Lecture Note 1
Introduction to Strategic Management

Learning Objectives

- **Define Strategy:** Distinguish "strategy" from "operational effectiveness."
- **Trace the History:** Understand how the field has evolved over time.
- **The Design vs. Emergence Debate:** Recognize that strategy is rarely a straight line; it is a blend of deliberate planning and on-the-fly adaptation.
- **Identify the Core:** Learn why "trade-offs" (what you choose *not* to do) are just as important as what you choose to do.

Welcome to Strategy

If I asked you to define "strategy," you might say it's "a plan to win," or "a long-term goal," or maybe even "being better than the competition." None are wrong, but they are incomplete.

In this course, we are going to break strategy down into something far more pragmatic. Strategy is not just about having an ambition to be the best. At its core, **Strategy** is the set of integrated choices a firm makes to create and sustain competitive advantage. It is about how a company like **Apple** can sell a phone for $1,200 when a functionally similar Android costs $400. It is about how **Southwest Airlines** can remain profitable for decades while other airlines go bankrupt trying to copy them.

A critical distinction we must make early on is the difference between **Strategy** and **Operational Effectiveness**. Operational effectiveness is about doing things *better*. Strategy is about doing things *differently*. **Table 1.1** highlights this difference. You typically cannot win long-term solely on operational effectiveness, because eventually, competitors will copy your best practices.

Table 1.1: Operational Effectiveness vs. Strategy

Feature	Operational Effectiveness	Strategy
Core Question	"How do we do this better/faster/cheaper?"	"Why do we do this differently?"
Focus	Best Practices, Efficiency, Validation	Unique Positioning, Trade-offs
Outcome	Temporary parity with rivals	Sustainable competitive advantage
Example	Toyota refining an assembly line process	Southwest flying only 737s to point-to-point airports

The Era of "Planning" (1960s – 1970s)

Imagine you are an executive at **General Motors** or **IBM** in 1965. The world was relatively stable. Global competition was low. If you wanted to know what your revenue would be in five years, you could probably calculate it with decent accuracy.

In this era, strategy was viewed as **Long-Range Planning**. It was an engineering problem. You analyzed the past, projected the trend line forward, and built a budget to match. This was the age of the "SWOT" analysis (Strengths, Weaknesses, Opportunities, Threats). The assumption was simple: If we plan rigorously enough, we can control our destiny.

The Problem: The world stopped behaving. The oil shocks of the 1970s and the rise of Japanese manufacturing (Toyota, Honda) proved that you can't simply "plan" your way to victory if the underlying rules of the game change overnight.

The Era of "Positioning" (1980s)

Enter Michael Porter (more on him in Lecture Note 2). In the 1980s, the focus shifted from internal planning to external **Positioning**.

Porter argued that it doesn't matter how good your 5-year plan is if you are competing in a terrible industry. Strategy became about finding a defensible "fortress"—a market position where you could fend off competitors.

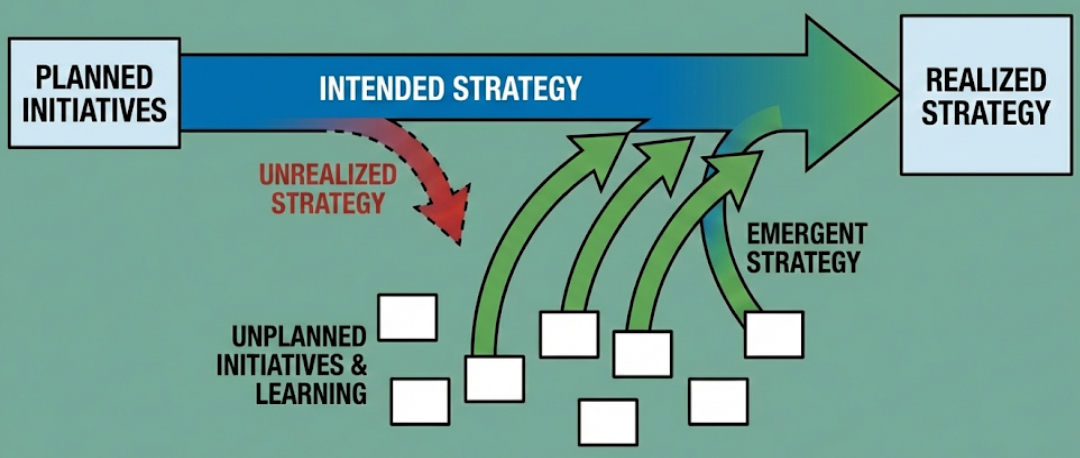
Think of **Coca-Cola**. Their strategy wasn't just "make good soda." It was to build a position so dominant (through branding and distribution) that no new entrant could possibly challenge them. This era gave us the "Five Forces" framework (covered in Lecture Note 2). The goal was stability and defense.

The Era of "Emergence" and Adaptability (1990s – Today)

Then came the internet. Then mobile. Then AI. In the modern economy, looking five years ahead is often a fool's errand. If a fintech startup like **Stripe** or **Square** tried to stick to a 5-year plan written in 2010, they would have died three times over.

This brings us to one of the most important concepts in this course: **Emergent Strategy**. Henry Mintzberg, a famous management scholar, argued that strategy isn't just what you write down in a boardroom document (**Intended Strategy**). Strategy is what you *actually do* (**Realized Strategy**). Often, the most successful strategies emerge from the bottom up, through trial and error. **Figure 1.1** (on the next page) illustrates this messy reality. Note how "Intended Strategy" often drops off (Unrealized), while new, "Emergent" ideas bubble up to form the actual strategy. The challenge of strategy is not choosing between planning and emergence, but knowing when to rely on each.

Figure 1.1: Intended vs. Emergent Strategy



Based on Mintzberg's model, showing how strategy is a blend of deliberate planning and adaptive learning.

Consider **Slack**. It didn't start as a workplace chat app. It started as a gaming company called Tiny Speck. They built a game called *Glitch*. The game failed. But the internal chat tool the engineers built to talk to each other while making the game was excellent.

- **Intended Strategy:** Build a successful video game.
- **Emergent Strategy:** Pivot to sell the chat tool to businesses.

If they had stuck to their "plan," they would be bankrupt. Instead, they sold to Salesforce for $27.7 billion. Modern strategy is a dialogue between your plan and reality.

Strategy as Trade-offs

So, if strategy changes, what stays the same? The need for **Trade-offs**. Strategy is arguably more about what you **choose NOT to do** than what you do. If you try to be everything to everyone, you end up being nothing to anyone.

- **Tesla** chose *not* to use a dealership network, accepting the cost of building their own service centers.
- **IKEA** chooses *not* to assemble furniture for you. They trade service for lower cost.
- **Sears** chose to be both a discount retailer and a premium department store—and lost the advantages of both.

Throughout this course, when we look at a company, I want you to ask: **"What did they say 'no' to?"** If you can't find the "no," they probably don't have a strategy—they just have a wish list.

Where We Go From Here

We are going to build your strategic toolkit in three phases:

1. **External Analysis:** Understanding the terrain (Lecture Note 2).
2. **Business Strategy:** Deciding how to compete (Lecture Notes 3, 4, and 5).
3. **Corporate Strategy:** scaling that advantage (Lecture Notes 6 and 7).
4. **Strategy & Society:** how to think about more than profits (Lecture Note 8).

Next up, we look outward. We are going to analyze the environment in which companies operate. This is what we call **External Analysis**.

Key Terms & Definitions

- **Strategic Management:** The integrative management field that combines analysis, formulation, and implementation in the quest for competitive advantage.
- **Strategy:** The set of integrated choices a firm makes to create and sustain competitive advantage
- **Operational Effectiveness (OE):** Performing similar activities better than rivals perform them. OE is necessary for survival, but usually insufficient for long-term advantage.
- **Competitive Advantage:** When a firm is able to generate more economic value (the gap between Customer Willingness to Pay and Cost) than its rivals.
- **Intended Strategy:** The strategy that an organization hopes to execute.
- **Emergent Strategy:** Unplanned strategic initiatives that bubble up from the bottom of the organization or from serendipitous events.
- **Realized Strategy:** The strategy that an organization actually follows.
- **Trade-offs:** Situations where more of one thing necessitates less of another. (e.g., High quality usually requires giving up low cost).

