GIOVANNA CAMPOPIANO
Associate Professor of Strategic Management
University of Bergamo

STRATEGIC MANAGEMENT IN THE DIGITAL ECONOMY

Purpose and Industry Analysis

Premise: What is the ultimate goal of a business?

“Profits are to business as breathing is to life. Breathing is essential to life, but is not the purpose for living. Similarly, **profits are essential for the existence of the corporation, but they are not the reason for its existence**.”

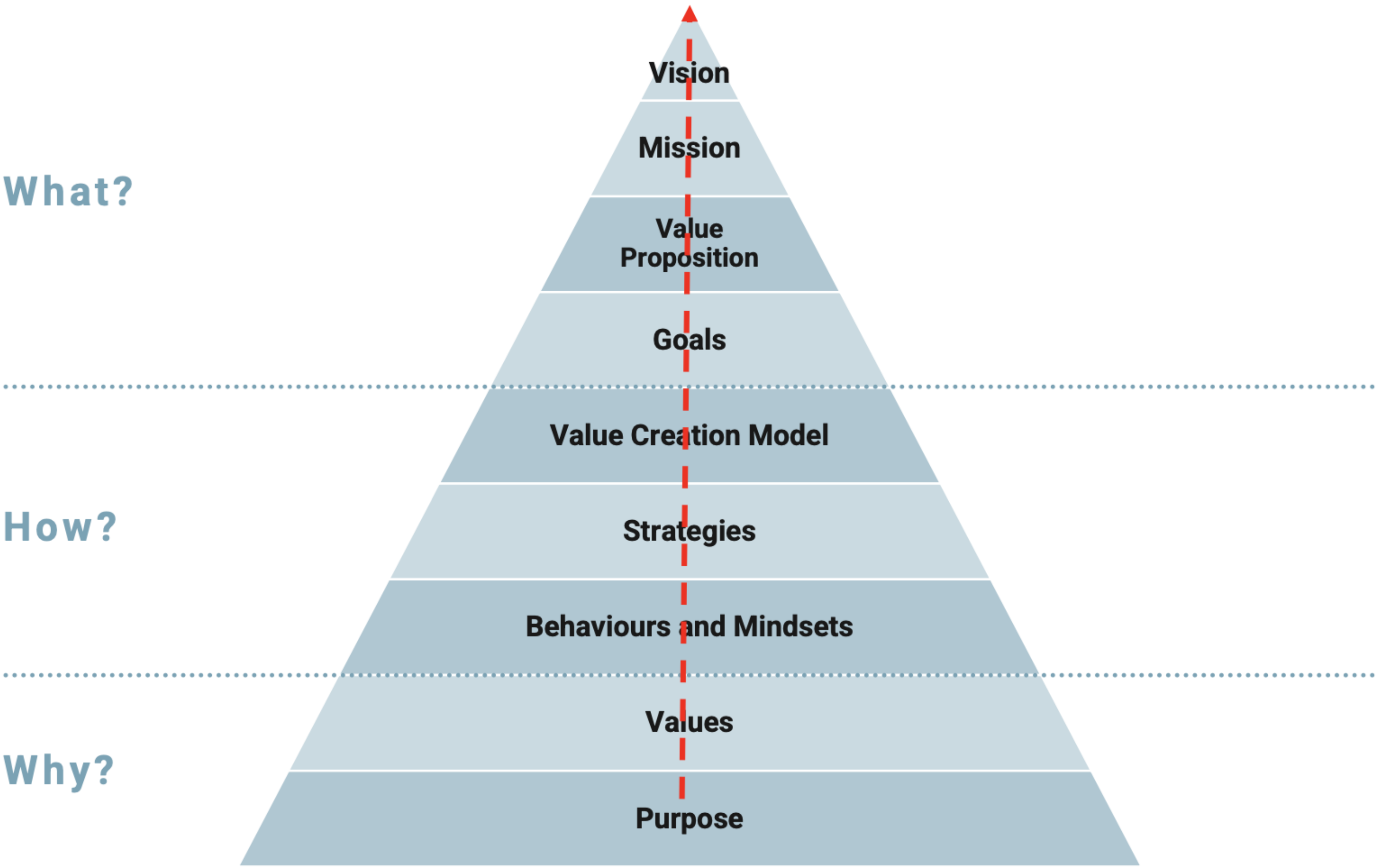
DENNIS BAKKE, FOUNDER AND FORMER CEO, AES CORPORATION

Purpose

- A business purpose is a feature of established companies as well as entrepreneurial start-ups: Cynthia Montgomery argues that "forging a compelling **organizational purpose**" is the ongoing job of company leaders and the "crowning **responsibility of the CEO**." (see video in Moodle)

- Organizational purpose is articulated in companies' **mission statements**:
  - Twitter's mission is "To give everyone the power to create and share ideas and information instantly, without barriers."
  - Nike's mission is "To bring inspiration and innovation to every athlete* in the world. (*If you have a body, you are an athlete.)"
  - The Lego Group's mission is "To inspire and develop the builders of tomorrow."

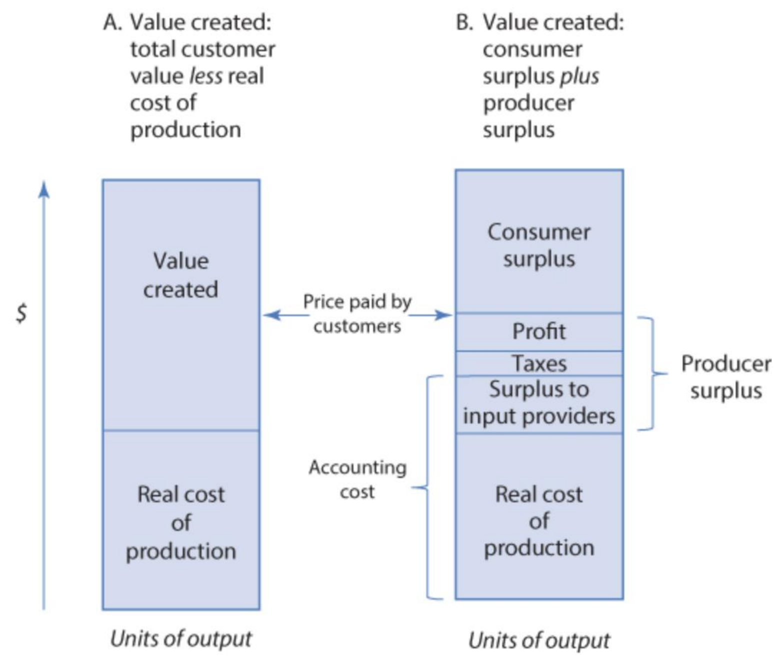
Purpose



What?
How?
Why?
Vision
Mission
Value Proposition
Goals
Value Creation Model
Strategies
Behaviours and Mindsets
Values
Purpose

Value Creation

- Within the multiplicity of organizational aims, there is a common denominator: **the desire, and the need, to create value**.
- Value is the monetary **worth of a product or asset**.
- The purpose of business is to create value for customers. However, if the firm is to survive and prosper, it is essential that it is **able to appropriate some of this customer value in the form of profit**.



Grant (2019)

Value for Whom?

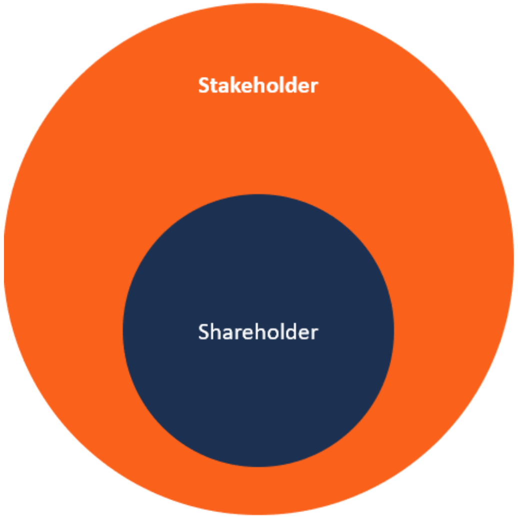
- Shareholders versus Stakeholders.
  The value created by firms is distributed among **different parties**:
  - customers receive consumer surplus,
  - owners receive profits,
  - government receives taxes, and
  - employees and the owners of other factors of production receive remuneration in excess of the minimum needed for them to supply their inputs.

- So, whose interests should the firm consider when considering which component of value to pursue?

Value for Whom?

- **Stakeholder value maximization**. Stakeholder theory proposes that the firm should **operate in the interests of all its constituent groups** (including society as a whole), which implies that the goal of the firm should be to **maximize total value creation** (i.e., the sum of consumer and producer surplus, including external benefits to society as well)

- **Shareholder value maximization**. Shareholder capitalism is based upon two principles, first, that firms should **operate in the interests of their owners** (who wish to earn profit); second, that the effectiveness of the market economy is dependent upon firms responding **to profit incentives** (the so-called "invisible hand").



Stakeholders are those that hold a stake in a given company (and are affected by its activities)

Shareholders hold units of shares in a company

All shareholders are stakeholders,
but not all stakeholders are shareholders

How to manage multiple stakeholders' claims?

