reasons. First, this strategy is just as rational for all competitors. If there is enough capital available to fund initial losses, everyone will follow it, and lowering prices
will not imply a lowering of costs, as it will not increase the volume of any competitor, since they all do the same. With well-financed companies and some exit barriers (specialized investments), the business can be ruinous for a long time, perhaps more than the financial backers are willing to tolerate. The idea is, in the end, that someone wins, when it remains alone. But, frequently, the final winner never recuperates the large initial losses. This is in the best of cases, that is, when the others leave. But if the economies of scale are not really significant enough to impede the presence of many competitors with similar costs (in terms of Chapter 1, the minimum efficient size is not very large compared with the total market), there will always be an abundant supply of competition and low margins.

Thus, while it is written in the business press that a sector that suffers from much competition will inevitably go through a shake-up period, in which the weak disappear, this is not true in many cases, either in theory or in practice. If the economies of scale are not significant, there is no reason why dozens, hundreds or thousands of competitors cannot coexist, as long as a technological change does not demand increased economies of scale, something that may never happen. In an industry of these characteristics, an investment in obtaining volume by lowering prices never receives its reward: costs do not go down as foreseen and competitors do not leave, thus making it impossible to recover the investment.

In fact, the accusation of dumping, frequently heard from companies that cannot stand more efficient competitors, does not fit our strategic logic: a competitor that sells below costs, to bankrupt the others, will only recuperate his losses if the entry barriers are such that, once the prices have gone up and he is earning a lot of money, new competitors cannot enter. But if they are high, the market was possibly already profitable and the dumping operation did not make much sense.

Being first has advantages (and is, therefore, worthy of investment) only when it bestows some sustainable competitive advantage. In those businesses with large economies of scale, it is evident that being first to develop a high volume establishes a solid cost position that will let the company survive the necessary consolidation and enjoy its fruits. But if this is not the case, it is much better to be second. In fact, by definition, we are speaking of new businesses in which, as we have seen, the degree of uncertainty about what the public really wants, what the best technologies are and so on is significant. In very few new businesses is the final leader the one who introduced the product: generally, it is the second or the third, which did not incur the development costs, the false starts and, if it is quick, can offer an improved product (with the experience suffered by the pioneer) before the entry barriers are raised.
There is, however, a case that has received much attention in the business press, and that does seem to give an enormous advantage to the first: the network effect.

The ‘Network Effect’: Towards the Natural Monopoly

We have already mentioned how Microsoft is a company which has created enormous wealth for its shareholders. It is important to understand why, and to try to extrapolate these reasons to other situations. To do this it is better, as usual, to use an example.

Imagine somebody decides to acquire a mobile telephone for the first time. He goes to the closest shop, and asks for one, without specifying a brand: he has no clear preference. Imagine also that the shopkeeper responds in the following manner: ‘Well, it is important that you decide what brand you want, since the telephones of each brand can only communicate with those of the same brand.’ Of course, we know that this is not the case, but let’s imagine that it is (there are many businesses, which we will discuss later, where this is indeed the case). Under these circumstances, most of us, after some surprise, would go, without doubt, for the bestselling brand. Of course, we would not discuss which telephone is smaller, which has a longer lasting battery, or even which is cheaper: an excellent and cheap telephone is not worth much if you can only talk to a few people.

If everyone answered, however, by asking for the bestselling brand, the result would be that in a very short time, the sector would be dominated by one company, precisely the one which, at the beginning, stood out from the rest, for whatever reason. Furthermore, it is clear that, once established, its position would be unassailable: almost no one will want to buy a telephone that does not allow talking to most users, no matter how inexpensive or technologically advanced it may be.

It is important to stress that a solid reason is not needed for the final leading company to stand out at the beginning. It could simply be by chance, or because at a certain moment, before the sector became consolidated, it hit on a characteristic that the public liked (although this characteristic was not sustainable and ended up being copied), or it received a large order from a ministry or whatever reason. Once a company stands out, however, if the telephones of each brand can only speak to those of the same brand, the market will converge on one, which will become the dominant company for good. This is what is called the network effect.
The reason is that there are products whose value for the buyer increases with the number of users. If I buy a Sony television, I am not doing a favour to any of the other users of Sony televisions, nor do I care how many use it. But if I buy a telephone under the conditions described above, I do favour other users of the same brand, since they have another possible contact, and I do indeed favour myself if I buy the phone that lets me talk to most people. In effect, one is not buying a telephone, but access to a network. Of course, to end with the example, we know that this is not the case in Europe, where the European Commission managed to get all the manufacturers to agree on a standard, GSM, so that all the telephones connect to each other. But this is not the case of personal computers.

If I buy a computer, normally it is to use programs and possibly to exchange data with other users. In both cases, I am interested in buying a computer whose operating system (which is the software that determines which programs can be used, and with which users it is possible to exchange data directly) is used by the maximum number of people. At the same time, the companies who develop the programs are interested in developing them so that they work under the most-used operating system. In short, the market converges quite quickly towards a situation of monopolistic domination, which is exactly what happened with computers, where Microsoft has more than 95% of the market share of operating systems.

It is interesting to observe how strong the entry barrier generated by the network effect is, since it generates the typical virtuous circle: the greater the market share of a certain operating system, the greater the interest of all the manufacturers of programs, peripherals and even computers in using it; and the more programs, peripherals and computers using the operating system, the more attractive it is for a new buyer, which reinforces the position of the leader. It is good to note that this does not have much to do with the intrinsic quality of the product: a mediocre operating system, used by everyone (that is, with many programs written for it and with many users whom to exchange information), is, in fact, better for the user than an operating system that may be superior from the technical point of view. In the same way, a heavy, expensive mobile telephone would be better than a lightweight, inexpensive one if the former permitted calling everyone and the latter only a few users. In a very simplified – but realistic – way, this is the story of Microsoft and Apple, which had an infinitely superior operating system to that of Microsoft nine years before (the Macintosh came out in 1984, while the first usable version of Windows came out in 1993). Apple has done nothing, however, but lose market share.

This network effect may arise in the most diverse sectors: think, for example, of any market. Why do all the furniture buyers go to the
Furniture Fair in Milan? Because they know that, as it is an important fair, all the manufacturers will be there. And why do the manufacturers go, in spite of how expensive it is to exhibit? Of course, because they know that all the buyers will be there. In principle, there is no problem in everyone going to another site that would be less expensive. But this would only happen if everyone agreed, something which is frankly improbable. In fact, if the management of the fair is good, it will use its capacity to generate profits to make sure that the fair functions well, which will make its position all the more solid. In addition, the advantages offered by the network effect usually bring about other advantages: as the company favoured by this effect grows, it can have access to economies of scale. To return to the example of Microsoft, its best protection is the network effect (the clients look for compatibility), but being much larger than its competitors also allows it to dedicate enormous sums to R&D, which its competitors cannot equal. In general, a competitive position based on the network effect is only lost by a radical change in technology, or after many years of very mediocre management.

Figure 3.5 shows three companies that benefit from the network effect: eBay (as we discussed in the Introduction), Pay-Pal and Monsterjobs. Pay-Pal proposes an on-line payment system (where, again, it is in the interest of all the participants to use just one system) and Monsterjobs is a site to announce employment opportunities. It is interesting to note, however, that in the case of the last two companies, the incentive for the users to

![Figure 3.5 Increase in users, in millions, of three companies with the network effect](source: The Economist, 23.2.2002)
have a single supplier is less than in the first. Thus, a single object can be auctioned (honestly) in only one place (in the same way that a seller only wants to go to a trade fair if he can find all the buyers there, since going to a fair is expensive), while putting the ad for finding personnel in more than one place is not very complicated. Consequently, the profitability of all these companies will be different, since the intensity of the network effect (the height of their entry barriers) is different.

This network effect is what many companies have sought by launching themselves into the Internet world, ready to lose money in order to establish their position. This only works, however, if the networks do not connect among themselves: to return to our example, given that any telephone can call any other, no company has this effect, so the competition between the different manufacturers has to be based on cost advantages and/or sustainable differentiation (which, by the way, are not easy to obtain, which is the reason the profitability of the sector dropped sharply once the demand began to be saturated). Furthermore, the network effect does not apply to the networks themselves, if they are connectable. Thus, a user of a minority mobile telephone company is not penalized, since with his telephone he can call the telephones of other networks. That is why the strategy of many airlines to grow at all costs, to offer their users a very wide network is quite debatable, since I can fly from Manchester to Frankfurt on British Airways, and in Frankfurt connect with no problem to the Lufthansa network to continue on to Shanghai. The fact that the second flight may or may not be operated by British Airways is irrelevant since the travel agency coordinates both flights and I can check in my baggage from my point of departure to my final destination. It is also important to note that almost all networks are interconnected, and for this reason they do not produce the desired network effect.

The network effect, which appeared unexpectedly in the world of personal computers, is now being sought systematically by some companies, at the same time as their potential clients try to avoid it through the adoption of public standards that impede the monopolization of the sector. Personally, I think it will be difficult to emulate Microsoft, although many companies are trying to do so precisely because of the vigilance of the buyers who do not want to find themselves in a similar situation.

**Evolving Strategies: the Erosion of Entry Barriers**

At the beginning of this chapter, we wondered how it was possible for some companies to have gained entry to sectors so well protected by entry
barriers as the automobile industry (Toyota is the most profitable of the mass-manufacturers in the world) or that of civil aviation, where Airbus has managed to grab 50% of the market against a rival, Boeing, which only a few years ago was five times larger. If we want to retain the structural (that is, stable) nature of the concept of entry barriers, we have to explain these cases, since they are cases in which the success of the new competitors is not due to a structural change in the sector, of the type discussed above, but to the fact that they really managed to jump over the barriers. We are not going to tell the history of these companies, but in almost all the cases of successful entry into a protected sector, there are some common elements that we will discuss now.

First, the ‘pretender’ usually attacks a segment of the market that is not very important for the already established leaders, since doing the opposite would invite a direct response from them. Thus, Toyota began in the segment of small, inexpensive cars, a segment in which the public is more sensitive to price and more willing to ignore the fact that the brand is unknown, if the price is right (as the Korean manufacturers do in Europe today). The leaders’ first reaction is one of curiosity, or even of some competitive response, but straightaway they realize that to fight in that terrain, with low margins, is not particularly interesting, and they tend to ignore the incoming company. The typical argument is ‘let’s leave them that segment, which is really not very profitable, and let’s concentrate on what earns money’.

The attacked segment is typically that of the least expensive products, in order to compensate for the lack of brand reputation. Either this, or a segment in which the established competitors are not very interested, such as motorcycles with small cylinder capacity in the case of Honda: the English and American manufacturers, such as Triumph and Harley Davidson, never considered that small 50cc mopeds were really their competition.

The next step consists of applying the competitive advantages that they develop in these first, uncontested segments to other areas of the business. Thus, Toyota began to reinvest its profits in advertising, making the public notice that its cars were not only inexpensive and fuel-efficient, but also were of an outstanding quality. Once the idea is accepted that the price is right and the quality excellent, it is only a question of time before they can sell more expensive cars. The endgame came with the introduction of the luxury brand Lexus, which entered the competition in the segment of luxury cars. Honda did something similar; it used economies of scale obtained with its motorcycles of small cylinder capacity to start manufacturing larger engines and even automobiles, always from the same
technological designs. Again, little by little, it obtained volume and brand recognition that, in the end, allowed it to confront the leaders directly. To do this it was necessary to begin in an almost unprotected segment, and the products had to evolve, so that the economies of scale obtained by manufacturing small engines were applicable to the manufacturing of the large ones. In this sense, it is very significant that from the beginning Honda manufactured 50cc motorcycles with four-cylinder engines instead of two-cylinder engines, as all its competitors did, because it wanted to manufacture cars, and to do this, four-cylinder technology is fundamental.

The entry of Airbus into the segment of jumbo jet-type planes can also be described in this way: instead of trying to design one directly, since, as we saw in Chapter 1, the size of the market would never have let it recuperate the enormous investment necessary, it used a policy of common elements in its models, which permitted it to make larger and larger planes, without each time having to invest the whole of the necessary funds for design. Twenty years after beginning this strategy, it can now attack the most profitable segment, that of the jumbo jets, where up to now Boeing has had the monopoly.

It is important to note that these strategies took many years (from ten to twenty) to bear fruit, which just goes to show that entry barriers are real and entry to a market protected by barriers is, in the short term, impossible. However, a sensible long-term strategy that combines a reasonable short-term profitability (necessary to survive so many years) with a slow but small improvement in the competitive position can end up being very profitable, since it is the only way to penetrate a well-protected market. The prize is important, since small family-run companies such as Honda or Toyota, or adventures in international collaboration such as Airbus, or many others, end up being solid companies with high profitability. When there are significant barriers, however, a frontal attack on the leaders cannot, by definition, be successful.

From Momentary Inspiration to Permanent Business

We have discussed various examples where a company begins to be successful with something that, although attractive, is copiable, and then it evolves towards a solid business. In many cases, the ideas of the entrepreneur are interesting but copiable. If so, the entrepreneur has two options: take advantage of the initial success to build sustainable advantages upon it or see the profitability of its business decline, as soon as the competitors copy it. As we saw, this is the case of companies such as The Body Shop
or Compaq, which began with an innovative idea that sold well but was copied by its competitors. If the company had developed other advantages (which implies that they can be developed, of course) before the imitation arrived, then we would have a story of medium/long-term success. If not, the success will be a ‘one-day bloom’.

As we have seen in this chapter, sectors evolve. This is why all companies, sooner or later, must develop new advantages to sustain their profitability, since the old ones, no matter how solid they may seem, end up being eroded. This is not easy: although many consultants (and professors), for obvious reasons, insist that the companies can change in order to transform themselves into something else, the reality is that this is very difficult, and the leading companies of an industry rarely maintain their leadership when the competitive basis changes drastically.

**Conclusion**

Although industries have structural characteristics that by definition do not change, the world does not stop turning. Sooner or later, even the basic structural characteristics of a business (the real possibilities for singularization) are altered. At that moment, the potential profitability changes and strategy must change drastically. Sooner or later, these changes occur, and this is the underlying reason that explains why in only a very few cases a company stays at the head of its sector for more than 30 or 40 years.

Changes can come on many fronts, and in this chapter we have underscored three as the most common motors of change: technology, legal regulation and demand characteristics. These are three areas that, although they do not change constantly for each business, have a demonstrated capacity for changing the rules of the game.

The key to being able to anticipate these changes well, and to prepare the company to take advantage of them, is to understand that the changes themselves affect the company’s profitability only as long as they affect the possibilities of singularization; and then they only modify the profitability of the affected activities, not the whole industry. Thus, we saw how an increase in oil prices can improve the profitability of the manufacturers of automobile components that have their own technology to reduce fuel consumption, without affecting too much, in the medium term, the profitability of manufacturers in general, contrary to what might be supposed. A technological change that does not modify the potential for singularization does not affect the profitability of the sector, apart from the discontinuity that it can create in the short term.
Another very important point is not to confuse growth with structural profitability. In effect, when the product or service is new and there is a strong demand, all participants tend to earn money, since demand exceeds supply. But if there are no entry barriers, supply will not take long to reach demand, and profitability will greatly decline. This phenomenon of ‘maturing’ provokes serious strategic errors in companies that, seeing the profitability of a certain product, decide to enter the competition, only to realize that they have arrived late, and the business suffers significant deterioration of margins. Of course, if there are factors that favour uniqueness (economies of scale, network effects and so on), some of the competitors will continue to be profitable once growth disappears. This is why it is essential to understand what the ultimate source of observed profitability is: pure growth effect, or the existence of factors that protect uniqueness. Strategy must be very different in each case.

A solid strategy that maintains the acquired profitability or leads us to the desired profitability involves knowing what is going to happen: knowing the competitive structure of the sector today is only interesting as long as it helps us to understand that of tomorrow, since strategy has to look ahead. Once the structure of uniqueness is ‘solidified’, there is not much that can be done to change it. In Chapter 8 we will see in detail some ideas for developing specific strategies, but all of them depend on a clear understanding of how the changes in the environment (technological, legal, demand) affect the possibilities of singularization of the business.

In short, we can formally state that the capacity of singularization of a sector rests on the variance that is found between the quality and the costs of the participants. If the variance is very small (all competitors have more or less the same costs and the same quality), profits will be small, as we saw in the first chapter. If variance is large, the potential for benefits will be greater, because buyers will be willing to pay more for that which is objectively better, or low-cost competitors will enjoy higher margins, even selling at average prices.

Notes

1. Of course, a government can decide to continue buying from its national champion, for protectionist reasons. The products of such a champion will, however, be more expensive than those available on the open market, which will cause all the economy of the country to suffer by having more expensive telecommunications than those of other countries.

2. An excellent description of the problems that IBM had in adjusting its business model in face of the arrival of the personal computer is found in *Big Blues: The Unmaking of IBM*, by Paul Carroll, New York: Crown Publishers, 1993. In addition to being an interesting story, the case permits a good appraisal of all the problems of the impact of a technological change on a leading company.
3. Clayton M. Christensen analysed in detail this phenomenon by which a technological advance can destroy the profitability of a business, by giving the product (and its competitors) a quality such that even the ‘simplest’ competitor provides a higher quality than that which the market asks for. See Clayton M. Christensen, The Innovator’s Dilemma: When New Technologies Cause Great Firms to Fail, Boston: Harvard Business School Press, 1997.

4. The government has announced a change in legislation for next year, but financial industry associations are lobbying hard to maintain the status quo.

5. See, for example, ‘Kodak In the Noose’, Fortune, 4.2.2002.

6. There is a part of the digital photography business that is indeed very profitable: that of the printers. Its profitability, however, comes precisely from the high entry barriers (especially technological and in volume of manufacturing) that cause Kodak not to be able to find a position for itself in this business.

7. We do not consider the possible effect of an increase in the overall demand due to the drop in price (elasticity of demand), since the greater volume rarely compensates for the decrease in margins.

8. It is curious to note that, in 1985, Microsoft still did not know the great profitability that the network effect could provide. In a letter dated in that year, Bill Gates recommended to John Sculley, President of Apple, that he sell his operating system to the public in general, for use in IBM-type computers. Gates feared that Apple would disappear; and he would not be able to continue selling word processors and spreadsheets for Apple users, which constituted his most profitable business at that moment. Of course, such advice went against the interests of Microsoft in the business of operating systems, but Gates, apparently, had not yet realized what enormous profitability this business would end up having. See Apple: The Inside Story of Intrigue, Egomania, and Business Blunders. J. Carlton, New York: Random House, 1997.
PART II

An Analysis of Company Development
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Chapter 2 made it clear that the key element in strategic analysis is the activity, not the company as a whole, since the characteristics of the activities are what determine the potential for profit. However, we have seen many examples of how the directors of different companies commit strategic errors by not thinking in these terms. The reason, of course, is that management is not used to thinking in terms of activities, but rather in terms of company: their professional performance is measured by the results of the whole company. But in fact, all companies include many distinct activities in their daily tasks, as we have seen, and the division of activities is very far from being evident, since they do not show up with a label: think about the restaurant owner in Chapter 2 who is really in two completely distinct businesses, running a restaurant and property investment, without knowing it, and is exposed to committing serious strategic errors as a consequence of his ignorance.

The decision as to which activities the company carries out and which it does not is essential to understanding the profitability of the company, as we have also seen. In this chapter we are going to analyse how these decisions are made and, above all, how they should be made: when a company should carry out an activity and when it should leave it to a supplier or a client. That is, we will analyse the decisions of vertical integration, which make up what the company is and determine its profit potential. If, as we have said, all companies carry out various different activities internally, that is, they are in fact integrated, we should make an effort to see how that integration fits (or does not fit) strategic logic.
Why Companies Integrate

‘This component is too important to assign to someone else: it is better that we do it ourselves.’ This statement, which is relatively common, describes vertical integration: ownership, by the company itself, of the means necessary to carry out different activities. For example, a paper manufacturer integrates when it buys and exploits forests from which it obtains the wood necessary to manufacture the cellulose; or a textile manufacturer integrates when it open stores through which it will sell its products to the final consumer. A completely unintegrated company would consist, possibly, of a single person, working in an (rented) office, connecting buyers and sellers. Although some businesses are similar to this (estate agents, for example), frequently they are not. Vertical integration is, therefore, in practice, inseparable from the actual company.

On the other hand, a company cannot be totally integrated, as it always ends up buying something outside. Even a company like Inditex, which sells clothing through its own stores with the brand Zara, uses many external companies in the making of the garments, and does not usually buy, but rents the premises from which it operates (thus avoiding being in the property business). The transportation companies it uses are of course external to the group, as are the providers of the services necessary to successfully manage its enterprise, from consultants to cleaning services.

Companies decide which activities to carry out based on a series of reasons. One can be that the company does not find an adequate supplier, for reasons of quality or volume. Another can simply be a desire to grow: incapable of increasing sales because competitors make it difficult, the company decides to add more value by beginning to do something itself that it used to buy, or selling directly to the final buyer, skipping the distributor (or, more exactly, playing the role of the distributor, and this distinction is very important, because the activity of distribution does not disappear: the only difference is that now another company does it, which is the same as the one that manufactures the product). In this way, the company grows, in terms of employees, invested capital, sales margins and so on, although the number of units of product sold remains constant. This is a way of growing without having to beat the competitors. Finally, another reason for integrating can be the desire to keep secret the method of manufacturing something, which would have to be communicated to an external supplier, compromising perhaps important information in competitive terms.

In any case, what is important is not so much why the companies integrate, but rather in which cases the integration follows strategic logic: can we, thanks to integration, make something better or less expensively than
our competitors? We have already seen, in Chapters 1 and 2, how the profit-
ability of different activities rests on the fact that they can be carried out in a way that is especially inexpensive or attractive for the clients, by only some competitors. Any activity that does not have these characteristics, that is, cannot be carried out better without the immediate risk of being copied, will not be profitable in the long term. In order to analyse the suit-
ability of a vertical integration decision, we have to turn to a similar test: does the fact of carrying out two activities within the same company decrease costs or increase the quality perceived by the clients? If it does, then integration will create value for the company (the integration itself will be a source of benefits). Otherwise, it will surely bring about a series of problems that we will analyse in the following pages, since the profit-
ability of the company will be identical to, in the best of cases, the sum of the profitability of the different activities: integration in itself does not add anything, it does not create value. Therefore, we have to understand why, in some cases, putting together two or more activities can make their joint costs decrease (or increase their attraction for the clients), and those in which it does not. Because it is important, we will begin by clarifying some very common errors.

The Great Fallacy of Vertical Integration: Elimination of the Intermediary

Vertical integration is frequently presented as a means of improving margins, based on absorbing the supplier’s margin (or the distributor’s): if I do it myself, I keep their margin. Frequently, statements of this type are heard: ‘I (manufacturer) sell to the distributor at €100, and he sells to the consumer at €130. If I sell directly, skipping the intermediary, I can sell at €120, be more competitive, and improve my margin.’ This statement is not only frequent, but profoundly erroneous and, therefore, dangerous for the financial health of the company. Let’s look at a simple example.

Take the case of a company that manufactures fabric for home deco-
ration, which is normally sold through retailers, who sell the product to the final consumer. To simplify, let’s say that the manufacturer sells directly to the stores, and that the costs and prices are those shown in Table 4.1. It appears that there is a lot of money to gain between the manufacturer and the final consumer, and that the manufacturer has an opportunity to open its own stores and sell directly to the public. If he does, for each metre of fabric he will earn his €15, plus the €20 of the margin that the store now keeps, thus having a margin that is more than double the previous one. Or
even better, it could pass part of the new margin on to the final clients, and sell at €65. In this way, besides gaining €30 per metre of fabric, he would increase his sales, by having a more competitive final price. The logic appears clear: margins and competitiveness improve by eliminating the intermediary. However, this is totally erroneous logic.

The problem with this argument is taking the joint margin of the two activities and seeing it from the point of view of just one. The manufacturer, with the mentality of a manufacturer, thinks that just covering costs in selling is enough, since what is important is to protect and reinforce the manufacturing business. Once he starts selling directly, however, the manufacturer is as much a retailer as a manufacturer, and if the profitability of the retail activity is low, the profitability of the overall company will suffer. What happens to the profitability of the stores if we lower the selling price from €70 to €65? It will fall sharply, as it implies a reduction in the margin from €20 to €15, that is, of 25%.

The store’s wide margin does not mean that it earns a lot of money. Profitability is not based only on the margin, but also on the volume and the investment made. So that our textile manufacturer can access the margins of the store, it must invest in the stores, either starting from zero, or buying a distribution chain. In both cases, there is an investment that must be made profitable. If the prices go down, the low profitability of the investment in the stores will depress the overall profitability of the company. If the prices do not go down, there will be no special advantage for the factory.

What happens is that the company embarks on a new business (retail selling), which can be profitable, or not. If it is not profitable, it is not a good idea to enter: besides having a factory with some problems, we would be investing our capital in a business that is not very profitable. If, on the other hand, profitability is high, we can be sure, by the strategic logic developed in the preceding chapters, that it will be protected by high barriers to entry, which means entrance will be necessarily much more expensive or less successful than foreseen. In any case, it is fundamental

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| Table 4.1 Costs, prices and margins for an integrated manufacturer/distributor |
|---------------------------------|-----------------|-----------------|-----------------|
| **Purchase price** | **Cost** | **Margin** | **Selling price** |
| Manufacturer | 10* | 10 | 15 | 35 |
| Store | 35 | 15 | 20 | 70 |

*raw materials
to understand one point: *the fact that one company is the owner of two links in the chain does not improve, in itself, the profitability of any of those links and, therefore, does not improve the profitability of the company*. Only if there were some additional advantage, as we will see later, in having a common owner would the integration be a source of benefits. But a company cannot earn money based on ‘buying’ its client, and then make him establish advantageous relations for the activity of the factory: everything that one gains, the other loses. Or to put it more simply: you cannot earn money selling to yourself, since what you earn on one hand you lose with the other. This erroneous logic is observed in those retailers who affirm that they can sell at prices lower than the competition because they themselves are manufacturers, so that they save the margin that a manufacturer would take (or the one that a seller would take). If the company actually carries out both activities, it needs both margins in order to be able to subsist (although, for publicity reasons, it can be a good argument, because a considerable portion of the public believes it). It is impossible to manage two businesses (manufacturing and selling) with just one margin, and have acceptable profitability. The fact that one produces (or distributes) to itself increases the margin, but it also increases the investment, so that we do not know, a priori, if profitability improves or not. If the margin is very high in relation to the investment, then the business is interesting. But strategic logic tells us that if the margin is very good with respect to the investment, that is, the profitability is high, the competitors will not wait long to lower the margin: or there are high entry barriers that impede us from capturing the margin that the suppliers (or distributors) now take.

To conclude, we can state once again that only if carrying out the two activities within the same company produces some additional advantage will vertical integration make economic sense. The simple accumulation of activities is equivalent in the end to diversification, as we will see later, but with all the risks of staying in the same industry. In addition, the company that integrates takes on a series of problems, almost all of them poorly understood, as we will discuss below.

**The Logic of Industry Disintegration**

Before we embark on a detailed discussion of when a company should strive for integration, we must analyse a phenomenon that is spreading to ever more industries. As usual, we shall see it in a specific example, and generalize from it afterwards.
As we saw in the previous chapter, the computer industry was dominated from its beginning until the 1980s by a few large companies: IBM, Sperry, Burroughs, Bull, ICL, Siemens, Fujitsu, Hitachi and a few more. A common characteristic of all these companies was their vertical integration. They used to sell complete systems to their clients: the computer itself, its complements (printers, storage units and so on), all the basic software (the operating system and middleware) plus a large number of the software programs that actually did the job (inventory control, payroll and so on). The hardware was manufactured internally by the company, based on proprietary designs for everything, with a high R&D content. Each manufacturer would design its own CPUs, storage systems and so on. Computers were, of course, incompatible with each other, in the sense that the different components would only work within the manufacturer’s systems. Each manufacturer offered unique solutions, designed, manufactured and distributed by itself. Figure 4.1 shows a simplified representation of this situation.

With the arrival of personal computers, the new players continued applying the same business model: Apple, for instance, would design the whole computer, with its own operating system and unique solutions (they would buy more parts outside than IBM, for their much smaller size did not allow them to make the more size-intensive parts in-house). And the traditional players, such as Digital Equipment, Sperry or IBM, when

![Figure 4.1 Vertical industry organization](image-url)
launching their PCs, followed the same pattern. The only difference was that, the launch of these machines being urgent, so as not to let the new entrants establish themselves too well, they decided to buy some components on the open market, such as the CPU or the operating system. But the idea was that each company would continue selling their own complete systems (for instance, they all came with printers from the manufacturer, even if in some cases the actual manufacture of the printers was subcontracted, and offered application programs to deal with basic tasks).

This is not what happened. The industry resembles more that shown by Figure 4.2. We have gone from an industry organized in ‘vertical silos’ to one organized in ‘vertical strata’.

A vertical organization implies that the company must do everything in-house. It has two advantages, one for the buyer and one for the seller. The advantage for the customer is that products tend to work very well with each other and the system is reliable. For the manufacturer, the system has the enormous advantage of forcing customers to keep buying from them, once they have bought the first system. As we saw in Chapter 1, switching costs are so important that margins may go very high without attracting competition. However, these two advantages (for the buyer and for the seller) are overshadowed by the massive value creation that a horizontal system represents for the customer. Let us see why.

In a vertical organization, each company must reinvent the wheel, with the attendant R&D expenses. Let’s remember that R&D costs, very high in

![Diagram of Horizontal Industry Organization]

**Figure 4.2** Horizontal industry organization
this sector, are fixed, and thus subject to economies of scale: the more CPUs we manufacture of a given design, the cheaper that design will be on a unit basis. Fragmenting R&D has a serious impact on costs, and the switching costs we discussed earlier make sure that those R&D costs can be passed along to the buyer. It all boils down to an industry with high costs, high margins and high prices. Innovation slows down because it is expensive, and because it might alter the competitive equilibrium, highly favourable to the manufacturers. Innovations would always be gradual, and always ‘backwards compatible’, that is, making sure that the old software systems (the root of the switching costs) would be left in place. It is telling that the radical innovations, such as the minicomputer or the personal computer, were always introduced by new players, who had no vested interests in the previous technologies.