Lecture Note 2
External Analysis

Learning Objectives

- **Distinguish Levels of Analysis:** Differentiate between the Macro Environment (PESTEL) and the Industry Environment (5 Forces).
- **Analyze Profit Potential:** Understand how industry structure drives long-term profitability.
- **Master the Five Forces:** Identify the specific underlying drivers of Rivalry, Supplier Power, Buyer Power, New Entrants, and Substitutes.

Structure vs. Execution

Imagine the most skilled management team in the world. Now, imagine they are running a company in a market with declining demand, overcapacity, and price wars. It doesn't matter how skilled that team is or how charismatic their CEO is; they are going to struggle to turn a profit.

In strategy, **Industry Structure** dictates the baseline potential for profit.

One of the biggest mistakes aspiring strategists make is focusing entirely on the company (the "Execution") and ignoring the industry (the "Structure"). They look at a struggling airline and say, "They need better marketing!" or "They need to innovate!" But the reality is, the airline industry is structurally difficult. It destroys capital. Meanwhile, the soft drink industry is structurally favorable; it historically generates massive returns.

Before we decide *how* to compete, we must analyze *where* we are competing. We do this at two levels: the **Macro** level and the **Industry** level.

The Macro Level: PESTEL Analysis

The Macro environment consists of the broad forces that affect *everyone* in the economy, not just your specific rivals. We use the acronym **PESTEL** to track them:

- **Political:** Trade policies, labor laws, stability.
- **Economic:** Inflation, interest rates, GDP growth.
- **Social:** Demographic shifts, changing consumer tastes (e.g., the shift to remote work).
- **Technological:** AI, automation, internet speed.
- **Environmental:** Carbon footprint regulations, weather patterns.
- **Legal:** Antitrust laws, intellectual property protection.

Think of PESTEL as the "weather." It's difficult to change the weather (at least in the short term), and you have to check the forecast before you set sail.

- **Example (Fintech):** If you are running a crypto exchange, the "Legal/Political" factor (SEC regulation) is an existential threat that overrides almost everything else.
- **Example (Auto):** For Ford or GM, the "Environmental" factor (mandates for EV adoption) is currently reshaping their entire century-old business model.

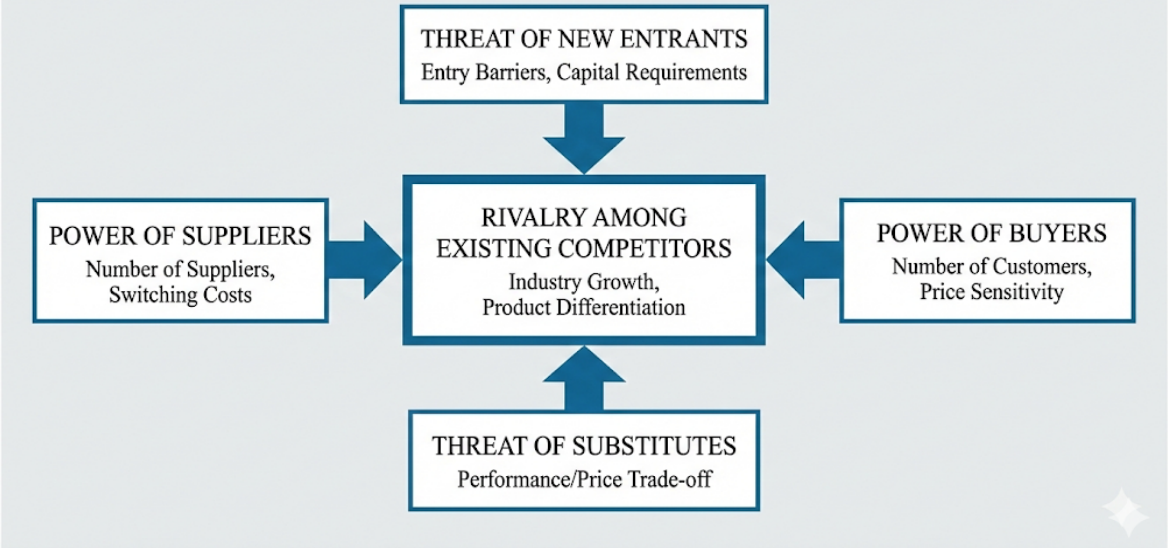
The Industry Level: Porter's Five Forces

While PESTEL is important context, it rarely tells us if a specific business will be profitable. For that, we zoom in to the **Industry** level using **Michael Porter's Five Forces**. Michael Porter is an influential professor at Harvard Business School.

This framework answers one specific question: **"Is this industry attractive?"** (i.e., is it likely to be profitable?). The stronger these forces are, the lower the profitability of the industry. **Figure 2.1** visualizes how these forces press inward on the firm, squeezing profit margins.

Importantly, an "attractive" industry does not guarantee success. Many firms have entered profitable industries and still failed due to poor positioning or execution. Five Forces explains the *average* profit potential of an industry—it does not tell you which firms will win within it.

Figure 2.1: Porter's Five Forces Framework



1. Threat of New Entrants

How easy is it for a new player to enter the market and steal market share? If entry is easy, profits get competed away.

- **Barriers to Entry:** As an incumbent, we want these to be *high*.
  - *Capital Requirements:* It costs billions to start a car company (High barrier). It costs $50 to start a consulting LLC (Low barrier).
  - *Switching Costs:* If I switch vendors, do I have to retrain my staff? (High barrier).

2. Power of Suppliers

Can your suppliers dictate terms? If you need them more than they need you, they will capture the value.

- **Example (Tech/PC):** In the 1990s, PC makers (Dell, HP, Compaq) had very little power. They *had* to buy chips from Intel and Windows from Microsoft. Intel and Microsoft kept the high margins; the PC makers operated on razor-thin profits.

3. Power of Buyers

Can your customers force you to lower prices?

- **Example (Manufacturing):** If you make plastic bottles and your only customer is **Coca-Cola**, you are in a weak position. They can demand rock-bottom prices because they know you have few other options.
- **Example (Retail): Walmart** leverages its massive scale to demand lower prices from its suppliers.

4. Threat of Substitutes

A substitute is NOT a rival product (Coke is not a substitute for Pepsi; they are rivals). A substitute is a product from a **different industry** that solves the **same problem**.

- **Example:** The substitute for an airline flight isn't another airline; it's **Zoom** (video conferencing). The substitute for a prescription sleeping pill isn't another pill; it's a meditation app or chamomile tea.

  When substitutes get better or cheaper, they place a "ceiling" on the prices an industry can charge.

5. Rivalry Among Existing Competitors

This is the intensity of the competition within the industry.

- **Price Wars:** Industries with high fixed costs and perishable inventory (like Airlines) are prone to price wars. Once the plane takes off, an empty seat is worth $0, so they slash prices to fill it. This destroys industry profits.
- **Differentiation:** Industries where products are unique (like Luxury Fashion) compete on brand, not price, which preserves profitability.

Summary

External analysis teaches us that not all profit is created equal. **Table 2.1** illustrates this by comparing a structurally attractive industry against a structurally poor one.

Table 2.1: Industry Profitability Comparison: Pharmaceuticals vs. Airlines

Porter's Five Forces	Pharmaceuticals (High Profit Structure)	Airlines (Low Profit Structure)
Threat of New Entrants	LOW THREAT (High barriers: patents, R&D costs, regulation)	HIGH THREAT (Moderate barriers: lease planes, access capital)
Power of Suppliers	LOW POWER (Commodity chemical suppliers)	HIGH POWER (Boeing/ Airbus duopoly, pilot unions)
Power of Buyers	LOW POWER (Patients need drugs, insurance pays)	HIGH POWER (Price-sensitive travelers, comparison sites)
Threat of Substitutes	LOW THREAT (Often no alternative for specific diseases)	MODERATE THREAT (Video conferencing, trains, cars)
Rivalry Among Existing Competitors	MODERATE RIVALRY (Patents create temporary monopolies)	HIGH RIVALRY (Intense price wars, perishable inventory)

Your job as a strategist is to position your firm where the forces are weakest—or to innovate in a way that alters the structure in your favor.

