Strategy Analysis

Strategy analysis is an important starting point for the analysis of financial statements. Strategy analysis allows the analyst to probe the economics of a firm at a qualitative level so that the subsequent accounting and financial analysis is grounded in business reality. Strategy analysis also allows the identification of the firm’s profit drivers and key risks. This in turn enables the analyst to assess the sustainability of the firm’s current performance and make realistic forecasts of future performance.

A firm’s value is determined by its ability to earn a return on its capital in excess of the cost of capital. What determines whether or not a firm is able to accomplish this goal? While a firm’s cost of capital is determined by the capital markets, its profit potential is determined by its own strategic choices: (1) the choice of an industry or a set of industries in which the firm operates (industry choice), (2) the manner in which the firm intends to compete with other firms in its chosen industry or industries (competitive positioning), and (3) the way in which the firm expects to create and exploit synergies across the range of businesses in which it operates (corporate strategy). Strategy analysis, therefore, involves industry analysis, competitive strategy analysis, and corporate strategy analysis. In this chapter, we will briefly discuss these three steps and use the personal computer industry and Amazon.com, respectively, to illustrate the application of the steps.

INDUSTRY ANALYSIS

In analyzing a firm’s profit potential, an analyst has to first assess the profit potential of each of the industries in which the firm is competing because the profitability of various industries differs systematically and predictably over time. For example, the ratio of earnings before interest and taxes to the book value of assets for all U.S. companies between 1981 and 1997 was 8.8 percent. However, the average returns varied widely across specific industries: for the bakery products industry, the profitability ratio was 43 percentage points greater than the population average, and for the silver ore mining industry it was 23 percentage points less than the population average. What causes these profitability differences?

There is a vast body of research in industrial organization on the influence of industry structure on profitability. Relying on this research, strategy literature suggests that the average profitability of an industry is influenced by the “five forces” shown in Figure 2-1. According to this framework, the intensity of competition determines the potential for creating abnormal profits by the firms in an industry. Whether or not the potential profits are kept by the industry is determined by the relative bargaining power of the firms in the industry and their customers and suppliers. We will discuss each of these industry profit drivers in more detail below.

Degree of Actual and Potential Competition

At the most basic level, the profits in an industry are a function of the maximum price that customers are willing to pay for the industry’s product or service. One of the key determinants of the price is the degree to which there is competition among suppliers of the same or similar products. At one extreme, if there is a state of perfect competition in the industry, micro-economic theory predicts that prices will be equal to marginal cost, and there will be
few opportunities to earn supernormal profits. At the other extreme, if the industry is dominated by a single firm, there will be potential to earn monopoly profits. In reality, the degree of competition in most industries is somewhere in between perfect competition and monopoly.

There are three potential sources of competition in an industry: (1) rivalry between existing firms, (2) threat of entry of new firms, and (3) threat of substitute products or services. We will discuss each of these competitive forces in the following paragraphs.

**Competitive Force 1: Rivalry Among Existing Firms**

In most industries the average level of profitability is primarily influenced by the nature of rivalry among existing firms in the industry. In some industries firms compete aggressively, pushing prices close to (and sometimes below) the marginal cost. In other industries firms do not compete aggressively on price. Instead, they find ways to coordinate their pricing, or compete on nonprice dimensions such as innovation or brand image. Several factors determine the intensity of competition between existing players in an industry:
Industry Growth Rate  If an industry is growing very rapidly, incumbent firms need not grab market share from each other to grow. In contrast, in stagnant industries the only way existing firms can grow is by taking share away from the other players. In this situation one can expect price wars among firms in the industry.

Concentration and Balance of Competitors  The number of firms in an industry and their relative sizes determine the degree of concentration in an industry. The degree of concentration influences the extent to which firms in an industry can coordinate their pricing and other competitive moves. For example, if there is one dominant firm in an industry (such as IBM in the mainframe computer industry in the 1970s), it can set and enforce the rules of competition. Similarly, if there are only two or three equal-sized players (such as Coke and Pepsi in the U.S. soft-drink industry), they can implicitly cooperate with each other to avoid destructive price competition. If an industry is fragmented, price competition is likely to be severe.

Degree of Differentiation and Switching Costs  The extent to which firms in an industry can avoid head-on competition depends on the extent to which they can differentiate their products and services. If the products in an industry are very similar, customers are ready to switch from one competitor to another purely on the basis of price. Switching costs also determine customers' propensity to move from one product to another. When switching costs are low, there is a greater incentive for firms in an industry to engage in price competition.