In a ‘horizontal’ industry, things are very different. Activities in which economies of scale are important tend to concentrate in very few producers, getting to the point of becoming monopolistic, when this is the natural economic result, as is the case in operating systems. Switching costs disappear (except for the monopolistic activities, of course), which drives up rivalry. As a result, margins and costs decrease. IBM, which is perhaps the only historic player with acceptable profitability, today employs less than half the employees it had in 1980 (having sharply increased its sales). Those companies that could not adapt have either disappeared or plod along as marginal players, still protected by switching costs. Unisys (created out of the merger of Sperry and Burroughs), for instance, still has some meaningful business with airlines, for the very complex systems that control worldwide airline reservations were written to work on Sperry computers many years ago.

A horizontal industry allows specialization by activity. The integrated company of vertical industries must carry out many heterogeneous activities, such as R&D (on different things), assembly, logistics and so on. The horizontal company can basically work on one thing. The net result is lower prices and a higher rate of integration: compare the technological and economic progress in personal computers to that in mainframes. Even the least profitable activities can spawn viable business if they are carried out by specialized companies, with the appropriate cost position.4

A similar evolution can be found in the automobile sector. From the famous Ford factory near the River Rouge, where trains loaded with iron ore and coal entered at one end and left loaded with cars at the other, to the current situation, the process has been one of disintegration, and the industry looks pretty much like that depicted in Figure 4.2. Of course, there are a number of companies that design, assemble and market cars.
Making the parts, however, is increasingly left to specialized manufacturers. In the most advanced factories, the suppliers themselves physically produce full modules next to the final assembly line. Porsche, not being big enough to do everything itself, is concentrating more and more on design and marketing, and has subcontracted the assembly of its Boxster model to Vahlmet of Finland and the whole manufacturing process of its Cayenne model to Volkswagen. More and more, the industry resembles that of personal computers and less and less that of the old mainframes. Something similar is happening in industries as different as airplane construction or electronics. Wherever some activities call for large economies of scale, there is a strong tendency to ‘stratification’.

This phenomenon is, naturally, highly worrying for the well-placed companies in vertical industries: a vertical company is, in fact, diversified into many activities, some of them highly profitable. If the industry goes horizontal and the company must specialize in a given activity, it runs the risk of being left outside the profitable activities, as has happened in personal computers and is happening in the automobile sector, where some highly specialized suppliers of unique parts are much more profitable than the car-makers themselves. In the following pages we will discuss how a company can avoid this risk, although we can already say that it won’t be an easy task.

The Reality of Entry Barriers in Vertical Integration Decisions

The comparison of vertical integration with diversification is appropriate, for each activity in a sector is, indeed, a different business, in the sense that the technology, the optimum size, the opportunities for differentiation and so on are almost always completely different, as we discussed extensively in Chapter 2.

Here we clearly see the fundamental objection to vertical integration, in the context of strategic logic, which has already been implicitly mentioned in previous paragraphs: vertically integrating implies having to confront the entry barriers that protect all businesses. If these are low, the business (the activity) cannot be profitable and integration will provoke a decrease in the average profitability of the company (although the margin goes up, the investment will go up even more). If, on the other hand, the activity is profitable (the supplier or the distributor whose activity is absorbed is consistently profitable), we can be sure, as strategic logic tells us, that there will be very serious entry barriers to the business which will deny profitability for anyone else who wants to enter. Of course, compa-
nies usually offer arguments such as ‘we know the market’ or ‘we have a captive clientele’. But this does not change the basic reality: if the activity is profitable, it will be because carrying it out efficiently will be difficult, the technology is complicated, the necessary volume is very large or for any of the reasons analysed in Chapter 1. Besides, as we will see in Chapter 6, the company that diversifies not only has the problem of overcoming the entry barriers, but also its own inexperience in the business. In the case of vertical integration, the fact that the company seems to remain in the same sector means even more mistakes are made, as the managers of the company can think that they know the new activity, when in reality they have never managed it in the past.

Two reasons – the integrating company’s inexperience in the new activity, plus all the efficiencies commanded by the usual supplier, which normally produces for various clients – explain why, in fact, the prices of the external supplier are almost always lower than the costs of the company that integrates. Only if the supplier has enormous margins can we expect that the costs of the company that decides to integrate will be lower than the prices of the supplier. But, as we already know, if the margins are enormous, it is precisely because no company, whether potential competitors or buyers who want to integrate, can perform the activity in question: the simplest strategic logic tells us that, if it were so easy, the margins would already be much lower. Put it another way: if we can start performing the activity with the same efficiency as the habitual supplier, it is very probable that others could also do so. Most probably, they already have. Perhaps the product in question is relatively recent, there are still few suppliers and the margin is high. If, however, there are no barriers to entry (as is shown by the fact that we can integrate without ‘penalty’), other suppliers will enter, lowering the margin in the medium term, as we saw in Chapter 1. We would then find that we have integrated an activity which was effectively profitable but which, shortly after entering it, loses profitability, for other suppliers begin to offer prices close to our costs: as in every profitable activity that is not protected, competition quickly erodes margins. In this case, we would find that we had expanded the company with an unprofitable activity, which requires effort, attention and involves risk, as it is new for us.

In spite of these inconveniences, we have seen that all companies of a certain size are, with very few exceptions, quite integrated. How can we explain this? One reason is that almost all of these companies have grown around an activity that, for some of the reasons analysed in Chapter 1, enjoys sustainable profitability, and this profitability ‘subsidizes’ the entrance to other activities in which the company is not, and not even close
to being, profitable. The problem is that this strategic error is not seen immediately, because it takes time to appear.

**Why Vertical Integration Usually Decreases the Efficiency of the Company in the Long Term**

Up to now we have seen some of the reasons why vertical integration may not be a good idea to start with. Now we are going to analyse a series of *dynamic problems* that afflict integrated companies over time: why vertical integration, even in those cases in which it can have a certain strategic sense, very frequently ends up sapping the profitability of the enterprise in the long term.

**Size**

The first way to lose efficiency is to carry out the activity with less efficiency than the habitual supplier (or distributor). This can easily occur because the company does not have enough volume to use all possible economies of scale. If this is the case, the company finds itself with an unpleasant alternative: either manufacture for itself, with a lower than optimum volume and, therefore, with higher costs than those of the competition, which is being supplied by a supplier of optimum size; or manufacture all that is necessary to reach the optimum size, and sell the ‘excess’ that it does not need. This second option, however, presents evident problems: in most cases, its potential clients will be its competitors, unless the activity in question produces something that can be sold in a very different sector. Maintaining this supplier/client relationship with competitors is something that can be done (some sectors have been functioning in this way for a long time), but it is not easy, especially when you have to start anew.

**‘Spillover Effect’**

Another reason for inefficiency is what we can call the ‘spillover effect’. As we have seen, many companies integrate, for whatever reason, when they already have a certain volume, which is the fruit of a relatively protected and, therefore, profitable activity. However, in almost all companies, higher-than-average profitability usually generates certain excesses in costs, whether in better working conditions, prestige invest-
ments such as luxurious central offices, social expenses such as cultural patronage and so on. All of them may be reasonable, since the company in fact has margins that are higher than normal, as a result of the protected competitive position that it has been able to develop. (Less positive, but also frequent, and within the same logic, there is usually an excessive growth in unproductive internal bureaucracy.)

The problem for a company that integrates is that, although it gets into activities with little profit, it usually carries with it extra costs, stemming, in a way, from the profitability of its original activities. This is reasonable since it is very difficult to direct a company in which the general level of costs varies substantially according to the activity to which each part of the company is dedicated. To continue with some of the examples that we saw in Chapter 2, it is very improbable that if Microsoft decides to start printing its own brochures, its printing would be at a very low cost. It has a tradition of great profitability in its traditional activities, which leads to some costs being higher than those strictly necessary (that is, compared to what they would be if the margins of the company barely covered its opportunity costs; as we saw in Chapter 1, this is the case of all companies in a perfectly competitive market).

All this has a disturbing implication: the mediocre activities of an integrated company will possibly be less profitable, systematically, than if they were carried out outside the company, since there is a ‘contagion’ or ‘spillover’ of high costs from the truly profitable activities. This ensures a certain competitive handicap for the successful company, by taking on activities in which, in fact, it loses money. While its main activity continues being very profitable, the situation is sustainable, although it would be better to reinvest in the main activity the money and effort lost in other activities. If one day, however, for any of the reasons discussed in Chapter 3, profitability is weakened, the company finds itself in a very difficult situation. In short, in a vertically integrated company, the cost level of an activity can be determined by the profitability structure of another.

Cultural Heterogeneity

It is not only a question of cost level. Frequently, the historically dominant activity of the company tends to impose its culture on the rest. To return once more to an example from Chapter 2, let’s think for a moment of a company such as Apple. If we want to have a unit that develops top quality software, we need a company culture that attracts and supports creative
individuals, with somewhat unstructured work habits and a very independent approach. If, at the same time, we want to assemble computers efficiently, we need a unit with a culture close to the military spirit, sober and disciplined. Of course, it is not impossible to combine both but it is very difficult. What usually happens is either the first culture imposes itself, making the costs of the second unit explode; or, on the other hand, it creates an atmosphere that can only deliver mediocre results in the departments that need creativity.

All this leads the integrated company to develop a certain inefficiency, aggravated by the amount of managerial personnel needed to coordinate all the activities, who normally do no more than defend the status quo. This situation leads many companies to realize, suddenly, that controlling the entire chain, which they considered to be a competitive edge, can rapidly become a serious disadvantage. Having to confront a strong bureaucracy, resistant to change, plus a lack of in-depth understanding of the profitability structure of the different parts of the company, as we saw in Chapter 2, are both recipes for trouble.

Increase in Operational Risk, Decrease in Flexibility

An evident practical problem is that all integration increases the fixed costs with respect to the variable ones, since we go from being supplied externally (or distributing through third parties, in the case of downwards vertical integration) to manufacturing ourselves, which always requires fixed investments. This implies a greater operational risk, since every decrease in activity will be accompanied by a more than proportional decrease in profitability.

This lack of flexibility is aggravated because a company normally ties itself to a specific technology at the time of integrating in order to produce something. If a company buys outside, and new technology appears that provides lower costs or better quality, a company can go to those suppliers that adopt this technology. But if it has decided to integrate, it will have to choose between getting rid of a suddenly obsolete means of production, or accepting another source of inefficiency. For this reason, vertical integration makes more sense in very mature markets, where it is not probable that the technology will change suddenly. Nevertheless, the risk exists and changes occur sooner or later in almost all sectors. When an important technological change occurs, the integrated companies especially are again ill prepared to adapt to it.
Loss of Real Control

Another reason for which efficiency can diminish in the long term is that in many vertically integrated companies we find ourselves with ‘internal monopolies’. Clearly, the company competes in the market with its products, but it can have entire internal divisions that are isolated from the pressure of competition, since they ‘sell’ their production to a captive client, that is, to other divisions of the company. At first, this situation can be efficient, since it avoids marketing expenses, both for the buyer and the seller. In the long term, however, it develops all the characteristics typical of monopolies: the managers in charge of these internal monopolies can end up developing an attitude similar to that of the directors of any monopoly, where efficiency and service are not the fundamental objectives, but rather fulfilling a production quota, or even the preservation of the status quo in general. Monopolies do not tend to be innovative, since they do not have much to gain and have much to lose. The threat, relatively frequent, that buying units are ‘free’ to purchase externally is credible in very few cases.

All this causes a lack of effective control in the activities that we have integrated. This is highly paradoxical, since one of the classic reasons in favour of integration is, as we saw at the beginning, the control, whether of quality, cost or supply. But the reality is that it is much easier to control an external supplier than an internal unit of the company. The threat of substitution, even implicit, is very clear in the relationship with a supplier, and non-existent inside the company, except in extreme cases. Of course, the threat of substitution is not effective against a monopolist supplier. But strategic logic indicates that a monopolist supplier guards his monopoly thanks to very high entry barriers, which the company that wants to integrate cannot, in principle, overcome. To avoid the problems that arise when facing oligopolistic suppliers, it is usually better to increase the number of suppliers than to integrate vertically. The number of suppliers can perhaps be increased by offering a long-term contract to a company that produces a product similar to the one that interests us, which could be turned into a reliable supplier; or by importing a company from another country that is experienced in the production of the product in question.

In general, an internal division has fewer incentives for producing efficiently than an external supplier. In order to align better the incentives, companies often establish complex transfer pricing systems that, besides adding costs (all the work necessary to design and maintain the systems), generate another long-term inefficiency: the switching of management
attention towards internal discussion of transfer prices, which are very important for their individual results but absolutely irrelevant for the company’s.

Vertical Integration and Learning

Another problem, particularly insidious as it only shows up in the long term, is that learning can be difficult for the vertically integrated company. It is well known that the most frequent sources of innovation for a company are its suppliers and its clients, and an integrated company distances itself from them in order to concentrate on itself. Although at the time of integration, the chosen technology will normally be state of the art, time passes and without the creative drive from the outside world, it can become progressively obsolete. This ends up in what has been called the ‘not invented here’ syndrome: the more protected departments inside the company usually try to have things done their way, thus protecting their raison d’être, without worrying if the wheel has already been invented somewhere else.

When Vertical Integration Can Make Sense

The above problems are numerous and, above all, important, for many of them really go against the essence of what makes a company profitable. However, this does not mean that vertical integration is always a mistake. There are cases in which it can make sense. We have already said that if carrying out two activities in the same company can decrease costs or improve differentiation, it will be a source of value. We shall now analyse those cases in which vertical integration can have a real impact on costs or differentiation.

Decrease in Costs for Technological Reasons

Imagine a manufacturer of steel that, among other things, smelts iron ore in a blast furnace to make steel and then hot rolls the steel to make sheet metal. The steel is produced in a blast furnace, a process that, in itself, is totally different from that of laminating steel, which is done on a lamination line: it requires a different installation, and the minimum efficient size is different, much larger in the case of the furnace than the lamination line.
In principle, strategic logic tells us that there is no reason that a steelworks could not limit itself to smelting the iron ore and selling it in ingots to other companies which would laminate it. If it did this, however, the laminating company would have to heat the ingots before laminating them (there is a process of cold lamination, but it is used to produce steel sheets of a different quality) and heating the steel ingots until they are red hot in order to laminate them is very expensive. An integrated company could laminate the steel as it came out of the blast furnace, before it cooled, and thus obtain lower costs in lamination that those of a non-integrated company (to this we can add the savings in intermediate transporting of the ingots). It is important to note that, in this case, a total savings is produced. We are not talking, as in the example of the textile manufacturer who starts distributing, of saving margins, but rather of making a costly activity disappear: transporting and heating the steel before lamination.

This example, frequent in manuals of microeconomy, shows well how there can be a technological advantage in vertical integration: occasionally, the fact that two activities are carried out together can lessen the overall cost of both. This also occurs when a company designs and manufactures its products, where being capable of creating a design that is easy to produce implies having profound knowledge of manufacturing. Or, when offering a unique product to the client implies knowing not only their needs but also what can be manufactured and what cannot. The company could, of course, specialize in one activity and subcontract the other, but perhaps it would then miss the chance to develop the knowledge necessary to carry out the activity as efficiently as an integrated company.

But let’s repeat again: it is not a question of lowering costs because we avoid the margins of the supplier (we have already seen that that is absurd, since by integrating we become the suppliers and our profitability would suffer without margins), but rather of making some element of overall cost disappear. Only if some costly activity disappears by being integrated can we state that the integration reduces the costs of the company.5

**Vertical Integration in Order to Obtain or Defend a Solid Competitive Position**

Being integrated can be useful in order to defend a key activity of a company. Take the example of a company that uses its own technology in a very important and profitable activity. It could happen that by subcon-
tracting the necessary pieces for this activity, it would have to explain in
detail its technology to an external supplier, with the risk that this supplier
could end up becoming a competitor or passing the information on to other
clients, our competitors. Something similar could be said of the sales
activity, which may require detailed knowledge of the secret technology of
what we are selling. In these conditions, it is also better to develop the
secondary activity, although in itself it may not be especially profitable, in
order to protect the extraordinary profitability of the main activity.

Vertical integration can be used not only as a ‘defence’ but also as an
‘attack’, that is, not only to protect the profitability of an activity, but to
increase it. For example, a company may decide to manufacture a compo-
nent in order to obtain the minimum necessary volume in the manufac-
turing of another component that it wants to make at all costs. This would
make sense if the volumes of both components can be added, from a tech-
nological point of view (they share the same cost curve). Or, integration
may try to ensure the total quality of the product. As we saw before, this is
not automatic: in many cases, it is much easier to obtain the desired quality
from a good supplier (or, better, from two or three), than from an internal
unit. If, however, the quality of many of the parts depends on the same
technology that the company possesses in a relatively exclusive fashion,
integration would make sense. This is the case of some luxury watch-
making companies (although the majority end up subcontracting the very
specialized parts, because they can’t justify the volume). This strategy is
also being applied more and more in the textile sector, in which the manu-
facturers that want to differentiate their products through a brand with
great personality prefer to sell their garments in their own stores, where
they can ensure that the service and the atmosphere are consistent with the
brand. Moreover, in this way they can obtain sales data in real time that
they can use later to manufacture and distribute in a much more efficient
way than a competitor that sells through wholesalers and retailers and has
only a distant knowledge of what is going on in the market.

Vertical integration can also be used as a learning tool. In some cases,
in order to carry out one activity well, it is important to have in-depth
knowledge of another one, as in the case of design and manufacturing,
basic technology and sales or when knowing the technology that is
implicit in a component can facilitate its utilization. McDonald’s, whose
basic strategy is not owning the restaurants but being a franchiser, owns
some restaurants in order to learn first hand what the problems of the
activity are, which is fundamental in order to be able to train the fran-
chisees later.
Vertical Integration to Lower Transaction Costs

Lastly, vertical integration can save money when the relationship between the buyer and the supplier is especially costly. Sometimes, it is expensive to maintain the flow of information between the buyer and the supplier, perhaps because there is a lot of fast changing information, it is highly sensitive or difficult to transmit. In these cases, integration would save a lot of the necessary transaction costs. If working with a supplier implies constant changes in the specifications, joint training, contacts on many levels and so on, a company can reach the conclusion that it is easier to integrate and absorb the supplier.

Thus there are three main reasons that vertical integration can be profitable: a decrease in costs for technological reasons (if the joint performance of two activities lowers their total costs); protection of a profitable activity, or learning about it; and the lowering of transactions costs. In most other cases, not integrating will probably be the best strategy. However, in order to have a complete idea of the problem, we should also analyse the problems that disintegration can bring about. We will now discuss this, and at the end of the chapter we will try to give some general ideas on how to make this type of decision correctly.

The Apparent Solution: Subcontract

The problems associated with vertical integration that we have just discussed are well known to the companies that experience them, although in some cases they are noticed too late. In the past few years this awareness has produced an important movement towards disintegration. This movement has adopted many forms, such as:

- the total separation of complete divisions, which are launched as a new company (Tabacalera, the old Spanish tobacco monopoly, and its logistics division, which is now an independent, quoted company called Logista, for example)

- the sale of units to suppliers, who take charge of them and continue working for the mother company, as an external unit (this is common in high-tech and consumer goods, where even Sony has sold some of its factories to specialized companies that use these factories to produce exclusively for Sony)
outsourcing, in which a company ceases to carry out an operation and subcontracts it to another company, which frequently takes charge of at least part of the personnel and the assets, as most companies have done with their cafeterias or cleaning services and some have with their information systems departments

simply closing units and using external suppliers.

In fact, in the past few years, a new kind of company has developed which specializes in just manufacturing for others. Thus, not even computer assemblers assemble that much any more: Sanmina SCI assembles for IBM and Hewlett-Packard and Solectron for Apple. Sony, Philips, Microsoft, Alcatel, Ericsson and many other electronic companies are now subcontracting a large part of their manufacturing operations to companies such as Flextronics, Solectron or Celestica. These companies are profitable, even if their activity is not particularly profitable, because they have very low costs, thanks to their single-minded pursuit of efficiency. Profitability is not enormous (after all, the business is not particularly attractive) but acceptable, something that the integrated manufacturers such as IBM or Sony could never achieve in their manufacturing operations for the reasons we have just discussed.

Logically, this restructuring solves the problems linked to vertical integration, since the company is not integrated any more. But, where it has advantages for the company, allowing it to concentrate on some activities of strategic interest and obtaining good inputs from outside, subcontracting, in the broad sense of no longer carrying out some activities of the chain, also has its specific problems. In the following pages we will deal with some of the more important ones.

Risk of Being Copied

We have already mentioned how subcontracting an activity can imply the communication of much information to the supplier, in order for them to be able to carry out their work in good conditions. The problem is that this information can be confidential, or can imply teaching the supplier to do something that no one else knows how to do. Once the supplier has acquired this knowledge, it can be used for other clients, who are of course competitors. Linked to this is the risk that the supplier, having acquired this knowledge, ends up taking the place of the subcontracting company. Take the case of a manufacturer who decides to launch a new product,
with its own brand, and in order to do so quickly, decides to subcontract production to a supplier. If the manufacturing of the product in question is not particularly profitable, because there are no great economies of scale or production difficulties of any sort that permit a differentiated quality, subcontracting is possibly a good idea. Imagine, however, that the product is new and the quality demanded by the market is not easy to achieve. The company works with the supplier until the desired quality is reached. At first, everything goes well for the marketing company: its product is unique (no one has yet achieved the quality that it offers) and a good brand and a powerful distribution network support it, but what will happen in the long term? If the product is really difficult to manufacture, the supplier that is producing it will probably improve its position to the point that it is truly unique in the activity of manufacturing. Once this point is reached, it is only a question of time before the supplier translates this singularity into profitability. It could achieve this by selling to other marketers or raising its prices, since it is the only one who can manufacture with the desired quality. In some cases, the supplier could even go into the business of selling directly to the consumer, supported by its unique quality. In all these cases, the profitability of the company that designed and helped to launch the product will be hurt.

We have already seen this example in Chapter 2, when IBM assigned the operating system of its new PC to Microsoft and the microprocessor to Intel. It has also happened to many consumer goods companies, where Western companies began subcontracting the manufacture of some of their simpler products to Japanese or Korean companies, even helping them to improve the quality of their production processes, only to end up seeing them become feared competitors.

Subcontract the ‘Wrong’ Activity

In essence, we can characterize this problem not only as the appropriation by the supplier of the competitive advantage, but also as an error, at the time, of judging the attraction of different activities. In effect, the manufacturer who subcontracts does so because the cost is low, compared to what it would cost to manufacture the product itself; and that the marketing margin is good, since otherwise the manufacturer would not bother to work with the product. But those are today’s static data. It is possible that, in the medium term, the attractiveness of an activity could change, either because the one who manufactures is favoured by an important ‘experience curve’, whereby the product becomes better and better, thanks to the accumulated
volume; or because the technology improves with practice. It could also be because there is a network effect, in which the final consumer wants to buy a product with the component manufactured by the same subcontractor, regardless of who the marketing company is (as we saw in the case of personal computers, where consumers first buy a given operating system, only later choosing the computer manufacturer that actually resells the operating system). In any of these cases, an apparently unprofitable activity ends up being the most profitable of the chain, and the company that ceded it to a subcontractor is, simply, guilty of not having been capable of foreseeing this evolution: IBM always believed that its brand, distribution network and economies of scale in purchasing components would protect the profitability of its personal computer business, without noting that its competitors could end up using the same operating system and that this fact alone would take value from its brand and transfer that value to the producer (exclusive, not copiable) of the operating system. In other words, the differentiation, for a computer, went from carrying one brand or another to using one operating system or another. The marketing (branding) activity loses profitability, and the one making the operating systems gains it.

This dynamic consideration is essential when deciding whether to subcontract something or not. If the manufacturing of the product in question is a determinant of a unique quality, or can be in the medium term, subcontracting the activity will be ‘exporting profitability’. If, on the other hand, we reach the conclusion that the manufacture does not require a special singularity, and that various suppliers are capable of obtaining the same quality/price ratio in a short time, subcontracting can be the appropriate step.

Loss of Contact with Clients and Suppliers: When Innovation Comes through Contact

A company that systematically subcontracts ‘upstream’ (that is, buys all its components) can find itself lacking direct contact with the base technology of the products it sells, making differentiating itself difficult: we saw in Chapter 2 how, in the majority of cases, the differentiation is not in the assembly but in some specific component. Besides, activities are sometimes interconnected and, as we have seen, it is difficult to design a product well if you do not know how it is manufactured.

Similarly, a company that subcontracts everything ‘downstream’, and sells everything through distributors, can find itself distanced from the consumer, and may be reduced to manufacturing the products that its
distributors indicate, without being really capable of manufacturing something that the final consumer can consider different.

In short, it is a question of valuing the importance that vertical integration can have in learning. ‘Learning by doing’ is often a reality: there are some things that are difficult to do (therefore, potentially profitable) that are only learned with practice. Besides, what you learn in one activity may be very pertinent in executing another well. In these cases, participating in both activities can result in greater profitability, through lower costs or differentiated products.

**Some Guidelines for Making Decisions on Vertical Integration**

As we can see, there are advantages and disadvantages and the risk of making the wrong decision is serious, since the inconveniences are at the same time important and not very evident. In any case, we can state that vertical integration follows strategic logic only when carrying out distinct activities in a company signifies a decrease in costs or a clear improvement for the client. Although, as we have seen, this is a lot less frequent than many managers think and has associated costs, it can be very useful in some cases.

In this sense, the following questions should be considered before making a decision on vertical integration.

**What Authentic Advantages are we Looking For? What is the Strategic Logic?**

It may seem obvious, but in the first place we should clarify what it is we are looking for. In other words, we should make the strategic logic explicit. If there are no real cost savings (not because ‘it is cheaper than buying outside’); no activities are eliminated; no new clear competitive advantages, such as improvements in the speed of transaction, the introduction in technological areas considered important for the future or protection of confidential information that the company needs to save, then integration does not follow strategic logic.

Very frequently, the decision to ‘buy or make’ is made as a pure short-term cost problem: companies analyse how much it would cost to make the product, look for the best possible price (internal or external) and decide on the less expensive. This is correct, of course, in the short term, but it does not take into account the evolution that the activity will have.
This is important, since in many cases the decision to integrate will require a series of investments that make it irreversible at least for several years.

We have already mentioned how the price that a supplier charges at a certain time may not be a good reason to decide about vertical integration. We should look at the profitability of the business in the long term. In this sense, an activity that has characteristics of long-term profitability (difficulty of some sort in being carried out) can be interesting, if our entrance is realistic. Otherwise, we may be leaving the future profitability of the entire business in the hands of a supplier. Conversely, starting to carry out an activity because the external price is high (the margin is good), when perhaps in the medium term that activity will become barely profitable (since it has no entry barriers and other suppliers will begin to compete and lower the price), can burden the company with a structurally unprofitable investment. In short, it is a question of going beyond the static consideration of a comparison of costs and evaluating the decision for what it is: entering, or not, a given business. This decision has to adapt to strategic logic: it is a good idea to enter the business if it offers good future profitability, which implies that it is protected by some type of barrier (of course, we must be able to enter it without too much of a penalty). If these barriers do not exist, the investment will not be a good one in the long term, although in the short term it may appear that we are saving money by not buying from an external supplier.

What New Costs will Vertical Integration Create and How Can we Minimize Them?

The fact that there may be a good reason for vertical integration does not necessarily mean that it is positive. As we have seen, decisions for vertical integration very frequently have a negative impact on the efficiency of a company in the medium term, from the creation of internal monopolies, with a consequent loss of incentives, to the increased risk of having technological innovation copied by external suppliers. It is important to be aware of these problems and, in case a company decides that the advantages outweigh the inconveniences, make an explicit effort to lessen them.

A method that can be used sometimes which contributes to minimizing the costs of vertical integration is the practice called ‘tapered integration’. Basically, it consists of carrying out the new activity in a volume lower than that needed by the company, so that it has to continue being supplied externally. This has the advantage of not creating an internal monopoly since, by design, the new unit will always have to suffer comparison with
external suppliers. Of course, there is always the risk of some lack of incentive, since the internal unit knows that it has sold its production, but the comparison with the external supplier is so immediate and clear that it is easy to enforce a certain level of exigence. Being exposed to the external supplier will also ease the task of staying up to date technologically and, in case of important changes, the company will at least be in a position to know that the changes are occurring before it is too late.

Unfortunately, this technique is only applicable in a few cases, since it requires the volume of operations of the company to be way above the minimum efficient size of the activity, so that it can produce its needs at optimum volume, and purchase its excess needs externally. If these needs are not sufficiently large, the internal costs will be too high and the penalty in efficiency too serious. Often a company does not have such a high volume, but integration is interesting for other reasons. An example in which this would be the case, as already mentioned, is a chain of franchises (McDonald’s or Benetton) that decides to have some stores of their own. Also in this category is the car manufacturer that decides to manufacture part of its needs of a certain part, whose technology it considers important to know, but where the volume is so large that, after making the part at efficient volume, it still has to buy some parts externally.

When tapered integration is not possible, because integrating with the appropriate volume requires producing all the needs of the company, other means are needed to reduce the negative effects of integration discussed in the first part of this chapter. Consequently, you have to be up to date on external suppliers’ prices, and perhaps establish a systematic programme of ‘benchmarking’: discovering the efficiency attained by others in their internal processes has been a big surprise for many companies. In the same way, it is essential to understand that the business, once integrated, is a collection of activities, without favouring some at the cost of others. Finally, companies must constantly reconsider whether the benefits of vertical integration are being produced or not, and respond with frankness to the question of what real advantages are being obtained from carrying out an activity internally, instead of subcontracting it, beyond the pure increase in volume of operations.

An Emerging Solution: ‘Strategic Networks’

All through this chapter we have seen how vertical integration is plagued with problems, and we have explained the current trend of concentrating on a few activities in the chain. However, an apparently opposite phenom-
enon is occurring, which is very interesting: the popularity of a type of organization that we can call the ‘strategic network’. Almost all companies can learn something useful from this system.6

Think about a company like McDonald’s. As everyone knows, McDonald’s is not the owner of the great majority of the restaurants that carry its brand, but rather it is the franchiser, that is, it designs the product, the image, the publicity, even the methodology of preparing the food, but then it leaves the ownership (and, with it, the management) of the restaurants to independent businesspeople, the franchisees. McDonald’s charges a franchise fee (a percentage of sales), in exchange for giving the franchisee all the technology needed to operate the business, as well as important marketing and advertising support: it is not the same to open an independent restaurant as one with the best known brand in its sector.

