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HANDOUTS

BUSINESS STRATEGY -ATTENDING STUDENTS-

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It is a useful tool for studying the subject, but does not guarantee preparation as exhaustive and complete as the material recommended by the University.



Strategy as a Field of Study

Introduction to Strategy

A strategy is considered successful when it achieves a **sustained competitive advantage** over rivals. This advantage comes from putting together a **unique bundle of resources** that competitors can't easily replicate. But having resources isn't enough, as success also depends on having a deep and accurate understanding of the **competitive environment**, so the company can anticipate changes and act effectively.



At the core, **it's all about strategy**: how each company defines its priorities, leverages its strengths, and navigates competition.

What is Strategy?

Strategy is the overarching plan that guides an organization's actions, helping it achieve its long-term goals in a structured and intentional way, it is about making intentional choices, focusing resources, and aligning efforts in a way that gives the company a clear, competitive edge over time.

Alfred Chandler emphasizes that strategy starts with defining a company's **long-term goals**, then determining the **actions** and **resource allocation** needed to achieve them. It's not just about setting objectives, but also about committing to a course of action.

Von Clausewitz, a military theorist, draws a distinction between tactics and strategy. While tactics are about winning individual battles, strategy is about understanding how those battles fit into the **larger purpose**. In business terms, this means strategy isn't about day-to-day decisions, but about shaping the **overall direction** of the company.

Michael Porter adds that strategy is a broad formula for how a company plans to **compete**, what **goals** it aims to achieve, and what **policies** will support that vision. It's about **choosing a path and sticking to it**, rather than trying to do everything.

Think of strategy as the intersection of three key components:

1. **Means (Resources)**: The assets, capabilities, and tools the company has to work with.
2. **Ends (Goals)**: What the company wants to achieve in the long term.
3. **Strategy**: The bridge between the two.



Strategic decisions are:

- **Important**: They affect the future direction of the company.
- **Difficult to reverse**: Once implemented, they often involve major commitments.
- **Resource-intensive**: They require a significant investment of time, money, or people.

In short, strategy is not just about reacting to what's happening today; it's about preparing for the future by building a coherent path forward.

Business Strategy vs. Corporate Strategy

Strategy is ultimately about **how a company creates long-term profitability**. But there are two levels that work together: **corporate strategy** and **business strategy**. They each focus on different questions and operate at different scopes within the organization.

Corporate Strategy

It addresses the question, "Where should we compete?"

It involves making decisions that affect the entire organization by determining which **industries or markets** to enter and how to shape the overall scope of the firm. This level of strategy is concerned with investments, acquisitions, diversification, and other moves that set the **long-term direction and boundaries** of the business. The choices made at this level depend on factors such as the **attractiveness** of various industries, market conditions, and the potential for growth across different sectors.

It's about first picking a playground, then deciding how to play to win the game. Ideally, the two should work together.

Business Strategy

It focuses on the question, "How should we compete?"

Once the industry or market is chosen, this strategy deals with the methods and actions that will allow the firm to achieve a **competitive edge** within that space. It involves decisions regarding product positioning, pricing, brand differentiation, and the creation of unique value for customers. In essence, business strategy is about deploying the company's resources effectively to establish and sustain a competitive advantage over rivals, continuously adapting to changes in the competitive landscape.

Strategy as Positioning and Direction

Strategy is not just about handling the **present**, it is also about preparing for the **future**. A good strategy must help a company compete effectively today while guiding its long-term development. This happens through two complementary dimensions:

- **Strategy as positioning** focuses on where the company is currently competing and how it does so. It defines the product and service markets, the geographic areas involved, and the stages of the value chain the company operates in. It also clarifies what gives the company a competitive edge in its current environment, allowing it to make strong choices in the **present**.
- **Strategy as direction** is about the **future path** of the company. It sets out what the organization wants to become, what it aims to achieve, and how it plans to get there. This includes defining a vision, setting goals, and choosing how to grow, whether through internal development, acquisitions, or partnerships. It gives the company a structured way to move forward with purpose.

By combining these two perspectives, a company can remain strong in the short term while moving intentionally towards its long-term goals ("*Competing in the present, preparing for the future*" - Grant).

Industry analysis

A company's performance depends on two main factors: the industry it is in, and the strategy it follows.

Some industries are naturally more profitable than others, and that sets a baseline. But even within the same industry, some companies perform better than others, and that difference comes from strategy. **Industry conditions influence what is possible, while strategy determines what is achieved.** Understanding both is essential if the goal is to outperform the average.

Both industry conditions and firm strategy influence how well a company performs, but not equally: some think that if a company is well managed, it can succeed anywhere, while others believe that industry conditions set hard limits on what is achievable. The truth is somewhere in between.

Why Industry Analysis Matters

Some industries are simply more profitable than others. Over long periods of time, industries like tobacco, tech hardware, and pharmaceuticals consistently show high returns. Others, like airlines, car manufacturing, or hotels, often struggle with lower profitability due to factors like high fixed costs, intense competition, or regulation.

However, even within the same industry, some companies perform far better than others. This tells us that industry conditions explain part of the story, but firm-level decisions also play a huge role. Two companies operating in the same space can end up in very different positions depending on their strategy.

Across time, this balance can shift: technological change, new business models, or shocks like the COVID crisis can reshape an industry's profitability. That's why both firm strategy and industry structure need to be considered.

In short:

- Profitability varies a lot between industries.
- It also varies a lot between firms within the same industry.
- Industry structure sets the stage, but firm strategy determines who wins.
- Industry and firm dynamics evolve, so timing and adaptability matter.

Five Forces Analysis

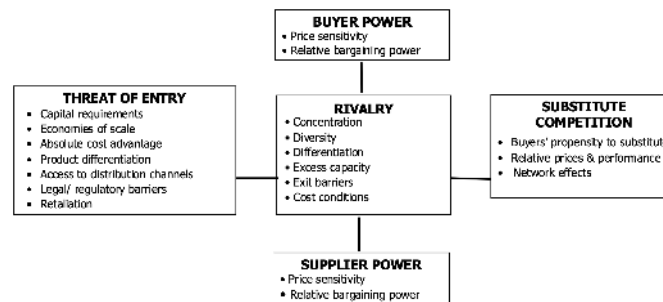
The idea behind industry analysis is to understand **why some industries are more profitable than others**, and what factors drive those differences. This approach comes from Industrial Organization (IO) Economics, which tries to explain why we don't always see perfect competition in the real world.

Michael Porter translated that thinking into a practical framework for strategy, which became known as the **Five Forces**: his work focused on identifying what makes industries structurally more or less attractive (what makes it easier or harder for firms in a given industry to be profitable).

The goal of this type of analysis is to look beneath surface-level competition and understand the **underlying forces** that shape outcomes. These forces are:

- **Threat of new entrants:** If it's easy for new companies to enter the industry, profits are harder to keep. High capital needs, strong brands, legal protections, and control over distribution make entry harder, protecting existing firms.
- **Bargaining power of suppliers:** When suppliers have few competitors or deliver something essential, they can charge more or demand better terms. The more power they have, the more pressure they put on your margins.
- **Bargaining power of buyers:** Customers with strong bargaining power can push prices down or demand better service. This happens if they're concentrated, price-sensitive, or can easily switch to another provider.
- **Threat of substitutes:** Even if direct rivals are weak, substitutes can steal demand. The easier and cheaper it is for customers to switch to something else, the harder it is to maintain profitability.

- **Intensity of rivalry:** The more intense the direct competition, the harder it is to stand out or raise prices. Rivalry is shaped by things like how many firms compete, how similar their products are, and how costly it is to exit the market.



By analyzing these forces, we can explain both **why some industries are so profitable**, and why others struggle. It also helps us understand **who has power** in the value chain, and how to **forecast future profitability**, by anticipating changes in industry structure. **Improving profitability** requires strategic thinking: once we know which structural features of an industry are helping or hurting profitability, we can position ourselves more effectively. We should also ask: are these pressures changeable through our own strategy, or would they need collective action across the industry?

Threat of New Entrants

This force is about how easy or hard it is for new firms to enter an industry. If it's easy to get in, established firms are constantly exposed to new rivals, which puts downward pressure on prices and profits. If it's hard to enter, existing companies are protected and can maintain stronger margins.

The key idea here is the concept of **barriers to entry**: the resources, capabilities, or conditions that new entrants must meet to join the competition and without which they can't compete. There exist two types of barriers:

1. **Ex ante barriers** (before entering): These are structural things that make it difficult to start competing:
 - **Capital requirements:** some industries require huge investments just to begin (like aviation or telecommunications)
 - **Legal restrictions:** pharma, banking, and telecom are often regulated and require licenses
 - **Economies of scale:** large firms can spread costs more efficiently
 - **Buyer loyalty or brand power:** if consumers are already attached to an existing brand, it's hard for new players to convince them to switch
 - **Access to distribution:** incumbents may control shelf space or supplier networks
2. **Ex post barriers** (after entering): Even after entering, new players can be pushed out or discouraged:
 - **Retaliation:** incumbents may cut prices or invest aggressively to defend their position
 - **Ongoing costs:** new firms need to build relationships, comply with regulations, or spend heavily on marketing just to stay in the game

Coca-Cola and Pepsi spend much less per unit in advertising because of their size, while smaller competitors like Fresca or Diet Rite have to spend much more just to get noticed, which makes it hard to compete. That's an example of an **economy of scale**, and a real entry barrier.

Amazon tried to enter physical grocery stores with Amazon Fresh, but ran into trouble because big retailers already were scaled up, had loyal customers, supply networks and know-how. Even a giant like Amazon can struggle to break into a space where the **incumbents have built strong entry barriers**.

Bargaining Power of Suppliers

Supplier power refers to the ability of suppliers to influence the **prices, availability, and quality** of the inputs that companies need in order to operate. When suppliers have a strong position, they can demand better terms, raise prices, or deliver lower-quality goods without much consequence. The power of suppliers depends on their **price sensitivity and bargaining position** relative to the businesses they supply: if a company represents a small portion of the supplier's business, or if the supplier's products are unique and hard to replace, the supplier holds the power.

Airlines often face high supplier power because airplane manufacturers like Boeing and Airbus are few and dominate the market. Meanwhile, Toyota might have low supplier power because it sources from many and has the scale to negotiate well.

Suppliers are particularly strong when:

- They are more **concentrated** than the buyers.
- They provide **differentiated or unique inputs**, which makes switching costly for the buyer.
- There are **few or no substitutes**.
- They are **not dependent on one industry**, but serve a range of sectors.

Bargaining Power of Buyers

This force is about the ability of buyers to influence prices and terms in their favor (lower prices or improve quality and service). This reduces the profitability of firms in the industry. Buyer power depends on two main factors: how **price sensitive** buyers are and how much **bargaining power** they hold relative to suppliers.

Buyers have high power when:

- They are **large, concentrated**, and **purchase in high volumes** (government agency ordering office supplies in bulk).
- The products they are buying are **standardized or undifferentiated** (gasoline or basic agricultural goods), as they can easily switch to another supplier if prices increase.
- There are **no switching costs**, which means buyers can change suppliers without financial loss, effort, or inconvenience.

Supermarkets have strong negotiating power over farmers, forcing down the prices they pay, but when they deal with major food manufacturers, the dynamic shifts. This shows that buyer power is not absolute but varies depending on the relationship and the size or influence of the supplier.

Switching costs are also essential: if buyers can move to a different supplier or product easily, their power increases; however, when switching involves a sacrifice (e.g., having to learn a new system, losing access to a familiar network, or giving up a trusted brand) buyer power decreases. Switching costs often depend on:

- **Product uniqueness:** if a product offers something distinct, it is harder for buyers to replace it.
- **Network effects:** when the value of a product increases because many people are using it, like social media platforms or collaborative apps, switching becomes less attractive.

This is why platforms like Facebook, WeChat, or even Wikipedia have such staying power. The value lies not only in the product itself but in the network and community that surround it.

