Quintessence Series

Philip Kotler
Roland Berger
Nils Bickhoff

The Quintessence of Strategic Management

What You Really Need to Know to Survive in Business

Second Edition

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Series editor
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Quintessential Strategies
Hamburg, Germany

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What You Really Need to Know to Survive in Business

Second Edition

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ISSN 2195-4941 ISSN 2195-495X (electronic)
Quintessence Series
ISBN 978-3-662-48489-0 ISBN 978-3-662-48490-6 (eBook)
DOI 10.1007/978-3-662-48490-6

Library of Congress Control Number: 2015957959

Springer Heidelberg New York Dordrecht London
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Printed on acid-free paper

Springer-Verlag GmbH Berlin Heidelberg is part of Springer Science+Business Media (www.springer.com)

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1 Introduction: Essential Strategy Know-How and Nothing More

A book on strategy and strategic management must inevitably be called into question. There are so many outstanding and relevant works on the subject, does the executive readership—many of whom were students at one time or another—really need another volume on the bookshelf? The state of knowledge on strategy and strategic management has not changed so dramatically in recent years as to justify another book in itself. Yet there remain two significant, mutually dependent gaps in the forest of books:

a) Even though the number of Business Administration graduates is countless and even though they and others develop strategies, most practitioners of strategy lack a fundamental understanding of the word itself, of the strategy process, of the mechanics of the key tools and their relationships.
b) The reasons for this lie in the vast and often excessive amount of information and the sheer number of approaches that exist on the subject of strategy. No one has yet attempted to present the quintessence of strategic management—or what you really need to know to survive in the competitive arena. Naturally with an objective such as this, some knowledge on the subject will fall by the wayside but what it boils down to here is the quintessence, the bottom line—for everything else there are extensive textbooks to refer to.[1]

[1] To cite but one example of a book that is truly outstanding and extensive: see Pettigrew et al. (2002).

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P. Kotler et al., *The Quintessence of Strategic Management*,
Quintessence Series, DOI 10.1007/978-3-662-48490-6_1

The aim of this book was and is, therefore, to fill this gap in a way that covers as few pages and is as accessible as possible, while communicating the fundamental, most important theoretical aspects and facilitating the transfer of this knowledge to real-life decision situations. There can be but few readers whose job description constitutes a knowledge of strategic management alone—and theirs must be a rather academic career at that. The majority will become (or already are) practitioners of strategy, who will need to structure and evaluate strategic situations—it is for these practitioners in particular that this book is intended.

However pragmatic or brief it may be, every book needs a structure: in this case there are three main sections. First we develop a common understanding of the word "strategy" and the process of "strategic management" to ensure that all readers start from the same base point. In the second section we present the frames of reference for strategic thinking, how they interlink and how they fit into strategic management.[2] Following these two fundamental sections, part three deals with selected management concepts as employed in strategy practice, which have taken up some of the core ideas from the frames of reference and integrated them in a practice-oriented manner. There is a great deal of practical relevance here: numerous fictitious and real examples, some of them disguised, are used throughout to illustrate the frames of reference and management concepts presented.

Having read this book:

- You will have a basic understanding of strategy and the process of strategic management.
- You will know the most important strategy tools (incl. the respective original literature) and how they interact.
- You will be aware of the focal areas and considerations of strategy in practice.
- You will be able to analyze and interpret business information with regard to the underlying strategic notions.

[2] The descriptions of the mechanisms are drawn solely from original articles by their developers in a bid to avoid distorted interpretations.

There is one thing we should get out of the way right from the start: no one—not even this book—can say for sure what the right or optimal strategy in a given situation is. This has a lot to do with the long-term perspective of strategic decisions, which are (almost) always made in complex and dynamic settings. That is why it is important to obtain a thorough picture of the strategic starting point and then to consider the possibilities from numerous perspectives. In doing so you take away some of the uncertainty of the decision and get an idea of the way forward—this is best achieved in combination with many years of experience in the industry and function concerned. You yourself will need to bring the many years of experience with you; this book will show you, among other things, how to apply processes and tools to reduce the risks you face on the way to making a strategic decision.

Reference

Pettigrew, A., Thomas, H., & Whittington, R. (Eds.). (2002). *Handbook of strategy and management*. London: Sage.

2 Strategy and Strategic Management: A First Basic Understanding

Let's start from the beginning. Let's assume you do not know what strategy means, either you've just heard the word for the first time or you've never used it consciously before. This section helps you establish an initial, basic understanding of strategy and the process of strategic management—please take it as a basic understanding and not as a conclusive definition: as you will see, a feel for strategy can only be developed on an individual, case-by-case basis.

2.1 What Is Strategy and How Is It Developed?

Strategy is not an easy thing to describe. You first need to understand the meaning of the word in all of its facets before you can develop an individual feel for strategy, which you will gradually enhance every time you put it to practical application. You will find, however, that your personal learning curve never flattens out: it will remain on a continuous upward trajectory. The concept of strategy is not restricted to the business world—private life, sports, and politics are also marked by strategies. The examples in this book deal mostly with economic issues but the content is equally applicable to other areas.

2.1.1 Modern Opinions

"*Nobody really knows what strategy is!*"—The British news magazine *The Economist* crisply and concisely conveyed the current state of knowledge back in 1993 (in its issue dated March 20, 1993). And to

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P. Kotler et al., *The Quintessence of Strategic Management*,
Quintessence Series, DOI 10.1007/978-3-662-48490-6_2

this day we are not a single step closer. Quite the opposite, in fact: the vigorous research conducted in recent years—besides producing a few good practical approaches—has increasingly blurred our view of what strategy is really about. Just as we often can't see the wood for the trees, so we can no longer make out the true meaning of strategy owing to the multitude of strategic concepts that exist. Even the renowned Harvard Business School complained of the danger of "paralysis through analysis": faced with a specific need to make strategic decisions, how are we supposed to manage the complexity of the copious analyses and formulate a good strategy? Markides, for his part, advises us against even bothering to integrate the concepts in a planning context. He defines a good strategy on the basis of its result: "*...behind every successful company there is a superior strategy*."[1] So "all" we need to do is understand and copy the strategies of successful companies and the issue of a precise definition becomes irrelevant.

2.1.2 Basic Historical Concepts

The concept of "strategy" comes from the Greek word "strategos," meaning "leadership" in the military sense: it concerns planning the deployment of resources to achieve certain objectives. It was Carl von Clausewitz (1780–1831), a Prussian general and military theorist, who said, "Strategy is the economy of force," which is why he is often referred to as the first strategist. A look back at history, however, reveals that many military leaders before him, such as Caesar, Sun Tzu, and Machiavelli, designed and formulated militarily motivated strategies (see Fig. 2.1). And each of these military strategies, some of which date back to antiquity, holds true for management by analogy.

After all, resource concentration, surprise, innovation, organization and communication, the coordination of objectives and resources, and the consideration of one's own strengths are watchwords for the decision makers of today in their everyday business in the market, competitive, and corporate arenas. Thus, the understanding of strategy has not changed, only the venue is a different one for managers.

[1] Markides (1999), pp. 55–63.

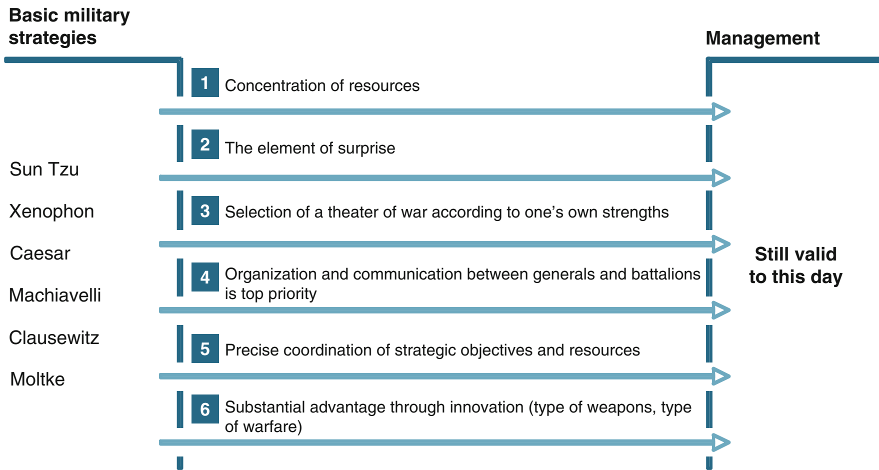


Fig. 2.1 Basic military strategies that still hold true for management today

2.1.3 A First Example: The Second Punic War

Sticking with the military leaders of antiquity, who are credited with being the first to apply strategies deliberately, an example can help demonstrate the complexity of strategy and show why even good strategies do not always bring lasting success.

After a lengthy struggle, Carthage had lost the First Punic War (264–241 BC) against Rome. The central Mediterranean Sea was controlled by the Romans, and in this situation Carthage feared another attack from the Roman fleet, whose aim was to achieve the city-state's complete subjugation (see Fig. 2.2).

Carthage recognized this danger and commissioned one of its commanders, Hannibal, to come up with a strategy.[2] Hannibal analyzed the initial situation and first compared the resources of Rome and Carthage. One of the results of this comparison (see Fig. 2.3) was that Rome was better equipped in terms of both infantry and warships—another naval war would therefore be extremely risky for Carthage. On the other hand, Carthage had advantages in terms of cavalry and—much more importantly—war elephants, a weapon unknown to the Romans at that time.

[2] The following remarks are of an illustrative nature and do not claim to be historically accurate, but the strategy could certainly have been developed in this or a similar way.

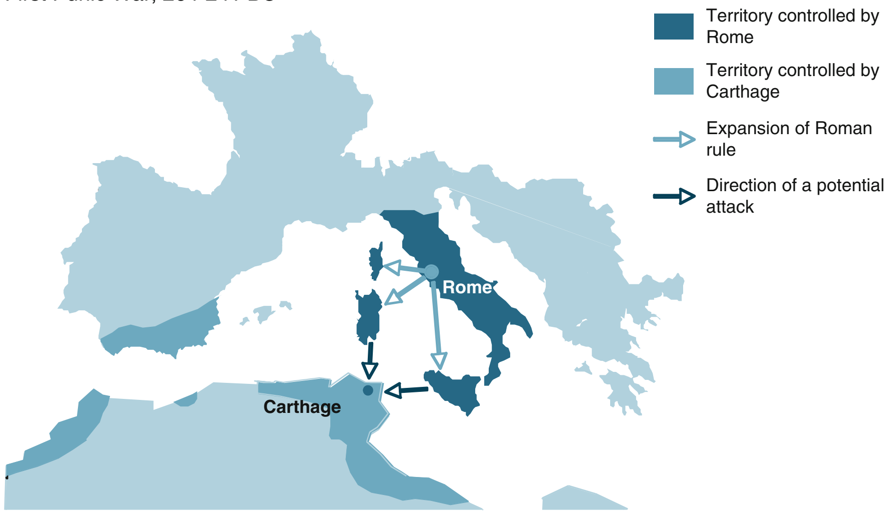
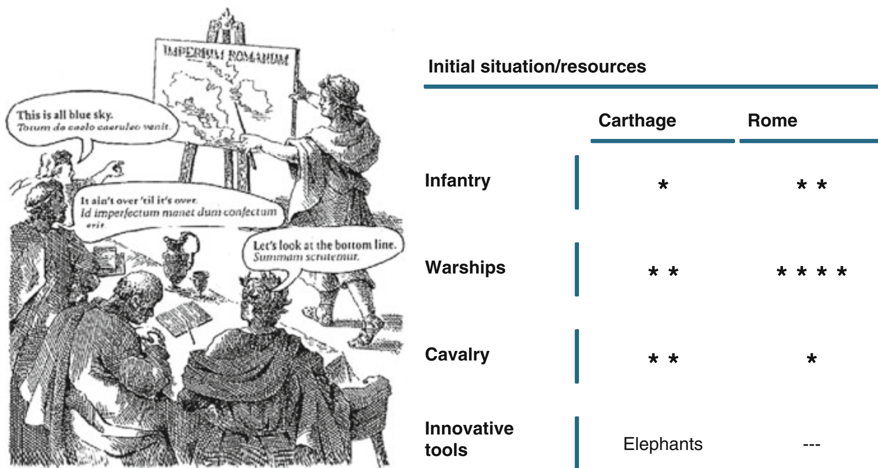


Fig. 2.2 Initial situation after the First Punic War



Initial situation/resources

	Carthage	Rome
Infantry	*	* *
Warships	* *	* * * *
Cavalry	* *	*
Innovative tools	Elephants	---

Fig. 2.3 Comparing the resources of Rome and Carthage

Taking the geographic circumstances into account, Hannibal quickly realized that Italy's position, surrounded by water, meant that Rome could not be attacked directly but only via a circuitous route over land. Moreover, the overland route was much more beneficial to Carthage in that its superiority in cavalry and elephants could show to full advantage.

Fig. 2.4 Hannibal's strategic decision: The route to Rome

Hannibal's strategic decision (see Fig. 2.4) was therefore to ship the army (50,000 infantry, 9000 cavalry, and 37 elephants) over to New Carthage on the Iberian Peninsula, subsequently to cross the Alps, and ultimately to fight against Rome on solid ground.

We can take the six examples of military strategies presented above (see Fig. 2.1) as a yardstick by which to evaluate Hannibal's (military) strategy. Hannibal obviously integrated all of these strategic considerations into his plans, and so we can give his strategy a positive evaluation as shown in Fig. 2.5.

		Description	Evaluation (- - … + +)
1	**Concentration of resources**	Hannibal stations his entire army in New Carthage	
2	**The element of surprise**	The unusual route across the Alps surprises the Romans, who had expected expansion on the Iberian Peninsula	
3	**Selection of a theater of war according to one's own strengths**	Since his fleet is much weaker than that of the Romans, he wages war on land	
4	**Organization and communication between generals and battalions is top priority**	The approach is well organized (few resources are lost en route)	
5	**Precise coordination of strategic objectives and resources**	The objective is to vanquish the Romans - with weapons that boast advantages	
6	**Substantial advantage through innovation (weapons, warfare)**	The Romans are at first unfamiliar with the elephants and their strengths/weaknesses	

Fig. 2.5 Evaluation of Hannibal's strategic planning

Given the military expertise Hannibal demonstrated with this strategy, the question naturally arises as to why he still lost the Second Punic War after 17 years. One of the answers historians give is that he failed to continue unconditionally on the path to Rome following his early victories. Instead he let himself get drawn into political and tactical battles, which ultimately weakened him and his resources. This gave the enemy the opportunity to rally and to adapt to Hannibal's strategy.

So this early example shows us that a strategy should take numerous perspectives into account. And it also demonstrates that even a well-planned strategy is not necessarily successful in perpetuity—a point we will discuss in more detail in Sect. 2.3.

2.2 The Theoretical Response: Strategy as an Integrated Concept

The previous chapter presented an initial idea of what strategy is and emphasized that it is evidently always beneficial to have your own strategy. As economic entities, companies need strategies in order to set their priorities as regards resource allocation, but they also need them to be able to react to changes in their environment, to respond to competitors' behavior, or to communicate the direction of their own business to employees, customers, and shareholders.

2.2.1 Strategy

In a bid to meet these diverse challenges, a strategy—according to the literature—displays five main features:

1. It has an integrated aspect, in other words it relates to overarching areas/parts of the company.
2. It is intended, in other words intentional on the part of the decision makers.
3. It is activity oriented, in other words formulated with a focus on direct action.
4. It is systematic, in other words comprehensible to third parties.
5. It pursues the long-term achievement of objectives.

Furthermore, the literature specifies a number of other requirements for a strategy: the overall objective of any strategy is to ensure long-term survival, and the focus lies on the relevant markets and their opportunities and threats. The concept of relevance is important here: it's a question of defining the market that is relevant to you from a material, geographic, and temporal perspective to enable you to develop your strategy. The following example illustrates the point: your local baker does not compete with a local baker from another city—they have no geographically relevant common market. And his bread rolls are not in direct competition with the local butcher's sausages, even though both are foodstuffs—they have no materially relevant common market.

Suppliers should utilize the opportunities available in relevant markets by knowing and taking proper account of their internal strengths and weaknesses.

Taken together, the above-mentioned points can be used to formulate a definition as follows:

> To sum up, strategy in corporate practice is an integrated concept with the object of ensuring long-term survival in active interaction with the competition and its inherent opportunities and threats, whereby the systematic realization of the concept is enabled by having regard to individual strengths and weaknesses.[3]

It is obvious that such an awkward and complex definition, as found in a similar form in most of the literature, will not help anyone formulate a strategy when it comes to the crunch. So let us merely state, for the record, that the concept of strategy can be broken down into a number of characteristics, the practical applicability of which is, however, extremely limited.

2.2.2 Strategic Management

Strategic management and strategic leadership are the same thing, according to the prevailing opinion. We will stick with the term strategic management in this book:

[3] Bickhoff (2000), p. 53.

> Strategic management is the process determined by specific persons to establish and implement the integrated concept that has already been described.[4]

The future conditions that specific persons (e.g. management, owners) strive to achieve represent the objectives of strategic management. The corporate culture, with its values and structures, provides a basis for this and shapes the management process in the sense that it gives rise to a vision and a mission. These very "soft" issues will not be pursued in more detail here, since they can only be changed in the very long term. For our purposes, let's assume that there is such a basis in place.

2.3 The Process-Based Response: Strategic Planning—An Organized Understanding of Strategy Processes

In accordance with the idea of strategic management being a process, the process can also be referred to as strategic planning (the concept of "*strategy as formal planning*").[5] It can be divided into four context-related areas: general planning, strategic planning, operational planning, and steering and controlling the operational planning.

2.3.1 General Planning

During general planning, managers or owners determine the future conditions for which they strive, in other words the objectives of strategic management. In this context, business leaders have been turning away from profit maximization as the sole corporate objective since the middle of the twentieth century. These days it is recognized that companies have a range of equally important objectives, with the result that firms now work with a "multi-attributive system of objectives." This consequently raises issues concerning the structuring and positioning of, and the connections between, the objectives in these systems.

[4] Ibid.

[5] See, among others, Brews (2003), pp. 34–43.

In terms of positioning, there is no question that the overall objective of such a system is always to ensure long-term survival in business, based on three vital "requirements for survival." According to these requirements, in order to be able to exist in the long term, a company must

- have short-term liquidity at all times,
- be profitable, at least in the long term, and
- register growth that is at least average in relation to the relevant market.

Below this overall objective there are a number of high-level clusters of objectives, which describe either formal economic goals or non-economic aims. The most common breakdown features earnings targets (profitability, sales, costs, etc.), market-based targets (volume sales, customers, markets, etc.), and performance targets (quality, environment, workforce, etc.) as the clusters of objectives as shown in Fig. 2.6. Each of the clusters supports the overall objective, although the clusters may contain competing goals: especially the performance targets are often in direct contradiction with profit/return targets. The clusters themselves are fleshed out in the general objectives of corporate policy—determining these objectives is the fundamental management decision that managers or owners must make.

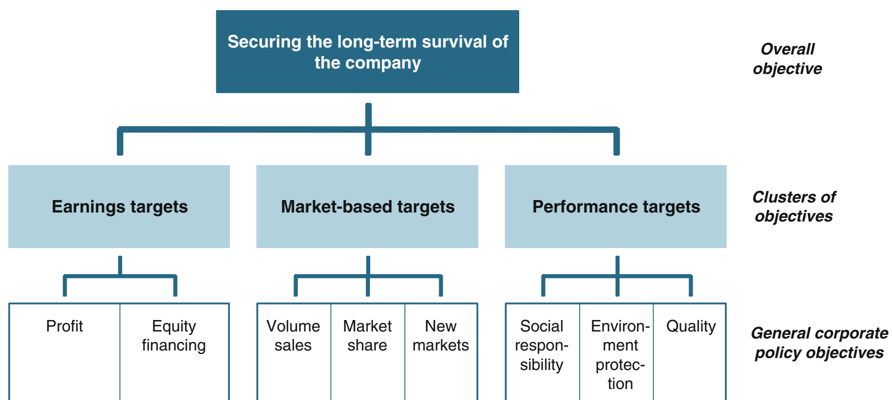


Fig. 2.6 Example of a hierarchically structured, multi-attributive system of objectives

Clearly, strategic planning displays a highly "organized understanding" of the notion of strategy, even in the early, general planning stages. The corporate policy objectives that a small group of people considers to be "right" are prescribed top down.

2.3.2 Strategic Planning

Strategic action planning is the next step in this organized understanding of strategy, where the prescribed corporate policy objectives are fleshed out with suitable actions. The level of detail in the actions is low in this step and the planning interval is long. The following example illustrates the approach: a suitable strategic action for increasing a commercial enterprise's volume sales by 30 % might be to increase the number of sales outlets from 50 to 80 within the next 2 years.

2.3.3 Operational Planning

Whereas the previous step was concerned with substantiating the objectives from a fairly rough and long-term perspective, the operational actions for implementing and achieving the targets are planned at this stage. The level of detail rises accordingly and the planning interval decreases. With respect to our example above, this means that the commercial enterprise now needs to plan the locations at which and the order in which the 30 new outlets should be established, and who is responsible for the various steps involved.

2.3.4 Steering and Controlling the Operational Planning

Steering and controlling the operational planning draws the strategic planning approach to a close and concludes the organized understanding of strategy. The process involves regularly comparing actual values against predetermined, quantified targets. This enables countermeasures to be initiated if need be. In our example, such measures would be necessary if one of the new outlets was not ready to be opened on the agreed date, for instance.

2.3.5 Implications of Strategic Planning as a Concept

Evidently, the concept of strategic planning suggests to decision makers a security it cannot guarantee. As we already saw in the case of Hannibal, good strategic planning is indispensable. However, a well-planned strategy alone does not necessarily lead to success. The organized, systematic understanding of strategy, on the other hand, means, first, that more administration than actual management goes on at a lot of companies that follow this process principle—the firms concentrate only on measurability and control, disregarding creativity and expertise. And second, the top-down approach of deciding on targets must be called into question: are those who make the decisions really so all-knowing?

That is why Mintzberg counterposed the concept of emergent strategies ("*strategy as learning*"[6]) to the concept of strategic planning ("*strategy as formal planning*"): thus, strategies tend to develop in an organization bottom up as the company learns from its successes and failures over time. Evidence of top management fallibility can be found in virtually any firm: just read a few consecutive annual reports from any corporation. Annual reports present the company's strategy to its shareholders and state the company's focus. In the majority of cases, the strategic focus a company communicates to its shareholders changes almost from year to year: from investment-based growth to consolidation to customer orientation to value management, and so on. Given the fact that strategy is long term by definition, the subject of a company's annual reports should be constant or should, at most, vary gradually. An almost annual variation in strategic issues merely serves to demonstrate that the idea of top management executing strategic planning is not necessarily sustainable and—see Hannibal's example—not necessarily successful either.[7]

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[6] Ibid.

