

Chapter 2

Market Imperfections and Value: Strategy Matters

Outline:

Perfect product or service markets:

- No restrictions on entry and exit
- No producers so large that they have price influence
- All producers manufacture identical products
- All producers have identical cost
- Complete information about competitors' actions

Perfect financial market

- No taxes
- No transaction cost
- No other restrictions on entry or exit
- No one buyer or seller large enough to influence interest rates (prices)
- Identical information resulting in identical beliefs (expectations)
- All participants are rational wealth maximizers

Competitive advantage

- Industry characteristics necessary for competitive advantage
 - Barriers to entry
 - Customers are not price sensitive
 - Customers care about product features
 - Customers are not fully informed
 - Demand is stable
 - Competitors are limited
- Product differentiation
 - Features, Quality, Image, Service, Distribution
- Cost advantage
 - Economies of scale
 - Technology
 - Corporate culture
 - Control of inputs
- Survival of competitive advantage
- Globalization and competitive advantage
- Competitive advantage and wealth creation

Strategic planning

- Steps to a strategy
 - Goals
 - Environmental assessment
 - Internal strengths and weaknesses
 - Conceptual models for strategic decision making
 - Strength and attractiveness grids
 - Product life cycle model
 - Implementing the strategy across the organization

Aligning capital budgeting with corporate strategy

Financing in imperfect financial markets

Major points

- * Characteristic of a perfect product or service markets and a perfect financial market.
- * Industry, product, and cost characteristics necessary for competitive advantage and maintaining a competitive advantage in practice.
- * Planning to strategically create, exploit, maintain and finance a competitive advantage.

Audience

This chapter introduces the importance of strategic planning and economic analysis in setting the vision for the corporation. In practice, strategy should be set before capital budgeting is performed. For this reason strategic planning and economic profit are covered in this chapter before the details of capital budgeting. The chapter is appropriate for students of all levels.

Suggestions for use

- * You may want to challenge the students to identify the location of actual markets on a continuum between perfect competition to imperfect competition.
- * Identify and discuss the characteristics of a perfect financial market and its importance in how the firm finances its operations.
- * Use actual examples supplied by the students to identify and discuss the industry characteristics necessary for competitive advantage.
- * Use actual examples of firms that have used product differentiation or cost advantage as their competitive advantage.
- * Discuss the steps to a strategy including the importance of identifying the present position of the firm and the role that capital budgeting plays in situating the company to exploit or develop a competitive advantage.

Questions

2-1. Strategy is the grand design of the organization, involving the decision as to what business the organization is in, and how the organization intends to position itself in relation to other existing and potential competitors.

2-2. The characteristic of perfect competitions are:

No restrictions on entry and exit,
No producers so large that they have price influence,
All producers manufacture identical products,
All producers have identical cost,
Complete information about competitors' actions.

Economic profit does not exist in a perfectly competitive environment. The only way to have a competitive advantage is to exploit some market imperfection.

2-3. The industry characteristics that create the potential for competitive advantage and examples are:

<u>Characteristic,</u>	<u>(Example)</u>
Barriers to entry,	(the cable TV or utility industry)
Customers are not price sensitive,	(the credit card industry)
Customers care about product features,	(the consumer products industry)
Customers are not fully informed,	(the real estate industry)
Demand is stable,	(the petroleum industry)
Competitors are limited,	(the automobile industry)

2-4. Differences in natural resources between counties, economies of scale, differences in technological expertise, and absolute levels of capital available.

2-5. Environmental assessment focuses on the threats and opportunities facing the organization from outside. Factors include the overall economy, demographic and cultural changes, government, trends in the industry in which the company operates, and behavior of competitors.

2-6. Assessment of personnel with an emphasis on the strengths and weaknesses of top management. Analysis of strengths and weaknesses of people continues through middle management to the production workers. The physical plant --its location, condition, and capacity-- can be a source of strengths or of weaknesses. Products and reputation can also be important issues.

