Strategic Management - The Competitive Edge

Prof. R. Srinivasan

Department of Management Studies

Indian Institute of Science, Bangalore

Module No. # 04

Lecture No. # 20

Business Strategy

Welcome to this class. In the last class, we discussed how to analyze a case; we took the example of an IT major company in India- one of the IT major companies is Infosys; and tried to explain how to analyze the performance of the company, taking into account the various ratios that we had gone through in the previous classes- the financial ratios whether it is a profitability ratio or the liquidity ratio or any other ratios which we considered to explain the performance.

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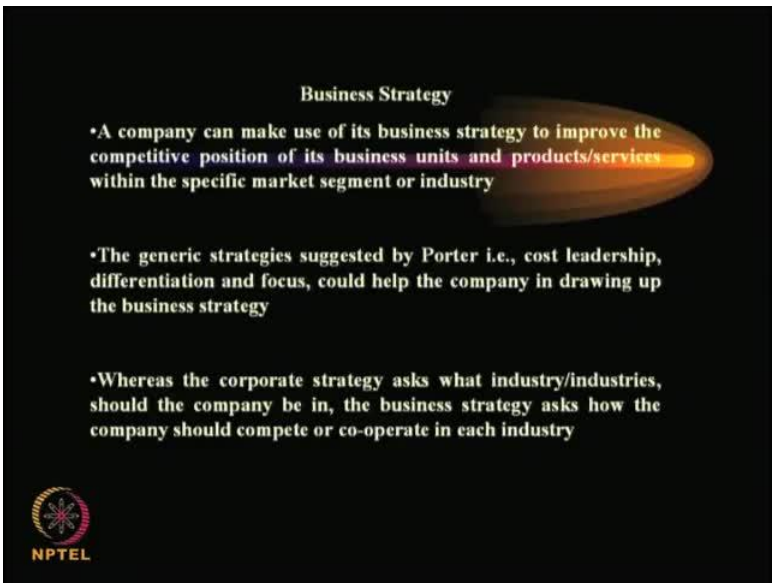

Now, after having gone through all this, let us go to the next step. So, what we have looked at is how does a company do in SFA analysis or drop in SFA matrix, that is a

Strategic Factor Analysis matrix; then to drop this SFA matrix, the company makes use of the External Factor Analysis matrix, then the Internal Factor Analysis matrix and then comes out with the SFA matrix.

I took the example of a hypothetical Indian company; I took the example of an existing American company, a consumer durable company, to explain the different points with respect to all these matrixes, whether it is the EFAS or the IFAS and the SFAS. Then, we looked at the performance indicators with respect to the companies for case analysis and analyzed the performance of Infosys.

Now, let us look at why we are doing all this; that is, why are we looking at the analysis of these companies? So that the company's business strategy can be focused more. Now, let us look at this business strategy in some depth; a little more; what is a business strategy? A company can make use of its business strategy, to improve the competitive position of its business units and products stroke service within this specific market segment or industry. What does it mean?

It means that any company will have a number of business units. That is what I explained to you in the earlier classes. Then a business units becomes a strategic business unit for the company, when it has its own products or product line; it has its own markets; and it has a dedicated strategic manager for drawing of strategies- so, 3 essential conditions.

Now you can look at any unit, any company operating in a competitive market having a number of different SPUs- they are different in the sense that each of them may be catering to different products or different product lines. So, this is the characteristic of any company in the present day Indian context. So you name it, whether it is a public sector or private sector, you will have different SPUs for different companies.

Now each of these SPUs has to draw up a business strategy in order to be effective in this competitive market; each of the business units has to draw up a business strategy. What is this business strategy, which the company has to draw: this is what we are going to have a look more in depth, in this class.

The generic strategies suggested by Porter, that is cost leadership, differentiation and focus, could help in drawing up the business strategy. So, in order to draw up the

business strategy, the company should make use of the generic strategies of cost leadership, differentiation and focus, which we have discussed in fair amount of detail in the earlier classes.

Whereas, the corporate strategy asks what industry stroke industries should the company be in; the business strategy asks how the company should compete or cooperate in each industry. Kindly, note the difference. In the corporate strategy, you are looking at the industry as a whole and then saying what industry should the company be in; and the business strategy asks how the company should compete or co-operate in each industry.