In practice the stakeholder approach encounters **two serious difficult**ies:

- **Measuring performance**. Pursuing stakeholder interests means maximizing total value creation and ensuring its equitable distribution among stakeholders. In practice, **estimating the components of value creation**—consumer surplus, producer surplus, and social externalities—**is nearly impossible**. Alternatively, it may be possible to **establish distinct goals for each stakeholder** group, but establishing **tradeoffs** among them is exceptionally difficult. As Michael Jensen observes: "*multiple objectives is no objective*."

- **Corporate governance**. If top management is to pursue and balance the interests of different stakeholders, **how can management's performance be assessed and by whom**? Must boards of directors comprise the representatives of every stakeholder group? The resulting conflicts, wrangling, and vagueness around performance objectives would make it easy for top management to substitute its own interests for those of stakeholders.

Primary goals

- The primary goal of strategy is to **maximize the value of the enterprise** through seeking to maximize profits over the long term.

- Having extolled the virtues of business enterprises as creative institutions, how can we rationalize this unedifying focus on **money-making**?
  - **Competition**: Competition erodes profitability. To survive a firm must, over the long term, earn a rate of profit that covers its cost of capital.

  - **Threat of acquisition**: Management teams that fail to maximize the profits of their companies tend to be replaced by teams that do. In the "market for corporate control," companies that underperform financially suffer a depressed share price. This attracts acquirers—both other public companies and private equity funds.

  - **Convergence of stakeholder interests**: There is likely to be more community of interests than conflict of interests among different stakeholders. Profitability over the long term requires loyalty from employees, trusting relationships with suppliers and customers, and support from governments and communities.

Profit, cash flow and enterprise value

What we mean by profit and how it relates to value creation?

- **Profit** is the **surplus of revenues over costs** available for distribution to the owners of the firm. But if profit maximization is to be a realistic goal, the firm must know what profit is and how to measure it.
- What is the firm to maximize: total profit or rate of profit? Over what period? With what kind of adjustment for risk? And what is profit anyway—accounting profit, cash flow, or economic profit?

Profitability measures for some of the world's largest companies, 2017

Company	Market capitalization[a] ($ billion)	Net income ($ billion)	ROS[b] (%)	ROE[c] (%)	ROA[d] (%)
Apple	824	48.4	26.9	39.0	16.3
Amazon	689	3.0	2.3	9.6	3.1
Alibaba	480	6.2	29.8	21.9	9.1
JPMorgan Chase	397	24.4	50.2	9.5	1.4
ExxonMobil	358	19.7	5.2	11.8	5.7

Grant (2019)

Profit analysis to design strategies

- A probing **diagnosis** of a firm's recent performance provides a **useful input into strategy formulation**.

- If we can establish why a company has been **performing badly**, then we have a basis for **corrective actions**. These corrective actions are likely to be **both strategic** (with a medium- to long-term focus) **and operational** (focused on the short term). The worse a company's performance the greater the need to concentrate on the short term. For companies teetering on the brink of bankruptcy, long-term strategy takes a back seat; survival is the dominant concern.

- For companies that are performing well, financial analysis allows us to understand the **sources of superior performance** so that **strategy can protect and enhance these determinants of success**.

Strategic Profit Drivers

- If **overall goals can be disaggregated into precise, quantitative, time-specific targets**, each member of the organization knows what is expected of him or her and can be incentivized toward achieving the targets set.

- However, a mounting body of evidence points to the **unintended consequences of performance targets**.

- In relation to profit maximization, **setting profit targets may induce behavior that undermines that goal's attainment**.
  - Thus, many of the firms that are most successful at creating shareholder value are those that emphasize purpose over profit.

  - Conversely, many of the firms most committed to profit and maximizing shareholder value—Enron, BP, and Lehman Brothers for example—have been spectacularly unsuccessful in realizing these goals.

- Boeing was one of the most financially successful members of the Dow Jones Industrial Index between 1960 and 1990. Yet Boeing gave little attention to financial management.

- CEO Bill Allen was interested in building great planes and leading the world market with them: "**Boeing is always reaching out for tomorrow**. This can only be accomplished by people who live, breathe, eat and sleep what they are doing."

- At a board meeting to approve Boeing's biggest ever investment, the 747, Allen was asked by non-executive director Crawford Greenwalt for Boeing's financial projections on the project. In response to Allen's vague reply, Greenwalt buried his head in his hands. "My God," he muttered, "**these guys don't even know what the return on investment will be on this thing**."

- In 1997, Boeing acquired McDonnell Douglas and a new management team of Harry Stonecipher and Phil Condit took over. Mr Condit talked proudly of taking the company into "**a value-based environment where unit cost**, **return on investment**, and **shareholder return** are the measures by which you'll be judged."

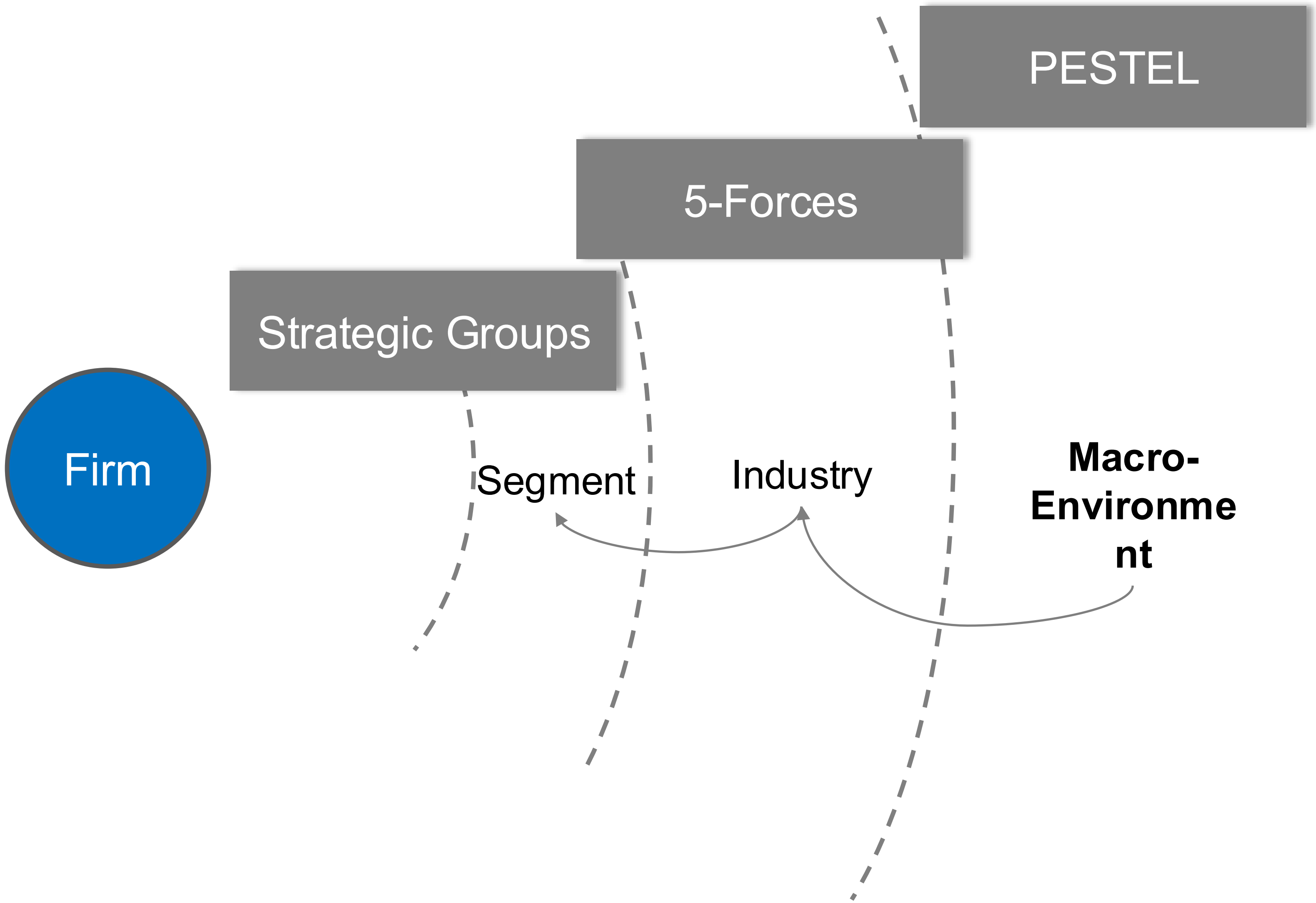
- The result was **lack of investment** in major new civil aviation projects and diversification into defense and satellites.

- Under Condit, Boeing relinquished market leadership in passenger aircraft to Airbus, while faltering as a defense contractor due partly to ethical lapses by key executives. When Condit resigned on December 1, 2003, **Boeing's stock price was 20% lower** than when he was appointed.

Strategy is forward-looking

- Analyzing the past only takes us so far. The world of business is one of constant change and **the role of strategy is to help the firm to adapt to change**.
- **The challenge is to look into the future** and identify factors that threaten performance or create new opportunities for profit.
- While financial analysis is inevitably backward-looking, **strategic analysis allows us to look forward** and understand some of the critical factors impacting a firm's success in the future.