Threat of Substitutes

Threat of substitutes refers to products or services that come from outside the focal industry but can fulfill the same need or offer similar benefits to customers. The stronger the threat of substitutes, the more pressure there is on prices and margins, as consumers can easily switch if alternatives become more appealing. Substitutes are more threatening when they are similar in function and performance, and especially when they are cheaper.

Zoom or Teams can replace business travel: they don't offer the same experience, but they do serve the same purpose at a much lower cost. This overlap creates a substitution threat for the airline industry.

Several factors make substitutes more or less threatening:

- **Price-performance tradeoff:** if substitutes are similar in quality and cost less, customers are more likely to switch.
- **Price elasticity:** when consumers are highly sensitive to price changes, they are quicker to adopt alternatives.
- **Low switching costs:** if it's easy and inexpensive for consumers to move from one product to another, substitutes become more powerful.
- **Network effects** can work in the opposite direction, since products that become more valuable as more people use them (like messaging apps or social platforms) make it harder for new substitutes to break in, raising switching costs.

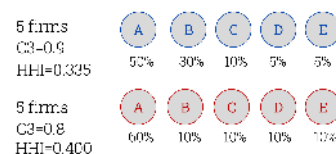
Ultimately, substitutes reshape industries: they don't compete head-on with the same product, but they offer new ways to meet the same needs, and in doing so, they quietly erode the value proposition of incumbents.

Intensity of Rivalry / Competition

To understand rivalry in an industry, analysts use specific indicators to measure competition levels:

1. **Number of firms:** More firms usually means more competition.
2. **Concentration indices (Cn or C3):** These show how much market share is held by the largest players. For example, C3 is the total market share of the top three firms. Higher values mean fewer dominant firms, suggesting less competitive pressure.

1. **Herfindahl-Hirschman Index (HHI):** This adds up the squares of each firm's market share. The result is a number between 0 and 1: the closer it is to 1, the more concentrated the market. The HHI is especially useful when there are many players of different sizes.



It is possible to have the same C3 but, depending on how market share is distributed, the HHI (and real level of concentration) may be very different. That's why both numbers matter.

The degree of competition depends on:

- **Concentration:** When a few firms dominate, they might compete less aggressively.
- **Market growth:** In slow-growing markets, firms have to steal share from each other, which increases rivalry.
- **Diversity of competitors:** When firms have similar strategies, they may compete head-to-head more directly.
- **Product differentiation:** The more different the offerings, the less direct the rivalry.
- **Excess capacity and exit barriers:** If companies can't easily leave and have unused capacity, they'll fight harder for customers.
- **Cost structure:** High fixed costs create pressure to fill capacity, which can lead to price wars.

Some industries naturally have high rivalry. Food is one, because products are similar and margins are thin. For Airlines, even though they try to differentiate, most customers focus on price, which leads to struggles when trying to stay profitable.

Complements: the 6th Force

While Porter's Five Forces focus on competition, many industries are shaped just as much by **complementary products or services** that come from other industries but increase the value of the core product. These complements don't directly compete, but they're essential for a complete user experience. When complements are strong, they can increase demand, enhance differentiation, and even create switching costs.

A car is far more useful when fuel or charging stations are easily available. A smartphone becomes more attractive when paired with an intuitive operating system and a reliable mobile network. A video game console has more value if it's supported by a wide and exclusive game library.

In this way, suppliers of complements can also exercise bargaining power and influence industry dynamics. Although they're not traditionally part of the Five Forces model, they often shape the competitive environment in ways that are just as important.

Limitations of Porter's Five Forces

Despite its usefulness, the Five Forces framework has some important limitations:

- It offers a **static view** of competition: industries today are often dynamic, with fast innovation and constant shifts, so the model can miss key developments.
- It places too much weight on industry structure and not enough on **individual company differences**: a firm's own capabilities, positioning, or innovation might allow it to outperform competitors even in tough industries (→ strategic groups).
- It underplays the role of **complementary firms**.

Segmentation and Strategic Groups

Porter's Five Forces is one of the most widely used tools for industry analysis. A quick look online or on platforms like ChatGPT, Gemini, or Google shows that it consistently appears as the go-to method for analyzing competition and industry profitability. However, while it's still dominant in practice, it's far less present in cutting-edge academic research: scholars are increasingly focusing on new concepts and frameworks that better reflect today's rapidly changing business environment.

The model has some clear shortcomings:

- **Industry structure is exogenous**, so firms are often limited in their ability to reshape the industry structure, especially because changing it through coordination (like price-fixing) is illegal and damaging.
- It is entirely focused on **capturing value**, offering no support for understanding how companies can **create value** through innovation, partnerships, or other proactive strategies.
- It is **largely static**, meaning it doesn't take into account how industries evolve over time and the different **life cycle stages** industries go through.
- It is **too broad**, failing to acknowledge meaningful differences between **strategic groups** (clusters of firms within the same industry that follow similar strategies but differ from other clusters).
- It **under-emphasizes company-level differences**, such as specific capabilities or strategic choices that can affect profitability independently of industry structure.

Because of these limitations, modern strategy thinking has extended beyond the Five Forces model. Three main directions have been developed to address its weaknesses:

1. **Industry evolution and life cycles**
2. **Strategic groups analysis**
3. **Complementors in the value chain**

These additions help fill the gaps left by the original model, especially in dynamic or highly innovative sectors.

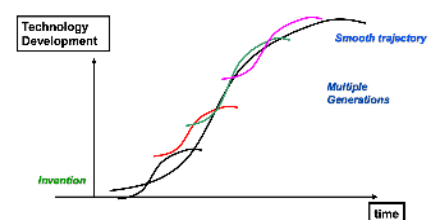
Industry Life Cycles

Industries don't stay still. They evolve over time as technologies shift, demand changes, and new players enter or leave. This process, called **industry dynamics**, reshapes the basic rules of competition.

What drives these dynamics?

- **Entry and exit** of competitors: New firms bring innovation and pressure; others leave when they can't compete.
- **Demand growth**: As consumer interest grows or fades, the structure of the industry changes.
- **Knowledge creation and diffusion**: New technologies or know-how spread through firms, altering how they compete.

The evolution of technology tends to follow an "**S-curve**": slow initial progress, followed by rapid growth, and then a plateau. This curve can repeat across **multiple generations** of a product, each time resetting the cycle. These shifts (in demand, competition, and technological progress) explain why no industry stays in a single phase forever. Understanding where an industry sits in its life cycle helps firms anticipate changes and adapt their strategy accordingly.



A useful way to understand industry dynamics is through the **industry life cycle**, which maps how an industry typically develops over time in four phases: introduction, growth, maturity, and decline.

1. Introduction

2. Growth

- The product or service is new and adoption is limited, mostly to early adopters or high-income users.
- There's intense product innovation and many competing technologies. Products tend to be low-quality and frequently redesigned.
- Manufacturing is small-scale, with skilled labor and niche distribution channels.
- There are only a few firms and the failure rate is high.

Success: innovating the product and building a credible image.

3. Maturity

- The market is now saturated. Sales are driven by replacement purchases and buyers become more price sensitive.
- Innovation slows, with small, incremental improvements. Commoditization begins.
- Overcapacity can appear, as firms have ramped up production.
- Fewer firms dominate, entry slows and price competition intensifies.

Success: cost efficiency to stay competitive.

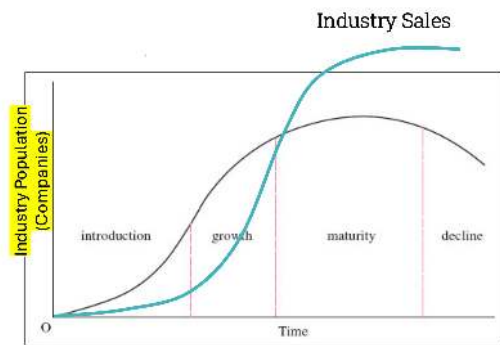
- Demand takes off as the market expands rapidly.
- A dominant product design and technical standards emerge. Process innovations improve production.
- Firms scale up manufacturing and face growing competition to access distribution.
- Many new firms enter, mergers take place, but failures start to decline.

Success: scaling up production, distribution, and brand building.

4. Decline

- Demand falls, often due to the rise of substitutes. The market becomes obsolete.
- There's little innovation left and products lose differentiation.
- Overcapacity is common, and firms cut back or shut down.
- Exit rates rise and price wars often begin.

Success: cost efficiency and rationalizing capacity.



These life cycle patterns are widespread across industries (e.g. automobiles, televisions, penicillin) but not identical, as there are always variations and exceptions, particularly regarding the number of firms rather than sales. Some markets decline slowly, others collapse quickly.

When to enter?

In the **digital era**, market adoption has accelerated significantly. Technologies such as smartphones, social media, and tablets have reached mass adoption far faster than older products like telephones or radios.

This rapid change also affects strategic decisions about when to enter a market.

| Factor | Early Mover Advantage | Late Mover Advantage |
|---|--|--|
| High technological and demand uncertainty | <u>Increases risks of failure</u> <u>High development costs</u> | Delayed entry diffuses risks Benefit from first movers' investments & tests |

| Factor | Early Mover Advantage | Late Mover Advantage |
|--|--|---|
| High learning curve | Decreases costs and increases quality of offering | <u>Costs of "catching-up" on efficiencies and value-proposition</u> |
| Preemption of scarce assets / Opportunity to set standards | Position Advantage Network externalities <u>Risk of adopting a losing standard</u> | <u>Loss of leadership potential</u> Imitation |
| Customer loyalty | Creates switching costs | Potential to go after niche, underserved segments |

Industry Segmentation: Strategic Groups

Strategic groups are clusters of firms within an industry that follow similar strategies or compete along the same strategic dimensions. While industry analysis often treats all firms as comparable, in reality, companies within the same industry can pursue very different approaches, which is why we also use strategic group analysis.

A strategic group, as defined by Porter in 1980, is "a group of firms in an industry following the same or similar strategy along strategic dimensions." The key factor in drawing group boundaries is **substitutability**, so if one firm could be substituted with the other (hypothetically).

To segment an industry into strategic groups, the key is to look for **important differences** in how firms compete. Not all firms within an industry are the same, and strategic group analysis tries to capture this variation by asking:

- Who are the firm's **main customers**? Do these customers have similar willingness to pay (WTP)?
Are they targeting premium buyers, budget-conscious shoppers, niche audiences, or the mass market?
- How broad is the **product offering**?
Does the company offer a single specialized product, or a wide range of related goods and services?
- Who are the **main suppliers**?
Analyzing **supply chain dependencies** can reveal how a firm's strategy is supported by its choice of suppliers and partners, and looking at the **value chain** helps you see if all activities align with cost efficiency, speed, quality, or innovation.
- What is the firm's **business model**?
Look into their:
 - **Value proposition**: what they offer and why it's valuable.
 - **Channels**: how they deliver that value to the customer.
 - **Key resources and partners**: what assets or collaborations they rely on.
- What's the **overall strategy**?
Is the firm pursuing **cost leadership** (competing on low prices) or **differentiation** (offering unique features, service, or prestige)?

With the rise of mobile apps between 2010 and 2016, new competitors like Tinder, Bumble, and Grindr disrupted the dominance of desktop-oriented platforms like Match.com and eHarmony. Though all were in the "online dating" industry, their strategies varied a lot in terms of user base, interface, and accessibility, so they formed different strategic groups.