Key Terms & Definitions

- **PESTEL:** An acronym for the macro-environmental forces: Political, Economic, Social, Technological, Environmental, and Legal.
- **Industry:** A group of firms producing products that are close substitutes for each other.
- **Porter's Five Forces:** A framework developed by Michael Porter that analyzes the competitive forces shaping an industry—specifically, the threat of new entrants, bargaining power of suppliers, bargaining power of buyers, threat of substitutes, and rivalry among existing competitors.
- **Barriers to Entry:** Obstacles that make it difficult for a new firm to enter a market (e.g., economies of scale, capital costs, regulations).
- **Switching Costs:** The fixed costs buyers face when they change suppliers (monetary, psychological, or time-based).
- **Substitutes:** Products or services from a *different* industry that can satisfy the same customer need.

Lecture Note 3
Competitive Advantage

Learning Objectives

- **Value Creation vs. Value Capture:** Differentiate between creating the total economic pie and how that pie is divided between the customer, the firm, and the supplier.
- **Cost Leadership vs. Differentiation:** Distinguish between the two ways to create value.
- **Master Drivers:** Identify the structural drivers firms use to lower costs or increase WTP.
- **Sustainability:** Learn why success attracts copycats and what "Isolating Mechanisms" prevent them from eroding your advantage.

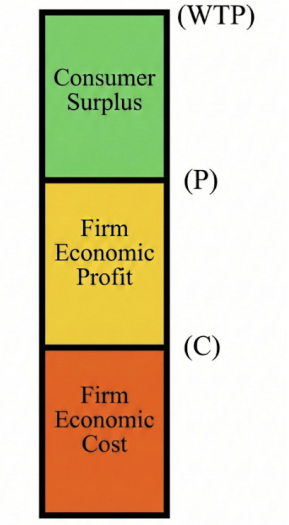
The "Wedge": WTP - Cost

In the last lecture note, we looked at the *industry*—the terrain in which firms operate. Now, we look at the *firm*. How do they actually win within an industry? Many people think the goal of business is "profit." But profit is just a result. The *cause* of long-term profit is **Value Creation**.

To understand this, we need to visualize a "**Wedge**" as depicted in **Figure 3.1**.

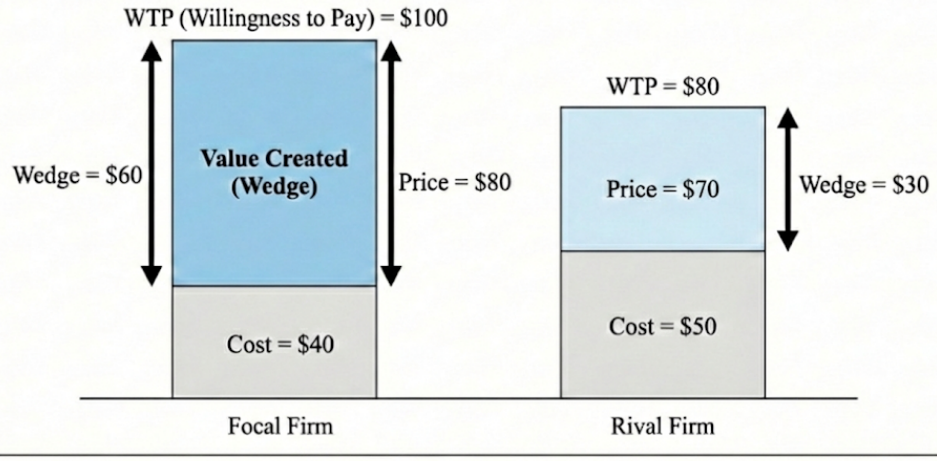
- The top of the bar is the customer's **Willingness to Pay (WTP)**: The absolute maximum amount they would spend for your product based on the perceived benefit.
- The bottom of the bar is the **Cost (C)**: The money required to produce and deliver it.
- The middle section (price minus cost) is the firm's profit, or the **value captured**. The top section (WTP minus price) is the consumer's surplus, the deal consumers feel they got.

Figure 3.1 The Wedge



Competitive advantage exists when a firm creates more value (a *wider wedge between WTP and C*) than its rivals. **Figure 3.2** on the next page illustrates the goal. The winning firm is the one that maximizes the value created – that is, the total size of the blue colored bar. Keep in mind, however, that even firms that create substantial value can struggle to capture it in industries with powerful buyers or suppliers (as we learned in Lecture Note 2).

Figure 3.2: The Value Creation Wedge



The Focal Firm creates a larger wedge between WTP and Cost, creating more value.

Two Ways to Create Value

Since the goal is to widen the wedge, there are mathematically only two ways to do it: pull the top up or push the bottom down. This framework simplifies reality, but it captures the core economic logic behind most competitive strategies.

1. Cost Leadership (Pushing the Bottom Down)

The goal here is aggressive cost-cutting. You provide a product that is "good enough" (acceptable WTP) but produced at a substantially lower cost structure than rivals.

How do firms achieve this? It isn't just about paying people less. It's about mastering specific structural **low-cost drivers**:

- **Economies of Scale:** Spreading fixed costs over huge volume. Walmart buys so much inventory and runs so many stores that their per-unit cost drops through the floor.
- **Learning Curve Effects:** The more times you perform a task, the more efficient you become. The 100,000th Tesla Model Y costs significantly less to build than the 100th because the company learned how to optimize the assembly line and reduce errors.
- **Low-Cost Inputs:** Gaining privileged access to cheaper raw materials, non-unionized labor, or advantageous geographic locations.
- **Process Innovation:** Inventing new, cheaper ways to do things. Think of IKEA designing furniture specifically to be flat-packed, drastically cutting shipping and storage costs compared to traditional furniture makers.

The Risk of Pursuing Low Cost: If you cut quality too deeply in the pursuit of lower costs, customers' WTP drops faster than your costs, and your wedge shrinks.

2. Differentiation (Pulling the Top Up)

The goal here is uniqueness. You provide a product or service so special that customers are willing to pay a premium that far exceeds the extra cost incurred to produce it.

How do you raise WTP? By focusing on specific **differentiation drivers**:

- **Product Features & Performance:** Think of the superior engineering in a BMW engine, the speed of a specialized chip, or the noise-canceling tech in Bose headphones.
- **Brand Image & Status:** People pay vastly more for a handbag with a Louis Vuitton logo than an identical unbranded one because of what the brand signals socially.
- **Customer Service:** Nordstrom's legendary return policies or the "genius bar" support at Apple create a service experience people pay extra for.
- **Design & Aesthetics:** How a product looks and feels. Apple is the master of this driver, making technology feel like luxury jewelry.

The Risk of Pursuing Differentiation: "Gold-plating." You add cool features that cost money to build, but customers don't actually care enough to pay for them (Cost goes up, WTP stays flat).

Table 3.1 summarizes the differences between these two approaches.

Table 3.1: Cost Leadership vs. Differentiation Strategies

Strategy Feature	Cost Leadership Strategy	Differentiation Strategy
Strategic Focus	Aggressive efficiency, process standardization, scale	Uniqueness, brand building, product innovation
Key Value Driver	Lowering Cost (C)	Raising Willingness to Pay (WTP)
Primary Risk	Cutting quality too much, eroding WTP	Gold-plating (adding features customers don't value)
Example	Ryanair, Spirit Airlines, Walmart	Apple, Nike, Rolex

The Danger Zone: Being Stuck in the Middle

The most common strategic error is trying to do both without mastering either. "We offer premium, customized service at the lowest price!" This sounds great in a marketing pitch, but in economics, it usually fails. Premium service requires expensive staff (raises Cost). Lowest price requires standardized, no-frills operations. If you try to be **Mercedes** (high differentiation) and **Kia** (low cost) at the same time, you usually end up like **Sears**—too expensive to be a bargain and not differentiated enough to excite anyone. You have no wedge.

Note: A few rare companies manage a "Dual Advantage" strategy, but it is extremely difficult and usually involves a massive business model innovation (like Amazon).

The Moat: Why Can't They Copy You?

Let's say you succeed in creating more value than your competitors. You build a massive wedge using these drivers. What happens next?

Competitors will notice and try to imitate!

If you are making huge margins, rivals will try to copy your drivers. If they succeed, your advantage disappears. To have a **Sustainable** Competitive Advantage, you need **Isolating Mechanisms** (often called "Moats"). These are barriers that prevent rivals from imitating you.

1. **Path Dependence (1st-mover advantage):** You have an advantage because of a long history that cannot be recreated quickly. A new rival can buy trucks, but they cannot buy Caterpillar's 80-year-old dealer network relationships overnight.
2. **Causal Ambiguity (The "Secret Sauce"):** Competitors can see *what* you do, but they don't understand exactly *how* the combination of your culture, processes, and talent creates value. Southwest Airlines has been studied for decades, yet few have successfully copied them.
3. **Intellectual Property:** Patents, trademarks, and copyrights that legally forbid copying.