In the terms discussed in this chapter, we could ask ourselves if McDonald’s is an integrated company or not. And the answer is not obvious. From a legal point of view, McDonald’s is not integrated, since it possesses few assets and carries out only a few activities: basically, R&D, marketing and business development. External companies carry out everything operational, such as production of raw materials, cooking, client service and so on, whether they are suppliers or franchisees. However, the integration of management is total: from its central offices in the United States, McDonald’s decides, for the entire world, everything from the exact variety of potato necessary to make the French fries to the colour of the uniforms of the personnel in the stores, including the specialized equipment and precise methodology of cooking its products. In this sense, it is a much more integrated company than any other in its sector (any other that does not imitate its system, of course).

Companies distinguish more and more between the ownership of the activities and their control. McDonald’s does not possess most of the units that in fact carry out the activities of the chain, but it does coordinate them carefully. This gives the advantages of vertical integration (overall design of the entire chain, quality assurance, efficiency between different activities, cross-training between some activities and others), without suffering the inconveniences (lack of motivation, size imbalances, technological stagnation). If McDonald’s were integrated, it would be very difficult to maintain some restaurants in good condition, since it is well known that, in this type of business, only the close proximity of the owner can ensure good service. But if it were not integrated (that is, the different restaurants were simply independent restaurants), it would not have the necessary volume to advertise or invest in technology. Expressed in the terms of the preceding chapters, the complete business system comprises activities whose efficient size
is very distinct: small for the restaurant, large for marketing. Pure integra-
tion is very problematic and disintegration makes it lose opportunities.

The strategic network, which combines the characteristics of integra-
tion and those of disintegration, is spreading to ever more sectors: as long
as there is a great heterogeneity in the activities, but some advantages of
coordination, it is a useful formula. Thus, we see how the textile sector is
advancing in this direction (Benetton, Lacoste, H&M, Gap, Zara) leaving
behind the model in which the manufacturer just makes the clothing,
which is sold through independent channels. These new competitors are
not, however, as integrated as they may appear to the public: a very impor-
tant part of garment production is subcontracted, as is the running of many
stores. Thus, the companies obtain economies of scale wherever they are
found (advertising, design, logistics) and avoid the diseconomies in the
rest (production).

Generalizing even more, we could include here all types of agreements
between suppliers and buyers that go beyond a pure external relationship
of client/supplier. For example, many companies are starting to be
supplied under long-term contracts, with prices determined for the dura-
tion of the contract, including contingencies, even in some cases with
‘open book’ policies. This sometimes leads to joint ventures or combined
enterprises, as many Japanese car-makers have been doing for years with
their suppliers. In reality, these are simply halfway solutions between inte-
gration and subcontracting, which can contribute to optimizing the
management of the system.

Of course, this way of doing business does not represent, in itself, a
sustainable competitive advantage, for it can be copied. In fact, the orga-
nizing principle behind McDonald’s network can be found today in
hundreds of companies, many of them its direct competitors. But as we
said in Chapter 1, there are organizational solutions that are hard to copy
(such as Toyota’s production techniques, Dell’s direct approach or
Easyjet’s low-cost system). The company that develops this organizational
form first has a precious time lead, during which it can develop other
advantages. Anybody can copy McDonald’s system now, but its brand,
technology and economies of scale, built up over the years, are strong
barriers that protect its profitability.7

Conclusion

As we said at the beginning of this chapter, the decisions taken around
vertical integration are absolutely crucial for the profitability of a
company, because they determine in reality to what it is dedicated, because each activity is, although it may not seem like it, a completely distinct business from the others. The special difficulty in making such decisions is that many of the problems that may occur only appear in the long term. Logically, these decisions are made in a way that, at first, seems reasonable. But problems such as the creation of internal monopolies, sacrificing the profitability of one activity so that another appears more profitable, or, in the case of disintegration, the loss of contact with technology or the needs of the clients are, nevertheless, very real, although they appear only in the long term.

However, strategic logic points out a problem that is often not considered: if an activity is profitable, it will be thanks to its protection by entry barriers, which means a company will not enter it easily. If it can enter, the profitability in the medium term is more than doubtful, since other companies could also enter, reducing current profitability. And this argument is applicable ex ante. Only if the company has some reason why it would be more profitable than others in the new activity (that is, its barriers to entry would be lower than average) will vertical integration make sense.

Finally, in some cases, there is the possibility of choosing ‘intermediate routes’, in which the relationship between the two activities is not one of common property or total independence, but rather a situation that tries to obtain the best of both worlds. This is not easy, but experience shows that when a company finds the way to do it, it usually obtains an additional competitive advantage that does not come strictly from any of the activities but from the way they are coordinated. If this is so, its competitors will be forced little by little to follow the new method (thus reducing in the medium term, as usual, the profits to the inventor), until the entire sector adopts the new formula. This has already occurred in the fast-food restaurant business, and it is rapidly happening in clothing. And it will come in other sectors such as the food industry, in which there are more and more long-term agreements between producers of raw materials and food preparers, or even in the financial services sector. In all these cases, a company coordinates and integrates the majority of the chain’s activities, but the ownership of them remains independent. I think that this is a model that will be extended to other areas, as companies find appropriate ways to do it.

Notes
1. Economists speak of ‘vertical integration’ when an enterprise integrates within itself various activities that follow each other in the production chain. It is a relatively new
phenomenon, since traditional production systems (watchmaking, textiles) were usually made up (they still are) of a series of independent, specialized companies, each one concentrating on one step of the process. Vertical integration appeared in the United States approximately 100 years ago, and reached its first popular expression in the Ford Motor Co. Economists speak of ‘upstream integration’ when the company eliminates a supplier; and supplies itself; ‘downstream integration’ consists, for an assembler, of going into distribution, or for a manufacturer of parts going into assembly; that is, beginning to carry out operations that are nearer to the final client.

2. To be precise, we must note that towards the end of this period, the Japanese manufacturers (and some Western ones too, such as Ahmdal or Siemens) started offering large computers compatible with those from IBM. But even in this case, practically all the hardware was designed and manufactured in-house, as was the software responsible for the compatibility.

3. Andy Grove, Chairman of Intel, one of the companies that, together with Microsoft, has profited most from this change, analyses the issue in detail in Andrew S. Grove, Only the Paranoid Survive, New York: Doubleday, 1996.

4. See, for instance, ‘Circuit Boards Generate Serious Profits’, Financial Times, 8.5.2001. Although not extraordinarily profitable, companies specializing in assembling electronic equipment under contract, such as Flextronics or Solectron, mentioned below, have enjoyed strong growth and adequate returns.

5. Strictly speaking, the argument that we developed does not require vertical integration, but rather the physical contiguity between the two activities: these could be carried out by distinct companies, one being the owner of the blast furnace, the other the owner of the lamination line. But, in practice, this would be a very complex situation, since both companies put themselves completely in the hands of the other. To avoid this situation, it is better that both activities belong to the same company, as we indicate later, when discussing transaction costs.


7. In fact, McDonald’s was not the first fast-food company to operate a franchise network: Kentucky Fried Chicken was.
Globalization is a complex and well-publicized phenomenon that leads to constant declarations and frequent actions and whose correct interpretation requires a strong dose of strategic logic. Declarations abound of the type ‘in order to succeed, a company needs global scope’. Furthermore, important actions follow those statements: in the year 2000 alone, the investments of companies in countries other than their own totalled more than a thousand billion dollars. In that same year, non-British companies invested more than £84 billion in Britain. These are not just macroeconomic statistics: behind these figures, there are hundreds of individual decisions made by companies to invest their resources, always scarce, in establishing operations beyond their borders. It is important, therefore, to understand what the strategic implications of the phenomenon known as ‘globalization’ are. To do this, it may be useful to start with a simple definition, since the meaning of the term varies enormously according to who uses it. In fact, it is interesting to observe that the meaning of the term ‘globalization’ is charged with very different connotations in different countries.

In France, *mondialisation* means that there is a culture (Anglo-Saxon) which is prevailing, sweeping away in its path valuable local particularities, while multinational companies try to impose their law on everyone, passing over the authority of legally constituted governments. From this point of view, globalization is a phenomenon that must be resisted or, at least, viewed with suspicion and kept under control.

When a Japanese speaks of the importance of globalization (*gurobaruka*), however, he is possibly stressing how important it is for Japanese companies to abandon their closed culture and open themselves to Western ways.
Finally, when a person from the United States speaks of globalization, he is possibly thinking that it is time for everyone to speak English and understand baseball metaphors.

If it means anything, globalization means the progressive interpenetration of world economies, that is, that companies act increasingly in countries other than their own, whether as buyers, sellers or investors. This increase in interrelations is very real, as Figure 5.1 shows. In recent years exports as well as direct investments in foreign countries have grown more rapidly than economic activity in general. This implies that the proportion of goods and services that, in each country, either come from outside the country or are produced by a subsidiary of a foreign company is increasing all the time.

Once again, these figures are only the statistical summary of specific enterprise realities, such as the software industry in India which supplies American and European companies with made-to-order programs, the development of the Moroccan textile industry, as a subcontractor of well-known European companies or, more simply, the almost universal presence of some brands, such as Coca-Cola, Nike, Adidas or Kit-Kat.

It is important, however, to put this increase in internationalization of the economy in perspective, because, from the media claims, it would seem that the entire economy is globalized, yet this is far from being the case. This caution is important because globalization is not an external phenomenon like glaciation or the changing seasons of the year, but rather the result of the individual decisions taken by thousands of companies all over the world. If the impression that one has of globalization, and its

![Figure 5.1 Growth in world exports, foreign investment and world GNP](image)

Source: UNCTAD, World Investment Report, 2001
causes, is incorrect, companies can make serious mistakes. Figure 5.2 shows that, although they have increased recently, exports are not as high as many people think, since they represent a relatively small percentage of the economic activity of advanced countries.

Besides, international activity is not so global: in fact, advanced countries export and import basically to other advanced countries and, within these, to nearby countries. Contrary to what one may think by reading the press, the main competitors of a British company are, almost always, other British companies. In the few cases where this is not so, their competitors are European companies; very rarely are they American or Japanese companies and almost never companies from developing countries. These are the facts. Even in supposedly globalized sectors, such as telecommunications, we find ourselves with this local competition: the main competitors of Vodafone in Britain are mmO2 and Orange and in the rest of the countries where they compete, their competitors are local. The fact that some of these competitors may, in turn, belong to the same multinational company (such as Orange to France Telecom) is relatively secondary and does not change the characteristics of the competition (in fact, Orange passed to France Telecom after becoming the main competitor to Vodafone in Britain).

Even more important, profitability, which is what really matters here, is not clearly linked to internationalization: as we will see later, there are many industries in which the most profitable companies are precisely those that have decided to concentrate on their local market, leaving international ventures to others. In short, the focus that strategic logic suggests
is not accepting globalization as a given, to which one must respond by internationalizing a company’s operations, but of carefully studying what are the structural changes that are occurring, if they are occurring, and how to take advantage of them in order to improve the profitability of the company.¹

**Globalization and Strategic Logic**

Once again, we return to our basic principle of strategic logic: everything a company does should be directed towards lowering its costs or improving its prices (in the most sustainable way possible). How does international strategy fit into this context? What does internationalization have to do with the competitive position of a company? What impact can selling in France have on the costs (or prices) of a German company? Let’s begin, as always, with a simplified analysis which will give us a solid basis to tackle later on the real, complex questions that all managers face.

As we saw in Chapter 1, every company has a cost curve that, frequently, is descending, as Figure 5.3 shows. Let’s consider here the complete costs, that is, R&D, supplies, distribution, marketing and so on. The reason it decreases is that, to a greater or lesser extent, there are usually some economies of scale, although we know that in some cases these may not be significant. The graph shows the complete cost of producing and selling a unit of the product or service of the company, according to the volume that it reaches.

![Figure 5.3 Cost curve when there are economies of scale](image-url)

¹ This is a reference to a note or source that is not provided in the text. It indicates that the idea about global strategy is not taken for granted and requires careful consideration of structural changes and how to leverage them. This approach is often associated with the concept of strategic logic, which emphasizes strategies that aim to reduce costs or improve prices in a sustainable manner. The text discusses how globalization can be managed strategically to enhance a company's competitive position by lowering costs or improving prices, addressing questions about the impact of international sales on costs and prices, and providing a simplified analysis to tackle complex real-world managers face.
Consequently, the company shown in this graph is interested in reaching a volume of production of a million tons/year, in order to have competitive costs. But markets are not infinitely large and, frequently, if a company wants to produce a greater quantity, in order to lower its unit cost, it will have to sell outside the original area of influence, since this area will not absorb any more of the product. The company that begins to have some success and wants to grow, often finds that it has to move to a nearby city to sell and then to another, as the market becomes saturated. Selling far away, however, has its own costs: transportation, in the first place (for physical products); but also other costs, less direct but no less real: adaptation of the product to different tastes (with its costs of R&D and perhaps added costs in production); supervision of activities that are farther and farther away and so on. These costs, less objective than those of transportation, are no less real, and are often much more important. For example, very few food and clothing retailers have really succeeded outside their country of origin, in spite of their heavy investments. According to some studies, the main reason is that the inhabitants of different countries have different purchasing criteria, which are difficult for retailers to perceive. Frequently, they put emphasis on what they have learned is important in their home market (low price, a large selection or good service), but they are not able to connect with their new customers, who look for other things.2

This increase in costs because of distance is reflected in Figure 5.4, which shows an ascending cost curve: the farther away we go to sell, the more expensive it is for us. But in the presence of economies of scale, costs go down with the additional volume, so there is an optimum situation, represented in Figure 5.5, which is just the sum of the two cost

Figure 5.4 Ascending cost curve, for the costs of distance effects
curves: the descending curve of production, and the ascending curve of selling at a distance. This optimum shows us what the natural playing field is for a certain business.

Returning to our basic notion from Chapter 1 of the minimum efficient size, imagine that the cost curve of a brick factory, determined by the technology of production, is like that of Figure 5.5. According to this line, it seems that a brick factory should have a minimum production of 5,000 to obtain maximum efficiency. If producing 5,000, however, implies having to sell the bricks far away, since the local market is not large enough to absorb them, then the costs of distance must be added to the costs of production. Given that transporting bricks is very expensive, it is perfectly possible that the optimum real size of the factory is not what the pure technology of production indicates, but a much lower one, which takes into account all the costs (3,500 in this example). In fact, a London company that wanted to sell bricks in Scotland would fail: although the additional sales could lower overall production costs, the costs of distance would be so high that the net result would be negative. In reality, we do not find multinational, or even national, brick companies: they are local. The case of tiles, however, is different. Economies of scale are much more important and the costs of transportation less, given the greater intrinsic value of the merchandise. As a result, we do see companies with national and even international coverage, especially in the high price range, where the high prices minimize the relative cost of transportation.

This example, which is very simple but realistic, contains almost the entire analysis of globalization’s impact on strategy, from the point of view of costs. As we have already said, we can quickly see that this impact

![Figure 5.5 Total cost curve, taking into account costs of production and distance](image-url)
will vary greatly among businesses: where economies of scale in production are very significant, and the costs of distance (transportation, adaptation, management and so on) are small, we will see companies with global reach, as the manufacturing of passenger airplanes can be. When the economies of scale are moderate and costs of distance high, we will see local, or at the most, national companies. In this sense, it is very significant to reflect on the banking sector, which it is customary to state is moving towards European integration. In my opinion, this is a totally gratuitous statement: a bank does not have economies of scale in a retail business beyond the size of a large country, and it has serious costs of distance. For many years to come (until one of the two cost curves and, therefore, the optimum changes), basically we will see national banks, with the exception of the investment banking division (where there are economies of scale) and those small and culturally similar countries (such as Benelux or Scandinavia), where the efficient size may be higher than the country and, at the same time, the costs of distance are moderate. This, of course, does not mean that there will not be trans-European mergers: they may indeed happen, since the pressures for them to take place are significant, as we will see in Chapter 7, but they will be a failure. The profitability of such operations will be negative: if two European retail banks from different countries merge, their joint profitability will be less than if they had not merged. Unfortunately, this type of operation occurs constantly, as we shall see, but this does not make it less erroneous.

![Figure 5.6](image)

**Figure 5.6** Different MES with regard to the size of the market determine the natural scope of the business.
In graphic terms (see Figure 5.6): if the optimum size that results from merging the cost curves of production and distance is smaller than the national market, we will have industries dominated by purely national companies (or even more local, as in the brick industry). If that optimum size is greater than the national market, we will move to Continental businesses, such as the automobile industry. Only where the optimum is really large will we go to strictly global sectors, such as airplanes, already mentioned, or microprocessors.

From the point of view of a company, all this implies that if its size is already at the optimum, it does not have to concern itself with globalization. If it is less, however, then it is imperative that it grows, and growing implies going farther away, possibly to other countries. In this case, and only in this case, internationalization becomes a life or death imperative. Internationalization that is not based on this strategic analysis can be very expensive, since the company will incur the costs of distance without obtaining an advantage that compensates for them. In intrinsically local markets, a local company is almost always more efficient, since expanding is expensive, and distracts the management from the main business, without reciprocal benefits. Of course, the basic reason for trying to expand is to continue growing but, as we have said and will repeat in detail in the next chapters, this ‘logic of growth’ is often radically opposed to strategic logic.

**Strategy for the Internationalization Process**

After setting the conceptual basis, it is time to turn to the question, how should the company go about its internationalization? To which countries should it go? Does it buy a local company, or start from scratch? Go alone or with a local partner? And so on. The previous pages should have made it clear, however, that the overriding question is, in fact, should the company really go international? That the press speaks as if it were absolutely imperative is not a reason, as we have just seen. In fact, in all those sectors where internationalization is not appropriate, the most profitable companies are those that do not try it, from retail banking to food distribution, to the construction of infrastructures. Only by understanding well the reasons why internationalization is convenient in each case can it be done rationally, that is, with reasonable expectations for profitability. Otherwise, the company embarks on an authentic international adventure, in which it does not really know what it is looking for, so it will be hard to use the appropriate resources.
Characteristics of Businesses that Demand Internationalization

We have already seen, from a theoretical point of view, in which cases internationalization is logical: when the decline in production costs more than compensates for the increase in distance costs. Let us consider in a little more detail what is hidden behind these wide concepts.

In the first place, as we have already indicated, internationalization is important when the minimum efficient size is very large in relation to the size of the total market of the country in which the company is established (and the distance costs, of course, are not very high). In fact, the effort to create the Single European Market is based, from an economic point of view, on this idea: European companies are not competitive (do not have sufficiently low costs) because they cannot reach the minimum efficient size due to the high distance costs inside Europe. If those costs are eliminated (or reduced to the minimum), companies could grow and reach that size. This idea, which makes clear sense, has been backed up by reality. First, many artificial barriers to intra-European commerce have been eliminated, such as obstructionist national standards, red tape, paperwork and so on. Then, deregulation of transportation has made it much cheaper to send goods across the Continent. Finally, the costs of operating in different currencies (both administrative and financial) have disappeared for much of the European Union with the introduction of the common currency. The net result has been that, in a very short time, commerce between the countries of the EU has shot up, which is, once again, the statistical and macro-economic way of saying that more and more European companies have gone international, with evident success in aggregate terms for the European economy.3

The first case, then, in which internationalization makes sense is when these three conditions are met: the local market is saturated; there are still available economies of scale (that is, a greater volume will generate lower costs); and the costs of internationalization are less than the savings in production costs.

Operating in several countries can also contribute to lowering the risk of the company: instead of diversification by products, we have geographical diversification. Although this argument is exposed to the general criticism of diversification that we will see in the next chapter, it can have important advantages. Imagine, for example, a company that manufactures and sells lifts. The primary business is closely linked to that of construction: if new buildings are not built, it is impossible to sell new lifts (there is a secondary business of renovation and servicing that is stable, but the primary business is totally dependent on construction). The
construction market, however, is very volatile, prone to boom and bust. The lift factory can thus find itself with great volatility in its demand. The most important part of its costs is qualified labour, which makes enduring the cycle difficult: if, in the low years, it dismisses the excess people, it will not have production capacity when the good years return, since it takes time to train specialized labour. If, on the other hand, employment is maintained, the losses will be very high in the years of little activity. A solution to the problem is to sell lifts in other countries whose construction sector operates on an uncorrelated cycle. By doing this, it could smooth out demand and maintain higher profitability through better capacity utilization.

In other cases, the reason for internationalization has nothing to do with costs, but with client service. You will recall that strategic logic tells us that everything a company does should be oriented towards lowering costs or increasing prices. Sometimes, it can happen that clients value the fact that a supplier is present in various countries. For example, think of the auditing business. It is a sector that, in the first analysis, does not seem to be a candidate for internationalization and, in fact, the majority of the auditing companies that operate in each country are purely local. The reasons are clear: there are no economies of scale (auditing each company requires a particular number of hours, and doubling the number of audits simply implies putting in twice as many hours); and the distance costs are also important as each country has different accounting standards, different legal requirements for practising the profession and so on. However, auditing large companies (which is more profitable than auditing small companies) is totally in the hands of five multinational companies (the ‘big five’) that operate worldwide. Why is this?

The reason is not costs: PricewaterhouseCoopers or KPMG do not have lower costs than a local competitor (in fact, they are usually somewhat higher, since they have to support an international infrastructure). The reason is that a multinational company, such as IBM, prefers, for evident reasons, that the same company audits all its international subsidiaries, or, put another way, it prefers that its auditor takes charge of the work in all the units of the company. To be truly able to aspire to this business, it is essential to have a global presence. Although a local competitor is willing to offer a better price to IBM for auditing a specific unit (whether it is the headquarters in the United States, or a subsidiary), IBM will not accept it, since there is a clear advantage in having a single auditor. Therefore, only the big five audit the large multinational companies, which has provided them with a solid reputation, absolutely fundamental in the auditing business. This reputation also helps them to get
business with clients of a certain importance, even if they are not international. For example, today it is almost essential to have the accounts signed by one of the big five in order to be listed on the stock market, apart from any international considerations. But it is interesting to observe that the differentiation is indirect: the big five have a reputation (even vis-à-vis local clients) because they audit the largest companies in the world; and they audit the largest companies in the world because these have global presence and prefer multinational audits.

This international presence as a characteristic desired by the clients is behind the internationalization of many sectors in which the cost equation, analysed earlier, does not show a clear need for internationalization. In these cases, internationalization takes place to serve the client better (raise the prices) rather than to lower costs. We could include here the internationalization of sectors such as investment banking (if a bank wants to mediate in international mergers, it is useful that they are present in both markets); consulting (to be able to help a multinational it is often useful to have local offices in different countries in which the multinational operates); outsourcing of services; credit cards; and so on.

The important factor is that if there are no economies of scale, the costs of distance will push total costs higher than those of a purely local competitor. It is fundamental, therefore, that the clients be truly interested in a multinational supplier, to the point of paying more than they would pay to a series of local suppliers. Sometimes, this is the case (as in auditing); in others, it is more doubtful (as in the contracting of a catering service for a company’s cafeterias). Of course, each client is different, and while some may be interested in paying the ‘multinational premium’, others will not. The company that internationalizes has to be very conscious of who its potential clients really are, that is, which ones are willing to pay the extra cost of international service. Otherwise, the company will find itself competing with local companies, at local prices (and higher costs). For instance, some companies in the food industry have tried to take advantage of the internationalization of some large retailers, such as Carrefour, in order to become internationalized themselves. After setting up operations in several countries, they offer their products in all the countries where the retailer operates. Although the story sounds good (‘we are a supplier with unique characteristics, because we can serve you everywhere’), the reality is that the buyer is not willing to pay extra for this, since it can buy perfectly well from local producers in each country. Moreover, these local producers are often more efficient than the multinational supplier, since they do not have the added costs of internationalization and are better adapted to local tastes.
Another reason for internationalizing the company can be *to leverage a resource* that the company has, which can be used in another market and cannot be exported. In general, this resource is the company’s *know-how*. So it is interesting to see that an American company such as Procter & Gamble, for example, can attack European markets in which there have been established competitors for more than 100 years, and end up prevailing in many of them, with its detergents and hygiene products. Evidently, it is not a question of economies of scale: in many cases, the products are manufactured in each country, with formulas adapted to it (this is now changing, as we will analyse later). Neither is it a question of ‘leveraging the brands’: brands must be built in each country, based on local advertising. Nor does it have anything to do with the clients: the Italian housewife who buys Ariel does not know if Ariel is sold in Sweden or not (and, of course, is not going to pay more if it is). It is simply a question of benefiting from a very long experience in how to develop, distribute and sell mass commodity products that few other companies in the world have. If local companies have not had the opportunity of developing this capacity (perhaps because their local industry is less sophisticated, or they enjoy a monopoly position), then the multinational company has an advantage that it can exploit. This was the reason that led many American companies to establish themselves successfully in Europe after the Second World War and many European companies in Eastern Europe after the fall of the Berlin Wall.

Companies can also have a *cost advantage* at the root of successful internationalization. Imagine that a company is capable of producing something at a lower cost than the rest, not based on economies of scale, but on their own way of doing things that reduces the cost of production and is difficult to imitate. Once its local market is saturated, this company will be interested in going international, since its advantage will give it an edge wherever it goes. In this case, the company has to decide between exporting the more or less finished product and establishing a factory in the foreign market. Exporting will make sense if the costs of distance (transportation, adjustments, customs, lack of brand recognition) are not excessive regarding its initial advantage; establishing a factory implies that the cost advantage can be replicated in the foreign country. That is, very briefly, the story of the Japanese car-makers, especially Toyota, which began exporting successfully and, when the costs of distance became too high, it had to begin opening factories abroad. But if the advantage does not exist, as in the case of many of the European manufacturers, establishing productive units is hardly profitable. In fact, this sector is one of those in which profitability is related to the lack of internationalization: for
years, the most profitable European producer has been PSA (Peugeot-Citroën), which has practically no activity outside Europe.

Two requirements must be met for this policy of internationalization to be successful: that the advantage is real, as we have seen, and that the company is able to transfer it. In many cases, the advantage is not real, but is the fruit of a certain delusion: ‘we have done it so well in our own country, surely we can do it better than the locals in another country.’ This does not take into account the need to adapt to different circumstances (perhaps what we know how to do is not valued as much in other markets as it is in our own), or the real difficulty in carrying out the technology transfer. We will discuss these problems in detail later on.

Finally, internationalization may mean not selling more products, but buying them: instead of markets, the company looks for resources, shifting production or purchasing activities to countries with lower costs. As long as those inexpensive resources are in principle available to all competitors, however, we cannot expect a sustainable competitive advantage, but it is always better to be first in lowering costs. Again, the advantages gained must compensate for the added costs, and these can be substantial: different countries, different standards of work (quality, productivity) and so on. What looks like a great opportunity (labour ten times cheaper) may not be so, once the differentials of productivity, costs of distance and the necessary ‘learning fee’ are taken into account. There are businesses, however, such as textiles, electronics assembly or footwear, in which a good knowledge of outsourcing worldwide is an almost essential requirement for competing.

**Why It Usually Turns Out Badly**

A reality that I have often found in my work with companies is that international operations are less profitable than national ones. In the beginning, this situation is considered normal, because the company is investing. But this low profitability (or even net loss) often plagues the company for years. In many cases, foreign operations never achieve the profitability of domestic ones. It is not unusual to find companies that, after several years, decide to concentrate on their core national activities and shut down the international venture, or at least an important part of it. This happens often enough to suggest that there must be some basic problems in the internationalization process of companies, and in the following pages we are going to discuss some of them. This analysis is important, since many companies view these losses in international activities as ‘the price to pay
for learning’. Although learning is indeed important, and no analysis, a priori, can substitute for learning in the field, the truth is that many of the most frequent errors are perfectly foreseeable and avoidable. If the company does its homework well before launching into the process of internationalization, it will attain faster, more in-depth learning and at a much lower cost.

Three kinds of problems lie behind the frequent lack of profitability of international operations: total lack of strategic logic; erroneous application of strategic logic; and bad implementation. All of them occur frequently, and often in combination.

When Internationalization Does Not Follow Strategic Logic

As we mentioned in the Introduction, and will see in more detail in the following chapters, many decisions of internationalization are taken with the sole objective of continuing to grow, without paying attention to the profitability of the operation. Of course, managers expect to earn money in the new operations, but without a very clear idea of why, and without asking the critical question, what will be the competitive advantage added by the international operations? As we have seen, operating at a distance always increases costs. If going international does not imply a decrease in overall costs (perhaps through economies of scale), or an improvement in the prices the company can charge (because clients prefer an international supplier), overall profitability will go down. This is so if everything works out as expected, not taking into account the typical start-up problems we will discuss later on. It bears repeating: a company that simply wants to grow, without reinforcing its competitive position with some added advantage, will perhaps be able to increase its size, but will see its profitability go down inexorably. The pursuit of this ‘logic of growth’, disregarding strategic logic, is usually at the base of many international operations’ chronic lack of profitability. I remember hearing the general manager of a Spanish company say ‘nowadays, we must be in Portugal and France: they are our market’s back yard’. In this real-life example, there was no strategic reason to go (except for geographical proximity) and there were many entry barriers to those markets for a Spanish company. Over five years, this ‘proximity logic’, totally outside strategic logic, cost the company more than €100 million, no small sum for the company in question (annual profits around €20 million). The French operation is now closed and the Portuguese venture continues to lose money.
The Wrong Application of Strategic Logic

It is possible to find companies that have made a strategic analysis of their international development, but have made some serious mistakes when applying the logic, typically in choosing the variables that determine the economies of scale. Some examples will help us to clarify this point.

Often a company reaches the conclusion that its profitability is not optimum because it is too small, and decides to expand internationally to grow. In itself, strategic logic is clear. The problem arises when it is not clear if the unit of analysis that determines the economies of scale is national or international. Imagine a company in a sector in which the activity most subjected to economies of scale is distribution. This has an eminently national character, since clients are, in the majority, national, and the means of advertising are national, as are the logistics networks and so on. The fact that a company has operations in various countries does not in reality increase its volume in the activity of distribution, since this activity must be analysed country by country, for its position on the cost curve depends on the volume for each country, not on the aggregate amount (the volume that I can distribute in Finland is not going to lower my logistics and distribution costs in Italy). Take two companies, A and B, as shown in Figure 5.7. Company A will be more profitable than company B, although its total sales are lower, thanks to its great profitability in

![Figure 5.7](Image)

**Figure 5.7** Total size has no importance if the variable that determines the economies of scale is national
Germany, based on its local economies of scale. Company B is not, as its managers thought, ‘a medium-sized multinational’ but rather a collection of companies that are all below the minimum efficient size.

