

Strategic and Operational Management

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MGM 630

Lecture 5



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LECTURE OUTLINE

5.1 Competitive Advantage and Firm Performance.

- Accounting Profitability
- Shareholder Value Creation
- Economic Value Creation
- The Balanced Scorecard
- The Triple Bottom Line

5.2 Business Models: Putting Strategy into Action.

- Popular Business Models
- Dynamic Nature of Business Models

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LEARNING OBJECTIVES

1. Conduct a firm profitability analysis using accounting data to assess and evaluate competitive advantage.
2. Apply shareholder value creation to assess and evaluate competitive advantage.
3. Explain economic value creation and different sources of competitive advantage.
4. Apply a balanced scorecard to assess and evaluate competitive advantage.
5. Apply a triple bottom line to assess and evaluate competitive advantage.
6. Outline how business models put strategy into action.

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5.1 Competitive Advantage and Firm Performance

It is easy to compare two firms and identify the better performer as having competitive advantage. But simple comparisons have their limitations. How can we understand how and why a firm has competitive advantage? How can we measure it? How can we understand that advantage within the bigger picture of an entire industry and the ever-changing external environment? And what strategic implications for managerial actions do we derive from our assessments? These apparently simple questions do not have simple answers — strategic management researchers have debated them intensely for at least 30 years.

At its core, a firm has a competitive advantage when it creates more economic value than its rivals — the gap between the benefit customers perceive in its product and the cost of producing it. Performance, however, is multidimensional. Accounting measures such as return on assets (ROA) and return on invested capital (ROIC) capture realized profitability, while market-based measures such as Tobin's q and total shareholder return reflect investors' expectations of future returns. Because no single metric tells the whole story, analysts triangulate across several, benchmark them against industry peers, and adjust for the external forces — rivalry, regulation, and technological change — that define what “strong” performance actually means in a given context.

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To address these key questions, we will develop a multidimensional perspective for assessing competitive advantage. Let's begin by focusing on the three standard performance dimensions:

1. What is the firm's accounting profitability?
2. How much shareholder value does the firm create?
3. How much economic value does the firm generate?

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- Accounting profitability

As we discussed in Chapter 1, strategy is a set of goal-directed actions a firm takes to gain and sustain competitive advantage. Using accounting data to assess competitive advantage and firm performance is standard managerial practice. When assessing competitive advantage by measuring accounting profitability, we use financial data and ratios derived from publicly available accounting data such as income statements and balance sheets.

The most widely used profitability ratios standardize performance so firms of different sizes can be compared. Return on assets (ROA) and return on invested capital (ROIC) show how efficiently a firm turns its asset and capital base into profit; return on equity (ROE) measures the return generated for shareholders; and gross and net profit margins reveal how much of each sales dollar survives after costs. Managers interpret these ratios relative to industry peers and over time, since a single year's figure can be distorted by accounting choices, one-off events, or differences in capital structure. Their key limitation is that they are backward-looking — they record value already captured rather than the future potential that markets price in.

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Since competitive advantage is defined as superior performance relative to other competitors in the same industry or the industry average, a firm's managers must be able to accomplish two critical tasks:

1. Accurately assess the performance of their firm.
2. Compare and benchmark their firm's performance to other competitors in the same industry or against the industry average.

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Accounting data enable us to conduct direct performance comparisons between different companies. Some of the profitability ratios most commonly used in strategic management are return on invested capital (ROIC), return on equity (ROE), return on assets (ROA), and return on revenue (ROR).

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Winning and Measuring Success**Apple vs. Microsoft**

To demonstrate the usefulness of accounting data in assessing competitive advantage and to derive strategic implications, let's revisit Apple and Microsoft and investigate the sources of performance differences in more detail. Exhibit 5.1 shows the ROIC for Apple and Microsoft (as of fiscal year 2014). It further breaks down ROIC into its constituent components, providing important clues for managers on which areas to focus when attempting to improve firm performance relative to their competitors.

The power of this comparison comes from decomposition: ROIC equals net profit margin ($\text{profit} \div \text{revenue}$) multiplied by working-capital and fixed-asset turnover ($\text{revenue} \div \text{invested capital}$). Two firms can reach a similar ROIC by very different routes — one through high margins on premium products, the other through faster asset turnover and a leaner capital base. Breaking the ratio apart shows managers exactly which lever is driving the gap, so an underperformer can see whether it should defend pricing and margins, use its assets more intensively, or both. This is why a single headline number is never enough; the diagnosis lives in the components.