Importantly, moats are not permanent. Technology and regulation can weaken or destroy even strong isolating mechanisms. Newspapers once had powerful local monopolies, but the internet eliminated their control over distribution and advertising. Taxi medallions were protected by regulation for decades, until ride-sharing platforms rewrote the rules. Competitive advantage must be continually defended—it is rarely forever.

Key Terms & Definitions

- **Value Creation:** The total economic value generated by a transaction (WTP - Cost).
- **Value Capture:** The portion of total value created that a firm retains as profit (Price - Cost).
- **Economies of Scale:** The cost advantage that arises with increased output of a product.
- **Learning Curve:** The concept that labor productivity increases (and costs decrease) as the number of times a task is performed increases.
- **Cost Leadership:** A strategy primarily focused on achieving lower costs than rivals through drivers like scale and efficiency.
- **Differentiation:** A strategy focused on producing unique products that raise customer WTP through drivers like brand, design, or service.
- **Isolating Mechanisms:** Barriers to imitation that prevent rivals from competing away a firm's advantage.

Lecture Note 4
Industry Value Chain

Learning Objectives

- **Map the Terrain:** Understand the Industry Value Chain as the sequence of activities from raw materials to the end consumer.
- **Identify Bottlenecks:** Learn to spot the "strategic control points" in a chain where power is concentrated.
- **Strategic Positioning:** Analyze how firms move within the chain to seize control of bottlenecks or bypass them entirely.

The $5 Latte Problem

Let's start with a simple question: When you buy a $5.00 latte at a coffee shop, where does that money go?

You might assume it goes to the cost of the coffee beans. But in reality, the farmer who grew, harvested, and dried those beans gets roughly **$0.05** of your $5.00. Where did the other $4.95 go? It went to the shipping company, the roaster, the real estate landlord for the shop, the barista's wages, the marketing department, and finally, the coffee shop's profit margin.

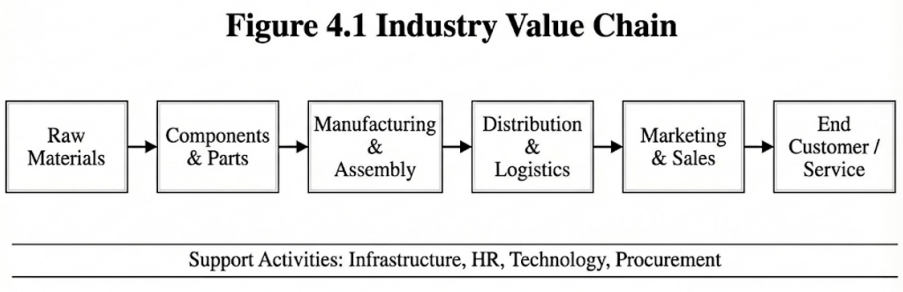
This is the essence of the **Industry Value Chain**. It is the sequence of all activities performed by various organizations to take raw material and turn it into a finished product for consumers. This is different from a firm's internal value chain, which looks at activities within a single company.

In Lecture Note 3, we discussed *creating* a wedge (value). Here we discuss *capturing* it. Just because an industry creates value for society doesn't mean every player in that industry gets rich.

Mapping the Chain

Every industry has a chain. It usually looks something like **Figure 4.1**:

Figure 4.1 Industry Value Chain



Think back to Lecture Note 2. When we analyzed an "industry," we were usually looking at just *one box* in that chain fighting with its direct rivals.

But the real battle for profit often isn't against your direct rivals; it's against the players *upstream* (your suppliers) and *downstream* (your buyers) in the chain.

Each step in the chain is a mini market with its own Five Forces dynamic.

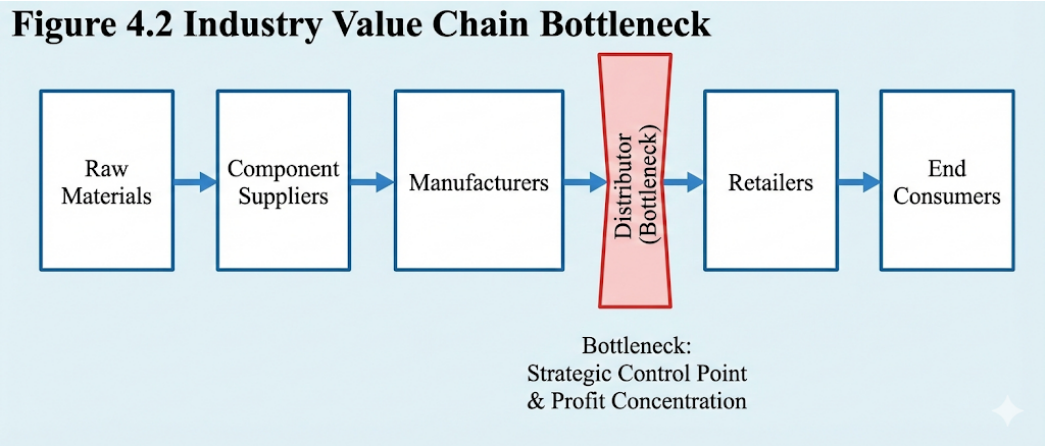
- If you are a coffee farmer selling to a massive global roaster like Nestlé, the buyer power is immense. You take the price they give you.
- If you are that global roaster selling to a small, independent cafe, your supplier power is high. You dictate the price.

The goal of value chain analysis is to figure out which step in the sequence has the most power to squeeze the others.

The Strategic Concept: Bottlenecks

In many value chains, power is not distributed evenly. It tends to concentrate at **Bottlenecks**.

A bottleneck is a point in the chain where the flow is restricted, usually because one or a few players control a critical asset that everyone else needs but can't replicate. **Figure 4.2** illustrates this.



Think of an hourglass turned on its side. The sand flows easily at the top and bottom, but it all has to pass through that narrow neck in the middle. The companies that controls the neck controls the industry value chain. Bottlenecks tend to capture a disproportionate share of value—but they are often contested and can shift over time.

The Classic Example: The PC Industry (1990s)

In the 1980s and 90s, the personal computer industry exploded. Enormous value was created for society.

- Who was involved? IBM, Compaq, Dell, HP (the manufacturers). They assembled the boxes and sold them to you.
- Who were their suppliers? Intel (chips) and Microsoft (operating system).

Who won?

The manufacturers engaged in brutal price wars (high rivalry), slashing their margins to almost zero to sell boxes. Meanwhile, every single one of those boxes *required* an Intel chip and Windows '95.

Intel and Microsoft were the **bottlenecks**. They had near-monopolies on the critical components. The PC manufacturers did all the hard work of assembly, marketing, and distribution, but they were essentially just passing the profits through to Wintel.

Strategic Moves in the Value Chain

Once you identify the bottleneck, what can you do? There are a few options:

1. Become the Bottleneck

This is the holy grail. Find a way to control something—a patent, a distribution network, a brand—that is indispensable to the chain.

- **De Beers Diamonds:** For decades, De Beers didn't own every diamond mine. But they bought up almost all the rough diamonds from other mines. By controlling the distribution point (the bottleneck) between miners and jewelers, they could artificially restrict supply and keep diamond prices sky-high.

2. Vertical Integration (Buy the Bottleneck)

If a supplier is squeezing you, buy them.

- **Netflix:** Netflix used to just distribute other people's content (movies from Disney, shows from NBC). They realized content owners were the bottleneck and would eventually squeeze Netflix on licensing fees. So, Netflix vertically integrated *backward* into becoming a studio itself, producing *Stranger Things* and *The Crown*.

3. Bypass the Bottleneck (Disintermediation)

Use technology to jump over the players that used to control access to the customer.

- **Warby Parker / Casper Mattresses:** These "Direct-to-Consumer" (DTC) brands realized

that the traditional retail chains (LensCrafters, Mattress Firm) were expensive bottlenecks marking up prices. They used the internet to bypass the retailer and sell directly to you, capturing that margin for themselves.

These moves are powerful, but risky—many firms destroy value by integrating or bypassing without understanding the economics of the adjacent stage.

Summary

Don't just look at your rivals. Look up and down the chain. Profitability is often determined by where you sit in the flow of goods and who has the power to stop that flow. The firm that controls the bottleneck controls the value capture.