Of course, if the variable that determines the economies of scale has an international scope (for example R&D to design a homogeneous product for all the countries), it will make sense to add the volumes of sales obtained in each country. But if the key variable is local, then one must be sure that it is large enough in each country; and being present in various countries does not help profitability at all. In fact, it makes profitability harder to attain, if this multinational dispersion involves not devoting sufficient effort to obtaining the minimum efficient size in some countries.

We must simply return to our analysis by activities, presented in Chapter 2. Each activity, as we saw, is in reality a different business, with its own efficient size and, we might add, its own costs of distance. This determines that each activity also has its own geographic scope: there are activities that require internationalization and others that do not.

Failures Starting Up the Process

Finally, there are errors due simply to faulty implementation. Even when the strategic approach is correct, an internationalization process is difficult to put into practice, since it implies for the company a true qualitative leap in its management capacity. Managers will have to direct operations in which they do not have immediate experience. And here the typical mistakes range from arrogance, in thinking ‘we know it all’, underrating local competitors, ignoring uses and customs that may not be evident, but are determinants for the success of the operation, to leaving things to foreign management, since ‘they know the territory better’, and not really managing to obtain the new advantages being sought. In the following pages we will give some advice on avoiding these errors.

Some Guidelines for Designing the Internationalization Process of a Company

As we have seen, the internationalization process is often presented to the company as an opportunity to grow, but there are many variables that must be resolved before the company can embark upon it. Companies must decide on things as basic as which countries to go to (European countries,
with geographic and legal proximity; English-speaking countries, with linguistic and cultural closeness; countries where the business is more advanced than ours; or less advanced countries to take advantage of our superiority?); but also many other variables: export or establish a branch in the foreign country? Do it alone or associated with others? Buy a foreign company or establish a subsidiary of our own? Send managers of the company itself or hire locals? Adapt the products and services of the company to foreign tastes or maintain the line of the company? And so on.

The success of the task of internationalizing a company will obviously depend on the answers given to these questions, but, as we have seen, these questions cannot be answered without a logical vision of why the company wants to go international. This international vision is absolutely essential for success, but is often forgotten: by definition, the companies that need it the most are those with little international experience.

It is appropriate to insist that if all a company is looking for is to continue growing, but its international expansion is not supported by solid competitive advantages, going international will result, at best, in a decline in profitability and, at worst, in serious problems. The process of internationalization is an enormously expensive exercise, both in monetary terms as well as in the managerial time that it absorbs. Due to the high cost, it is necessary to obtain an added value from the process, beyond the increment in sales: if the margins of the company are not going to be higher because it has become international, then profits will decrease because the costs will surely be higher as a consequence of internationalization.

Or to put in strategic terms: if the company does not obtain new competitive advantages thanks to going international, its position will worsen, even in its own market. In fact, internationalization has been the beginning of the end for many companies, because of the negative impact that the high international operating costs had on the company, as we will see in Chapter 7, when we discuss mergers and acquisitions. The key idea, however, is clear: unless the company improves (not simply gets bigger) due to the internationalization process, it should probably stay at home.

The first step, therefore, is the development of a ‘strategic vision’, which is just the application of strategic logic to the internationalization process, as we defined it in previous pages. The company has to know exactly what it is looking for, in competitive terms, when going to other countries: an increase in volume that lets it capture economies of scale and, with them, lower unit costs? Better service for its clients, who are willing to pay for it (with a premium higher than the inevitable cost increases)? Diversification of the country risk, by distributing operations among
various, unrelated markets (again, without an excessive increase in costs)? In short, any of the reasons we have noted justify internationalization. If the company does not, honestly, find any of these reasons, it can be fairly sure that internationalization will contribute to an increase in sales and a decrease in profitability.

Only when the company has clearly thought out the advantages of internationalization can it begin to answer the pressing questions referring to the process itself. For example, the answer to the question, ‘which countries to go to?’ depends on what the company is looking for: if it is a sharp increase in production, to gain economies of scale, it will have to look for large markets, with well-established channels of distribution where it is relatively easy to place the product (supposedly at a good price, of course). If what it is looking for, however, is to stabilize its profits, it will have to look for stable markets or markets with economic cycles opposite to those of the country of origin.

The company can then establish a classification of markets following the concept of ‘country attractiveness’, in terms of entry barriers to the country, potential market, advantages to be gained and so on. Taking into account what we have discussed up until now, it is obvious that the concept of attractiveness depends on the type of competitive advantage that the company is looking for. If a solid vision is not present, companies will fall for superficial analyses of the kind: ‘it is a large market’, ‘there is little competition’ or ‘they speak our language’. All these things can be important, or not, but the key for the company is to see how they fit into a realistic vision of the creation and exploitation of competitive advantages. Not making this reflection leads to the frequent situation of a company that decides which country to go to according, purely and simply, to opportunistic reasons. Thus, it is frequent to see companies that are established in a country because someone from there called them, offering them what seemed to be a good deal; or for any other more or less superficial reason. In the world of business, it is natural, of course, to take advantage of opportunities as they come, but if these opportunities do not follow a clear logic, they rarely contribute to profitability. The ‘country error’ (we should have gone somewhere else) is more frequent than people think, as incredible as it may seem from the outside.

A similar analysis can be made of the entry mode to a new market. If the company wants to amortize an investment in factories already built in the original country, it will probably choose a strategy of exporting. If the key factor is the amortization of high R&D costs, the granting of licences could make more sense. In a similar way, a joint venture can be the solution when manufacturing and local knowledge are necessary.
Let the Process Follow the Objectives

The nature of the competitive advantages being sought by the company should determine the type of internal organization of the international subsidiaries. In the case of a company I had the chance to work with, a key reason for having different factories in different countries was the possibility of shifting the production from one country to another following the significant variations in exchange rates in the areas’ currencies. To be able to achieve this flexibility, however, the company needs wholly owned local subsidiaries, not joint ventures, where the local partners would resist sending work (and profits) to other foreign branches in which they do not have a financial stake. Looking for a competitive advantage (financial efficiency in the allocation of production) requires organizing production in a centralized form; while another advantage (local knowledge) requires decentralization and the use of local partners. If these dilemmas are not anticipated and dealt with, the company can find itself in an untenable position.

Some car-makers have committed a similar error. When some Japanese producers began opening factories in Europe to save transportation costs and the poor political image of an excessive level of exports, they had to decide between building factories from scratch or buying a local producer. In the abstract, one solution is as good as the other (it will depend on the price of the local producer, compared to the cost of building a plant, of course). If the company is trying to exploit a very special method of management, however, that provides low costs with high quality, as we saw earlier, they will have to build factories from scratch: although it is a slow process, it is the only way to ensure that the European subsidiary will have the culture that is the basis of the success. If they do not act in this way, perhaps to take advantage of the opportunity of a European producer for sale at a good price, they can find themselves not being able to apply their basic strategy. Nissan has higher productivity in its plant in England, which was started from zero, than in its Japanese plants. Its Spanish subsidiary, Motor Ibérica, which is the heir of old companies that had failed and that Nissan bought some time ago, is very far from that productivity and the company is now thinking of closing it, at great cost.

Consensus and Learning

More than in other cases, the process of internationalization requires a consensus within the company to be successful. Often, the pressure to go
international comes from some of the managers. International operations are then perceived as secondary within the company: many executives are afraid of the unknown and feel that profits should be realized in the local market, with current clients. Often, selling in foreign countries implies modifying the products (even if only in the format or packaging), which causes inefficiencies in production, for example. Providing the appropriate service to faraway, foreign clients who perhaps have different demands is expensive. No matter how well things are done, there are always errors, unforeseen costs and so on. All this often makes going international poorly understood in the company, since it is a real source of problems for everyone, but without a clear commitment from everyone, the project will not succeed.

The development of a clear vision of the internationalization process is a basic tool for obtaining the commitment: only if senior management is capable of clearly articulating what the fundamental reasons are for going international, what advantages it is looking for, why it makes specific decisions, what the basic milestones to achieve are and so on, can it have general support which is absolutely necessary for the success of the process. Without this analytical and didactical effort, internal resistance can endanger the overall process, as the company must expect tension in this process, since its organizational systems, probably well adapted to the style of local management, can be inappropriate for an international business.

Having a clear, sound strategy for internationalization (that is, consistent with strategic logic and the reality in the company) is of great help when trying to convince the entire organization that the effort is worthwhile. This is crucial since, as we have seen, the practical difficulties that arise even with a good strategy are always very important. If the entire company is not clearly committed to the strategy of internationalization, it will not receive the necessary support and its failure is almost guaranteed. Moreover, an important part of the company tends to regard internationalization with apprehension, for it rightly feels that the centre of gravity of the organization is shifting. Thus it is essential to explain why the strategy is good for the company as a whole, in order to obtain the support of all, especially when problems arise that, as we have said, might derail the whole process.

**Strategy in a Multinational Company**

So far, we have discussed the process of internationalization through which a hitherto basically local company expands beyond its borders. But what
are the specific strategic problems of companies that are already multinational? The fact that a company is multinational, that is, has operations in different countries, does not change strategic logic: if the company wants to have good profitability, it must have some type of sustainable uniqueness in its activities. A multinational company, however, has to develop and sustain that uniqueness, by definition, in various countries and the way it works in those countries will have an impact on its strategic position. Thus, as we have seen, it will not be the same if a multinational manufactures its products in each of the countries in which it is present, as when it manufactures them at a central plant and distributes them: its potential for economies of scale in manufacturing will be very different. In the same way, carefully adapting the products to each country can have an impact on the level of differentiation (positive), but also on that of its cost position (negative).

If formulating a plan for internationalization for a local company is a complex endeavour, dependent on multiple variables, the strategy of a large multinational company is even more complex. In short, it is a question of adding a dimension (international) to all the strategic variables that we have been discussing throughout this book. Doing this in detail would be tedious, since there are endless combinations, but there is a way to summarize the impact of the international dimension on the strategy of a multinational company that is useful and relatively simple.

It is a question simply of widening our concept of production costs and distance costs to the context of an international company. Thus, we can simplify the great amount of environmental variables that the company faces by separating them into two large groups: forces that push towards centralization, and forces that give importance to local characteristics. Among the first, which we will call ‘centralizing pressures’, are, as we have already seen, economies of scale, when the minimum efficient size of a business is above the size of the national markets (since it will not be a good idea to manufacture in each country, but rather to centralize production in optimum-size factories); or the internationalization of the clients, who push suppliers to follow (and with it a sales effort, price levels and service structures that must be centralized). Among the second set of forces, which we will call ‘localizing pressures’, are significant transportation costs; differences in tastes of the clients of different countries (or local preference in general); political and bureaucratic obstacles to international businesses (protectionism); and so on. We can then establish a small matrix that indicates where each business falls in a space defined by these two dimensions, as shown in Figure 5.8.

This shows that, for example, the business of building large passenger aeroplanes is an industry in which the centralizing pressure is very high,
since economies of scale are enormous (recall the discussion in Chapter 1 about Boeing and Airbus), and the localizing pressure is very low: there are no transportation costs, the tastes and needs of users are the same in all countries and so on. At the other extreme, we have the food sector, in which economies of scale are not very important, but costs of transportation, differences in taste and protectionism are high. With a similar analysis, we can ‘put on the map’ any sector, such as the examples shown in Figure 5.9.

Logically, the strategy of the successful companies must fit the characteristics of their business, and over the years companies have adjusted
their operations to satisfy these requirements. Thus, each position on the map corresponds to a more or less typical strategy. These typical strategies are not models to follow, but rather answers, quite generalized, to the different demands found by companies, but they are not unique and there are important exceptions, as we will see later on.

Global Strategy

A company that faces an important centralizing force with very little localizing pressure is Boeing, for example. In this case, the typical strategic response usually consists of centralizing most activities, and attacking the world market as a single entity, with the same products, the same prices and identical approaches everywhere. This comes from the structural characteristics themselves of the business: economies of scale, which require centralization, and absolute homogeneity of clients’ needs.

![Global strategy diagram]

**Figure 5.10 Characteristics of global strategy**

Other examples of well-known companies that follow this type of strategy (with their own characteristics, of course) are Casio, which sells the same watches and calculators everywhere, manufacturing them in a very reduced number of factories, or Intel, which acts in a similar fashion.

‘Multinational’ Strategy

In contrast to general belief, there are not many companies that follow a strictly global strategy, since there are not many sectors where that
strategy is appropriate: on the one hand, economies of scale are not usually so important and, on the other, strong localizing forces act on many companies. For this reason, the appropriate answer is often very different to the global one. If we take Nestlé as an example, we see that its mode of operation is radically different from that of Boeing: where Boeing has strong centralization and a clear national character, Nestlé is a much more diffused entity. Indeed, less than 2% of the employees or the assets of Nestlé are in Switzerland, the location of the head office. In each country where it operates, Nestlé is a complete company: it manufactures its products (many of them designed specifically for the country, in the country), it distributes them and it sells them. The vast majority of its employees in each country are natives of that country. In fact, the only difference with a purely local company is that the shares belong to a Swiss group and there is some basic technology and know-how, from which each subsidiary can benefit. Where the global company exports, the multinational company invests abroad, in order to sell locally manufactured products. Although Boeing and Nestlé are two fully internationalized companies, the difference in approach could not be greater.

The strategy that we have called global favours taking maximum advantage of economies of scale; the multinational adapts perfectly to the terrain. Both are appropriate when the exigencies of the market are one-dimensional, that is, when there is only one problem to solve. But, what should companies do if economies of scale are important and, in addition, they must adapt to the territory?
Mixed Strategies

Consider the case of Toyota. It is a very successful company, which, as we saw in Chapter 3, has been capable of overcoming important entry barriers to make a place for itself in international markets, especially in the United States and Asia. Historically, its strategy has been very close to the global model: centralized production in Nagoya, identical models everywhere. This strategy, which was very successful for a number of years, began to show its limits in the 1980s. In the first place, the majority of American consumers, for example, prefer cars with characteristics different from the typical Japanese car. Once the segment of the market that bought Toyotas because they were inexpensive was saturated, the company had difficulty increasing sales, as their products were not really well adapted to local tastes. Even more serious, the success of Toyota in the low price models created economic problems for its American competitors, which led the American Government to intervene with protectionist measures that made the penetration of the Japanese even more difficult. Finally, a strong rise in the yen against the dollar showed the company that having all its expenses in one currency and an important part of its income in another implied a risk that was impossible to absorb.

The strategy of Toyota in the last decade is well known: opening factories in other countries, first in the United States and later in Europe (besides some Asian assembly lines). This was not an easy decision for, as we saw, Toyota’s real competitive advantage lies in its culture or way of doing things. Maintaining that advantage while opening factories in countries with very different cultural traditions is a managerial challenge of the first order. The success of Toyota has shown that the characteristics of its way of working are not intrinsically Japanese and they can be successfully exported.5

Similarly, other companies that were very close to the territory, as Nestlé has found, especially in Europe, were not being as effective as the new conditions of the Single Market permitted. In effect, although economies of scale in many food products are not very important, and transportation and adaptation costs are appreciable, there are cases in which the policy of ‘doing everything in each country, for each country’ had gone too far, especially in the context of the complete disappearance of duties and the decrease in transportation costs, from the liberalization of this market. Consequently, Nestlé is doing the opposite of what Toyota is doing: going from a purely multinational strategy to a more centralized one. Figure 5.12 shows this movement graphically.
But let’s not fool ourselves by falling for the simplicity of a graph. These ‘movements on the graph’ are extremely difficult to pull off in real life, basically because it is not very clear how to win new advantages without losing the previous ones. This question is at the heart of the current strategic debate in large multinational companies.

Adding, Not Substituting, Competitive Advantages

Evidently, if Toyota manages to avoid its problems of lack of localization by losing its previous advantages, victory would by Pyrrhic: it would become another Fiat, a company with excellent local connections, for it builds locally in many countries, but low efficiency due to its fragmented operations. Conversely, if Nestlé is looking for efficiencies, giving rise to a disproportionate increase in transportation costs or, even worse, begins to offer products not adjusted to the taste of the consumers, its competitive position would be compromised. This is why the company has to be extremely careful in its analysis and go beyond simplistic discussions about centralization versus decentralization. At this point, our activities analysis in Chapter 2 becomes crucial: a good breakdown of what the company does into activities will show us which really gain by being integrated and which can be decentralized and what the cost/benefit relationship is of doing each thing in one way or the other. There are many
examples of companies that, wanting to ‘move on the graph’, as we indi-
cated, have gone too far, throwing out of the window their traditional
advantages, going to efficiently manufactured products very poorly
adapted to their different markets or, on the other hand, trying to sell too
expensive products well adapted to the taste of their clients.

The second problem is putting it into practice. Actually, it is easy to
say, ‘the company moves on the graph’. For a company like Nestlé (or
Philips, Alcatel or so many others in the same situation), however, to ratio-
nalize production means closing design centres, factories, changing the
professional career of its managers, dismissing employees and so on,
while at the same time, maintaining its good, hard-earned local image. In
the cases mentioned, companies must change the way they have been
operating for decades, and this is not at all easy. There are extreme cases in
which the company has simply not been able to do it, such as ITT
(absorbed by Alcatel), or it takes many years to make progress, like
Philips. This implicit tension in trying to obtain the advantages of both
standard strategies dominates, as we said, the reality of many multina-
tional companies today, and leads them to lurch from one side to the other.
But it is a necessary task, since the competitive position of the company
that better manages the reconciliation of these very different demands is
greatly improved.

Conclusion

Perhaps the most important point of this chapter is the simplest: no matter
how much talk there is of globalization, strategic logic does not change. A
company should look for profitability in its sustainable singularity, and the
considerations of geographic reach should be taken in light of this basic
imperative. Launching into international ventures because ‘it is in
fashion’, or because ‘you have to have a world stature’, when the struc-
tural reality does not so advise only leads to problems, some serious, such
as constant restructurings, chronic lack of profitability of international
operations and even bankruptcy. The argument that ‘we can no longer
grow in our home market and, therefore, we should expand’, is silly: it is
better not to grow and stay profitable than to grow ruinously, as we will
repeat in the next chapters. In fact, there are many examples of sectors in
which the most profitable company is the least internationalized, from
Lloyd’s Bank in Britain to Peugeot-Citroën in Europe. In short: ‘look
before crossing’. Companies, before launching into the process of inter-
nationalization must develop a clear vision that is compatible with strategic logic and the realities in the company.

In this same way, within the multinational company, a strategy that does not respect the realities of its business and tries to centralize or adapt locally more than necessary also has serious problems. The ability to steer a reasonable course among all the different possibilities, given the complexity of the issue, can be a solid competitive advantage for a company, sustainable for several years.

Notes

3. This last barrier is very important in economic terms. Thus, Germany’s intra-European trade has risen from 27.2% of GDP in 1998 – the last year before the euro – to 32.2% in 2001. The French share is up from 28% to 32.2%. Overall, the average rise in trade shares in the eurozone is 3.3 percentage points. By contrast, British trade with the rest of the EU has fallen back from 23.4% of GDP to 22%. The average trade share of the three countries that have not joined the single currency is unchanged. See ‘Stay Out, Miss Out’, *Financial Times*, 9.4.2002.
4. At the time of writing this, Arthur Andersen has basically disappeared, as a result of its errors handling the Enron accounts. The fact that, on its dismissal, the industry has immediately gone from five ‘majors’ to four, without any second-tier company having even the chance to occupy at least some of Andersen’s territory, shows the height of the barriers to entry.
In the preceding chapters we identified ‘company’ with ‘business’, that is, we spoke as if companies were dedicated to just one thing. In the real world, of course, this is not the case. There are few companies that are not engaged in several different things, selling not only a variety of products to different markets, but trying to compete in really different businesses. In fact, diversifying beyond their initial nucleus is a constant in the life of companies. So much so, that we can describe the typical development of the company as one of growing along one (or more) of three axes: geographic, vertical integration and products (Figure 6.1). In the previous chapters we applied strategic logic to the two first growth vectors of the company, and in this chapter we will analyse how to move along the third.

The reader will probably have noticed that the reason for diversification that was just noted, namely, to maintain the growth of the company, is not the most commonly given explanation. Typically, the reason given for diversification is the need to decrease risk for the company. It seems obvious, after all, that if a company is active in several
Strategic Logic

businesses, it will have more stable results than if it is in only one. We will return at the end of this chapter to this argument, but the truth is that companies do not diversify to reduce risk, but to continue growing, whatever they may say.

The basic reason is that all businesses sooner or later reach their saturation point. Faced with this situation, managers interested in maintaining a rhythm of growth for the company basically have three options, the three options represented by the axes of Figure 6.1: they can attack foreign markets within their company’s traditional business; they can integrate more activities into the company’s business system; or they can remain in their country but enter different businesses (of course, they can also go into a different business in a new country, but the management risk of this option is evident, and it is almost never attempted). Thus diversification is, in practice, one more way for a company to grow, to which strategic logic must be applied in the same way as to the other two.

Of course, a rigorous application of strategic logic to this question requires starting with a clear definition: what does diversification mean exactly? As is to be expected, the answer is not binary, in the sense that a new activity can be more or less different from what the company did before: it is not a question of black or white, but of many tones of grey. Thus, an automobile company, specialized in small cars, diversifies if it launches a large car model, but it is more different to produce a truck or a motorcycle. If it buys a locomotive company, a computer services company or a satellite company, it is clear that it diversifies much more (all these, by the way, were real purchases made by both General Motors and Daimler Benz). Diversification, therefore, is a question of shading, in the same way that it was for vertical integration (every company of a certain size is in more than one activity, if we define the activities with sufficient precision) and geographic expansion (every company acts at a certain distance from its central nucleus, no matter how local it is). In this chapter, we will understand diversification as the entry into businesses where the most important characteristics, from a strategic point of view (technology, brand, channels of distribution), are really different.

Management of a Diversified Company

The large majority of companies of a certain size are diversified, even in the strictest sense of the term. A practical approach to the question will start, therefore, by asking how a diversified company should be managed, since, by definition, it will be difficult for management to know the businesses well.
In fact, this difficulty is so serious that, for years, it acted as a brake to companies’ diversification, and it was not until the 1950s that companies found a practical way to manage diversification. It is only from that period, therefore, that the practice of diversification has become widespread. The procedure used was that of ‘divisionalization’, which consists of dividing a company into almost totally independent divisions, united only at the top by a layer of corporate management. Although the idea seems simple, it is not, and its results have had a great influence on the way companies are managed. In the following pages we are going to study this solution in detail, and we will see how an organizational arrangement can end up determining the strategy of the company.¹

Imagine the situation of the general manager of a company diversified into several businesses, with a traditional functional structure. She has to determine a strategy for each one of them, with the enormous complexity that this involves, since, as we have seen, determining the appropriate strategy implies a deep knowledge of the industry in which the company competes. Likewise, she has to control managers whose task is also complex: the director of marketing can be overwhelmed by the need to sell products with very distinct characteristics, in very different markets, with clients who have different ways of buying. Something similar can be said of the managers of the rest of the functional areas of the company: production, finances and so on. Each one of the different businesses can have very distinct demands, some of them contradictory to others. Thus, some may be businesses directed to the high segment of the market, with its typical emphasis on exclusivity, quality and image; while others may concentrate on the mass market, with its usual emphasis on high volume and low costs. This creates evident management difficulties, since it demands that managers radically change their mindset several times a day.

In order to solve these problems, the system of divisionalization was designed: the company is divided into autonomous divisions, each one with its own general manager, in charge of coordinating her own directors of marketing, personnel, production and so on. Thus, the supreme general manager of the company does not have to be concerned with all those problems directly, and the persons in charge of resolving them are close to them, have a good knowledge of them and the environment in which they move.

The idea is excellent and, once tested, it spread like wildfire. But, as a solution to the management problems typical of a diversified company, it is not complete, since it leaves on the table the most serious problem for corporate management: how to allocate the funds to develop the different businesses. Logically, all the divisional directors tend to see their business as very important, full of future possibilities, as long as the investment in
it is sufficient. Quite probably, they are all correct, if the company has chosen the businesses well. However, the available funds are always limited and the general director will have to find some way of allocating them. How to make this allocation in a way that will optimize the global result for the company is not an easy question to answer, especially if we recall that the general director is not (cannot be) an expert in the different businesses among which she has to allocate the company funds.

**Portfolio Planning Techniques**

To help to answer these questions, portfolio planning techniques were developed at the beginning of the 1960s. In essence, the idea behind these techniques consists of considering the company as a portfolio of businesses and the role of management is to maximize the combined profits of this portfolio. The idea is quite intuitive: it seems clear that whoever has more than one business should dedicate more effort to the business that has the best prospects to earn money. That is, priorities in dividing the funds have to be established. In addition, we can ask that the businesses with less future support those that have more. These intuitive ideas were developed to form precise techniques, which we are now going to describe. Although these techniques have gone out of fashion in management schools, the reality is that they continue to be used in many companies. It is important, therefore, to know them in detail and see how they fit in with strategic logic.

There are as many portfolio planning techniques as there are consulting firms which developed them. However, they all share the same basic characteristics. Consequently, we will analyse only one in detail, which is without doubt the best known: the market/growth share matrix, developed and popularized by the Boston Consulting Group (BCG) at the end of the 1970s.²

This technique places its emphasis on the cash flow generated by the different businesses, not on their profits. This nuance is important, since a business can be very profitable and yet require constant investments, so that the company, although it earns money, constantly has to contribute more and more cash. This is a typical situation when a business is starting: although margins may be good and the business profitable, volume is still so small that the investment in inventories, development of the sales network, advertising and so on may take all the profits and then some. Conversely, there can be businesses that do not have high profits, but do have positive cash flow, since they no longer require any new investment...
to keep operating. Cash flow is the key variable, since in order to be successful in a business it is not enough to have profits, it is necessary to have available the cash needed to make all the essential investments. In a sense, it is the variable that is more important that profit, especially in the short term (in the long term, cash flow and profit tend to be the same). The objective of management will be, therefore, to manage the overall cash flow of the company in a way that it produces optimum long-term results.

In the BCG model, the generation of more or less cash flow in a business depends on two basic variables: the growth of its market and the company’s relative market share. The basic idea is that a business unit that competes in a growing market needs funds for its development, while one that operates in a mature market can contribute all its cash flow to the group, without harming its position. At the same time, a high market share is also considered to generate cash, since the company has economies of scale that its competitors do not have, so that, in principle, it should be more profitable.

If we combine these two variables, we obtain a matrix, represented in Figure 6.2, in which we can place each one of the business units of the company: those that have a good market share in a business of strong growth will be in the top right-hand quadrant; those that have a good share operating in a mature market will be in the bottom right-hand quadrant and so on. To give greater simplicity to the analysis, the BCG divided the

![Figure 6.2 Market growth/share matrix](source: Boston Consulting Group)
matrix into four areas, giving a name to each one of them which exemplifies the situation of the unit that operates in them.

Thus, the role of the ‘cash cow’, which is assumed to be a net producer of cash, is to support the ‘stars’ and the ‘question marks’, while the company must get rid of the ‘dogs’ as soon as possible. There is, in addition, a dynamic aspect to all this: the goal is to have stars, but sooner or later, their market becomes saturated, so they turn into cows. With the money that these generate, the company will finance the new question marks which, if things are done properly, will end up as stars, thus closing the cycle. If a unit falls into the dog area, it is sold, in order to generate more money to invest in the question marks and stars.

Apparently simplistic, the method is clear and, above all, normative: it tells general managers very clearly where to put their money and where not, which was, as we saw, their main problem. As a result, in its different variants, this method had enormous success and was used in one way or another by almost all companies of a certain size. Even today, when this type of methodology has lost favour among strategy experts, companies frequently continue to use it, more or less adapted to their needs.

Consequently, the 1970s saw the great boom of the conglomerates: a whole series of companies, in all countries, began to buy others in completely diverse businesses and gave them the divisional treatment. As usually happens in these cases, capital markets applauded this new fashion and the shares of companies practising this strategy rose sharply. This only made their work easier: having a high share price makes it is easy to buy other companies which, with more normal prices, seem cheap. This purchase of companies at a good (relative) price improves the profits per share of the buyer, apparently confirming the market’s high valuation and causing new rises in the share prices of the conglomerates, thereby reinforcing the cycle.

As tends to happen in these cases, the cycle ended badly. Practically all the companies that embarked on a strategy of diversification and used the management tools that we just described experienced dramatic falls in their profits and their stock market price. Companies that became famous applying these strategies with more zeal and apparent success than the rest, such as ITT or Textron, have disappeared, after ruining their shareholders. Others have restructured drastically, recognizing heavy losses. In the following pages we will analyse why this common debacle occurred, and what can be done to grow along this ‘third dimension’ of the range of products, respecting the laws of strategic logic, so that the company increases its profitability instead of decreasing it.
Why Portfolio Management Methods (and Conglomerates) Do Not Work

There are several reasons why the results obtained by following this methodology have been profoundly disappointing, ranging from technical errors in the methodology itself to problems with the basic strategic focus. Let us begin with the less serious problems, those linked to the methodology itself.

In the first place, although the basic concepts are reasonable, they are not always applicable to the specific situation of a company. For example, it is true that a rapidly growing business tends to require more capital than a stable one. But this is not always true. For example, a supermarket gets paid by its customers in cash (or quickly redeemable credit card slips) but pays its suppliers several weeks later. This means that opening a supermarket generates free cash, and the more supermarkets that the company opens, the more cash it generates, which is just the opposite of the typical situation. Admittedly, this example is extreme, but it illustrates an important point: each business has different characteristics. As long as we use a methodology that assumes a homogeneity that does not exist, we run the risk of committing serious errors. To answer that managers already know whether this is the case or not does not solve the problem: remember that the whole point of portfolio management techniques is to allow managers to allocate capital among businesses they do not really know.