Strategic Group Map

To build a strategic group map, start by **identifying potential variables** that define a firm's strategy. These could include:

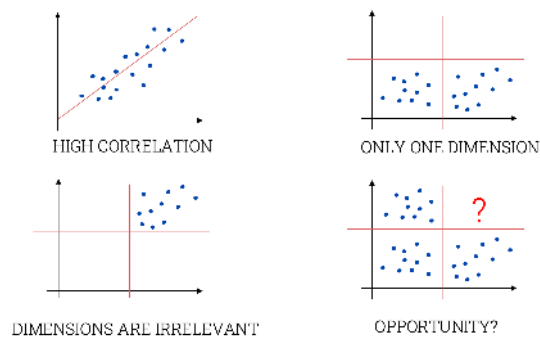
- Level of diversification
- Geographic scope

- R&D expenditures
- Pricing range
- Technology
- Brand strength
- Distribution channels
- Value proposition

Once you've gathered a broad set of variables, **position each firm in relation to them** (you might want to use a table for this step). Then, **choose two variables** that are especially important to the industry (more than two is possible, but makes visualization harder) and which should meet a few key criteria:

- Be as **uncorrelated as possible**, so that all firms don't just fall along a single line (if they are correlated, **combine them into a category**).
- Show **high variance across firms**, so the differences in strategy are visible.

After drawing **two axes** based on the chosen variables, each firm should be **positioned** in relation to the chosen variables, so it will be possible to **identify clusters** of firms that share similar positions (pay attention to clusters that are associated with **higher profit**).



Pros

Strategic group analysis has several benefits. It helps us **understand the different strategies** adopted in an industry. It also allows us to **analyze competition**, both within a group (intra-group) and different groups (intergroup). Studying intra-group competition can be useful to **analyze which groups are the most profitable**.

Moreover, strategic group analysis **helps identify niches**. Focusing on a specific niche means a company can:

- Develop a **focused strategy**.
- **Take advantage of its capabilities** more efficiently.
- **Manage change more easily** and pursue innovation and a sustainable competitive advantage.
- **Avoid retaliation** from competitors.
- **Charge premium prices** and generate higher profits.

Strategic groups **extend industry analysis** by focusing attention on the most relevant competitors and strategic dimensions. They help bridge the analysis from the industry level to the **company level**, focusing on strategic positioning and business models.

Cons

However, strategic group analysis is not without limitations, as it is **not possible in all industries**: for example, in **standardized commodity markets**, companies may not differentiate enough to form strategic groups.

Another risk is that **niches can become overcrowded** if too many competitors pursue the same focused strategy. Additionally, a niche can be **too narrow to generate enough revenues** to sustain a business.

This highlights the **importance of barriers to mobility** and **segment-specific capabilities or business models**: these can help firms defend their niche positions against rivals.

Cost Advantage

Competitive Advantage

Competitive advantage refers to a firm's ability to **outperform** its rivals. It is achieved when a firm is able or has the potential to generate **above average profitability** relative to its industry over the medium to long term.

Competitive advantage is generated by **change** and must be sustained over time. The **longevity** of competitive advantage is evident when looking at the evolution of the world's top companies by market capitalization: a shift towards the dominance of tech companies took place.

Sustainability is crucial when evaluating competitive advantage. Profitability alone is a short-term indicator; what matters is **how firms use profits**, whether it is to reward shareholders and employees or to invest in innovation. The average lifespan of companies in the S&P 500 has declined from 67 years in the 1920s to about 15 years today, although this varies across markets such as Japan and the U.S.

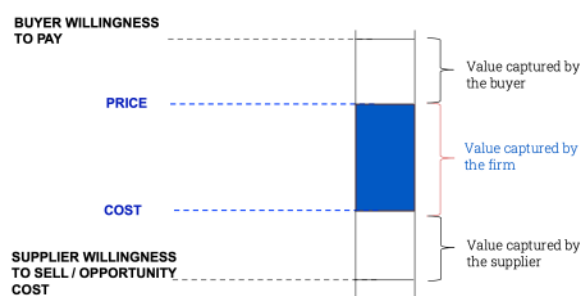
Toyota has maintained profitability for over 50 years, thanks to continuous innovation and its hard-to-replicate lean production system. **Southwest Airlines** has been profitable for more than 30 years, leveraging a low-cost business model and strong employee loyalty. These examples raise questions about whether younger companies possess competitive advantage.

Value Creation and Value Capture

Competitive advantage is based on value creation and value capture. **Value creation** involves generating **benefits for partners**, especially customers and suppliers, through economic exchange. **Value capture** focuses on how much of this created value the firm can secure as **cash flow and profits**.

Creating competitive advantage means **widening the gap** between the buyer's willingness to pay (**WTP**) and the supplier's willingness to sell or their **opportunity cost**. The value captured is then divided: **buyers** capture the surplus between willingness to pay and price, **firms** capture the margin between price and cost, and **suppliers** capture the difference between cost and their minimum acceptable price.

The firm's success depends on expanding this gap and securing a larger share of the total value.



Fit/Adaptation

According to the **sociological perspective**, competitive advantage arises from a company's ability to **fit with industry conditions**, particularly by understanding and responding effectively to **environmental pressures**. Firms that can **anticipate** shifts in consumer preferences and market dynamics are better positioned to maintain their competitive advantage over time. An example of lost competitive advantage due to poor fit is **Blackberry**, which lost it when the industry shifted focus from business to personal use, as Blackberry's business model emphasized security and lacked focus on complementary products.

To defend competitive advantage from a fit perspective, companies must adapt by aligning themselves with **market changes** through regeneration and reconfiguration.

Regeneration involves investing in products through research and development, design, and technical capabilities, as well as engaging consumers to show them the product's value (Apple emphasizes design and regular product events).

Reconfiguration, on the other hand, is about transforming the entire business model to meet market demands (IBM: manufacturing PCs → IT services; Netflix: DVD rentals → streaming).

With international travel restricted due to COVID, airlines found different ways to maintain engagement and generate revenue: flight simulators, tours of their facilities, "flights to nowhere", and turning aircraft into

restaurants are some examples.

Market Power

The **economics perspective** explains competitive advantage as internally generated through **innovation**, allowing firms to gain **market power** or even temporary monopoly positions. This form of advantage focuses on **strategic innovation**, so on developing new ways to serve customers and outperform rivals.

One approach is the **Blue Ocean Strategy**, which targets untouched market spaces to avoid head-to-head competition (see segmentation). Another is **business model innovation**, where firms reinvent how value is created and captured (like shared ownerships, platforms like Uber and food delivery apps).

Nvidia, for example, dominates the high-end GPU market and gained a massive edge by **betting early on AI-specific chips, anticipating market shifts** and delivering superior products, ensuring long-term dominance.

Protecting the Competitive Advantage

Maintaining competitive advantage over time requires protection from imitation. Firms rely on several mechanisms to defend their position:

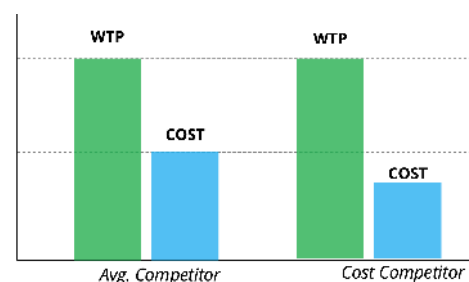
- **Legal protection** through patents and copyrights safeguards innovation.
- **Customer loyalty** raises switching costs by creating ecosystems and network effects, as seen with Nintendo.
- **Causal ambiguity** hides the true source of advantage, as with Toyota's lean production system, which remains difficult for competitors to fully replicate.
- **Secrecy**, like Coca-Cola's recipe, shields key elements from competitors.
- **Accounting skills** can obscure financial advantages, for instance through the use of subsidiaries or tax strategies.
- **Unique resources and capabilities** that are scarce and difficult to transfer.

In the **Silicon Valley**, they say: **"What is your moat?"**, so what defenses protect your competitive advantage from rivals?

Cost-Based Competitive Advantage

Cost-based competitive advantage arises when a firm achieves superior performance by operating at a **lower cost** than its competitors, without necessarily sacrificing quality or value. This allows the firm to either **offer lower prices** to customers or **capture higher margins**. The core idea is to find and exploit opportunities for **cost reduction** across the value chain.

A cost advantage works by lowering the firm's costs while maintaining a similar **willingness to pay (WTP)** from customers compared to competitors. While both the average competitor and the cost competitor offer similar value to customers, the cost competitor incurs **lower costs**, expanding the margin between cost and price, thus capturing more value.



Cost-based strategies are critical in industries where **price competition is intense** or where customer segments are highly **price sensitive**. They are also essential when addressing **broad consumer bases** across different niches. However, there are downsides: cost advantages can be difficult to **sustain over time**, especially if competitors can easily observe and imitate the sources of cost reduction. Additionally, an excessive focus on cost leadership can trigger **price wars**, eroding profitability across the industry.

▼ Examples

Walmart: minimizes costs in products, operations, and workforce, which enables it to gain substantial market share.

Ryanair: offers similar routes and safety standards as competitors but at much lower prices.

Shein: rapidly designing, producing, and distributing fashion at minimal costs.

Drivers of Cost Advantage

Firms can achieve cost advantage through several mechanisms:

1. **Scale Economies:** Costs per unit decline as production volume increases.
Example: Ford's Model T mass production.
2. **Scope Economies:** Producing related goods jointly reduces average costs.
Example: McDonald's using the same kitchen equipment for various products.
3. **Learning Economies:** Efficiency improves over time through experience, reducing waste and defects.
Example: TSMC in semiconductor manufacturing.
4. **Load Factor and Economies of Fixed Cost Absorption:** Maximizing the use of capacity spreads fixed costs over more units.
Example: airlines and hotels optimizing capacity utilization.
5. **Organization of Production:** Employing efficient production methods such as lean manufacturing or just-in-time systems.
Example: Toyota and fast-fashion brands.
6. **Vertical Integration:** Controlling multiple stages of the supply chain to lower coordination costs.
Example: Zara managing design, manufacturing, and retail.
7. **Input Costs:** Accessing lower-cost labor, materials, or locations.
Example: oil extraction in the Middle East benefits from geographic cost advantages.
8. **Product Design:** Designing products that require fewer or cheaper inputs.
Example: Tata Nano, a car engineered for ultra-low cost.
9. **Residual Efficiency:** Unique organizational efficiencies or employee motivation that competitors struggle to replicate.
Example: Southwest Airlines' employee-driven efficiency.

How to Exploit a Cost Advantage

When a firm successfully achieves a cost advantage, it can choose between two main strategies: **aligning prices with competitors** or **lowering prices to gain market share**.

Aligning prices with competitors enables the firm to earn larger margins that can be **used strategically** (distributing returns to shareholders or employees, acquiring rivals, or investing further in innovation and marketing) or channeled into strengthening the firm's position through **regeneration** (improving existing products or customer loyalty mechanisms) or **protection** (e.g., patents).

Alternatively, the firm may choose to **lower prices** to capture a greater market share. By offering similar quality at a more attractive price, the company **increases the volume of units sold**. If this scale is sufficient to maintain profitability, total profits can rise. Over time, this pricing strategy can place pressure on competitors and even drive them out of the market, provided that lower prices do not negatively affect **perceived quality and price elasticity** is sufficiently high.

A critical assumption here is that customers perceive the quality of the lower-priced product as comparable to competitors, and that the market is sensitive to price changes. If this assumption fails, lowering prices could harm the brand or value capture.

Cost-Based Strategy

Cost-based strategies are linked to how customers **perceive product quality**. If price drops are interpreted as **lower quality**, this may harm the brand: in the 1990s, Apple cut prices across several products to boost demand but the benefits were limited, especially as Microsoft was introducing competing products and Apple's premium brand image risked dilution (against value proposition).

The viability of cost-based strategies heavily depends on price **elasticity of demand**, that measures how demand responds to changes in price:

- When price elasticity is **high**, demand increases significantly as prices drop (prices down → sales volumes up). This makes cost-based strategies **appealing**.
- When price elasticity is **low**, consumers are relatively indifferent to price changes (e.g.: craft beer, luxury goods, medications, high-end technology, ...). This makes cost-based strategies **less effective and potentially harmful** to brand image.