Scale/Learning Economies and the Ratio of Fixed to Variable Costs  If there is a steep learning curve or there are other types of scale economies in an industry, size becomes an important factor for firms in the industry. In such situations, there are incentives to engage in aggressive competition for market share. Similarly, if the ratio of fixed to variable costs is high, firms have an incentive to reduce prices to utilize installed capacity. The airline industry, where price wars are quite common, is an example of this type of situation.

Excess Capacity and Exit Barriers  If capacity in an industry is larger than customer demand, there is a strong incentive for firms to cut prices to fill capacity. The problem of excess capacity is likely to be exacerbated if there are significant barriers for firms to exit the industry. Exit barriers are high when the assets are specialized or if there are regulations which make exit costly.

Competitive Force 2: Threat of New Entrants
The potential for earning abnormal profits will attract new entrants to an industry. The very threat of new firms entering an industry potentially constrains the pricing of existing firms within it. Therefore the ease with which new firms can enter an industry is a key determinant of its profitability. Several factors determine the height of barriers to entry in an industry:

Economies of Scale  When there are large economies of scale, new entrants face the choice of having either to invest in a large capacity which might not be utilized right away or to enter with less than the optimum capacity. Either way, new entrants will at least initially suffer from a cost disadvantage in competing with existing firms. Economies of scale might arise from large investments in research and development (the pharmaceutical or jet engine industries), in brand advertising (soft-drink industry), or in physical plant and equipment (telecommunications industry).

First Mover Advantage  Early entrants in an industry may deter future entrants if there are first mover advantages. For example, first movers might be able to set industry
standards, or enter into exclusive arrangements with suppliers of cheap raw materials. They may also acquire scarce government licenses to operate in regulated industries. Finally, if there are learning economies, early firms will have an absolute cost advantage over new entrants. First mover advantages are also likely to be large when there are significant switching costs for customers once they start using existing products. For example, switching costs faced by the users of Microsoft's DOS operating system make it difficult for software companies to market a new operating system.

**Access to Channels of Distribution and Relationships** Limited capacity in the existing distribution channels and high costs of developing new channels can act as powerful barriers to entry. For example, a new entrant into the domestic auto industry in the U.S. is likely to face formidable barriers because of the difficulty of developing a dealer network. Similarly, new consumer goods manufacturers find it difficult to obtain supermarket shelf space for their products. Existing relationships between firms and customers in an industry also make it difficult for new firms to enter an industry. Industry examples of this include auditing, investment banking, and advertising.

**Legal Barriers** There are many industries in which legal barriers such as patents and copyrights in research-intensive industries limit entry. Similarly, licensing regulations limit entry into taxi services, medical services, broadcasting, and telecommunications industries.

**Competitive Force 3: Threat of Substitute Products**

The third dimension of competition in an industry is the threat of substitute products or services. Relevant substitutes are not necessarily those that have the same form as the existing products but those that perform the same function. For example, airlines and car rental services might be substitutes for each other when it comes to travel over short distances. Similarly, plastic bottles and metal cans substitute for each other as packaging in the beverage industry. In some cases, threat of substitution comes not from customers' switching to another product but from utilizing technologies that allow them to do without, or use less of, the existing products. For example, energy-conserving technologies allow customers to reduce their consumption of electricity and fossil fuels.

The threat of substitutes depends on the relative price and performance of the competing products or services and on customers' willingness to substitute. Customers' perception of whether two products are substitutes depends to some extent on whether they perform the same function for a similar price. If two products perform an identical function, then it would be difficult for them to differ from each other in price. However, customers' willingness to switch is often the critical factor in making this competitive dynamic work. For example, even when tap water and bottled water serve the same function, many customers may be unwilling to substitute the former for the latter, enabling bottlers to charge a price premium. Similarly, designer label clothing commands a price premium even if it is not superior in terms of basic functionality because customers place a value on the image offered by designer labels.

While the degree of competition in an industry determines whether there is potential to earn abnormal profits, the actual profits are influenced by the industry's bargaining power with its suppliers and customers. On the input side, firms enter into transactions with suppliers of labor, raw materials and components, and finances. On the output side, firms either sell directly to the final customers or enter into contracts with intermediaries in the distribution chain. In all these transactions, the relative economic power of the two sides is important to the overall profitability of the industry firms.
Competitive Force 4: Bargaining Power of Buyers
Two factors determine the power of buyers: price sensitivity and relative bargaining power. Price sensitivity determines the extent to which buyers care to bargain on price; relative bargaining power determines the extent to which they will succeed in forcing the price down.6

Price Sensitivity Buyers are more price sensitive when the product is undifferentiated and there are few switching costs. The sensitivity of buyers to price also depends on the importance of the product to their own cost structure. When the product represents a large fraction of the buyers' cost (for example, the packaging material for soft-drink producers), the buyer is likely to expend the resources necessary to shop for a lower cost alternative. In contrast, if the product is a small fraction of the buyers' cost (for example, windshield wipers for automobile manufacturers), it may not pay to expend resources to search for lower-cost alternatives. Further, the importance of the product to the buyers' own product quality also determines whether or not price becomes the most important determinant of the buying decision.