So, how should the company go about competition, facing competition or co-operating; this co-operating can acquire different routes: it can be through mergers, it can be through acquisition. So, this is where in a strategic environment, the role of 'M and A' becomes extremely important.

So that is why in each of these large companies, you have a dedicated unit or a dedicated team, which is given the task of assessing this 'M and A's only. So, this is the first thing. Let us now come to the Indian context: in order to draw up this business strategy, we said cost becomes an important part; how is the cost dynamics working in India; this is what we are trying to see.

Now, before we go to this cost dimensions in India, let me take you through one exhibit which is given in my book- that is the differentiation focus strategy; that is, I just told you- that in order to draw up the business strategy, a company should make use of the generic strategies suggested by Porter.

One such example is given to you from this book; this is the differentiation focus strategy; that is the differentiation focus at Morgan Motor Company from page number 110 of the book on strategic management; what does it say? By focusing on the values of traditional British top down sports car motoring, the Morgan motor company has successfully found a way to differentiate itself from all competitors, once competing with a respected British marks of MG, Triumph, Austin Healey, Jaguar, Aston and Martin.

The Morgan is now the sole occupant of a small, but durable propitious niche. Founded in 1919 by Henry F.S. Morgan, the company continues to use the same factory in

England's west midlands to produce automobiles seemingly unchanged from those produced before World War 2.

Although, Morgan is known as Marks by admirals, has state of the art engines with fuel injection, electronic ignition and pollution control devices; the basic front end suspension design has remained relatively unchanged, since the company's founder built the first Morgan by hand in 1908.

Although, the chassis is based on a simple steel frame, the body is still constructed on a hand built wooden frame of specially aged ash. The Morgan's hand cut body panel must be fitted by hand onto the car. The company makes 3 models ranging in price from 35,000 dollars to 50,000 dollars. It has no long term debt and enjoys sturdy growth in sales and profits. Sports cars with reputations comparable to those of the Morgan sell for 1,50,000 dollars and upwards.

For the person who needs a personalized car, the Morgan is available in 35,000 hand-painted colors; note that 35,000 hand-painted colors. The company will employees just enough skilled workers to build 10 cars a week for an annual capacity of fewer than 500 cars. Because the company receives about 600 to 800 new orders each year, the current waiting list for a new Morgan is about 2500 to 5000 cars- about 10 years production.

The forms response to a rapidly changing automobile industry seems perfectly tuned to staying in its propitious niche. According to Charles Morgan, grandson of the founder, "We believe the Morgan policy of gradual and carefully considered change will enable us to maintain the cars' qualities and unique appeal and there by ensure its survival for the foreseeable future".

So, what is the company trying to do? It is differentiating its product in such a wonderful manner, in the sports car segment and also being highly cost effective. So, if you really see a comparable car, costing more than 1,50,000 dollars available to you, but between 35 to 50000 dollars from Morgan, now, that is how a company makes use of differentiation; that is how a company makes use of focus- to focus on the market segment; so, this is just one example.

Now, let us look at the dynamics of cost or the cost dynamics in India. By saying the cost dynamics in India, what are we trying to say? What is the type of environment in which the companies have to produce; in which the companies have to operate.

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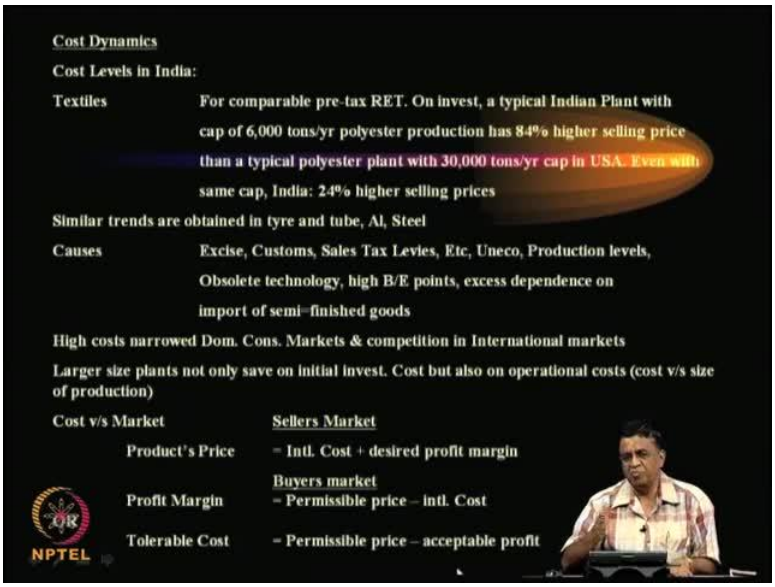

Now, what I have tried to bring out to you is a very simple example. I have taken it from the textiles. What can be mentioned with respect to the cost levels in India for this textiles segment: for comparable pre tax Return On Investment, that is a pre tax ROI - this is a comparison - the typical Indian plant with a capacity of 6,000 tons per year polyester production has 84 percent higher selling price than a typical polyester plant with 30,000 tons per year capacity in USA.