Something similar happens with the rest of the concepts that make up the model. Thus a business is considered a cash source if it shows little growth (we have already seen why) and if it has a large relative market share. The latter is predicated on the concepts of economies of scale and economies of experience (the more units of a product it has manufactured in the past, the lower the costs, since it learns to do it more cheaply). Again, this is a reasonable concept and, in fact, applies in many cases. But not in all, because it is more than possible that in a company with many business units in its portfolio, there will be many exceptions and errors will be made.

Moreover, this methodology is not as objective as it appears. The division of a company into necessarily arbitrary business units predetermines the result of the analysis. For example, if Nestlé followed a technique of the kind we are discussing, and decided to consider its coffee business as a unit, it would appear as a dog: small world market share and little growth. If a unit for instant coffee was separated from normal coffee, it would appear as a cash cow, thanks to Nescafé’s strong position. Again, if they separated the new ‘Nespresso’ system, the immediate preparation
of espresso coffee from some special capsules, they would have a star or a question mark. In short, very important investment decisions (how much money do we put into this business, instead of others that are very different such as chocolate or mineral water?) would be made according to a division into units that has to be necessarily subjective, and therefore open to political influences in the heart of the company.

This brings us to another group of problems that the portfolio planning systems will cause in practice: organizational infighting. It is difficult to motivate a management team that knows that their business has been labelled as a cash cow, so that its chances of getting investment and growth are practically nil, even if the business is doing well (if not, it would not be a cow). The internal tensions that this creates and the manoeuvring to manipulate the system have been documented in many studies. It is difficult for a manager to accept that the final decisions on her business are taken by someone who does not know it well, based on a more or less mechanical system.

In short, this is the fundamental problem: what is the role of the general manager in a very diversified company, managed by procedures of portfolio planning? It is not, of course, to manage the businesses or determine the strategy, in the sense that we have been giving here to the concept of strategy. As we will see below, management becomes a substitute for financial markets, deciding who receives funds and who does not. The impression is given that strategy consists of being right about which businesses to enter and which to leave, rather than an effort to build a sustainable singularity in a certain business.

**Managing a Portfolio is Not a Strategy**

In a company managed by one of the techniques discussed above (a company that, to be brief, we have been calling a conglomerate), general management spends its time deciding in which businesses to invest, but not in how to earn money in these businesses. The profitability of each business is taken as a given, external to management: a unit has a high market share and this is good, but general management is not concerned with improving it or even maintaining it, since it has abdicated that function to the divisional managers. Portfolio management techniques do not tell us anything about the strategy to follow in the business units. The task of general management is limited, then, to two things: on the one hand, transferring money from some units to others, according to what the technique being used recommends; and, on the other, selling the units that do
not function and trying to buy others that do. Deep down, general manage-
ment assumes the role that the financial markets usually play, but with
much less information than these have.

Seen like this, there is no value added in the work of general manage-
ment: divisional managers could obtain financing from the financial
markets if their projects are good. Markets impose a much stronger disci-
pline than a conglomerate, always subject to particular circumstances. For
example, at any given moment, the liquidity of the conglomerate can be
low, because a business is doing worse than expected, and all units suffer,
for there is no money to invest even if their projects are good or the invest-
ments are highly recommended for competitive reasons. However, their
competitors can invest, since, if the timing is right, they can find funds in
the markets. Or, very often, the opposite occurs: there is too much money
in the conglomerate and for years it subsidizes units which, if they were
independent, would have closed. Of course, there is the possibility that,
once in a while, general management, determined to finance for years a
project with losses in which no one believes, ends up being right and
earning money. This does happen sometimes and constitutes excellent
material for writing articles in the specialized press and cases in business
schools. However, they are exceptions which stand out from the more
frequent reality of money lost year after year, without great profits to show
at the end (similarly, there are also people who each week play the same
numbers in the lottery, until they finally win. This objective fact does not
make the investment in the lottery, in general, a good business, nor does it
show how right it is to always play the same numbers).

**Strategic Logic and Chimpanzees**

The fundamental problem of diversification is that, as strategic logic
shows us, the profitability of a business depends on its entry barriers. In
this sense, it is not especially useful to know that good businesses should
be bought and bad businesses should be sold: the purchase price (or selling
price) already reflects this quality of the business. This is an essential
point, to which we will return in Chapter 8, on strategy in the real world.
Actually, it is typical to think (and many companies act accordingly) that
strategic planning consists of determining what businesses are going to be
good in the future (in short, high growth, little competition, good margins)
in order to enter them. But to think like this shows a lack of understanding
of the essence of strategic logic: *a business is good precisely because it is
difficult to enter*. For this reason, if a company wants to diversify by
entering a certain business, and it is true that this business is really attractive, it will find entry barriers that will make access difficult. If these barriers are not high, other competitors will do the same (it is not reasonable to think that no one else has thought that the business in question is a business with a future), and we will find ourselves, as shown in Chapter 1, with disappointing profitability, although demand, in fact, is there and the company was right in thinking that it was a business with a future (after all, video rental shops did have a future in terms of demand, but not in terms of strong profitability).

In fact, a conglomerate-type company, where the added value would be in entering and leaving the businesses appropriately, is conceptually identical to an investment fund, in which the manager buys and sells shares. Moreover, it is well known that practically no fund surpasses the yield of the overall market, that is, that better results are obtained by buying shares at random rather than assigning the job to an expert. The reason is not that the experts do not know anything (in some cases that is the reason, but not in all of them), but rather they all know the same. It is certain that Microsoft’s profits will be better over the long term than those of a steel company. The problem is that everyone knows this, so the price of Microsoft’s shares reflects this reality. If the general forecast becomes reality, it will just validate the price that had been paid in advance.

The Wall Street Journal organizes an ongoing contest with its readers. Each quarter it asks four investment analysts and four readers to choose their preferred shares for the next few months. In order to give it a little more interest, they include a third category of participant, a monkey that also chooses shares by throwing darts on a page with all the companies listed on the stock market: the shares ‘selected’ by the monkey are those on which the darts fall. The results, over the years, are those that could be expected of a purely random game: the experts, the amateurs and the monkey each win more or less a third of the time. Of course, the companies selected by an expert function better in the long term than those selected by the monkey, but they are more expensive to purchase, so that profitability for the investor is the same (and this does not take into account the problem that, in the real world, experts charge much more for their advice than monkeys, with the result that most investment funds have worse profitability than the general index of the stock market).

Exactly the same thing occurs to the company that diversifies as a conglomerate, buying and selling businesses. In addition, it has another problem: buying shares on the stock market is relatively inexpensive (the brokerage commissions are around 1% for individuals and much less for large funds), and the costs of maintaining a fund are rarely more than 2%
of the investment. However, buying and selling companies is very expen-
sive, as is entering into new businesses, where there is usually an unprof-
itable start-up period. For a conglomerate to be profitable, it would have
to compensate for those high costs with a profitability in its individual
businesses that is higher than those businesses would achieve if they were
on their own. In general, this is impossible. Let us see why with a very
recent example.

In February 2002, the Spanish company Dragados y Construcciones
decided to buy the Dutch construction company HBG for €756 million, in
cash, equivalent to €21.25 per share. At the time of the operation, the
shares of the Dutch company were worth less than €14, and had been for
more than a year. Dragados y Construcciones said the purchase was good
because it was diversifying the business geographically (HBG is present
in countries where Dragados does not operate), gave it entry to very prof-
itable businesses (the Dutch company is world leader in dredging, a more
profitable activity than those of Dragados) and profits would go up imme-
diately, for it would now incorporate HBG’s substantial earnings (the
interest paid on the loan taken to buy HBG was lower than the profits
contributed by HBG).

Dragados’s shareholders, however, (who are, let us not forget, the
owners of Dragados’s money) could have obtained all these advantages
by buying shares of HBG on the Amsterdam market for €14, 60% less
than what Dragados’s management paid for them. Since there is no
synergy between the two businesses, the only thing clear to the share-
holder is that an agent of his has just paid €21 for something that he could
have bought for €14. This is not creation of value: it is pure destruction.
Only if the profits of the merged company were to be higher than those of
the two companies separately would value be created (higher by more
than the €400 million of extra charges). And for that to happen, either the
prices charged by the new company would have to go up (the clients
would have to be willing to pay more because the companies are now
together) or costs would have to go down (synergies are produced). This
is not the case in this real-life example, so that the destruction of value by
Dragados’s management is clear (the beneficiaries of this are, of course,
the shareholders of HBG. Since there is no synergy, we are in a zero-sum
game: what they gained is what Dragados’s shareholders lost). In the next
chapter we will see why these operations continue to be carried out.5

In short, adding businesses, like adding countries or activities, does
not create value in itself, rather it tends to destroy it. Only when growth
contributes a specific value, in terms of better prices or lower costs, does
it really create value. In the following pages we will see which diversi-
fication strategies are really profitable. But first we must discuss the important matter of up to what point diversification can create value, although it does not increase profits, through the decrease in risk.

**Diversification Does Not Diminish Risk ... Except for Some**

In fact, we should still answer an essential point: as we saw at the beginning of this chapter, the most frequently alleged reason in favour of diversification is to decrease risk. The argument seems irrefutable: given that business is intrinsically unpredictable, it seems reasonable not to put all your eggs in one basket, but to have various sources of income, if possible unconnected. This is an evident truth for the private investor, but not for a company. Let us see why with an example.

Imagine a person who has all her savings invested in IBM shares. The investment is solid, but there is an unavoidable risk: if the computer business in general, or IBM in particular, takes a turn for the worse, our saver risks losing a significant part of her capital. There are two solutions to this. The first is that IBM, with the money it earns, instead of distributing dividends, buys a biscuit company, for example. This may appear stupid (and it is) but it is not so far-fetched: Tubacex, currently a very successful Basque company specializing in seamless stainless steel pipes, decided years ago that the steel industry was not very attractive and invested all its spare cash flow in works of art, a market which it thought had a great future. We could also mention investments by many European electric utilities in telecommunications or television stations which have been sources of endless losses. However, to return to our example. With the biscuit business ‘inside’ IBM, the shareholder can sleep a little better, since she knows that, should people stop buying computers, they will probably continue buying biscuits (or the other way around), so that at least a part of her capital will be protected, since the profits of the ‘new’ IBM will be more stable in the long term, coming from two different sources.

This is undoubtedly true, but there is a simpler solution: our saver could sell some of her IBM shares and buy shares in Danone, Nabisco or whatever company she likes. This second method has at least three advantages: the investor can decide in what to diversify (if we leave it to IBM, it will be the management who decides whether to buy biscuits, beer or missiles); it is a less expensive procedure, since the commissions (and prices) for buying shares are much lower than for buying a whole company; and, perhaps most importantly, it allows the IBM management, who supposedly know about computers, to devote itself full time to managing a computer
company, leaving the biscuit business to specialists (the example is curious because the current president of IBM was previously president of Nabisco, the leading American manufacturer of biscuits).

In short, the diversification of a company diversifies the risk of its shareholders, but in a way that is extraordinarily inefficient and full of problems. If the goal is to diversify the risk of the shareholder (something very reasonable), there are much better ways to do it.

Employees’ risk, however, is not diversified. If a diversified company finds that one of its businesses is doing badly, it will have to close factories and reduce its activity in that business. Generally, employees cannot be transferred from one division to another, for obvious reasons of specialization, geographic location and so on. This important group will therefore not benefit from diversification. Thus, neither of the two key stakeholders of a company, the owners and the employees, profit from diversification.

There is a third group, however, that does benefit: top management. It is more comfortable for a general manager to present stable, reasonable results, rather than very volatile ones, although on average they might be better. In addition, as we have mentioned several times and will see in the next chapter in detail, the management of a company usually has a vested interest in growing, although profitability may suffer. And since diversification is good for managers and managers make the decisions, diversification takes place. Of course, in those cases in which shareholders really control management (family companies, for instance), this phenomenon is less common, but when managers are entrenched (companies quoted in the stock market in a context in which hostile takeovers are difficult), diversification flourishes, at the cost of value destruction for the shareholder.

In recent years, most conglomerates based in those countries where the stock market really operates like a capital market (United States, Great Britain, Switzerland) have broken up, either by themselves or under pressure from new owners. In fact, it has been relatively easy to earn money by taking them apart: after the fall of the share value, which occurs when shareholders realize that value is being destroyed, someone with financial means takes control of the company and breaks up the conglomerate by selling its parts, which are worth more than the total. This ‘play’ is so clear that it constitutes in itself a profitable strategy, as we shall soon see.

The word ‘conglomerate’ has become, therefore, rather pejorative. Consequently, managers usually try to make their diversifications not appear as such, since they fear a negative market reaction (no manager today accepts the label ‘conglomerate’ for his company). The fashionable phrase is ‘core competence’: diversifying is good, as long as it is within
the company’s basic area of expertise. This, of course, is true, but so vague that it does not mean much in strategic terms: Dragados’s managers said that their company was not diversifying, since it continued to be in the construction business. This may or may not be true (in the end, it is a question of definition), but labels have nothing to do with the creation or destruction of value.

Moreover, diversification not only fails to lessen the risk for the owners of the company (the shareholders), it actually increases it. The reason is that operational risk increases when trying to manage businesses that are not well understood, no matter how many consulting techniques are used. Behind many dramatic failures (and many others less well known, because less important), such as the bankruptcy of the Barings bank, which disappeared in a day because of the enormous losses incurred in derivatives operations in currency markets, there is a company that a short time ago entered into a new business and found itself with unexpected problems, as a result of its inexperience.

In fact, to the famous saying of ‘don’t put all your eggs in one basket’ the opposite can be stated: ‘put all your eggs in one basket and watch it closely.’ In general, a specialized company has much less operational risk than a diversified company since, by definition, it knows its own business better. And this includes, of course, the general management who must determine the company’s strategy.

All these arguments explain why the few conglomerates that remain today are valued by the stock market with a strong discount, that is, at a price lower than the sum of their parts, which is a definitive example of the destruction of value by corporate management. As we will now see, there are a series of mechanisms that prevent this situation from becoming widespread, but in countries with poorly developed capital markets (such as most of Continental Europe, not to mention developing countries) the situation can be stable and the conglomerate can continue destroying value for its shareholders (and society as a whole) for years without anything happening.

**Growth in New Businesses That Does Respect Strategic Logic**

We have seen why diversification that we can call typical does not work: it starts with an erroneous concept of strategy, creates companies that are difficult to manage, does not take into account the reality of entry barriers and the essence of profitability (in a word, strategic logic). This criticism is
Diversification

profound, since it does not refer to the execution of a particular diversification plan, or even to most of them, but to the idea of growing by entering other businesses. It could appear, therefore, that there is no way of growing along the third dimension, while preserving profitability, but there are ways to do it, and we are going to analyse them in detail. Basically, there are two ways to earn money through diversification: restructuring and sharing costs. Let’s begin with restructuring.

Diversification Based on Restructuring

Imagine a company that is in a mature sector, with little growth, without special investment needs and protected by entry barriers. Logically, it is a business that should provide good profitability and a strong cash flow, year after year. Imagine now that this company is quoted on the stock market, and that ownership is very spread out, so that there is no clear owner. In such a case, it is quite common for the managers of the company to make decisions that in fact divert a significant part of cash flow to uses that are not in the shareholders’ best interests. This money could go to expand the company in fashionable but not profitable businesses, or more simply, to ensure a comfortable lifestyle for management: salaries, offices, perks, even a small aeroplane, if the company is large enough. This situation of relative inefficiency is stable, since not even the competitors can tighten the screws (remember there are entry barriers), nor can the owner put things in order, since ownership is fragmented, and the company is, in fact, controlled by management. In order to simplify our example, let us assume that the company’s spare cash flow could be €100 million, but only €50 million make it to the balance sheet, because of a combination of the inefficiencies described above. If the market assigns a PER (price/earnings ratio) 15 to companies with the characteristics of our example (stable profitability, little growth), the market value will be €750 million, and will increase very slowly, as profits inch upwards over the years.

Now imagine that someone launches an offer to buy the company at that price, or even paying a premium: €1000 million. Shareholders will be happy to sell, since they obtain an immediate capital gain. Once in control of the company, the new owner can clean up the activities that detracted from the creation of value and, without the need to invent anything, merely dropping unprofitable businesses and reducing unnecessary general expenses, can obtain the potential cash flow of €100 million. Since
nothing changes, the PER will remain the same, so the company will have a value of €1500 million, generating a large capital gain for the buyer.

This strategy has been used successfully on some conglomerates, especially in countries such as the United Kingdom and the United States, with wider capital markets, which allow, firstly, the existence of companies without owners and, secondly, the possibility, given sufficient financial means, of buying and restructuring them, without excessive political or social problems. Of course, this creation of value by restructuring only happens once: when the company has been acquired and cleaned up, its belonging to larger company (which will have become a conglomerate itself) no longer creates value. To return to our example, the market value of €1500 million is not going to increase further by being part of the larger group. Instead, it will possibly decrease, for the reasons indicated in the previous section on the problems of managing diversified companies. The logical implication is that once the company is restructured, the most reasonable thing to do is sell it at its new value and with the money (and experience) thus obtained, repeat the same operation, perhaps with a somewhat larger target (and therefore, more difficult to buy but, presumably, with more fat to cut).

Although very profitable, this strategy has some limitations that cannot be ignored. In the first place, it cannot go into complex businesses, ones with investment needs or based on fast-changing technologies: the new owners, in their desire to eliminate superfluous costs, may damage the competitive position of the company; or, what is more frequent, for fear of making that mistake, they do not dare to restructure with the necessary energy, thus not obtaining the expected benefits.

The second limitation of the restructuring strategy has to do with growth. As the restructured company goes about its business successfully, it grows. This means that in order to maintain its rate of growth, the restructuring operations must become larger and larger. But the opportunities for buying cheap companies and restructuring them are limited. In addition, there aren’t that many barriers to entry to this strategy, so other companies engage in restructuring. Finally, the managers of companies that are candidates for the treatment end up seeing the problem coming, and they themselves proceed to restructure their companies, in order to save their jobs. Consequently, the restructured company, which has turned into an acquisition machine, either reduces its growth sharply (with a more than probable drop in its own share price, which will make future work more difficult) or ends up buying something that it should not, being too expensive, difficult or simply outside its field of knowledge. The result is usually one or two years of problems and the taking apart of the conglo-
erate, which is fragmented into a series of companies, giving independence to the ones that remain inside. This is what happened with Hanson and Tyco, two companies that practised this strategy very successfully during the last two decades (Figure 6.3).

**The Search for Synergy: Sharing Costs**

The second strategy for entering profitable businesses successfully, in spite of the entry barriers that protect them (since if there were none, the business would not be profitable) is simply not having to pay the full entry price. Imagine a company that wants to enter the yoghurt business. There are entry barriers to some of its various activities: perhaps there are economies of scale in supplies and manufacturing, the distribution logistics of a fresh product also requires a large volume and certainly there is a strong barrier in marketing, if the company wants to sell with its own brand. All these barriers help the business to maintain its profitability, without the appearance of new competitors.

If, however, the company that decides to enter the yoghurt business is already in other food businesses, it could probably use the same brand and the same physical distribution, as well as its knowledge of negotiating with large distribution chains and marketing consumer products in general. In this case, the company does not have to completely pay the entry ticket, since part at least is covered by its current businesses, which have already

**Figure 6.3** Value of shares of Tyco International

![Graph showing the value of shares of Tyco International from 1997 to 2002.]
paid for it. When a company can enter a profitable business without paying the full entry costs, there can be the creation of value. This strategy, which we discussed in the first chapter when we talked about shared costs, is what the majority of the large multinational companies follow, with more or less success, from food companies (Nestlé, Danone, Unilever) to consumer electronics, such as Sony and Matsushita.

Of course, this strategy also has its limitations: for it to be logical, there must really be shared costs. Here it is relatively easy to be fooled, stretching the notion of synergy until it includes almost anything. Synergy does not arise because the company so decides. There is synergy if the company can carry out an additional activity without incurring all the necessary costs, because some of those costs are already being incurred in another activity, and it is not necessary to replicate them. If there are no real cost savings, the company has really embarked on unrelated diversification, like the conglomerates that we spoke of earlier, although their businesses may be similar. Realism is important: it is easy to expect to find synergies by sharing a sales network, production installations or even a brand, only to realize later that in order to be as efficient as specialized competitors, there must be specialized assets. In this case, synergy does not exist. Companies also often find that fixed costs are more variable than expected. In a particular case in which I participated, a company acquired another and one of the basic synergies was to be that it could do without the sales network of the second, since the salesperson of the purchasing company, who already visited the same clients, could sell the new products. This turned out to be false: a salesman cannot sell 80 products with the same efficiency that he sells 40. In addition, as we have repeated throughout the book, a large company is always more expensive to manage than a small company; if the synergies are not real, the diversified company will be less profitable than a collection of specialized companies.

A strategy of related diversification and shared costs also implies related management. If the company decides to enter a new business because it already knows some of its essential aspects well, thanks to its current operations, it must make sure that this knowledge is really applied to the new business: it will not happen on its own. A company such as Nestlé, for example, must be managed as a unit, making sure that the core know-how is transferred from the traditional activities to the new ones. A more decentralized management would not be able to ensure the desired synergies. As we can see, it is an approach that is radically different from that of a typical conglomerate, in which each division is independent. Even if there are potential synergies, they are not automatic: the company must arrange organizational mechanisms to ensure the capturing of those
synergies. Without these mechanisms (which are expensive), such as common training of managers, rotation of managers, central consulting services, remuneration systems and control based on the group and not the division and so on, the transfer will not occur.

These two strategies, restructuring and shared costs, are compatible: a company buys another that has a potential for improvement, restructures it and then keeps it within the group, enjoying synergies. But keeping it in the group, that is, creating a diversified company, only makes strategic sense if there are ongoing synergies, that is, if the new business is more profitable inside the group than it would be outside. This profitability can only come, as we know, from a decrease in costs (because there are shared costs) or from an improvement in prices (because clients really prefer to buy from a supplier with a complete line). As we saw in the previous chapter on internationalization, however, the company must be sure that its clients really value (that is, are willing to pay more for) a full offer from one company than an offer from specialized suppliers.

Here one must be careful of a series of strategic myths. For example, many companies justify the purchase of others in similar, although different, businesses, stating that in this way they offer a ‘full solution’ to their clients. This may be true, but they still have to see that their clients value this. Consider the following detailed example.

As is known, auditing companies have been getting into the information systems consulting business, general consulting, tax advisory, and then almost everything, to the point of presenting themselves as ‘integrated professional services providers’. Strategic logic throws a different light on the validity of offering each of these services.6

When the auditing company offers a client help to improve its information systems, it is following strategic logic, since its costs as a consultant will be lower than the costs of any other consultant, given the auditor’s intimate knowledge of the client’s information systems (and it has already been paid by the audit client to obtain that knowledge).

Something similar occurs with the services of tax advisory: all auditing involves, by law, an evaluation of the tax risk of the client, which implies that the auditor has to know the client’s tax policies and can, at very little additional cost, offer him valuable advice, if there are areas for improvement.

But when the auditor wants to offer legal services, or strategic and technological consultancy, it is entering another territory: here the auditor has no special advantage over any other competitor, and there are no synergies. Consequently, clients do not have any special advantage in hiring them. The argument that ‘they know us and trust us’ only goes so
far: a large client also knows other suppliers and often prefers to engage specialists for each different job (apart from the conflicts of interest that can arise in the example we are discussing).

In short, the advantage for the client of ‘buying everything from the same supplier’ is exaggerated, since the client is perfectly able to manage different specialists; on the other hand, the costs of ‘buying everything from the same supplier’ are very real: lack of specialization, conflicts of interest, complexity of management. Frequently, specialists are the most profitable suppliers, except in those cases where there are real synergies, as we have seen.

Conclusion

Growth along the product/market axis is an essential road for a company’s development. The capacity to leverage the assets of the company, especially the intangible ones, such as brand, reputation, know-how and so on, in order to attack markets protected by high barriers, that is, profitable, but in which it does not have to pay the full entry price, is one of the clearest ways by which the managers of a company can create value, but this is not easy, as experience has shown. Generally, diversification consists of entering areas that the company does not know well, usually by buying another company, as we will see in the next chapter. But this almost never works: if the business is good, the purchase price (entry barriers) cancels out any possible future profitability. And if it is not, making a company grow does not consist of planning which businesses have a good future and entering them. If it were so simple, everyone would do it, and it would not be profitable, no matter how much future those businesses may have. As we know, the profitability of a business stems precisely from the difficulties that new entrants find when trying to establish a solid position in them. For this reason, only a diversification that is supported by a reality that gives the company a rebate on the entry price makes strategic and economic sense.

Private investors should, of course, diversify their savings, by investing in unrelated businesses. Managers, however, should not take the place of the investor, and should concentrate on their task of creating value: reducing costs, increasing prices because the clients want to pay them because they find value, and developing new businesses in which they have an advantage over the rest. Diversification that does not follow these rules will always end with a serious destruction of value for the shareholders and, in the long term, for society as a whole.
Notes

1. Alfred D. Chandler, in his important book *Strategy and Structure*, describes how the divi-
sional structure appeared in Dupont and General Motors in order to confront the prob-
lems described, and how it was extended to practically all sectors of the American

2. Pankaj Ghemawat, in *Strategy and the Business Landscape*, provides an excellent historical
description of the creation and development of these concepts. Reading, MA: Addison-
Wesley, 1999.

3. The difference between absolute (or normal) market share and relative share is the
following. If a company’s sales are a third of the total market, we say that it has a market
share of 33%. This is the absolute market share. The relative market share is obtained by
dividing the absolute market share of the company by the absolute market share of the
company that sells the most. Thus, if a company has a 33% market share and the leader
sells the rest, our relative market share is 0.5 (33% divided by 66%). If the leader has a
50% quota, our relative share is 0.66. If our company is the leader and the second has a
10% share, then its relative market share is 3.3 (33% divided by 10%), that is, its absolute
share divided by the following share.

The reason for using the relative share is important: to say that we have 20% of the
market is not saying much about our competitive position: if there is a competitor with
80%, we are possibly in a weak situation; if all the other competitors do not reach 3%, we
could possibly set the prices. Using relative data, the difference is immediately obvious:
0.25 against 7.

4. For evident practical reasons, some time ago the *Journal* replaced the monkey with a
computer program that generates purely random decisions. But the newspaper continues
to refer to it as the ‘monkey’.

5. Recently, a Spanish competitor, ACS, has taken advantage of the dip in Dragados’s share
price (induced by this value-destroying operation) to take it over. Their first decision has
been to sell HBG.

6. Recent events where auditors have apparently failed in their duties (Enron, Worldcom)
have given support to the idea that auditors, to avoid conflicts of interests, should restrict
their work to auditing. This is probably so, but the following paragraphs analyse the ques-
tion from an efficiency point of view.

7. Peter Lynch is one of the most successful investors of all times, having been the manager
of the Magellan investment fund, the largest of Fidelity Investments, which is in turn the
largest fund manager in the world. In the different publications in which he expresses his
principles of investment, he always insists on avoiding investing in diversified companies,
and in selling the shares of a company that announces a diversification process. To rein-
force his message, he always uses the term ‘diworsification’, instead of ‘diversification’.
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The explosion in the volume and value of mergers and acquisitions (M&As) in the 1990s has become commonplace in the comments in the economic and business press. The impression that we often get is that there are more and more companies merging and that companies in general are becoming bigger and bigger. The data, of course, backs up this impression: as Figure 7.1 shows us, M&A activity has increased enormously in recent years, only to taper off recently because of the drop in the world stock markets from 2001 on.

**Figure 7.1** Mergers and acquisitions, 1990–2001

*Source: Thomson International Securities*
This phenomenon is very important for the management of a company, since it is just the way that the strategies of diversification, internationalization and so on that we have been discussing are carried out. M&As are not, therefore, a strategy in themselves but rather a way of implementing a company’s strategy. The growth of the company, along the three axes of integration, diversification and internationalization can occur in an organic way or by acquisition. In the first case, the company hires people, builds factories and introduces new brands or products. In the second, the company acquires other companies that are already involved in the operations that it wants to establish in order to grow along the three axes. This is why, in practice, mergers and acquisitions represent an important part of the company’s strategic activity, although they are a strategic means, not an end.

But it is also frequently mentioned that, in spite of their popularity, mergers and acquisitions are not a one-way ticket to success: a great many fail. Although data are not precise (we would have to start with a long discussion on how to define exactly ‘failure’), the studies that have been published by academics as well as consulting companies on the issue show that two-thirds of the M&As are failures, in the sense that they do not reach the desired objectives and, in many cases, destroy value for the shareholders (that is, the additional profits, although they may exist, do not compensate for what was paid for them).¹ Thus, in the latest of these studies, the consultancy KPMG analysed the 500 largest M&A deals made between 1996 and 1998. The results, a few years later, are striking: more than a third of the companies that bought another had already sold it, or were trying to. Even more shocking: 32% of the presidents or financial directors concerned with originating the deals had lost their jobs. The great majority (more than two-thirds) have destroyed value for the shareholders.²

There is a phenomenon, less discussed but no less common, which we could call ‘demergers’: companies that bought others at a high price because they expected to earn a lot with them, selling them some years later, after heavy losses, often for much less than they paid. These cases go from BMW getting rid of Rover, six years and DM6 billion later, for £1 sterling; to AT&T, which first bought NCR, in 1990, for $6 billion, only to get rid of it through a ‘spin-off’ in 1995; afterwards it entered the cable business, paying billions again, only to proceed in 2001 to separate itself from these companies too.

In many cases, demergers are not the response to a failure as obvious as the previous ones, but rather to the recognition that some businesses are better separated than together, as we saw in the previous chapter. In recent years we have seen the separation of Vivendi Environment (water treat-
ment) from Vivendi Universal (films and music) and the separation of British Telecom and its mobile phone subsidiary.

However, the reality is that companies frequently merge, in their desire to grow, and results are often not good. If we admit as approximately correct the figure of two-thirds ending in failures cited above, we will have to conclude that, as an operation, M&As are extraordinarily risky. In spite of this, their popularity increases. In the following pages we will attempt to understand the motives that justify a merger or acquisition within our strategic logic, the fundamental reasons for so many failures, and what practical advice can be given to the company that is considering such an operation. In order to do this, first we must reaffirm the principles of strategic logic that will allow us to analyse a process as complex as some of the large mergers that have been carried out in recent years.