[7] A look at five consecutive annual reports from any company will give you an insight into specific cases.

2.4 The Innovative Response: Creative Rule-Breaking as an Alternative Way of Executing Strategy Processes

If we want to reduce the administrative dimension in strategy processes and to bring more creativity back into strategic planning, we need to combine the formal approach of a strategy process with the intuition of emergent strategies. Simply put, this means that only intensive communication and discussion can lead to creative strategy solutions. To ensure that creativity does not end in chaos, however, a systematic process that aids the development of rule-breaking strategies in four stages can help.[8]

2.4.1 Why Rules Need to Be Broken

Of course, it is right to follow the rules of the market in which you operate as a matter of principle. However, some market players find their long-term survival seriously under threat, especially in markets or times that present limited possibilities for technological innovation coupled with growing consolidation tendencies. In such situations, business success can often be found in purposefully breaking the rules of the market. Ryanair,[9] IKEA, Dell, and H&M are examples of companies that broke the rules in their traditional markets and enjoyed substantial market share gains and success as a result. But not everyone that breaks the rules is successful, because breaking the rules brings more than just opportunities: it also entails risk. What this means in relation to a process-based approach is that it is crucial to know the rules of your own business in order to have a basis upon which to examine, as systematically as possible, whether there are opportunities to deviate successfully from the rules.

Rule-breaks do not normally come about "out of nowhere," which is why developing a rule-breaking strategy is a complex affair that will always retain an added measure of uncertainty—compared to a strategy that follows the rules. Given that the success (or failure) of a

[8] With respect to the remaining remarks in this section—and particularly those on the forms of rules—see zu Knyphausen-Aufsess et al. 2006, pp. 369–377.

[9] See also Sect. 4.1.2.

strategy only becomes apparent in the long term, most risk-averse decision makers shy away from breaking the rules of their industry, preferring to stick to the rules and so minimize the uncertainty. Breaking the rules comes easier if the associated uncertainties can be lessened. Consequently, in order to promote creativity and the rule-breaking that comes with it, there needs to be a process that raises creative strategies' prospects of success.

We generally learn in existing contexts. In other words, we develop our strategies within the context of given environments like the industry or the legal framework. Yet these set natural limits to strategic creativity: we are not normally able to think outside the "box" of our own business, persisting instead in the traditional thought patterns. In doing so we achieve only marginal changes in our strategy, never a rule-break.

To incorporate creative ideas into the formulation of their strategies, companies can integrate experts from other industries into the strategy development process. Many firms do this by bringing in senior executives from other industries who, they think, will inject a breath of fresh air into the organization. Unfortunately, these people tend to acclimatize to their new organization very quickly, and the breath of fresh air soon turns out to be more than a little stale. However, constant renewal of the management team is not the answer either—all this does is cause considerable unease in the company.

One alternative is to bring in consultants, who also represent new ideas, given their wealth of experience and industry knowledge. But every project comes to an end at some point, and then the ideas and the stimulus, or at least the people who provided them, are no longer with the company. So it is important for the organization itself to be able to see the bigger picture so that it can derive its own innovative strategies based on what it has learned. A new strategy development process, the "rule-breaking strategy creator," can help here.

2.4.2 The Rule-Breaking Strategy Creator: Four Steps to Breaking the Rules

The rule-breaking strategy creator consists of four steps, described in more detail below. The first two steps derive from the sphere of

strategy consulting, while steps three and four come from the venture capital scene:

1. Establish and maintain a generally applicable framework for analysis and exploration.
2. Regularly combine the information gained into innovative approaches and strategies.
3. Translate the innovative approaches into business opportunities.
4. Evaluate these opportunities and the underlying strategic notions.

The combination of these tools innovatively integrates the capital market perspective with entrepreneurial aspects and creativity techniques. Against the backdrop of the contexts analyzed, a process of strategy development emerges, which minimizes the risks of breaking the rules for the company concerned and maximizes the strategic creativity that flows into the process.

The first step involves putting the company in a position to see the bigger picture and systematically to challenge the identified rules. The systematic approach is so important because otherwise the information that is learned ends up getting lost (as people leave the company, for example). The exploratory framework provides for a fixed sequence of six exploratory questions (see Fig. 2.7).

Consider an example: A German company operating in the automotive supply industry wants to develop the capacities it built up over many years (production sites, personnel, plant and equipment, etc.) into a fresh competitive advantage. The top-level issue (for instance how to deal with overcapacities) can be subdivided into individual issues or subsegments, such as:

- How can we make work time more flexible in innovative ways?
- How can we market seasonally available warehousing capacity to third parties?

It might be fair to assume that everyone in your own industry and your own country would address the issue in more or less the same way. Yet it may be worth thinking out of the box here. Our sample company can analyze these individual questions using the exploratory framework systematically in respect of different industries, different

1 Exploratory questions (standardized)	Context/top-level issue							
	Subsegment 1				Subsegment 2		Subsegment ...	
	Own industry	Industry A	Industry B	Industry ...	Own industry	Industry ...	Own industry	Industry ...
What are the existing rules in this business that lead to the dominant strategies?								
What alternative rules/ processes are there for determining strategies?								
Why are these alternative rules better?								
What are the enablers that can create these alternative rules?								
What are the drivers that can create these alternative rules?								
How can these rule-breaking strategies be implemented?								

Fig. 2.7 Step 1—The principle of the general framework for analysis and exploration

nations, and even different links in the value chain. The six exploratory dimensions that are the same for all industries and all companies need to be applied to the situation at hand and the following questions asked:

(a) What are the existing rules of the business?
(b) What alternative rules are there?
(c) Why are these rules better?
(d) What are the enablers behind these alternative rules?
(e) What are the drivers behind these alternative rules?
(f) How can these rules be implemented?

The complexity of these questions rises from (a) to (f), but the more another industry or country has done to develop the issue, the easier it is to answer the questions. It is then a simple matter to standardize and systemize the knowledge from other industries on all kinds of top-level issues.

It goes without saying that an exploratory framework of this kind can never be rigid; it is always changing, usually filling up gradually,

and never ceasing to grow. Strategy consultants use tools like this to file their knowledge away for the future, so that they can use it to offer their clients industry-spanning solutions at a later date. And with the help of such a framework the German company in our example may eventually learn how copper mining companies in Australia approach work time issues and how food producers in India deal with seasonal warehousing needs.

The second step (see Fig. 2.8) involves combining the observations from one—or several—exploratory frameworks to progress from the new information to creative strategic approaches. At this point, anything goes in that the entire spectrum of creativity techniques can be applied: the systematic/logical approaches (such as morphological methods, progressive abstraction, relevance tree analysis) and the intuitive/creative methods (like brainstorming, method 635, synectics). External experts (academics, consultants, industry experts) select certain observations and use them to challenge company management in a workshop setting in a bid to identify new approaches together (for example: "Could the Australian approach be relevant to our business and could it give us competitive edge?"). The potential rule-breaking strategies developed in this manner—typical of strategy consulting—are rooted in different environments and

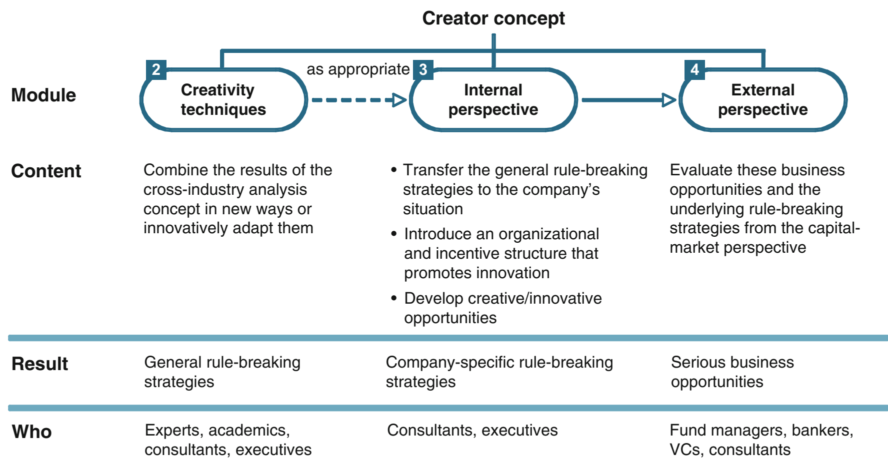

Fig. 2.8 Steps 2 through 4—Using the general analytical framework in the creator concept

therefore need to be examined against the specific background of the company concerned.

The challenge in step three (see Fig. 2.8) is to map the innovative approaches onto the current business system and the company's situation so as to derive new strategies and business opportunities. The managers involved need to develop an internal outlook toward the approaches, thus becoming "intrapreneurs" who—to stay with our example—come up with new models to deal with overcapacities (such as a group company that implements flexible work time models along the lines of those used at the Australian copper mines, or a service offering for shared warehousing directed toward outside firms and modeled on that of the Indian food producers). The basic prerequisite for achieving an internal outlook and the resultant business opportunities is that the company's organizational and incentive structures must be suitably geared toward innovation. At the end of this step the company will have innovative business opportunities available to it, which it would not have been able to cultivate without integrating knowledge from outside of the industry. Some companies, Bertelsmann among them, offer incubator concepts for this purpose: employees become intrapreneurs tasked with developing a new business model within the constraints of certain resources (time and capital), but separate from the group organization.

In step four (see Fig. 2.8), the business opportunities developed in step three and the underlying rule-breaking strategies need to be verified. This evaluation cannot be conducted by company insiders—first because, generally speaking, company managers are already actively involved in developing the business opportunities that are being evaluated; and second because they usually compete with each other, which gets in the way of a fair evaluation. The managers would thus be doubly prejudiced. A better way of doing it is to have the evaluation carried out by several impartial and experienced capital market experts (investment bankers, fund managers, consultants, and executives). These experts have only one question to answer based on the information available to them and using the tools at their disposal. That question is: "Would you invest your money in or work for a company that planned to break the rules in this way?" This is the typical question that all investors ask themselves when evaluating a new business model. If the answer is yes, not only is the uncertainty regarding the effect of the non-conforming behavior mitigated, but a

part of the necessary capital and/or management capacity may already be on board as well.

Rule-breaks are the flywheel of each and every industry, and in the long run only rule-breaking companies will survive in the market to enjoy substantial success and competitive advantages. There can, however, never be 100 % certainty that a rule-break will be successful. The approach described here can diminish the risks involved in breaking the rules without the need to invest more resources than are already earmarked for the—frequently little more than administrative—process of strategy development.

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3 Strategic Frames of Reference: The Key Tools of Strategy Determination, Their Principles, and How They Interact

Mintzberg demonstrated in a number of case studies that top managers cannot be strategic, all-knowing planners as well as organizers, coordinators, and controllers all at once—they do not have the time. They should instead share information and build up an overall picture in order to make the right strategic decisions.[1] This overall picture and the information required to develop it can be analyzed and evaluated with tools from the sphere of strategy content research. This chapter presents the key tools of strategy determination. They are also known as frames of references, since their job is to prompt you to think and to make it easier for you to know where to start when analyzing strategies. There is also the field of strategy process research, upon which we will touch only briefly, since the strategic planning approach presented previously lies at the heart of this.

The primary goal of Anglo-American-style strategy content research is practical relevance. It aims to make practice-oriented tools available to those who need them in their work. Here, performance (the result) is taken as the empirical measure of strategy. Viewed retrospectively, superior returns indicate a good strategy. So if a company in a certain industry permanently achieves higher returns than its competitors, it has chosen the right strategy. The research analyzes the company's past in a bid to pick out patterns from which to derive strategies and tools. This section is therefore not

[1] See Mintzberg (1975), pp. 49–61.

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P. Kotler et al., *The Quintessence of Strategic Management*,
Quintessence Series, DOI 10.1007/978-3-662-48490-6_3

about prescriptive planning but about descriptive analysis of strategic perspectives.

3.1 Why It Is Important to Structure the Market, the Competition, and Your Own Company Properly

Against the backdrop of a constantly rising flood of information and the increasingly dynamic international markets, it is becoming ever more difficult for companies to formulate the “right” strategy. As we already demonstrated, strategic planning may be suitable as a thought process to integrate and provide an organized representation of all of the management steps. But it does not give any indication of the extent of the potential success of the chosen strategy—it suggests a certainty to decision makers but it does not guarantee success. Consequently, if they want to get any closer to the issue of a strategy’s success, decision makers first need to adopt a diverse range of perspectives by applying strategy tools. Only then will they have an understanding of all of the layers of a strategy, providing them with an overall qualitative assessment of the situation and an essentially objective decision aid for strategy selection.

3.1.1 Interdependencies Between the Key Approaches

Figure 3.1 presents the most important frames of reference and how they interact. Practitioners should at least be aware of these approaches as well as the concepts behind them, what they entail, and the amount of information they potentially offer. The SWOT analysis provides the basis of data for all subsequent steps—the other frames of reference will not be any use at all unless this analysis is executed in a precise and exhaustive manner. The next step is to examine both the corporate strategy and the business strategy based on the SWOT findings. These two strategic issues subdivide into numerous perspectives, developed using seven different tools, to which the rest of this section is dedicated. In relation to the strategic management process, these frames of reference are applied in the

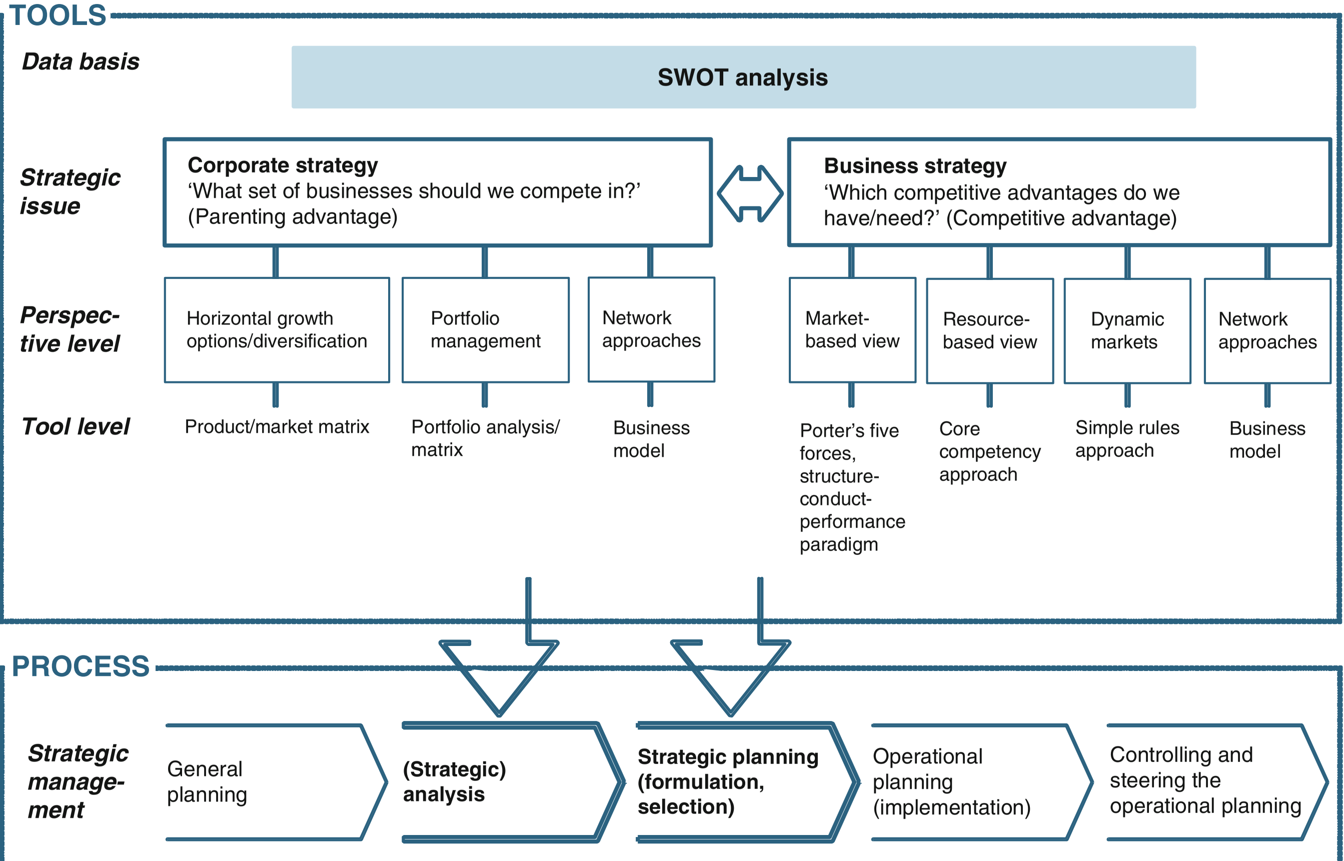

Fig. 3.1 Frames of reference for considering strategic options

sphere of strategic analysis and planning: they consequently depict the whole of the content side of strategy determination.

3.1.2 The Harvard Business School SWOT Analysis: The Data Basis for All Interpretive Tools of Strategy Determination

In any attempt to determine a strategy you need to start by gathering and analyzing all of the necessary information. Given the much-cited flood of information with which we are faced, this is something of a never-ending task: the Internet, libraries, corporate PR departments, and a flood of internal documents quickly cause you to lose track and forget what you were really looking for in the first place. The frame of reference constituted by the SWOT analysis represents the basic analytical framework for strategy research. It was developed in the 1960s at Harvard Business School[2], and today Henry Mintzberg sees "*... SWOT as underlying all attempts to formalize the strategy making process.*"[3]

This frame of reference breaks down the available information into four areas: **S**trengths, **W**eaknesses, **O**pportunities, and **T**hreats. According to this, a strategy is the result of the opportunities and threats of the technological and economic environment and the strengths and weaknesses of the company.[4] Whereas the strengths and weaknesses constitute the internal analysis of the company, the opportunities and threats represent the external analysis of the relevant market. In the first instance, you as a practitioner are therefore required to do no more than sort all of the information gathered into these four areas. The deeper analysis and interpretation is done later with other tools that draw on this preliminary work.

You should bear in mind that the SWOT analysis remains highly abstract in practice, since its findings are purely descriptive and it does not make any recommendations or set any priorities.[5] Nor does it

[2] For a detailed view see Andrews (1980).

[3] See Mintzberg (1994).

[4] The interests of management and the requirements of society are sometimes explicitly incorporated in the consideration as well. But we will leave these aspects aside here.

[5] For additional points see Hill and Westbrook (1997), pp. 46–52.

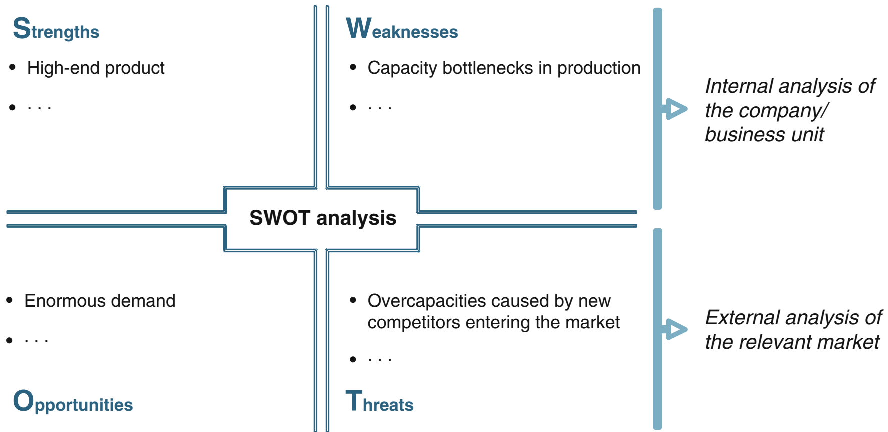

Fig. 3.2 Sample SWOT analysis

need to; its job is merely to present a structured, and therefore reusable, depiction of the situation for which a decision is required.

The example in Fig. 3.2 illustrates the point: a company produces an extremely high-end product and is faced with enormous demand. It is unable to satisfy this demand due to capacity problems in production operations. The threat is that new competitors entering the market may lead to the development of overcapacities, which would put pressure on volumes and prices. This sample situation, effectively reduced to four pieces of information, demonstrates the potential of the SWOT analysis: the structure is there, but there is nothing to help make a decision. Whether the company should expand capacity, running the risk of new suppliers causing overcapacities, or keep its capacity tight, with the danger of customers switching to other suppliers, is a decision that can only be made with the help of additional tools. However, structuring countless pieces of information at the same level of abstraction is only the first, albeit very important, step in understanding and describing the complex situation in rough.

When you apply this method in practice, it is essential to bear the following points in mind, otherwise the frames of reference for strategic planning cannot be applied or exploited to the full—this is definitely a case in which thoroughness takes precedence over speed:

- Keep the statements descriptive. It is very hard to avoid jumping straight to interpretation when you are condensing all of the information down to a few points, but such evaluation should be left to the tools at the perspective level.
- Certain points cannot always be assigned unambiguously. A statement saying that 30 % of US households have a broadband connection could be an opportunity (70 % market potential remaining) or a threat (limited acceptance). Since you should not be interpreting the points during the SWOT analysis, you need to list the statement as both an opportunity and a threat.
- Concentrate on information for the external analysis. Most companies remain on the level of internal analysis, taking an inside-out perspective, because there are naturally a lot of internal documents available on this aspect, and every employee has an opinion on the company's strengths and weaknesses. The act of gathering external information on the market through anything other than the online channel is regularly less than successful: the people tasked with the job are often afraid to call competitors, industry associations, or other entities under a clever pretense (such as researching for an academic paper) to ask for information that is not in the public domain. Yet this is the very information that determines the quality of an external analysis.
- Keep a sharp distinction between internal and external analysis. Many practitioners will let themselves be taken in by the obvious notion that weaknesses also represent opportunities, and will thus mix internal and external points.[6] This must not be allowed to happen—"external" really does mean the pure market perspective.

[6] It is quite astonishing, in fact, that this happens time and again. Even the dictum of "the crisis as an opportunity" derives solely from the fact that external threats or changes lead to corporate crises, which then lead to weaknesses and present the opportunity to make a new start. Thus, there is an indirect connection at most.