Even with the same capacity, in India 24 percent higher selling prices. What does it mean? It means that the cost, suppose we take the ROI- pre tax Return On Investment- the capacity of the steel plant between India and USA; what is the type of difference them you are finding? In India it is 6,000 tons per year whereas, in the USA it is 30,000 per tons per year. So, 5 times more and that is you can establish a plant which can have 5 times higher capacity that is 500 percent more.

Now, suppose you established the same plant in India- that is 30,000 tons per year in USA and 30,000 tons per year in India also, then what is going to happen? Even if the same plant capacity, the cost dynamics in the Indian situation is such that the selling

price will be 24 percent higher. So, you are not deriving any cost advantage, even though you may say you have got surplus labour. That is our labour cost is extremely competitive and all those types of things really not working out when it comes to the market dynamics situation. This is what is happening in textiles, but the similar trends are obtained in other industries also like tyre and tube, Aluminum and Steel.

What might be the typical causes and why it is happening? We have a labour advantage, labour cost advantage; we India does not lack in its natural resources and all those types of things. We have all the types of plus points there, but still why our product cost is coming out to be higher. The possible causes are: our excise duties are higher; similarly customs, sales tax levels, the uneconomical production levels with which we operate.

So, this is what I mentioned - the economies of scale should be kept in mind while operating the plant, in the earlier classes. Many of our units uses obsolete technology and as a result, production suffers then consequently the sales also suffers and so; the profits also suffer - come down; high breakeven points, excess dependence and import of semi finished goods.

So, high cost has narrow domestic consumer markets and there is heavy competition in international markets in larger size. Now, what is the solution for this? There is no point in the Indian industry especially, the manufacturing industry like the one which we discussed looking at only small size plants. They must be willing to look at large size plants; this is what is happening now as you are seeing many states: the state of Orissa or even now the recently the state of Karnataka is going in for large size Steel plants or at least there is a MoU signed between this Mittal group, who is a well known Steel manufacturer in the globe from India to start up Steel plants in Orissa and also in the state of Karnataka.

So, this is the way things are changing even in the Indian context. So, in other words what does it mean? The manufacturers realize that it is in their own interest to build a large size plant not only on initial investment cost, but also on operational cost; that is cost versus size of production.

Now, let us look at cost versus market. What happens, if suppose, it is a sellers market and what you mean by a seller’s market? There are number of sellers selling the same

product. In such a situation, how does the price of the product get reflected in the market place? What will be the price that will be charged for the product? What is going to happen is a products price will be equal to internal cost plus the desired profit margin.

Suppose it is a buyers market, then there are number of sellers producing different products, but making all differentiations. Then this first line - that is, a product's price will be equal to internal cost plus the desired profit margin. So, the companies can say I want 10 percent profits minimum; it will work in the market place. Suppose it is a buyer's market, then it is a large number of companies were producing the same product. The buyer is having a choice to pick between a, b, c and d like that; then, what is going to happen? The profit margin for the company will get dictated by the prevailing market conditions and gets reflected in quantitative terms. So, in a buyers market the profit margin will be permissible price minus the internal cost. It may result in profit or it may also go to loss. Then all the tolerable cost would be equal to the permissible price minus the acceptable profit.