Key Terms & Definitions

- **Industry Value Chain:** The full sequence of activities required to bring a product from raw materials to the final consumer, involving multiple firms.
- **Bottleneck:** A stage in the value chain where supply is constrained or controlled by a limited number of players, giving those players significant bargaining power.
- **Bargaining Power:** The ability of a firm in the value chain (suppliers or buyers) to influence prices and terms in its favor.
- **Disintermediation:** The removal of intermediaries in a value chain, allowing firms to sell directly to customers and capture margins previously earned by middlemen.

Lecture Note 5
Network Effects

Learning Objectives

- **Understand Network Effects:** Distinguish between Direct (same-side) and Indirect (cross-side) network effects.
- **Identify the "Sixth Force":** Recognize the role of Complements, particularly in technology and platform markets.
- **Platform Dynamics:** Recognize the unique challenges of two-sided markets, specifically the "chicken-and-egg" launch problem.
- **Market Outcomes:** Learn why markets driven by network effects often experience "tipping points" and lead to "winner-take-all" scenarios.

The Lonely Telephone

Imagine it is 1876 and Alexander Graham Bell just invented the telephone. He offers to sell you the very first one for $1,000. Should you buy it?

Absolutely not. A single telephone is useless. Who would you call?

Now, imagine a year later, 100 of your friends have telephones. Suddenly, that same piece of hardware is incredibly valuable.

This is the essence of **Network Effects**.

In traditional strategy (like manufacturing), we talk about *supply-side* economies of scale: the more you make, the cheaper it gets per unit. Network effects are **demand-side economies of scale**: the more people connect, the more valuable the service gets for everyone involved.

In the modern economy, many of the most powerful companies—Facebook, Uber, Visa, Microsoft, Airbnb—derive their competitive advantage not from how cheaply they make things, but from how many participants they have in their network.

Two Types of Network Effects

Not all networks are created equal. We need to distinguish between two types.

1. Direct (Same-Side) Network Effects

This occurs when an increase in usage by one set of users increases the value to a different set of users in the same group.

- **The Classic Example:** The telephone network. Every new person who gets a phone makes *my* phone more valuable because there is one more person I can call.
- **Modern Example:** WhatsApp or Facebook Messenger. If none of your friends are on it, it has zero value to you. As more friends join, the utility skyrockets.

2. Indirect (Cross-Side) Network Effects

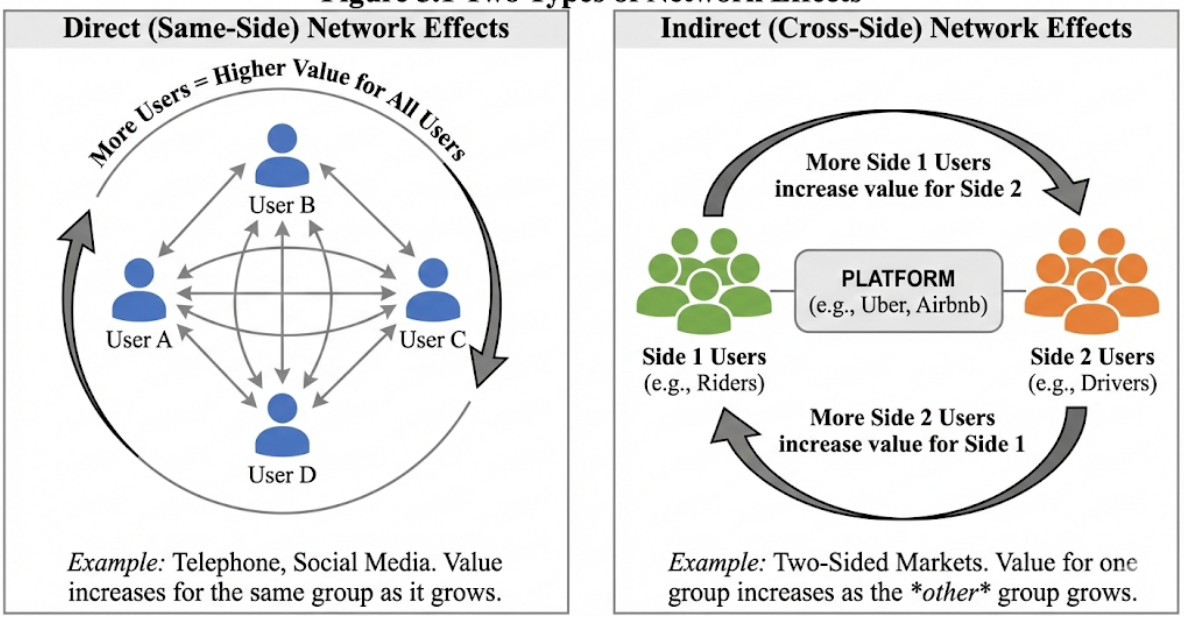
This is the engine of the modern "Platform" economy. This occurs when an increase in usage by one group of users increases the value to a *different* group of users.

These businesses are **Two-Sided Markets** (or Multi-Sided Platforms). Their job isn't to make a product; it's to make a connection.

- **Uber:** Uber needs two distinct groups: Riders and Drivers.
  - The more drivers there are, the lower the wait times, making the platform more valuable for riders.
  - The more riders there are, the less idle time between trips, making the platform more valuable for drivers.
  - Uber's strategy is managing the friction between these two sides.
- **Gaming Consoles (Xbox/PlayStation):** Gamers want the console with the most games. Game developers want to build for the console with the most gamers.

Figure 5.1 visualizes these differences between Direct and Indirect network effects.

Figure 5.1 Two Types of Network Effects



The "Sixth Force": Complements

When we studied industry analysis, we used Porter's Five Forces (Rivalry, Suppliers, Buyers, Entrants, Substitutes). However, in the modern tech economy, Porter's original five miss a crucial element: **Complements**. While complements are not a competitive force in the Porter sense, they strongly shape value creation in platform markets.

While **Substitutes** are products that *reduce* the value of your product (e.g., video conferencing is a substitute for business travel), **Complements** are products that *increase* the value of your product.

- **Hardware & Software:** An iPhone (hardware) is a paperweight without Apps (software). The more high-quality apps exist, the more valuable the iPhone becomes.
- **EVs & Chargers:** An electric car is useless without charging stations. Tesla's strategic move to build the Supercharger network wasn't just about "selling energy"; it was about building a complement to ensure their main product (the car) had value.
- **Hot Dogs & Buns:** A classic low-tech example. If the price of hot dog buns drops to 1 cent, the demand for hot dogs goes up.

Strategic Implication: With platforms, you cannot just focus on fighting rivals. You must actively cultivate your complements. If your complements are weak (e.g., a new VR headset with no games to play on it), your product will fail regardless of how good the technology is.

The "Chicken-and-Egg" Problem

Platforms are incredibly powerful once they are running, but they are excruciatingly hard to start.

If you launch a competitor to Airbnb today, how do you get hosts to list their homes if you have no travelers? And how do you get travelers to browse your site if you have no homes listed? This is the **cold-start problem** or the "chicken-and-egg" dilemma.

Successful platforms usually have to subsidize one side of the market to get the flywheel spinning.

- **Ladies' Night:** A classic offline example. A bar wants more men to buy drinks. Men go where the women are. So, the bar lets women in for free (subsidizing one side) to attract the other side (the paying customers).
- **Adobe PDF:** Adobe gave away the "Reader" for free to everyone to build the user base, and then charged businesses for the "Writer" software to create the documents.

Tipping Points and "Winner-Take-All"

Markets dominated by network effects behave differently than traditional markets. They rarely settle into a stable equilibrium with 10 competitors holding 10% market share each.

Instead, they tend to have **Tipping Points**.

Imagine two new social networks launch at the same time. Network A gets a slight lead—say, 55% of the users versus 45% for Network B. Because A is slightly bigger, it is slightly more valuable to join. New users flock to A. Current users on B realize their friends are on A, so they switch. (Keep in mind though that as networks grow, congestion and quality degradation can reduce value if not carefully managed.)

Very quickly, 55/45 becomes 70/30, then 90/10, then 99/1. The market "tips."

This leads to **Winner-Take-All** (or winner-take-most) markets. Why is there essentially only one professional networking site (LinkedIn)? Because nobody wants to be on the second-best networking site. The value is in the totality of the network. Importantly, early network advantages are not always permanent. MySpace and Friendster both had strong early network effects but lost users due to poor product design and governance.