3.2 Analyzing Corporate Strategies

Corporate strategy is also known as enterprise strategy and it addresses the strategic question, “What set of businesses should we compete in?” This means it examines and clarifies at the group level which businesses should be operated overall. The best example of this are the conglomerates, such as General Electric and Siemens, which bring a wide range of very diverse businesses—from power plant construction to fridge manufacture—under one roof. In the case of legally independent integrated companies, there are also parent companies, each of which has a number of subsidiaries, which, in turn, all operate different businesses. For a parent company to justify its existence economically, it must offer its subsidiaries a parenting advantage. Such parenting advantages may be benefits arising from a common umbrella brand, from having management structures and systems consolidated at a single point instead of present in each company, from value-oriented portfolio management, and from other economies of scope. If the parent company does not provide this advantage, its role as a strategic holding company must be questioned. In this case it can either be interpreted as a financial holding company or, if the subsidiaries are large and independent (for the most part listed or listable corporations), it can be disestablished. So there is no parenting advantage unless the company as a whole is worth more than the sum of the individual, independent companies within it.

3.2.1 Horizontal Growth Options: Ansoff’s Product/Market Matrix

Igor Ansoff first published his deliberations on the product/market matrix in 1957.[7] In a bid to address the corporate strategy of the future, his approach delivers the perspective of growth options on the horizontal (group) level and introduces the possibility of diversification. The first starting point of Ansoff’s deliberations was the fact that companies need to grow fast in order to improve their position among the competition. The second starting point was the assumption that

[7] See Ansoff (1957), pp. 113–124 (1957) and also Ansoff (1965).

	Existing products	New products
Existing markets	***Market penetration*** Intensifying market development, relaunching products, imitation, cutting costs and prices, unbundling (Market leadership)	***Product development*** New products, new product lines, new services and/or problem and system solutions (Extending the value chain)
New markets	***Market development*** Expanding the market, new customer strata, new distribution channels, new uses for the products (Realizing economies of scale)	***Diversification*** New products for new markets – Vertical – Horizontal – Lateral (Additional mainstay, risk balancing)

Fig. 3.3 The product/market matrix

there could be uncertainties in the existing businesses, which would mean that it might make sense, in the context of growth, to spread the risk (for instance if the markets are subject to seasonal cycles).

Building on these two notions and utilizing empirical data, Ansoff developed his generic product/market matrix (see Fig. 3.3). Based on the fundamental question, "Which products should be supplied in which markets?" this frame of reference depicts the four general growth options for a company's horizontal strategy. In order to substantiate this "set of businesses," a distinction is made between existing products and new products as well as existing markets and new markets.

The box at top left describes the status quo at the company. In line with this frame of reference, it incorporates the four principal, horizontal growth options of market penetration, market development, product development, and diversification. All of the descriptive results of the SWOT analysis are needed here as the options are evaluated and a prospective corporate strategy developed. If, for instance, there are virtually no opportunities in other markets and the company's in-house product expertise is limited, a strategy of market penetration would seem appropriate. This entails no expansion of business activities; instead the company should develop the

status quo more intensively in order to attain or defend a position of market leadership through relaunches, price cuts, etc.

If, on the other hand, opportunities for the existing products in other markets are good, the group should develop the market. This generally involves penetrating new customer groups in the same geographic market, although it can also mean expanding the current market geographically. In either case, the group supplies its existing products in these new markets, for instance by establishing or buying a foreign subsidiary. The objective is to realize scale economies[8] by achieving better utilization of existing production capacities through market extension and the acquisition of new customer strata, and by bringing fixed costs down as a result.

Where the opportunities in other markets are not good but the in-house product expertise can be expanded, the company should pursue a strategy of product development: offering existing customers or geographic markets either a brand-new set of products (generally achieved by buying up a subsidiary) or new product lines or system solutions building on the current product and service spectrum. With this strategy, growth centers on extending the value chain, in other words on upstream or downstream integration.

If the SWOT analysis shows that the company faces substantial threats to its existing businesses (for instance seasonal or cyclic fluctuations), diversification may be a suitable growth strategy. Here, the aim is to offset the threats present in the current markets by establishing an additional mainstay of the business to balance the risk at the group level. Lateral diversification[9] entails a complete departure from any prior expertise, with the company supplying brand-new products in brand-new markets. The above-mentioned conglomerates are examples of companies that follow this principle: a fridge and a power plant have nothing in common on the product or the market side—except the parent company.

Self-evidently, any synergies within a group's existing business diminish the further the strategy moves away from the status quo. With lateral diversification, there is no synergy between the

[8] Also known as economies of scale.

[9] We will not address the other two forms of diversification (vertical and horizontal) in any more detail here.

businesses, so the success of this strategy is much more risky—but on the other hand, it is the best way of spreading the risk. What this means for conglomerates is that they must manage their individual subsidiaries very strictly, since there is no mutual support between them. General Electric, for instance, lives this principle by stipulating that any subsidiary is only kept in the portfolio if it is sustainably the number one or the number two in the market. Where this is not (or no longer) the case, the subsidiary is divested. This strategy of market leadership on the part of all of its subsidiaries is what made the General Electric conglomerate one of the five most valuable companies in the world and is indeed what keeps it in that position.[10]

3.2.2 Portfolio Management: Portfolio Analysis (Matrix)

Complementing Ansoff's perspective of growth options, the portfolio analysis offers a perspective for the active evaluation and management of the existing portfolio. These two frames of reference are used in parallel and together they produce a suggestion as to the right corporate strategy for the company concerned.

The portfolio analysis considers all of the group's strategic business segments and subsidiaries from the corporate perspective, evaluates all aspects of them, and takes this as a basis to plan the allocation of resources and, with it, the corporate strategy. It has its origins in Markowitz's financial portfolio analysis (1952), the aim of which is to achieve an optimal return. The objective of portfolio analysis is, therefore, to realize as high a return as possible while incurring as little risk as possible and to operate or establish such strategic business segments as are necessary to achieve this. The process turns the parent company into an investor with a medium to long-term orientation, holding individual shares or subsidiaries in its portfolio in line with its return/risk preferences in much the same way as a shareholder would do.

The analysis is mapped onto a portfolio matrix, which, in most cases, contrasts the strengths and weakness with the opportunities and

[10] In fact, GE is often the most valuable company in the world, but—depending on oil prices or technological innovations—is continually superseded by either Microsoft or Exxon.

threats. As such, all of the descriptive findings of the SWOT analysis flow directly into the portfolio matrix. Generally speaking, the matrix combines attributes that describe the strength of a market (and also the strength of the competition) with attributes that express the market's attractiveness to arrive at four (or more) generic strategies. With a strategic portfolio matrix you should always ensure that one of the axes depicts internal criteria while the other portrays external criteria. Only then are the attributes completely independent, and the whole of the portfolio matrix can be utilized or filled. Time and again, we come across portfolios that use mutually dependent axis criteria (namely both external or both internal attributes). The interdependency results in automatic regression—the portfolio matrix cannot fully be utilized and its strategic significance is dramatically impaired.

Bruce Henderson developed the best-known portfolio matrix, the BCG matrix, in the late 1960s.[11] It is based on three theoretical fundamentals, which afford it significant relevance at the strategic level (as long as those who use it are aware of these fundamentals).[12]

Henderson studied the semiconductor industry in the U.S. in the course of his work. In the context of quantitative-empirical research, he discovered the following law, which we now know as the experience curve: each time the relative market share doubles, the relative costs decline by at least 20 %. The relative market share is calculated as a ratio consisting of a company's own market share and the market share of the biggest competitor—an increase in this ratio signifies a dramatic rise in the cumulative production volume and, thus, the emergence of learning effects in the conduct of business operations, which bring corresponding cost benefits.

Since Henderson discovered the experience curve, it has been demonstrated in countless works pertaining to an extremely diverse range of industries, and as a result it now counts as a widely accepted economic law. It represents the first theoretical fundamental of the BCG matrix.[13] The attribute that the relative market share reflects in

[11] BCG stands for Boston Consulting Group, the company Henderson founded.

[12] With regard to the following remarks see Henderson 1974, 1979, 1984.

[13] Experience curve effects relate unit costs to cumulative volume; economies of scale relate unit costs to units of volume per unit of time. This is an important

this matrix is a company's market power, which equates to the internal analysis of strengths and weaknesses. The better a company's position here, the greater its cost and margin benefits, the greater its market power.

The second theoretical fundamental of the BCG matrix is the four-phase lifecycle concept: young markets grow very fast and thus demand substantial investment in research & development, in building up capacities, in branding, in human resources, and so on. Mature and saturated markets grow slower and tend to require lower investments to sustain the business. In the BCG matrix the growth of the market reflects the attractiveness of the relevant market as an attribute, which equates to the external analysis of opportunities and threats. According to this, young markets are theoretically more attractive, but they necessitate a great deal of investment, making them prone to risk as well.

The third and crucial theoretical fundamental of the BCG matrix is the use of free cashflow (FCF) as one of the target criteria in the portfolio. It is not profit but freely available liquid funds that need to be optimized: FCF is defined as cashflow less maintenance capex[14], and it represents the liquidity available in excess of that needed to operate the business in line with the market. This liquidity can be distributed in the form of dividends, for example, or used for diversification, acquisition, etc. In the BCG matrix, free cashflow is calculated by looking at the relative market share, which determines how much cash is freed up, and the growth of the market, which determines how much cash is consumed (in other words, maintenance capex).

A diversified company can use the BCG portfolio to analyze its portfolio of activities in great detail and to plan the allocation of

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difference, because it means that experience curve effects are even available to small firms that have been active in the market a long time—for instance the local shoemaker. Economies of scale, on the other hand, can be experienced by large companies only—those that make better use of their production capacities, for instance. This, of course, means that these larger companies also feel experience curve effects.

[14] For a first approximation you can quickly calculate cashflow from the following figures in the profit and loss statement: annual profit plus depreciation and amortization.

Fig. 3.4 The Boston Consulting Group portfolio matrix

investments to the most productive areas of business. The standard matrix shown in Fig. 3.4 serves to illustrate the ensuing description.

A "Cash cow" has a high relative market share in a mature market. This means it frees up more cash than it consumes. Accordingly, the company should hold this business segment in its current position by making maintenance investments so that the cash can be "harvested."

"Stars" also have a high relative market share but operate in a market that is still growing fast. Consequently, the amount of cash freed up is offset by the amount consumed. Companies should definitely promote stars with the funds at their disposal because such investments can help stars become cash cows in time.

A high level of market growth means that business segments in the "Question mark" quadrant use up more cash than they can generate with their relatively low market share. A selective approach is called for with these businesses: depending on the future prospects, the division should either be promoted or divested. Question marks are, in any case, the areas in which the company must make a decision and take action the fastest, since they consume cash.

"Poor dogs" have a low relative market share in a mature market. Therefore, they neither consume nor free up much cash, and they also tie up management resources at the parent company or group level. The preferable course of action for these business units is thus to divest them, or sell them to other companies. If this is not possible, they should be liquidated, in other words closed down.

A company should have a balanced portfolio. In order to achieve this, it needs to employ scoring models or direct measurement to assess where on the axes a business segment is positioned, between low and high. The coordinates determined on both axes enable the firm to mark the division's position as a dot in the portfolio. Once all business units have been marked on the matrix, the portfolio of the company as a whole can be evaluated and developed. A balanced portfolio encompasses a few cash cows and strong stars as well as some question marks with potential, while also exhibiting a positive free cashflow overall. The cash cows release cash that can be used to promote the stars and question marks. The rest of the free cashflow can be put to good use promoting certain areas of the business more strongly or building up other high-potential business segments (mostly question marks).

Their respective lifecycles mean that all three types are needed for a portfolio to be balanced: cash cows tend to degenerate and stars become cash cows as their lifecycle progresses. And only question marks with potential can develop into stars over time. If a company has only cash cows, it will generate a lot of cash but will have no future-proof business activities—the firm should put the funds at its disposal to use creating a balanced portfolio by developing or acquiring question marks and stars. Poor dogs have no place in a balanced portfolio: even if they are cash-neutral, they tie up management capacity and can lead, among other things, to image problems for the parent company.

At a single glance, the portfolio matrix makes it possible to draw conclusions about a company's situation and to see where action needs to be taken. If the company does not have a balanced portfolio for want of stars, it can formulate a corporate strategy by integrating considerations from Ansoff's product/market matrix: What horizontal strategy will balance the portfolio by creating question marks with potential or stars—or, to rephrase the question, "What set of businesses should we compete in?"

3.3 Analyzing Business Strategies

Business strategies are concerned with establishing competitive advantages in each of the strategic business segments. They endeavor to answer the question, "Which competitive advantages do we need or do we have?"

A company can develop the crucial competitive advantages by looking to the market, on the one hand. In this case the firm employs what is known as the market-based view (MBV). This is all about the opportunities and threats in the markets, which means that only these descriptive results of the SWOT analysis flow into the considerations. In other words, the approach takes an outside-in perspective: a company's position in the market or competitive environment is the crucial determinant of its success (the concept of "*strategy as positioning*").[15] The focus lies on the customer, the market, or the industry, and the key questions are: What do I need to offer in order to be successful? What competitive advantages do I need in order to do this? In this view, the firm's existing competencies are not decisive factors.

On the other hand, a company can develop the crucial competitive advantages by looking at resources. Otherwise known as the resource-based view (RBV), this approach considers only the firm's strengths and weaknesses and the descriptive results of the SWOT analysis upon whose basis these are assessed. An inside-out perspective like this sets out—based on the specific company's resources—to find the markets in which the highest returns can be achieved with these competencies. The key question here is: What competitive advantages do I have? Opportunities outside of the company's own world are not taken into account. This perspective finds consideration in the concept of "*strategy as stretch and leverage*", which involves setting barely attainable targets (stretch) to be achieved through the innovative use of resources (leverage).[16]

We will now take a look at the MBV with reference to the structure-conduct-performance paradigm and Porter's five forces.

[15] See, among others, Brews (2003), pp. 34–43.

[16] Ibid.

The core competency approach subsequently serves to explain the RBV.

3.3.1 The Market-Based View: The Structure-Conduct-Performance Paradigm and Porter's Five Forces

Thoughts around the MBV are based on the structure-conduct-performance paradigm from the field of industrial economics.[17] The paradigm states that the industry and its structure are decisive factors in the behavior of market players and in the market's potential (see Fig. 3.5). Oligopolistic market structures thus induce different behavior than those in a polypoly because oligopolies have the chance to secure high returns by means of adapted behaviors. Polypolistic structures, on the other hand, exhibit very intense competition and result in lower returns. Of course, there are recursive processes, which is to say that high returns increase the probability of new providers entering the market, thereby changing the market structures and consequently changing the behaviors in the market as well as other market results.

"Tell me what industry you're in and I'll tell you what you earn." This sentence aptly paraphrases the fundamental thought behind this frame of reference. In the early 1990s the steel industry was marked by low demand and high capacities—the returns were correspondingly poor. Only when there was a demand shock from India and China did the market structures change to such an extent that high returns can now be realized once again. By the same token, international oil companies have for decades been generating outstanding returns in their oligopoly, whose substantial startup investments afford it excellent protection from the incursion of new competitors. Accordingly, the MBV demands that individual companies take a good look at the markets and choose the ones that offer the best returns. Based on the structure-conduct-performance paradigm, Michael Porter presents this process of selection in a structured manner in his "five forces" approach in the interest of showing companies exactly what positioning options and strategies are open

[17] See, among others, Scherer (1980), or Bain (1956).

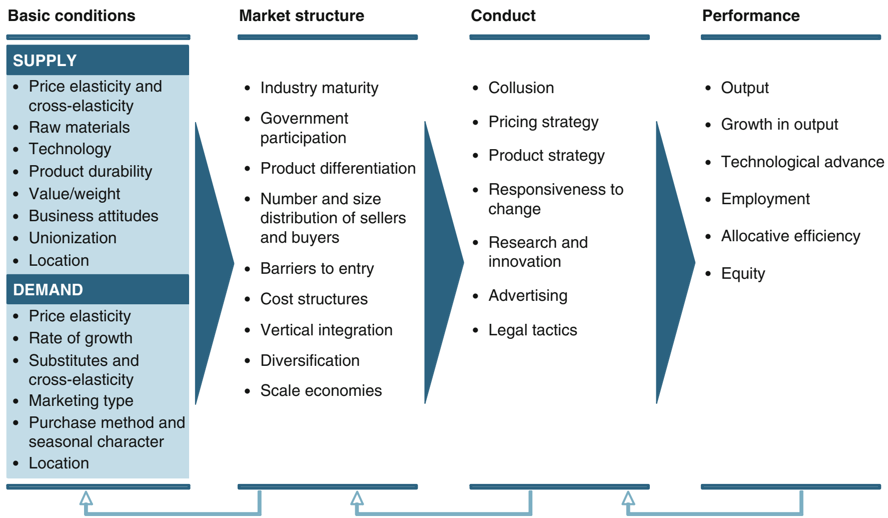

Fig. 3.5 The structure-conduct-performance paradigm from the field of industrial economics (Scherer 1980)

to them in the context of the opportunities and threats present in a given market.

Porter takes competitive intensity as a criterion and applies it to five fundamental competitive forces that shape the market and its environment.[18] The more intense the combined competitive strength in these areas of an industry, the lower the potential for profit (and vice-versa). The five forces are:

- Rivalry among existing competitors
- Bargaining power of suppliers
- Bargaining power of buyers
- Threat of new entrants
- Threat of substitute products

With the aid of these forces, a company can perfectly structure and analyze its value chain and its external environment or potential market. Figure 3.6[19] illustrates Porter's typical presentation of the

[18] With regard to this section see Porter (1980, 1991), pp. 95–117.
[19] Hutzschenreuter (2001), p. 137.

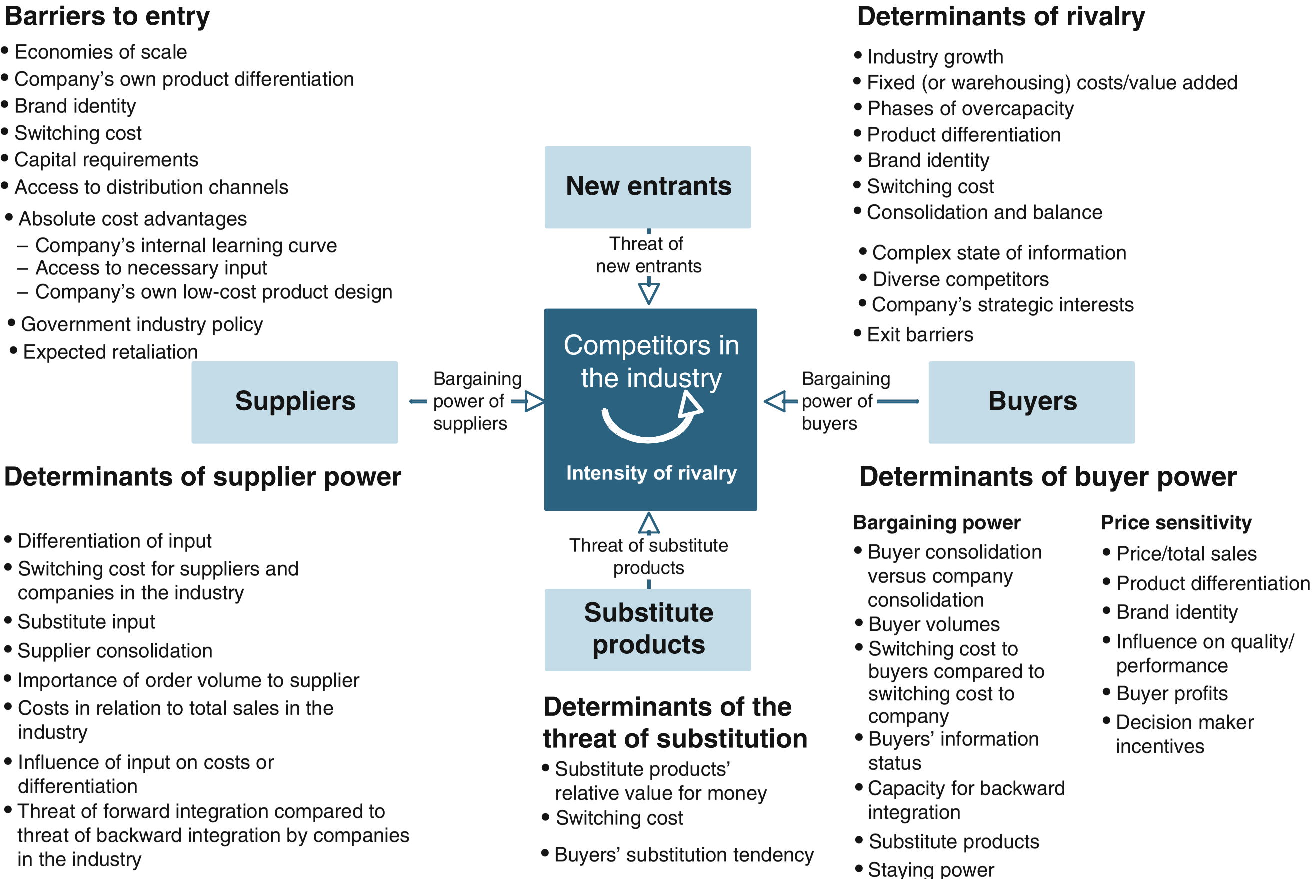

Fig. 3.6 Porter's five forces model for analyzing an industry's structure

model and also depicts the key determinants or criteria that can be used to analyze and evaluate competitive intensity.

The descriptive results concerning the external opportunities and threats as identified in the SWOT analysis are applied to the five forces using Porter's system in order to evaluate the intensity of the competition. This involves individually examining and conducting a qualitative assessment of the separate determinants or criteria by placing them in relation to one another with statements in the form of "The [more/less] . . ., the . . .." Below are a few examples for the different quadrants:

- The stronger the industry growth, the lower the competition and the competitive intensity.
- The lower the capital requirements, the greater the market entry opportunities and the competitive intensity.
- The greater the supplier concentration, the greater the supplier dependency and the competitive intensity.
- The lower the customer volume, the lower the customer dependency and the competitive intensity.
- The higher the switching costs, the lower the threat of substitution and the lower the competitive intensity.

As many of the determinants as possible should be examined and evaluated using this method. The information from the SWOT analysis is not always available in a comprehensive form, so it may not be possible to use certain criteria. Having carried out the evaluation, the company will know which areas and forces drive the competition in particular and how high the competitive forces and therefore the profit potential in the industry is overall.

If the company decides, on the basis of this potential, to remain in or to enter an industry, it can use the individual determinants to identify which competitive advantages are necessary in the industry concerned. Porter also refers to this as competitive strategy and offers two alternatives: in the defensive alternative, the company's establishment of the necessary competitive advantages enables it to find a position in the existing market in which it can shield itself optimally against the competitive forces. In the offensive alternative, however, the firm attempts to influence the balance of forces in the existing

market or to exploit a change in the competitive fundamentals to create new competitive advantages for the industry and to establish itself there.

In the interest of enabling firms to successfully grapple with the five competitive forces and implement a competitive strategy, Porter cites three generic strategy types for both alternatives. According to these, companies should strive for a position in the market either through cost leadership, through differentiation, or by focusing on niches in the market. A strategy between cost leadership and differentiation is stuck in the middle and cannot be successful in the long run.