INDUSTRY ANALYSIS


PESTEL
5-Forces
Strategic Groups
Firm
Segment
Industry
Macro-
Environme
nt

“**Industry structure drives competition and profitability**, independently of whether an industry procures a product or service, is emerging or mature, high tech or low tech, regulated or unregulated”

Porter (2008)

Sources of profit lie in the external environment

- **The firm's proximate environment is its industry**; hence, industry analysis will be our focus.

- Industry analysis is **relevant both to corporate-level and business-level strategies**.

  – **Corporate strategy** is concerned with **deciding which industries** the firm should be engaged in and how it should allocate its resources among them. Such decisions require assessment of the **attractiveness of different industries in terms of their profit potential**. (WHERE)

  – **Business strategy** is concerned with **establishing competitive advantage**. By analyzing customer needs and preferences and the ways in which firms compete to serve customers, we identify the general sources of competitive advantage in an industry—what we call key success factors. (HOW)

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- The business environment of the firm consists of all the **external influences that impact its decisions and its performance**.

- Given the vast number of external influences, how can managers hope to monitor and analyze the firm's environmental conditions?

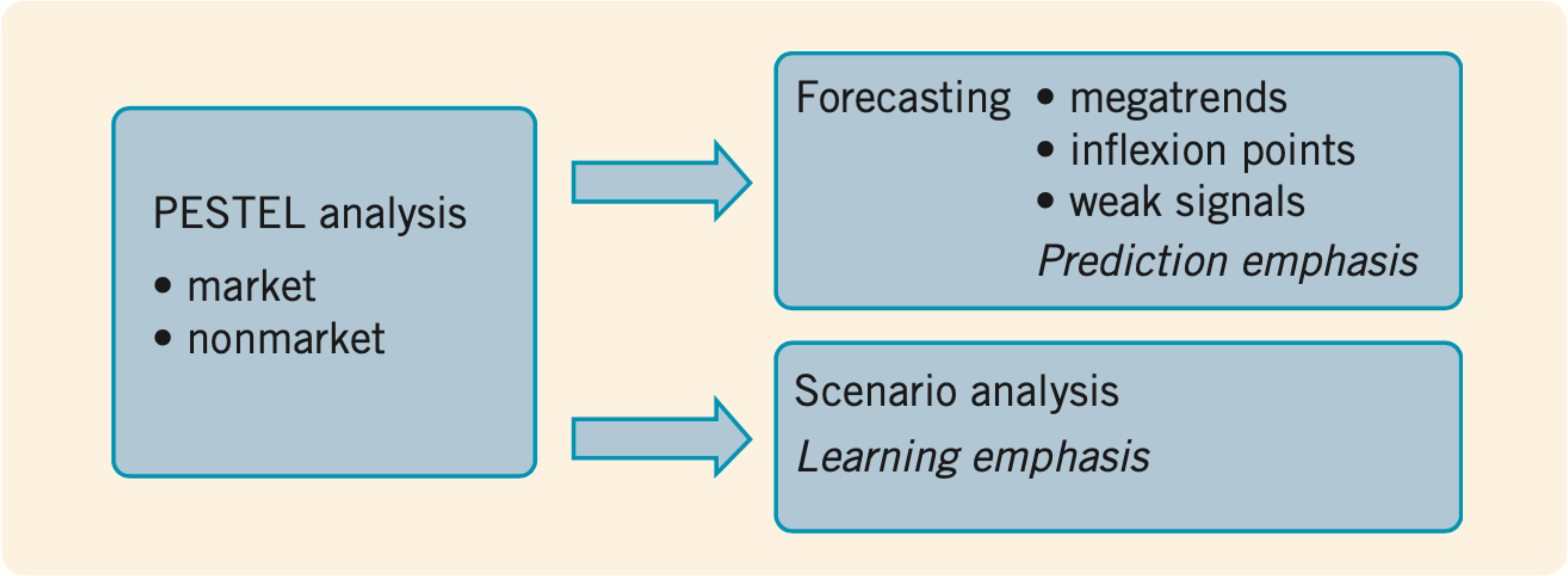
- The starting point is some kind of system or framework for organizing information. Environmental influences can be **classified by source**, for example, **PESTEL analysis considers the political, economic, social, technological, ecological and legal factors that impact a firm**.

- PESTEL analysis and similar approaches to **macrolevel environmental scanning** can be useful in keeping a firm alert to **what is happening in the world**

- NOTE: this type of analysis may result in information overload.

- Macro-environmental changes can often seem too **big, complex or unpredictable** for managers to grasp. Thus many traditional retailers, banks and newspapers were slow to seize the opportunities of the internet.

- The environment includes not only the economics of markets, but also *nonmarket* factors. Organizations need to consider **both market and nonmarket aspects** of strategy.



Johnson et al. (2017, p. 34)

PESTEL

- Companies typically compete for **resources, revenues and profits**. Pricing and innovation are often key strategies here.

- **Social, political, legal and ecological** factors can affect firm's decisions, which can also be impacted by economic factors. Key participants in the nonmarket environment are not just other businesses, but also non-governmental organizations (NGOs), politicians, government departments, regulators, political activists, campaign groups and the media.

- In the nonmarket environment, organizations need to build **reputation, connections, influence and legitimacy**. Lobbying, public relations, networking and collaboration are key nonmarket strategies.

P-ESTEL

- The political element of PESTEL highlights the role of the state and other political factors in the macro-environment. There are two important steps in political analysis: first, identifying the **importance of political factors**; second carrying out **political risk analysis**.

- *Importance of political factors*:
  - The role of the ***state****.* In many countries and sectors, the state is often important as a direct economic actor, for instance as a customer, supplier, owner or regulator of businesses.

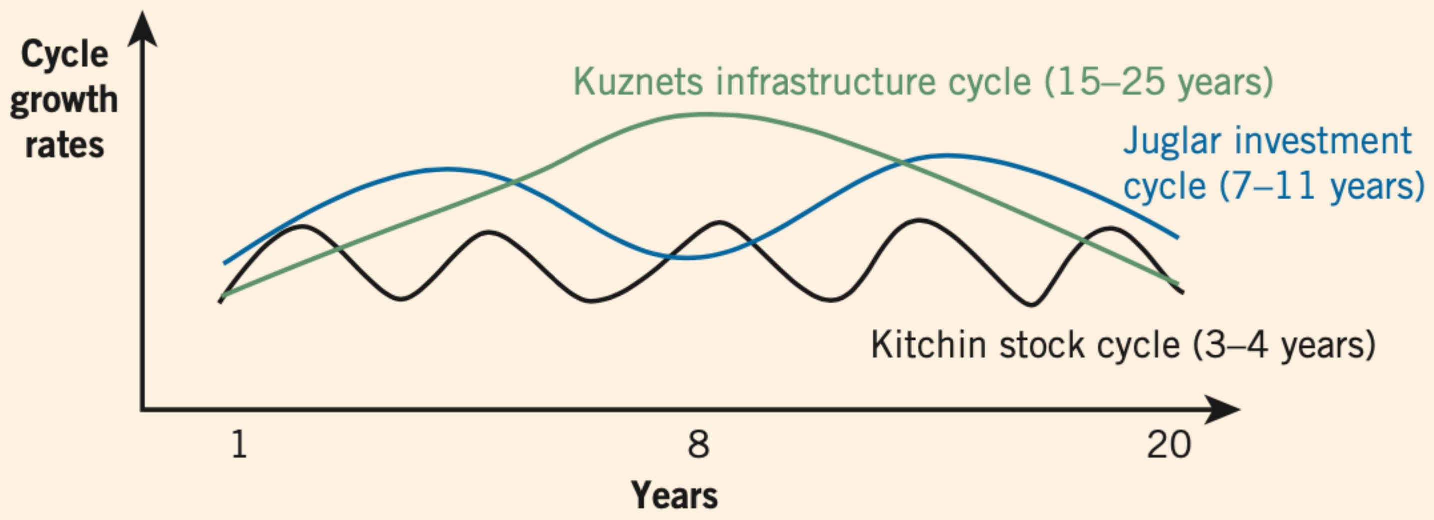
  - Exposure to ***civil society* organizations**. Civil society comprises a whole range of organizations that are liable to raise political issues, including political lobbyists, campaign groups, social media or traditional media.

P-ESTEL

- *Political risk analysis,* the analysis of **threats and opportunities** arising from potential political change:
  - The ***macro–micro* dimension**. The macro dimension refers to the risks associated with whole countries. The micro dimension relates to the specific risk of particular organizations or sectors within a country.
  - The ***internal–external* dimension**. The internal dimension relates to fac-tors originating within the countries; External political risk analysis involves careful analysis of economic, political and other linkages between countries.

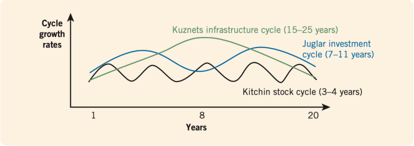
- The macro-environment is also influenced by macro-economic factors such as **currency exchange rates, interest rates and fluctuating economic growth rates** around the world.

- A key concept for analyzing macro-economic trends is the ***economic cycle***.