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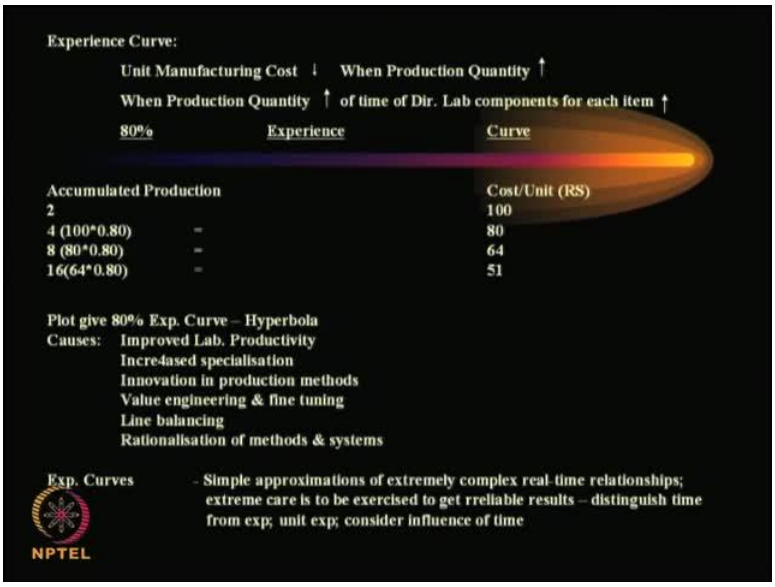

Now, in the light of this cost dynamics scenario which we are looking at, it may be better to look at the experience curves. This experience curves gives you or a company a different type of approach towards the market. That is, you make use of the experience of the production shop worker to come out with more number of units; as his experience increases in a particular line of production, it is very possible that he may be able to

increase his production because he is going through the same productions cycle over and over again; there is a learning which is taking place. So, when that learning is taking place, it is getting reflected in higher production, the unit manufacturing cost will come down.

What is going to happen when the unit manufacturing cost comes down? So, just I am giving you a small example of this experience curve by bringing out in this manner. The unit manufacturing cost decreases when production quantity increases and when production quantity increases, the time of direct labor components for each item also increases. So, that is what is going to happen. That is the direct labour component for each item also increases. Now, suppose you are operating in an 80 percent experience curve; this experience curve is a typical hyperbola. (Refer Slide Time: 24:50) Suppose, you are operating in a typical 80 percent experience curve and suppose your accumulated production is 2 units and the cost per unit is 100 rupees. Now at 80 percent experience curve, if your production goes up to 4, then what is going to happen is the learning is going to take place in this manner: 100 into 0.80; so, the cost per unit comes down to 80. When it goes up to 16, what is going to happen is the cost per unit comes down to 51; so, when you go further and further the cost per unit may not decrease - it may reach a plateau and you may say, this is the maximum experience curve benefit that we can derive for this product or product line.

So, what are the causes for this decrease in the cost per unit, due to this experience curve? Why does the cost come down? It may be due to improved labour productivity; increased specialization; or innovation in production methods; value engineering and fine tuning; the line balancing; and rationalization of methods and systems. So, in other words, what are we trying to say? We are trying to say that the company should make use of the learning process of the workers to come out with products at lower cost; and when you come out with lower cost - product sets lower manufacturing cost, then it is possible that you may be able to compete better in this competitive market place.

A few more points on this experience curve: Experience curves are the simple approximations of extremely complex real time relationships. So, extreme care is to be exercise to get reliable results. Distinguish time from unit experience and consider influence of time; these are highly very important points to note. Distinguish time from experience, what does it mean? A person might have spent a long time in the

organization, but might not have really improved his skills then his longer stay or duration of stay in the organization has really not benefited the organization. So, this is why we say quality is very important.

How does quality get reflected? Quality gets reflected in the quality of the labor which goes into the production of the product. Sometimes, we see in so many states, so many times power cuts getting effected. One of the common comments you hear is, these people are not able to efficiently manage the power sector; that is whether it is the different electricity supply companies or the distribution companies ESCOMs or whatever you have in different states.

So, this is the way people comment and many times they say, even in a city like Bangalore, if you see a rain which comes with some force is able to disrupt power supply for hours, which does not happen in a developed country. Many times even at the start of the rain itself you find that the electricity companies become cautious and switch off the power, but that does not happen in developed countries; and this is called mastery over energy. We have not yet got the mastery over energy or the energy self-sufficiency. So, this is the way the quality of your manufacturing or the quality of the services is going to impact the price and also the output in the market place. That is what is going to happen in the present scenario.