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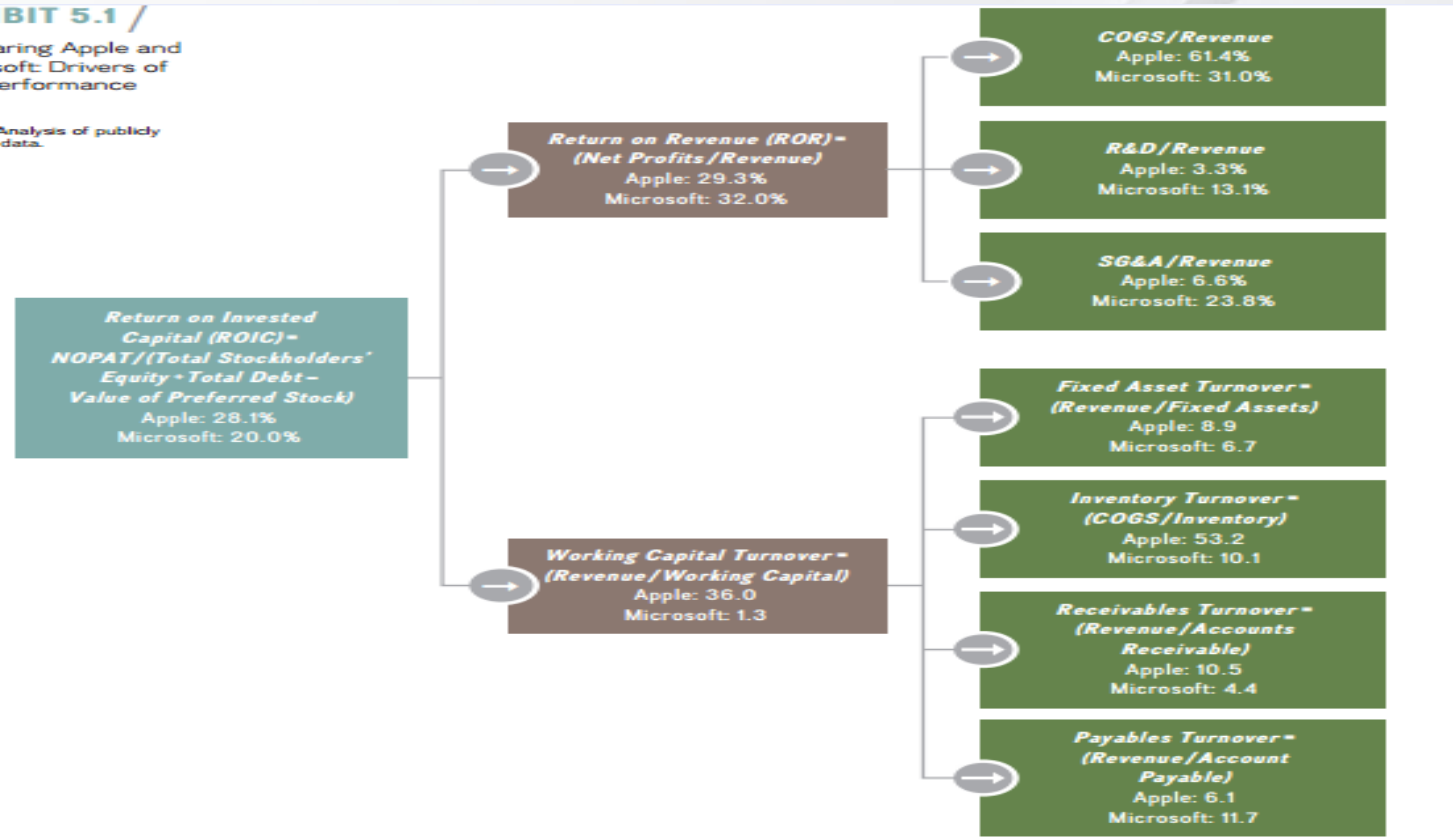
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EXHIBIT 5.1 /

Comparing Apple and Microsoft: Drivers of Firm Performance (2014)

Source: Analysis of publicly available data.