To determine whether a cost advantage is **sustainable**, firms must assess the competitive intensity of their industry and anticipate the risk of a price war. The key is to understand the firm's and its competitors' **cost structure**: how far can you go in lowering prices without compromising profitability, and how far can your rivals go?

For a cost strategy to work long-term, the firm must **outperform competitors in cost efficiency consistently**: IKEA demonstrates that it is possible to establish a long-lived low-cost position through operational excellence and consistent brand positioning.

Cost Advantage Roadmap

To transform a temporary cost benefit into a sustainable competitive advantage, firms can follow a structured approach:

1. Assess whether the firm has a **real cost advantage**, drawing on a combination of factors:

- Scale, scope, and learning curve.
- Load factor, production organization, and vertical integration.
- Input cost efficiency, product design, and residual efficiency.

2. Choose how to **exploit** it:

Align prices with competitors to enjoy higher margins.

OR **Reduce prices** to gain volume and expand market share

3. Consider how to **defend** the advantage, through:

- **Adaptation** (adjusting to the environment).
- **Protection** (using legal or structural barriers).
- **System fit** (ensuring internal coherence and alignment with market needs).

Differentiation Advantage

Differentiation refers to the ability of a firm to offer a **product or service that is unique and valuable to buyers**. This uniqueness enables the company to charge a **premium price**, thereby achieving a **differentiation advantage**. While cost advantage relies on producing similar goods at a lower cost, differentiation hinges on increasing **buyers' willingness to pay (WTP)** for a distinct product offering.

This strategic positioning contributes to **competitive advantage**, which occurs when a firm is able (or has the **potential**) to generate **above-average profitability** relative to its industry over the **medium to long term**. As the diagram illustrates, competitive advantage can stem from either a **cost advantage** (same product, lower cost) or a **differentiation advantage** (unique product, higher WTP).

Differentiation and Competitive Advantage

Differentiation advantage occurs when a firm delivers **something unique that buyers value**. This uniqueness increases the **willingness to pay** compared to competitors, creating a wider gap between **cost and value**. The greater this gap, the more value the firm captures.

Differentiation often manifests in various attributes such as:

- **Product features and quality**
- **Brand strength**
- **Customer relationships and service quality**
- **Design**
- **Compatibility with complementary products or services**

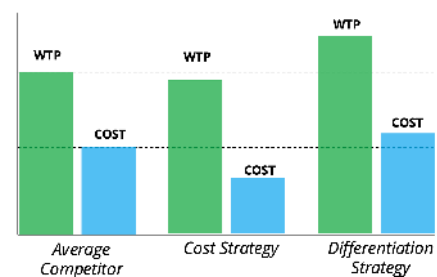
All of these factors contribute to shaping a **strong value proposition** that justifies premium pricing.

Value

To illustrate the impact of differentiation, a comparison of three strategies is presented:

1. **Average competitor:** WTP and cost are balanced with little value capture.
2. **Cost strategy:** Lower cost increases the value captured by reducing expenses.
3. **Differentiation strategy:** Higher WTP creates a larger value surplus while keeping costs stable.

As shown in the graph, differentiation leads to a **greater total value created** because the increase in WTP outweighs the potential rise in costs. This additional value can then be **shared between the firm and the buyer**, depending on pricing.



Value Capture vs. Value Creation

While most firms are good at **value creation** (innovating and improving products), **value capture** is often more difficult. In the tech industry especially, many firms spend years creating value before becoming profitable. These delays suggest that while value creation is essential, **capturing** the value requires **network effects**, robust **business models**, and **scalable operations**.

Characteristics of Differentiation

Many successful firms build **competitive advantage** by crafting a strong **differentiation strategy**. This involves offering a product or experience that is **unique, recognizable**, and perceived as valuable by a specific group of

consumers.

- **Gucci** differentiates itself through high-end fashion, strong brand image, and association with luxury, exclusivity, and status.
- **Starbucks** is known for its standardized store layout, cozy ambiance, customer experience, and personalization (e.g., writing your name on the cup).
- **Lush** offers handmade cosmetics with distinctive scents, colorful designs, ethical sourcing, and a retail space of sensory appeal.

These firms target consumers who value **identity**, **experience**, or a **set of values**.

Uniqueness

Differentiation is not necessarily about offering the highest quality or earning the highest profits. Instead, it's about achieving **higher perceived uniqueness**, which:

- **Is not the same as quality**: Quality is objective and measurable, but perceived uniqueness is subjective, as it depends on what a specific consumer group values.
- **Is not the same as profits**: Differentiation may require greater investment (in design, service, brand image, etc.) to maintain uniqueness.

The goal is to stand out in the eyes of the **right** consumers, not all consumers. Uniqueness matters most when it **appeals to a clearly defined consumer group**. Firms that succeed with a differentiation strategy tend to:

- **Understand** their core customer segment
- **Improve** key features those customers care about
- **Add features** over time to enhance loyalty or broaden appeal without alienating the core

This approach results in **higher willingness to pay (WTP)** and a more **sustainable advantage**. Differentiation is easier and more effective when focused on a **segment** or **submarket**, rather than trying to please the entire market.

Willingness to Pay (WTP)

WTP is the **maximum amount** a consumer is willing to pay to either **gain** something they desire or **avoid** something undesirable. In the context of differentiation:

- Firms try to **push consumers toward their highest WTP** by enhancing what they care about most.
- Since not all consumers value the same things, firms **segment** the market and target the segment that most values their differentiating features.

This is why differentiation often works best within **niches** rather than the general market.

▼ **Bombardier CSeries**

The **Bombardier CSeries** aircraft offers a compelling example of differentiation based on **product uniqueness**:

- **Swiss International Air Lines** was the first to fly it in commercial operations, followed by **Lufthansa**, **Air Baltic**, and others such as **Delta** and **Air Canada**.
- Features that distinguish the CSeries include:
 - **Reliability**
 - **Fuel efficiency** (up to 20% better than competitors)
 - A better **passenger experience**, thanks to:
 - Large cabin windows
 - Higher humidity
 - Lower noise levels (20 decibels quieter)

- 3-2 seat layout
- Wider seats (19 inches vs. 17 on most Boeing and Airbus models)

These features address **both airline** needs (operational performance) and **passenger** expectations (comfort), increasing WTP on both fronts. However, to ensure that these advantages translated into **orders**, Bombardier had to:

- Set initial prices **below WTP** to gain traction.
- Face **retaliation**: Boeing accused Bombardier of unfair competition due to Canadian subsidies, leading to 300% **customs duties** on CSeries jets.

Eventually, **Airbus acquired the CSeries program** in 2018 (now the A220), and **Bombardier exited commercial aviation**, refocusing on private jets.

Tangible and Intangible Differentiation

The perceived uniqueness of a product can come from both:

- **Tangible features**, shaped by **R&D**: design, service, physical characteristics, technical performance

▼ Apple

Apple exemplifies **tangible differentiation** through its investment in **product design, research and development**, and **intellectual property**. Its uniqueness is rooted in observable and functional aspects:

- Products are ready to use **out of the box**, offering a seamless experience.
- The software is **user-friendly** and tailored especially for creative tasks like design.
- Apple devices benefit from **better security**, with fewer targeted attacks.
- Their **design** includes sleek aesthetics, large high-resolution screens, and quality hardware like metal casings and responsive trackpads.

These elements make Apple computers **distinctively tangible** and raise their **perceived uniqueness** among users.

▼ Leica vs. Canon

Leica stands out with superior craftsmanship and minimalist design.

▼ Virgin vs. EasyJet

Virgin differentiates on service experience, whereas EasyJet focuses purely on cost.

- **Intangible factors**, shaped by **marketing**: branding, emotional appeal, identity, symbolism

▼ Camera Brands

Brands like **Canon, Sony, Nikon, Leica**, and others don't just compete on technical specs. They cultivate strong **brand personalities** and **emotional resonance** with distinct consumer identities:

- **Canon**: Bold, muscular, professional.
- **Leica**: Stylish, niche, artistic.
- **Fujifilm**: Retro, thoughtful, niche-focused.

These personalities are built not only through product design but also through **storytelling, community**, and **positioning**, making the differentiation largely **intangible**.

▼ Coke vs. Pepsi

While **Coke** and **Pepsi** offer nearly identical products in blind taste tests, their **perceived value** and **brand identities** are very different:

- **Coke** emphasizes **family, friendship**, and **tradition**, often using nostalgic imagery like Santa Claus and polar bears.
- **Pepsi** promotes **adventure, individuality**, and **youthful trendiness**, often leveraging pop culture and fashion.

Here, **differentiation is not in the product itself**, but in the **emotional associations** consumers attach to each brand. This is a pure case of **intangible differentiation**.

▼ Patagonia vs. North Face

Patagonia and **The North Face** both operate in the outdoor apparel market but appeal to **very different values**:

- **Patagonia** differentiates through **environmental activism** and ethical stances. Their “Don’t Buy This Jacket” campaign reflects a bold commitment to **sustainability** and conscious consumption.
- **The North Face**, instead, focuses on **performance** and **endurance**.

Both brands sell similar technical products, but their **intangible positioning** creates distinct identities, targeting **different consumer mindsets**.

Often, tangible and intangible differentiation **reinforce each other** and must be **consistent**: a common issue arises when firms attempt to appear unique without delivering substance, like for **greenwashing**.

▼ H&M and Greenwashing

H&M was accused of **misleading sustainability claims**, presenting themselves as environmentally friendly while the reality of their practices suggested otherwise. Consumers were told that clothes would be recycled or avoided landfills, but reports highlighted that the **recycling solutions were unavailable at scale**. This created a **misalignment** between the **intangible image** and the **tangible reality**, ultimately undermining trust.

▼ Nokia

In contrast to the H&M case, **Nokia** was recognized for **genuine sustainability efforts**, ranked as the **world’s most sustainable tech company** by Dow Jones and Greenpeace. Nokia’s communication was transparent, engaging directly with consumers about its environmental record, and thus maintained alignment between **brand promise** and **actual performance**.

Harley-Davidson

Tangible Differentiation:

- Iconic motorcycle design (e.g., V-twin engine, cruiser style).
- High-quality, durable manufacturing.
- Strong customization options.

Intangible Differentiation:

- A **powerful brand identity** built on **freedom, rebellion, and individualism**.
- Deep emotional connection with riders.
- Community-building through the **Harley Owners Group (HOG)**.
- Represents a **lifestyle** more than a product.

Creation of Differentiation

Differentiation is the result of a firm’s strategic decisions across several dimensions. These choices impact how unique a product appears and how much consumers are willing to pay for it. There are seven key **drivers of differentiation**:

1. **Organization of Production**: A company can create uniqueness by organizing production in a way that enables distinctive output.

Example: **Zara** and **IKEA** innovate constantly in product design and distribution. Zara, specifically, is able to ideate, produce, and deliver a new design in **just one week**, launching around **12,000 new designs per year**. This ability to constantly refresh collections makes the brand stand out in a saturated market.

2. **Vertical Integration**: Controlling several stages of the value chain enables better coordination, quality control, and the creation of integrated products that stand out.

Example: **Tesla** handles both software and hardware in-house, it delivers a tightly integrated product experience. **DeBeers** controls both diamond mining and retail distribution, ensuring product scarcity and brand prestige.

3. **Branding and Advertising:** Branding is often associated with intangible differentiation. A strong, consistent brand image shapes consumer perception and generates emotional connections. The brand becomes part of the product's value proposition, contributing to higher **Willingness to Pay (WTP)**.

4. **Early-Mover Advantage:** Being the **first** to offer a successful product in a new market can build long-term differentiation. The early-mover becomes the reference point in its category.

Example: **Uber**, by being first, captured market loyalty before competitors could enter.

5. **Complementarities:** Offering unique combinations of products or services increases perceived uniqueness.