Relative Bargaining Power Even if buyers are price sensitive, they may not be able to achieve low prices unless they have a strong bargaining position. Relative bargaining power in a transaction depends, ultimately, on the cost to each party of not doing business with the other party. The buyers' bargaining power is determined by the number of buyers relative to the number of suppliers, volume of purchases by a single buyer, number of alternative products available to the buyer, buyers' costs of switching from one product to another, and the threat of backward integration by the buyers. For example, in the automobile industry, car manufacturers have considerable power over component manufacturers because auto companies are large buyers with several alternative suppliers to choose from, and switching costs are relatively low. In contrast, in the personal computer industry, computer makers have low bargaining power relative to the operating system software producers because of high switching costs.

Competitive Force 5: Bargaining Power of Suppliers
The analysis of the relative power of suppliers is a mirror image of the analysis of the buyer's power in an industry. Suppliers are powerful when there are only a few companies and few substitutes available to their customers. For example, in the soft-drink industry, Coke and Pepsi are very powerful relative to the bottlers. In contrast, metal can suppliers to the soft drink industry are not very powerful because of intense competition among can producers and the threat of substitution of cans by plastic bottles. Suppliers also have a lot of power over buyers when the suppliers' product or service is critical to buyers' business. For example, airline pilots have a strong bargaining power in the airline industry. Suppliers also tend to be powerful when they pose a credible threat of forward integration. For example, IBM is powerful relative to mainframe computer leasing companies because of its unique position as a mainframe supplier and its own presence in the computer leasing business.

APPLYING INDUSTRY ANALYSIS: THE PERSONAL COMPUTER INDUSTRY

Let us consider the above concepts of industry analysis in the context of the personal computer (PC) industry.7 The industry began in 1981 when IBM announced its PC with Intel's microprocessor and Microsoft's DOS operating system. By now personal computers are ubiquitous—over 136 million units were shipped worldwide in 2002 alone. Despite the spectacular growth in the sales volume in this industry, however, it was characterized by
low profitability. Even the largest companies in the industry, such as IBM, Compaq, Dell, and Apple, reported poor performance in the early 1990s and were forced to undergo internal restructuring. What accounted for this low profitability? What was the computer industry’s future profit potential?

### Competition in the Personal Computer Industry

The competition was very intense for a number of reasons:

- The industry was fragmented, with many firms producing virtually identical products. Even though the computer market became more concentrated in the 1990s, with the top five vendors controlling close to 60 percent of the market, competition was intense, leading to routine price cuts on a monthly basis.
- Component costs accounted for more than 60 percent of total hardware costs of a personal computer, and volume purchases of components reduced these costs. Therefore there was intense competition for market share among competing manufacturers.
- Products produced by different firms in the industry were virtually identical, and there were few opportunities to differentiate the products. While brand name and service were dimensions that customers valued in the early years of the industry, they became less important as PC buyers became more informed about the technology.
- Switching costs across different brands of personal computers were relatively low because a vast majority of the personal computers used Intel microprocessors and Microsoft Windows operating systems.
- Access to distribution was not a significant barrier, as demonstrated by Dell Computers, which distributed its computers by direct mail through the 1980s and introduced Internet-based sales in the mid-1990s. The advent of computer superstores like CompUSA also mitigated this constraint, since these stores were willing to carry several brands.
- Since virtually all the components needed to produce a personal computer were available for purchase, there were very few barriers to entering the industry. In fact, Michael Dell started Dell Computer Company in the early 1980s by assembling PCs in his University of Texas dormitory room.
- Apple’s Macintosh computers offered competition as a substitute product. Workstations produced by Sun and other vendors were also potential substitutes at the higher end of the personal computer market.