**Strategic Reasons for a Merger or Acquisition**

As we have mentioned repeatedly, any strategic decision only makes sense if it increases the profitability of the company (or at least protects it), and this can only be obtained by increasing prices or lowering costs (while maintaining all other variables constant, of course). An operation that does not give these results will normally be negative. And this is especially so in the case of mergers and acquisitions because, as we will see later, they often create costs of their own. The argument we have used to analyse organic growth along the three axes – growth that only adds volume without improving profitability is negative, since all growth involves costs and risks – applies even more to growth through mergers and acquisitions.

A merger/acquisition only makes sense if it creates value, that is, if the resulting company is more profitable than the sum of the two previous companies. This is the first necessary condition for a merger to respect strategic logic. An accumulation of companies that does not produce an improvement in joint profitability, through any one of the ways we will now analyse, will destroy value, for its own increased costs will lead to a decrease in profitability. There are also other necessary conditions to make a merger/acquisition successful, which we will analyse later on, but the first is that it must absolutely improve the profitability of the company, that is, produce an effect of increasing the profitability of the merged company over the profitability that the merging companies would obtain separately. In the pages that follow we will see in which cases a merger/acquisition can create value.
Searching for Size

The first logical reason is to grow to reach the minimum efficient size, since a merger is without question the fastest way for a company to get there. We have already discussed several times why a company needs to reach the minimum efficient size, if it is to compete in the medium and long term. If the company is below this size, it only has one option: to grow until it reaches it. This can be impossible in practice, since the market can be more or less saturated, and competitors are not going to make room easily. In other cases, many competitors are below this minimum size because, as we saw in Chapter 3, a change in technology can involve greater economies of scale; or a change in legislation can open to competition a sector occupied by protected companies, previously able to survive with an uncompetitive size.

Facing the need for strong growth in order to obtain size and lower costs, and the impossibility of obtaining it organically, companies have just one way out: merge with other companies, either buying them or letting themselves be bought by them. This is the case, for example, of SEAT and Volkswagen.

In the 1960s, the Spanish Government decided to promote its own automobile industry. Following the essentially protectionist and autarchic philosophy of the times, it formed a company called SEAT, majority owned by the government, to manufacture cars. The technology was contributed by FIAT, which obtained part of the capital and some royalties for its contribution. The product was not competitive on the international level, since the factory was relatively small (the Spanish market could not absorb, in those years of economic difficulty, the production of a factory that reached the minimum efficient size), and the government proceeded to protect the company: importing automobiles was greatly limited, so that SEAT could easily maintain a very large market share in Spain. The company grew with the Spanish economy in the 1970s and 80s, but it never developed its own technology (because it did not have enough volume), and it could never grow much, since it could not export (FIAT did not let it compete with it outside Spain). In addition, the company was never very efficient, as is normal in protected companies with a guaranteed market. Its dominant position in the Spanish market was more or less guaranteed.

When Spain entered what was then the European Economic Community, a basic legal change occurred: the Spanish Government could not continue discriminating against foreign-made cars and, in a period of three years, had to liberalize the market completely. SEAT, which had never sold
more than 600,000 cars a year, found itself with the need to triple its sales in order to reach the efficient size necessary to compete with the Peugeots and Volkswagens of this world on equal terms. The task was obviously impossible (where would SEAT make and sell the extra million cars per year?), so there were only two realistic options: close the company or merge it with a group that did have the necessary size. Finally, after FIAT had rejected the purchase, Volkswagen took over SEAT and incorporated it fully into its group, giving it access to its technology and design and its European distribution network, as the guarantee of quality necessary to sell in markets in which the SEAT brand was not known. Suddenly, SEAT became a viable company; by becoming part of a larger group, it had access to a series of necessary assets (research, marketing) in order to compete, but which it could not have paid for by itself, given its small size. The creation of value is clear: SEAT earned more than before, and Volkswagen, if it paid the right price, took advantage of that renewed profitability at very low marginal costs.3

This type of merger/acquisition is frequent in fast-changing situations, whether they are induced by technological or legal changes, which more or less suddenly leave a number of companies below the minimum size. The union of several of these to form a viable group or, more simply, the absorption of the smaller ones by others that do have the size, along with the means to compete, can be a clear source of creation of value: the companies become more profitable than before.

Increase the ‘Reach’ of the Company

A second reason can be to gain not so much size as reach. A company that wants to expand geographically can choose, as we saw in Chapter 5, to open its operations in a new country from scratch, or it can acquire a local company already in operation. Evidently this is a rapid way of internationalizing a company, at the same time obtaining the desired assets and the local personnel necessary to run them. Thus, the European banks that, enthused by the liberalization of the market, wanted to enter other countries of the EU, normally did so by buying a bank already in operation there: although it is more expensive than starting from scratch, it is much faster and decreases operating risks, since it is a bank that already works, with a track record that can be checked.

This increase in reach can also be pursued along the two other axes of growth: diversification and vertical integration. In effect, for a company like Nestlé it is faster to enter the segments of the food market where it
still is not present through the purchase of already established companies than to start from scratch, especially if the business acquires a well-known brand or some proprietary technology, as was the case with Nestlé’s purchase of Rowntree. Of course, as we saw in Chapter 6 on diversification, Nestlé will have to pay the real value of the brand that it is buying, which means that it will not gain much unless it develops additional advantages, as we saw. But if these advantages are real (such as sharing costs), then value may be created. In short, an acquisition carried out to fill the gaps will be within the rules of strategic logic and capable of generating value when having a complete range makes strategic sense, because clients value it or because producing and selling a full range has lower costs than producing and selling individual products.

The increase in reach can even define a new vision for the company. It can, for instance, transform a company basically dedicated to water supply, like Générale des Eaux, to a telecommunications and later music and cinematographic production giant, to the point of changing its name to Vivendi (and later to divide itself again, as we have seen). Logically, this is the riskiest growth, and we will see in the following pages why it almost always destroys value for shareholders, no matter how celebrated it is at the time.

**Reduce Installed Capacity**

The third strategic reason that can make sense for a merger is one of which protagonist companies do not usually speak in public, but which is behind many of the operations that are observed, although the reasons given in public are different: it is simply a question of reducing the installed capacity.

There are many businesses where technological advances make companies able to produce more and more with the same resources. If the market does not grow or there is little growth, the result is an excess of capacity, which tends to depress margins, since it sharpens competition, as we saw in Chapter 1. This is the case with retail banking: advances in computer technology allow banks to offer clients more services with less personnel. This creates excess capacity in the banking sector, which undermines its profitability. A solution to this problem is, of course, to reduce staff and offices systematically, but this is not easy: if it reduces the number of offices too rapidly, a bank runs the serious risk of losing market share, if a competitor does not do it at the same rhythm. The evident solution is to merge. Once united, the banks can calmly optimize the networks and needed resources, improving overall profitability.
In many cases, a merger that is presented as an attempt to obtain economies of scale is, in reality, a relatively simple way of withdrawing capacity from the market. The problem is not that the merged companies were too small but rather, paradoxically, they were too large for the real size of the market. A merger permits them to eliminate an important part of the installed capacity, optimizing the result.

Of course, these mergers provide an added advantage: not only do they reduce installed capacity, but also the number of competitors, which, as we saw in Chapter 1, is one of the determinants of the intensity of competition in a sector. It is very interesting to observe the profitability of the banks in different European countries according to the number of competitors, which follows a perfectly predictable guideline: higher concentration (that is, fewer competitors), more profitability.

This competition-reducing effect sometimes forces governments to intervene, preventing the merger, in order to avoid a de facto monopolistic situation, as happened with the attempt to merge Ernst & Young and KPMG in the audit sector, or First Choice and Airtours in packaged holidays. An excessive industry concentration can clearly be detrimental to customers and the overall economy. But there is no doubt that mergers can be a good way to reduce excess capacity, therefore creating value for shareholders.

Acquisitions in Order to Restructure

A company may acquire other companies if it knows it can manage them better than their current managers, as we saw in the previous chapter. In this case, value can be created, but the conditions we noted must be taken into account: buy simple businesses that are easy to manage without an excessive knowledge of the sector, with stable cash flows and reasonable sizes. A company that develops the ability to find poorly managed companies which have potential can earn good money by acquiring and fixing them, and then selling them to avoid falling into the inefficiencies of conglomerates.

Acquisitions to Consolidate

In discussing mergers carried out to reach the necessary volume, we mentioned how these are frequent in sectors in consolidation. Thus, there are many businesses that have been fragmented traditionally (very small
efficient size with respect to the total size), but which begin to consolidate, because some company discovers a more efficient way to do things, which requires size. An example is office cleaning services, a business that started with a multitude of small companies because there are no large economies of scale, but that starts consolidating when a company manages to find a way to work more efficiently at a higher minimum efficient scale. In cases like this, small companies will disappear, often by selling out to the company or companies that are actively consolidating the industry. These acquisitions lower the exit barriers to unviable competitors and facilitate the growth of those that are viable. If the prices paid are reasonable, the strategy makes much sense, as it achieves several objectives at the same time: increasing the size of the leading companies, decreasing the number of competitors, reducing the exit barriers and facilitating geographic expansion, which is usually necessary as part of the strategy of the leading companies. The development of companies such as Rentokil or Compass can be understood along these lines.

**Why Mergers/Acquisitions Fail so Often**

We have seen some very important reasons that justify mergers. However, we have already said that most of these operations do not work. Why? There are three levels of problems: strategy, execution and price. We will discuss each of them in detail.

**When the Merger does not Respect Strategic Logic**

We begin with strategic errors. We have seen some reasons that from a strategic point of view *can* lead to the creation of value in a merger/acquisition, but, frequently, the operation does not really fall into any of the categories we have noted. Let us take each of the key strategic reasons in turn and see how what appears to be a sound strategic reason may not really be one.

Let us start with *size*. We saw that a merger can be a way – perhaps the only way – for a company to grow as rapidly as required to reach the minimum efficient size. But what happens when both merging companies are already above the minimum efficient size? They cannot, by definition, reduce their costs through economies of scale. This is more frequent than it appears, since economies of scale rarely reach the infinite (or they are more than counterbalanced by the additional costs generated by the
complexity of managing a larger company). Thus, the merging companies hope to obtain savings, thanks to their greater size, but these do not occur, since they were already obtaining all the possible savings. As a top manager of Daimler-Benz said to me after the merger with Chrysler: ‘We hoped to save money by pooling the purchases of the two companies, but we realized that we were both already buying at the lowest possible price.’ No supplier can sell for long without making money, which puts an evident limit to the savings to be obtained. If both companies were already sufficiently large before the merger to obtain the lowest possible prices, it is clear that, by definition, the merger cannot lower those prices. And this is very common. In fact, it is difficult for two large companies that merge to be able to really improve their costs through economies of scale. The idea that they have to be larger to compete is simply false when the companies have already reached the necessary volume. The merged companies are larger, but not necessarily more profitable.

Yet they still face the added problem that, as we have repeated on numerous occasions, large companies are costlier to manage than small ones. Therefore, if they do not obtain new economies of scale, but incur new management costs, the net result is negative. The example of DaimlerChrysler is illustrative, but not at all exceptional. The fact that DaimlerChrysler had, six months after the merger, more employees than the sum of Daimler-Benz and Chrysler before the merger is telling, but logical: there were no economies to achieve and there was a more complex company to manage.

If the search for size just for size’s sake is a frequent strategic error, so is extending reach, when this makes no strategic sense. We see this often with the urge to reach globalization, as we discussed in Chapter 5. This globalization of the company might not follow strategic logic at all: if there are none of the advantages that we saw, a global company will be, with almost total certainty, less competitive than a local company, which concentrates on its natural market (whether it is purely local, national or continental). However, public opinion sometimes seems to push companies to globalization as an objective in itself. Thus, it is not unusual to hear or read statements such as ‘if this company really wants to rise to the occasion, it must accelerate its globalization process’. But the objective of a company is not to ‘rise to the occasion’, or ‘not to lag behind’, but to earn money; and this is only achieved, as we have repeated in each chapter, by improving the margins: raising prices or lowering costs.

As we have already seen, in some cases internationalization can help to achieve this goal, and then it is essential, since those competitors
pursuing it will drag the rest along; but if the necessary strategic circumstances do not exist (need for a large market in order to achieve economies of scale, preference of the multinational clients for a single supplier and so on), the process of internationalization will not work. As a corollary, mergers carried out without these strategic circumstances will fail. In this sense, the comment a member of the board of directors of a large multinational company, with headquarters in Germany, is illustrative. To my question of why they were buying a Japanese company in serious difficulties, he answered by showing me a world map in which the volume of sales of the German company in each country was marked in red. The map showed heavy coloration in Europe, medium in America, and almost nothing in Asia. His answer was: ‘As you see, we do not have an option. If we want to be global, we must be in Japan.’ This is obviously true, but totally divorced from strategic logic. I repeat, a company’s mission is not to be global, but to be profitable. The fact that the sales map appears unbalanced cannot be the reason behind an investment of billions of euros.

Frequently, geographic expansion does not produce any real advantages, as we have seen. This is one of the reasons why the merger between Terra and Lycos, which created ‘Europe’s largest Internet company’ at the time, made no real strategic sense. Managers said that the company had become the ‘leading global Internet company’. Well, apart from leaving out some countries such as most of Western Europe or Japan, the reality is that the supposed globalization did not make much strategic sense. In effect, what advantages does the fact that the company now has operations in the United States bring to the Spanish user of Terra? There is no joint use of contents (for reasons of language and interest), base technology or even the sales effort for advertisers: most of them are different in each country, and the few global ones (Sony, IBM, Coca-Cola) either do not advertise in this medium or they can contract with different portals, one in the United States, another in Spain and yet another in any country they want to advertise in. If the reason for the merger is to have the capacity to offer advertising in many countries at the same time for less money than it would take to advertise on a country by country basis, the merger destroys value: to lower prices, companies do not need to merge; they can do it on their own. In the absence of a lowering of costs, all decrease in prices is pure value destruction.

Along these lines we can include the merger of Dragados and HBG, mentioned in the previous chapter. It is true that Dragados became a larger company, with a strong new presence in the Netherlands and Germany, but this does not help its shareholders at all: it is not going to obtain better prices from its clients, nor is it going to be able to lower its costs, since the
two merged companies basically do different things in different places. To this lack of synergy one must add the additional costs that are derived from trying to manage a Spanish/Dutch company, with all the cultural and management problems this entails, without any additional benefit, except for boasting that they are now fourth in the industry’s European ranking.

There are many examples that we could add here. In fact, it would be enough to go back to the headlines of the last decade’s Financial Times to select some. What did Deutsche Telekom’s shareholders gain when it bought the American Voicestream at an extremely high price? It makes for nice copy of the type ‘becoming a global player’, but how does that improve its services? How does it lower its costs? What value is created? None.

If the mergers in search of size or greater reach frequently fail to follow clear strategic logic, the risk is clearly greater in the mergers that want to develop a great strategic vision, because it is here that the cardinal errors are often committed. A good example is the decision made by several airlines in the 1980s to become something more than simple transporters and turn themselves into suppliers of all the travel needs for the business. Specifically, the idea was to sell the plane ticket, the hotel room and the rental car in the same package. To this end, various airlines, beginning with American Airlines, bought hotel chains and controlling shares in car rental companies.

Superficially, the strategy seems to make sense: airlines’ most profitable customers are businesspeople, so anything that helps to sell them more services, with the high margins of a business class ticket, has to be profitable. Since the business traveller often needs, in addition to a plane ticket, a hotel reservation and a rental car, why not sell him the three things at once?

The strategy only makes sense, however, if you forget strategic logic. The only way to improve the profitability of the company, as we have repeated over and over, is either by improving its prices or lowering its costs. How does being ‘a full-line supplier’ help either of these two things? No one is going to pay more for a plane ticket or a hotel room because the company that sells both is the same one. In fact, one usually expects a discount when buying more. And there are no real cost savings: the only shared cost might be the sales operation itself, but in the real world, this is done through a travel agency, and it has to introduce the different data separately into the computer. The fact that the hotel we are going to belongs to the airline we are flying with does not reduce any costs at all.

In fact, not only does this strategy not follow strategic logic, it is also impossible. For a medium-sized airline to truly offer its customers a
complete hotel and car rental service, it would have to have hundreds of hotels, in various price ranges. British Airways, for example, flies to well over one hundred destinations. Moreover, to be able to really offer a hotel to its business clients in Tokyo, Paris or New York, it would need at least ten in each city, with the necessary variety of price and location that its travellers will in fact demand. Even if it does this, many travellers will prefer a hotel closer to the place where they will be working. The main criterion for choosing a hotel is not its owner, but its location and price.

In addition, this does not take into account management complexity, which is so easily forgotten. What do the managers of an airline know about managing hotels, where the necessary skills are very different? Of course, if the airline acquires a hotel chain, it also acquires a management team. We are, however, getting into the complexities of the diversified companies that we saw in the previous chapter: general management will have invested in a business that it does not know, and this usually has negative consequences, especially when problems arise (the hotel business is very cyclical). The real-world result, of course, was that the strategy did not work and, after a few years of not having any additional profits (and in many cases, losing money), airlines proceeded to get rid of their hotel chains and car rental companies, although some have not been able to sell them yet at a price remotely similar to that which they paid for them. For, to cap it all, there are many reasons why, in these cases, prices paid for acquisitions tend to be much higher than they should reasonably be, making the profitability of the operation impossible from the start. We will see some of the reasons in the pages that follow.

A similar case, from the structural point of view, was the attempt by Japanese consumer electronics manufacturers to penetrate the market of content production. In 1990, both Sony and Matsushita decided, in order to ensure that their equipment had software, it was best to get directly involved in the business of its production. So, Sony bought Columbia for $5 billion and Matsushita bought Universal Studios for $6.6 billion.

This argument seems to make a certain sense: Sony suffered when its Betamax video system did not prevail, since the entire market went to Matsushita’s VHS. Sony attributed the problem to the fact that the film studios did not want to issue films in Betamax format, which slowed its sales. Anxious to see that this did not occur again, Sony decided to be the owners of the films. This is, essentially, a case of vertical integration, as we discussed in Chapter 4.

The attentive reader of that chapter will, of course, have already detected the strategic fallacy: if the film studios do not produce films in a certain format, it is probably not because they have a special animosity
towards that format’s owner, but because they think that it is not profitable to do so. If the format is not profitable, Sony will lose money in its new film-producing unit. But what if what Sony loses producing Betamax tapes is less than what it earns selling Betamax video players? Vertical integration is not justified in this case either. In effect, Sony could use the money it would spend in enduring the losses in the production of tapes in subsidizing the film studios (all of them, not just one), so that they would produce tapes in the format it wants. That amount of money will always be less than the foreseeable losses in entering a new business.6

In practice, of course, strategic logic prevailed. Sony and Matsushita lost enormous amounts of money by trying to manage businesses completely different from their own. For years, Hollywood was full of stories about the culture shock experienced by the Japanese bureaucrats when confronting producers, screenwriters and actors and their quite different working (and spending) habits. Eventually, Matsushita sold out for an accumulated loss of $3 billion.7 Sony decided to keep the business (now called Sony Entertainment), basically because it saw no dignified way out. Profits are relatively marginal, and the losses of the first few years were several billion dollars, to be added to the $5 billion it paid up front.

Something similar can be said of visions that, in the end, just involve the purchase of a distribution channel, with the purpose of ‘making a stronger company, able to distribute its own products’. This, again, is totally false, as we saw in Chapter 4: a sales channel is another business that has to earn its own way. When Disney bought ABC, one of the large United States television channels, it gave as a strategic reason that in this way it could distribute its products. But this is absurd: Disney (and any producer) can distribute its products with high profits if the products are good. In fact, it is more unique (and therefore, more profitable) to be the owner of Snow White than to be the owner of a television channel that has to buy its programmes, in competition with the other channels. But if being the owner of a channel were more profitable, the purchase price of the channel would reflect this profitability. In other words, no matter how much managers resist accepting it, there is no synergy between owning the contents and owning the distribution channel, at least in general terms. If there is some special reason that creates this synergy (some reason for which the clients will pay more if both activities are owned by the same company, or joint costs decrease), the acquisition will make sense. But only in that case, which is certainly not that of Disney/ABC.

More recently, America On Line (AOL) and Time Warner merged with the same idea: the contents of Time Warner (itself the result of a not very profitable merger) would be distributed through the Internet by AOL, thus
giving shape to a vision consistent with the convergence of the old and the new economies. Of course, the story is fascinating for analysts, public opinion and, especially, investment bankers. But it follows no strategic logic. Only one year later, the market began to see the reality: they are different businesses and they have to earn their way differently. The fact that one can sell the products of the other does not generate any synergy: they could do that before. There is no creation of value (higher prices or lower costs). Today, whoever wants to see an official Harry Potter Internet site can only do so by being an AOL subscriber. To obtain that exclusivity (which may or may not be a good marketing idea), however, it is not necessary that AOL be the owner of the producer of the Harry Potter movie: McDonald’s does not need to buy Disney when it wants to give away (exclusively) toys based on Disney film characters. It must be reiterated that there is no value created in doing so. The only thing created is a new, much larger company, which generates large commissions for investment banks, consultancies and auditors, a strong infusion of vanity for the managers, who appear in the press as visionary leaders of great world companies and a monster impossible to manage. Figure 7.2 shows the changes in the share price of AOL Time Warner.

In short, the problem with visions is that, frequently, they are hallucinations. Unfortunately, because it would all be more fun, strategic success is almost never (note the ‘almost’) in a brilliant idea, but rather in the work of many years of finding positions in the market that are, at the same time,
attractive for the clients and competitively defensible. In almost all cases, as we will see in the next chapter, this requires a detailed knowledge of the needs of the clients in order to find original solutions, company capacities and strategic logic in order only to invest in these defensible ideas. The rest is pursuing brilliant solutions, but ones that are not based on reality: hallucinations.

We see then how, frequently, mergers/acquisitions do not follow clear strategic logic, but illusory competitive advantages that cannot be translated into better profitability. It is also relatively frequent, however, that a merger/acquisition, conceived with respect for the rules of strategic logic, ends up not bringing the company the expected results. This can be due to two further problems: the execution of the operation is defective or the price paid is too high. Now let us consider the sources of these two problems.

Managerial Reasons: Optimism and Information Asymmetry

Practically all mergers, in order to make strategic sense, involve changing something inside the companies involved: if the idea is to obtain economies of scale, for example taking advantage of a common distribution network to do this, it will be necessary to actually merge the two distribution networks of the companies that are merging, either by developing a new one from the previous two, or closing one and beginning to distribute all the products through the other. One thing is clear, however: if the two distribution networks remain more or less intact, the cost savings will not occur, and the merger, although it could have been a success, will not be so, since in fact it will not create the value that it could have created. This error of not putting a merger into practice is not so rare: BMW decided to buy Rover to increase its size, but then it feared that the prestige of its brand, which allowed it to charge a premium over the price of other manufacturers, would be devalued because of too close an association with a much less recognized brand. Consequently, it decided to keep the operations of the two companies separate. Evidently, it did not produce any synergy, and the company ended up selling Rover for £1 sterling to a group of local investors, after having lost DM6 billion, as we have already seen.

More common than not realizing the possible benefits of a merger is the problem of realizing them later than foreseen. Thus, in our previous example, the distribution networks end up being optimized, the general expenses rationalized and the marginal factories closed, but much later
than anticipated, since they are complex projects requiring profound changes in the operation of the companies, which are generally quite delicate machines and which have to continue generating cash flow while they are subjected to perhaps deep and always traumatic surgery. This delay in obtaining the benefits of the merger (when the price has normally been paid in advance) worsens the financial equation and the benefits for the purchasing company end up being much lower than foreseen, although, in the long term, things do improve. We should understand the qualification as a ‘failure’ of many mergers in this sense: the merger ends up working, of course, but with economic results that do not at all justify the investment made by the purchasing company’s shareholders.

This delay is often due to the appearance of unexpected problems after the merger. In the buying/selling of companies there is what economists call ‘asymmetric information’: the seller knows the product much better than the buyer. No matter how much due diligence is done, it is often after the acquisition that buyers really get to know the acquired company. As is to be expected, negative surprises are much more common than positive ones.

A last source of problems when putting the mergers into practice is the enormous amount of management time they absorb. When two companies merge, or an important acquisition occurs, the attention of the entire management is absorbed by the operation. First, because of its importance and, second, because of the unexpected problems that we have mentioned. But this concentration on the merger/acquisition is made at the expense of the daily management of the business. Sometimes, a merger/acquisition opens an extraordinary opportunity for competitors to improve their position, since the merging company loses its competitive edge, at least for a few months, distracted by its own internal problems.

The study made by the consultants Deloitte & Touche is enlightening. Deloitte reviewed the last 40 projects where it had worked as a consultant for companies in serious difficulties. The analysis showed that 57% of the cases had a badly managed merger/acquisition as the origin of the crisis. In many cases, according to the study, the idea was bad, or the price excessive and, in almost all, partly as a result of a lack of strategic logic, the integration of the businesses was very defective, which made obtaining synergies impossible. This was aggravated by the price paid for the acquisition: if it had been too high, the situation of the company, burdened by unproductive debt, deteriorated quickly, running short of the necessary funds for the development of the basic business: advertising, new products, R&D and so on.
When the Idea is Good, But Too Expensive

We have seen that there are two reasons why mergers/acquisitions are frequently disappointing: the idea behind them may not follow strategic logic or, while following it, it is not put into practice correctly. But even when the idea is good and things are done right, mergers often destroy value. The reason is simple: if one company pays too much for another, it will never recover the investment, no matter how well things go. Let us consider this with a specific example.

Take a company, quoted on the stock exchange, which has €50 million in annual profits. Assume that the market gives it a value of €500 million, that is, it considers that this business is worth about ten times its profits. This company, in its desire to grow, obtain synergies, consolidate its position and so on, decides to buy its main competitor, a similar although smaller company that is not quoted on the stock exchange, with annual profits of €20 million.9

If the price paid is less than €200 million, the purchaser will have made a good deal, since the market values the company at 10 times its profits. If it adds €20 million to these, the market will value the company at €200 million more. If it only pays, for example, €150 million, there will be net value creation for its shareholders, but this is not what typically happens. To understand what occurs in reality, we must revisit the concept of synergy.

It is clear, in our example, that if the acquisition simply involves the addition of a new company, without other advantages, the operation will not make sense for the buyer unless the price is clearly below €200 million, since we know that, at a price of €200 million, the overall profitability does not improve but it increases the complexity of the company. But setting a price under €200 million is not interesting for the seller, since the market values at €200 million a company capable of earning €20 million. Why would their owners sell it for less? Now, as we know, a good merger/acquisition implies that the resulting company will be more profitable than the sum of the two previous ones. In our example, this could occur through a rationalization of production, closing barely efficient factories, or specializing plants in longer series; or through a joint utilization of logistics platforms; economies of scale in marketing; or simply more power vis-à-vis clients, which now have one supplier less and must face a much stronger one. In any case, let us assume that the merging companies think realistically that the future profits can be the €50 million of the buyer, the €20 million of the purchased company, plus €15 million coming from the synergies that we have just listed.
If we accept this forecast as correct (with the major qualification that these forecasts are frequently excessively optimistic, as we said before), it is clear that the purchasing company should be ready to pay more than €200 million for the purchased company, since its profits will not go up by €20 million, but rather by €35 million (€20 million of the acquired company’s profits, plus the €15 million coming from synergies). Since the market values this business at ten times profits, a price of €300 million suddenly seems attractive.

That is where the problems begin. In their desire to close the deal and access all the improvements in its competitive position that we have pointed out (and eliminating an inconvenient competitor), the purchasing company’s managers have a strong tendency to be overoptimistic. They want to believe that synergies will be significant, for this will justify the typically high price asked by the seller. Logically, the seller knows this (and if she does not, her banker does and will make it clear to her), so the price tends to go up to the maximum justifiable by optimistic expectations of synergies. In our example, that price would be around €300 million.

But what happens if the synergies are €10 instead of €15 million? The operation has no longer created value. As we have said, even if the synergy forecasts turn out to be realistic, they tend to happen later than expected, dramatically worsening the operation’s financial results. And these are, in fact, the best cases. In reality, almost all the examples of mergers carried out in recent years have shown minimal or negative synergies, since the company is distracted, as we have said, by internal matters and loses competitiveness. The destruction of shareholder value is fast and important.

This destruction of value is so evident that the typical reaction of the stock market to a merger rumour is a sharp drop in the price of the purchasing company’s shares and a comparable rise in the target company’s. Investors have learned, by painful experience, that reality tends to be closer to the example we have just discussed than to the slick presentations made by the acquiring company’s managers. (The example, by the way, corresponds to a real merger between two companies which I had the opportunity to observe first-hand.)

In short, the problem rests on evaluating the synergies that will be produced, and in the distribution of the value of these synergies between the buyer and the seller. Frequently, the synergies are exaggerated, and the seller ends up with all the value produced and more, since the buyer ends up destroying value. There are very few companies that can show a history of purchases of other companies in which the price paid has been fully justified by the incremental benefits obtained. Why, if the problem is so
clear, and the experience so frequent, do companies continue buying badly? There are those who say that these operations are, simply, the triumph of hope over experience, but there are very deep reasons that explain it.

In the first place, most managers usually have no experience of a merger/acquisition until it happens. Therefore, although there may be some literature (like this book, for example) that forewarns them of the difficulties, it is tempting to think, ‘it will not happen to us’. They honestly believe that synergy expectations are realistic (they try to err on the conservative side), but they are a forecast on a very complex operation and on something with which they have no experience, or the in-depth information that is only obtained once the company is purchased. It is not unusual, then, to be overly optimistic, given the managers’ almost unavoidable bias in favour of the operation.

Furthermore, a merger/acquisition is surrounded by a whole team of worthy professionals (investment bankers, strategic consultants, accountants) who, in general, have an enormous vested interest in carrying out the operation: bankers normally charge a percentage on the volume of the operation, and consultants earn money with all the work there is to do in restructuring the company, once it has merged. In general, these professionals, although having impeccable professional ethics, tend to see the positive aspects more than the negative ones, since this is how they earn a living. And managers also want to see it that way. In the next chapter we will analyse this management bias in favour of acquisitions (and growth in general), even at the expense of the company’s profitability. It is not surprising that if all the actors in the operation (managers, accountants, bankers, consultants) have a personal interest in it taking place, it will end up happening, although its strategic logic may be doubtful. This very real conflict of interests between all the actors and the shareholders has been aggravated by the recent trend to award managers an important bonus if the operation takes place, making no reference to the price, which is assumed to be good. It is difficult for a manager, in such a situation, to get up from the table and cancel a deal because the price is unreasonably high.