Summary

Network effects are one of the most potent forms of competitive advantage today. They create massive barriers to entry—you can't just copy features; you have to copy the entire ecosystem of users. However, getting to that tipping point requires clever strategy to overcome the initial chicken-and-egg hurdle.

Key Terms & Definitions

- **Network Effects:** A phenomenon where the value of a good or service increases for both new and existing users as its user base grows.
- **Demand-Side Economies of Scale:** Another term for network effects, emphasizing that value grows on the customer (demand) side, rather than costs falling on the supply side.
- **Platform (Two-Sided Market):** A business that enables interactions between at least two distinct groups of users (e.g., buyers and sellers, drivers and riders).
- **Direct Network Effects:** When more users on the *same side* of the market add value for each other (e.g., telephones, social media friends).
- **Indirect (Cross-Side) Network Effects:** When more users on *one side* of the market add value for users on the *other side* (e.g., more gamers attract more game developers).
- **Complements:** Products or services that increase the value of the focal product when used together (e.g., apps for a smartphone).
- **Tipping Point:** The critical threshold where a network gains enough momentum that growth becomes self-reinforcing, often leading to market dominance.
- **Winner-Take-All Market:** A market where the leading platform captures the vast majority of users and profits due to strong network effects, leaving very little for competitors.

Lecture Note 6
Corporate Strategy

Learning Objectives

- **Distinguish Levels of Strategy:** Differentiate between Business Strategy (how to win in a single market) and Corporate Strategy (deciding which markets to be in).
- **Understand Horizontal Scope:** Explain the logic of expanding into related industries to create "synergy" through shared resources.
- **Understand Vertical Scope:** Apply Transaction Cost Economics (TCE) to decide when a firm should "make" a component in-house versus "buy" it from the market.
- **Evaluate the "Better Off" Test:** Recognize that corporate expansion is only justified if the new business is more valuable owned by the firm than it would be as a standalone entity.

The Two Big Questions

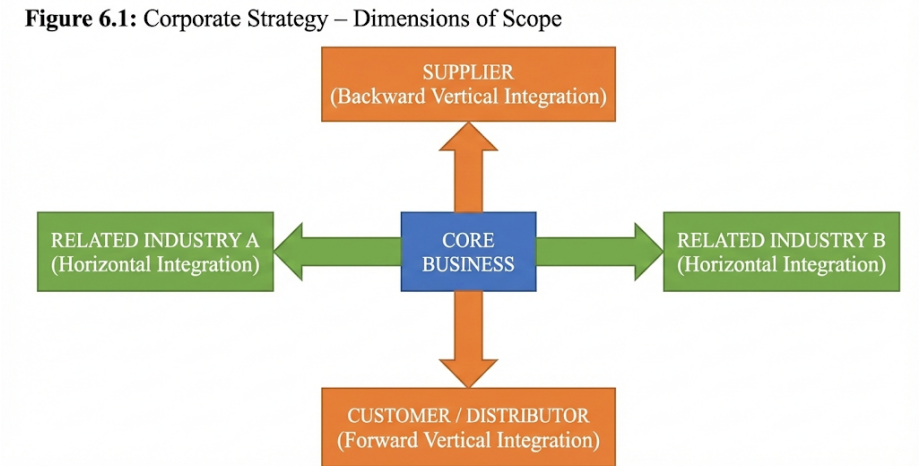
So far in this course, we have been answering one specific question: **"How do we win in this industry?"** (e.g., "How does Southwest win in airlines?" or "How does Apple win in smartphones?"). This is called **Business Strategy**.

Now, we zoom out to the CEO level of a large, multi-business corporation like General Electric, Alphabet (Google's parent), or Disney. These leaders face a different, broader question: **"Which industries should we be in?"** This is **Corporate Strategy**.

Corporate strategy is about managing the **scope** of the firm. It's about deciding where the boundaries of the company should begin and end. There are dimensions of corporate scope:

1. **Horizontal Scope:** Which range of products and services should we offer?
2. **Vertical Scope:** Which stages of the industry value chain should we participate in?

Figure 6.1: Corporate Strategy – Dimensions of Scope



Horizontal Integration: The Search for Synergy

Why would a company that makes laundry detergent also make diapers and shampoo? (Think **Procter & Gamble**). Why would a search engine company also build self-driving cars and thermostats? (Think **Alphabet**).

The goal of horizontal integration—expanding into new, but related, industries—is to create **Synergy**. This is the magical strategic math where **$2 + $2 = $5 or more**.

Synergy doesn't just happen. It comes from **Resource Relatedness**. Many conglomerates pursued diversification in the 1960s and 1970s under the banner of synergy, only to destroy value as complexity overwhelmed coordination. You don't just buy random companies; you buy companies that can share your firm's core, valuable resources.

- **Tangible Resources:** Sharing manufacturing plants, distribution channels, or sales forces. P&G can use the same trucks and same relationships with Walmart to sell Pampers, Tide, and Head & Shoulders.
- **Intangible Resources:** Sharing a brand name, technology, or know-how. **Disney** is the master of this. Their core resource is their intellectual property (Marvel, Star Wars). They leverage this single resource across dozens of industries: movies, theme parks, cruise lines, merchandise, and streaming. The value of the Marvel brand is far greater under the Disney umbrella, where it can be exploited across all these platforms, than it would be as a standalone comic book company.

Vertical Integration: The "Make or Buy" Decision

Vertical integration is about moving up or down the **Industry Value Chain** (Lecture Note 4).

- **Backward Integration:** Buying your suppliers. (e.g., A car company buying a steel mill).
- **Forward Integration:** Buying your customers or distributors. (e.g., An apparel manufacturer opening its own retail stores).

The fundamental question here is **"Make or Buy?"** Should we make this component ourselves in-house, or should we buy it from the market? To answer this, we use a framework called **Transaction Cost Economics (TCE)**.

TCE teaches us that using the market isn't free. There are **transaction costs** associated with buying things from outside suppliers:

- **Search Costs:** Finding the right supplier.
- **Negotiation Costs:** Haggling over price and contract terms.
- **Enforcement Costs:** Monitoring the supplier to make sure they don't cheat on quality.

The Rule: You should only vertically integrate ("make") when the costs of using the market become too high. When does that happen?

The biggest driver is **Asset Specificity**. This is when you need a component that is highly customized and unique to your product, and has little value to anyone else.

- **Example: Tesla Seats.** You might think seats are a commodity. But Tesla's Model X seats were incredibly complex works of engineering. No outside supplier could make them to Tesla's spec without massive investment and risk. The market failed to provide the solution. So, Tesla had to build its own seat factory.
- **Counter-Example: Office Paper.** Every company needs printer paper. It is a standardized commodity with zero asset specificity. There are zero transaction costs to buying it. It would be insane for a tech company to buy a paper mill. You always "buy" commodities.

Summary

Whether moving horizontally or vertically, the guiding principle of corporate strategy is the **"Better Off" Test**. Just because a company *can* buy another company doesn't mean it *should*. Expansion is only justified if the corporation can add value to the new business—by sharing resources, transferring best practices, or reducing transaction costs—that an average, outside investor could not. If you can't pass that test, stay focused on your core business.

Key Terms & Definitions

- **Business Strategy:** The strategy for how a firm competes and wins within a single, specific industry or market.
- **Corporate Strategy:** The strategy for a company that operates in multiple industries, focusing on managing the portfolio of businesses and deciding which markets to enter or exit.
- **Horizontal Integration:** Expanding a firm's activities into other products or services, typically within related industries.
- **Synergy:** The concept that the combined value of two businesses operating under common ownership is greater than the sum of their individual values ($2 + 2 = 5$).
- **Vertical Integration:** A firm's ownership of its production of needed inputs (backward integration) or of the channels by which it distributes its outputs (forward integration).
- **Transaction Cost Economics (TCE):** A theoretical framework used to analyze the costs of conducting economic exchanges in the market versus within a firm, helping to determine the boundaries of the firm ("make or buy").
- **Asset Specificity:** The degree to which an asset or component is specialized to a particular use or transaction and has little value outside of that specific relationship. High asset specificity often leads to vertical integration.
- **"Better Off" Test:** The criteria that a corporate diversification strategy must create more value for shareholders than they could create on their own by holding a diversified portfolio of stocks.