Limitations of accounting data: Although accounting data are readily available and easily transformed into financial ratios to assess competitive performance, they also exhibit some important limitations:

- All accounting data are historical and thus backward-looking. Profitability ratios show us only the outcomes of past decisions, and the past is no guarantee of future performance.
- They do not capture off-balance-sheet items — such as pension obligations or certain lease commitments — which can materially change a firm's true economic position even though they fall outside the reported ratios.
- Most importantly, they largely ignore the value of intangible assets — brands, patents, customer relationships, and human capital — which are often a firm's most valuable, hardest-to-imitate resources and the real source of competitive advantage.

- Accounting data do not consider off–balance-sheet items. Items such as pension obligations (quite large in some U.S. companies) or operating leases in the retail industry can be significant factors. Because they sit outside the reported statements, they can understate a firm’s real liabilities and make its performance look stronger than it truly is, distorting comparisons between rivals.
- Accounting data focus mainly on tangible assets, which are no longer the most important. In today’s knowledge economy, much of a firm’s value comes from intangibles — brand, intellectual property, and know-how — that balance sheets capture poorly. This limitation is nicely captured in the adage: “Not everything that can be counted counts, and not everything that counts can be counted.”

Intangibles and the Value of Firms: Intangible assets that are not captured in accounting data have become much more important in firms' stock market valuations over the last few decades. Exhibit 5.2 shows the firm's book value (accounting data capturing the actual cost of assets minus depreciation) as part of its total stock market valuation (shares outstanding $\times$ share price). Book value reflects the historical cost of a firm's assets, whereas market valuation is based on future expectations for growth potential and performance.

The gap between the two has widened dramatically: a few decades ago book value explained most of a firm's market value, but today it often accounts for only a small fraction. The difference reflects intangibles the balance sheet never records — brands, patents, software, data, customer relationships, and human capital. For managers, this signals where competitive advantage increasingly lives: investing in and protecting these hard-to-imitate intangible resources matters far more to long-run value than the tangible assets traditional accounting measures best.

For the firms in the S&P 500 (the 500 largest publicly traded companies by market capitalization in the U.S. stock market, as determined by Standard & Poor's, a rating agency), the importance of a firm's book value has declined dramatically over time. This decline mirrors a commensurate increase in the importance of intangibles that contribute to growth potential and yet are not captured in a firm's accounting data.

A few decades ago, tangible book value accounted for the large majority of the S&P 500's market value; today it explains only a modest share, with the remainder driven by intangibles such as software, brands, intellectual property, and data. This shift has been led by technology- and knowledge-intensive firms whose most valuable resources never appear on a balance sheet. The strategic implication is clear: because accounting figures increasingly understate what actually creates value, managers and investors must complement them with market-based and intangible measures to judge a firm's true competitive advantage.

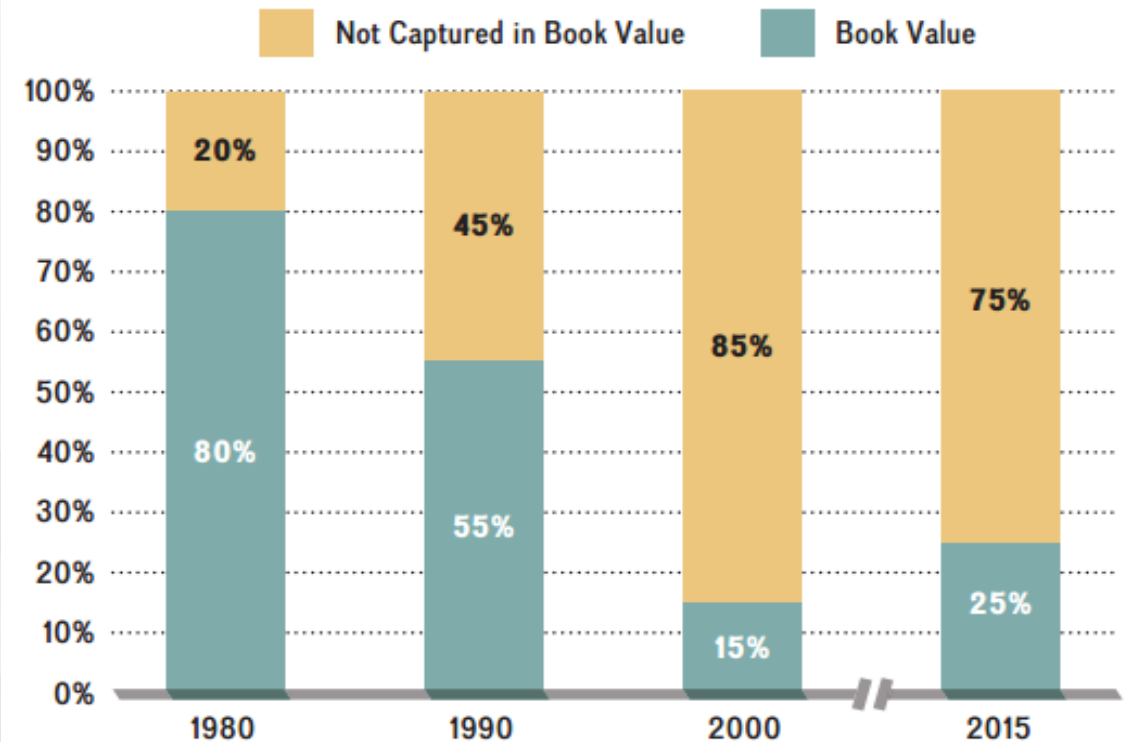
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In 1980, about 80 percent of a firm's stock market valuation was based on its book value with 20 percent based on the market's expectations concerning the firm's future performance. This almost reversed by 2000 (at the height of the Internet bubble), when firm valuations were based only 15 percent on assets captured by accounting data. The important take-away is that intangibles not captured in firms' accounting data have become much more important to a firm's competitive advantage. By 2015, about 75 percent of a firm's market valuation was determined by its intangibles.