There are other reasons why deals may be closed even when careful analysis reveals that the idea (or the price) is not good: once negotiations have advanced, the companies have exchanged so much confidential information that the idea of returning to being competitors becomes very difficult. In many cases, beginning serious discussions means they are almost obliged to finish them in an agreement, at almost any price.
Finally, there are a series of circumstantial reasons that push managers to accept excessively high prices. Often, these decisions must be taken very quickly, for there may be several bidders; the target company may be the only one with the right strategic characteristics, and the argument that ‘if we do not buy it our main competitor will’ weighs heavily. All of this leads to the destruction of shareholder value. The case of Coca-Cola, where the board stopped the agreed purchase of Gatorade for $14 billion, for the simple reason that the price was excessive, is rare. Few independent directors challenge the CEO, especially if they suspect (as indeed happened) that their main competitor, Pepsi, may end up bagging the target. After this, they had to put up with seeing every day in the press that ‘Pepsi beats Coca-Cola in the business of sport drinks’. But the result is that, although it is true that Pepsi now sells more in that segment than Coca-Cola, Pepsi’s profits have gone down while Coca-Cola’s have been preserved.

All this has ended in the dramatic situation of many companies that have grown through overpaid acquisitions and now find that they cannot generate enough funds to pay the interests on the loans they had to take to carry out those acquisitions. If synergies do not materialize, and the price paid is higher than the profits of the target company justify, overall profitability will collapse. Deutsche Telekom cannot pay the interest generated by the loans it took to buy Voicestream, nor can France Telecom for Orange, or Vivendi for a whole series of extremely over-priced acquisitions. If the vision behind those mergers proves to be a hallucination, that is, does not respect strategic logic, the harm to the company may be serious.

Practical Considerations

Of course, all this does not mean that a merger/acquisition is something to avoid absolutely. But it explains why a large majority, in spite of the undoubtedly good intentions of the protagonists, fail in terms of creation of value. Now, as we saw at the beginning, there are important reasons why a merger/acquisition may be able to create value, as long as the price paid is reasonable, and the execution correct. In this sense, we cannot give simple formulas: each merger is a distinct case and has its own peculiarities, but there are some generalities that apply to most.

Deals in which there is a purchaser and a clear purchased tend to be easier to manage than mergers of equals. The reason is that the latter usually produces a long period of political instability, in which the two
organizations try to impose their ways of doing things, and individual managers try to ensure their positions. As soon as a merger between equals is announced, there is only one idea in the minds of all second-level managers: to save their job against their equivalent who comes from the other company. This, of course, does not lead to an easy and harmonious optimization of operations, or maintaining the focus on the customer or the competition. Sometimes, to get around political problems, co-presidents are even created. This launches a clear message of equality – and ensures that the fight for power and the dysfunctional attitudes are not limited to the second level of management, but reach all the way to the top. In very few cases, the two co-presidents end their terms: by the end of around 18 months, one of the two loses the battle and resigns, recognizing that the other side has won. But these are 18 lost months, in which the supposed synergies, that had justified the merger, have not been achieved to the fullest extent because of management’s distraction. DaimlerChrysler and Banco Santander Central Hispano (Euroland’s largest bank by market capitalization) are two recent examples of this problem.

Therefore, acquisitions with a clear boss are better, in operational terms, than mergers between equals, but they usually have an excessive price since, as we have seen, the acquired company usually includes in the price a good part of the future synergies. If these do not materialize to the amount and with the speed foreseen, the acquisition, which perhaps was going well from a political point of view, since there was one clear boss, will destroy value for the shareholders, because the additional profits will not compensate for the price. The advantage of mergers between equals is that they do not usually pay a premium for the acquired company, since there isn’t one: both join their assets, at market value, if both are quoted on the stock market or at a valuation in similar terms if they are not. What is gained in price, however, is usually lost, as we have seen, in lack of clarity of command and political infighting. There is a clear dilemma, and no best solution: each case depends on the prices being considered and the protagonists’ management skills. We can find examples of successes and failures in both types of mergers. What is important, in practice, is to know the specific problems of the situation in hand and evaluate them in a realistic manner.

From the discussion that we have developed up to now, a few practical conclusions can be draw. For a merger to be successful, it has to meet the following conditions:

1. It must follow strategic logic.
2. There must be clear authority from the beginning.
3. The price has to include the possibility of the synergies being much lower than forecast and, above all, that they may be achieved with a delay of up to two years.

Evidently, the application of these simple rules would abort a great number of mergers, which would be fine, since it would avoid a large amount of value destruction (although it would make life complicated for a whole series of professionals).

If these guidelines are respected, however, mergers/acquisitions can be a solid source of creation of value, since they allow rapid growth at times when this may be necessary. They also permit the restructuring of a sector, the international deployment of the company, the combination of different technological capacities to create new products and services and, in general, realize innovative and profitable strategies. But the enormous difficulties that they pose in terms of management and the great temptation that there is to see things too optimistically should not be underestimated. Once it has paid too much, a company has no possibility of recovering the value that has been destroyed, although it may become solid and profitable again in the future. In the next chapter we will analyse in more depth this destruction of value and we will go into the essence of this book: how to create value with strategy.

Notes

1. See, for example, ‘Deals That Create Value’, McKinsey Quarterly, 2001/1, or ‘World Class Transactions 2001’, prepared by KPMG.
3. In reality, SEAT’s situation was so desperate that the Spanish Government had to give Volkswagen Pta300 billion (around €2 billion) so that it would accept taking charge of the company.
4. See, for example, ‘Oligopolies Are on the Rise As the Urge to Merge Grows’, Wall Street Journal, 24.2.2002, where it describes how the last wave of mergers in the United States have resulted, in many cases, in the creation of real oligopolies, in which two or three companies control more than two-thirds of their market. A similar phenomenon is occurring in Europe, in such different markets as communications media, steel and cement.
5. One of the last airlines to sell its hotel divisions has been Japan Airlines. The losses incurred in the operation, estimated at $1.2 billion, have now cost the job of all the managers involved. See ‘Japan Airlines to Write Off $1.2 bn, Top Officers to Quit’, Wall Street Journal, 18.2.1998. Also, Swissair; which was waiting for a rise in prices to sell its hotels had to liquidate them, in order to confront the heavy losses that its failed international expansion caused. See ‘Swissair: le salut ne viendra pas de l’expansion’, Le Temps, 3.12.2001.
6. To give a clear example: the mobile telephone operators have been subsidizing and even giving away mobile telephones to their users. This has proved to be a great idea, since the potential clients had many doubts before spending €500 on a telephone. However, it
made sense for the operators, since they recouped that money in a few months of calls, which for them are a pure fixed cost (that is, without marginal cost). But to do this, the operators of mobile phones did not have to buy Motorola or Nokia: buying the telephones or, even more simply, paying a subsidy per unit sold was enough.

7. Some companies seem to attract bad strategic decisions. Matsushita sold to the Bronfmann family, owners of Seagram’s, who wanted to diversify out of the drinks business. They, in turn, merged the music and film operations with Vivendi, to create Vivendi Universal: another illogical move. Their fortune sharply diminished, now they are trying to get it out of Vivendi, to do what?


9. Of course, whether or not the companies are quoted on the stock market does not affect the argument at all, but it makes the valuation of the results easier, since there is an objective and immediate market price.

10. To get an idea of up to what point the investment banks ‘push’ the operation, it is sufficient to see that one of the most important banks in the world has been advertising in the economic press the argument that ‘we will recommend that you do not do the operation, if that is what is best for your company’. That is the equivalent of a hospital that advertises saying ‘we will only operate on your appendicitis if there really is an infected appendix’.

11. An especially problematic case, because of its amount, was that of the ‘bonus’ given to Chris Gent, President of Vodafone, for the purchase of Mannesmann: £10 million sterling. See ‘Vodafone’s Folly’, The Economist, 13.7.2000.


13. Top-level managers usually, as part of the negotiation prior to the merger, obtain all types of contractual guarantees on their future. In some cases, a lack of an agreement on this point brings down the entire process, regardless of the strategic logic that it may or may not have. See, for example, ‘Glaxo, Smithkline in Battle of Egos’, Wall Street Journal, 25.2.1998.
This chapter is, without doubt, the most important one in the book. In Part I we saw the basic elements of strategic logic and in Part II we applied them to the three dimensions that in fact define the strategy of a company. In these chapters we have tried to understand why the profitability of one business is so different from that of another, and what the basic variables that determine it are. In this sense, they are theoretical chapters that try to *explain* reality. To address most readers’ interest, however, we must go one step further: to see how to apply strategic logic ‘forwards’, that is, how the ideas that we have been discussing in this book can help to design a strategy that leads a company to the desired profitability. In Chapter 7 we tried to see how strategic logic throws light on the complex questions of mergers, but here we will try to apply this logic to the most creative aspect of a manager’s job: the determination of what the company is going to do in the future.

Reading the preceding chapters, many a reader may have discerned a negative undertone, as if the contribution of strategic logic to business analysis was basically to point out errors. But if this catalogue of errors is frequent it is because companies, in many cases, do not follow strategic logic. That is why this book is important: if entrepreneurs had strategic logic as firmly rooted in their thought processes as they have formal logic, it would be superfluous. In fact, strategic logic’s usefulness goes well beyond this necessary critical role: it is essential to design a successful strategy.

Of course, in these pages we are not going to provide a tool that generates a good strategic plan. Expecting this would be like asking a book on
logic to generate good theories in any other science. But by marrying the rigour of strategic logic to business experience, we can give some guidelines for thinking and some conceptual tools, that suggest possibilities for action that are a priori interesting. But it is management’s creativity and knowledge of the business that will make possible the development of a good strategy.

The Failure of Strategy

To a witness of the development of business management theory, it must come as a surprise that business profitability has not improved in the past 50 years. The efficiency of any other technique does nothing but increase: think how much better and cheaper automobiles have become, the new medicines that have been discovered, to say nothing of the progress in computers and telecommunications. However, the professionalization of management and the popularity of economic studies and business schools have not brought about an improvement in the profitability of companies. This is due to two phenomena: on the one hand, the zero impact, in terms of profitability, of the objective advances in a whole series of specific techniques, such as financing, logistics, marketing and so on, and, on the other, the uselessness of the strategic models that have been proposed.

Regarding what we could call ‘functional techniques’, we find the following paradox: these techniques contribute an objective and undeniable improvement in the efficiency of companies, but do not improve their profitability. We have already seen the profound reason why: as long as these techniques are available to all competitors, the competitive position of none of them will improve. What improves is the quality/price ratio that buyers get. Thus, while the quality/price ratio for cars is always improving, thanks to constant advances in production techniques, not only does the profitability of car manufacturers not improve, it has actually deteriorated in the past few years. In fact, it is a phenomenon similar to one we have discussed on numerous occasions in these pages: a machine that radically lowers production costs will not improve profitability for producers, if that machine can be purchased by all of them. It is important to remember this point, in order to understand the frustration of managers who, with great effort, implant modern management techniques in their companies, only to see no positive results on the balance sheets. And the reason is, of course, that their competitors are doing the same. This simply means that, although necessary to manage the business in the most efficient possible way (if not, the situation would be much worse), the new techniques are not at all suffi-
cient to improve profitability. The sought-after profitability will never come from the adoption of best practices that can be easily copied by all, because the same consultants who help one company help the rest. Profitability only comes from original strategic approaches that are difficult to imitate. And this is where strategy should be of help.

Strategy has been one of the key areas in the great boom in business management theory. Business strategy, as a field of study, only became established in the 1960s and rapidly became the star of the management disciplines. During the 1970s and 80s, rare was the company that did not have a strategic planning department, and did not hire some of the strategy boutique consultancies that were created during those years. At the same time, business schools became widespread, specialized publications appeared and the phenomenon of business gurus arose.

Here we could indeed complain of a lack of results. Logistics or financing have made measurable contributions to business efficiency, although they may not have helped profitability much, as we have seen. But the frequency and seriousness of strategic errors have not diminished in recent decades, as was recently shown by the bubble of activities called the ‘new economy’, and had been shown previously by the failed waves of diversification, integration and so on that we have discussed in previous chapters. The strategic reflection weekends, the long-term plans and the consultants have not improved the percentage of successes in mergers, the internationalization of companies or their pursuit of growth. In fact, the scientific appearance of some strategic planning techniques has made the occurrence of more serious errors even more likely.

The preceding chapters showed the reason for this failure: often, what is considered (and practised) as strategic planning is nothing more than a series of analytic techniques and classification schemes deprived of strategic logic. In the following pages, we are going to review, briefly, what strategy is not. We have to begin here, since erroneous conceptions of strategy are very widespread, and we cannot advance without seeing clearly why they do not work. Later, we will see how we can use strategic logic to formulate a strategy that helps to improve the profitability of a company.

**What Strategy is Not**

In order to seriously approach what strategy is, we should reflect for a moment on its objective. Although this may appear obvious, it is not, since very often the strategy really pursued by companies does not go in the direction one would expect.
Let us start from the principle that the objective of strategy is to ensure, as far as possible, that the company obtains a profit on its invested funds above the cost of these funds, adjusted for risk. Everything else is value destruction, and if managers charge a salary (paid by shareholders), it is to do just that. If they do not exceed the cost of the capital, the shareholders should simply close the company and put the money in the bank (of course, in real life, closing a company can involve the loss of a good part of the capital, so it may be in the interest of shareholders to keep going. But this does not mean that management is not destroying value). There is, then, a relatively simple way to measure the success of the company: the level and evolution of profits per share (that is, per unit of shareholder’s money). If these are good, and increase, management will have been appropriate. If profitability is low, and even decreasing, management has been poor. Seen in this way, we return to the logical position of the entire book: everything should be directed towards improving profitability, that is, increasing profits per share (or at least maintaining them). This seems obvious, but it must be stated explicitly, since in practice this is not the logic that many businesses follow.

**Strategic Logic and the Logic of Growth**

As we have seen when speaking of internationalization or diversification, companies frequently carry out important operations whose net result is growth in the *volume* of the business but not in its *profitability*. In fact, in many companies, growth is considered as something valuable in itself, independent from profitability. It is not difficult to find managers who think that their real goal is growth, subject to a minimum of acceptable profitability. They follow what we can call the ‘logic of growth’.

Growth is an enormously positive phenomenon for investors. Recent years have shown how a high and sustained growth rate can, through the miracle of compound interest, create authentic fortunes. Thus, £1000 pounds invested in Microsoft shares in 1983, when they came out on the market, today would be worth the incredible amount of £350,000 (no, that is not an error). Any person who invested a modest amount (a few thousand pounds) today is a millionaire. And something similar has occurred in other cases, such as Intel, Dell, General Electric and so on. In Europe, Amancio Ortega, founder and majority partner of Inditex (Zara), has amassed a fortune calculated at more than €10 billion, having started from scratch 30 years ago (thus becoming Spain’s richest man by far). Ingvar Kamprad, founder of Ikea, is the world’s 17th richest man, according to *Forbes* maga-
zine. It is clear that a good growth in profits (let’s say, 20–25% yearly) can do real wonders if it is maintained for a long time. Logically, investors know this, and are ready to pay high prices for the shares of those companies with good growth perspectives. In fact, it is enough for the managers to convince the market that profits are going to grow for the share price to go up, even before the growth in question occurs.

Growth is also very positive for the company itself, not just for the shareholders. Managing a growing company is much more pleasant, and even easier, than managing a stagnating one. First, it is much easier to motivate the employees, especially managers, when the possibilities of a promotion increase almost automatically, with the passing of time. In addition, mistakes of every conceivable type are relatively easy to cover: if an investment does not turn out well, it can always be compensated for with the growing profits of the rest, so that the overall result is still positive. If the company made a mistake hiring somebody, there is always a place to put him, given the constant need for new people at all levels.

For all these reasons, it is rare to find a company that does not have some ambitious growth targets. A review of the statements coming from managers of quoted companies during recent years shows a quite clear convergence around a target of 15% profit growth. With the few exceptions of very ambitious high-tech companies and some companies in a mature sector and with very conservative management, this 15% has an almost ‘minimum’ character.

However, most industries do not grow by 15% annually. In fact, very few do. Consequently, the company that wants to maintain these high levels must either grab market share from its competitors (which is usually very difficult, since they are in the same situation), or grow along one of the axes discussed in this book: more vertical integration, entry into new businesses, or expanding into new countries (costs can also be lowered, of course. But a lowering of costs has a limited impact on profit growth, since costs cannot go down indefinitely and, besides, most competitors will end up doing something similar, so that profit will not improve much, as we have seen).

The problem is that growing profitably above the market’s rate of growth is difficult. In many cases this encourages managers to put the exigency of profitability in parenthesis, giving more importance to growth. In this sense, the use of the term ‘leadership’ applied to companies is interesting. Frequently, it is said that a company is the leader when it is the one that sells the most. If the second in the ranking merges with the fourth, it is said that it has stolen the leadership from the one that until then was first. This is not only a manner of speaking: I have been able to observe directly how the members of the board of directors of a very large multinational
company reacted with concern to the news that a competitor – until then with lower sales – had acquired a company, thus now having a sales figure higher than the old leader. This concerned reaction would be logical, of course, if the purchase implied a reinforcing of the strategic position of an important competitor. But, in reality, it was the purchase of a company in a sector almost unrelated to the main business, and the only thing it did was to add size (and problems). If we accept that the job of a manager is to make the investment of the shareholders profitable over the long term, the fact that a competitor buys a company that is only going to give it more sales volume and management problems should not be cause for concern, but rather the opposite. In strategic logic, the leader is not the largest, but the one that is able to maintain superior profitability in the long term.

The previous example (that we could multiply over and over) indicates clearly that, frequently, the logic that managers follow is not the strategic logic that we have developed throughout this book, but the logic of growth: it is concerned with size instead of profitability. This explains a common phenomenon in many companies: sales grow faster than profits. In effect, few companies (less than 20% of all quoted companies) fulfil the famous objective of 15% growth, if we concentrate on profits per share, which is what matters to shareholders. If sales grow a lot but profits per share decrease, then the company is not following strategic logic but a logic of growth.

Of course, the reason for this lack of growth in profits is that it is not enough to decide on it: companies must be able to obtain it. And as we have seen throughout this book, it is not easy to obtain profitability above the cost of capital. And if it is difficult to obtain this profitability, it is even more difficult to make it grow: as we have said, there are few sectors that grow significantly for years, which means that all growth above average necessarily implies taking market share away from competitors (which usually costs profitability, as it is usually done by lowering prices) or entering other businesses/activities/countries, with the risks that this entails.

Forced growth often leads to adding businesses, products and activities which are less profitable so that overall profitability suffers, especially if we take into account that, as we have pointed out several times, complexity always brings added costs: it is common for the managers of a company to evaluate the future profits of a new operation without taking into account that the general management expenses of the company will rise precisely because of the new operation, even though the nature of that rise is not evident.

That profitability takes second place to growth in many companies can be seen in the way they treat dividends. Usually, companies pay out only
part of their profits as dividends: a significant part (on average, two-thirds) is reinvested in the business. Thus the profitability that a shareholder receives is not what it seems: a profit per share of 15% does not imply that the investment is better in shares of the company than in a treasury bond at 5%, since a very significant part of the profitability of the company remains in it, while the 5% of the bond reaches the investor in its totality. Of course, if the part that is reinvested in the company is in turn highly profitable, then management will be doing their job well: the reinvestment ensures a source of future profitability, thanks to compound interest. The problem is that this does not usually occur.\(^2\)

Take the example of Telefónica of Spain, representative in this respect of many other companies. At first glance, its performance as a company in the past five years has been excellent: it has gone from sales of €12 billion in 1996 to sales of more than €31 billion in 2001, that is, a growth of 21% in that period. But its profits have not grown as much: they went from €900 million to minus €2.1 billion. This is only part of the problem, however: the growth in sales has been possible because every year the company has kept the profits that belong to the shareholders, since it decided not to pay dividends, ‘to be able to pursue exciting opportunities in its industry’. As we said, if the company keeps the profits, and reinvests them profitably, shareholders are well served, since they will earn more money next year, due to the marvellous law of compound interest. But that is not what happened in Telefónica. After keeping all the profits, and then asking for more money in several public offerings, profits per share were €0.35 in 1997, €0.39 in 1998, €0.52 in 1999, €0.62 in 2000 and €0.45 in 2001. A sharp drop in profitability to close to zero will be seen in 2002, as a result of the writing-off of many of the investments made during those years. The retained profits, invested in a bond at 5%, would have given better results, with no risk.

This often happens. Of course, the managers could always say that profits per share would have been worse if most of the profits had been paid out to shareholders as dividends, but this is not realistic: what happened is that the retained funds were invested in unprofitable businesses, in which it was not at all necessary to invest. If those investments had not been made, the company would have certainly grown less, but its shareholders would have earned more.

There are two types of growth: ‘natural’ growth and ‘forced’ growth. In natural growth, a company introduces a product or service for which demand is growing. The company, although profitable, will have to reinvest all its profits (and perhaps more) in the new business, since it must build factories, establish distribution networks and service centres and so on. In
In forced growth, the opposite is true: it is not the business that pulls, but rather the company that pushes. Management begins with a desire to grow and if the current business cannot attain this rate, it launches the company towards other ventures, using the profits obtained in the current business to fund them. In these cases, margins diminish while the sales figures grow.

The very deep (logical) reason is the following. Companies can buy sales, they can even buy profits (by buying a profitable company, overall profits go up), but they cannot buy profitability: as we saw in Chapter 5, entering a profitable business will, necessarily, cost more money than it will return or it would not be a profitable business (unless the company has some special synergies to gain, as we have also seen). It is easy to buy volume. It is almost impossible to buy a good return on equity, for nobody wants to sell it.

The tragedy for shareholders is that, for management, growth without profitability is better than profitability without growth. The general manager of a company with sales of €10 billion and a profitability of 7% is often better paid than the manager of a company with sales of €1 billion and a profitability of 17%. It should not come as a surprise then that the second company’s manager decides to retain the profits in the company in order to reinvest them in growth, even if this growth implies lower profitability. As we have seen, when too much is paid for an acquisition, shareholders suffer. With time, however, the excess is forgotten, the share price begins to go up (from an unnecessarily low point, of course) and the manager recovers his reputation and builds his empire. Managers become great preachers of the ‘long term’.

The Fallacy of the ‘Long Term’

This is where strategic logic often begins to get lost. Evidently, no shareholder is interested in management decisions that earn a lot of money for the company in the short term, only to drive it into bankruptcy shortly thereafter. This we saw in Chapter 1: profitability must be adjusted for risk. A very profitable company that is constantly playing with fire is less attractive as an investment than a less profitable one, with an almost guaranteed stability. Consequently, every reasonable manager will always be ready to sacrifice immediate profitability for the sake of a solid future,
whether it is through investment in research, initial subsidy of businesses with a future or simply treating its employees better than is strictly required by law.

The problem, of course, is that the long term is difficult to foresee, and the expected benefits of the current sacrifice may never appear. As the purely economic long-term calculations do not have any reliability, the tendency is to drop the criterion of profitability for other strategic criteria that do not necessarily follow strategic logic, such as leadership, client service, reduction of costs and so on. All these objectives are, of course, reasonable in principle. But without careful respect for strategic logic they can be counterproductive: there are many companies that have given excellent service to their clients and have gone bankrupt because the clients were not willing to pay for it and preferred less expensive suppliers; or the opposite: remember the failure of Henry Ford when he became obsessed with low costs (‘the clients can have any colour car they want, as long as it is black’) and he saw how the buyers went to General Motors, which offered somewhat more expensive products, but better adapted to their desires. In short, the search for long-term profits cannot become an excuse for investing in activities whose profitability is more than doubtful.

Strategic Visions or Hallucinations

Philosophical approaches, much in vogue in recent years, can be dangerous. Most large companies have developed, and printed in their annual reports, their guiding mission statement, and even the vision that sustains it.

Of course, a sense of mission at work is important, as is a vision of where the company is going.\textsuperscript{4} The problem is that the difference between a vision and a hallucination is at times very small. You will recall how, as we saw in the previous chapter, in the 1980s many airlines developed the vision of going beyond their usual business, to become ‘integral providers of travel services for businessmen’, and began to buy hotel chains and car rental companies. The vision can be superficially attractive (in fact, billions were invested), but it may not follow strategic logic at all, as we have already discussed. The result, of course, was a bad ‘hangover’, with forced sales, restructurings and destruction of value.\textsuperscript{5}

Does this mean that managers should never plan for the future and work exclusively from day to day, trying to improve efficiency and leaving the great strategies to the competition? Not at all. We have already seen
how purely operational improvements will hardly be a source of profits, since competitors will imitate them sooner or later: they are necessary, but not sufficient. As we have indicated throughout the entire book, obtaining profitability above the cost of capital is not easy, and requires a very special competitive position. And this position is not obtained (or maintained) by pure chance: the company must be certain what its goal is. This implies not being led by fashions, such as globalization, integration or disintegration, diversification or convergence. It is in these dramatic strategic plays that much value gets destroyed for shareholders (and, of course, for society as a whole).

**Strategy as Cosmetic Surgery**

Strategy is not some sort of cosmetic surgery for the company either. It may be tempting to think that, facing a harsh business environment, salvation lies in selling divisions, buying others and generally transforming the company in a radical manner, to change the company from one anchored in the past to one well positioned to capitalize on the future. The chapters on diversification, internationalization and mergers and acquisitions have shown why this almost never works. Of course, management constantly has to re-evaluate the activities of the company. But to enter and exit business cannot be a profitable strategy, except for the intermediaries in the buying/purchasing exercise. For each success story, in which the company succeeds in transforming itself from one thing into another, there are hundreds of disasters: either the company does not achieve anything, or it does so at a cost higher than the cost would have represented to the shareholders if they had gone directly to the desired businesses. Although some consultants and managers may pretend to the contrary, a company is not an entity that lends itself easily to ‘transformation’ in the way that a person can have his or her nose reduced in size. Companies are complex social systems that, when upset, react in unpredictable ways and tend to preserve the status quo. The radical solution (sell the whole thing and buy another) is not something for managers but for shareholders to do. Managers in companies are not paid to allocate funds, but to develop strong competitive positions through the delivery of uniquely good products and services at reasonable cost.
Strategy as Planning

These visionary and transformative approaches to strategy are naive, when not downright harmful. Fortunately, they are not followed most of the time. Let us turn now to study what most companies actually do when they get in a strategy mode.

Few companies today lack some sort of strategic planning process. Unfortunately, this is usually quite useless. In fact, the mere concept of strategic planning is a curious contradiction in terms: as we have seen, a strategy has to be something necessarily original and is exposed to continuous change. Detailed long-term plans are often just an extrapolation of previous results, with a desired growth rate. What many companies call a strategic plan is nothing but a medium-term budget arrived at by multiplying last year’s figures by an appropriate factor (somewhat higher revenues, slightly lower costs). It does not say, however, exactly why the forecast improvements (there are always forecast improvements) are going to occur, that is, what advantages the company is going to have that its competitors are not going to erode. And the essence of strategy is precisely this why: profits are, in a way, a byproduct. The budget will be met only if the strategy is sound, that is, if competitive advantages are obtained, not the other way around.

If one thing is sure, in the world of businesses, it is that things happen. One can plan sales, costs and so on for a five-year, three-year or even one-year term, but managers can be sure that in this period unforeseen events will occur, a competitor will merge with another, or introduce an important new product, a key customer will run into problems and stop buying, a critical supplier will run into problems and stop serving, the key manager who was going to lead the new business will leave the company to do something else, the new product the company wanted to launch does not really take shape, or the last one it launched does much better than expected and there is not enough production capacity to satisfy demand. As Clausewitz said, ‘strategic plans are valid until the first encounter with the enemy’. At that moment, they fall to pieces, since nothing happens as expected (especially because the enemy makes sure this is the case). Traditional strategic planning is, in fact, not very well adapted to the real world we live in.

Precisely because of this inability to confront real management problems, strategic planning has been losing its reputation in companies, until it has often been reduced to a simple annual budgetary exercise, in which the company asserts that it will sell more at lower costs, but without a profound strategic analysis of how all this is going to happen. Occasion-
ally, short strategy retreats are carried out that produce as their only result a bunch of obvious conclusions without any practical use. I have had the opportunity of witnessing innumerable meetings where strategic analysis consisted of detecting businesses in which a good growth in demand was expected, and deciding that entering these businesses was the strategy. Evidently, an exercise of this type is useless, since it ignores strategic logic: if a business is of interest, it is because it is protected by entry barriers. In 90% of cases, the company really does nothing about it once the retreat is over, probably because managers realize there is not much they can do. In the remaining 10%, they do something about it, and the company loses money, precisely because the entry barriers are there. For the results of a planning exercise to be useful, it is not enough to identify a product/service with a future. Managers must also analyse why that business will be profitable, that is, what entry barriers will protect it, and what the company will do to place itself on the good side of the barriers. This is a position which, by definition, the competitors cannot imitate because if they could, there would not be real barriers. It is not easy, of course, but anything else is not a strategy.

Strategy as a Budget

Therefore, what is often presented as strategy is nothing more than the budget for the next year, or, if it wants to give the impression of really thinking in the long term, the budget for the next three years (the five-year budgets disappeared with the first oil crisis in the 1970s). Numbers that show sales growing at 10%, a decrease in costs of 5% and an increase in profitability of 15% are not strategy, however: they are a wish. Strategy will be the plan that allows a company to increase sales (and, above all, margins) in the presence of competitors at least as aggressive as it is. Without this analysis (and, of course, the corresponding actions), budgets are little more than a ‘letter to Father Christmas’, as one manager described it to me some time back.