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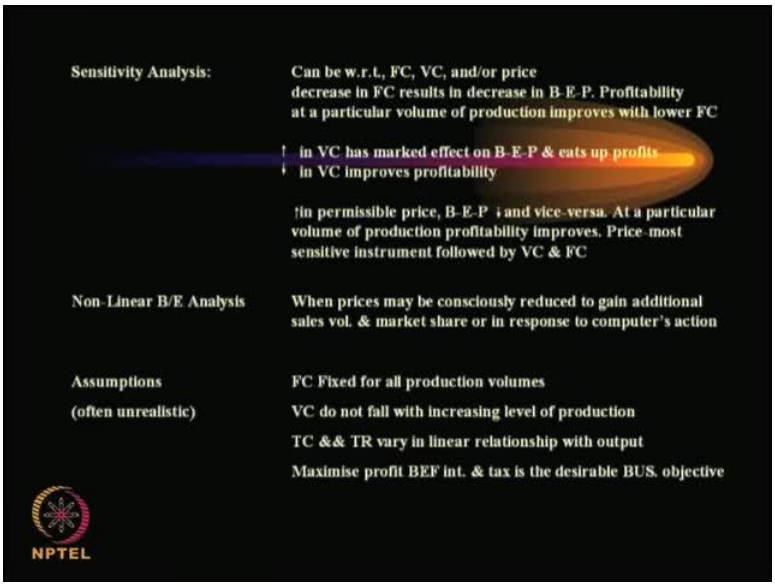

Now, given this type of sensitivity analysis, you can do a sensitivity analysis with respect to fixed cost of a company; a variable cost of the company; and/or price of the product. So, just looking at the sensitivity analysis with respect to breakeven. A few more points on the breakeven, we will go along, when we go to the next slide.

The sensitivity analysis with respect to breakeven can be with respect to fixed cost, variable cost and/or price. A decrease in fixed cost is likely to result in decrease in breakeven point. So, when we are looking at breakeven analysis - what is breakeven analysis? When your total cost will be equal to total revenue, then that will be a breakeven point.

So, when will you do a sensitivity analysis? The sensitivity can be done with respect to fixed cost, variable cost and/or price and this is where the whole experience curve also starts fitting in. So, what are we trying to do in this whole experience curve concept is, by working and working over and over again, you are trying to bring down the variable cost per unit. So, the decrease in fixed cost results in decrease in breakeven point. Profitability at a particular volume of production improves with lower fixed cost.

What happens when the variable cost increases? Increase in variable cost has marked effect on breakeven point and eats up profits. So, this variable cost is the one which holds a higher key and the lever is higher. Similarly, a decrease in variable cost results in improved profitability. An increase in permissible price makes the breakeven point to come down and vice versa. At a particular volume of production, profitability improves; price - most sensitive instrument followed by variable cost and fixed cost. So, this price is the most sensitive instrument in the market place; this is what the most of the studies bring out.

So, lot of research takes place - market research on how to price the product; how can the company derive some strategic advantages by differential pricing, or segment pricing, all those types of things. Normally a breakeven analysis is linear but sometimes it can also be non-linear. So, when it is non-linear, the prices may be consciously reduced to gain additional sales volume and market share or in response to the company competitors action.

So, the assumptions on which this breakeven analysis works is many times unrealistic also: fixed cost fixed for all production volumes; variable cost do not fall with increasing level of production; total cost and total revenue vary in linear relationship with output; then, maximizing profit before interest tag and tags is the desirable business objective. Many companies may have different business objectives also.

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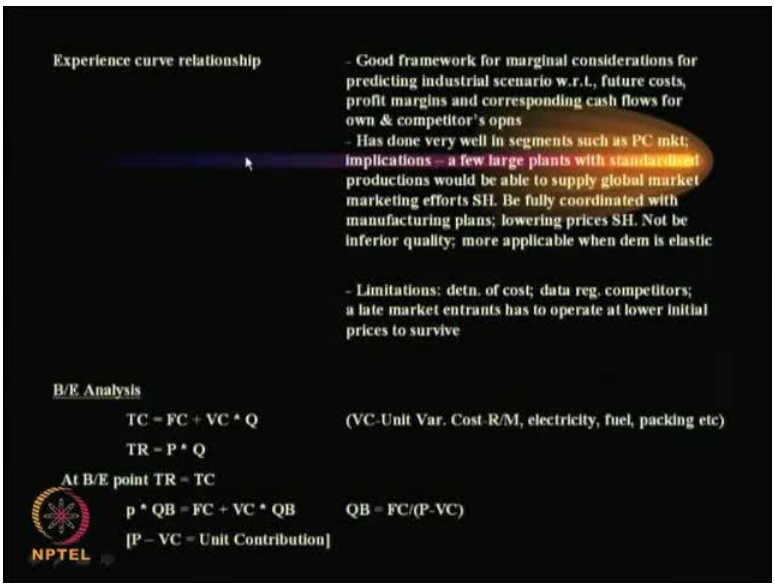