EXHIBIT 5.2

The Declining Importance of Book Value in a Firm's Stock Market Valuation, 1980–2015



Source: Analysis and depiction of data from Compustat, 1980–2015.

- Shareholder Value Creation

Shareholders—individuals or organizations that own one or more shares of stock in a public company—are the legal owners of public companies. From the shareholders' perspective, the measure of competitive advantage that matters most **is the return on their risk capital**, which is the money they provide in return for an equity share—money they cannot recover if the firm goes bankrupt.

Shareholders earn this return in two ways: appreciation in the firm's stock price and the dividends it pays out. Total return to shareholders—capital gains plus dividends, measured against the amount invested—is therefore the key market-based gauge of competitive advantage. Because it reflects investors' expectations of future performance and is judged relative to other investments of similar risk, it complements backward-looking accounting profitability with a forward-looking, risk-adjusted view.

Limitations of Shareholder Value Creation: Although measuring firm performance through total return to shareholders and firm market capitalization has many advantages, just as with accounting profitability, it has its shortcomings:

■ ***Stock prices can be highly volatile, making it difficult to assess firm performance, particularly in the short term.*** This volatility implies that total return to shareholders is a better measure of firm performance and competitive advantage over the long term, because of the “noise” introduced by market volatility, external factors, and investor sentiment.

■ ***Overall macroeconomic factors such as economic growth or contraction, the unemployment rate, and interest and exchange rates all have a direct bearing on stock prices.*** It can be difficult to ascertain the extent to which a stock price is influenced more by external macroeconomic factors (as discussed in Chapter 3) than by the firm's strategy

■ ***Stock prices frequently reflect the psychological mood of investors, which can at times be irrational.*** Stock prices can overshoot expectations based on economic fundamentals amid periods like the Internet boom, during which former Federal Reserve Chair-man Alan Greenspan famously described investors' buoyant sentiments as "irrational exuberance." Similarly, stock prices can undershoot expectations during busts like the 2008–2009 global financial crisis, during which investors' sentiment was described as "irrational gloom."

- Economic value Creation

The relationship between economic value creation and competitive advantage is fundamental in strategic management. It provides the foundation upon which to formulate a firm's competitive strategy for cost leadership or differentiation (discussed in detail in the next chapter). For now, it is important to note that a firm has a competitive advantage when it creates more economic value than rival firms. What does that mean?

Economic value created is the difference between a buyer's willingness to pay for a product or service and the firm's total cost to produce it. Let's assume you consider buying a laptop computer and you have a budget of \$1,200. You have narrowed your search to two models, one offered by Firm A, the other by Firm B. Your subjective assessment of the benefits derived from owning Firm A's laptop is \$1,000—this is the absolute maximum you'd be willing to pay for it, or the **reservation price**.

Limitations of economic value Creation: As with any tool to assess competitive advantage, the economic value creation framework also has some limitations:

■ ***Determining the value of a good in the eyes of consumers is not a simple task.*** One way to tackle this problem is to look at consumers' purchasing habits for their revealed preferences, which indicate how much each consumer is willing to pay for a product or service.