Example: **Apple** designs both its hardware and software for a seamless user experience. **Digital platforms** like Amazon or Google benefit from large networks of complementors, which reinforces differentiation: the more third-party services they attract, the more indispensable the platform becomes.

6. **Product Design and Innovation:** Innovation that affects form, function, or sensorial characteristics can strongly differentiate a product.

Example: the **sound of a Ducati bike** or the **aesthetics of Leica cameras** become part of the brand identity.

7. **Input Quality:** The use of rare or premium inputs enhances perceived value.

Example: **Loro Piana** is known for sourcing the finest wool.

While these elements foster differentiation, many of them can also help achieve a **cost advantage**, or at least **cost parity**.

Dual Advantage

Theoretically, the combination of **cost leadership and differentiation** can lead to both **efficiency plus value gains**. However, in practice, achieving both is **rare and risky**: as Porter warns, firms attempting to combine both approaches often end up "**stuck in the middle**", lacking clarity and internal coherence., as the internal logic of cost and differentiation strategies may clash: if **Ryanair** attempted to launch a luxury long-haul service to compete with **Emirates**, it would contradict its entire operating model, which is built on minimal service and ultra-low cost. Thus, **internal fit** remains critical: the elements that support one type of advantage may **undermine** the other.

Defending Differentiation

Differentiation must be **defensible** and **sustainable** against imitation and competitive threats. In general, **differentiation is more defensible than cost advantage**. There are three main reasons for this:

1. **Combination of Tangible and Intangible Resources:** When a firm differentiates through both **tangible** (e.g. design, performance) and **intangible** (e.g. brand identity, emotional appeal) aspects, it becomes harder for rivals to copy the entire offering. This mix is often unique and difficult to replicate holistically.
2. **Investment in R&D and Market Knowledge:** Firms that invest in research, innovation, and deep customer insight can continuously adapt and innovate. This ensures they stay ahead of competitors, and it gives them more **agility** in reacting to market shifts.
3. **Focus on Niche Customers:** By targeting **specific customer segments**, a company can tailor its value proposition and build loyalty. This focus often results in reduced direct competition, making the differentiation easier to sustain.

However, differentiation is not necessarily always defensible:

1. **Wrong Combination of Tangibles and Intangibles:** A firm may create something that is objectively unique but **unwanted**.

Example:

- **Google Glasses**

- **Windows Vista**
 - **Cheetos Lip Balm**
 - **Bic Perfume**
2. **Niche Market Risks:** Even a well-matched product might target a **segment too small or too volatile** (over time, demand may disappear)

Example:

- **Apple Vision Pro at \$3500:** even if innovative, the market may be too limited or unwilling to pay such a price.

In Summary

A **strong differentiation strategy** is:

- Built on **complex combinations** of tangible and intangible attributes.
- Supported by **ongoing innovation** and **deep market insight**.
- Protected by **customer loyalty** in **clearly defined segments**.
- Defended against imitation by ensuring internal coherence and fit across the value chain.

However, firms must always ensure that their uniqueness aligns with customer preferences and market size. Misalignment can make even the most original offerings unsustainable.

Sustainability

Leadership and Social Impact

Business leaders must increasingly recognize **sustainability** as central to their role for both **reputational** and **operational** reasons. **Public trust** in business executives is consistently **low**, and this underlines the need for companies to demonstrate **responsible behavior** toward society and the environment.

Environmental performance is another pressing concern. **Business actors** have not fared well in managing the natural environment. Scientific data confirms a clear upward trend in global land and ocean surface temperatures, especially since the mid-20th century. This **warming** is closely linked to **human activity**.

This environmental crisis translates into **concrete and costly consequences**. The frequency and severity of billion-dollar disaster events in the United States (hurricanes, floods, wildfires) have increased dramatically over recent decades. These disasters are not only humanitarian emergencies but also represent **severe financial risks for governments, businesses, and insurers**.

At the same time, the business sector holds immense power to influence change. **Private investment** and **corporate strategies** can significantly impact the trajectory of environmental sustainability. This is illustrated by the **rise in renewable energy** consumption and in **global investment** in clean energy technologies, which reflects not only an awareness of risk but also the pursuit of opportunity in the **transition to a low-carbon economy**.

Leaders who ignore the strategic imperative which sustainability represent, risk their firms' long-term viability and social legitimacy. Those who embed it in their core decision-making gain competitive advantages, stakeholder trust, and resilience in a rapidly changing world.

The Responsibilities of Business Leaders

Historically, there have been several approaches to defining the relationship between businesses and society, often reflecting different ethical, economic, and managerial schools of thought.

A divide can be observed in the views of

Milton Friedman

The only social responsibility of business is to increase its **profits**. As a 1976 Nobel Prize-winning economist and advocate of **free enterprise**, he believed that corporate executives are accountable to shareholders and should focus solely on **value maximization**. Nonetheless, Friedman acknowledged that, in the long run, actions aligned with **community welfare could be justified** if they ultimately benefit the firm.

R. Edward Freeman.

Developed the *Stakeholder Theory of the Modern Corporation*: both **shareholders and stakeholders** have legitimate claims on a firm's decisions (each stakeholder has a vested interest in the firm, corporations rely on the implicit support of society to operate). Freeman frames the balancing of stakeholder interests as a **moral issue** and rejects the idea that shareholder interests must always come first. He even suggests that the appropriate choice may depend on the context (**situational**).

While Friedman and Freeman agree that **creating value** is a common goal, they fundamentally **disagree on the primary beneficiary**. Friedman centers on shareholders and fiduciary duty, whereas Freeman emphasizes the ethical need to consider broader social impacts.

The relationship between business and society is often discussed through frameworks such as **Corporate Social Responsibility (CSR)** and **Environmental, Social and Governance (ESG)** metrics.

CSR - Corporate Social Responsibility

According to Carroll's definition (1979), CSR encompasses the **economic, legal, ethical, and discretionary expectations** that society has of businesses at any point in time. CSR is voluntary, driven by the belief that businesses should **do good for their stakeholders** and go **beyond compliance** with regulations.

There are four central arguments used to justify CSR:

1. **Moral obligation:** It is a company's duty to act ethically.
2. **Sustainability:** Firms should contribute to environmental and community well-being, addressing the triple bottom line: economic, social, and environmental.
3. **License to operate:** Securing acceptance from stakeholders is essential to continue operations.
4. **Reputation:** A strong CSR strategy protects brand value, especially during crises.

Many CSR approaches propose a **hierarchy of responsibilities**, as illustrated by Carroll's Pyramid (2016). At the base are **economic and legal obligations**, required by society. These are followed by **ethical responsibilities**, which are expected, and finally **philanthropic responsibilities**, which are desired but not mandatory. The top of the pyramid may also be interpreted as "directive" or "transformative," encouraging firms to **leave the world a bit better than they found it**.



In this context, **measuring environmental performance** becomes crucial. Companies now use metrics to track **outcomes** such as:

- **Carbon emissions**, via tools like the Carbon Disclosure Project (CDP).
- **Toxic waste** through data from entities such as the EU's Eurostat and the US EPA.
- **Chemical usage and/or waste**.

To track progress towards **independently set goals**, instead, we use:

- **Supply chain sustainability**, often aligned with international standards like ISO 14000.
- **UN's 2030 Agenda for Sustainable Development**, which set out 17 Sustainable Development Goals (SDGs) in 2015. Examples include SDG 1 (No Poverty), SDG 2 (Zero Hunger), SDG 7 (Clean Energy), and SDG 11 (Sustainable Cities). Many companies now align their reporting with SDGs, even though commitments remain largely voluntary. Still, evidence suggests that such alignment can contribute positively to outcomes, especially in the private sector.

ESG - Environmental, Social, and Governance

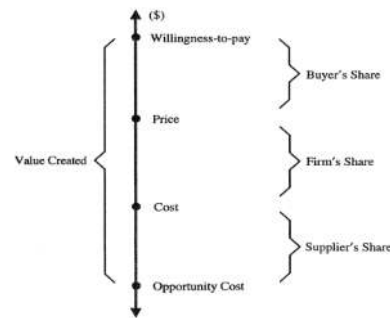
ESG ratings vary significantly by provider. Research shows that the lack of correlation among major ESG scores (aka "aggregate confusion") stems from differences in measurement techniques and scope. Moreover, **Goodhart's Law** reminds us that once a metric becomes a target, it risks losing its reliability. This means that firms may focus on achieving high ESG scores rather than actually improving outcomes, which can distort decision-making.

Despite these tensions, sustainability and social responsibility are increasingly seen not as trade-offs to profitability, but as **strategic imperatives**. Business leaders are called to integrate social and environmental concerns into core decision-making, not just as a moral or reputational necessity, but also as a response to systemic risks, evolving stakeholder expectations, and the long-term viability of the markets they serve.

Sustainability and Strategy

Sustainability is integral to how companies create and capture value. Understanding this connection begins by revisiting the concept of value creation. **Value creation** is traditionally defined as the difference between customers' willingness-to-pay and the firm's total cost of production. This surplus is distributed among:

- The **firm** itself (as profit).
- The **supplier** (as margin over opportunity cost).
- The **buyer** (as consumer surplus).



Shared value is defined as the sum of the profits of the company and the value that flows to other stakeholders through the activities of the company.

The firm becomes the center of a broader value system, connected to a network of stakeholders. The company's ability to succeed is intertwined with the health and prosperity of these actors. By enhancing conditions around them, businesses ensure their own sustainability.

Shared value is created through **policies and operating practices that improve the company's competitiveness while simultaneously advancing social and economic conditions in the communities where it operates**. This perspective shifts attention away from redistribution and towards the creation of new value. It is a move from a zero-sum view of value ("dividing the pie") to a positive-sum approach ("expanding the pie").

Several strategies illustrate how firms can do this in practice:

- **Reconceiving Products and Markets:** Companies can innovate products to meet unmet societal needs.
Example: Unilever redesigned its Lifebuoy soap to improve hygiene outcomes in developing countries.
- **Redefining Productivity in the Value Chain:** Businesses can improve their cost and environmental footprint simultaneously.
Example: Nespresso embedded environmental and social considerations into its sourcing strategy.
- **Enabling Local Cluster Development:** Firms can invest in the broader ecosystem, including training, infrastructure, and suppliers.
Example: Nestlé's investment in a dairy supply chain in rural India is a prime example of local cluster development supporting both the business and the community.

Stakeholders play a critical role in this framework. **Employees** benefit through income, skill development, and personal fulfillment. **Suppliers** gain long-term business and stability. **Local economies** thrive from multiplier effects as spending circulates. **Customers** enjoy improved products and the satisfaction of supporting responsible businesses. In turn, companies depend on these stakeholders' commitment and investment, especially at times of change.

The stakeholder view of the corporation distinguishes between two main categories of stakeholders based on their **role and proximity** to the organization's core activities. **Primary stakeholders**, according to the narrow definition, are those whose involvement is essential to the survival and success of the company, and with a direct and immediate influence on the firm's operations (employees, shareholders, customers, and key suppliers). In contrast, **secondary stakeholders**, defined more widely, are any individual or group that can affect, or be affected by, the corporation (NGOs, media, activists, or the general public). While they may not be directly tied to

the firm's operations, their actions and expectations can significantly influence its legitimacy, reputation, and long-term success.

Stakeholders are typically divided into **three categories**:

- **Internal** stakeholders include directors, employees, and executives who are directly connected to the organization.
- **Economic** stakeholders consist of customers, suppliers, distributors, creditors, and competitors—economic actors who engage with the firm across organizational boundaries.
- **Societal** stakeholders such as communities, NGOs, the media, and government bodies reflect broader political and cultural interests.

Notably, while environmental sustainability is a central concern, the environment itself is not considered a stakeholder in these traditional models, raising a critical conceptual gap.

There is no universal formula for determining which stakeholders a company should prioritize. As Freeman and Elms (2018) argue, **stakeholder management is dynamic**. Businesses create value through their interactions with customers, suppliers, employees, and other actors, but the balance among them must constantly evolve depending on the firm's strategic context.