So, this is a type of thing which you have with respect to this breakeven analysis; if you really see, it can be represented by these equations: the total cost is equal to the fixed cost plus the variable cost into the quantity produced or the quantity which the companies able to really take out of its production lines; the total revenue is the price charged into the number of unit sold. So, this is the way it will be and at breakeven point, the total revenue will be equal to total cost; then it is characterized by p into Q B will be equal to F C plus V C into Q B and the Q B that is a breakeven quantity will be equal to F C divided by P minus V C; this P minus V C is referred to as the unit contribution.

So, this is the way breakeven analysis can be represented and that is how the sensitivity analysis with respect to breakeven is done. Now, as I mentioned, this breakeven analysis is one of the simple method by which you find out whether by using the experience curve or you can bring down the variable cost. If you are able to bring down the variable cost per unit of the product, it is likely to result in improving profitability. But will all these good points, which you are mentioned - kindly note that this experience curve is a

simple concept and not a very complicated concept; it can be a good frame work for marginal considerations for predicting industrial scenario with respect to future costs, profit margins and corresponding cash flows for one; and competitors operations.

It has done very well in segments such as PC units. What are the implications, for example, PC markets? A few large plants with standalone production would be able to supply global marketing efforts. It should be fully coordinated with manufacturing plants; lowering prices should not be with inferior quality; and then more applicable when demand is elastic. What are the limitations of this experience curve? You find that determination of cost is one of the real hurdles; so, you may not be able to determine very correctly. So, data regarding competitors - you may not be able to get fully.

A late marketing entrant has to operate at lower initial prices in order to survive, because the others might have already gained the advantages of the experience curve. This is the way the present situation you may find yourself in. All this competitive market brings you to some considerations or some terminologies, which are used frequently in the present market set up. We say a company has gone into doom loop. What is this doom loop? Why does the company go into a doom loop?

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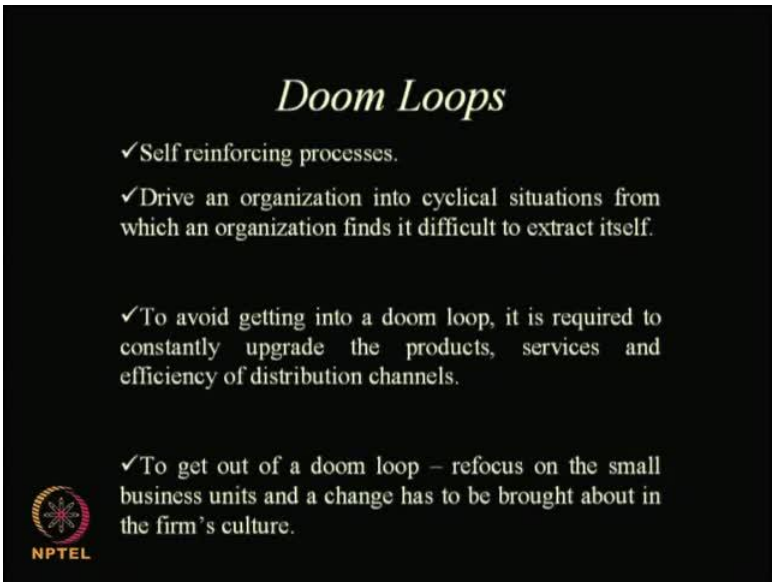

This doom loop is a self reinforcing process and it can drive an organization into cyclical situations from which an organization finds it difficult to extract itself. What should the

organization do to avoid getting into this doom loop? It is required to upgrade the products, services and efficiency of distribution channels.

Now, suppose the organization has got stuck in the doom loop; what should it do? It should refocus on the small business units and a change has to be brought about in the firm's culture. I am just giving you an example of how this dooms loop works like.