- ***The value of a good in the eyes of consumers changes based on income, preferences, time, and other factors.*** If your income is high, you are likely to place a higher value on some goods (e.g., business-class air travel) and a lower value on other goods (e.g., Greyhound bus travel).
- ***To measure firm-level competitive advantage, we must estimate the economic value created for all products and services offered by the firm.*** This estimation may be a relatively easy task if the firm offers only a few products or services.

- The Balanced Scorecard

Just as airplane pilots rely on a number of instruments to provide constant information about key variables—such as altitude, airspeed, fuel, position of other aircraft in the vicinity, and destination—to ensure a safe flight, **so should managers** rely on multiple yardsticks to more accurately assess company performance in an integrative way. The **balanced scorecard** is a framework to help managers achieve their strategic objectives more effectively. This approach harnesses multiple internal and external performance metrics in order to balance both financial and strategic goals.

Exhibit 5.8 depicts the **balanced-scorecard framework**. Managers using the balanced scorecard develop appropriate metrics to assess strategic objectives by answering four key questions. Brainstorming answers to these questions ideally results in a set of measures that give managers a quick but also comprehensive view of the firm's current state. The four key questions are:

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1. How do customers view us? The customer's perspective concerning the company's products and services links directly to its revenues and profits. Consumers decide their reservation price for a product or service based on how they view it.



2. How do we create value? Answering this question challenges managers to develop strategic objectives that ensure future competitiveness, innovation, and organizational learning. The answer focuses on the business processes and structures that allow a firm to create economic value.



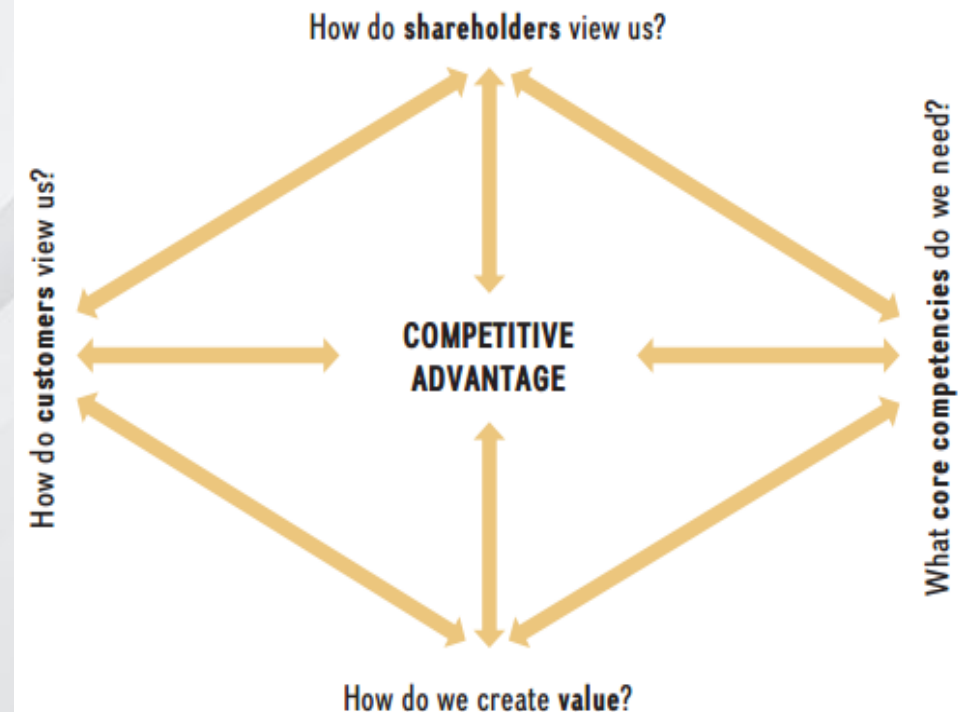
3. What core competencies do we need? This question focuses managers internally, to identify the core competencies needed to achieve their objectives and the accompanying business processes that support, hone, and leverage those competencies.



4. How do shareholders view us? The final perspective in the balanced scorecard is the shareholders' view of financial performance (as discussed in the prior section).

EXHIBIT 5.8

Balanced-Scorecard Approach to Creating and Sustaining Competitive Advantage



Advantages of The Balanced Scorecard: The balanced-scorecard approach is popular in managerial practice because it has several advantages. In particular, the balanced scorecard allows managers to:

- Communicate and link the strategic vision to responsible parties within the organization.
- Translate the vision into measurable operational goals.
- Design and plan business processes.
- Implement feedback and organizational learning to modify and adapt strategic goals when indicated.