This gives rise to what is known as a **non-market strategy**, which involves managing relationships with stakeholders outside of direct market exchanges. Companies often do this not just out of moral responsibility but from an understanding that their survival depends on cooperation with governments (e.g., increase in lobbying expenditures for internet companies in the US), civil society, and institutions. Even self-interest dictates the need for strategic stakeholder engagement. In developing such a strategy, it is essential to evaluate stakeholders along two dimensions:

- **Alignment**: the degree to which a stakeholder's goals are compatible with those of the company.
- **Influence**: the level of power a stakeholder has to affect the outcome of a given issue.

Different business models imply different sets of key stakeholders, and understanding the relationship between a firm's structure and its stakeholder groups is essential for defining both its social mission and strategic approach.

▼ **Example: Nike**

In 2016, Nike decided **to double its business while halving its environmental footprint**. This target led to innovations such as plant-based materials and a new foam technology that significantly reduced carbon impact. By 2023, Nike had joined the Science-Based Targets Initiative, committing to reduce supply chain emissions by 30% by 2030.

To achieve such goals, Nike mapped out its stakeholder landscape, assessing where support lies and where resistance might emerge. A simplified assessment shows:

- Shareholders and regulators hold high power but show uncertain or partial alignment.
- Employees and buyers are more clearly aligned with the sustainability mission.
- Consumers, while moderately powerful, are fragmented in opinion.
- Competitors and suppliers demonstrate low alignment and influence.
- Society at large is moderately powerful but difficult to clearly position in terms of alignment.

| Stakeholder | Power (--- to +++) | Alignment (-- to +++) |
|----------------------|-----------------------|--------------------------|
| Shareholders | +++ | +/? |
| Employees | + | +++ |
| Government/Regulator | +++ | ? |
| Competitors | | --- |
| Consumers | ++ | fragmented |
| Buyers | ++ | + |
| Suppliers | + | --- |
| Society | ++ | ?? |

To wrap-up:

Question 1: Why should companies pay attention to sustainability? *Because business depends on a healthy society and environment.*

Question 2: What are the social and environmental responsibilities of business leaders? *They rise hierarchically from basic economic responsibility for the company to a broader positive impact.*

Question 3: How does sustainability relate to strategy? *As a type of value creation and as a non-market strategy to engage with actors beyond just the immediate product market.*

Growth Strategies

Growth is a key component of corporate strategy because **firm survival and longevity are closely linked to size**. Over time, companies that endure tend to grow. There are both economic and strategic motivations for growth: it increases revenue and profit potential, enhances resilience to market shocks, improves the retention and motivation of employees and suppliers, and satisfies the expectations of shareholders. Behavioral reasons also play a role, as both managers and shareholders often see growth as inherently desirable.

In **1998**, Amazon expanded internationally by launching websites in the UK and Germany. In **2012**, it pursued **vertical integration** through the acquisition of Kiva Systems, enhancing its internal logistics and automation. In **2017**, it diversified into the grocery sector by acquiring Whole Foods. Amazon's growth story reflects deliberate decisions in direction (geographic, vertical, and product) and mode (organic development and acquisition), all contributing to its dominant market position today.

Historical Patterns of Growth

Looking at the evolution of large firms over time reveals changing patterns in how companies have pursued growth. The **First Industrial Revolution** was defined by the rise of factories and mechanization. Then came the era of **railroads and telegraphs**, enabling companies to expand geographically. The **Second Industrial Revolution** brought electricity, the telephone, and early management techniques that fueled organizational growth. The post-war period was marked by expansion through **scale and scope**, supported by mass production and emerging technologies like computing. Later, internationalization and diversification became central. In the 1980s and 1990s, **consolidation through M&A** gained prominence, followed by **restructuring and downsizing**, especially as firms began prioritizing shareholder value and strategic focus.

Modes of Growth

Firms also choose **modes** of growth. **Internal growth** relies on building and deploying the firm's own resources and capabilities (Apple). **Mergers and acquisitions** involve buying or combining with other firms (PSA and Fiat, Veolia and Suez). Other firms grow through **alliances and contracts**, which include joint ventures, franchising (like McDonald's), and licensing deals (Star Wars' agreement with Lego). The choice of mode depends on the firm's goals, resources, and market conditions.

Directions of Growth

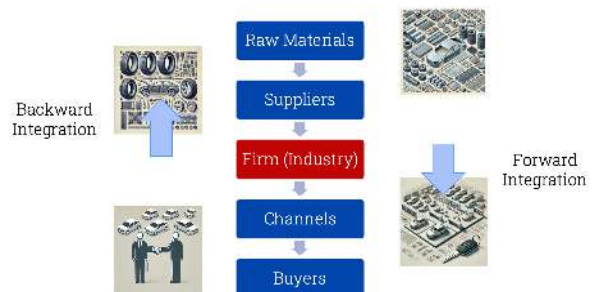
Growth strategies can unfold in different **directions**. Some firms expand **vertically**, taking control of more stages in the value chain (De Beers). Others engage in **diversification**, spreading into entirely new industries (Alphabet). Alternatively, firms may pursue **geographic expansion**, entering new international markets (Vodafone). These strategies are not mutually exclusive; firms often combine them over time.

Vertical Integration

Vertical integration refers to a firm's **ownership and control of multiple stages** along the **supply chain** of a product. The level of integration is measured by the number of stages in the value chain that the company controls. This integration can be **backward** (towards the supply side, such as raw materials and intermediate suppliers), or **forward** (towards distribution channels and final consumers). Firms can either be **fully integrated**, owning and managing all stages from production to sale, or **partially integrated**, controlling only specific links in the chain.

A common misconception is that some firms, such as Apple, are fully vertically integrated. In reality, while Apple controls key aspects of design, software, and customer-facing channels, it still relies on a complex global network of suppliers for many hardware components. The integration model is therefore partial and selective, focusing on what Apple considers most strategic for innovation and user experience.

The value chain can be broken down into raw materials, suppliers, the firm or industry itself, distribution channels, and buyers. A firm practicing backward integration would take control over raw materials and suppliers, while one pursuing forward integration would expand into distribution and direct sales. This movement along the chain represents a strategic decision to internalize activities that were previously outsourced or handled externally.



Historical Evolution

In the early and mid-20th century, vertical integration was the dominant model. Companies operated in a context of relatively **unsophisticated markets**, which favored **in-house production** and tight control over the supply chain. Henry Ford famously captured this spirit with the maxim, "If you want it done right, do it yourself."

However, by the latter part of the 20th century, **globalization** and technological advancements led many firms to move in the opposite direction. Increased complexity and new sourcing options encouraged **disintegration**. Steel companies divested from their mining operations, and car manufacturers outsourced components to independent suppliers, aiming for flexibility and cost efficiency.

Today, we are witnessing a **resurgence of vertical integration**. Many firms are once again internalizing parts of their value chain in response to new strategic priorities, including quality control, customer experience, supply chain security, and differentiation. Apple, Tesla, and BYD illustrate how integration is being used not only to optimize internal operations but also to shape **market strategy** and **competitive advantage**.

▼ Example: Zara vs. H&M

Zara's value chain is tightly integrated, with in-house design, manufacturing, distribution, and retail. This allows Zara to maintain speed, flexibility, and responsiveness to consumer trends. H&M, by contrast, outsources both manufacturing and part of its distribution, prioritizing cost over control. This strategic difference reflects Zara's intent to use integration as a source of agility and value creation, while H&M relies on economies of scale and external partnerships.

▼ Example: Apple

Apple integrates design, hardware, software, and retail.

▼ Example: Tesla

Tesla manufactures most of its cars (80%) in-house.

▼ Example: Netflix

Netflix controls content creation, platform delivery, and original productions.

▼ Example: De Beers

De Beers controls the diamond journey from mining to the retail product.

▼ Example: Disney

Disney's investment in **streaming platforms** is shift toward vertical integration. In 2017, Disney acquired a 33% stake in BAMTech, later raising it to 75%. This technology platform enabled Disney to develop its own streaming services like ESPN+ in 2018 and Disney+ in 2019, bypassing third-party platforms such as Netflix.

First, vertical integration enabled Disney to build **direct relationships** with customers and control content distribution. This not only increased **strategic independence** but also reinforced **customer loyalty** and **brand coherence**. It also gave Disney control over the technology needed to ensure **high-quality, user-friendly experiences**. Moreover, integration brought **flexibility** in content strategy and enabled **synergies** across its businesses. This helped Disney strengthen its competitive position and **reduce dependence** on external platforms.

Disney's investment in streaming has grown increasingly strategic over the years. The company announced a major expansion in original content for Disney+, including new Star Wars and Marvel series, other original productions, and feature films. By 2024, Disney+ content spending was projected at \$8–9 billion, and across all its streaming services (Hulu, ESPN+, etc.), the investment could reach \$14–16 billion. Global data showed Disney+ rising rapidly among streaming services, closely trailing Netflix and Amazon in subscriber volume.

ESPN+ officially launched in 2018, shortly followed by Disney+ in November 2019 in the United States. The launch was preceded by Disney's \$71 billion acquisition of Fox's entertainment assets, which enabled content production for both traditional and streaming channels. Disney+ focused on five core brands: **Star Wars, Marvel, Pixar, Disney, and National Geographic**. At a lower price point than competitors and despite early losses, Disney aimed for profitability by 2024 with a target of 90 million subscribers.

Transaction Costs

Firms constantly face the decision of whether to produce a component or service in-house ("**make**") or procure it externally ("**buy**"). This decision is based on the evaluation of **transaction costs**, which are all costs incurred in managing the transfer of goods or services between parties. These include selection costs (identifying a partner), contracting and monitoring costs, and negotiation costs. **Producing in-house** leads to **governance costs**. These entail hiring and motivating employees, owning and managing assets, coordinating internal activities, and navigating complex bureaucratic and communication structures. The firm must **balance** the costs of external transactions with the internal burden of governance when deciding between market sourcing and vertical integration.

▼ Example: General Motors and Fisher Body

Initially, GM relied on Fisher Body to supply automobile frame components. However, Fisher refused to adapt production to GM's evolving design needs, prompting friction in their commercial relationship. In response, GM acquired Fisher in 1919, internalizing the transaction. This vertical integration allowed GM to align production with strategic priorities. Interestingly, the Fisher brothers continued working for GM until 1944, illustrating continuity despite the change in ownership.

The case shows that it's often easier for companies to work together efficiently when one owns the other, rather than relying on contracts between separate firms, which is a key idea from Ronald Coase's 1936 theory *The Nature of the Firm*.

Benefits

Vertical integration offers several advantages for firms seeking control and efficiency across their value chains. Among the most relevant **benefits** we have:

- **Superior Coordination and Integration:** By managing a larger portion of the value chain internally, firms can ensure a smoother flow of information and resources, reducing delays and inefficiencies.

Example: Zara.

- **Quality:** A vertically integrated model can also enable stricter quality control.

Example: LVMH manages high-end production processes to safeguard brand integrity and product excellence.

- **Access to Strategically Important Resources:** Companies adopted vertical integration to protect access to scarce or essential inputs, minimize competitive threats, and respond to uncertainties in the supply market. In this way, vertical integration becomes a tool to build barriers to entry and achieve strategic independence from volatile markets.

Example: BYD

- **Asset Specificity:** The structure allows for better asset specificity and encourages long-term cooperation and mutual adaptation when transaction-specific investments are involved.
- **Cost Reductions:** Vertical integration can also contribute to cost reductions, particularly in industries like steel and cement, where firms benefit from technical economies such as the co-location of operations or the elimination of redundant transportation steps. Inventory management and overall value chain efficiency also improve.