Johnson et al. (2017, p. 39)

- Some industries are **particularly vulnerable to economic cycles**. For example:
  - *Discretionary spend* industries. In industries where purchasers can easily put off their spending for a year or two, there tend to be strong cyclical effects. Thus **housing, restaurants and cars tend be highly cyclical** because many people can choose to delay or curtail spending on these for a while. After a period of curtailed spending, there is liable to be a strong upturn as pent-up demand is finally released into the market.
  - *High fixed cost* industries. Industries such as **airlines, hotels and steel** suffer from economic downturns because high fixed costs in plant, equipment or labor tend to encourage competitive price-cutting to ensure maximum capacity utilization when demand is low. For example, an airline might try to fill its seats in the face of falling demand simply by offering cheap tickets. If its competitors do the same, the resulting price-war will result in low profits for all the airlines.



Johnson et al. (2017, p. 39)

PE-S-TEL

- The *social* elements of the macro-environment have at least two impacts upon organizations. First, they can influence the specific nature of **demand and supply** within the overall economic growth rate. Second, they can **shape the innovativeness, power and effectiveness of organizations**.

- Aspects that shape demand and supply
  - Demographics
  - Distribution
  - Geography
  - Culture

- Networks and organizational fields can be analyzed by means of ***sociograms***, maps of potentially important social (or economic) connections. For a new high-technology enterprise, important network connections might be links to leading universities, powerful firms and respected venture capitalists

An **organizational field** is a **community of organizations that interact more frequently with one another than with those outside the field.**

- ***Technologies*** such as the internet, nanotechnology or new composite materials, impact far beyond single industries. As in the case of internet streaming, new technologies can open up opportunities for some organizations (e.g. Spotify and YouTube), while challenging others (traditional music and broadcasting companies)

- There are <u>five primary indicators</u> of innovative activity:

  – *Research & development budgets.* Innovative firms, sectors or countries can be identified by the extent of spending on research, typically reported in company annual reports and government statistics.

  – *Patenting activity.* Firms active in patenting new technologies can be identified on national patent registers, the most important being the United States Patents and Trademarks Office.

– *Citation analysis.* The potential impact of patents and scientific papers on technology can be measured by the extent to which they are widely cited by other organizations, with data available from Google Scholar for instance.

– *New product announcements.* Organizations typically publicize their new product plans through press releases and similar media.

– *Media coverage.* Specialist technology and industry media will cover stories of the latest or impending technologies, as will various social media.

PEST-E-L

- *Ecological* stands specifically for ‘green’ macro-environmental issues, such as pollution, waste and climate change.

- There are three sorts of challenges that organizations may need to meet:

  – *Direct pollution obligations* are an obvious challenge, and typically involve not just cleaning up ‘at the end of the pipe’ (e.g., disposing of waste by-products safely), but also **minimizing the production of pollutants in the first place**.

  – *Product stewardship* refers to managing ecological issues through both the **organization’s entire value chain and the whole life cycle of the firm’s products**.
    - Stewardship here might involve responsibility for the ecological impact of external suppliers or final end-users.
    - It will also involve responsibility for what happens to products at ‘end of life’, in other words how they are disposed of when consumers have no more use for them.

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- *Sustainable development* is a criterion of increasing importance and refers not simply to reducing environmental damage, but to **whether the product or service can be produced indefinitely into the future**.

  This sustainability criterion sets **constraints on the over-exploitation of particular sources of raw materials**, for instance in developing countries, and often raises issues regarding the economic and social well-being of local communities.

PESTE-L

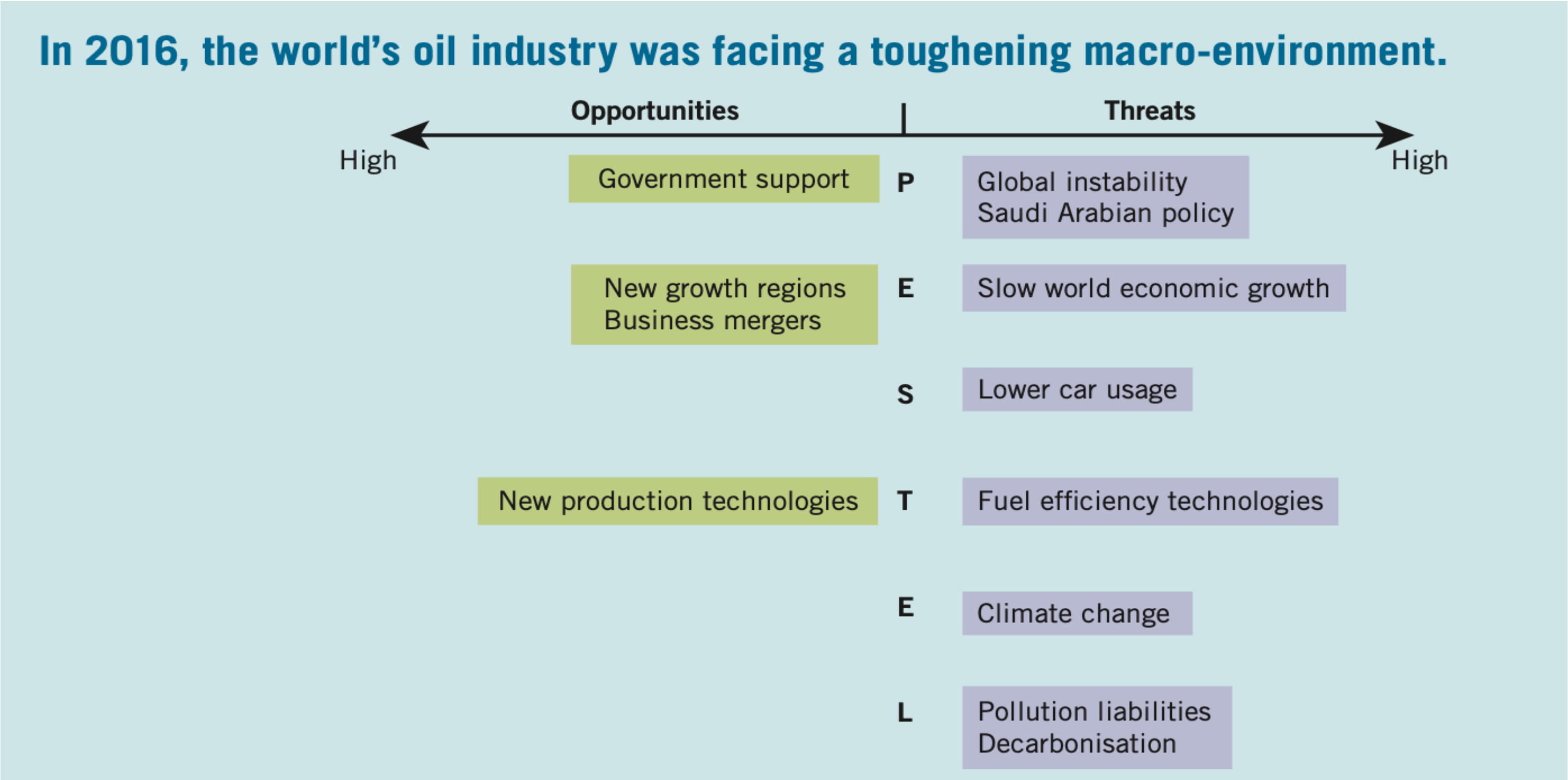
- *Legal* aspects can cover a wide range of topics: for example, labor, environmental and consumer regulation; taxation and reporting requirements; and rules on ownership, competition and corporate governance.

- Legal issues form an important part of the *institutional environment* of organizations, by which is meant the formal and informal ‘rules of the game’.

- Although every country differs in detail, three broad varieties of capitalism have been identified, whose formal and informal rules lead to different ways of doing business:
  - *Liberal market economies* are institutional environments where both formal and informal rules favor competition between companies, aggressive acquisitions of one company by another and free bargaining between management and labor (e.g., US and UK).
  - *Coordinated market economies* encourage more coordination between companies, often supported by industry associations or similar frameworks (e.g., Germany and Japan).
  - *Developmental market economies* tend to have strong roles for the state, which will either own or heavily influence companies that are important for national economic development (e.g., Brazil, China, India).