Disadvantages of The Balanced Scorecard: Though widely implemented by many businesses, the balanced scorecard is not without its critics. It is important to note that **the balanced scorecard is a tool for strategy implementation, not for strategy formulation.** It is up to a firm's managers to formulate a strategy that will enhance the chances of gaining and sustaining a competitive advantage. In addition, the balanced-scorecard approach **provides only limited guidance about which metrics to choose.** Different situations call for different metrics. All of the three approaches to measuring competitive advantage—accounting profitability, shareholder value creation, and economic value creation—in addition to other quantitative and qualitative measures can be helpful when using a balanced-scorecard approach.

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- The Triple Bottom line

Today, managers are frequently asked to maintain and improve not only the firm's economic performance but also its social and ecological performance. CEO **Indra Nooyi** responded by declaring **PepsiCo's** vision to be Performance with Purpose defined by goals in the social dimension (human sustainability to combat obesity by making its products healthier, and the whole person at work to achieve work/life balance) and ecological dimension (environmental sustainability in regard to clean water, energy, recycling, and so on), in addition to firm financial performance.

Three dimensions—economic, social, and ecological—make up the **triple bottom line**, which is fundamental to a sustainable strategy. These three dimensions are also called the three Ps: profits, people, and planet:

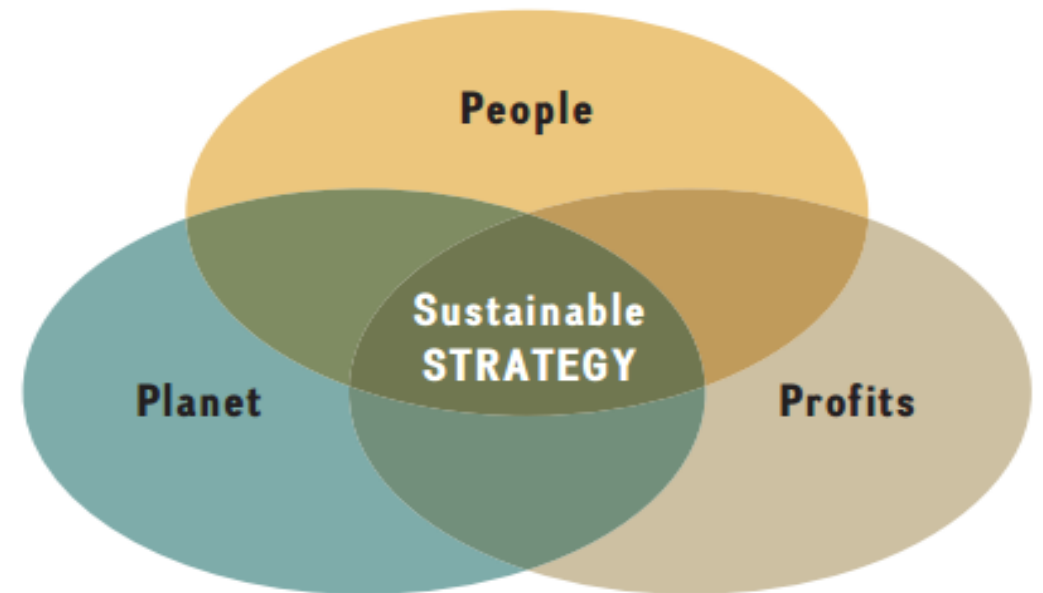
- **Profits.** The economic dimension captures the necessity of businesses to be profitable to survive.
- **People.** The social dimension emphasizes the people aspect, such as PepsiCo's initiative of the whole person at work.
- **Planet.** The ecological dimension emphasizes the relationship between business and the natural environment.

As the intersection of the three ovals (profits, people, and planet) in Exhibit 5.9 suggests, achieving positive results in all three areas can lead to a **sustainable strategy**. Rather than emphasizing sustaining a competitive advantage over time, sustainable strategy means a strategy that can be pursued over time without detrimental effects on people or the planet.

EXHIBIT 5.9

Sustainable Strategy: A Focus on the Triple Bottom Line

The simultaneous pursuit of performance along social, economic, and ecological dimensions provides a basis for a triple-bottom-line strategy.