2-7. Investments that create or maintain competitive advantage are most likely to contribute to economic profit. These include investments that take advantage of economies of scale, investments that contribute to product differentiation and quality, investments that give the company a cost advantage over competitors, investments that improve the distribution of the product to the customers, and investments that take advantage of government regulations creating barriers to entry.

2-8. Yes. Net present value analysis is used to determine which strategy will create the most shareholder wealth.

2-9. Organizational strategies deal with how the company will organize itself to implement its overall strategy. Included are issues such as centralization vs. decentralization.

Marketing and distribution strategies assure that the product will be presented to the customers in a way consistent with the company's strategy.

Production and processing strategies assure that quality, quantity, and cost structure are consistent with the company's strategy.

Personnel strategy assures that the quantities and types of people needed to implement the strategy will be available.

2-10. Capital budgeting policy can thwart corporate strategy if strategic implications are not recognized in the analysis of capital investments. A policy biased in favor of replacement decisions, for example, can keep the company from changing its product emphasis to implement its strategy. Focusing on short-term results can also inhibit implementation of strategy.

2-11. Financial strength is a key factor affecting power in the marketplace. If a company is financially strong it might be willing and able to battle for market share. Therefore, the decisions of entrenched companies depend on the perceived strengths of their competitors; a financially strong competitor may never be challenged. Flexibility is another key issue; flexibility can be achieved by maintaining a capital structure that allows the company to raise new funds or retire existing securities under various conditions.

2-12. COKE -- One potential threat to Coke is the introduction of generic or store branded soda-pop. Another is the increasing popularity of non-soda products like bottled water and teas. Coke might introduce its own generic brand or its own new products. To reduce the price pressure of the generics, Coke will have to continue to invest in informing the consumer that their product is different from the generic brands to an extent that justifies the higher price.

NIKE -- One potential threat to Nike is the introduction of new non-athletic shoes since they have associated their name with athletic shoes. Another is the labor relations problems they are having in sourcing their production in Asia. News shows have shown pregnant employees earning very low wages and working until they drop from exhaustion. This kind of publicity could hurt. Nike might introduce its own non-athletic shoe brand (possibly using another name). To reduce the potential labor problem, Nike could bring the production back to the US or it can address the labor practices in the Asian suppliers (assuming the news reports are accurate).

DISNEY -- One potential threat to Disney is their exposure to the losses at Eurodisney. Disney believes they have structured the deal so they can walk away. European courts may not agree. Another threat is the increasing popularity of other theme-parks, gambling and improvements in virtual reality technology. These competing substitutes are growing in popularity and may absorb more of the dollars spent on entertainment. Disney might decide to close the Eurodisney operation, wait on the opening of the "chunnel" from England, wait for more European unification, or wait on a stronger dollar to see if any of these variables influence attendance at this theme park. In addition Disney may venture into gambling under a non-Disney name (as they did with more adult films). Disney may integrate some of the virtual reality into smaller theme parks using the Disney name to attract people to these smaller parks.

McDONALDS -- One potential threat to McDonalds is the growing popularity of quick, inexpensive, and fast "double drive through" (no indoor seating) hamburger stands. These stand are gaining market share by pricing their sandwiches at \$.99 or less. Another is the increasing popularity of non-hamburger outlets like chicken, Mexican, Italian and pizza establishments. McDonalds has already invested capital in building copy-cat "double drive through" stands. They have added chicken items, Mexican items, and even pizza to their menu. In addition, McDonalds is using its appeal with kids to open indoor playgrounds (much like Discovery Zones) in various communities around the country.

SOUTHWEST AIRLINES -- One potential threat to Southwest Airlines is the size, history, and financial strength of several of their very large competitors (like Delta, United, and American). If one of these competitors decides to compete head-to-head until death in a particular market, in all likelihood the large company can out last Southwest. Southwest's competitive advantage is in its efficiency of operations. It is strengthening its balance sheet and expanding into new areas on a slow but steady city-by-city basis. At some point it will probably have the size, history and financial strength equal to any of the existing players.