Example: BP's PESTEL

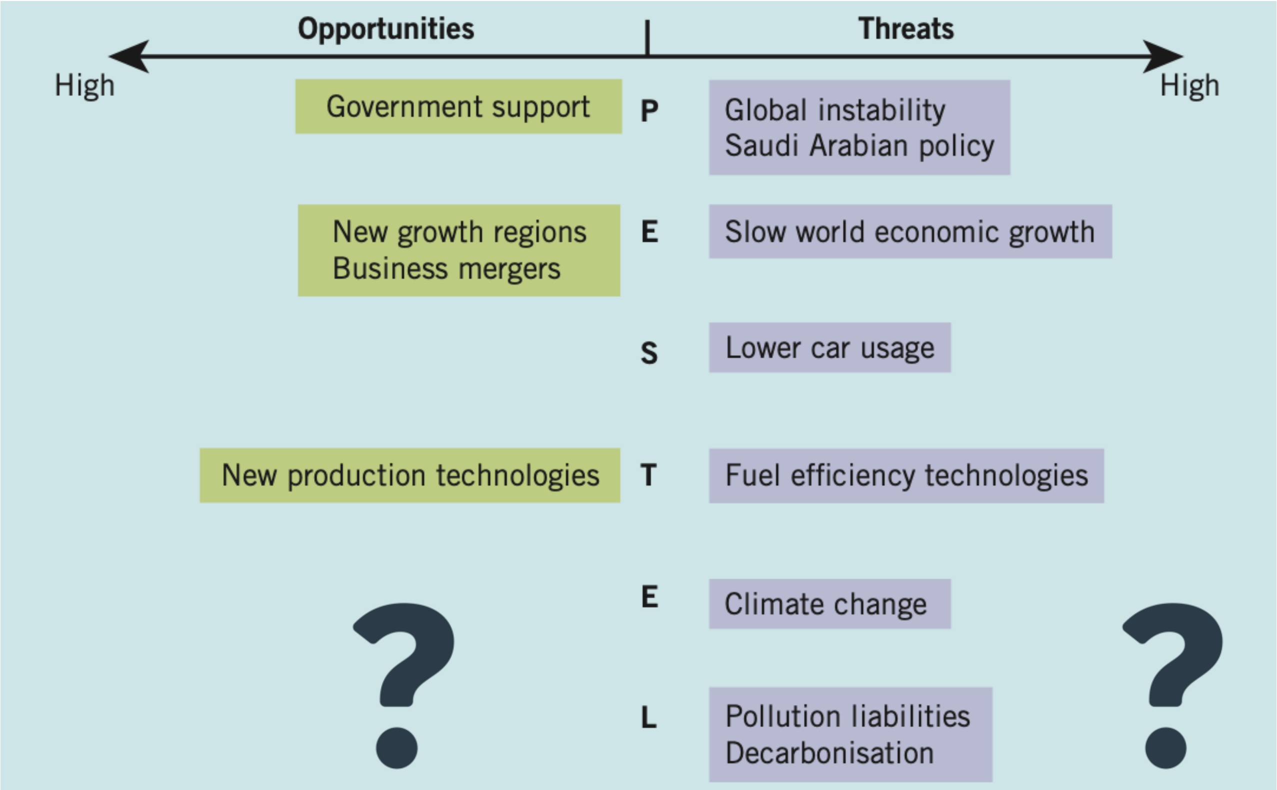
A PESTEL analysis can be done using **published sources** (e.g. company annual reports, media articles and consultants' reports) or more extensively **by direct discussion with managers, customers, suppliers, consultants, academics, government officials and financial analysts**. It is important not to rely just on a firm's managers, who may have limited views.



Johnson et al. (2017, p. 36)

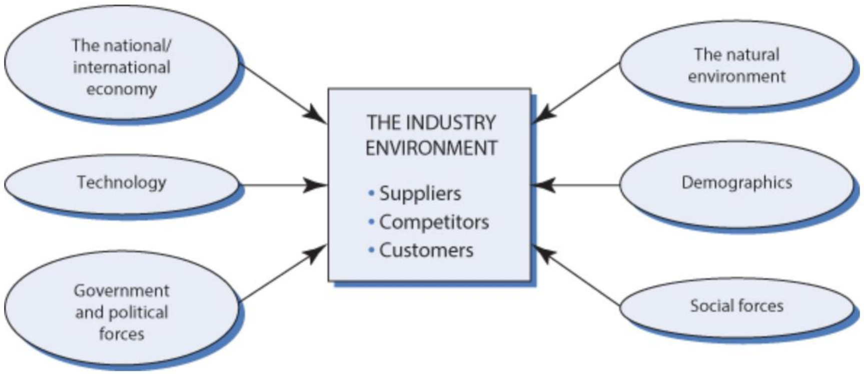
- In the light of this analysis, **what strategic options would you advise** a Western oil producer such as Shell or BP to consider?

- Have **Opportunities and Threats changed** since 2016? How would you update this analysis?



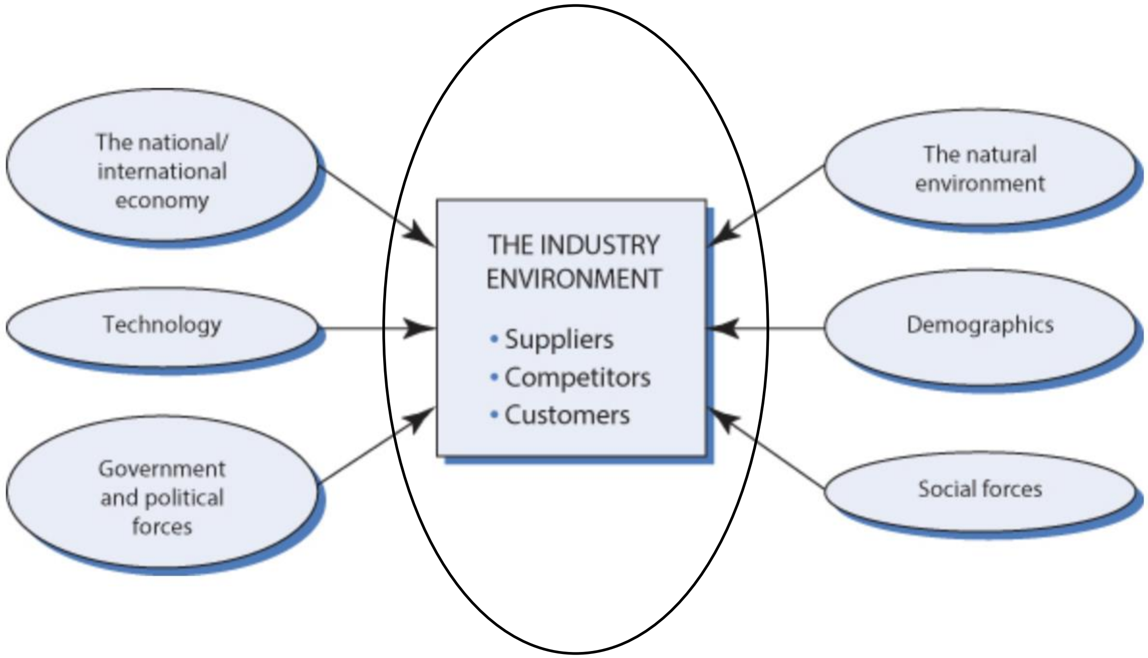
From macroenvironmental forces to industrial environment

- What features of a firm's external environment are critical to its decisions.
- For the firm to make a profit, it must **create value for customers**. Hence, it must understand its customers. Second, in creating value, the firm **acquires inputs from suppliers**. Hence, it must understand its suppliers and manage relationships with them. Third, the ability to generate profitability depends on the **intensity of competition among firms** that vie for the same value-creating opportunities. Hence, the firm must understand competition.
- The core of the firm's business environment is formed by its relationships with three sets of players: customers, suppliers, and competitors. This is its **industry environment**.



Five-forces model for industry analysis

- Framework developed by Michael Porter to analyze competition within industry or sector.
- Based on **industrial organization economics**.
- 'Industry' refers to the **group of firms producing the same principal product or service** or a group firms producing close substitutes for each other.
- Originally developed to assess the profit potential and **attractiveness** of an industry.
- Can be applied to any organization.

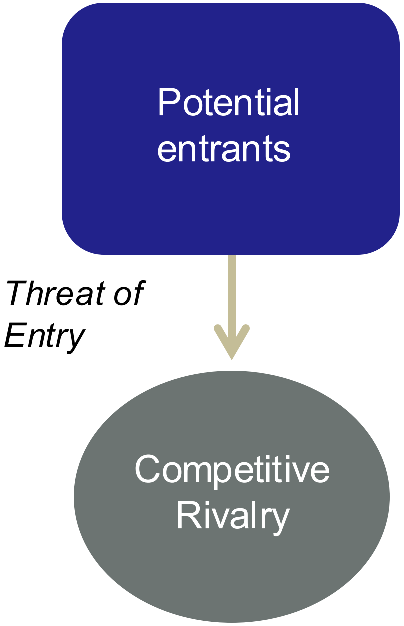


Five-forces model for industry analysis

Competitive Rivalry

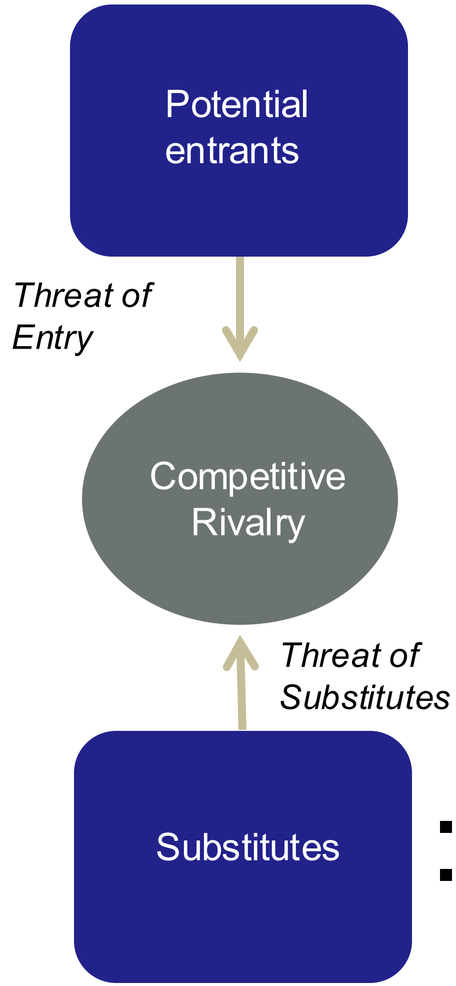
- Concentration
- Product differentiation
- Excess capacity and Cost Conditions
- Exit barriers