### The Power of Suppliers and Buyers

Suppliers and buyers had significant power over firms in the industry for these reasons:

- Key hardware and software components for personal computers were controlled by firms with virtual monopoly. Intel dominated the microprocessor production for the personal computer industry, and Microsoft controlled the operating system market with its DOS and Windows operating systems.
- Buyers gained more power during the ten years from 1983 to 1993. Corporate buyers, who represented a significant portion of the customer base, were highly price sensitive since the expenditure on PCs represented a significant cost to their operations. Further, as they became knowledgeable about personal computer technology, customers were less influenced by brand name in their purchase decision. Buyers increasingly viewed PCs as commodities and used price as the most important consideration in their buying decision.
As a result of the intense rivalry and low barriers to entry in the personal computer industry, there was severe price competition among different manufacturers. Further, there was tremendous pressure on firms to spend large sums of money to introduce new products rapidly, maintain high quality, and provide excellent customer support. Both these factors led to a low profit potential in the industry. The power of suppliers and buyers reduced the profit potential further. Thus, while the personal computer industry represented a technologically dynamic industry, its profit potential was poor.

There were few indications of change in the basic structure of the personal computer industry, and there was little likelihood of viable competition emerging to challenge the domination of Microsoft and Intel in the input markets. Attempts by industry leaders like IBM to create alternative proprietary technologies have not succeeded. As a result, the profitability of the PC industry may not improve significantly any time in the near future.

Limitations of Industry Analysis

A potential limitation of the industry analysis framework discussed in this chapter is the assumption that industries have clear boundaries. In reality, it is often not easy to clearly demarcate industry boundaries. For example, in analyzing Dell’s industry, should one focus on the IBM-compatible personal computer industry or the personal computer industry as a whole? Should one include workstations in the industry definition? Should one consider only the domestic manufacturers of personal computers or also manufacturers abroad? Inappropriate industry definition will result in incomplete analysis and inaccurate forecasts.

COMPETITIVE STRATEGY ANALYSIS

The profitability of a firm is influenced not only by its industry structure but also by the strategic choices it makes in positioning itself in the industry. While there are many ways to characterize a firm’s business strategy, as Figure 2-2 shows, there are two generic competitive strategies: (1) cost leadership and (2) differentiation. Both these strategies can potentially allow a firm to build a sustainable competitive advantage. Strategy researchers have traditionally viewed cost leadership and differentiation as mutually exclusive strategies. Firms that straddle the two strategies are considered to be “stuck in the middle” and are expected to earn low profitability. These firms run the risk of not being able to attract price conscious customers because their costs are too high; they are also unable to provide adequate differentiation to attract premium price customers.

Sources of Competitive Advantage

Cost leadership enables a firm to supply the same product or service offered by its competitors at a lower cost. Differentiation strategy involves providing a product or service that is distinct in some important respect valued by the customer. As an example in retailing, Nordstrom has succeeded on the basis of differentiation by emphasizing exceptionally high customer service. In contrast, Filene’s Basement stores is a discount retailer competing purely on a low-cost basis.

Competitive Strategy 1: Cost Leadership

Cost leadership is often the clearest way to achieve competitive advantage. In industries where the basic product or service is a commodity, cost leadership might be the only way to achieve superior performance. There are many ways to achieve cost leadership, including
Figure 2-2 Strategies for Creating Competitive Advantage

**Cost Leadership**
- Supply same product or service at a lower cost.
- Economies of scale and scope
- Efficient production
- Simpler product designs
- Lower input costs
- Low-cost distribution
- Little research and development or brand advertising
- Tight cost control system

**Differentiation**
- Supply a unique product or service at a cost lower than the price premium customers will pay.
- Superior product quality
- Superior product variety
- Superior customer service
- More flexible delivery
- Investment in brand image
- Investment in research and development
- Control system focus on creativity and innovation

**Competitive Advantage**
- Match between firm's core competencies and key success factors to execute strategy
- Match between firm's value chain and activities required to execute strategy
- Sustainability of competitive advantage

economies of scale and scope, economies of learning, efficient production, simpler product design, lower input costs, and efficient organizational processes. If a firm can achieve cost leadership, then it will be able to earn above-average profitability by merely charging the same price as its rivals. Conversely, a cost leader can force its competitors to cut prices and accept lower returns, or to exit the industry.

Firms that achieve cost leadership focus on tight cost controls. They make investments in efficient scale plants, focus on product designs that reduce manufacturing costs, minimize overhead costs, make little investment in risky research and development, and avoid serving marginal customers. They have organizational structures and control systems that focus on cost control.

**Competitive Strategy 2: Differentiation**
A firm following the differentiation strategy seeks to be unique in its industry along some dimension that is highly valued by customers. For differentiation to be successful, the firm has to accomplish three things. First, it needs to identify one or more attributes of a product or service that customers value. Second, it has to position itself to meet the chosen customer need in a unique manner. Finally, the firm has to achieve differentiation at a cost that is lower than the price the customer is willing to pay for the differentiated product or service.