5.2 Business Models: Putting Strategy into Action

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors or the industry average. The translation of strategy into action takes place in the firm's business model, which details the firm's competitive tactics and initiatives. Simply put, the firm's business model explains **how the firm intends to make money**. The business model stipulates how the firm conducts its business with its buyers, suppliers, and partners.

How companies do business can sometimes be as important to gaining and sustaining competitive advantage as what they do. This also implies that business model innovation might be as important as product or process innovation.

- popular Business models

Given their critical importance to achieving competitive advantage, business models are constantly evolving. Below we will discuss the some of the more popular business models:

■ **Razor-razorblades.** The initial product is often sold at a loss or given away for free in order to drive demand for complementary goods.

- **Subscription.** The subscription model has been traditionally used for (print) magazines and newspapers. Users pay for access to a product or service whether they use the product or service during the payment term or not.
- **Pay as you go.** In the pay-as-you-go business model, users pay for only the services they consume.
- **Freemium.** The freemium (free + premium) business model provides the basic features of a product or service free of charge, but charges the user for premium services such as advanced features or add-ons.

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- **Wholesale.** The traditional model in retail is called a wholesale model. Let's look at the book publishing industry as an example. Under the wholesale model, book publishers would sell books to retailers at a fixed price (usually 50 percent below the recommended retail price).
- **Agency.** In this model the producer relies on an agent or retailer to sell the product, at a predetermined percentage commission.
- **Bundling.** The bundling business model sells products or services for which demand is negatively correlated at a discount.

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- **Dynamic Nature Of business models**

Business models evolve dynamically, and we can see many combinations and permutations. Sometimes business models are tweaked to respond to disruptions in the market, efforts that can conflict with fair trade practices and may even prompt government intervention.

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Combination. Telecommunications companies such as AT&T or Verizon, to take one industry, combine the razor-razorblade model with the subscription model.

Evolution. The freemium business model can be seen as an evolutionary variation on the razor-razorblade model. The base product is provided free, and the producer finds other ways to monetize the usage.

Disruption. When introducing the agency model, we mentioned Apple and book publishing, and you may already know how severely Amazon disrupted the traditional whole-sale model for publishers.

response to Disruption. The market is dynamic.

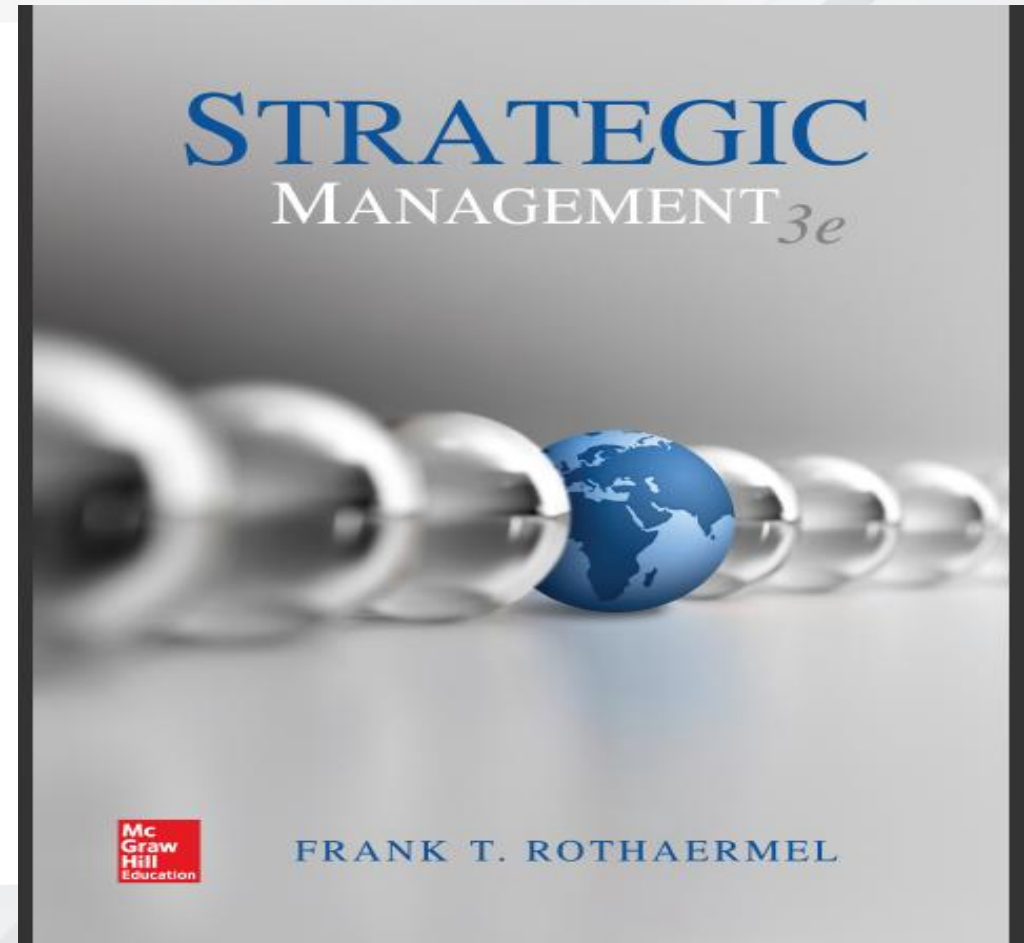
legal conflicts. The rapid development of business models, especially in response to disruption, can lead producers to breach existing rules of commerce.