Five-forces model for industry analysis



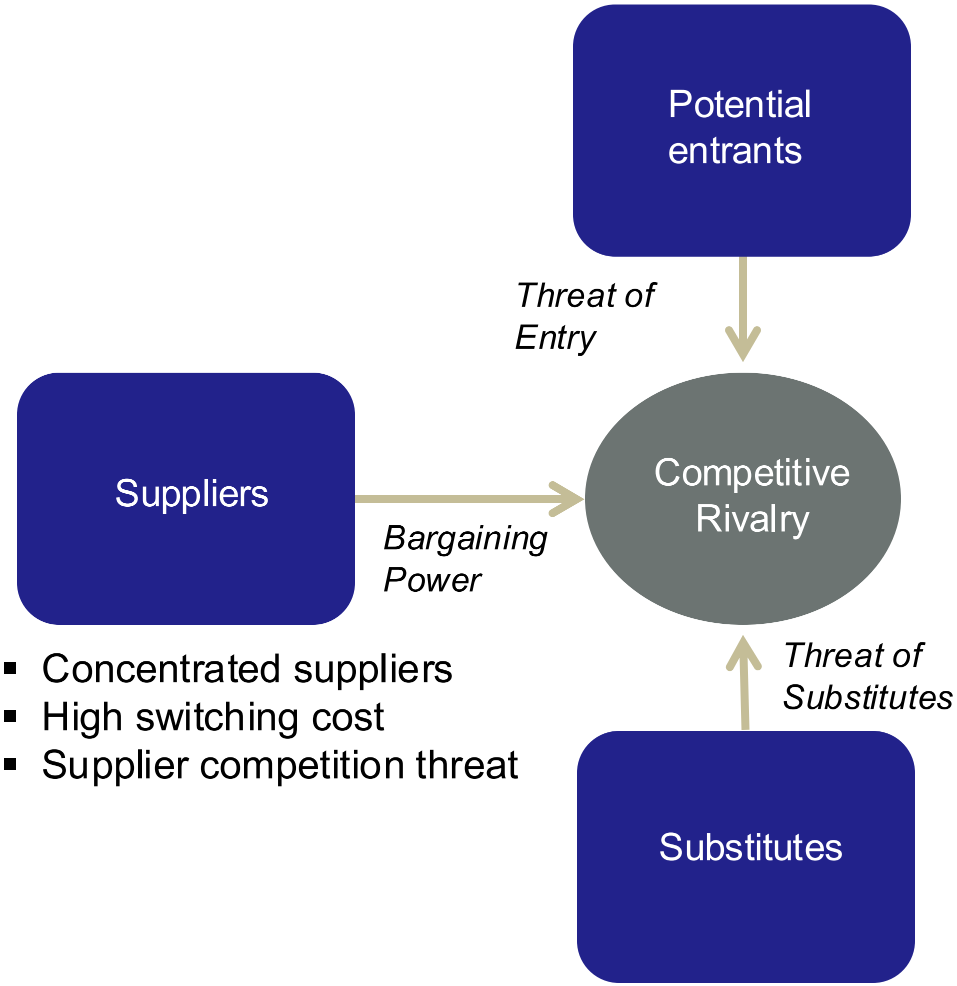
- Economies of Scale and Experience
- Access to supply and distribution channels
- Expected retaliation
- Legislation or government action
- Differentiation

Five-forces model for industry analysis



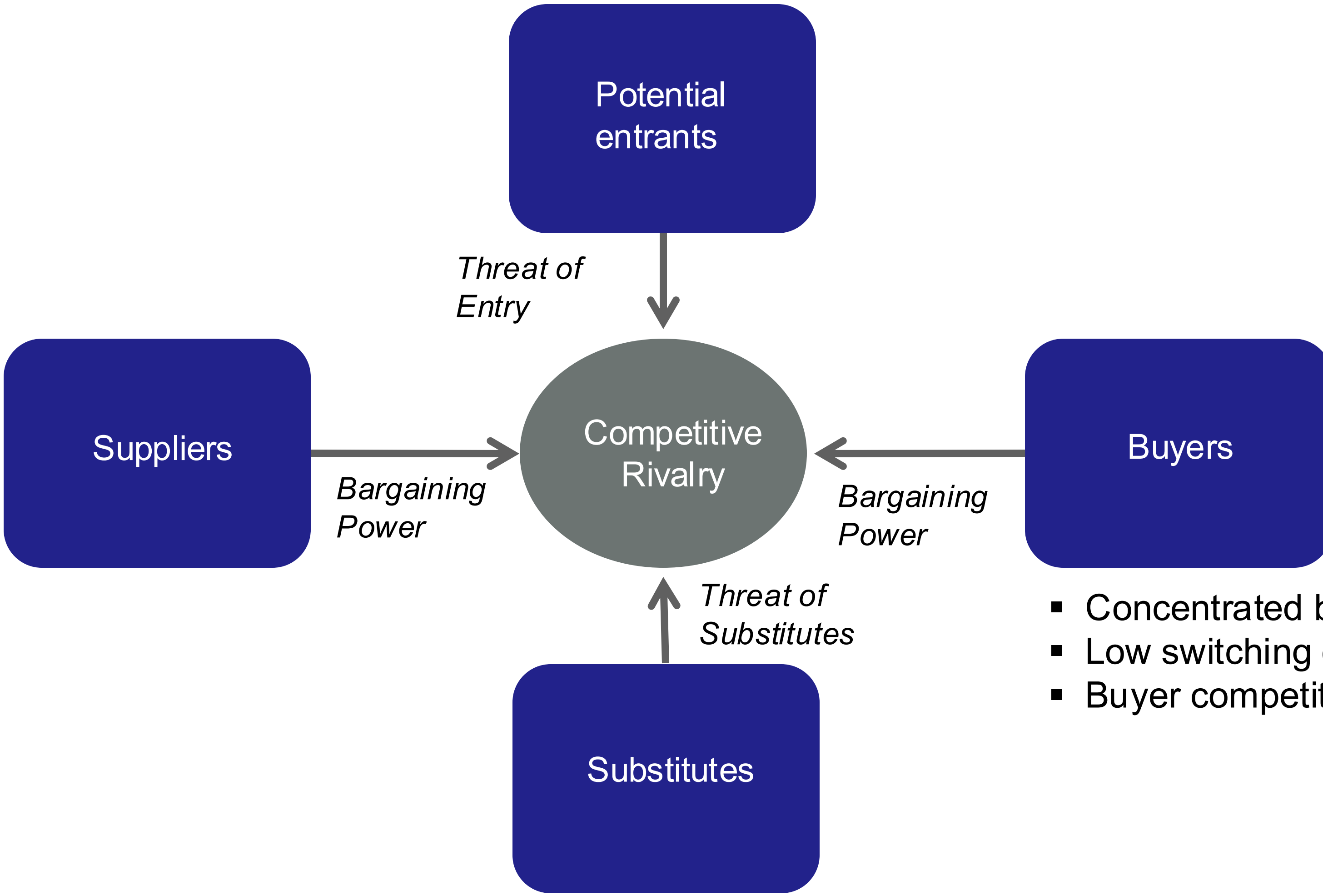
- Price/Performance Ratio
- Extra-industry effects

Five-forces model for industry analysis



- Concentrated suppliers
- High switching cost
- Supplier competition threat

Five-forces model for industry analysis

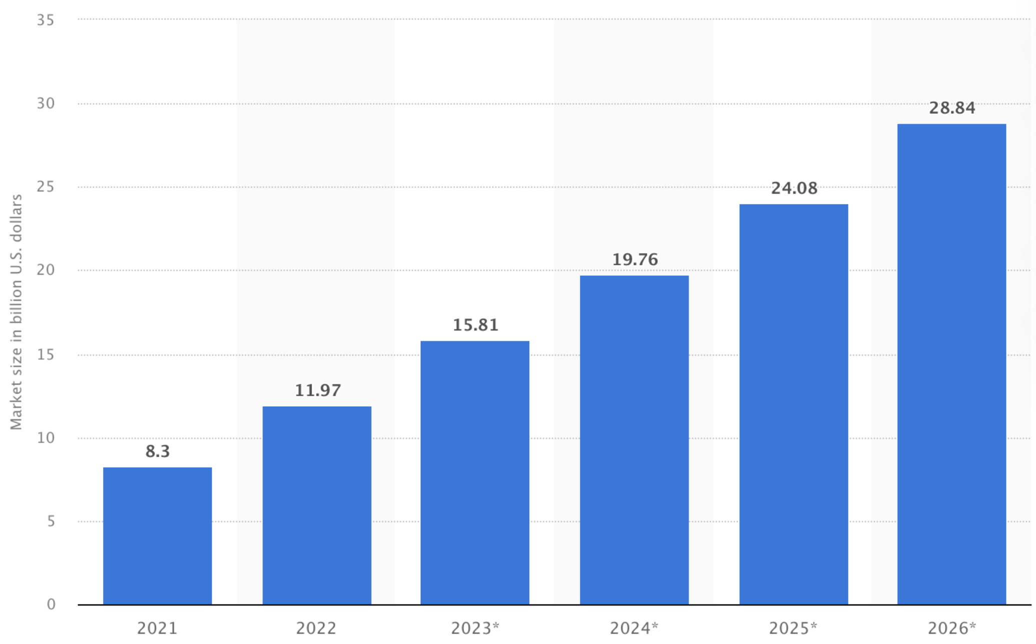


- Concentrated buyers
- Low switching cost
- Buyer competition threat

Example: Virtual reality

Consumer and enterprise virtual reality (VR) market revenue worldwide from 2021 to 2026

(in billion U.S. dollars)



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Additional Information

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October 2022

Region

Worldwide

Survey time period

2020 to 2021

Supplementary notes

* Forecast.