Lecture Note 7
Global Strategy

Learning Objectives

- **The "Semi-Globalized" World:** Understand why the world is not actually "flat" and why distance still matters.
- **The CAGE Framework:** Learn to analyze the four dimensions of distance (Cultural, Administrative, Geographic, Economic) to assess market attractiveness.
- **Adaptation vs. Aggregation:** Distinguish between customizing for local tastes (Adaptation) and standardizing for global scale (Aggregation).
- **Arbitrage:** Recognize strategies that exploit economic differences between countries (e.g., "buy low, sell high").
- **Entry Mode Choice:** Understand the strategic trade-offs firms face when choosing how to enter foreign markets (exporting, licensing, joint ventures, or wholly owned subsidiaries).

The Myth of the Global Village

In the early 2000s, it became popular to say "The World is Flat." The idea was that the internet, shipping containers, and free trade had made geography irrelevant. A customer in Bangalore was the same as a customer in Boston.

Reality Check: The world is *not* flat. It is semi-globalized.

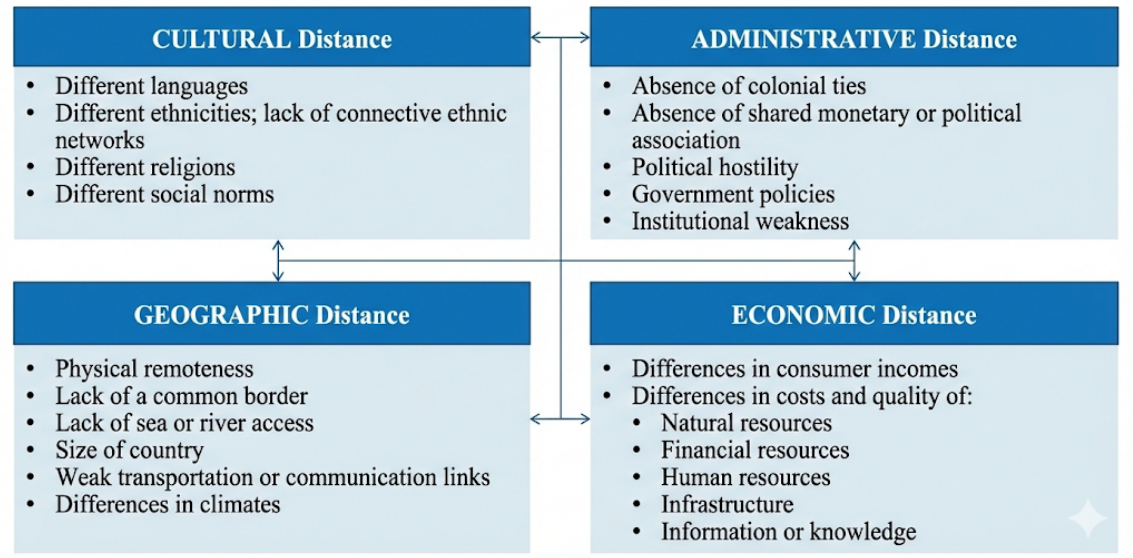
Most business is still local. If the world were truly flat, international trade would be 90% of global GDP. In reality, it's closer to 20-30%.

For a strategist, ignoring borders is fatal. "Going Global" is not just about translating your website into Spanish. It involves crossing barriers that create friction and cost. To measure this friction, we don't just use miles or kilometers; we use the **CAGE Framework**.

The CAGE Distance Framework

Developed by Pankaj Ghemawat, CAGE reminds us that "distance" comes in four flavors (see **Figure 7.1**). The greater the distance in any of these categories, the harder it is to succeed in that new market. These distances create what scholars call a "liability of foreignness"—extra costs that domestic firms do not face.

Figure 7.1: The CAGE Distance Framework



1. Cultural Distance (C)

This refers to differences in language, ethnicity, religion, and social norms.

- **The Trap:** Assuming your product will work because it's popular at home.
- **Example: Home Depot** failed in China. In the US, Home Depot relies on a "Do-It-Yourself" (DIY) culture. In China, labor is cheaper, and the cultural norm for the middle class is "Do-It-For-Me" (hiring someone). Home Depot tried to export a culture that didn't exist there.

2. Administrative Distance (A)

These are legal and political differences: tariffs, trade agreements, currency, and government stability.

- **The Trap:** Underestimating regulation or corruption.
- **Example: Google** struggling in Europe with privacy laws (GDPR) or in China with censorship requirements. These are "administrative walls" that make it hard to transfer the US business model abroad.

3. Geographic Distance (G)

This is physical distance, but also time zones, climate, and access to ports.

- **The Trap:** Logistics costs eating your margin.
- **Example:** It is easier for the US to trade with Canada (close, shared border) than with England, even though England is culturally similar. Fresh flowers from Colombia dominate the US market because they can be flown in overnight; they are rare in Japan because the "G" distance destroys the product value.

4. Economic Distance (E)

This refers to differences in consumer income, infrastructure, and cost of labor.

- **The Trap:** Pricing yourself out of the market.
- **Example:** A $1,000 iPhone is a mass-market product in the US (high income). In India (lower average income), it is an ultra-luxury good. Apple has to change its strategy entirely (selling older models, financing) to compete.

How to Compete: The Three A's

Once you analyze the CAGE distance, you have to choose a strategy to overcome it. We call these the "AAA" strategies (Adaptation, Aggregation, Arbitrage).

1. Adaptation (Fitting In)

You change your product or service to minimize the "Cultural" or "Economic" distance. You try to look like a local player.

- **Example: McDonald's**. In India, they don't serve beef (Cultural distance). They serve the "McAloo Tikki" (a potato burger). In France, they serve macarons.
- **Trade-off:** Adaptation is expensive. You lose economies of scale because you are making different products for every country.

2. Aggregation (Scale)

You ignore the differences and focus on "Global Standardization." You treat the world as one big market to get massive economies of scale.

- **Example: Boeing** or **Apple**. An iPhone is basically the same in Tokyo, New York, and London. They don't redesign the phone for every country. They win by making millions of identical units to lower costs.

3. Arbitrage (Exploiting Difference)

Instead of viewing differences as a problem to be fixed, you view them as an opportunity to make money. You buy where it is cheap and sell where it is expensive. Arbitrage strategies are powerful but fragile.

- **Economic Arbitrage:** Outsourcing manufacturing to Vietnam (low labor cost) and selling in the US (high willingness to pay).
- **Cultural Arbitrage:** Selling French wine or Swiss watches at a premium in the US specifically *because* they are foreign. The "foreignness" is the value.

Entry Mode Choice

Global strategy involves not just where to compete, but how to enter a foreign market. Entry modes differ in control, risk, and commitment.

- **Exporting:** Produce at home, sell abroad. Low risk and low control; shipping and tariffs reduce margins.
- **Licensing:** Let a local firm use your brand or technology. Low investment, but weak control and risk of imitation.
- **Joint Ventures:** Share ownership with a local partner. Access local knowledge, but risk conflict and slower decisions.
- **Wholly Owned Subsidiaries:** Full ownership and control. Highest investment and risk, but strongest coordination and IP protection.

There is no best entry mode. Firms choose based on **CAGE distance**, regulatory constraints, and how much control the strategy requires.

Summary

Global strategy is a balancing act.

- If you Adapt too much, you become a collection of small, inefficient local businesses.
- If you Aggregate too much, you risk selling a generic product that nobody wants.
- If you ignore CAGE, you risk crashing into a cultural or legal wall you didn't see coming.

The best global companies pick their battles: they aggregate where possible (back-end IT, finance) and adapt where necessary (flavors, marketing).

Key Terms & Definitions

- **CAGE Framework:** An acronym for Cultural, Administrative, Geographic, and Economic distances, used to assess the challenges of international expansion.
- **Semi-globalization:** The perspective that international integration is imperfect; borders still matter, and markets are neither completely isolated nor completely integrated.
- **Adaptation:** A strategy of tailoring products or business models to local preferences to boost market share (overcoming Cultural/Economic distance).
- **Aggregation:** A strategy of standardizing products globally to achieve economies of scale (overcoming distance by ignoring it).
- **Arbitrage:** A strategy of exploiting differences between markets (e.g., wage rates) to create value (turning Economic distance into profit).
- **Entry Mode:** The method a firm uses to enter a foreign market, balancing control, risk, and investment.