Drivers of differentiation include providing superior intrinsic value via product quality, product variety, bundled services, or delivery timing. Differentiation can also be achieved by investing in signals of value such as brand image, product appearance, or reputation. Differentiated strategies require investments in research and development, engineering skills, and marketing capabilities. The organizational structures and control systems in firms with differentiation strategies need to foster creativity and innovation.
While successful firms choose between cost leadership and differentiation, they cannot completely ignore the dimension on which they are not primarily competing. Firms that target differentiation still need to focus on costs so that the differentiation can be achieved at an acceptable cost. Similarly, cost leaders cannot compete unless they achieve at least a minimum level on key dimensions on which competitors might differentiate, such as quality and service.

Achieving and Sustaining Competitive Advantage

The choice of competitive strategy does not automatically lead to the achievement of competitive advantage. To achieve competitive advantage, the firm has to have the capabilities needed to implement and sustain the chosen strategy. Both cost leadership and differentiation strategy require that the firm make the necessary commitments to acquire the core competencies needed, and structure its value chain in an appropriate way. Core competencies are the economic assets that the firm possesses, whereas the value chain is the set of activities that the firm performs to convert inputs into outputs. The uniqueness of a firm’s core competencies and its value chain and the extent to which it is difficult for competitors to imitate them determines the sustainability of a firm’s competitive advantage.11

To evaluate whether a firm is likely to achieve its intended competitive advantage, the analyst should ask the following questions:

- What are the key success factors and risks associated with the firm’s chosen competitive strategy?
- Does the firm currently have the resources and capabilities to deal with the key success factors and risks?
- Has the firm made irreversible commitments to bridge the gap between its current capabilities and the requirements to achieve its competitive advantage?
- Has the firm structured its activities (such as research and development, design, manufacturing, marketing and distribution, and support activities) in a way that is consistent with its competitive strategy?
- Is the company’s competitive advantage sustainable? Are there any barriers that make imitation of the firm’s strategy difficult?
- Are there any potential changes in the firm’s industry structure (such as new technologies, foreign competition, changes in regulations, changes in customer requirements) that might dissipate the firm’s competitive advantage? Is the company flexible enough to address these changes?

Applying Competitive Strategy Analysis

Let us consider the concepts of competitive strategy analysis in the context of Dell Computer Corporation. In 1998 Round Rock, Texas-based Dell Computer was the fourth largest computer maker, behind IBM, Hewlett-Packard, and Compaq. The company, founded by Michael Dell in his University of Texas dorm room, started selling “IBM clone” personal computers in 1984. From the beginning Dell sold its machines directly to end users rather than through retail outlets, at a significantly lower price than its competitors.

After rapid growth and some management hiccups, Dell firmly established itself in the personal computer industry by following a low-cost strategy. For the fiscal year ending January 31, 2003, Dell achieved $35.4 billion in revenues and $2.12 billion in net income. Dell’s growth rates over the previous three years were extraordinary. Dell’s stellar performance made it one of the most profitable personal computer makers in a highly competitive industry. How did Dell achieve such performance?
Dell’s superior performance was based on a low-cost competitive strategy that consisted of the following key elements:

- **Direct selling.** Dell sold most of its computers directly to its customers, thus saving on retail markups. As computer users become sophisticated, and as computers become standardized on the Windows-Intel platform, the value of distribution through retailers declines. Dell was the first company to capitalize on this trend. In 1996 Dell began selling computers through its Internet web site. By 2003 the company was generating a very significant amount of its sales through on-line orders.

- **Made-to-order manufacturing.** Dell developed a system of flexible manufacturing that allowed the company to assemble and ship computers very quickly, usually within five days of receiving an order. This allowed the company to avoid large inventories of parts and assembled computers. Low inventories allowed Dell to save on working capital costs, it also reduced costly write-offs of obsolete inventories, a significant risk in the fast-changing computer industry.

- **Third-party service.** Dell used two low-cost approaches to after-sales service: telephone-based service and third-party maintenance service. Dell had several hundred technical support representatives accessible to customers by phone any time of the day. Using a comprehensive electronic maintenance system, the service representatives could diagnose problems and help customers to resolve them in the vast majority of cases. In the rare instance where on-site maintenance was required, Dell used third-party maintenance contracts with office equipment companies such as Xerox. Through this service strategy, Dell was able to avoid investing in an expensive field service network without compromising on service quality.

- **Low accounts receivable.** Dell was able to reduce its accounts receivable days to an industry minimum by encouraging its customers to pay by credit card at the time of the purchase or through electronic payment immediately after the purchase.