3.3.2 The Resource-Based View: The Core Competency Approach

10 years on from Porter's five forces, the opposite perspective was presented in the core competency approach,[20] which is at the center of the notion of the RBV. This frame of reference analyzes the strengths and weaknesses of a company and states that there are certain core competencies that constitute competitive edge. These core competencies may be resources, skills, or general assets, and a company must look for the markets in which it can achieve the highest returns on the basis of these core competencies. A core competency must meet certain requirements:

- It must be valuable—in other words scarce and non-substitutable.
- It must be heterogeneous and immovable—in other words differentiating and non-transferable.
- It must be accessible to the company—in other words the company cannot be denied the use of it.
- It must not be imitable—in other words it must be genuinely unique.

The core competency approach attracted a large following in the 1990s, and even today the concept of core competency is still firmly established in the management and consulting arenas. However, the

[20] See Prahalad and Hamel (1990), pp. 79–91.

practical relevance of the approach has been markedly qualified in the field of strategy research. The notion of the "causal ambiguity of competitive advantages" conceals the following thought: if a company, a consultant, or an academic were to succeed in precisely identifying one of a company's core competencies, it would only be for the purposes of employing this core competency more widely. Yet this would infringe on the inimitability requirement, and competitors would be able to build up the apparent core competency themselves. In practice it is therefore better to speak of strategic competencies that constitute competitive advantages for the company and that meet some but not all of the requirements of a core competency. This is not to imply that there are no such things as core competencies: the strength of this frame of reference lies in illustrating that there are, for example, certain organizational capabilities on the part of a company that give it competitive edge. What is important is that, though they exist, these advantages cannot be perceived and reproduced in detail. If it plans to adopt a resource-based view, a company should therefore examine its own strengths and weaknesses as depicted in the SWOT analysis against the four attributes of a core competency in order to identify its strategic competencies: if one or two or even several of the conditions are met, the competency at hand is indeed a strategic one, which holds a competitive advantage.

3.3.3 Dynamic Markets: The Simple Rules Approach

The MBV and RBV were developed against the background of "traditional" markets. In light of the growing dynamism of the markets and environments in an era of increasing technological progress and networking, the two perspectives and their recommended strategies became ever less relevant; they were too slow to build up competitive advantages in fast moving markets. Kathleen Eisenhardt carried out a number of extensive case studies in the late 1990s and discovered that successful companies in fast moving markets work not with complex strategy tools, but with simple rules and few core processes. These simple rules can be split into five categories:[21]

[21] See Eisenhardt and Sull (2001), pp. 107–116.

1. *How-to rules* define how a company should carry out its core processes and how it can make them unique.
2. *Boundary rules* set guidelines concerning which business opportunities managers should pursue and which they should not.
3. *Priority rules* help managers rank the perceived business opportunities.
4. *Timing rules* synchronize the dynamics of markets and business opportunities with internal processes such as product development.
5. *Exit rules* discipline managers to get out of obsolete business opportunities at the right time.

The simple rules approach therefore offers a special frame of reference, which builds neither on positioning nor on resource aspects, but places the focus firmly on seizing, implementing, and exiting short-term business opportunities. The opportunities and threats as well as the strengths and weaknesses identified in the SWOT analysis are all used and are interpreted with regard to the market dynamism and the internal processes and rules. Figure 3.7 illustrates how this approach differs from the other two and enables all three approaches to be defined on the basis of eight criteria.

	Positions	Resources	Simple rules
Strategic logic	• Establish position	• Leverage resources	• Pursue opportunities
Strategic steps	• Identify an attractive market • Locate a defensible position • Fortify and defend	• Establish a vision • Build resources • Leverage across markets	• Jump into the confusion • Keep moving • Seize opportunities • Finish strong
Strategic question	• Where should we be?	• What should we be?	• How should we proceed?
Source of advantage	• Unique, valuable position with tightly integrated activity system	• Unique, valuable, inimitable resources	• Key processes and unique simple rules
Works best in	• Slowly changing, well-structured markets	• Moderately changing, well-structured markets	• Rapidly changing, ambiguous markets
Duration of advantage	• Sustained	• Sustained	• Unpredictable
Risk	• It will be too difficult to alter position as conditions change	• Company will be too slow to build new resources as conditions change	• Managers will be too tentative in acting on promising opportunities
Performance goal	• Profitability	• Long-term dominance	• Growth

Fig. 3.7 Comparing the MBV, RBV, and simple rules approach (Eisenhardt and Sull 2001, p. 109)

Whereas the MBV and RBV pursue sustained strategies and competitive advantages in slower markets—in line with their underlying concepts as presented above—the simple rules approach adopts a very short-term orientation, engaging in a permanent search for the best opportunities and exits. All three approaches exhibit the same risk typology, however: once successful, the organization or the management will find it difficult to adapt to the new conditions or even to exit the markets. The fact that success can make you lazy therefore applies irrespective of what strategic perspective you adopt or what the market dynamics are like.

3.4 Network Approaches: The Business Model—An Integrative Frame of Reference for Describing a Strategy

"Nobody really knows what strategy is!"—Can the opening quote of this book be refuted based on the frames of reference presented thus far? To put it another way, do we now know what strategy is? Mintzberg cites the following aspects, among others, with respect to the definition of strategy[22]—they summarize some of the thoughts behind the frames of reference:

- Strategy is an action plan—this reflects the action-based principle of "strategy as formal planning."
- Strategy is a pattern of consistent actions—this is the descriptive view of American-style strategy research.
- Strategy is a position in the competitive hierarchy—this statement expresses the concept of the MBV.
- Strategy is a perspective (from the inside out)—this is fundamentally true of all frames of reference but can be taken as a particular expression of the RBV.

In summary, therefore, we can say that the frames of reference presented so far have given us various tools and processes with which to formulate a strategy, but have not brought "enlightenment"

[22] See Mintzberg (1994).

concerning what strategy is. The business model frame of reference attempts to close this gap by integrating aspects of corporate and business strategy and complementing them with certain additional issues.

3.4.1 From Old to New Business Models

The business model approach emerged in the mid-1990s and was driven by the topics in and around the net economy, namely the technological progress that the Internet brought, and also the general globalization of companies and economic processes. Crucial to this development is the fact that these issues transformed economic activities from bilateral processes of exchange into multilateral, interconnected relationships of exchange (see Fig. 3.8).

The concept of the business model was developed to describe this heightened complexity. It is, first and foremost, a model (for describing complexity) with which a company should do business (in other words make a profit). It features three components through which to structure the complexity of the interconnected world:

1. The choice of product/market combinations
2. The determination of the revenue mechanism
3. The configuration and execution of value adding activities

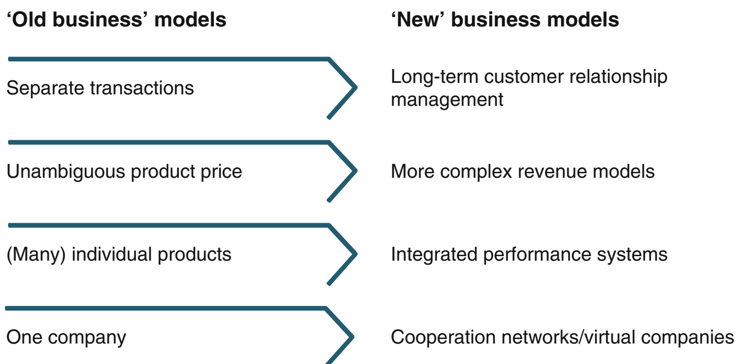

Fig. 3.8 The transformation from old to new business models

A differentiating feature by virtue of being new, the revenue mechanism aspect had played a secondary role in strategies up to this point. But the all-round networking and advances in technology created a need to properly plan the different types of revenue streams because—as we will see below—they have a decisive influence on the corporate system and therefore on strategy. A business model is a fairly recent attempt to formulate a simplified description of a company's strategy and is therefore the tool for the perspective level of the network approaches, which are found in both the corporate and the business strategy (see Fig. 3.1). The business model draws upon many of the tools presented above as well as all of the results of the SWOT analysis. It is therefore the approach that takes us the closest to answering the question of what strategy is.

3.4.2 The Three Components of a Business Model

The choice of product/market combinations is based on Ansoff's deliberations as presented above as well as his product/market matrix. According to these, the business model is a means of describing the products with which the company (or the group) currently operates in which markets and whether it plans to expand this field of activity for the purposes of growth (see Fig. 3.9). These statements produce the three central parameters of a strategy: the sphere of activity, the target markets/groups relevant to this sphere, and the economic logic of the choice (spreading the risk vs. exploiting the synergies).

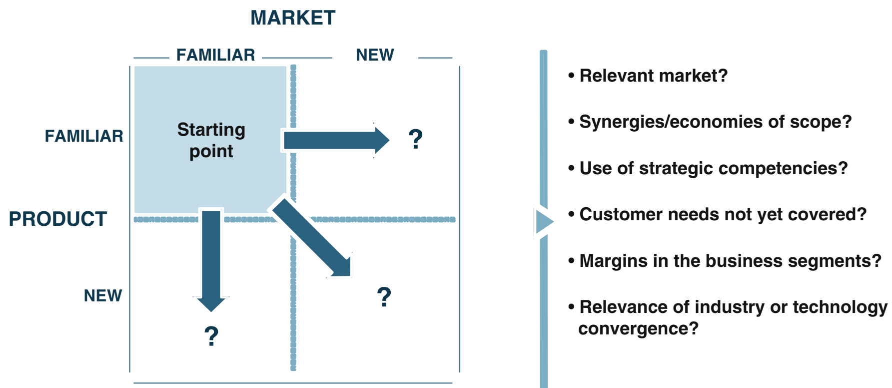

Fig. 3.9 Alternatives and criteria in the choice of product/market combinations

Providers of the service \ Customers of the service	*Consumer*	*Business*	*Administration*
Consumer	**Consumer-to-consumer** e.g. online classifieds market	**Consumer-to-business** e.g. job boards with ads from job seekers	**Consumer-to-administration** e.g. taxation procedure for private individuals (income tax, etc.)
Business	**Business-to-consumer** e.g. a customer's order in an online shopping mall	**Business-to-business** e.g. a company's order from a supplier via EDI	**Business-to-administration** e.g. taxation procedure for companies (sales tax, corporation tax, etc.)
Administration	**Administration-to-consumer** e.g. processing benefits (welfare, unemployment compensation, etc.)	**Administration-to-business** e.g. public institutions' procurement activities in the domestic and international markets	**Administration-to-administration** e.g. transactions between public institutions in the domestic and international markets

Fig. 3.10 The nine-box matrix for specifying the market strategy (Zu Knyphausen-Aufsess and Meinhardt 2002, p. 69)

In accordance with the findings on the networked economy, the market dimension was subdivided into target groups to make the specification of the strategic choice even clearer. Using a nine-box matrix (see Fig. 3.10) the market strategy can be explained in much greater depth in a business model than with the previously conventional split between consumer goods and industrial commodities. B2C, B2B, and the like are now common parlance and provide a straightforward explanation of what type of customer is being served by what type of provider.

The second component of a business model concerns the determination of the revenue mechanism. Before this aspect became the subject of more intense interest, relationships of exchange were, from a corporate perspective, based on the bilateral approach under which price multiplied by quantity equals sales. As mentioned, the planning of revenue streams has since become considerably more complex. For a start, it is important to note that business models can theoretically be based on usage-independent and usage-dependent revenues as shown in Fig. 3.11.

Usage-independent revenues come from basic charges, such as the TV licenses that are common throughout Europe, which are paid once per television receiver regardless of how much TV a household watches. Usage-dependent revenues, such as those from movie

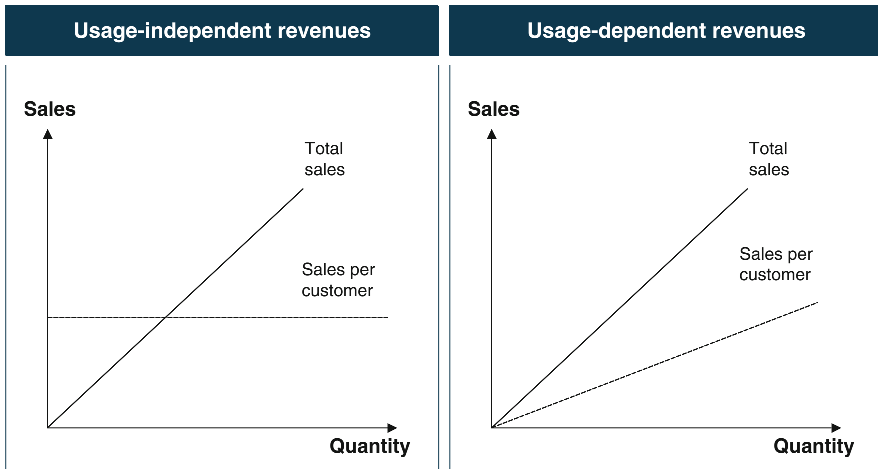

Fig. 3.11 Basic forms of revenue mechanism (Zu Knyphausen-Aufsess and Meinhardt 2002, p. 77)

theater tickets, are generated with each visit (each use). And there are, of course, hybrid forms like telephone lines: in their most elementary version the provider levies a basic charge and the usage fees depend upon the actual calls made.

Whereas the first two, pure forms can be planned without any trouble whatsoever, the hybrid form is already indicative of the complexity of the subject of revenue streams. Telecommunications companies need to decide on a strategy for pricing their products and services within their businesses: how high is the basic charge and what are the secondary charges per network type as a function of and in relation to the basic charge, how many free minutes do customers get, how much does a text message cost, is there a discount for customers who allow the provider to send advertising by text message, and so on? In this case the maximization of revenues is limited by the number of customers per revenue type and their price sensitivity. But there are other optimization problems with the revenue streams as well. Consider, for example, a company that sells a B2C product exclusively via its website. In this case the term "usage" is replaced by "transaction," so there are transaction-dependent and transaction-independent revenues. As sales figures rise and the product becomes better known, more and more users visit the site. At some point this volume of "traffic" is so great that the operator is able to sell advertising banners and links on its homepage. What

Old economy

	Product/ service	Product + investment/operation
Usage-dependent	• Volume-dependent • Distance-dependent	• Pay on production • Operator model
Usage-independent	• Fixed per period • Fixed per order • Fixed per lifecycle	• Bonuses • Minimum revenues

New economy

	Direct revenue generation	Indirect revenue generation
Transaction-dependent	• Transaction revenues • Connection charges • Usage charges	• Commission
Transaction-independent	• Setup charges • Basic charges	• Banner advertising • Data mining revenues • Sponsorship

Fig. 3.12 Revenue possibilities in the old and new economies

proportion of the homepage can be filled with advertising without the company's own product fading into the background? The space on a homepage is limited, so there is an optimization problem for two fundamentally different revenue streams, which were brought together by a new technology and which were inconceivable in combination until the mid-1990s. Figure 3.12 illustrates the complexity of this decision and the associated assertion regarding the business model—and thus the choice of strategy.

So complex revenue streams exist not only in the new economy. In the old economy too, decision makers have numerous possible combinations at their disposal, some of which evolve around the product only, but often around the company's entire value creation too. Accordingly, globalization, networking, and advances in technology led to specialization and competitive pressure even in the old economy—creating, among other things, innovative pricing models and, hence, revenue models.

The configuration and execution of value adding activities is the third and final component of a business model for describing a strategy. Here too, influenced by the issues cited above, a broad spectrum of variants has established itself. The following four basic forms are the most important of these (see Fig. 3.13).

Traditionally a company occupies a position in one or more of the links in an industry's value chain. The more links in the value chain it covers, the greater its degree of vertical integration. The oil industry, for instance, can be differentiated as follows: searching for and

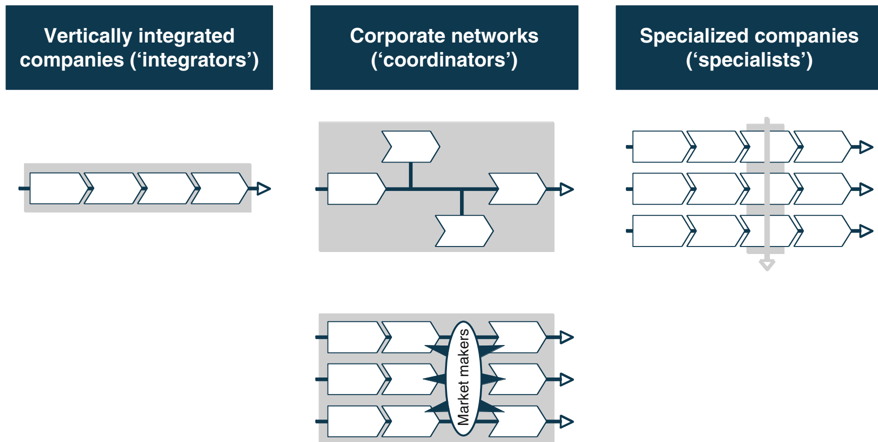

Fig. 3.13 A company's positioning options in the value chain (Zu Knyphausen-Aufsess and Meinhardt 2002, p. 73)

exploring crude oil, transporting crude oil to the refineries, processing crude oil into petroleum products in the refineries, transporting the petroleum products to the wholesalers/retailers, and selling the petroleum products. International oil companies like Exxon and Shell are integrated in the whole of the value chain, meaning that they operate in all of the links. But besides them there are other players like independent gas station operators, selling petroleum products only and therefore operating in just one of the links in the value chain.

Specialized companies emerged in substantial numbers in the late 1980s: they offer the same service across several industries, which is why this strategy is also known as business migration. The gas station operator, for instance, migrated from a seller of gas to a store operator: specializing in sales, the operator is able to offer petroleum products, bakery goods, and general supermarket items—covering at least three normally separate industries.

The other two basic forms that originated in the sphere of corporate networks first attained significance with the advent of networking and technological progress. On the one hand there are business models in which providers from various industries come together for a limited period in order to offer the entire value chain for a given industry. Such forms are frequently referred to as virtual companies, and they are mostly small market players who use this method to offer and execute large single contracts. Examples include construction

consortia and coalitions of service providers such as advertising agencies, IT consultants, and strategy consultants. On the other hand the Internet itself created the "market maker" model. This signifies companies that break up a traditional value chain and introduce a new link, sometimes even across several industries simultaneously. Internet trading platforms exemplify this model: eBay, Amazon, and countless online B2B platforms opened up new, previously non-existent marketplaces beyond traditional sales. Whereas Amazon put old sales channels online, B2B platforms that sell things like leftover warehouse stocks of screws or similar items from one company to another represent brand new links in the value chain given that the assets sold here were simply scrapped in the past.

A strategy must take numerous issues into account, and numerous decisions need to be made in the formulation of a strategy—the business model as the expression of a strategy represents the best attempt so far at describing strategies and their complexity. It does, however, remain at the level of description; even this does not irrefutably answer the question of what strategy is.

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4 Current Focal Areas in Strategy Practice: Four Significant Management Concepts of the Past 20 Years

Besides the fundamental theory of strategy and the frames of reference elucidated above, there are certain focal areas in strategy practice, which, while not constituting tools in themselves, have nevertheless had a substantial influence in recent years on the orientation of the tools presented here. Thus, they do not represent additional perspectives over and above those; rather, the existing perspectives are integrated into these focal areas in many cases, and it is this combination of frames of reference and management concepts that ultimately explains the strategic paths companies have taken. The following example illustrates the point: companies' value-based strategies are always founded upon business plans, and the sales figures in these business plans can be forecast most precisely with the help of SWOT analysis, Porter's approach, etc. So if we go down the path of descriptive analysis upon which the focus lies, knowledge of practical considerations combined with the frames of reference is important in understanding the strategic route upon which a company has embarked. This will help us separate the good (in other words successful) strategies from the bad and learn from the former.

Here in part three we will highlight four significant notions of the past 20 years, which incorporate the frames of reference presented above to a greater or lesser extent. Each one is split into a concept section and an example section—the concepts are necessary from a theoretical perspective but they are unavoidably prosaic and complex as we have deliberately kept them brief. For those of you not so well-versed in the subject, more information on the content of these four

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P. Kotler et al., *The Quintessence of Strategic Management*,
Quintessence Series, DOI 10.1007/978-3-662-48490-6_4

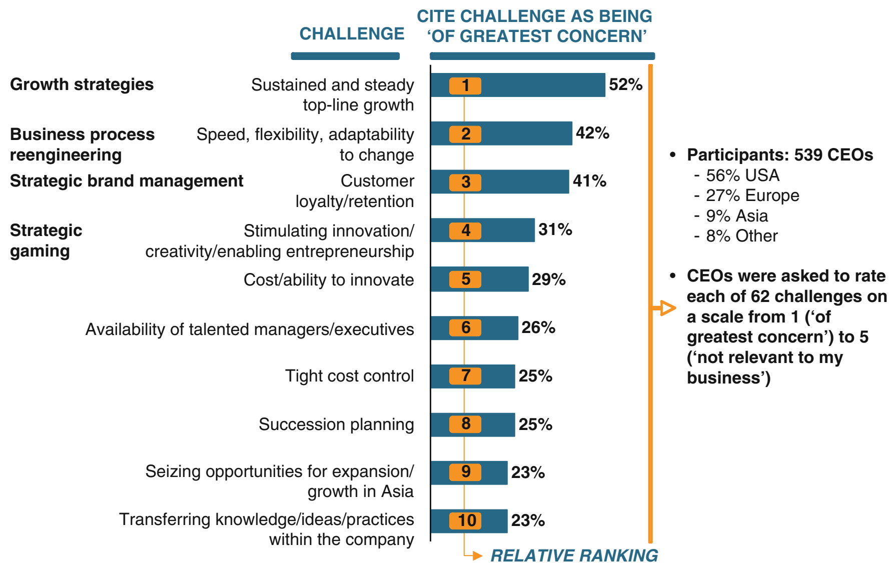


Fig. 4.1 Top challenges for CEOs (Conference Board Survey 2003)

"crash courses" can be found in the bibliographical references cited at the end of the book.

The four topics were selected on the basis of a diverse range of surveys conducted among top management (generally CEOs or board chairmen). Such surveys are regularly conducted to ascertain which topics are right at the top of the management agenda. The following four issues have long been among the most frequently mentioned challenges for corporate management:

- Growth strategies
- Business process reengineering
- Strategic brand management
- Strategic gaming

Figure 4.1 illustrates the findings of the Conference Board Survey 2003, exemplifying the numerous surveys conducted. The remaining six issues in the figure need not be addressed explicitly given that they constitute the sub-content of the four dominant issues.