2-13. a. As president of the Aberfoyle Springs bottled water you would want to tell the investors that the competitive advantage is something that can be sustained in

the future. This advantage could be Aberfoyle Springs's positioning of itself in bottled water as a portion of the population moves to more healthy consumption. With bottled water perceived as more healthy than other beverages, Aberfoyle Springs with its existing distribution and availability, has cashed in on this movement.

- b. This competitive advantage is going to be hard to sustain. The consumers of bottled water seem to be rather fickle in their loyalty and tend to change to the most recent bottled beverage. Since this problem was written Aberfoyle Springs has seen its unit sales decrease dramatically.
- c. Aberfoyle Springs will need to protect its competitive advantage by publicizing its availability, popularity, and healthy image by spending money on the advertising of its product. It could also choose to introduce competing brands of teas, flavored waters, and sports drinks. If it does not have a lock on its distribution network, it may need to spend capital in this area. In the past both Pepsi and Coke have hampered upstarts by purchasing and converting bottling plants which were used by these small competing upstarts.

- 2-14.** a. As president of Orville Redenbacher popcorn you would probably see the company's competitive advantage as the perceived product quality differentiation your gourmet popping corn has achieved. The consumer obviously perceives this since they often pay several times more for Orville Redenbacher's popcorn than for other popcorn.
- b. The perceived quality difference (competitive advantage) is going to be hard to sustain. There are cash rich competitors that have observed the consumer's willingness to pay for a higher quality popcorn. As you can observe in the store, there are no less than a dozen brands of gourmet popcorn now.
 - c. Orville Redenbacher can invest in advertising to continue to convince the consumers that Orville's is better. It can introduce the flavorings that competitors are using as their competitive advantage. Or it can find another product like pork and beans that have become a commodity and introduce a gourmet "pork and bean" product. (Hey nobody thought it would work with popcorn!)

- 2-15.** a. The population is getting older -- projects include: product targeted to the elderly, the travel industry, the healthcare industry, retirement housing, errand services tied to a reliable established name such as Sears.

Crime is increasing -- projects include: security products, drug rehabilitation, for-profit prisons, uniforms, anti theft devices, insurance.

Wealth is becoming more concentrated -- projects include: personal banking, financial planning services, estate and succession planning, very high end products and services.

b. This question has many answers which are only limited by the student's imagination. It is included in the book to encourage creative or entrepreneurial thinking.

2-16. a. Exxon might see the following benefits or disadvantages: a more elderly population might pay for (and frequent) a service station that caters to the elderly; the increase in crime might require additional security measures; concentrated wealth might encourage home delivery of gasoline to the rich or use of promotions with chauffeurs; computer processing might allow all kinds of at the pump services or "Exxon finding" computer maps in every car; engineered materials might lighten the weight of the average car and therefore increase fuel efficiency.

Kinko Copies might see the following benefits or disadvantages: a more elderly population might not need as many copies or may need more copies; concentrated wealth might encourage home delivery of copies or an increase in the use of color copies; computer processing might influence the copy business the most because data may be stored in machines rather than copied; genetic engineering may develop paper that accepts copies at a lower cost or higher quality.

Ford Motor Company might see the following benefits or disadvantages: a more elderly population might pay a premium for an "elderly-friendly" car. The increase in crime might require additional security measures in dealerships and production facilities and could mean additional security instruments added to the vehicle. Concentrated wealth might encourage a different car design or a different way to shop for a car. Computer processing might allow all kind of driver assisting gadgets on the typical car. Engineered materials might lighten the weight and increase the durability of the average car. Improvements in pharmaceuticals might increase the health care exposure and pension benefits promised by the company to retirees.

Federal Express might see the following benefits or disadvantages: a more elderly population might require additional home delivery. The increase in crime might require additional security measures for the delivery fleet and could be used as a competitive advantage for consumers that will pay for additional security in the delivery of their packages. Concentrated wealth might encourage the use of overnight delivery. Computer processing will probably decrease the use of overnight delivery as more data will be transferred over wires or satellites. Engineered materials might lighten the weight of the delivery van and possibly reduce operating costs. Improvements in pharmaceuticals might increase the health care exposure and pension benefits promised by the company to retirees.