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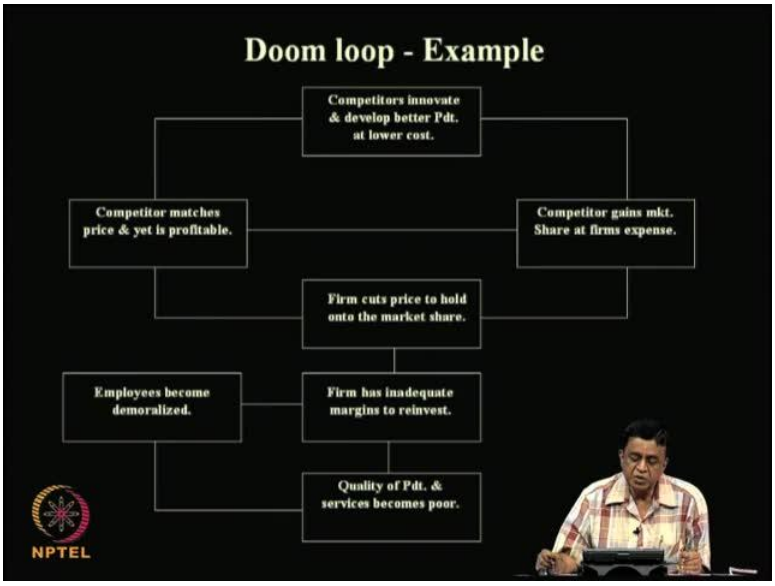

So, this is an example just to illustrate to you on how the dooms loop actually operates in a real market situation? What is that you are seeing? You are in a hypercompetitive market. You are in a competitive market. What do you mean by saying that you are in a competitive market? The product that the company is producing is being produced by number of other players also. So, in order to stay put or stay ahead in this type of a market – What do you mean by saying staying ahead or stay put? You want to retain your market share, stay ahead and increase your market share.

In order to do this, the firm may think that price could be a good method; that is, you cut the price of the product and when you cut the price of the product, you can expect the demand for the product to increase. If it does not increase your profits, it will atleast help you to hold onto your market share. So, let us look at this scenario: a firm cuts price to hold onto the market share. Now, you are not the only player in a market, and then what does the competitor do? The competitor matches this firm's price and yet is profitable; so

your competitor may be using methods by which he not only matches your price, but also he is making profits, compared to you.

Then, what is going to happen? A competitor's innovativeness – what does it do for the company? It helps in coming out with better products at lower cost. So, innovation holds the key in this type of a market place. Suppose, you do not innovate and you only start to have the same products or the product line and not able to improve on the features, but the competitor innovates, then what is going to happen is the product becomes better - the same product what you are putting out, he may also be putting out, but better because of the input characteristics and at lower cost. So, what is going to happen in such situations? In such a situation, the competitor is likely to gain market share at your expense that is at the firm's expense. So, you are not able to match him and he gains at your expense. Then what is going to happen?

Now, you start thinking why did this happen? You find out the competitor is innovating - he is into this innovation mode. So, in order to go into this innovation mode, the company requires investments and in order to make this investment, the company should have got adequate margins.

You find that in the case of your firm have got inadequate margins to reinvest. So, this is a situation where you find that employees are telling the company, we also want to innovate, but the company is not able to go along with the employees because it does not have adequate margins. So, you find yourself in this block, that is firm has inadequate margins to reinvest. Then what is going to happen.

You have a situation where employees want to really match the other players in a market place; and you are not able to really help them with the margins that are required, that is, the investment that is required. Then, what is going to happen is employees become demoralized. When employees become demoralized, the quality of the product and the services become poor. So, when this type of a doom loop starts coming in, the quality of the product and the services become poor. So, the best example for this doom loop exercised is, many of the public sector units have gone into this doom loop, not able to match the private sector. The latest one to happen is that of the Mysore lamps, right here in Bangalore - It was coming out with good quality; that is, ISI certified quality tube lights, incandescent lamps and all those types of things.

Because of the different types of administrative glitches to which the company got into, it found itself competing in a market and getting into this type of a doom loop exercise. So, getting to extricate itself from this doom loop would be very difficult for the company and the result is the company was forced to shut down. Such a nice company coming out with good products with no problems in the product of the company, but still not able to hold on. Why was it not able to hold on? Because of so many operational problems into which it got itself into. The result is the company itself had to close down. So, that is the type of result which this doom loops can impose on a company.

We stop here. We will continue in a next class. Thank you.