4.1 Growth Strategies

As discussed, the development of growth-based strategies is the key task of strategic management. Given the risks inherent in decisions concerning growth, which always involve investments, it is these strategies that separate the wheat from the chaff.[1] In the interests of understanding the issue of growth and its implications for value creation, this section will address the following questions:

- What is growth?
- Why do companies need to grow in the first place?
- Is there a limit to growth?
- What approaches to growth exist in practice?
- Are companies that grow more successful than others?

Examples from an empirical study are used to demonstrate the final point.

4.1.1 Value-Based Management, Protecting Your Market Share, Limits and Approaches

What is growth? First and foremost, growth in an economic context must pursue the objectives of a company in the sense of ensuring its long-term survival. In other words it must be intentional (cost growth is naturally unintentional unless it is the manifestation of investment activity in the form of costs). While the growth of national economies is expressed in their performance potential (e.g. GDP, GNP, productivity ratio), companies have a different set of indicators to describe their performance.

Market growth (absolute) or market share growth (relative)—calculated on the basis of volume or value sales—is a traditional growth parameter that supports market objectives. Another classic growth ratio is the increase in enterprise size: net investment, or any investment activity in excess of stay-in-business capex, increases the

[1] This holds particularly true when such strategies are compared with cost-based strategies, which are much easier to conceptualize since the approaches and solutions are more apparent.

amount of invested capital. Indicators include movements in the schedule of non-current assets and changes in the balance sheet (such as those in non-current assets). An important presumption here is that the benefit of the investment is greater than the cost—in other words the investment appraisal must produce a positive net present value.[2] In this case, the increase in enterprise size supports earnings objectives. Other indicators include earnings growth, which is, however, implicitly incorporated in the investment-based enterprise size, and headcount growth, though—with a few exceptions in the service sector (such as consultancies)—this is not an expression of a company's performance.

Although every relevant publication cites numerous reasons, there are ultimately, at the highest level, only two reasons why companies should grow. First, a company needs to record at least average growth in relation to its relevant market in the long term so as to sustain its market share. Above-average growth brings a rise in market share, while below-average growth diminishes market share, and the company risks being crowded out of the market. So this reason is itself one of the three requirements for survival, as mentioned above. Second, a company must strike a balance between shareholders and the capital markets and regularly enhance shareholder value. If the enterprise size, that is the amount of invested capital, rises based on the assumption of a positive net present value for the investments made, more profit is generated or value created as a result. Therefore, increasing shareholder value by expanding the enterprise size pursues the other two requirements for survival, namely liquidity and profitability.

Shareholder value (SHV) is basically calculated as enterprise value less debt. The formula illustrated in Fig. 4.2 shows the formal structure of this concept.

The shareholder value approach is similar to a net present value calculation and consists of three main components: first, the total of all future free cashflows (FCF) over a period starting from the present, discounted at the weighted average cost of capital. In practice, most

[2] The total of all discounted cashflows generated by an investment is also known as the net present value, which takes into account the initial cash out. One of the best books on the subject is Hawawini and Viallet (2002).

$$\text{SHV} = \sum_{t=1}^{T} \text{FCF}_t / (1 + \text{WACC})^t + \text{GCV} / (1 + \text{WACC})^T - \text{IBD} + \text{NOA}$$

SHV = Shareholder value (value of equity)

FCF_t = Free cashflow in year t

GCV = Going concern value (perpetuity value: last FCF or average divided by WACC)

IBD = Interest-bearing debt

WACC = Weighted average cost of capital

NOA = Non-operating assets

t = Year

T = Last year in the planning period

Fig. 4.2 Formula for calculating shareholder value (See, among others, Rappaport 1999)

forecast periods are no longer than 5 years in duration, beyond which the forecast uncertainty is too great. This is because the free cashflow is calculated on the basis of future balance sheets and profit and loss statements (P&Ls), and all items need to be furnished with detailed assumptions on the development of the business.[3] This process is also frequently known as business planning, and it integrates both the SWOT analysis and all of the perspectives from the business strategy, since it is concerned with forecasting operating and strategy-induced business figures as precisely as possible. However, because companies are in business for longer than 5 years, the going concern value is calculated for the period beyond that. This is technically a perpetuity value: either the last free cashflow or the average of all free cashflows is divided by the weighted average cost of capital and then discounted. The sum of the accumulated and discounted free cashflows and the discounted going concern value equals the enterprise value. Interest-bearing debt is then deducted to finally arrive at the shareholder value.

[3] For the SHV approach in its simplest form, free cashflow can be defined as earnings before net interest income, plus depreciation and amortization, less operating capex.

It is essential for the free cashflow forecast to be very good, since that is what drives both of the value components.[4] In practice, the going concern value normally makes up more than 70 % of the enterprise value.[5] If the enterprise size then increases as a result of profitable investment activity, these investments lead to a positive earnings contribution, which generates sustainable growth in free cashflows and, thus, shareholder value.

This sustainable rise in shareholder value can be achieved through investment-based growth only; therefore, shareholders will not be satisfied with companies that do not show sustaining growth. Divesting parts of a company generates only one-time liquidity effects. While this does have a positive impact on cashflow, it has no impact whatsoever the following year, so it barely carries any weight in the formula. Nor does a constant enterprise size normally bring any growth in shareholder value—companies need to improve their return spread to improve shareholder value. The return spread is the positive difference between the return on equity and the cost of equity. The cost of equity is calculated based on a safe investment (such as government bonds) plus a company risk premium, which is specific to the particular company and the industry in which it operates. Both of these together mean that the cost of equity is usually 15 % or more. To create any real value, companies must earn this cost plus an additional return.

Figure 4.3 illustrates this link and also points out that an accounting profit can destroy value, representing an economic loss for shareholders. This knowledge is something of a revolution for the subject of companies' strategic planning as mentioned above: it is not accounting profit or long-term corporate survival that matters—creating value is the only relevant goal.

The larger the spread, the higher the shareholder value. At constant enterprise size, the return spread is achieved by reducing costs in particular. However, compared to investment-based growth, even this is not a lasting means of increasing shareholder value, because a

[4] It is particularly important to remember that the respective free cashflow is used up in each period and cannot, therefore, be included in the following period. For more on the subject see Schwenker and Spremann (2009), p. 143.

[5] There are specific formulae that also take market dynamism into account in the going concern value, sometimes resulting in very low going concern values.

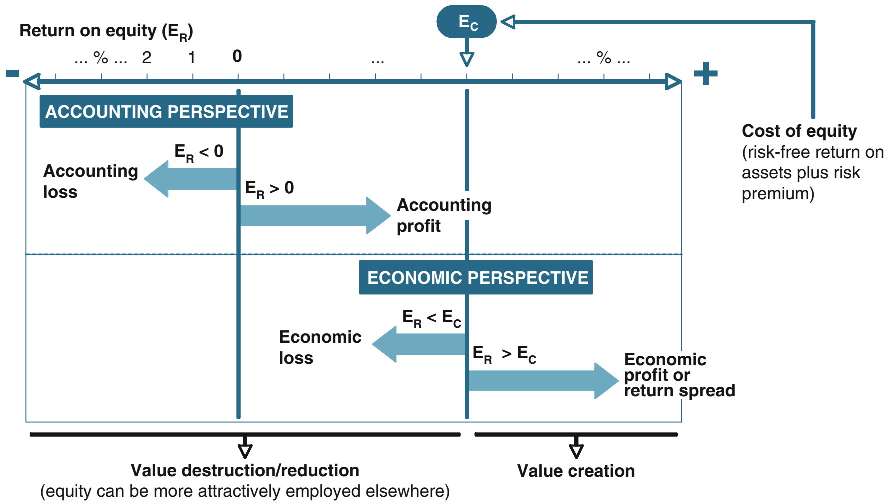


Fig. 4.3 The return spread system (Bötzel and Schwilling 1998, p. 32)

company that is "constant" will at some point realize all of its cost-cutting potential.

The two reasons outlined above provide striking proof of the fact that it is absolutely essential for companies to grow. But is growth finite, or to rephrase the question, what might firms have to take into account? In the theoretical discussion, experts conjecture that there is a minimum optimal size for an enterprise, at which unit costs no longer decline even as production volumes per unit of time continue to rise. In other words the economies of scale tail off. As the enterprise grows bigger still, diseconomies of scale even arise (these are negative economies of scale caused by complex administrative structures, information asymmetries, etc.). The problem with this concept is that it is not possible in practice to ascertain when the diseconomies first set in. Saturated markets may restrict growth, but then, is there even such a thing as a saturated market? It is ultimately the responsibility of Marketing to generate perpetual demand—unless the product is no longer salable on technical grounds (like the walkman, for example).

A lack of resources could also restrict growth: skilled employees and raw materials are scarce resources, and the companies that use them are dependent upon them. But when shortages do occur, suppliers can always be found in the medium term who are prepared to resolve the problem in order to take advantage of the buyer's

readiness to pay for the service. For instance, it is common knowledge that, with crude oil prices averaging 65–75 US dollars a barrel in the long term, oil companies are capable of making the technological investments necessary to exploit the Atlantic reserves through deep-sea drilling. And new private universities have been opening their doors every year since the late 1990s in a bid to meet the urgent need for qualified experts. From the individual perspective of each company, there is therefore no real limit to growth. There are, at most, temporary inhibitors of growth, and even the Earth's ecological balance and the call for companies to moderate their consumption and pollution levels is not—from an individual perspective—perceived as a limit to growth.

In practice, there are two options for implementing growth—once a horizontal growth strategy has been determined in accordance with Ansoff: companies can grow organically, that is to say intrinsically, with the firm's own resources and expertise. This approach tends to be on the slow side but it is safe, controllable and generally not too cost intensive. The other option is inorganic growth, signifying extrinsic growth through mergers and acquisitions (M&A). This option entails rapid growth through acquisition and thus involves the risks inherent in high costs and inferior controllability. This is partly why more than half of all M&A activities fail in an economic sense: excessively high purchase price premiums, hard to calculate synergies, incompatible corporate cultures, and belated planning and implementation of actions make the anticipated advantages materialize far too late or prevent them from materializing at all. This generates enormous interest and compound-interest costs and, with them, opportunity costs—and value is destroyed on a massive scale. To avoid such value destruction, bidding companies should set the maximum acquisition premium as the net present value of the synergy potential and should already have a detailed implementation and action plan[6] in place by the purchase and payment date.

So, from a theoretical perspective, growth is essential. But it is also an arduous and risky business. It is therefore justifiable to ask whether fast growing firms are actually any more successful than other companies.

[6] This process is often referred to as post-merger integration (PMI).

4.1.2 Seven Growth Strategies in Strategy Practice

In a bid to answer this question, consultancy firm Roland Berger Strategy Consultants (RBSC) conducted an empirical study of the world's top 1700 companies in 2002.[7] Using publicly available financial indicators, the study aimed to examine how many companies—and which ones—were growing faster than the average, and whether this growth was also more successful than that of the others. Each firm's annual sales growth between 1996 and 2001 was calculated first. This indicator shows a company's growth. Then the annual EBIT growth[8] was determined for the same period to depict each firm's financial success.

One of the findings was that 441 of the 1700 companies in the study recorded sales growth above the average of 11.8 % p.a. and EBIT growth above the average of 8.5 %. What this means is that in the given period, 26 % of the companies examined created value through strong growth (and can be classed as outperformers). In these companies the additional indicators such as total shareholder return[9], productivity, and headcount were also above average. It can therefore be concluded that strong growth has a positive impact on all of a company's stakeholders.

The second analysis conducted as part of the study is interesting from the perspective of practice-oriented growth strategies: What strategic patterns can be identified retrospectively among the 441 companies with above-average performance?[10] RBSC formulated seven strategies for these outperformers (see Fig. 4.4). Each strategy is illustrated here with an example from the group of 441 outperforming firms.

Intel Corporation provides a very good example of innovation and branding. Since the late 1960s the company drove the development and refinement of microprocessors in particular, bringing ever-faster

[7] With regard to the remarks in this section see, in particular, Schwenker and Bötzel (2007).

[8] EBIT stands for earnings before interest and tax.

[9] Share price gains plus dividend payouts.

[10] See also the introduction to Chap. 3 outlining the descriptive analysis approach.

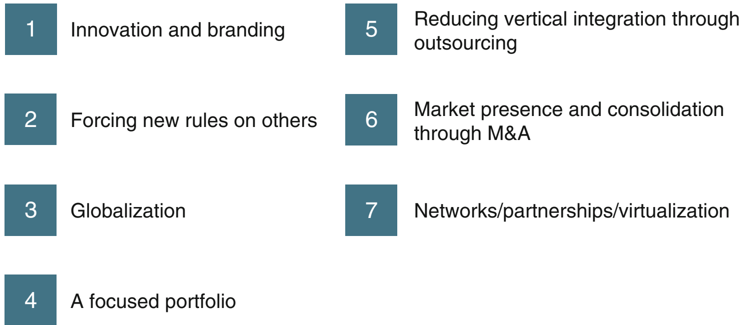


Fig. 4.4 Seven successful growth strategies in practice

versions to market at ever-shorter intervals. In parallel, the company achieved global branding with its "intel inside" logo and the associated jingle, with the result that competitors like AMD were almost always left in a catch-up role.

Ryanair is an example of a strategy of forcing new rules on others. Before Ryanair, the market consisted of major national airlines, which offered their customers a large, cost-intensive route network. Ryanair broke the rules of the business in many ways by formulating a clear strategy of cost leadership through which it could price tickets cheaply. Instead of commuting between an elaborate system of different airports, Ryanair flies exclusively from one location to another and back (point-to-point). The company uses only provincial airports in order to keep charges low and to speed up turnaround times thanks to shorter standing times. Moreover, for a long time the company used only one aircraft type to keep the complexity of parts purchasing and training down. Tickets are sold through Ryanair direct, with no commission going to travel agencies, and everything on the flight costs extra (food, drinks, etc.). Flight travel was thus reduced to the essentials: getting from A to B—at the lowest possible cost and in the shortest possible time. Ryanair thereby offered an alternative to the existing, expensive airlines for the large group of travelers who had no need to travel long distances via various different locations.

Vodafone provides a good demonstration of the globalization aspect. The company succeeded in becoming a genuinely global cell phone carrier thanks to a large number of mergers and many partnerships with the biggest telecommunications companies across

all five continents. The company made international investments in Germany, Australia, Great Britain, Fiji, and South Africa in 1993/1994. 1995 saw cooperative ventures with partners in the Netherlands, France, and Hong Kong. The company merged with U.S. provider Airtouch in 1999. Vodafone took over German company Mannesmann D2 in 2002 and also founded Verizon (a joint venture with Bell Atlantic from the U.S.). It acquired Ireland's Eircell in 2001 and entered into a cooperative deal with China's biggest provider, China Mobile. According to 2007 figures, Vodafone has affiliates in 25 countries across five continents and has additional partnerships with telecommunications companies in another 40 countries.

A focused portfolio is a growth strategy for long-term success achieved through a strict focus on a core business and the associated economies of scale and learning curve effects. E.ON is a good example of this strategy. The company was created out of the merger of the VEBA and VIAG conglomerates in 1999/2000. Both companies were already power and water utilities but also had a lot of affiliated companies operating in other industries. Following the merger, the main industries concerned were telecommunications (o.tel.o), chemicals (Degussa), oil (VEBA Öl), real estate, electronics, logistics (Stinnes), aluminum (VAW), glass (Gerresheimer), and specialty chemicals (Schmalbach Lubeca). In the wake of the merger E.ON had begun to sell off the various divisions and to arrange the group as a utility, a pure supplier of electricity, gas, and water. Two large, national conglomerates thus became a major international provider.

Porsche employed a strategy of reducing vertical integration through outsourcing to get back on the road to success, having been a restructuring case in the early 1990s. Today the sports car manufacturer has the lowest level of vertical integration of all automakers and buys in around 80 % of the value added. The company focuses exclusively on innovation and product development (engines and technology) in addition to marketing, and has thereby become the most profitable automotive manufacturer in the world.

Market presence and consolidation through M&A as a growth strategy professes the goal of dominating a market by buying up the main competitors in order to attain a substantial market share. In the

mid-1990s Europe had a large number of medium-sized firms in addition to the three big, global oil companies, Royal Dutch/Shell, BP, and Exxon. The French firms Elf Aquitaine and Total and the Belgian Petrofina were among them. Elf Aquitaine had, until then, taken a very aggressive stance in the market and had bought the former East German state-owned company Minol, among others. It appeared to be only a matter of time before Elf acquired Total as well, creating a major French industry champion. Total's management became aware of the danger and, to the surprise of the entire market, took over Belgium's smaller Petrofina for 12 billion euros in 1998. Now bigger and stronger, just 1 year later Total was in a position to take over its competitor, Elf, a company of almost the same size, which it acquired for 49 billion euros in 1999. The new company, Total Fina, thus became the undisputed number four in the global market within 2 years and a real competitor for the three big, established firms.

Among the 441 outperformers, Puma is a good example of the networks, partnerships, and virtualization strategy. Puma is the much-cited and enormously successful model of a virtual construct. There are three virtual headquarters: Germany with the R&D, Purchasing, Strategic Planning, Logistics, Sales, and Distribution functions; the U.S. with R&D and Marketing, and Hong Kong with Purchasing and Marketing. The three locations form one virtual Corporate Center, which draws on the strengths in the regions. There is no in-house production; products are purchased from a varying set of suppliers in the Far East and marketed under the brand name *Puma*. The *Puma* brand is itself virtual in the conventional understanding of the word in that it represents nothing more than an umbrella brand for the cooperation between the national companies and the manufacturers.

4.2 Business Process Reengineering

As previously demonstrated, business process reengineering (BPR) is very high on the CEO agenda. This is initially surprising, given the fact that process changes are seen internationally as a matter for Operations Management, being in a general sense concerned with scrutinizing and enhancing operational processes. If the essence of BPR makes it first and foremost a topic for operational management

rather than strategic management, why is it on the top management agenda, indicating that it is actually a strategic issue and concept? Answering the following key questions can help clarify the matter:

- What is BPR? Why did it evolve? What are its components, characteristics, and advantages?
- What are the parameters of BPR? How is BPR conducted in theory? What risks are incurred when applying it?
- What are some of the specific practical applications?

4.2.1 Belief and Reality

The BPR approach[11] entails more than process improvement—it is an element of organization theory in which a distinction is made between the organization of corporate structures (what is the right structure for the organization?) and the organization of corporate processes (how is value created?). Back in the late eighteenth century Adam Smith reflected that industrial work should be divided into simple and definable tasks to enable goods to be manufactured at optimum cost and maximum output. Taylor perfected this principle in the early twentieth century within the scope of mass production (Taylorism). These considerations resulted, among other things, in the vertically structured organization in which functional experts in their respective departments were organized down to the minutest activities. Processes, value creation, and coordination (in other words the process itself) take place within a vertically structured organization exclusively inside the departments: R&D, Purchasing, Production, Sales, etc. each finalize one work step and pass the "finished product" on to the next department—the individual departments are, metaphorically speaking, walled off from each other, preventing any exchange.

With the switch to buyers' markets in the 1980s and the growing competitive pressure resulting from the internationalization of markets, it became apparent that the customer benefit, in other words the value added, was actually generated in customer-oriented processes and not in departments or functions. To remain competitive

[11] With regard to the remarks in this section see, in particular, the classic work by Hammer and Champy (1993).

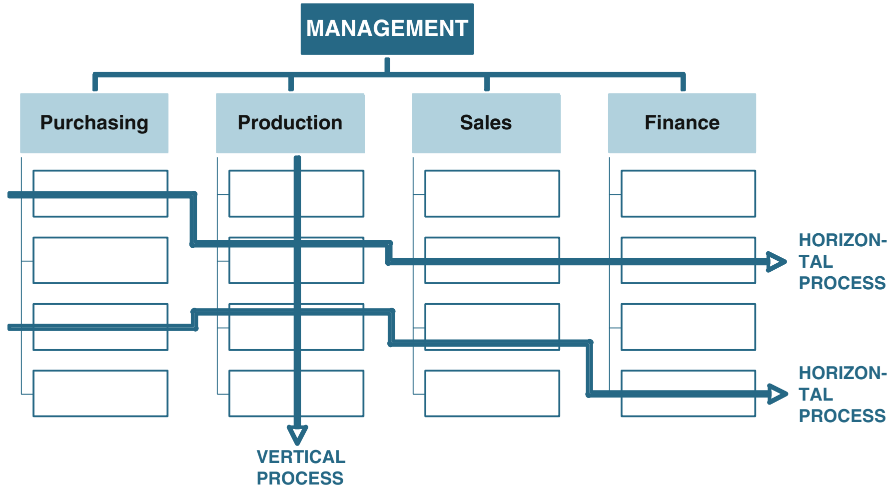


Fig. 4.5 A vertical company organization and the integration of the horizontal process perspective

in this changed environment, an organizational paradigm switch was instituted at the end of the 1980s: the vertical organization of corporate structures was joined by the cross-departmental, horizontal process perspective, as illustrated in Fig. 4.5.

In order to understand the concept of BPR, it is important to first define the business process. Harrington did this very precisely back in 1989:[12]

- *"Process: Group of activities that takes an input, adds value to it, and provides an output to an internal or external customer. Processes use an organization's resources to provide definitive results."*
- *"Production process: Any process that comes into physical contact with the hardware or software that will be delivered to an external customer to the point the product is packaged."*
- *"Business process: All services and processes that support production processes. A business process consists of a group of logically related tasks."*

[12] Harrington (1991), p. 9.

In processes, inputs are therefore processed to such an extent that the output is of a higher value, irrespective of whether the customer is an internal or external party. Processes create results and value, in other words they should not encompass any superfluous activities that destroy value. As soon as these processes come into physical contact with the product in the sense of directly enhancing it, they become production processes—regardless of whether they are manufacturing processes or services. These processes are *not* a part of BPR. BPR considers only the processes that support the production process—these interfacing processes are cross-departmental and therefore need to follow a business logic in order to create value rather than destroy it.

Hammer and Champy expanded this definition shortly afterward by formulating four key requirements for BPR, resulting in them being considered the "fathers" of the approach:

> Reengineering is the fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical, contemporary measures of performance, such as cost, quality, service, and speed.[13]

The authors state that the four key requirements must be observed for reorganization to be considered genuine business process reengineering:

1. *Fundamental*: The fundamental questions must be asked. These are: Why do we do what we do? What do we really need in order to do it and how should we in fact do it?
2. *Radical*: It's not about improving things on the surface but about rethinking the entire business and, if need be, changing it radically.
3. *Dramatic*: BPR is not conducted to achieve marginal improvements. On the contrary, it is done to achieve substantial improvements in the company's performance.
4. *Processes*: Reengineering applies to processes only—a process perspective is a priority in such projects; it is not concerned with the organization of corporate structures in the first instance.