Markets are **not frictionless** (fully efficient), and vertical integration can help reduce the various **transaction costs** that arise when relying on external providers. These include search and negotiation costs, opportunism from suppliers, and issues arising from **taxes and regulatory burdens** applied to market transactions. Moreover, contractual arrangements are often incomplete due to ex-ante uncertainty, making it difficult to fully anticipate future conditions or enforce all terms. In such cases, integrating the value chain internally can provide stability and greater predictability.

Costs

Despite its advantages, vertical integration also entails significant disadvantages:

- **Developing and coordinating a wide range of internal capabilities** is difficult.
- **Reduced strategic focus**, especially when firms manage diverse business units with conflicting goals.
- **Limit economies of scale and learning**, particularly when firms stretch resources too thin across different stages of the chain.
- **Isolate firms** from technological innovation and market feedback, **reducing their adaptability** compared to more networked competitors. Firms that are not vertically integrated, for instance, may benefit from working with a wider variety of partners and staying closer to external trends.
- **Reduce flexibility** in reacting to shifts in consumer demand or operational changes.
- **Higher exposure to regulatory scrutiny**, especially antitrust laws.

Example: the EssilorLuxottica acquisition of GrandVision faced delays and needed EU approval two years after the deal's initiation.

Industry Influence on Vertical Integration

The decision to vertically integrate is shaped by **industry characteristics**. One factor is the **size** of the industry itself. When markets are large, external suppliers are more likely to exist, reducing the need for internalization. In contrast, small or emerging industries often lack mature external markets, which compels firms to initially build integrated operations.

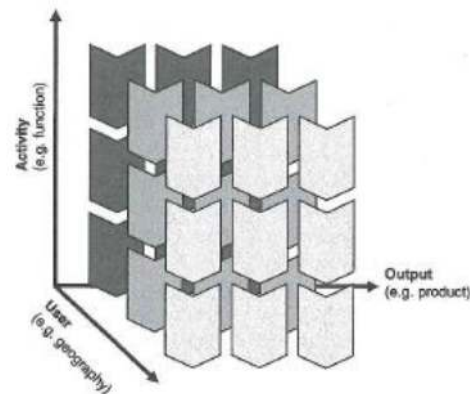
Another key aspect is the **stage** of the industry. In early stages, firms typically adopt vertical integration to serve new or underserved markets. As the industry matures, however, specialized external providers emerge, offering opportunities for outsourcing and unbundling of the value chain.

Lastly, we have **cost structure**. If outsourcing offers drastically lower costs, especially in sectors such as textiles or electronics, then internal integration must deliver a very high strategic payoff to be justifiable. This makes vertical integration a context-specific strategy, influenced by market dynamics, transaction costs, and the strategic importance of internal control.

Diversification

Diversification is a corporate strategy in which a company expands into a new industry that is not currently part of its operations. Unlike vertical integration, where the firm moves forward or backward along its supply chain, diversification means stepping into an entirely different sector that is **not linked by a buyer-supplier relationship** to its core business.

Corporate strategy operates across multiple dimensions. Firms can expand by offering different **products** (output), operating in different **geographies** (user), or performing different **activities** along the value chain. This multidimensional space means companies must decide not only **what** to sell, but also **where** and **how** to position themselves in terms of operations and customer relationships.



▼ **Example: Fast-Moving Consumer Goods**

Companies like **Nestlé, Unilever, Procter & Gamble, and PepsiCo** operate across **dozens of industries**, from food and beverages to personal care and cleaning products. These businesses achieve economies of scope while managing a wide brand portfolio, illustrating how diversification can be managed effectively at scale.

▼ **Example: Walmart and Microsoft for TikTok**

In 2020, Walmart submitted a bid to acquire **TikTok**, partnering with Microsoft, because TikTok had more than **100 million U.S. users**, many of them young. By integrating e-commerce with a social platform, the company hoped to enter **social commerce**, blending entertainment, product discovery, and online shopping. Walmart's share price rose more than 5% on the day of the announcement.

▼ **Example: the Virgin Group**

Virgin pursued diversification across **airlines, media, healthcare, finance**, and more, with **68 companies in 34 countries**. Historically, many of these moves were driven more by the founder's intuition than by a unified strategy. However, since **2011**, under CEO **Josh Bayliss**, Virgin has adopted a more structured approach to branding and business expansion to **bring coherence**.

▼ **Example: the Charoen Pokphand Group**

Charoen Pokphand (CP) Group, based in Thailand, began as a seed shop in 1921. Over the decades, it has evolved into one of the country's largest conglomerates. Today, it controls more than **200 subsidiaries** and employs over **300,000 people**. Its activities span **insurance, agriculture, food processing, retail, cloud computing, and real estate**

▼ **Example: Baidu**

Baidu, a search engine, acquired **YY Live**, a live-streaming platform, and invested in **cloud computing** and **autonomous driving**. Its commitment to **"intelligent driving"** includes robotaxis, smart transportation systems, and electric vehicle platforms.

Rationale

Not every rationale behind diversification is compelling

- **Growth:** A common reason for diversification is the desire to escape **stagnant or declining industries** (tobacco, oil, newspapers) by entering new markets that offer higher growth potential. This rationale often serves the **interests of managers** more than those of shareholders, as such moves may reduce shareholder value. Growth alone is not a sufficient justification for diversification.

Agency theory highlights how **shareholders** and **managers** often have different goals. While shareholders seek long-term value (stock price maximization), managers may aim to increase their **salary, security, and power**. Managers prefer to lead large organizations, avoid layoffs, and build business empires, making diversification an attractive strategy for them, even when it doesn't serve the firm's core interest.

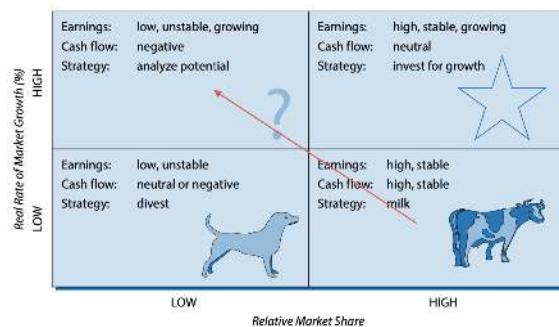
Example: Amazon expanded from e-commerce into cloud services with AWS, becoming the “operating system of the internet”. Google entered the video streaming market by acquiring YouTube.

- **Risk Spreading:** Diversification stabilizes income streams, so reducing the **variance of profit flows** might be another reason. This is a **portfolio management** logic: the risks of one business can be offset by another. However, this **fails the market test:** companies shouldn't diversify just to spread risk, because shareholders can do that more efficiently by holding a diverse portfolio themselves, and only unsystematic risk is reduced, not market-wide (systematic) risk, as shown by the CAPM (Capital Asset Pricing Model). Thus, risk spreading is only valid if the firms operate in **emerging markets** with **underdeveloped financial systems** (family conglomerates). This has led shareholders to push for **divestment** from non-core businesses emphasizing that **strategic exit** can be a legitimate part of corporate evolution

Example: In 2016, **Anglo American** announced its departure from diversification with a dramatic restructuring, reducing its mines from 55 to 16. The goal was to focus on just three core products: diamonds, platinum, and copper, aligning its operations with cyclical commodity dynamics and cash flow predictability.

The **BCG matrix** classifies business units based on **market share** and **growth rate**:

- **Dogs** → should be **divested**
- **Question Marks** → **invest or divest**
- **Stars** → **invest heavily**
- **Cash Cows** → **fund other units**



Value creation, for which the combined businesses under common ownership must generate **higher profitability** than they would separately, is the only compelling rationale. This requires real **synergies** between units (financial, operational, or strategic). A great example of this is ARM, which was a profitable investment for Softbank (Japan). But it made sense to sell it to Nvidia, which could create more value with it in the chips business.

Resources and Capabilities

Resources are the firm's **available assets** used to build a competitive advantage. These include **tangible** resources (factories, equipment, capital) and **intangible** ones (brand, organizational culture, relationships, knowledge).

Capabilities are the firm's **competencies**, so the ability to combine and deploy resources effectively. They allow firms to transform inputs into valuable outputs.

| Shared Elements | Firms |
|---|--------------|
| Financial resources, coordination, HR | P&G, Samsung |
| Technological and engineering capabilities | 3M |
| Efficient volume manufacturing and operational capabilities | Zara |
| Design and brand capabilities | Apple |

These capabilities can be leveraged across units to **reduce cost, enhance differentiation, or increase scale advantages.**

Economies of Scope

Economies of scope exist when producing two outputs together is **cheaper** than producing them separately: **Cost(α + β) < Cost(α) + Cost(β)**. This occurs through:

- **Operational relatedness:** shared tangible and intangible resources across businesses (R&D, logistics, brand, reputation).
Example: General Electric, Google, Disney+.
- **Strategic relatedness:** shared **managerial and organizational capabilities** at the corporate level (marketing expertise, innovation processes, leadership models).

Example: Samsung deploys central product development and marketing systems across multiple business units.

Diversification can also **increase willingness to pay (WTP): $WTP(\alpha + \beta) > WTP(\alpha) + WTP(\beta)$** . This can be achieved through:

- **One-stop shopping:** customers benefit from variety in one place.
Example: HSBC's integrated banking, insurance, and investment services.
- **Bundled/integrated solutions:** combined value proposition increases convenience and functionality.
Example: Microsoft Enterprise Solutions (cloud + productivity + security). Apple's ecosystem (hardware, software, services)

These integrated offerings allow firms to **increase perceived value, deepen loyalty, and command premium prices.**

Performance

There is no consistent relationship between diversification and performance: while some evidence points to a curvilinear pattern (initially increases profitability but, beyond a certain threshold, begins to reduce it) this is not always reliable. McKinsey & Co. have noted that moderate diversification can be beneficial, particularly for firms that have exhausted growth within their core activities, but the direction of causality remains unclear: does diversification lead to profitability, or are more profitable firms simply more likely to diversify?

Diversification can occur between businesses or industries that are either related or unrelated. **Related** diversification involves similarities that enable the sharing of **resources and capabilities** across units (Honda uses engine for cars, motorcycles, lawnmowers, and marine equipment; LVMH focuses on luxury), while **unrelated** diversification doesn't allow this. Research shows that **related diversification usually outperforms unrelated diversification**: related diversification offers **greater synergies**, but it also entails higher management costs due to the need to coordinate more closely integrated units.

Costs

Although diversification is often pursued to create synergies or enter new markets, it can backfire when not managed carefully. These are some of the most common challenges and costs associated with it:

- **Loss of focus:** As firms diversify into multiple areas, managerial attention becomes scattered, reducing effectiveness in any single domain.
- **Challenging to realize synergies:** It can be difficult to integrate new and old businesses effectively, especially when they operate in different industries or require different capabilities.
- **Coordination problems:** More businesses mean more complexity, which increases the likelihood of misalignment, inefficiencies, and slow decision-making.
- **Barriers to redeployment of managerial expertise:** Skills and knowledge may not transfer easily across unrelated business units, limiting the benefits of internal talent mobility.
- **Risk of cannibalization:** Diversified product lines or business units may end up competing with each other, reducing total profitability.
- **Wrong motivations** for diversification:
 - **Managerial ego:** Leaders may diversify to build personal empires rather than create shareholder value.
 - **Incentives tied to size and scope:** Managers' compensation may depend on growing the firm's size, regardless of whether growth is profitable.
 - **Imitation of others:** Firms may diversify just because their competitors do, without a solid strategic rationale.

Value Creation

To ensure that diversification truly creates shareholder value, it must pass what Porter calls **three essential tests**. These tests help assess whether diversification efforts are strategically sound and economically justified.