- 2-17. a. As a union leader you want the company to give the union members the job security they are striking for. Since the company has taken the position of replacing the workers if they continue to strike, this appears to be a futile request. In explaining this to the union the point should be made to the union members that the best job security is to assist the company in positioning itself strategically to exploit its competitive advantage, expand employment opportunities, and create wealth. For Caterpillar this advantage is in the production of high quality construction and earth-moving equipment. Japanese competitors, such as Kabota and Komatsu, have captured some of Cat's market by replicating the quality advantage and matching or beating the leader's price. On a personal level the union rep can encourage the workers to return to their relatively well-compensated jobs and compete against these Japanese suppliers or they can market their specialized skill in the market and earn considerably less money.
- b. The union's actual request was not that the existing employees be guaranteed job security but that the company guarantee that the number of union employees working for the company be guaranteed at the present level of employment. Asking for job security with a company that is losing market share could be considered a shifting of wealth from the shareholders to the specific union employees. The union's insistence on a total number of employees can be viewed as an attempt by the union to retain its position or wealth at the expense of the shareholders. When an organization which represents the workers takes on a life of its own in negotiations, it is not hard to understand the unyielding position that management chose. It was left with the possibility of losing wealth slowly or losing wealth quickly.

Problems

- 2-1. To see who has a comparative advantage, we can check on the ratios of labor per unit in each country.

	Country A	Country B
<u>Labor per unit computers</u>	5	4
Labor per unit shoes		

In other words, Country A must give up 5 units of shoes to produce 1 unit of computers. Country B, on the other hand, must give up only 4 units of shoes to produce 1 unit of computers. Country B has a comparative advantage in computers. Both countries will benefit if Country B produces 10 more computers and exchanges those computers for shoes produced in Country A.

- 2-2. Must be answered from current information.
- 2-3. Must be answered by individual students.
- 2-4. Must be answered from local information.
- 2-5. Must be answered from local information.
- 2-6. Must be answered from local information.
- 2-7. No. An investment of \$1,000,000, when investors can earn 12 percent elsewhere, must generate a profit in excess of \$120,000 to earn an economic profit.
- 2-8. Yes, a normal profit is 10% of \$1,000,000 or \$100,000 and an economic profit is an above normal profit. Specifically: $NPV = \$200,000 \times 6.1446 - \$1,000,000 = \underline{\$228,920}$ The investment will create an economic profit.
- 2-9. Must be answered from current information.
- 2-10. We know that competition will increase as growth begins to slow, and that many companies will probably be forced out of business. Price competition will become intense. By positioning itself at the high

quality end of the market, this company will be exposed to less risk than the typical manufacturer. However, the company must still prepare itself for increased competition by developing effective cost controls, a strong capital structure, and so forth. The company may want to plan for possible acquisition of competitors who have not planned for the shake-out phase.

- 2-11. Must be answered from local information.
- 2-12. Must be answered from current information.
- 2-13. The company we will have \$200,000 in income (\$150,000 + \$50,000). This is a 20% return on an investment of \$1,000,000. Since this is above the required 18 percent needed, this investment is attractive.

Micromaster Case

1. We assume that Patricia's primary goal is to maximize her wealth, which means maximizing net present value. Obviously, she is also interested in continuing in her own business.

2. Alternative 1: Churchmaster data base.

Environmental opportunities include the increasing number of churches using computers, the increasing number of people who are familiar with computers, and the declining prices of computers. This created the opportunity to sell additional computer-related services.

The two major environmental risks are lack of demand and competition. The system could fail because churches are unwilling to buy the data base at a price that would generate a profit. A second risk is that competitors would begin to offer competitive products. As Patricia probably realized by that time, a profitable opportunity is almost certain to draw competitors.

The threat of competition was somewhat limited, in this case, to the people who offered record-keeping systems to churches. By getting there first with a high-quality system, Patricia could become the market leader and make it very difficult for competitors to take away market share.