Business process reengineering is thus defined as the complete redesign and the complete reengineering of existing business

[13] Hammer and Champy (1993), p. 32 ff.

processes. Many small and medium-sized businesses still do not have fully formulated business processes in the form of ISO certification and a quality management handbook—in this case we would call the activity business process engineering: the first-time design and first-time engineering of a business process.

Such a strict and exacting definition of BPR naturally has an impact on the content and structure of this process perspective. What it comes down to is sharpening the eye to perceive what is really important and laying bare what is unimportant and what destroys value. As a result, the considerations always focus on the end product of a company's own value creation—customer orientation and customer satisfaction are the crucial factors in meeting the needs of the buyers' markets (both B2C and B2B). It consequently becomes easier to manage the business from a results-based perspective given that the entire business process is conducted through key performance indicators (KPIs) that are exclusively geared toward the end product, rather than through a department's own indicators, which are seldom customer oriented. The mapping and control of business processes is optimized by modern information and communication technologies, whose effectiveness can be put to much better use, since they link up different departments and, where applicable, even business locations.

The advantages of the process perspective introduced by BPR are obvious and document why this is a strategic management issue—and there is no mistaking the fact that the resource-based view, in other words the competencies and capabilities of a company, combined with the SWOT analysis, is included:

- BPR clearly stipulates that it is concerned with the company's core processes in which value is created. The processes are therefore the expression of a company's strategy—they depict the value creation configuration that is formulated in strategic terms in, for example, a business model. It is no longer a case of "*structure follows strategy*." The saying now goes "*process follows strategy, structure follows process*"—first the core processes are defined, then the organizational structure ensues.
- The magic triangle of time, cost, and quality (TCQ) targets—magic because they are fundamentally opposed—can be optimized by BPR because a process perspective improves all three variables:

processes are accelerated across departments (time), cost drivers are eliminated thanks to efficient processes (cost), and the cross-functional focus on end customers promotes total quality management (quality).

- Cross-functional processes lead to interorganizational communication and thus to positive network effects. What's more, all employees gain a clear realization of what their own contribution to the end product is and how it is intertwined with the rest of the organization.
- Processes can be arranged in order of hierarchy as main processes, secondary processes, subprocesses, activities, and actions. Each of these processes can be managed and optimized on a results basis and the individual actions organized in sequence or in parallel (see Fig. 4.6). Business processes optimized and standardized in this manner provide a platform for fast growth, since they are easy to duplicate for the purposes of opening new business locations, etc.

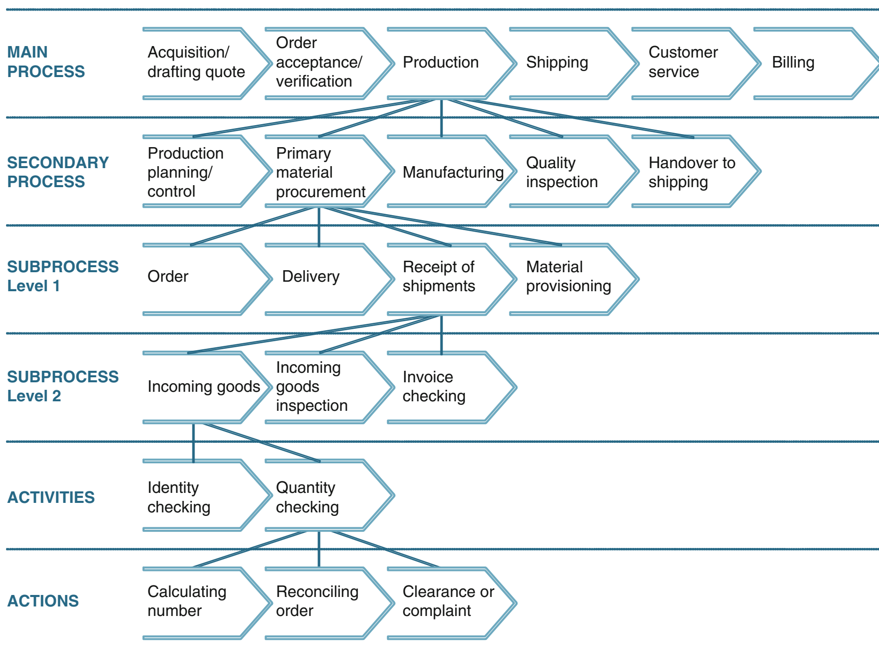


Fig. 4.6 Hierarchies within a business process

BPR optimizes internal processes in the first instance, but should subsequently be used to design intercompany processes as well.[14] The process is identical in both cases. There are seven main steps:[15]

1. Identify the corporate strategy: This is done either by looking at existing strategy documents or by applying the frames of reference presented here.
2. Determine the strategic competencies needed to execute the strategy: This is done either by looking at existing strategy documents or by applying the frames of reference presented here.
3. Conduct a detailed analysis of processes: This highlights the non-value-added actions (duplication, idle time, redundancy, etc.) by asking
   – whether all actions in a process are necessary,
   – whether certain actions can be done at a higher level of quality or faster (at the same level of quality), and
   – whether several actions can be consolidated in order to reduce the number of interfaces and the wait periods.
4. Select the processes to be changed: Following the process analysis the individual processes need to be evaluated in order to facilitate their selection or prioritization for BPR. Naturally, not all of a company's core processes can be changed at once; this would jeopardize ongoing business operations. The criteria used for selection are
   – the process's influence on customer satisfaction (to what extent does it affect the customer?),
   – the process's strategic significance (how important is the process to the company?), and
   – the process's optimization potential (what opportunities exist?)
5. Define the key performance indicators (KPIs) for BPR: The KPIs for controlling the processes along the parameters of time, cost, and quality are described in two dimensions: effectiveness (external perspective focusing on quality) and efficiency (internal perspective focusing on time and cost). Process effectiveness asks:

[14] See Hammer (2001), pp. 82–91. Examples of intercompany processes include supply and R&D processes between suppliers and producers.
[15] See Hammer and Champy (1993).

how well does the process meet the requirements of end customers or how well does the subprocess meet the requirements of the main process? Indicators include complaints, warranty costs, returns, declining market share, and delayed completion. Process efficiency asks: how fast and how cheap is the process? Indicators include lead times, resource deployment, and wait times per unit of output.

6. Begin the operational execution of BPR: BPR itself is carried out in two main steps: redesign and reengineering. The redesign stage is all about creatively redesigning processes. Why do we do a certain thing and why do we do it the way we do it and not differently? Designing the activity as a whole therefore takes precedence over executing it in the minutest steps. Furthermore, processes are aligned toward results and the customer rather than toward the activity itself. Reengineering involves the operational redesign of processes: *who* (the organizational unit responsible) should be doing *what* (activity, task) *when* (time, trigger event, period) and *with what* (necessary information)?
7. Permanently monitor and continuously improve the new processes: Managing the new processes using the KPIs by comparing actual figures against targets is the final, continuous task of BPR. From this point onward the continuous improvement of processes is sufficient to remain competitive providing the company's strategy and, hence, its business activity did not change dramatically. If processes are not continuously improved in this way (or if the company's strategy changes), a new BPR project will be an urgent necessity within a few years.

Even though BPR involves the same seven steps every time, projects can vary dramatically in practice—determined by the company's internal situation, but also by the industry, the product, and the external environment. Hammer and Champy nevertheless established a number of regularities at a higher level of abstraction across a great many projects back in the early 1990s.

At the redesign stage, the following changes in particular come up time and again:[16]

[16] Hammer and Champy (1993), p. 51 ff.

- Several jobs are combined into one.
- Workers make decisions.
- The steps in the process are performed in a natural order.
- Processes have multiple versions.
- Work is performed where it makes the most sense.
- Checks and controls are reduced.
- Reconciliation is minimized.
- A case manager provides a single point of contact.
- Hybrid centralized/decentralized operations are prevalent.

And reengineering results in the following consequences, in other words changes concerning the work done within the company:[17]

- Work units change—from functional departments to process teams.
- Jobs change—from simple tasks to multi-dimensional work.
- People's roles change—from controlled to empowered.
- Job preparation changes—from training to education.
- Focus of performance measures and compensation shifts—from activity to results.
- Advancement criteria change—from performance to ability.
- Values change—from protective to productive.
- Managers change—from supervisors to coaches.
- Organizational structures change—from hierarchical to flat.
- Executives change—from scorekeepers to leaders.

All too often, however, BPR projects fail to meet the core requirements expounded by Hammer and Champy, and the changes and results illustrated above do not materialize. The reason is that BPR is frequently used as a cover for projects aimed at nothing more than cost cutting. Consequently, BPR fails to focus on strategic optimization and instrumental improvement. The improvement potential is achieved only through headcount reductions and any increase in productivity is short lived.

In a bid to solve this problem, BPR was expanded to include two additional components, namely change management and the

[17] Hammer and Champy (1993), p. 65 ff.

integrated perspective, in the mid-1990s. This approach is also known as "corporate transformation"—a far-reaching and proactive process whereby reorganization of a company encompasses all of the divisions, the corporate culture, and the employees in order to bring about real strategic change in people's heads. The key factors in corporate transformation are permanent top management commitment and the collective formulation and communication of a new vision. Viewed from an operational perspective, the aim must be to strive for the innovation of all processes and areas, with all employees involved in the changes, and their individual fears taken into account. And in order to succeed, the transformation must be managed tenaciously, objective by objective. What this means is that results must be implemented continuously, improvements must be incorporated consistently, and the lengthy process must be seen through to the end.

In practice, projects proceed as per the seven steps, although people usually only distinguish between the three phases of situation audit, redesign/reengineering, and implementation. Real BPR and transformation projects take at least a year before the processes are finally implemented, and in large organizations they can last several years. Such projects consequently have their own project organizations with steering committees, project managers, and task teams, as well as communication staff. The tasks that need to be completed to achieve the objective are shared out among the project members (company employees and possibly external consultants) and are controlled through a system of action management until the project has been brought to a conclusion and the new processes are up and running.

4.2.2 An Implementation Example

The following example features a company that provides services in the sphere of fitting out property (buildings, etc.).[18] The company was structured by function, specifically by trade (electricians, electrical

[18] The material derives from a consulting project conducted in the 1990s, with the client's identity disguised. The client company generated hundreds of millions of Deutschmarks in sales at the time.

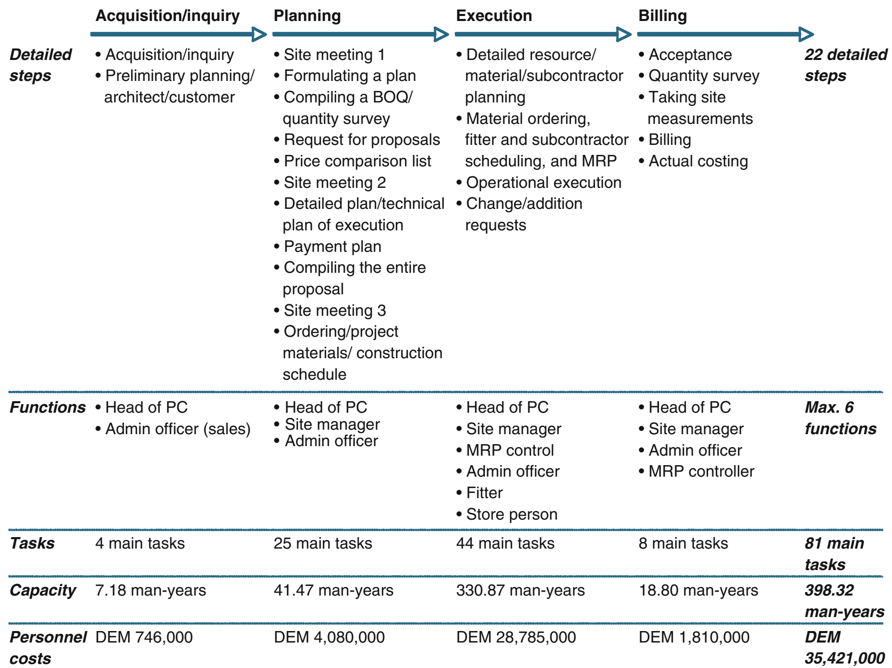
engineers, brick masons, etc.), with each trade forming a separate profit center. This meant that the head of each trade was responsible for sales, costs, and profit. The structure was replicated in four principal offices (North, South, East, and West) and managed from a head office. Projects that involved more than one trade—which was the norm—were planned centrally. However, the heads of the profit centers afforded their own projects higher priority than other projects, with the result that it was often impossible to keep to the agreed time schedule, idle time was incurred, and customers were annoyed. Since the company had a considerable order backlog, this not only created customer dissatisfaction but also economic inefficiencies.

In order to meet these problems head-on, management initiated a project that was to bring in efficient, customer-oriented processes. Conducting a comprehensive situation audit was the first task: the teams worked out the actual core process in a number of workshops, since it had never been written down. They then used functional cost analysis to identify which functions carried out this process, involving which activities, what length of time, and what costs. Figure 4.7 provides a summary of the results at the highest level.[19]

It is clear to see that the way projects were executed in the status quo was highly complex. Six different functions carried out 44 main tasks, tying up more than 80 % of the capacities and personnel costs. The planning step, on the other hand, was involved to a relatively small extent, even though good planning can bring substantial advantages in project execution. Additional analyses of problems among customers and in the internal environment confirmed that project execution had become a weak point throughout the entire company as a result of the complexity (see Fig. 4.8).

Once this insight had been gained, the next step was to develop approaches that could provide solutions for designing and engineering the main process steps. This was done in conjunction with the client, and the focus was placed squarely on project execution. Following numerous workshops and rounds of concept development the target process shown in Fig. 4.9 was approved.

[19] In projects like this, all charts outlining the results are naturally backed up with a large number of detailed analyses and exhibits.



	Acquisition/inquiry	Planning	Execution	Billing	
Detailed steps	• Acquisition/inquiry • Preliminary planning/ architect/customer	• Site meeting 1 • Formulating a plan • Compiling a BOQ/ quantity survey • Request for proposals • Price comparison list • Site meeting 2 • Detailed plan/technical plan of execution • Payment plan • Compiling the entire proposal • Site meeting 3 • Ordering/project materials/ construction schedule	• Detailed resource/ material/subcontractor planning • Material ordering, fitter and subcontractor scheduling, and MRP • Operational execution • Change/addition requests	• Acceptance • Quantity survey • Taking site measurements • Billing • Actual costing	***22 detailed steps***
Functions	• Head of PC • Admin officer (sales)	• Head of PC • Site manager • Admin officer	• Head of PC • Site manager • MRP control • Admin officer • Fitter • Store person	• Head of PC • Site manager • Admin officer • MRP controller	***Max. 6 functions***
Tasks	4 main tasks	25 main tasks	44 main tasks	8 main tasks	***81 main tasks***
Capacity	7.18 man-years	41.47 man-years	330.87 man-years	18.80 man-years	***398.32 man-years***
Personnel costs	DEM 746,000	DEM 4,080,000	DEM 28,785,000	DEM 1,810,000	***DEM 35,421,000***

Fig. 4.7 The actual fit-out process—Approximately 400 man-years are directly tied up in the four main steps of the core process (Man-years reveal an employee's actual work capacity as available to a company. Someone who works only half a day counts as one employee but represents only half a man-year)

The new target process provided for two of the steps in project execution to be brought forward into the planning stage ("a job well planned is a job well done") and backed up with a detailed set of planning instructions (known as the fit-out folder). In addition to this, clear project responsibility had to be established—moving away from responsibility for a trade or a department to responsibility for the process and, hence, the result obtained by the customer. Last but not least, actual costing was integrated into the new process as a final step, giving the company commercial control at the project level for the first time ever. The target process naturally varied depending on which customer groups the company was targeting and/or how many architects or other subcontractors were involved in the planning and project execution phases, and to what extent. But the fundamental mindset of planning and preparing as many activities as possible at an

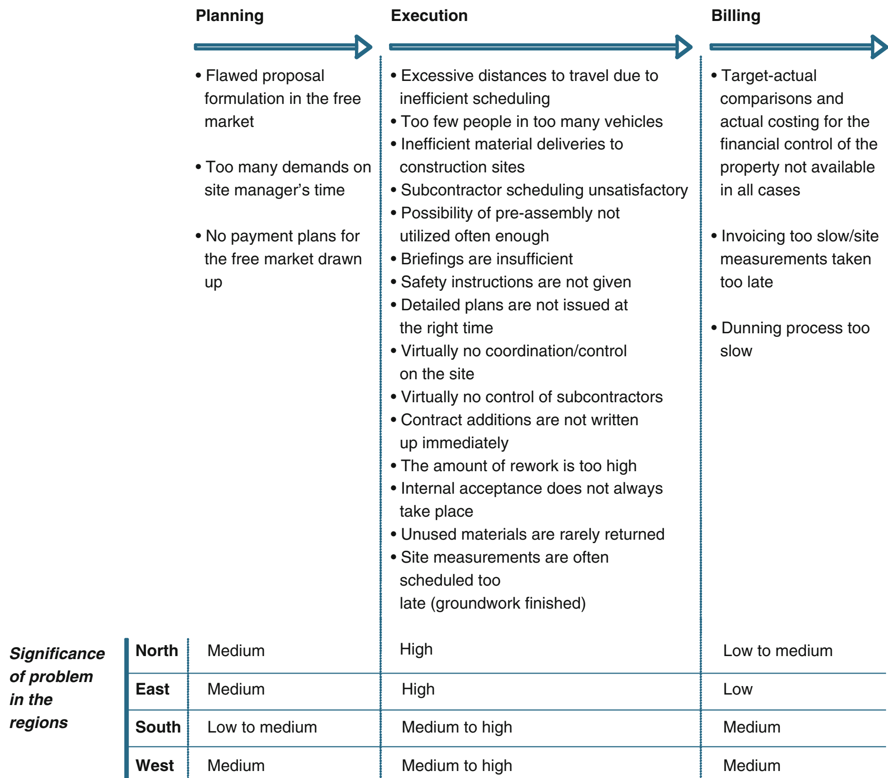


Fig. 4.8 Accumulation of problems in the detail of project execution—Weighting assigned by branch offices underlines the critical state of affairs

early stage in the interest of meeting the customer's mandate quickly and smoothly was the same in all variants.

Within the scope of this new process sequence it was also necessary to clarify the organizational functions in which the process was to take place. And so it followed that the new target organization comprehensively replaced the old functional model (see Fig. 4.10).

There was now one manager in overall charge of the business, and four regional managers who ran all of the trades in their respective region and were accountable for sales, costs, and profit there. One level below them, each business location had a number of project managers who worked across all trades, were responsible for individual projects, and were also involved in acquisition activities—in conjunction with the regional manager or the manager in overall

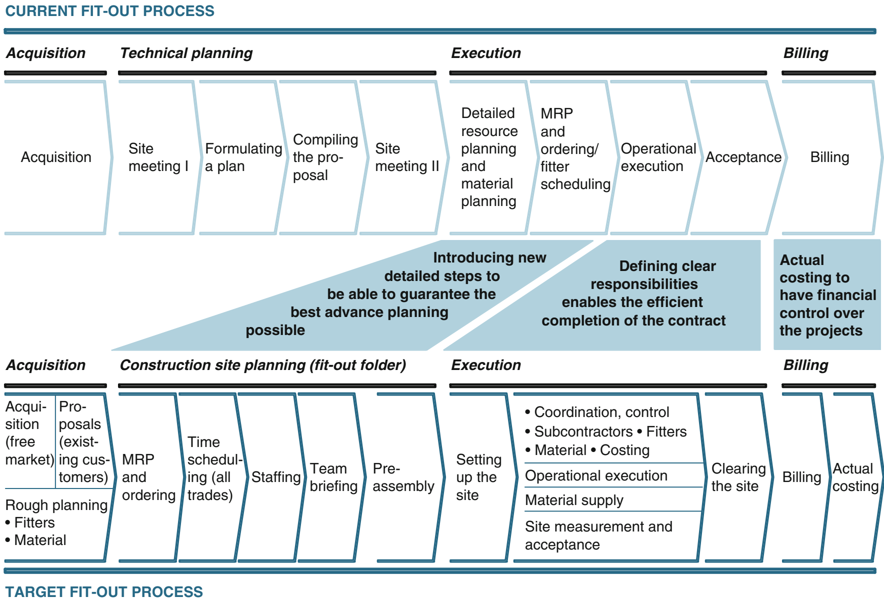


Fig. 4.9 Introducing new and earlier detailing steps and clear responsibilities for the target process

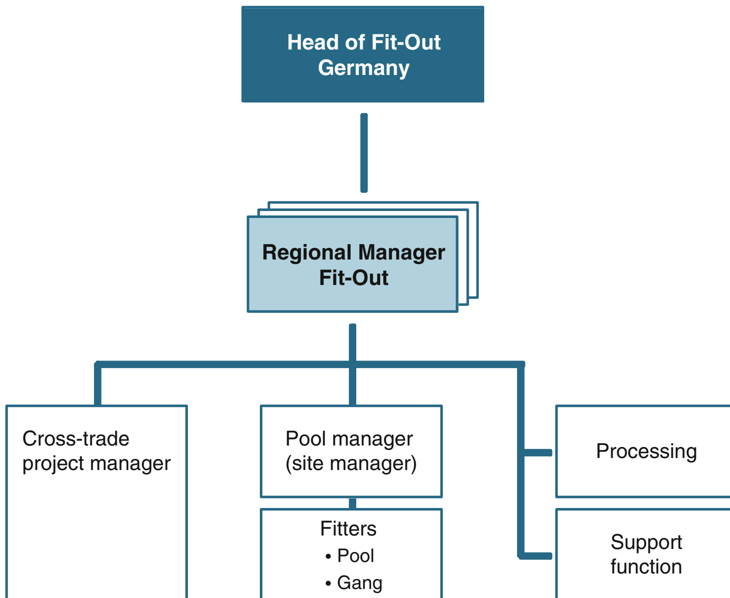


Fig. 4.10 New corporate structures—The business was no longer managed by trade

charge. All other fitters who were not project managers were overseen by a "pool manager" under a pooling arrangement: the pool manager was responsible for managing the capacity and deployment of all fitters in a given branch, which helped avoid any competition for manpower. As a result of all of this, the corporate structures now reflected the new process thinking as well, and the old departmental thinking was eliminated.

The combination of new process and new functions resulted in the creation of new process sequences or directives, an example of which is presented in Fig. 4.11 for the first, highest level.