Lecture Note 8
Strategy and Society

Learning Objectives

- **The Friedman Doctrine:** Analyze the argument for Shareholder Primacy and the agency costs associated with corporate philanthropy.
- **Stakeholder Theory:** Contrast Friedman's view with the modern view that firms must balance the needs of employees, communities, suppliers, and the environment.
- **Purpose-Driven Strategy:** Evaluate how "mission-first" strategies and alternative ownership models (like B-Corps) can create a distinct competitive advantage.
- **Measuring Impact:** Apply an Effective Altruism framework to critique "Social Impact Initiatives" and distinguish between feeling good (Warm Glow) and doing good (Actual Impact).

The Great Debate: Whose Money is it?

For decades, the dominant view in strategy was defined by **Milton Friedman**. In his famous 1970 *New York Times* essay, he argued:

> *"The social responsibility of business is to increase its profits."*

Friedman wasn't arguing that businesspeople should be evil. He was making a structural argument based on **Agency Theory**:

1. The CEO is an *agent* of the shareholders (the *principals*).
2. The money in the corporation belongs to the shareholders.
3. If a CEO spends that money on "social causes" (like charity or eco-initiatives) that do not increase profit, he is essentially taxing the shareholders without their consent and spending their money on his personal whims.

The Friedman Conclusion: If you want to do good, maximize profit, distribute it to shareholders, and let *them* donate to the charities they choose. Friedman did not argue that firms should ignore ethics or law—only that social goals should be pursued through profit-maximizing activity rather than discretionary spending.

The Stakeholder Counter-Argument

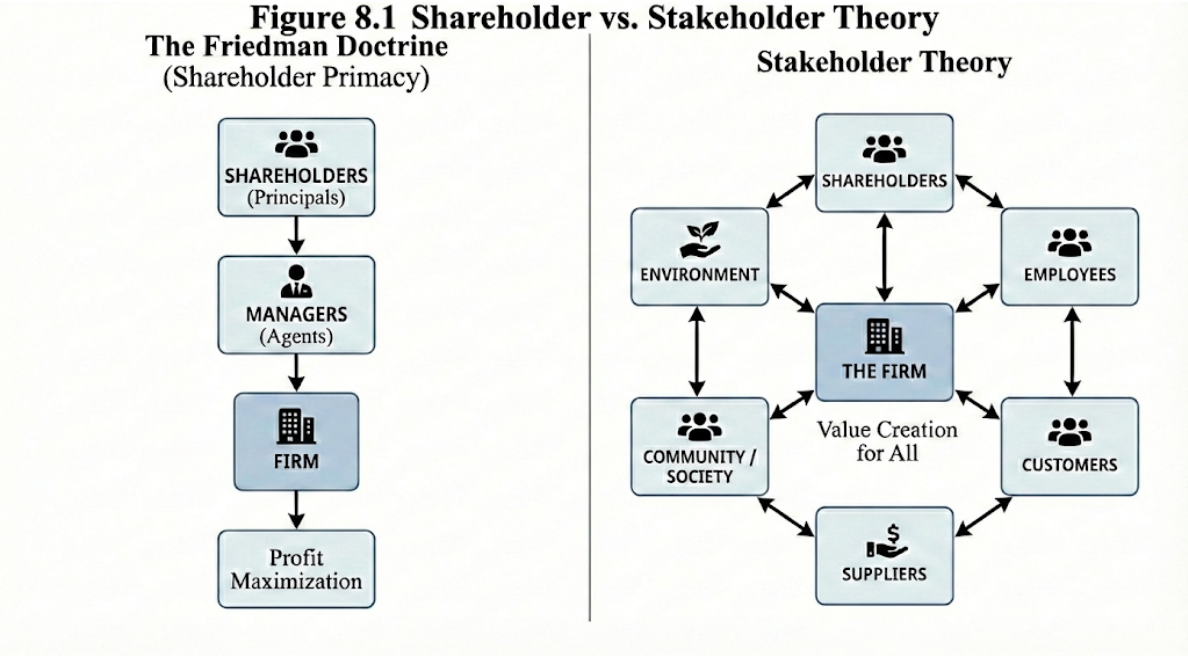
In the 21st century, some have shifted toward more of a **Stakeholder Theory** (championed by R. Edward Freeman). This view argues that a company cannot exist in a vacuum. It relies on a "license to operate" from society. Therefore, the firm has a fiduciary duty not just to

shareholders, but to **Stakeholders**: anyone who can affect or is affected by the firm's actions.

- Employees
- Customers
- Suppliers
- Local Communities
- The Environment

Figure 8.1 illustrates the shift from a linear "Owner-Manager" model to the complex "Stakeholder Web." Importantly, stakeholder interests often conflict, and strategy requires prioritization rather than universal satisfaction.

Figure 8.1 Shareholder vs. Stakeholder Theory



Purpose-Driven Strategy & Structural Commitment

How does a firm prove it cares about stakeholders? Talk is cheap, and consumers are skeptical of marketing claims.

To create a competitive advantage through social purpose, firms often need **Structural Commitment**.

1. Authenticity as Differentiation

In a crowded market, "Purpose" can be a differentiator. Firms that authentically align their product with a social mission can tap into a higher Willingness to Pay (WTP) from values-driven consumers. Purpose-driven strategies can create advantage, but only when the mission is tightly integrated with the firm's economics and operations.

- *The Paradox of "De-marketing":* Some firms explicitly tell customers to buy *less* (e.g., "reduce, reuse") or criticize their own industry's waste. Paradoxically, this extreme honesty often builds immense brand loyalty and increases sales, as it signals that the mission is real.

2. Alternative Governance (Locking the Mission)

To escape the "Friedman pressure" of quarterly earnings, some firms adopt alternative legal structures:

- **Benefit Corporations (B-Corps):** A legal designation that requires the board of directors to consider social and environmental impacts alongside shareholder profit. It protects the CEO from being sued for "not maximizing profit."
- **Purpose Trusts / Steward Ownership:** An advanced structure where the voting shares of a company are held by a trust dedicated solely to the mission, ensuring the company can never be sold or stripped for parts.

Social Impact vs. "Greenwashing"

Because "Purpose" sells, many firms fake it. This leads to **Greenwashing**: marketing stunts designed to make the company look good without changing core operations (e.g., an airline offering "carbon offsets" while lobbying against climate regulations).

The Effective Altruism (EA) Framework

How do we know if a social impact initiative is actually effective? We can borrow a framework from **Effective Altruism** to audit a company's strategy.

Don't just ask "Is this a good cause?" Ask the rigorous questions:

1. **Scale:** How many lives are improved, and by how much? (Is the firm donating to a local museum, or eradicating malaria?)
2. **Neglectedness:** Is anyone else solving this problem? (Corporations often flock to "popular" causes like breast cancer awareness, leaving high-impact but "unsexy" causes like de-worming initiatives underfunded).
3. **Tractability:** Can we actually make progress?

The "Warm Glow" Trap:

Many firms engage in CSR that gives them a "warm glow" (feeling good) rather than maximizing impact.

- *Ineffective:* A bank organizing a "volunteer day" where highly paid bankers paint a school fence poorly. (High opportunity cost).
- *Effective:* The bank donating the bankers' hourly wages to hire professional painters, creating jobs and getting the fence painted better.

Summary

The definition of "winning" in strategy is expanding. It is no longer just WTP - Cost. It is about building a resilient firm that adds value to all stakeholders. However, strategists must remain skeptical: Are we truly creating social value through structural commitment, or are we just spending shareholder money on ineffective marketing (Greenwashing)? Social strategies that lack isolating mechanisms, structural commitment, or clear value creation are unlikely to be sustainable.

Key Terms & Definitions

- **Shareholder Primacy:** The view (Friedman) that a corporation's only social responsibility is to maximize profits for its owners within the rules of the game.
- **Stakeholder Theory:** The view that a firm should create value for all parties involved, including employees, customers, suppliers, communities, and financiers.
- **B-Corp (Benefit Corporation):** A type of for-profit corporate entity that includes positive impact on society, workers, the community, and the environment as part of its legally defined goals.
- **Greenwashing:** Marketing that falsely conveys to the public that an organization's products, goals, or policies are environmentally friendly.
- **Effective Altruism:** A philosophy and social movement that advocates using evidence and reasoning to determine the most effective ways to benefit others.
- **Warm Glow:** The personal satisfaction ("feeling good") one gets from the act of giving, which can sometimes distract from the actual effectiveness of the gift.