Alternative 2: Market the accounting package at a low price.

Decreasing prices of computers and a resulting increase in the number of computers in existence could potentially open up the market for low-priced software. This would be an opportunity for Micromaster. Furthermore, major software houses were unlikely to reduce their prices to anything close to that being considered by Patricia.

One threat would come from other small companies that failed to compete with the major software houses. They are likely to (and, in fact, did) use low-price tactics similar to those Patricia was considering. As a result, the low-priced end of the market may be quite competitive.

A low-price strategy would also be made difficult by competition among the major software houses. If the major software houses reduced their prices in response to competition, Micromaster would be left with a smaller price advantage.

Alternative 3: Update and market the accounting package.

The major opportunity in this area is probably that the market continues to grow rapidly. On the negative side, numerous competitors have established positions and have the capital necessary to carry out major promotions. In short, the environmental threats seem to be overwhelming.

3. Alternative 1: Churchmaster data base.

Micromaster's strengths include a strong position in the church information market as well

as an understanding of that market. The budget required to launch the new service is within the means of Micromaster.

Failure to maintain a leadership position in the market can, however, be considered a weakness of Micromaster. Following initial success with its previous two offerings, Micromaster has failed to press the advantage by investing enough in program development and promotion to develop a dominant position in the market. Movement into any new product may mean less attention being paid to the existing Churchmaster product, with the resultant loss of market share.

Alternative 2: Market the accounting package at a low price.

The major internal strength is the existence of the product. The product can be sold in its present form with no development cost. In addition, the promotional budget is within Micromaster's means. On the disadvantage side, the product has no known characteristics which would cause it to stand out from other low-price entries.

Alternative 3: Update and market the accounting package.

Micromaster's major strength is past experience with an accounting program.

Micromaster's main disadvantage is that it lacks the capital or marketing expertise necessary to attempt to gain a significant share of a market that has matured considerably and is dominated by a few major producers.

4. Alternative 1: Churchmaster data base.

Externally, churches are computerizing but there is currently a lack of demand, the price may be too high for many churches, and competitors might begin to offer competitive products.

Internally, getting there first with a high-quality system could make Micromaster the market leader and make it difficult for competitors to take away market share. Micromaster has a strong position in the church information market, an understanding of the market, and the budget required to launch the new service. Over the years Micromaster has failed to press their competitive advantage by investing enough in program development and promotion to develop a dominant position in the market. With this alternative there is real potential for Micromaster to establish a sustainable competitive advantage.

Alternative 2: Market the accounting package at a low price.

Externally the prices of computers are decreasing, the number of computers in existence are increasing, the major software houses are unlikely to reduce their prices to a level that would undercut Micromaster, but smaller companies are likely to (and, in fact, did) use low-price tactics similar to Micromaster.

A low-price strategy would also be made difficult by competition among the major software houses. If the major software houses reduced their prices in response to competition, Micromaster would be left with a smaller price advantage.

Internally, they have an existing product, no development cost, a promotional budget that is within Micromaster's means, but the product has no known characteristics which would cause it to stand out from other low-price entries.

This alternative has potential but a significant risk lies in the competitors response. A competitive advantage would be hard to maintain even if established.

Alternative 3: Update and market the accounting package.

Externally the market continues to grow rapidly, numerous competitors have established positions and have the capital necessary to carry out major promotions. Internally Micromaster has prior experience with an accounting program but it lacks the capital or marketing expertise necessary to attempt to gain a significant share of a market that has matured considerably and is dominated by a few major producers. Their potential to gain a competitive advantage is questionable for this alternative.

5. The most promising approach is certainly to build on competitive advantage by strengthening her position in the church information field. The new information service is one way to do this, as is continual program development, training, and promotion for the existing church software. This is probably where she has the best opportunity to create positive net present value. She could do a market test of the promotion of the existing accounting package by promoting the package in a couple of local markets.

The development of new accounting software is above her financial means and provides no opportunity to exploit competitive advantage.