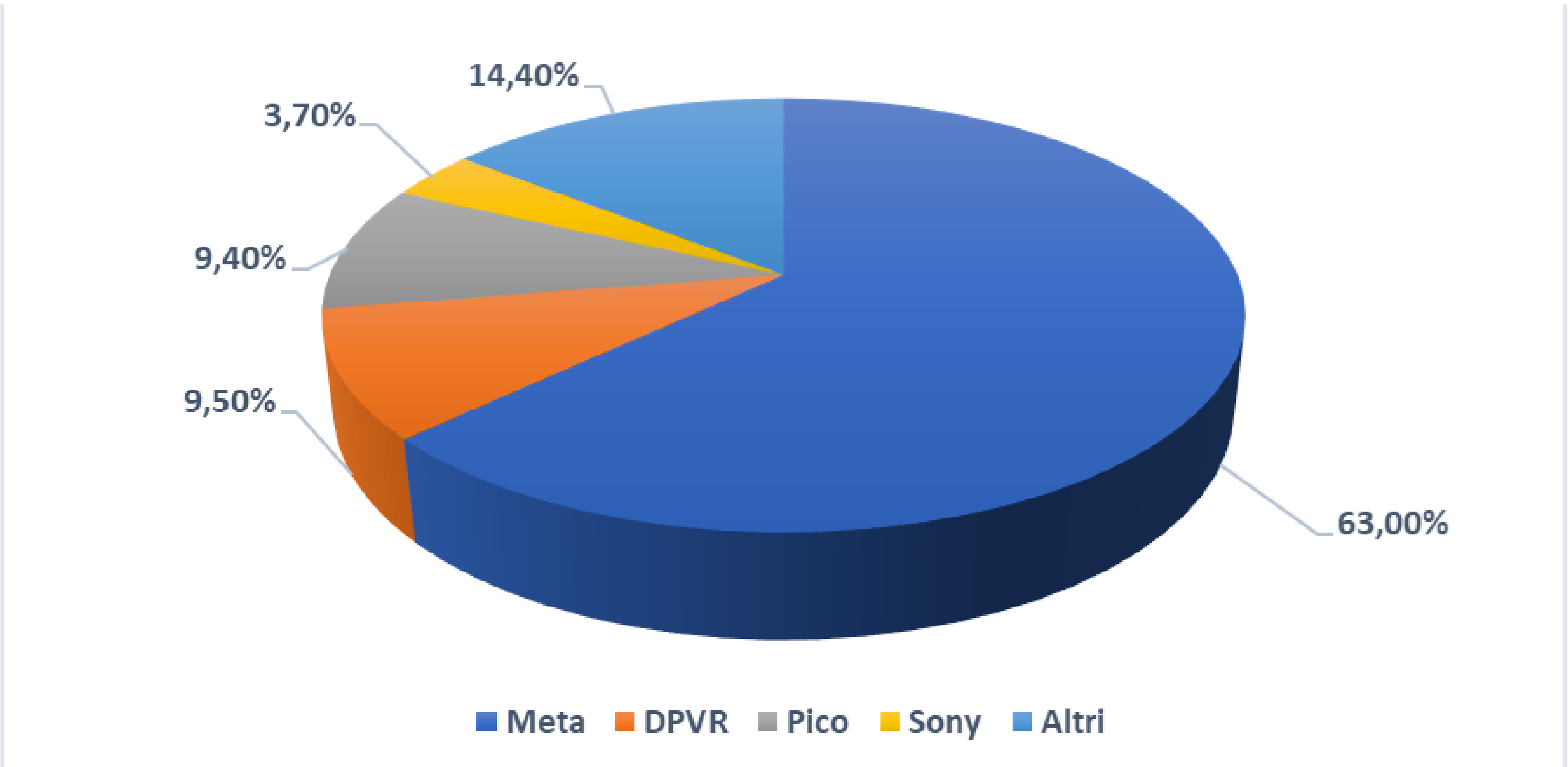
Includes consumer hardware, enterprise hardware, consumer software, enterprise software, LBVR Admissions, and Advertising. The hardware segment includes console VR headsets, PC VR headsets, and standalone VR headsets. Screenless VR viewers are not included.