The budget as it is drawn up in many cases also has the added problem of its use as a target to measure the performance of managers. As soon as managers’ compensation is based, explicitly or implicitly, on achieving the budget, they begin to play games, first by lowering the objectives as far as possible and, later, to make budget no matter what, even though the maximization of the manager’s specific objectives may be to the detriment of the overall objectives of the company. Anybody who has taken part in a budget exercise knows these problems well.
However, companies must make a budget and they must plan. A company with a certain complexity cannot function without some clear and coherent plans for all its functions and activities. But this necessary task is not sufficient: in order to improve profitability it is essential that these plans be based on solid strategic logic. Budgeting must come after strategy making.

**Strategy as Plans for Operational Improvements**

Often, the profitability improvements introduced in the budget are based on putting into practice operational plans to lower costs, or increase sales. As we have repeated many times, these operational improvements are absolutely necessary, but they do not constitute a strategy: it is naive to think that most competitors are not doing something similar. However, many companies limit themselves to formulating these plans, thinking that they now have a strategy.

In summary, we often find ourselves with a company not having a real strategy, since it frequently falls in one of the two apparently contradictory defects: either the strategy is vague and empty (the fantasy visions), or it is so concrete that it does not go beyond an operational plan (there are companies that manage to do both things: visions that do not mean anything and very detailed budgets that are not based on anything).

In order not to make these errors, we must return to strategic logic, in all its simplicity and strength: improving the company’s profitability, in the long term, involves placing it in a position in which it can either raise its prices, because it offers something really unique and valuable to its clients, or lower its costs more than its competitors. Anything else will be destruction of value. We are going to see, in the following pages, how we can think about strategy so that it is truly a source of future profitability.

**Strategic Thinking**

The goal of strategic analysis is to find activities (or new ways of carrying out activities) that improve the intrinsic profitability of the company. As implied by the previous paragraphs, we are taking for granted the operational excellence of the company. Of course, in many cases, this excellence will just not be there, and the company will have to devote a great effort to achieve it. This, however, is not strategy. For, *in addition* to oper-
ational excellence, a strategic reflection is needed if the company wants to obtain results above the cost of the capital.

The best starting point for this strategic reflection is to look nearby. Often, companies with profitability difficulties try one of two things (or both): simply to improve efficiency (which, as we said, will not solve the problem by itself), or move, looking for a solution in diversification or internationalization. Although, as we have seen (and we will see in more detail) this diversification or internationalization can be the appropriate conclusion of a thorough strategic analysis, beginning there generally implies an authentic flight forwards, which rarely turns out well: if a company cannot earn money in the business it knows, it will be difficult for it to do it in a new one.

Beginning nearby signifies knowing well the strategic structure of the activities that the company carries out already. It is very rare that in a company there are not some product lines, some clients, some geographic areas that are clearly more profitable than others. Frequently, this fact is passed over by managers focusing only on the average. This is a serious mistake that indicates a lack of understanding of the strategic structure of the business. The fact that some units, products or clients are consistently more profitable than others very probably implies, in strategic logic, that entry barriers which ensure this profitability protect these areas. Perhaps it is a question of a class of clients being less sensitive to price, because the reputation of the company is more important to them than to others, for some reason. Or a geographic area is found in which there is less competition, since transportation costs are high and there are no local competitors. Or some clients may have technical needs that the company is in a unique position to satisfy; or a thousand other reasons. Very often, the strategic structures of products that the company considers similar are completely different: economies of scale in manufacturing, for example, can be different, in some cases forcing concentration (and relatively high profitability) and in others fragmentation (and low profitability). It is absolutely imperative that the company understands the profitability of its activities, and this cannot be done by looking at the average, since the average means nothing: as we saw in Chapter 2, each activity is really a different business, and generic steps cannot be taken and expected to be successful, since each business has its own demands.

Often, however, the company does not have a really deep understanding of its profitability, and is satisfied with explanations such as ‘we are profitable thanks to the quality of our products’ or ‘the dedication of our people’; or we are not profitable because of ‘excessive competition’ or ‘the pressure of customers’; or any other excuse. This understanding of
what aspects of the company are profitable and, above all, why they are profitable is the first absolutely essential condition in being able to manage the company in a strategic, not reactive, way. In very simple terms, it consists of discovering where it really earns money, and why; and then doing more of this, and less of the rest. In effect, if a company substitutes 10% of its sales each year in more profitable products (or clients, or areas) for sales of the less profitable ones each year, profits will shoot up, without having to do anything really new. But to get to this the company needs to know which products are the most profitable and why. Otherwise, it will not be able to increase sales of these products.

A concrete way of carrying out this analysis is to study the possibilities of development of the company along the three axes that we have discussed (vertical integration, product and geography), and see how strategic logic can suggest winning strategies.

**Decisions of Vertical Integration from a Strategic Point of View**

Very often, as we have seen in Chapter 4, decisions about vertical integration are not given the attention they deserve. They are frequently made in a relatively superficial way, reducing the discussion to a pure question of costs (‘to manufacture or buy’), without taking into account that the impact in the medium term on the profitability of the company can be enormous.

Take the case of a company that develops a new product. This product, although it is covered by the company’s well-known brand and distribution capacity, has some manufacturing characteristics that are different from the current products. For this reason, manufacturing it would involve installing new capacity, with different techniques, that the company does not know well. In this case, quite typical, the discussion is usually settled as a purely technical problem: can we manufacture the product, in time and at a reasonable cost, or is it better to subcontract it to someone, as long as conditions are acceptable? This is absolutely correct, but only in the short term. Behind this apparently technical decision can be the entire future of the company.

You will recall the story (a true story, unfortunately for them) of how IBM decided to subcontract the operating system of its new product, the PC, to a small company called Microsoft. From the point of view of IBM, the operating system was just one more component of its new product, that had to be finished rapidly and at a reasonable cost. It is certain that, in the short term, buying it from Microsoft was a good decision: used to working on their large computers, where they enjoyed a de facto monopoly posi-
tion, IBM systems engineers would have taken years to finish the product and at a higher cost. However, in the long term the decision was disastrous, since it gave rise to Microsoft’s current domination of the industry, and it left IBM reduced to working on the less profitable activities, as we saw in Chapter 2.6

A similar story (although less well known) is repeated every time a company decides to subcontract something without taking into account what the future profitability of the subcontracted activity will be. Thus, when the company in the previous example poses the question of whether or not to do the manufacturing, in addition to the necessary cost equation, it should ask itself the following questions: ‘will manufacturing this product, in the medium term, be subject to entry barriers? Is it a manufacturing process that requires great volume, or special technology? If we can determine that, in the medium term, the manufacturing will be a difficult activity and, therefore, profitable because subject to little competition, the company should do it itself: the opposite is giving the business to the supplier. And it should do it, even if, at first, the supplier has a somewhat lower price. On the other hand, if the manufacturing activity seems devoid of entry barriers and, therefore, ultimate profitability, it will not be interesting to go into it, although at first manufacturing may seem more economical if done by the company.

There is a less evident but potentially more profitable line of analysis: as we saw in Chapter 4, the company could already be carrying out some very profitable activity, but this activity has a single client in the company itself. It may be the moment to realize that this activity could sell to the outside world and change the subjective emphasis of the company (I say subjective because the activity is already being done, although it may be considered just an internal activity, necessary for the real business of the company). For instance, the company that designs its own products can do so for other companies, and even end up leaving the business of manufacturing and concentrating only on design, which is perhaps more profitable, or the opposite. Each activity of the company must be analysed to see which ones are really profitable and why, and what can be done to emphasize these more and lessen those whose profitability is below average.

Searching for Profitable Products (or Clients)

The next expansion axis is what we called the product/market axis and we analysed it in detail in Chapter 6, on diversification. As we saw, diversification for companies is not a question of black and white, but of grey:
every company is diversified to a greater or lesser degree, and what matters is to do it so that it adds value and does not destroy it, as is frequently the case. Again, the solution is not so much to look for new things as it is to understand which things the company does profitably, and how to extend this profitability.

In effect, as we already saw in Chapter 6, new products (or businesses) in which the company does not have any special advantage cannot be very profitable: if they are protected by entry barriers, the company cannot be competitive; if they are not, the business itself will not be profitable. Only if there are entry barriers, and the company is on the good side of some of them (because it has a key technology, contact with the clients or the distribution network) will there be true profitable diversification.

Therefore, how do we search for new products to launch? Copying what the others are doing, as we can see, will hardly lead to profitability. Besides, there is a typical trap in imitation. Consider that a competitor launches a new product. It sells well and, thanks to its novelty, growth is good and margins solid. After some time for analysis, a company decides to participate in this profitable business. The problem is that if entry barriers do not protect the business, all its profitability (real, up to this time) is based on its novelty: supply has not yet met demand. But when the imitator enters, others will too, competition intensifies and margins evaporate, with dramatic consequences if there are exit barriers (that is, if it is difficult to undo the investments made to enter the business and they are substantial).

The solution consists of looking for areas (some of them, as we said, extensions of what the company already does) where the company has good cards to play, that is, some advantages over its competitors that will serve as entry barriers. These areas will probably be small, and will require a new understanding of the company, but that is where profitability will be found. Let us consider some examples.

Take the case of the company that has a basic line of not very profitable products, since there are no large economies of scale and all competitors have more or less the same quality, at least from the customers’ point of view. In these circumstances, buyers only notice the price, and this, as we know, tends to decrease to the point where margins disappear. If, however, the company has some differentiating characteristic, it can play it. Imagine that the company is, in fact, larger than its competitors. In our example, this is not particularly useful, since we have seen that there are no economies of scale. In fact, as we know, a large company, in a business that has no economies of scale, usually operates with higher costs than its competitors which, in the absence of differentiation, is really dangerous.
A larger company can, however, invest a little bit more, in absolute terms, than its competitors to look for more profitable things. Continuing with our example, imagine that a segment of the market would be willing to pay something more if they were offered a product that today no one offers, because it requires an investment in technology that no one has made. If this investment is high compared to the size of most competitors, and with the segment of the market in question, it will be intrinsically protected by entry barriers, and can offer a higher profitability. This is the case of the food and restaurant industry. Traditionally, the only variable that really matters when selling food products to the hotel and restaurant sector is the price. Some products, of course, are more expensive than others (caviar compared to cheese) but, within each category, most buyers, with the exception perhaps of luxury establishments, look only at price, given an acceptable level of quality. This makes sense, since the final consumer is not going to see the brand of the supplier, so no differentiation can be sustained. If we add to this that all products are, in reality, the same (the technology is mature and well mastered by all suppliers) and the costs of producing them are subject to few economies of scale, we realize, following our strategic logic, that the manufacture and sale of these products will hardly be a profitable business (distribution, where economies of scale in logistics can be significant, may be a different thing).

Facing this situation, a competitor with financial means can decide to progressively abandon the activity of manufacturing these standard products, which cannot be profitable, and look for those segments of the market that may be interested in special products. For example, there are more and more fast-food restaurants, either belonging to chains or independent. For the chains, a guarantee of service, quality and hygiene, which only a large company can give, can be attractive (and therefore, profitable, if there are few large companies). For the independent restaurants, semi-prepared products, to which the cook does not have to dedicate much time but which ensure high quality in the final dish, can also be interesting. In this second case, the client will be willing to pay more for the product, if it reduces his costs and improves his differentiation. And as long as the development of these products is relatively complex and difficult to copy, the company will be developing a very profitable line in an apparently commoditized business. This is the type of reasoning that can lead to a winning strategy, since it creates value for the client, but in a way that permits the company to conserve a part of that value.
In fact, the old marketing tool known as ‘market segmentation’ is a fundamental ally of strategic thinking. It is extremely likely that there will be a part of the market where the specific characteristics of the company can be translated into entry barriers. Even in an example like the previous one, when the company faces a perfectly competitive market, there will often be segments with special needs that can be the basis of higher profitability. However, to find them, managers need at least three things: profound knowledge of the business; creativity in finding solutions to problems that perhaps the buyer himself does not know how to solve; and a strong dose of strategic logic to know in which cases the investment will be profitable in the long term, and in which it will be copied by competitors. The first two requirements are often contradictory, because knowledge of the business is usually linked to a narrow vision of the ‘it has always been like this’ variety. Managers who have these capacities can, however, create very profitable businesses, with strong growth, from businesses that are apparently unattractive, such as the cleaning of offices, repairing of electronic equipment under contract with the manufacturer and many others.

This line of reasoning applies to the overall innovation effort of the company. The task of innovation may seem intrinsically positive, but it is not: it should also follow the guidelines of strategic logic. Thus, to innovate by introducing products whose singularity is not defensible, because they are easily copied, can be a bad idea. We must distinguish between ‘permanent’ innovation and ‘temporary’ innovation.

Permanent innovation leads to clearly unique products, because patents (or other mechanisms) protect them and generate good profits for several years. We could include here pharmaceutical products, some electronic products and many others. The fruits of temporary innovation, on the other hand, are not easily defensible, since they can be copied relatively quickly. But if the extra margin that can be obtained before the products are copied compensates for the effort of their development and launching, then it is a profitable strategy. It is a dynamic source of differentiation, in the sense that it must always be in operation, knowing that no new development will solve things once and for all. In this case, it is obvious that the efficiency with which the company translates its innovation effort into new products will be the key to profitability: a department in charge of developing and introducing new products that is not fast and efficient cannot possibly justify its existence. But a continuous flow of innovative products that carry a good margin before they are copied, if developed at low cost and fast enough, can be the source of profits in a sector where, in the medium and long term, it is difficult to differentiate.
Geographic Deployment

In Chapter 5 we saw in detail, from the point of view of strategic logic, what the correct approach to the geographic expansion of the company is. It is sufficient here to insist again on the need to base this expansion on a rigorous logic that looks to create new competitive advantages, or at least reinforce the previous ones, without falling into the growth for growth’s sake trap. Once again, reality shows that companies do not always act in this way: after some years of economic euphoria, we now see many companies backing away from their international expansion. What, in better times, were announced as ‘projects of great strategic value’ now appear as ‘less profitable operations’ that have to be closed or drastically cut back. When the economy improves, of course, we will see new ventures in internationalization that are not based on strategic logic, but on the pure logic of growth.

If geographic expansion is to increase the company’s profitability, and not just its size, it must reinforce its competitive position. A company active in a business subject to strong economies of scale has to expand in order to reach the necessary volume. But once the minimum efficient size is reached, internationalization will increase costs, instead of lowering them. On the other hand, it is possible that the company’s customers may be interested in a supplier that can serve them in various countries, but this interest will only be real if it can be translated into better prices for the supplier. It is typical of buyers to ask suppliers to expand to a new country, in order to have a full service. Once installed in the new country, however, the supplier has to compete on price with local suppliers, for the buyer is perfectly willing to buy from them as soon as prices get out of line. In short, there is no real differentiation, since there is no higher price.

Perhaps the only case of international expansion in which pure growth is a reasonable objective is when the company has a greater know-how than its competitors which is defensible in the long term. We can understand Toyota’s expansion to the Unites States and Europe along these lines. Even clearer is when the company decides to install itself in an emerging country, in which there are still no established competitors, and where it is possible, therefore, to construct a solid position before the entry barriers typical of a mature market are raised (if the business has any). This is the policy that many of the multinational companies which originated in more advanced countries have always followed. It is the situation now of many companies that are trying to become established in Eastern European countries, where there are no solid local competitors for obvious
historical reasons, but possibly there are markets that will mature in a few years, making entry for those that are not yet installed difficult.

In this last case, it is very important to be aware that what the company in reality is exporting is management capacity and if it does not have the capacity to actually export it, it will not be successful. Thus, it is not unusual for a Western company to buy a recently privatized company in an Eastern country, but not contribute sufficient capital or, more importantly, the human means to drastically improve management. The fact that exporting managers is difficult and expensive, because they are scarce, as well as the difficulty of being well received in countries about which they know nothing, makes the companies tend to intervene as little as possible in the new acquisitions, beyond the obvious technical improvements in the production process. But this attitude contradicts the avowed strategy. The company cannot expect to earn money when it enters a less sophisticated market and then does not contribute the supposed sophistication.

In short, managers must be aware that more than any other strategic plan, internationalization demands that the company has to be able to undertake an extraordinary management effort. Otherwise, even an operation designed following the best strategic logic will not be profitable.

Some Guidelines for Strategic Thinking

A method that has given good results for me personally in stimulating strategic reflection consists of four simple steps.

In the first place, we pose the question of which customer needs are not yet totally satisfied, or if there are some segments not sufficiently well served. An example of this could be food with an absolute guarantee of quality, after the episodes of 'mad cow' disease or contamination by dioxins. Today, no company is really in a position to offer 100% security because of the overall structure of the sector. Another example could be a personal computer that is really easy to use, or the development of many non-polluting industrial processes. It is a question of establishing what the criteria of demand will be in five or ten years, and trying to project the attendant changes, as we saw in Chapter 3.

The second step is, once the stage is set, to develop strategies that appear to be winners in this context. Winners in our analysis mean, of course, the ones that are capable of responding to the demand, but conserving part of the value created, through entry barriers.

It is important, in the first two steps, to make an effort not to think of the company itself (which would lead us to not seeing new possibilities), but of
the market and the business in general. In the third step, however, we have to come down to reality: among the different possible strategies (in most cases there will be many very different ones), the company must decide which one is the most interesting, taking into account its resources. In terms of action plans, the consequences will not be difficult to deduce: where the company needs to invest more, what needs to be de-emphasized and so on.

This simplified outline can help to focus attention on the medium/long term, outside the company, on the customers. Of course, the action plans are the key, and they have to be full of experiments: managers cannot make a five-year plan and think that ‘now it is all a matter of execution’, since, as we have seen, this serves only to discredit strategic planning. What is needed is to design intermediate actions that will help us to give shape little by little to the strategy, correcting the aim when circumstances and our improved understanding of reality advise it.

That is why it is essential, in all strategic reflection, to have a strong critical attitude towards one’s own company. It is very important to ask constantly what is going worse than expected and what is going better. We have to start from the base that reality is very complex and strategic work does not consist of planning but of discovering. (Almost) all companies have golden nuggets inside them that must be discovered in the middle of the averages. But this requires a constant effort of self-interrogation and a rigorous strategic logic to understand what is actually going on. Imitation of what successful competitors do, vague statements (‘to be leaders’) or concentration only on operational plans do not constitute a strategy that improves the profitability of the company.

**Conclusion**

In short, strategic reflection is a permanent dialogue with reality (co-workers, competitors, clients, technologies, social developments), carried out within the rules of a strict logic, that we have given the name of strategic logic. Above all, it involves learning, discovering, having the capacity to be surprised, to be creative. It is, therefore, the opposite of the application of a cold and formulaic methodology. It requires a profound knowledge of the business (indeed, what we call ‘reality’) and, at the same time, the humility of knowing that one only understands a small part of it. That is why it does not make sense to limit strategic reflection to a certain time in the year: the best ideas often come while waiting for a traffic light to turn green and the mind is thinking over the constant problems of management.
But formalization is important. Although an informal yet solid strategic reflection is preferable to a planning process without strategic logic, there is no reason why managers cannot obtain the advantages of both. Thus, good reflection will be much more fruitful if it is embedded in the ordinary management of the company; if not only the profit and loss account and the balance sheet are measured, but also all those intermediate variables that are truly strategic, in the sense that they are what will determine whether the results will really be achieved in the future. These variables can be new products introduced, the satisfaction index of clients, the decrease in manufacturing defects, or anything that is the best indicator of progress in the advancement of the strategy. Without this measuring effort (‘what is not measured is not managed’), the strategy will not really advance. This consideration leads us to the final conclusions of this book.

Notes

1. See, for example, ‘The 15% Delusion’, *Fortune*, 5.2.2001.
2. Of course, the total profitability to the shareholder comes from the dividend plus the appreciation of the share price, but this last variable is not directly under the control of the managers, since markets go up and down. What the managers can (and should) do is increase the profits per share, knowing that, in the long term, the market reflects the real profitability of the companies.
3. As we saw in the previous chapter, many mergers do not respond to a clear strategic logic. The underlying logic is a logic of growth, in many cases understood as growth in the personal power of the managers who make the decisions. See, for example, the testimony of many participants in the American financial markets in ‘Egos can Make – and Unmake – Mergers’, *Wall Street Journal*, 24.1.2000.
4. However, these must be realistic. In most cases, the definitions of ‘mission’ and ‘vision’ are fairly formalistic and inoperative in their vagueness (there are companies that subcontract their formulation to consultants). In addition, people usually go to work to earn a living, not to carry out transcendental missions, although, of course, pleasant surroundings and a task that makes sense is welcome. Pretending otherwise is in many cases naivety or an attempt to manipulate.
5. It is interesting to note, to understand how the real world works, that this particular vision was not developed by a visionary leader; as one may expect, but by a consulting company, who sold the strategy to most competitors in the industry (nice example of economies of scale when preparing consulting reports). The same consulting company helped the airlines undo their mistakes a few years later. Since then, it has continued to advise airlines, with interesting visions that have had similar results. The consulting company keeps being hired, however, thanks in part to its in-depth industry experience.
6. For years, the business and technology press praised IBM’s visionary decision to finally open up by taking the revolutionary decision of buying the operating system outside. When the clones began to erode IBM’s profits, these voices grew silent.
CONCLUSION

From Logic to Practice

One of the central ideas of this book is that, behind any business, there is a structural reality, economic and technological, that determines to a great extent its potential for profitability and provides a logic that strategy must follow. By now, I hope that this has been made clear to the reader. Is it, therefore, the industry that determines profitability, independently of what the managers do? It seems to me that the answer should also be clear, but it is important to express it in detail to conclude the book.

Being in the Good Sector or Having Good Management?

Since the middle of the 1950s, when a group of economists began to develop the idea that the specific characteristics of each sector determine the profits of the participants in it, the debate between structure/management has raged among the specialists. Traditionally, economists have supported the idea that the structural variables are what determine the result. Professors of business schools have tended to concede a much greater role to the work of management.

The truth is that both visions are incomplete and complementary. We have already seen how the basic characteristics of a business do indeed condition the results: for example economies of scale determine how many competitors fit, and the number of competitors has an evident influence on the intensity of the competition in a sector. And this is so, regardless of any other consideration.

However, for years it has been difficult to prove a statistical relationship between industry structural variables and the results of companies competing in them. In my opinion, the reason is that the definition of the
industry is very rough, as we saw in Chapter 2. In effect, if we talk of computers, we will have to put together Microsoft and Compaq, Dell and Hewlett-Packard, companies that, as we saw, compete in really different businesses.

Thus, the question for managers is not so much one of deciding in which business to be, but of knowing how the rules of strategic logic apply to whatever they are doing. The classification in industries can be useful for statistical and even pedagogical reasons, but as we saw in Chapter 2, and noted throughout the rest of this book, it has harmful effects on strategic reflection. The real issue is not so much ‘being in a business’ as, in many cases, inventing it. In this sense, a recent study is very interesting. In it, after a detailed statistical analysis, the authors find that, for the typical companies in each industry (those that earn an average profitability), the structural variables are the determinant. In other words, the average company is as profitable as its industry would lead us to expect, but some companies stand out, both above and below the average. These very profitable or very unprofitable companies owe their situation to specific factors characteristic of good or poor management, part of which rests on finding profitable activities within the industries. In fact, there are profitable companies in all industries, from Toyota in the automobile industry to easyJet in airlines, or Dell in the assembling of personal computers; and companies that fail. And a good part of the success of the very profitable companies comes from their understanding of the rules of the game, in order to use them in a different way for their benefit. And this leads us directly to the role of management in the success of the company.

Strategic Logic and Management Capacity

In the Introduction we said that this book wanted to develop a real theory of profitability, able to account for the very distinct fortunes of real-world companies. In the preceding chapters, we have established an entire analytical logic that permits us to do this. We have not spoken much, however, about something that for most management texts and public opinion is fundamental when explaining the success or failure of companies: the quality of their managers. Does this not matter or should we only attend to the structural characteristics of the business?

Of course the quality of management is important, and very much so. Anyone who has worked in a company has been able to observe how there are bosses who know how to motivate, and bosses who discourage; work environments that promote creativity and others that eliminate it. But what
a good manager cannot do is go against the force of gravity. Warren Buffet, one of the best investors in history, likes to say that ‘when a good manager confronts an industry with a reputation for being difficult … it is the industry that usually keeps its reputation intact’.

The strategic logic that we have analysed in the book shows us that the structural characteristics of the business impose very serious limitations on what can be done. For example, a great manager can make a company be one of the winners in a business in which few competitors fit. Or he can find, according to some of the guidelines noted above, new products or services that can be profitable, but if entry barriers do not protect the business, profitability will at best be merely sufficient.

We could even say that the importance of the quality of management is in inverse relation to the entry barriers that protect the business. A video shop manager, to return to our first example, cannot be inefficient or unpleasant: he would disappear very quickly. However, a monopoly can act systematically in an arrogant fashion and does not need to concern itself too much with innovation. In fact, some of the most profitable companies in the world are not well managed: they are simply protected by very high entry barriers, perhaps inherited from the past, that allow them to not be very good in management. Of course, times change and when the barriers fall, the problems begin, as we saw in Chapter 3.

What should we say, then, of mythical businessmen, such as Jack Welch, Bill Gates and many others? I think there is a combination of management quality and luck at being in the right place at the right time. In fact, it is not unusual for the reputations of many companies and managers to fall hard just after having been praised as exemplary by experts in business schools and management books.² It is said that the appearance of the president of a company on the cover of Business Week is an omen of its decline.³ Are the analyses of the experts systematically erroneous? Probably not, but they tend to concentrate too much on the figure of the great man (it is rarely a woman), without taking into account the external circumstances that cause the results. And when these circumstances change, very few companies can recover the lost glory, with the same managers or, more often, with others.

This indicates that the profitability of a specific company depends on many factors, structural as well as occasional, logical as well as random, and that trying to find the secret is courting ridicule.⁴ Of course, management that is capable of putting into practice, for example, the best operational techniques in less time than their competitors will achieve a slightly higher profitability. Experience shows, however, that, with very few exceptions, this excellence in management is very difficult to sustain,
since it depends on specific persons, who come and go. In short, we should understand that excellence in management is a necessary but not sufficient condition for success: as we have seen throughout this book, excellent results require the development of a strategy that takes advantage of the market imperfections. If these are small and hardly important, the best thing a good manager can do is obtain an acceptable profitability and not waste money in attempts that cannot work.

**Luck, a Key Variable**

Often luck also plays a decisive role. In Chapter 3 we discussed how, in 1985, Bill Gates suggested to Steve Jobs licensing the Macintosh operating system to other manufacturers. This idea, which would indeed have done wonders for Apple, would have destroyed the future of the Microsoft system, today the foundation of the greatest fortune in the world. It is evident that Bill Gates did not get where he is today through a strategy planned from the beginning, but rather more as trial and error, supported by luck. It is also true, however, that the capacity to understand what is happening, although slightly late, and to evaluate the strategic consequences of the different options, facilitate reaching (and, above all, conserving in times of change) a solid situation. To think in terms of strategic logic does not facilitate guessing the future, but it helps to avoid errors and take advantage of the opportunities as they come. Although not too often, I have found managers, even in small companies, who, in an intuitive way, think in very clear terms: the need to introduce products for which there is no competition; the importance of not setting prices too high, even if the company is the only producer; to avoid imitation; not investing in non-defensible products; selling the capacities they have to whoever wants to buy them, without insisting on wrapping them in complete products (that is, in activities in which they are not competitive); and so on.

I would like to end with a touch of realism. We have tried to elaborate something very ambitious: an entire logic of business profitability. I am convinced that the concepts we have studied are absolutely essential for the development of this logic, but there are many other variables, and reality is very complex. Leadership, politics, technical capacity, opportunity and luck greatly influence the results of specific companies. But the rules of strategic logic are at the base of what happens, as the law of gravity is present in a football match: it does not explain everything, far from it, but it cannot be ignored.
In conclusion, the last thing I want to say is that my desire with this book has been to transmit to the reader my experience of 20 years as an observer of management, and my reflections on the daily reality of how difficult it is to improve profitability in practice. If I have contributed to providing the reader with a series of simple but useful mental outlines that help him to understand the reality beyond the clichés of the media and the strategies in fashion; to exclaim ‘aha, that is why!’ when reading a piece of news; to thinking twice before entering a business that appears sure, critically analysing what will be the competitive situation in the medium term; to analysing reality in search of that difficult marriage between what we know how to do better than anyone else and what the market is looking for, I will feel enormously satisfied. If these pages help, in short, to improve the business decisions in which the savings of the investors and the jobs of the employees are at stake, I believe that we will have achieved something important.

Notes

2. The case of Percy Barnevik is especially flagrant: after many years of being considered the ‘best manager of Europe’ for ‘turning ABB around’, he had to resign as president of the group because of the almost bankrupt situation of the company. To make things worse, it was made public that his resignation was accompanied by a payment of more than €150 million as a ‘pension’. There are several lawsuits pending on the subject. See ‘A Harsh Farewell for Percy Barnevik’, Financial Times, 14.2.2002.
3. While I write these lines, the American company Enron just declared the most important bankruptcy in the history of the United States (which, in business terms means in all of humanity). Apparently, the business was not very transparent, and the accounts quite ‘rigged’. But not long ago the professors of Harvard Business School, among others, published cases and articles in which they analysed the excellent strategy of the company, and its visionary management. See, for example, ‘Strategy as Simple Rules’, by Kathleen M. Eisenhardt and Donald Sull, Harvard Business Review, 1.1.2001. The company was, likewise, for years among the ‘most admired’ by the readers of Fortune magazine.
4. It is also a well-known fact that of the companies selected in the famous book In Search of Excellence as objects of study and sources for learning, more than half had been ruined ten years later.
5. Along these lines, the change that Bill Gates made in his company is impressive, once it was established that the Internet could put his dominant position in danger. After first thinking that the Internet had no importance, he realized how it could dramatically alter the structure of the business, undermining Microsoft’s position. In a very short time, especially for such a large company, he changed the strategic priorities.
What follows is not an academic bibliography, in which the author tries to show how many books he has read (or at least knows) on the subject. It is a brief list of books that I think are very useful for anyone who wants to have a complete idea of what strategy is. As I said in the Introduction, the final success of a company is determined by many variables. In my opinion, the logic developed here is necessary but there are many other aspects to take into account. These books will help the reader to incorporate them into his or her way of thinking. A characteristic that I have looked for in these books is that they are relatively easy to read. Almost all of them are: I leave to the reader to discover (it will be easy) which ones are not in this category. They are classified according to the chapters of this book, although logically many of them deal with different themes.

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