- **Focused investment in R&D.** Dell recognized that most of the basic innovations in the personal computer industry were led by the component suppliers and software producers. For example, two key suppliers, Intel and Microsoft, invested billions of dollars in developing new generation processors and software, respectively. Dell’s innovations were primarily in creating a low-cost, high velocity organization that can respond quickly to these changes. By focusing its R&D innovations, Dell was able to minimize these costs and get high return on its investments.

As a result of the above strategy, Dell achieved a significant cost advantage over its competitors in the personal computer industry. This advantage resulted in a consistent pattern of rapid growth, increasing market share, and very high profitability in an industry that is characterized by rapid technological changes, significant supplier and buyer power, and intense competition. Further, because the strategy involved activities that are highly interrelated and involved continuous organizational innovations, Dell’s business model was difficult to replicate, making its competitive advantage sustainable. In fact, Dell’s success inspired several of its competitors, including Compaq and IBM, to attempt to replicate parts of its strategy. However, no competitor to date has been able to replicate Dell’s business model. The extraordinarily high earnings and book value multiples at which Dell’s stock has been trading in recent years is evidence that investors are betting that Dell’s competitive advantage and its superior profit performance is likely to be sustained for the foreseeable future.
CORPORATE STRATEGY ANALYSIS

So far in this chapter we have focused on the strategies at the individual business level. While some companies focus on only one business, many companies operate in multiple businesses. For example, the average number of business segments operated by the top 500 U.S. companies in 1992 is eleven industries. In recent years, there has been an attempt by U.S. companies to reduce the diversity of their operations and focus on a relatively few "core" businesses. However, multibusiness organizations continue to dominate the economic activity in most countries in the world.

When analyzing a multibusiness organization, an analyst has to not only evaluate the industries and strategies of the individual business units but also the economic consequences—either positive or negative—of managing all the different businesses under one corporate umbrella. For example, General Electric has been very successful in creating significant value by managing a highly diversified set of businesses ranging from aircraft engines to light bulbs, but Sears has not been very successful in managing retailing together with financial services.

Sources of Value Creation at the Corporate Level

Economists and strategy researchers have identified several factors that influence an organization’s ability to create value through a broad corporate scope. Economic theory suggests that the optimal activity scope of a firm depends on the relative transaction cost of performing a set of activities inside the firm versus using the market mechanism. Transaction cost economics implies that the multiproduct firm is an efficient choice of organizational form when coordination among independent, focused firms is costly due to market transaction costs.

Transaction costs can arise out of several sources. They may arise if the production process involves specialized assets such as human capital skills, proprietary technology, or other organizational know-how that is not easily available in the marketplace. Transaction costs also may arise from market imperfections such as information and incentive problems. If buyers and sellers cannot solve these problems through standard mechanisms such as enforceable contracts, it will be costly to conduct transactions through market mechanisms.

For example, as discussed in Chapter 1, public capital markets may not work well when there are significant information and incentive problems, making it difficult for entrepreneurs to raise capital from investors. Similarly, if buyers cannot ascertain the quality of products being sold because of lack of information, or cannot enforce warranties because of poor legal infrastructure, entrepreneurs will find it difficult to break into new markets. Finally, if employers cannot assess the quality of applicants for new positions, they will have to rely more on internal promotions rather than external recruiting to fill higher positions in an organization. Emerging economies often suffer from these types of transaction costs because of poorly developed intermediation infrastructure. Even in many advanced economies, examples of high transaction costs can be found. For example, in many countries other than the U.S., the venture capital industry is not highly developed, making it costly for new businesses in high technology industries to attract financing. Even in the U.S., transaction costs may vary across economic sectors. For example, until recently electronic commerce was hampered by consumer concerns regarding the security of credit card information sent over the Internet.

Transactions inside an organization may be less costly than market-based transactions for several reasons. First, communication costs inside an organization are reduced because
confidentiality can be protected and credibility can be assured through internal mechanisms. Second, the headquarters office can play a critical role in reducing costs of enforcing agreements between organizational subunits. Third, organizational subunits can share valuable nontradable assets (such as organizational skills, systems, and processes) or non-divisible assets (such as brand names, distribution channels, and reputation).

There are also forces that increase transaction costs inside organizations. Top management of an organization may lack the specialized information and skills necessary to manage businesses across several different industries. This lack of expertise reduces the possibility of actually realizing economies of scope, even when there is potential for such economies. This problem can be remedied by creating a decentralized organization, hiring specialist managers to run each business unit, and providing these managers with proper incentives. However, decentralization will also potentially decrease goal congruence among subunit managers, making it difficult to realize economies of scope.