Citation formats

→ View options

Example: Virtual reality

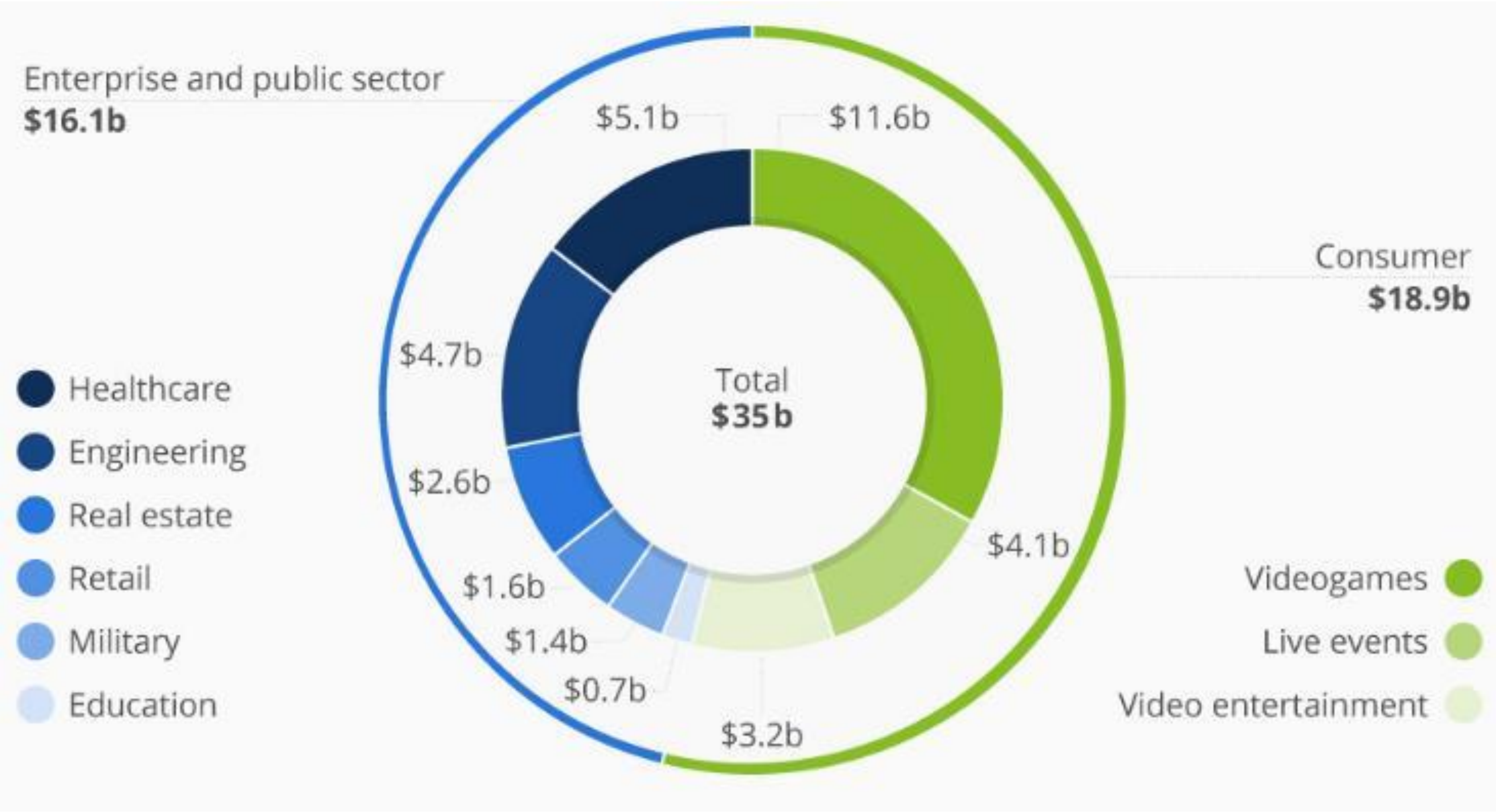
Global market share worldwide



GlobalData, October 2022

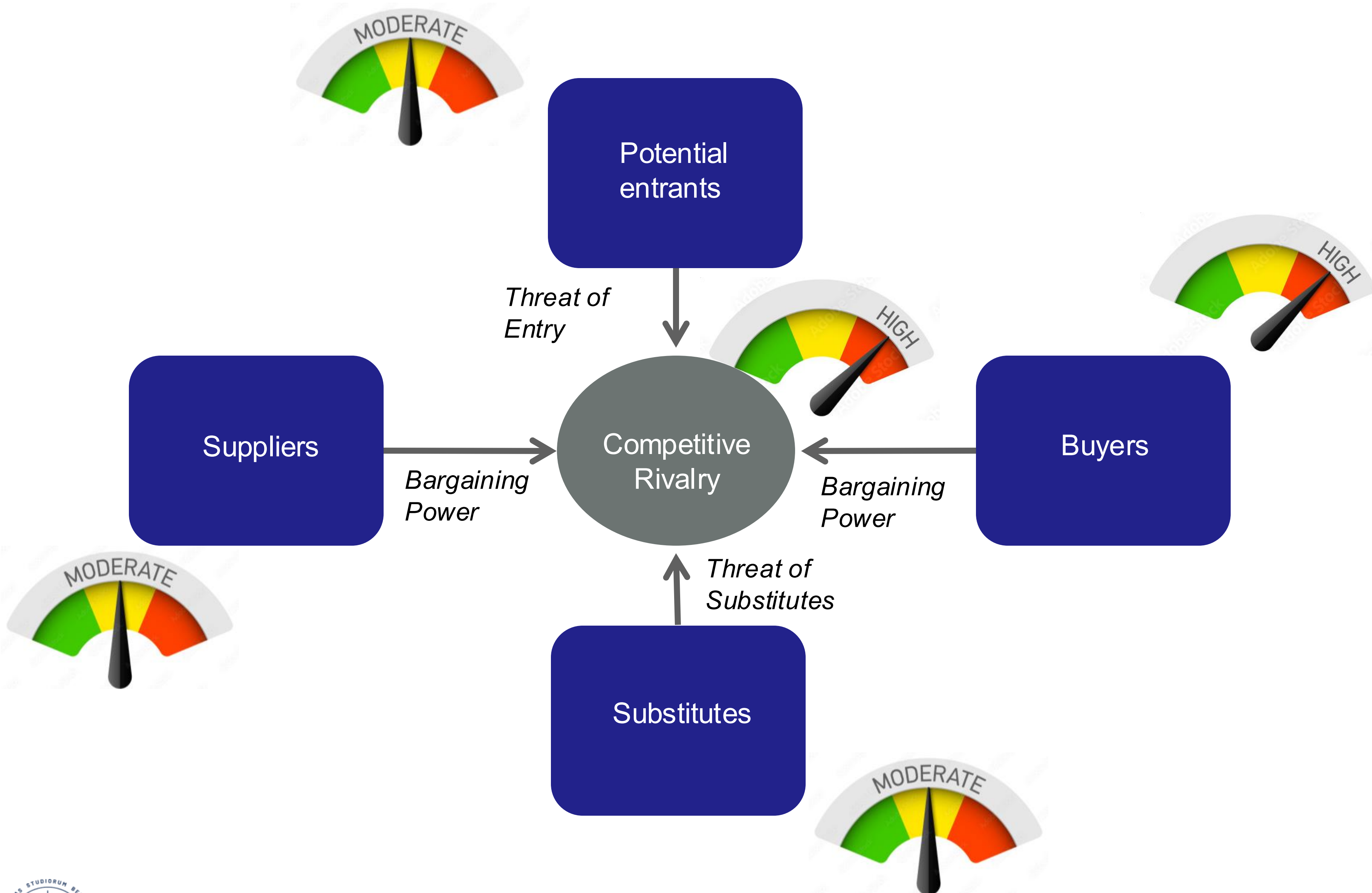
Example: Virtual reality

The Diverse Potential of VR & AR Applications
Projections by 2025



Statista, April 2016

Example: Virtual reality



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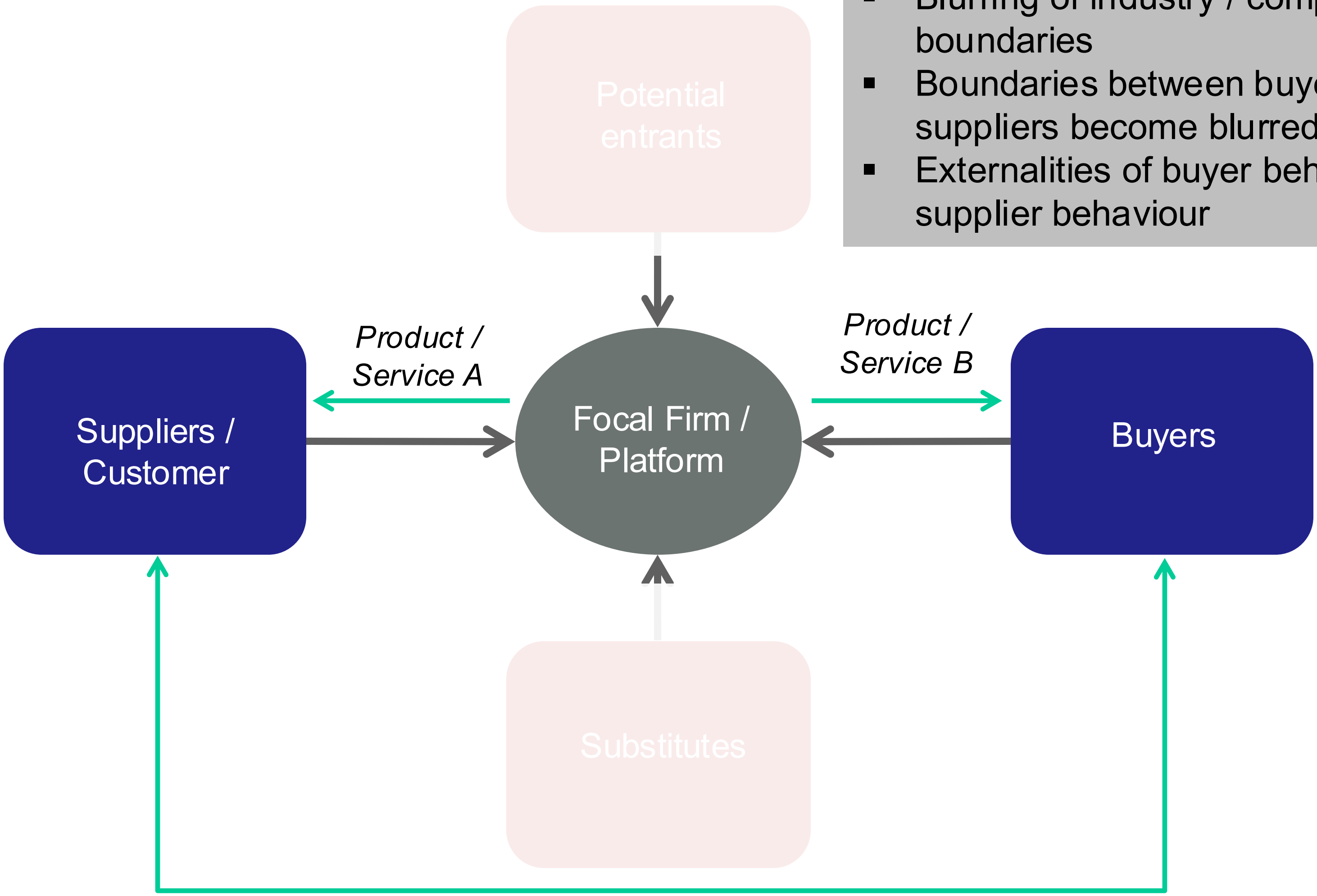
A special case: Two-sided markets

A **two-sided market** is a meeting place for two sets of agents who interact through an intermediary or platform
(*FT Lexicon*)

A special case: Two-sided markets

- Multiple product / service offerings
- Blurring of industry / competitive boundaries
- Boundaries between buyers and suppliers become blurred
- Externalities of buyer behaviour on supplier behaviour



Mutually influences attractiveness

- Go to the PRESENTATION in Moodle
- Download the slides with the **PESTEL template** and the **5 Forces Model** by Porter, work on them and upload it on Moodle assignment in PDF [please, add your names into the PDF you upload]

PROBLEMS WITH THESE ANALYSES

Problems with environmental and industry analysis

Ending up with long lists as a result of:

- Failing to understand the **key driving forces**
- Failing to assess how they **all link together** to affect the organization
- Failing to distinguish between **different markets or segments**
- Failing to use the analysis to identify **sensible opportunities**

Problems with environmental and industry analysis

- **Political**
  - restrictive government transport policies
  - change in government: more restrictive
  - investment in rail infrastructure
  - EU pressure to regulate road haulage companies e.g. truck size, driver hours, registration requirements
  - toll roads
  - restriction in central road building
  - excise duty on diesel
  - increasing levels of truck road tax
- **Economic**
  - effects of economic cycles and demand for new trucks
  - FX fluctuations
  - single EU currency
  - increasing interest rates/new vehicle
- **Social**
  - lobby of governments to reduce road traffic congestion
  - increase in demand for clean cities
- **Technological**
  - complexity in truck design
  - innovation in on-board management systems
  - channel tunnel - rail freight
  - innovation in fuel consumption/emission control technology
  - alternative fuels
  - IT logistics & distribution
- **Environmental**
  - EU emissions
  - lobby for rail freight
  - engine service requirements
  - increasing public concern re health, QoL etc
- **Legal**
  - dealers "Block exemption" review
  - EU harmonisation
  - truck sizes increases/scale efficiencies

- Which firms are direct competitors of your company?
- What are the key uncertainties for the future in this industry?

NEXT STEPS

Next steps

Are they competitors?

Are they competitors?

How do we define the right industry and market?