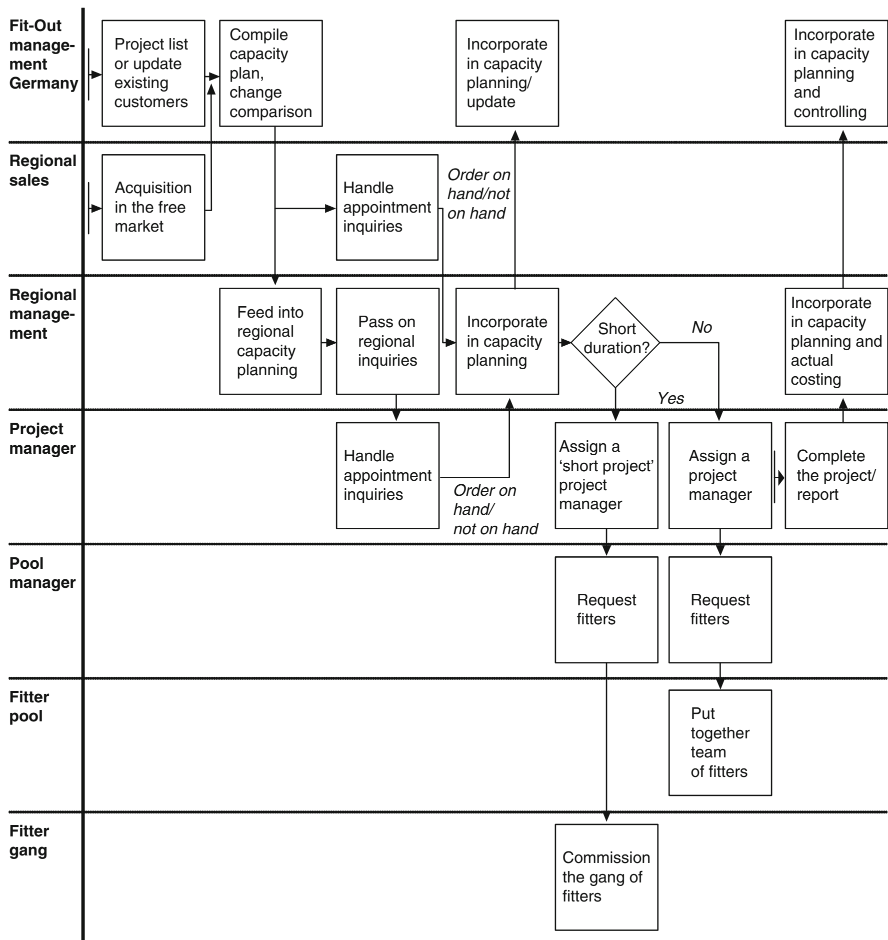


Fig. 4.11 Target process sequence in Fit-Out incorporating the new functions

This main process was finally detailed in a document covering more than 80 pages, where each function and each activity was described and the employees were shown the optimal procedure for future fit-out projects. In the implementation stage, the company first carried out a number of pilot projects to test the new procedure, and the employees later received intensive training in the new procedure and their responsibilities, some of which were new to them. As a result, the new process organization made it possible to complete projects faster, better, and more efficiently to the satisfaction of the customers, a fact that was also reflected in the fit-out business's overall profit.

4.3 Strategic Brand Management

In many companies the strategic management of the brand is very similar to the strategic management of the business units, since business units or affiliated companies often constitute brands in themselves. But even pure product brands need to be managed with strategic considerations in mind in order to be successful in the long run. Back in 1960, Theodore Levitt formulated the decisive notion that companies wishing to achieve continuous growth must look at the markets from the customer perspective given that—in dynamic environments—no state of affairs can be taken for granted and the customer is king. He cited the relevance of the railroads in the U.S. as an example: their relevance was declining because the firms involved saw themselves not as transportation companies but as railroad companies. Their strategy focused on "railroad" as a product rather than on "transportation" as a customer need. This caused them to lose their initial advantage, and the burgeoning demand was covered by cars, trucks, and airplanes.[20]

In order to consider this fundamental notion and additional aspects in detail, we will examine the following questions:

[20] See Levitt (1960), pp. 45–56.

- What is strategic brand management? Why did it evolve? What are its components and characteristics?
- What is brand value? How is it measured? What is it based on?
- What is the future for brand management? What are the challenges ahead?
- How can we identify our own brand position and, if need be, develop the brand so that it achieves the desired position?

4.3.1 The Brand: Complex and Meanwhile Indispensable

The brand itself has become increasingly central since the end of the 1980s, among practitioners and academics alike.[21] One of the drivers of this trend, as already mentioned, was Michael Porter's introduction of the market-based strategy perspective—brand management is based directly on the results of SWOT analysis and the market-based view.

Another driver was the change from suppliers' markets to buyers' markets, which had taken place in all of the consumer goods markets by then. Prior to this change the product and the production perspective had been dominant: in the boom times of the 1950s and against the backdrop of rising affluence, suppliers had produced whatever they thought made technological sense and, from a business point of view, whatever brought unit costs down. In the markets of the day, customers bought these products as initial purchases, but as the markets became ever more saturated the pressure on manufacturers grew, given that almost every household had a phone, a TV, and a car by the middle of the 1970s. For one thing, there was more competition among suppliers to win each customer and for another, suppliers had to induce customers to buy a product for a second time or to replace an older model. Marketing as a function therefore became more and more of a focal point of corporate management: Production now had to coordinate with Marketing in order to align itself with what the needs of the customers were assumed to be in order to be successful in the buyers' markets. Admittedly, even today, this kind of market-based corporate management is only lived out by the big, successful consumer goods corporations—those that have a dedicated Director

[21] With regard to the remarks in this section see Kotler and Keller (2008).

of Marketing or other executives of a similar mind. In all other companies marketing, and thus the brand itself, is not a matter to be dealt with at top management level: it is primarily anchored in the second tier of management and responsibility rests with the marketing manager.

This is a big mistake. Strategic brand management is all about making customers loyal to a certain product or product line over a long period. Given that this provides a guarantee of growth and sales, it should definitely be a matter for top management and ought to be central to a company's strategy. This applies without restriction in consumer goods markets (those for durable and non-durable goods alike), while in some of the markets for capital goods, and in contract manufacturing in particular, suppliers' markets remain the dominant form.

Now, these remarks do not apply to all companies, because not all products are brands. A newly founded company has a product (or a service) when it first starts out. The product generally has a physical attribute that clarifies its origin, in other words a name or a symbol. What we are talking about here is merely a trademark; the product is a powerless brand, so to speak. In order to become a powerful brand, the new product must prove itself in the competitive arena and to its customers. This is what's known as the impact perspective: a product is only a brand when it has built up a positive, relevant, and unmistakable image among consumers. It normally takes several years and numerous product innovations before a product establishes itself in the consumer consciousness.

Once the product has become a brand, it then has a brand core at its very center. This is composed of the virtually unshakable relevant values and memory structures that the brand calls forth. Moving away from the core, the brand then exhibits intangible attributes such as emotional aspects and associations. Next come the tangible attributes that make up the product's functionality, and finally the physical attributes of the product are displayed (see Fig. 4.12).

Brands are normally modified only by altering physical or functional attributes (such as by changing the packaging or improving the spreadability of margarine) because the two innermost segments create the identification with and the loyalty to a brand. With good brand management, a strong brand core can endure and be successful

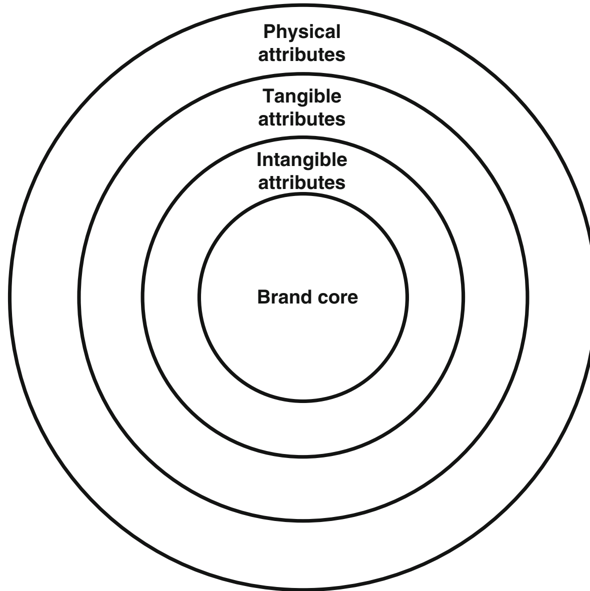
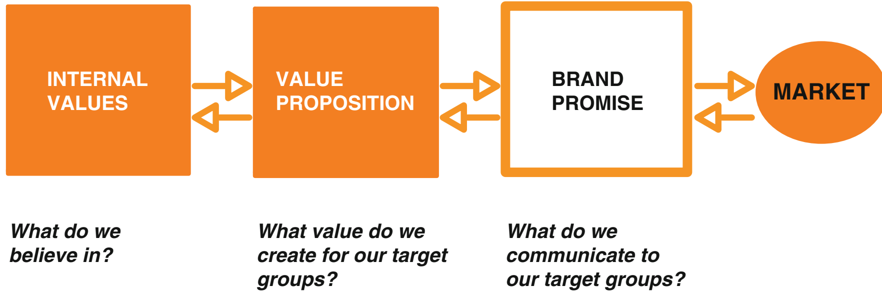


Fig. 4.12 The “onion model” of the brand

for decades, as proven by Nivea, Coca-Cola, and the like. But it can also suffer terrible damage under poor management—consider, for instance, the sinking of the Brent Spar drilling platform on the part of oil company Shell that was scheduled to take place in 1995 but was ultimately called off. The consumer protests caused Shell to lose market share in Germany and created negative feeling that is still associated with brand today and that has indeed weakened it.

Companies have a brand core too, although theirs is much more complex in that it is located at the point of confluence of a wide range of products, categories, and business segments. However, this type of brand core is one that can be designed in a very active manner. It is based on the company’s internal values, which answer the question, “What do we believe in?” In the first step, these internal values need to be transformed into the value proposition. Here, the key question is, “What value do we create for our target groups?” The final step is then about translating this value proposition into a brand promise: “What do we communicate to our target groups?” The brand promise may be, but is not necessarily, the same as the company’s slogan.



BMW example:

Ultimate engineering
Innovation
Dynamics
Dedication

Delivers a sporty driving experience

Freude am Fahren- Sheer Driving Pleasure;
The Ultimate Driving Machine (U.S. slogan)

Fig. 4.13 Designing a company's brand core

If a company follows these steps and is honest with itself, its brand core will have a consistent terminology in spite of the product complexity. In this case, the target customers the firm is addressing in the market will experience a brand promise and a value proposition that the company actually keeps, because it represents the real, internal values of the employees and the products: it meets the expectations raised. Figure 4.13 below takes the positive example of BMW to illustrate this bidirectional process of designing a company's brand core.

Those to whom the tagline "Sheer Driving Pleasure" appeals will find this brand promise repeated in the internal values and thus in the products themselves as well as in the way BMW employees see themselves. When designing a company's brand core, it is important to bear the following additional points in mind:[22]

- The internal values should preferably be market oriented and not random.
- The value proposition should be formulated not from the internal perspective but from the external perspective, in other words it

[22] Experience based on numerous projects and benchmarks.

should address itself to the expectations and needs of the (potential) customers.
- The benefit for the target groups should be formulated in a concrete and not an abstract manner.
- The statements should be worded in an emotional and not a rational way (because more than two thirds of all decisions are made on the basis of emotional motivations).

By observing these points and following the process described above, any company can design an authentic and differentiating brand core.

Generally speaking, what the brand is to consumers is concentrated information that helps guide them through the maze of offerings on the market. To a company, the brand is the firm's opportunity for differentiation. Baumgarth very aptly defines the brand as follows: "... a name, a word, a sign, a symbol, a design, or a combination of these, which is familiar to the relevant consumers and which presents a differentiating image vis-à-vis competing offerings, leading to preferences."[23]

Strategic brand management (also known as branding) begins only when a brand is already developed or has actively been built up. Branding aims to keep customers loyal to the company in the long term and to strengthen the brand. A precise understanding of the relevant market and the company's own position in this competitive arena is essential to achieve this goal. The management must regularly make decisions in four dimensions on that basis:

1. Breadth of the brand: How many products will be managed under a brand? In line with corporate strategy, this concerns the explicit question of the *parenting advantage* of an umbrella brand, such as that offered by General Electric. In the absence of an umbrella brand there will be a single brand.
2. Depth of the brand: How many brands will be managed in a business unit? In line with business strategy, this concerns the explicit question of the *competitive advantage*: what competitive advantage does a multi-brand strategy such as that of Volkswagen

[23] Baumgarth (2001), p. 6.

(Golf, Lupo, Passat, Phaeton, etc.) bring over a single-brand strategy?
3. Brand hierarchy: How are different brands arranged in the company? Why is the Phaeton a sub-brand of Volkswagen rather than a top brand like Audi, Seat, Bentley, etc.?
4. Brand portfolio: How will the existing brands look in their entirety? As in the strategy portfolio, this is concerned with the roles of the brands (strategic brand, prestige brand, cash cow, etc.) and the overall sustainability of the portfolio.

It is evident that the very similarity of these questions to the key questions of strategy makes this a job for the executive board or top management. The market implementation should then be handled by Marketing using the tools of the marketing mix.[24]

The target for strategic brand management and those responsible for it is naturally the enhancement of brand value, because "Value makes a brand, and as a result a brand has added value."[25] In general terms, the brand value describes a group of assets and drawbacks that are associated with a brand, its name, or its symbol, and that increase or decrease the value of a product or service to a company or its customers.[26] In economic terms, brand value is the present value of all future incoming cash surpluses that arise as a result of the brand. So on the financial side it is expressed in monetary units and leads directly to a rise in the enterprise value. From a marketing perspective it is the additional value that a product attains thanks to the brand. If a company's own product is preferred over an identical, competing product the attributes that differentiate them substantiate the brand value. The more distinct and the stronger they are, the greater the value of the brand will be. For Marketing, the behavioral-science issue of how brand value arises and how it can be enhanced is much more relevant than the economic value of the brand.

Market research institute Interbrand[27] is one of those that conduct economic measurements of brand value, publishing its findings

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[24] We will not go into the well-known marketing mix and its 4 Ps (product, price, place, promotion) in any more detail here.

[25] Pearson (1996), p. 6.

[26] See, among others, Aaker (1991).

[27] www.interbrand.com

Brand	2000-2015	Brand	2000-2015
Coca-Cola	+7%	Mercedes	+76%
Microsoft	-3%	Citibank	-47%
IBM	+23%	Hewlett-Packard	+10%
GE	+11%	American Express	+19%
Intel	-10%	Gillette	+29%
Nokia	-92%	BMW	+185%
Disney	+9%	Cisco	+50%
McDonald's	+43%	Honda	+53%
Toyota	+158%	Ford	-67%
Apple	+2329%	Sony	-50%

Fig. 4.14 Brand value trend of the 20 most valuable brands in the world between 2000 and 2015 (total)

annually in *Business Week*. They do not disclose how their findings are obtained, however, and merely describe the process in highly qualitative terms. Moreover, it is questionable just how correct the absolute level of their estimates is, given that there are various methods of estimation, each of which produces different results. These estimates are nevertheless taken as a starting point when it comes to buying and selling trademark rights, calculating license prices, and assessing claims for damages, for instance. What is of much greater interest is the long-term view of the trend in brand values: which firms manage to grow the value of their brands using the same methodology (such as the one employed by Interbrand)? Figure 4.14 above shows that 14 of the 20 most valuable brands in the world in 2000 made it through to 2015—proving that strategic brand management really is a major challenge. Google, the second most valuable brand in the world, is not shown in the figure as it did not even exist in 2000.

In contrast to the economic measurements, there are also models from the sphere of behavioral science that incorporate customers and their preferences. These either result in overall scores drawn from scoring models or they position brands in the perception matrix by means of multidimensional scaling.[28] Brand value as seen from a behavioral-science perspective rests upon five elements, some of which are interdependent, that represent the major pointers for

[28] Examples are presented in the next section.

successful branding with the objective of generating value for the customer and for the company:[29]

1. Brand loyalty: The objective is to make the customer loyal to the brand for the long term by placing customers and customer satisfaction at the heart of the company's efforts.
2. Brand awareness: The objective is to make the name of the brand known, because new customers prefer brands that they know to brands that they don't due to the familiarity factor.
3. Perceived quality: The objective is to increase the quality as perceived by—but seldom identifiable to—the customer, since this has a direct influence on the purchase decision and on brand loyalty.
4. Brand associations: The objective is to enrich the brand with other associations or feelings on the part of the customer, because this, too, has a positive impact on the purchase decision (a Jaguar or a Porsche convey the idea of a certain lifestyle to the customer).
5. Other brand assets: The objective is to build up other brand advantages such as patents, trademarks, sales channels, etc. so as to prevent customer loyalty from being compromised.

Figure 4.15 presents the five elements of brand value and their respective advantages.

There is, overall, a natural predominance of the advantages that derive from a strong brand with a high market value, given that these are the ones that

- differentiate a company's own offering from that of the competition,
- enable price premiums,
- have fixed customer bases,
- represent barriers to market entry,
- offer a better platform for brand extension through new products or the extension of product lifecycles (as seen in the example of the Mercedes E-Class), and
- provide new customers with a point of orientation.

[29] See Aaker (1991).

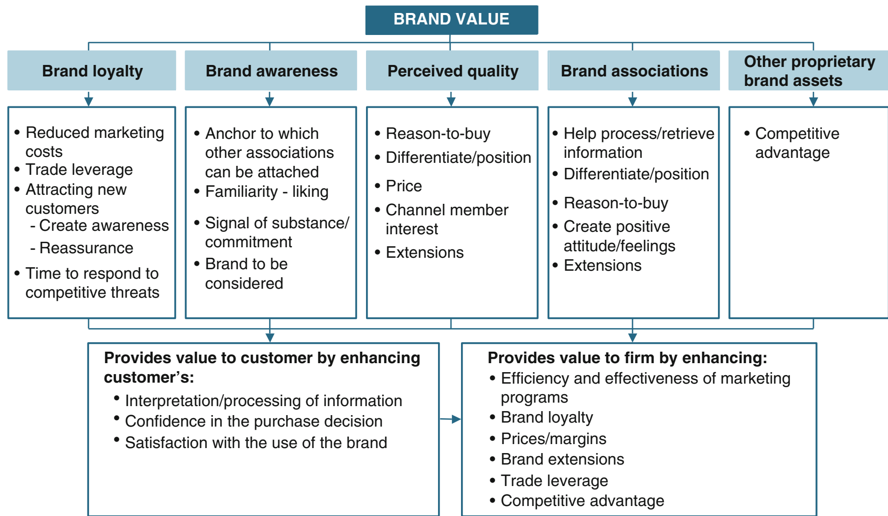

Fig. 4.15 Brand value as seen from a behavioral-science perspective and its five elements for strategic brand management (Aaker 1991, p. 269)

Yet strong brands also exhibit potential risks, most of which have their foundations within the company itself:

- Strong brands can lead to laziness: Those responsible for a brand may rest on the laurels of past successes and eventually lose their control of the brand.
- In a sales crisis there is a danger of sales managers discounting branded products to boost sales in the short term. This causes lasting damage to the brand and its value in that customers will always expect discounts from then on and the brand will at some point be perceived as "cheap" in the sense of "lower value."
- Extending the brand too quickly with the objective of generating sales carries the risk of brand dilution if the brand core and its potential for extension are not carefully considered.

Besides the internal challenges already mentioned—starting with the necessary customer understanding and knowledge of the buyers' markets—there are many external challenges for strategic brand management to deal with. Consumers face information overload thanks to the explosion of product and brand variety brought about by increasing market segmentation, globalization, and significantly

shorter product lifecycles combined with an inflation of product communication triggered by the new media and media tools. And the consumers' growing desire for experiences (the fun factor, living life to the full, work-life balance) coupled with the emergence of new psychographic customer types like *smart shoppers* (enjoy bargain hunting), *system beaters* (wait for special offers) and *hybrid consumers* (exhibit situational behavior—use the subway and drive a Mercedes S-Class) causes them to switch brands at ever shorter intervals. In such an environment—unsurprisingly—private labels (such as Wal-Mart) are becoming increasingly successful in permanently raising their profile with respect to manufacturer brands and in competing with the latter.

Given all of these new challenges, strategic brand management is a process that requires constant improvement—it is imperative for a company to be aware of its competitive position and to react early to changes. The following section presents an instrumental approach to support this analytical role that strategic brand management should fulfill. Yet it is worth mentioning, before we move on, that "Brand image does not necessarily equal brand usage."[30] Strategic brand management must not be an end in itself—high brand value from a behavioral-science perspective must also lead to real consumption.

4.3.2 Examples of Brand Evaluation Using Positioning Analysis

The task of identifying a brand's positioning in order to determine the brand value from a behavioral-science perspective and to manage the four dimensions of strategic brand management[31] is currently accomplished predominantly by means of multivariate analysis, specifically multidimensional scaling (MDS). This quantitative analytical method from the field of economic and social science research is also known as positioning analysis.

MDS works on the basis that objects such as products and brands occupy a position in people's multidimensional perception matrix. A

[30] Kapferer (2001), p. 112.

[31] See the previous section.

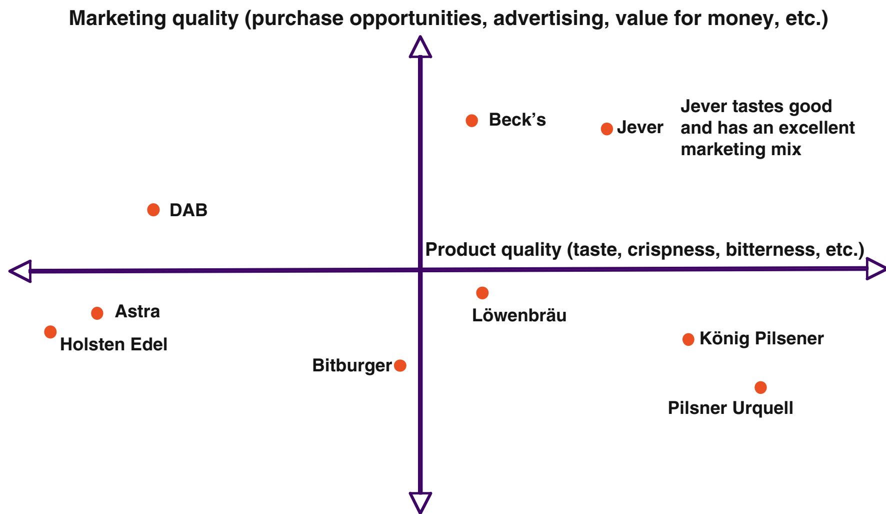

Fig. 4.16 Positioning beer brands using MDS (Adapted from Hansmann 1997, p. 50)

survey is first conducted to ascertain the perceived global similarities between the objects. The underlying dimensions of perception are then derived through MDS. Finally, all of the objects are positioned relative to each other and along the underlying dimensions in order to model the perception matrix.