Whether or not a multibusiness organization creates more value than a comparable collection of focused firms is, therefore, context dependent. Analysts should ask the following questions to assess whether an organization's corporate strategy has the potential to create value:

- Are there significant imperfections in the product, labor, or financial markets in the industries (or countries) in which a company is operating? Is it likely that transaction costs in these markets are higher than the costs of similar activities inside a well-managed organization?
- Does the organization have special resources such as brand names, proprietary know-how, access to scarce distribution channels, and special organizational processes that have the potential to create economies of scope?
- Is there a good fit between the company’s specialized resources and the portfolio of businesses in which the company is operating?
- Does the company allocate decision rights between the headquarters office and the business units optimally to realize all the potential economies of scope?
- Does the company have internal measurement, information, and incentive systems to reduce agency costs and increase coordination across business units?

Empirical evidence suggests that creating value through a multibusiness corporate strategy is hard in practice. Several researchers have documented that diversified U.S. companies trade at a discount in the stock market relative to a comparable portfolio of focused companies. Studies also show that acquisitions of one company by another, especially when the two are in unrelated businesses, often fail to create value for the acquiring companies. Finally, there is considerable evidence that value is created when multibusiness companies increase corporate focus through divisional spinoffs and asset sales.

There are several potential explanations for the above diversification discount. First, managers' decisions to diversify and expand are frequently driven by a desire to maximize the size of their organization rather than to maximize shareholder value. Second, diversified companies often suffer from incentive misalignment problems leading to suboptimal investment decisions and poor operating performance. Third, capital markets find it difficult to monitor and value multibusiness organizations because of inadequate disclosure about the performance of individual business segments.

In summary, while companies can theoretically create value through innovative corporate strategies, there are many ways in which this potential fails to get realized in practice. Therefore, it pays to be skeptical when evaluating companies' corporate strategies.
Applying Corporate Strategy Analysis

Let us apply the concepts of corporate strategy analysis to Amazon.com, a pioneer in electronic commerce. Amazon started operations as an online bookseller in 1995 and went public in 1997 with a market capitalization of $561 million dollars. The company grew rapidly and began to pose a serious threat to the dominance of leading chain store booksellers like Barnes & Noble. Investors rewarded Amazon by increasing its market capitalization to a remarkable $36 billion dollars by April 1999.

Flush with his success in online book selling, Jeff Bezos, the founder and chief executive officer of Amazon, moved the company into many other areas of electronic commerce. Amazon claimed that its brand, its loyal customer base, and its ability to execute electronic commerce were valuable assets that can be exploited in a number of other online business areas. Through a series of acquisitions beginning in 1998, Amazon expanded into online selling of CDs, videos, gifts, prescription drugs, pet supplies, and groceries. In April 1999 Amazon announced plans to diversify into the online auction business by acquiring LiveBid.com. Bezos explained, “We are not a book company. We’re not a music company. We’re not a video company. We’re not an auctions company. We’re a customer company.”

Amazon’s rapid expansion attracted controversy among the investment community. Some analysts argued that Amazon could create value through its broad corporate focus for the following reasons:

- Amazon has established a valuable brand name on the Internet. Given that electronic commerce is a relatively new phenomenon, customers are likely to rely on well known brands to reduce the risk of a bad shopping experience. Amazon’s expansion strategy is sensible because it exploits this valuable resource.
- Amazon has been able to acquire critical expertise in flawless execution of electronic retailing. This is a general competency that can be exploited in many areas of electronic retailing.
- Amazon has been able to create a tremendous amount of loyalty among its customers through superior marketing and execution. As a result, a very high proportion of Amazon’s sales comes from repeat purchases by its customers. Amazon’s strategy exploits this valuable customer base.

There were also some skeptics who believed that Amazon was expanding too rapidly and that its diversification beyond book retailing was likely to fail. These skeptics questioned the value of Amazon’s brand name. They argued that traditional retailers such as Barnes & Noble, Wal-Mart, and CVS, who are boosting their online efforts, also have valuable brand names, execution capabilities, and customer loyalty. Therefore these companies are likely to offer formidable competition to Amazon’s individual business lines. Amazon’s critics also pointed out that expanding rapidly into so many different areas is likely to confuse customers, dilute Amazon’s brand value, and increase the chance of poor execution. Commenting on the fact that Amazon is losing money in all of its businesses while it is expanding rapidly, Barron’s business weekly stated, “Increasingly, Amazon’s strategy is looking like the dim-bulb businessman who loses money on every sale but tries to make it up by making more sales.”