- **Attractiveness Test:** Diversification should be aimed at entering **attractive industries**, or at least those with the **potential to become attractive**. This ensures that the new business has solid growth and profit prospects.
→ *How attractive is the industry to be entered?*
- **Cost of Entry Test:** The cost of entering the new market or industry **must not absorb all future profits**. High entry costs can negate the value of even a promising opportunity.
→ *Does the cost of entry counteract the attractiveness?*
- **Better-Off Test:** The new unit should either **gain competitive advantage** from being part of the company, or help the existing business do so. This test ensures synergies that enhance overall performance.
→ *What is the potential for interactions between the two businesses that enhance the competitive advantage of either business?*

Internationalization

Internationalization refers to firms' expansion into different international markets, which can mean both selling products internationally (**sell** internationally) or establishing international production sites (**produce** internationally). The concept applies across the entire value chain.

Different industries exhibit **different patterns** of internationalization depending on their exposure to international trade and **foreign direct investment (FDI)**. These patterns can be classified into four types:

- **Trading Industries:** These industries have high levels of international trade but low FDI.
Example: COFCO International, Chinese state-backed food trader.
- **Global Industries:** These feature both high trade and high FDI.
Example: Hyundai balances a broad market reach (creates jobs and invests in the US as a response to the tariffs) and regional customization (Europe).
- **Sheltered Industries:** Characterized by both low trade and low FDI.
- **Multidomestic Industries:** These rely on high FDI but low trade.
Example: Burger King in Africa, where the population is growing rapidly.



Comparative Advantage

Comparative advantage refers to a country's relative efficiency in producing certain goods, measured by the ratio of share of exports in a category over the share of total exports. This data provides insight into which countries specialize in which products:

- **Switzerland** has a striking comparative advantage in pharmaceuticals (6.9) and clocks/watches (21.1).
- **The US** leads in aerospace (4.5).
- **Germany** and **Japan** specialize in vehicles (2.2 and 2.6 respectively).
- **Australia** and **India** are strong in cereals (4.3 and 3.5 respectively).
- **China** shows strength in apparel (2.8) and electronics (2.6).

Porter's **National Diamond** framework helps explain why some countries tend to support more competitive firms in specific industries. This model outlines four key conditions:

1. **Factor conditions** refer to the quality and availability of resources in a country, but what matters most are "home-grown" capabilities developed through education, training, and innovation, rather than just natural endowments.
2. **Related and supporting industries** are crucial because the presence of strong local suppliers and competitive complementary industries helps generate synergies and fosters innovation through close collaboration. This is often seen in "industry clusters."
3. **Demand conditions** highlight the role of domestic customers in shaping product quality and innovation. Sophisticated and demanding local buyers pressure firms to constantly improve.
4. **Strategy, structure, and rivalry** focuses on how companies are created, organized, and managed in each country. Domestic rivalry, in particular, pushes firms to innovate, improve efficiency, and constantly upgrade their offerings.

Rationale and Benefits

Firms pursue internationalization for two main reasons. The first is to **expand into new markets**. This allows them to exploit economies of scale and scope, access new customer bases, and respond to the globalization of demand. This is a market-driven motivation rooted in top-line growth.

The second motivation is to **exploit comparative advantages in production**. Firms may seek out countries that offer favorable **labor supply** (labour costs below \$10/hour in Mexico, Philippines, etc.), **natural resource endowments**, **capital stock**, or **local expertise**, including efficient supply chains and specialized industrial districts.

These motivations can coexist: a firm might seek both new customers and more efficient production locations simultaneously.

Beyond market expansion and cost efficiency, internationalization offers other **strategic advantages**:

- **Achieve scale and replication** by aggregating production or operations across borders (helps spread fixed costs and standardize practices).
- **Tap into global customer bases**, especially in B2B services, where the clientele is already international.
- **Arbitrage** is obtained by exploiting **cross-country differences** (in wages, technologies, or regulatory environments) to optimize operations and reduce costs.
- **Enhances organizational learning**, as exposure to tough foreign competition encourages firms to improve. Example: IKEA's expansion to Japan.
- **Strengthen competitiveness** in domestic markets, as cross-subsidization between markets allows firms to support weaker markets using profits from stronger ones, improving overall strategic resilience.

Globalization's Reality

Despite its potential, globalization is embedded with difficulties. Many **sales subsidiaries** fail to meet performance expectations, particularly in less developed countries. Examples include GM and Whirlpool in China, and Star TV in Asia.

In some cases, **divestment** is the only option. For instance, Tyco Toys experienced international expansion failures that also harmed the core business back home.

Success is more likely when foreign subsidiaries are part of a **production network**, rather than just local sales outposts. Still, even top MNEs have faced dramatic failures. **McDonald's struggled against JollyBee** in the Philippines, and **Wal-Mart failed in Germany**, where it couldn't adapt to local preferences and business practices.

Global expansion is characterized by high risks, which highlight the importance of **local responsiveness**, strategic fit, and the ability to navigate foreign regulatory and market conditions.

Internationalization presents various challenges for multinational enterprises (MNEs), which can be grouped into three major categories:

- **Complexity of MNEs**: Managing operations across different countries requires **difficult coordination** among business units, especially when there are **varying levels of ownership and control** over subsidiaries. Firms

often struggle to balance the **need for global integration** with the **need for local responsiveness**, which can create tension in decision-making. Effective **headquarters-subsidary relationships** are essential. These relationships can be structured in a **top-down** way, where the headquarters defines the subsidiary's role or charter, or **bottom-up**, where initiatives emerge directly from the local units.

Example: some areas where these tensions surface include decisions on **corporate social responsibility**, **anti-bribery compliance**, or **pollution controls**, all of which may be perceived and implemented differently depending on the local context.

- **Liability of Foreignness:** It refers to the additional costs and difficulties firms face simply because they are foreign. This includes the challenge of **buying, producing, or selling in unfamiliar cultural environments**. Different **ways of doing business** (local regulations, government restrictions, and common business practices) can make it hard for foreign firms to operate effectively. Moreover, foreign firms often suffer from a **lack of legitimacy** in the host country. Local buyers and suppliers may be reluctant to interact with them, either due to unfamiliarity or **economic nationalism**.

Example: **eBay in China** failed to recognize the differences between the Chinese market and the Western business environment. The company appointed leaders who neither spoke Chinese nor understood the local market. As a result, the firm made misguided investments, including spending heavily on advertising strategies that were ineffective in the Chinese context.

- Distance: There are **various dimensions of distance** that make international operations more difficult. These can be:
 - **Cultural:** Cultural distance can affect how businesses communicate and operate.
 - **Institutional and Political:** Historical and political ties between countries (or the lack thereof) influence how easily firms can operate across borders. For example, shared institutions and legal systems reduce the barriers to entry.
 - **Geographic:** Physical distance leads to **increased costs** due to factors like time zones, shipping logistics, and travel expenses.

To understand cultural differences, managers often refer to **Hofstede's cultural dimensions**, which compare countries on factors like **power distance, individualism, masculinity, uncertainty avoidance, and long-term orientation**. These differences can significantly affect managerial practices, communication styles, and customer expectations.

CAGE Framework

To make informed decisions about where to expand, firms can use **Ghemawat's CAGE framework**, which highlights four key dimensions that increase the difficulty of operating across borders:

1. **Cultural Distance:** Differences in language, religion, social norms, and the absence of connecting ethnic or social networks. This affects industries with high linguistic or cultural content, such as food, wine, and music.
2. **Administrative and Political Distance:** Includes the absence of shared political systems, historical hostility, or weak institutions. It mostly impacts industries seen as **strategically important**, such as energy, defense, and telecom.
3. **Geographical Distance:** Refers to lack of common borders, long shipping distances, or inadequate transport and communication links. This affects **low value-to-weight** products or **perishables** like milk, and services where real-time interaction is key (e.g., finance).
4. **Economic Differences:** Differences in consumer income levels, available resources, and knowledge. This is especially relevant for **luxury goods**, which are income-elastic, and **labor-intensive products** like apparel.

| | Cultural distance | Administrative and Political Distance | Geographical distance | Economic differences |
|---|---|---|--|--|
| <i>Distance between two countries increases with.</i> | <ul style="list-style-type: none"> • Different languages, ethnicities, religions, social norms • Lack of connecting ethnic /social networks | <ul style="list-style-type: none"> • Absence of shared political or monetary association • Political hostility • Weak legal and financial institutions | <ul style="list-style-type: none"> • Lack of common border, or transportation or communication links • Physical remoteness | <ul style="list-style-type: none"> • Different consumer incomes • Differences in resources • Different information or knowledge |
| <i>Industries most affected by source of distance</i> | Industries with high linguistic content (TV, publishing) and cultural content (food, wine, music) | Industries viewed by government as strategically important (e.g. energy, defense, telecom) | Products with low value-to-weight (cement), or fragile (glass) or perishable (milk), or where communication is vital (financial services). | Products with income elastic demand (luxuries). Labor intensive products (clothing). |

Data on trade flows and foreign direct investment show how impactful these dimensions are in real-world decisions. For instance, **the volume of trade between regions within 100 miles of the US-Canada border far exceeds that between distant regions of the US or of Canada**, emphasizing the role of geographic proximity. Research by **Frankel and Rose** also shows that **administrative and political ties** are the most influential: countries that share a **colonial relationship** trade 900% more than otherwise similar pairs; those with a **common currency** trade 340% more; and being in the same **regional trade bloc** increases trade by 330%. Cultural ties, too, are important, with **common language increasing trade by 200%**.

▼ **Example: Starbucks in Italy**

Culturally, the Italian market for coffee is challenging: coffee is consumed quickly at the bar, prices are low, and local traditions dominate. Administratively, Italy and the US are aligned under the EU-US relationship, with no major institutional barriers. Geographically, both countries are well-connected, with physical and digital infrastructure enabling operations. Economically, however, the **consumer behavior** differs: Italian consumers expect quality coffee at low prices, making Starbucks' premium pricing model a risky bet.

Success in Italy would not only hinge on Starbucks' ability to **adapt to local preferences** (e.g., smaller menus, lower prices, local partnerships) but also on how well it can **leverage brand experience** without alienating the local consumer.

Foreign Entry Modes

When firms expand abroad, they must choose between **high control with high investment** and **low control with low investment**. This decision depends on strategic objectives, risk tolerance, market conditions, and the firm's resources. There are five main modes of entry:

1. **Greenfield investment** involves setting up a fully owned subsidiary from scratch. This grants full control over operations, culture, and processes, but requires high capital investment and longer time to market.
2. **Merger or Acquisition** refers to acquiring a full or partial stake in an existing local company. This mode allows rapid entry with access to local networks and assets but may bring integration challenges and cultural clashes.
3. **Joint Venture** means forming a new entity jointly owned by the foreign and local firms. This option shares risk and investment, facilitates knowledge transfer, and offers local insight, though it may complicate governance.
4. **Alliance or partnership**, such as licensing or franchising, involves cooperation with a local firm without equity involvement. This enables faster market access with lower financial exposure, though control over brand and operations may be limited.
5. **Exporting** relies on local distributors or sales agents. It is the simplest and least risky mode, suitable for testing a market or reaching regions without heavy investment. However, it offers the least control and weakens responsiveness to local conditions.

Each mode reflects a trade-off between **control, risk, speed, and resource commitment**, and the right choice depends on the firm's priorities and the host market's characteristics.

Concerns about Globalization

In recent years, scholars and policymakers have questioned whether globalization is slowing or reversing. A report titled "Deglobalization: An Ongoing Realignment" captures this discussion. Since the 1990s, two core beliefs shaped trade policy: that free trade encourages peace (goods cross borders, not soldiers), and that cheap imports placate globalization's losers, especially in Europe and North America.

However, recent **year-on-year growth rates in trade** reveal a clear slowdown. Export and import growth have both declined across the world's top 10 economies, especially since mid-2022. Political tensions, trade wars, and a rethinking of global supply chains are driving this realignment.

Despite concerns about deglobalization, **trade as a share of global GDP** remains historically high. While there are current shifts in **the pace and direction** of trade, especially due to rising nationalism and strategic reshoring, we are likely witnessing **a transformation** of globalization, where global trade remains central, but firms navigate a more complex and fragmented landscape.

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