The distance between the objects reveals their relative similarity, and their proximity to the arrowheads in the system of coordinates shows how positively they are perceived in a given dimension.

Although this example (see Fig. 4.16) from the German beer market is already several years old, it provides a striking demonstration of the brands that are regarded as similar and the areas where positioning potential might still exist. The two axes depict the condensed information from a range of different parameters, and the point of intersection divides the graph into positive and negative perceptions. Accordingly, Jever's positioning is the best in this analysis, while that of Holsten Edel is the worst. Consumers view Pilsner Urquell and König Pilsener as more mutually similar than, for instance, Pilsner Urquell and Beck's. In terms of the brand value from the behavioral-science perspective, the strongest brands are Jever and Beck's; all others—according to their respective positioning—have improvement potential, and in some cases substantially

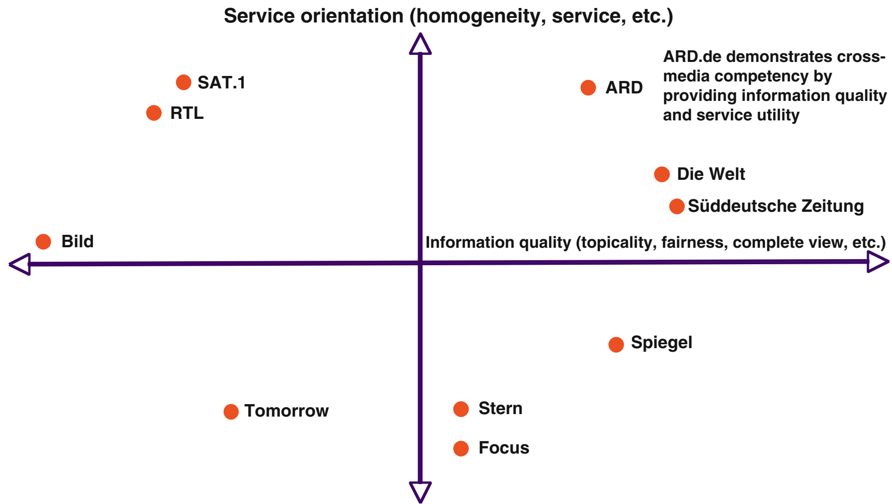

Fig. 4.17 Positioning online media products using MDS (Adapted from Kröger 2002, p. 301)

so. The perception matrix is also attractive to new suppliers and their products, as only two beers occupy the top-right quadrant.

The more recent example (see Fig. 4.17) of online media products can be interpreted in the same way: ARD is perceived as the best in the dimensions of information quality and service orientation. The offshoots of the private television broadcasters (RTL and SAT.1) and of "Bild" are well-edited but the quality of information is poor. "Tomorrow" occupies the worst position, while "Spiegel" is rich in content online, as in print, but is not attractive. Whereas the media products provided by RTL and SAT.1 display a high level of mutual similarity, the "Spiegel" is diametrically opposed to them.

The third example (see Fig. 4.18) is somewhat more complex. The matrix describing public events in Hamburg is four-dimensional, with three of these dimensions pointing in a similar direction. Some of the well-attended events are still seen as an attraction for the city (particularly the Hamburg Port Festival) but are fairly unpopular among survey respondents and fail to meet their expectations. On the other hand, the events perceived as positive in these qualitative dimensions tend to have fairly low attendance figures. Consequently, the analysis supports the fundamental notion that quality and quantity are

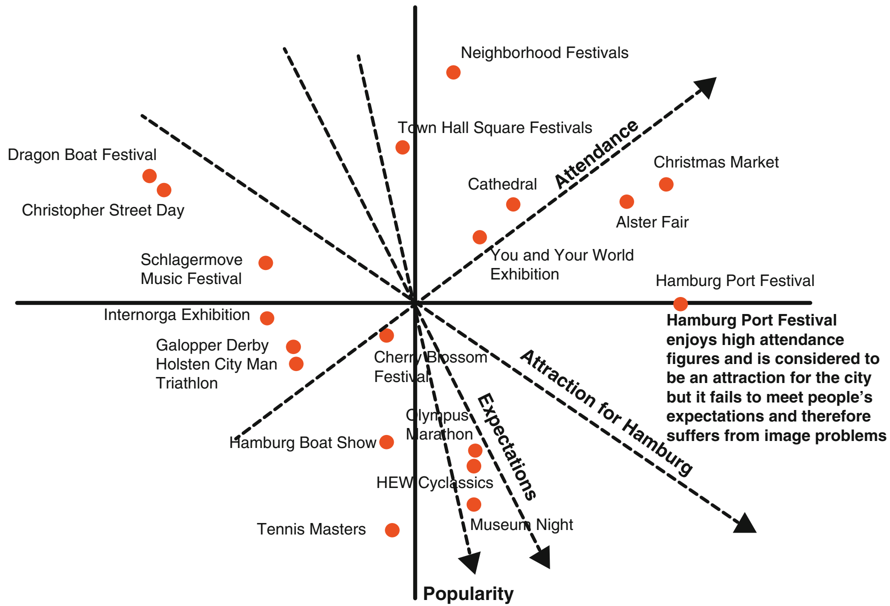

Fig. 4.18 Positioning public events in Hamburg using MDS (Adapted from Hansmann et al. 2005)

competing parameters when it comes to events. Notwithstanding the four dimensions, it is possible to compare the mutual positioning of the individual events directly: the Marathon and Cyclassics events are perceived by consumers as very similar to each other, whereas the neighborhood festivals, for instance, are very dissimilar to them.

The identification of brand value by means of MDS or other methods enables the current positioning of brands in the consumer perception matrix to be analyzed. Beyond that, how a brand fulfills the dimensions also provides an indication of where a company's strategic brand management may have the potential for improvement. The issue of how, in concrete terms, a brand can improve its position is addressed by the actions in the marketing mix. The image-building aspect is, in substantial part, always the remit of creative agencies, inasmuch as causal, economic analysis has no more hand in the success of a brand from here on in: it points out the possible course, but it cannot develop it any further.

4.4 Strategic Gaming

Everything we explained above on the subject of strategic management shows that all of the tools, and even the process of analysis itself, face the underlying problem that perspectives and recommendations are exclusively static. The analysis of the current state (or equally the SWOT analysis) ascertains the status quo on a given day, and the tools are applied based on these findings. Dynamic interdependencies—what competitors will do if a company executes a certain strategy—cannot be tracked by these frames of reference.

This final chapter rectifies this "flaw": game theory provides the foundations for modeling competitive situations as a dynamic game and thereby analyzing actions and reactions in a market from a predictive perspective.

The next two sections deal with the foundations and specific practical applications based on the following two questions:

- What are the central ideas in game theory?
- How, in practice, can game theory help companies make their strategic decisions, taking into account the dynamic environment in which they operate?

4.4.1 Game Theory: A Way of Dynamically Modeling the Competition

Game theory[32] is a mathematical theory of strategic behavior and—as a supplement to decision theory—analyzes situations in which a decision is required. Put simply, it examines the interactive and therefore interdependent strategies of competing individuals. As such, however, it also addresses issues of interactivity and communication: the more you know about your opposite number, the better you can react, and act, in response to the behavior displayed. Game theory attempts to find the strategy by which the optimum result can

[32] There are many very good books on game theory. With regard to the remarks in this section see, among others, Dixit and Nalebuff (1991), which presents the subject matter in a very easy-to-read manner. For those interested in the math behind game theory, try Dutta (2001).

be achieved in a given situation. The strategy need not be determinist—it can also work with probabilities.

Scientists historically concentrated on zero-sum games to begin with, later turning their focus to non-zero-sum games and formulating cooperative and non-cooperative game theory. John von Neumann made the first contribution to game theory in 1928 when he proved the maximin theorem.[33] He published a book in conjunction with Oskar Morgenstern entitled "Theory of Games and Economic Behavior" in 1944, which established game theory as a science in its own right. In the 1950s John Nash developed an equilibrium for two-player games, which is now famously termed the *Nash equilibrium*. He was awarded the 1994 Nobel Prize for Economics as a result.[34]

The fundamental concept of game theory need not be understood in a purely mathematical sense: its main characteristics can also be communicated in a qualitative sense. To begin with it is important to formulate the basic understanding of a strategic game:

- Strategic situations are modeled in the form of a game.
- Game rules stipulate who can do what and when.
- There are two or more players with fundamentally competing interests.
- A player's strategy is a plan of what kind of action the player will choose to take in any conceivable situation.
- The utility or the loss resulting to a player from a situation is called the payoff.
- All players are rational—they attempt to achieve the highest possible utility in any situation.
- Faced with an opponent's given strategies, the best response from a player is the one that maximizes the player's own payoff.

These basic concepts are familiar to all of us from parlor games like Blackjack or Monopoly. Parlor games are usually based on simple strategic situations, whereas the games that need to be modeled in

[33] Maximin theorem: A player chooses the strategy that maximizes the (guaranteed) minimum that the opponent cannot take away.

[34] Together with John Harsanyi and Reinhard Selten, who are also scientists in the field of game theory.

economic or political contexts are more complex. There are a number of significant conceptual couples in game theory that help structure the situation in each game—these are fundamental to a basic understanding and are explained below.

The *two-player zero-sum games* mentioned above are games in which one of the players wins what the other player loses. Cooperation or non-cooperation is ruled out: structurally speaking this is the simplest form of game (heads or tails, etc.). Communication can be completely cut out, since winning is all that counts for both players. In this case, the maximin rule provides the optimum solution in equilibrium for any decision situation: maximize the minimum achievable payoff. In *non-zero-sum games* the players can improve their situation through cooperation but they can also increase their profit over and above their opponent's loss through non-cooperation. In reality, non-zero-sum games tend to be the dominant form; their appeal lies in the non-cooperative behavior. For stable equilibria, the trust between players is the decisive factor in practice. However, according to game theory, players are rational, and trust is not normally the rational solution—this problem will become clear as we go on to examine the prisoner's dilemma. Non-cooperative behavior in non-zero-sum games is differentiated into aggressive strategies aimed at gaining an unfair advantage, and blind strategies that follow the principle of randomness.

There is also the concept of the *dominant strategy*: each possible combination of strategies in a game is calculated by each player individually, and each player chooses the strategy that provides the greatest utility from a purely personal perspective. If the player chooses the same strategy for each of the possible combinations, this represents that player's dominant strategy in the game—the player always chooses the same strategic option in each decision situation. In other words, the optimum strategy from the player's rational perspective never depends upon the opponent's strategy. A strategic option that is not consistently better but is, in fact, consistently worse than any other strategy, is known as a *dominated strategy*—such strategies should be avoided. Frequently, players have neither dominant nor dominated strategies, and in that case the best response or strategy for a player depends upon the opponent's choice of strategy (and the same applies in reverse to the opponent)—so a

different option is chosen depending upon the specific decision situation. The Nash equilibrium provides the solution to such a game when the strategies are pure: there is a combination of strategies in which each player's choice of strategy represents the best response to the opponent's (taken as given) choice of strategy—there is therefore no rational incentive to change the solution or the stable situation unilaterally, since neither player will get any more out of it. This equilibrium is also known as the "best mutual response principle" and is likewise the solution if both players have a dominant strategy.

In *parallel or simultaneous games* the players make their decisions at the same time. Each player is therefore called upon to see things from the other's perspective and attempt to predict the result of the game. This scenario is described in the game matrix or the decision matrix, which contrasts the various strategic options open to the players in numerous decision situations. In *sequential games* the decisions are made in sequence. The player whose turn it is must consider how her action will affect the action of the other person. Game or decision trees are used to represent this scenario, and the moves are depicted as nodes from which the possible paths branch off in different directions. At first sight it might appear more difficult to plan the strategies for a parallel game. But if you've ever played chess you'll know that a purely sequential game is incredibly complex too.

Games are either static or dynamic. *Static games* take place once and can be repeated ceteris paribus (for instance heads or tails). *Dynamic games* involve numerous moves and explicitly factor in the changed environment and/or lessons learned from previous moves—they therefore take place across several chronological decision levels. They can be parallel, sequential, or even mixed parallel-sequential games.

Pure strategies in games decide unequivocally for or against a possible strategy or move. *Mixed strategies* assign a probability (depending on the individual risk preference) to each strategic option or each move that could be played.

In a game of *complete information*, the players know all of the strategies and possible combinations as well as all of the resulting payoffs in the game. This information is also known as the technical aspect of a game. As soon as this no longer applies in full for any of the players, there is a state of *incomplete information*. In the real

economy companies do not normally have complete information—except in a planned economy.

If a player is unaware of another player's choice of strategy, the game is one of *imperfect information*. This is always the case with simultaneous games. If, however, each player is at all times aware of the strategic choices the opponents have made, the game is in a state of *perfect information*—this applies to games in which the moves are exclusively sequential.[35]

The prisoner's dilemma is an example of a simultaneous non-zero-sum game that nicely illustrates the problem of the fundamental assumptions in game theory:[36] two prisoners, A and B, are suspected of having committed an offense. The maximum jail sentence is 8 years. The judge makes each of them the following offer: "If you implicate the other guy you'll go free and he'll get the full 8 years. If you both refuse to talk we have enough evidence to put each of you away for 3 years. If you both confess you'll both be sentenced to 5 years." The prisoners cannot coordinate with each other, so each has two options: cooperate with the other, meaning keep quiet, or defect from the other, meaning confess. The resulting four possible strategy combinations are usually presented in a payoff matrix (see Fig. 4.19). In this case the payoffs, or the number of years in jail, are preceded by a negative sign, since jail sentences do not represent a positive utility. The first figure in the parentheses is A's payoff and the second figure is B's payoff.

According to the assumptions of game theory, rational behavior is employed in decision making: each player wants to maximize the individual utility from a personal perspective. From A's point of view (and from B's point of view) there are two possibilities in this simultaneous situation: the other player will either cooperate or defect. In both cases it pays off for the prisoners to defect, in other words to confess: a payoff of 0 is better than -3, and a payoff of -5 is better than -8. To put it another way, freedom is better than 3 years in

[35] See Dixit and Nalebuff (1991). This book provides a practical summary of everything described above, in other words the basic concept of game theory, in a simple and logical form based on four rules.

[36] Details of the prisoner's dilemma may vary in the literature (for instance the length of the jail sentences), but the dilemma itself is the same.

		B	
		Keep quiet	Confess
A	Keep quiet	(-3, -3)	(-8, 0)
	Confess	(0, -8)	(-5, -5)

Fig. 4.19 The payoff matrix in the prisoner's dilemma

jail, and 5 years in jail is better than eight. Since both players have the same dominant strategy, there is also what's known as an equilibrium of dominant strategies here. However, rational behavior leads to a suboptimal result in this case, since both prisoners confess and get 5 years in jail. Cooperating by keeping quiet would be better for both, as they would then receive sentences of only 3 years' duration.

The game-theoretic assumption of rationality and the associated maximization of individual utility is naturally a common assumption in business economics as well. The prisoner's dilemma thus proves the notion that companies in market situations should cooperate in order to improve their own situation overall. Instead of conducting aggressive advertising campaigns for established products, for instance, it may make sense to save the money and keep the existing market share.

Yet the problem with such cooperation—as demonstrated by the prisoner's dilemma—is the fact that each player always has an incentive to defect. If one keeps quiet, the other one confesses and goes scot-free. Or if one does without an advertising campaign, the other can quickly gain market share by running such a campaign. Cooperative solutions can therefore only exist if there are suitable sanction mechanisms in place.

Game theory has consequently developed a large number of standard mathematical strategies, which compete against each other in computer games in the form of algorithms. The best known of these is

the "tit for tat" strategy based on the principle of "an eye for an eye." It is cooperative from the very first move, in each turn playing the same move as the opponent just played. This makes it a fundamentally friendly strategy, albeit one that can quickly be provoked into becoming permanently uncooperative. That's why it is dangerous to employ this strategy in situations that could be prone to misunderstandings (such as global situations marked by large distances and different languages and cultures). Driven by the principles of industrial economics in particular, standard mathematical strategies are formulated in terms of market behaviors: there are, for example, absolute strategies, in which a player signals to the opponent a credible commitment to his own choice of strategy by burning his bridges.[37] Such strategies can be market entries associated with the buildup of substantial fixed plant/production capacities and corresponding sunk costs. And there are strategies that threaten sanctions or promise rewards in the case of cooperation—such sanction and incentive systems are generally stipulated in a contract.

4.4.2 Dynamic Competitive Simulation in Reality

Retrospectively, any economic, political, sporting, personal, or military situation can be analyzed and evaluated with game theory. Ex ante application of the fundamental knowledge from game theory is, however, fairly rare—this has to do with the restrictions and the complexity of the material. Some initial approaches for ex ante application and a number of examples have been developed nonetheless.

These approaches are generally known as "strategic gaming" (or "war gaming"), since they have their origins in military application. While originally employed to simulate the effects of military strategies, the approaches have since become widespread in the business world. In an experimental phase major global corporations such as oil companies took the strategic approach on board. Having

[37] The expression is derived from the notion of an army burning down the only bridge to an island after crossing it during a military campaign to take said island. It shows the opponent the absolute nature of one's own strategy.

since spread to the big listed companies,[38] the approaches can now be described as technically mature. They are normally provided to the corporate groups by the major international management consultancies. The consultants prepare the game, conduct it with the client, and subsequently analyze the individual moves and the result.

Conceptually speaking, strategic gaming is the dynamic simulation of real business situations. It is intended to give top managers a way of evaluating their strategic decisions against a background of explicit assumptions on the market and competition. A game consists of the following main steps:

- Formulating the core hypothesis to be tested.
- Working out the economic model (market and competition).
- Putting together four to five teams to represent the client company and its key competitors.
- Executing three to four game moves, each of which depicts a real timeframe of 1–2 years.
- Analyzing the individual moves and evaluating the key decisions at the end of the game.
- Providing feedback to summarize planned and unexpected results.

In the pre-game phase there are two critical points that need to be prepared in detail: the economic model and the formation of the competitor teams. The economic model is a quantitative computer model that simulates the market and competition, and reacts to the individual moves in the game. In accordance with the content of the core hypothesis, the relevant data need to be modeled; these may be demand elasticities, supply parameters, and growth rates in the market, for example, and on the competition side the sales and cost structures and the investment potential, inter alia, are modeled. Each game move is incorporated into the model, and there are corresponding reactions from the market and/or the competitors. Of course, the client team and the competitors can only be played by people from the client company itself, so the players need to be capable of putting themselves in the position and the role of top managers at the competing companies to enable them to play the

[38] Dax 30, S&P 500, FTSE 100, etc.

latter's moves as faithfully as possible. In order to facilitate this, the competitors' top managers are assigned a standardized psychological profile in the pre-game preparatory phase so as to give the player concerned as precise as possible a picture of the person being played:

- What position (CEO, CFO, Chairman, etc.) and what role does the person occupy (entrepreneur, networker, cost cutter, controller, etc.)?
- What is the person's leadership style (authoritarian, tense, perfectionist, etc.) and how does he or she make decisions (democratic, participatory, autocratic, etc.)?
- How does the person behave in a team setting (coordinator, team worker, specialist, etc.) and in general (extrovert, introvert, intuitive, emotional, etc.)?
- What is the person's background (education, private life, career steps, past strategic decisions, etc.)?

Both the economic model and the personality profiles are formulated on the basis of intensive research in databases, market reports, annual reports, press releases, and so on. Moreover, interviews with experts can provide greater understanding of internal cost structures and even top managers' individual character traits. It is therefore evident that working out the economic model and putting together the competitor teams calls upon all of the established frames of reference: SWOT analysis, corporate strategy, and business strategy. Preparing a game takes about 10–12 weeks and occupies two to three consultants.

The game itself lasts 2 days, during which time the next 5 years or so are dynamically simulated in three to four game moves. At the start of the game all teams are requested to analyze, formulate, and inform the game controller of their fundamental strategic decisions for the first period of time. The teams are in separate rooms, thus precluding communication. The moves are initially made simultaneously and are subsequently incorporated in the economic model. The model's reaction and the preceding moves are then communicated to all teams so that they can each play a new simultaneous move with knowledge of the strategies already played and the model's reaction to them. Each team has around 4 h to conduct its analyses and prepare a move,

although minor in-between moves may also be made during this time in order to properly simulate an entire year (for instance holding an analysts' conference). Once all of the moves have been played the game will produce a result in respect of the initially formulated core hypothesis in accordance with how the economic model reacted. Depending on whether the strategy of the client company was successful or not, an analysis of the moves can highlight which were the winning moves or where a wrong path was taken and what move would have been better. This kind of post-game analysis, involving a complete rehash of the entire game, takes about 2 weeks.

Strategic gaming has been used on the following issues and core hypotheses, among others: market entry strategies, expanding vertical integration, M&A price strategies, hostile takeover strategies, and awarding publicly tendered contracts (UMTS licenses, armaments contracts). The initiator of one of these games has the advantage of being able to test strategic decisions in a dynamic simulation—one that takes account of how the market and the competitors react—while incurring absolutely no risk. Winning the game indicates that the initiator can proceed with the intended plan. Losing the game gives the initiator the chance to reconsider the planned course and to examine whether other moves might represent a winning strategy. In any case such games complement the static tools by offering an additional perspective of strategic management—one that is dynamic as no other.

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5 Summary: It's Your Turn!

A little over a hundred pages is absolutely sufficient space in which to gain an understanding of the fundamentals of strategy and strategic management, to become familiar with the most important frames of reference and their interdependencies, and to draw closer to the major issues of corporate practice. It provides precisely the strategic knowledge you really need to survive in the face of tough competition—the quintessence of strategic management.

There's little more another publication could do to help you resolve your strategic challenges. In our opinion, a textbook along the lines of "The Right Strategy in 30 Days," "The 10 Secret Formulas of Strategic Success," or any similar manual purporting to make your managerial life easier would be pointless. The mother of success is always unknown at the start, and successful companies seldom have the same fathers.

Time and again, as we have shown here, strategy development and the final strategy alike are subject to unpredictable market developments: parameters change, competitors do not behave as expected, technology takes another leap forward—the list of inconveniences is long. Yet that is exactly why most of you decided to become decision makers in the first place: to come up with successful strategies in complex situations and make the right decisions for the good of the company and those who work there. This book helps you to do so.

And if, on top of this, you accept the permanent uncertainty as your own personal challenge and are not afraid to revise strategic

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P. Kotler et al., *The Quintessence of Strategic Management*,
Quintessence Series, DOI 10.1007/978-3-662-48490-6_5

decisions, occasionally in a hurry—but always on the basis of well-founded analyses and perspectives—you have a very good chance of achieving long-term success for your corporation. After all, you don't get anywhere standing still.

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P. Kotler et al., *The Quintessence of Strategic Management*,
Quintessence Series, DOI 10.1007/978-3-662-48490-6

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