Investor concerns about Amazon’s corporate strategy began to affect its share price, which dropped from a high of $221 dollars in April 1999 to $118 dollars by the end of May 1999. Still, at a total market capitalization of about $19 billion dollars, many investors are betting that Amazon’s corporate strategy is likely to yield rich dividends in the future.
An interesting question to examine is whether there are systematic reasons to believe that a company such as Amazon can succeed in pursuing a wide focus because its business model—on-line selling—somehow allows it to manage this diversity in a fundamentally different manner than a traditional retailer would be able to. Amazon’s change in stock market fortunes from year 2000 on suggests that investors were reassessing in this respect. In response, Amazon’s management was also making a series of changes in its business to make the company more cost-efficient, even though in 2003 the company was still in a wide range of product lines.

**SUMMARY**

Strategy analysis is an important starting point for the analysis of financial statements because it allows the analyst to probe the economics of the firm at a qualitative level. Strategy analysis also allows the identification of the firm’s profit drivers and key risks, enabling the analyst to assess the sustainability of the firm’s performance and make realistic forecasts of future performance.

Whether a firm is able to earn a return on its capital in excess of its cost of capital is determined by its own strategic choices: (1) the choice of an industry or a set of industries in which the firm operates (industry choice), (2) the manner in which the firm intends to compete with other firms in its chosen industry or industries (competitive positioning), and (3) the way in which the firm expects to create and exploit synergies across the range of businesses in which it operates (corporate strategy). Strategy analysis involves analyzing all three choices.

Industry analysis consists of identifying the economic factors which drive the industry profitability. In general, an industry’s average profit potential is influenced by the degree of rivalry among existing competitors, the ease with which new firms can enter the industry, the availability of substitute products, the power of buyers, and the power of suppliers. To perform industry analysis, the analyst has to assess the current strength of each of these forces in an industry and make forecasts of any likely future changes.

Competitive strategy analysis involves identifying the basis on which the firm intends to compete in its industry. In general, there are two potential strategies that could provide a firm with a competitive advantage: cost leadership and differentiation. Cost leadership involves offering at a lower cost the same product or service that other firms offer. Differentiation involves satisfying a chosen dimension of customer need better than the competition, at an incremental cost that is less than the price premium that customers are willing to pay. To perform strategy analysis, the analyst has to identify the firm’s intended strategy, assess whether the firm possesses the competencies required to execute the strategy, and recognize the key risks that the firm has to guard against. The analyst also has to evaluate the sustainability of the firm’s strategy.

Corporate strategy analysis involves examining whether a company is able to create value by being in multiple businesses at the same time. A well-crafted corporate strategy reduces costs or increases revenues from running several businesses in one firm relative to the same businesses operating independently and transacting with each other in the marketplace. These cost savings or revenue increases come from specialized resources that the firm has to exploit synergies across these businesses. For these resources to be valuable, they must be nontradable, not easily imitated by competition, and nondivisible. Even when a firm has such resources, it can create value through a multibusiness organization only when it is managed so that the information and agency costs inside the organization are smaller than the market transaction costs.
The insights gained from strategy analysis can be useful in performing the remainder of the financial statement analysis. In accounting analysis the analyst can examine whether a firm’s accounting policies and estimates are consistent with its stated strategy. For example, a firm’s choice of functional currency in accounting for its international operations should be consistent with the level of integration between domestic and international operations that the business strategy calls for. Similarly, a firm that mainly sells housing to low-income customers should have higher than average bad debts expenses.

Strategy analysis is also useful in guiding financial analysis. For example, in a cross-sectional analysis the analyst should expect firms with cost leadership strategy to have lower gross margins and higher asset turnover than firms that follow differentiated strategies. In a time series analysis, the analyst should closely monitor any increases in expense ratios and asset turnover ratios for low-cost firms, and any decreases in investments critical to differentiation for firms that follow differentiation strategy.

Business strategy analysis also helps in prospective analysis and valuation. First, it allows the analyst to assess whether, and for how long, differences between the firm’s performance and its industry (or industries) performance are likely to persist. Second, strategy analysis facilitates forecasting investment outlays the firm has to make to maintain its competitive advantage.

**DISCUSSION QUESTIONS**

1. Judith, an accounting major, states, “Strategy analysis seems to be an unnecessary detour in doing financial statement analysis. Why can’t we just get straight to the accounting issues?” Explain to Judith why she might be wrong?

2. What are the critical drivers of industry profitability?

3. One of the fastest growing industries in the last twenty years is the memory chip industry, which supplies memory chips for personal computers and other electronic devices. Yet the average profitability for this industry has been very low. Using the industry analysis framework, list all the potential factors that might explain this apparent contradiction.

4. Rate the pharmaceutical and lumber industries as high, medium, or low on the following dimensions of industry structure:

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Given your ratings, which industry would you expect to earn the highest returns?