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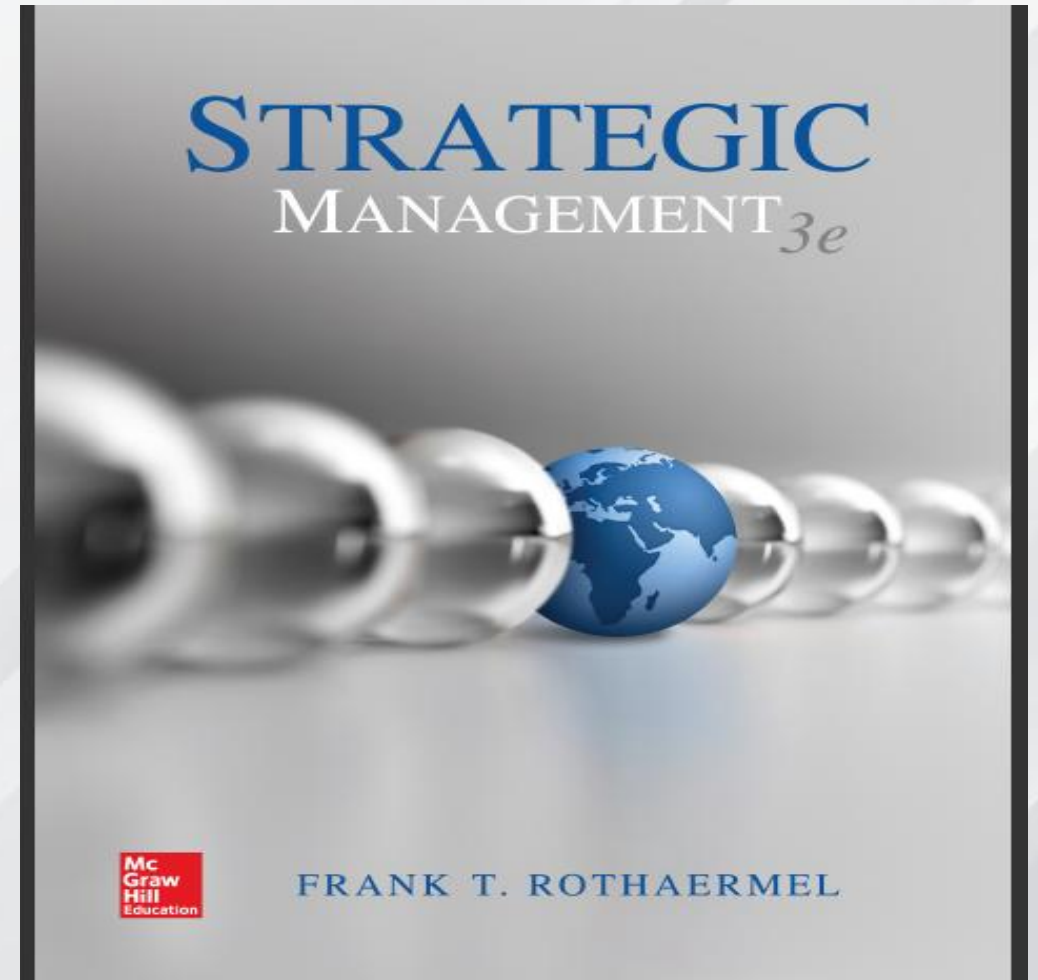


Thank You



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Thank You