# Preface

In 1981, when I was a young strategy consultant about to go to business school, I looked forward to the publication of Michael Porter's *Competitive Strategy* with great anticipation. I thought that it would unlock the competitive mysteries of how one business thrives when another fails. Unfortunately, while the book was interesting and informative, I was perhaps one of a very small minority of readers who felt profoundly disappointed with the content of the book.

It provided few specific, honed concepts or examples from practice to help businesses formulate winning strategies that allowed them to make more money than their competitors. Porter's Five Forces framework provided the means to assess the context in which businesses compete against each other, but in terms of just how they competed against each other we were told only that businesses pursued either cost leadership, or differentiation or a niche focus. These prescriptions were much too broad to be straightforwardly applicable to specific businesses.

For instance, when I carried out a structural industry analysis for clients, this did not provide any implications as to what exactly my clients should do, but simply revealed a void of ignorance: given this is the context how can we make more money sustainably than the businesses we are competing against? What should we do? How can we establish a cost advantage? What are the relevant costs? Along which lines can we differentiate ourselves in an advantageous way? How can we mix elements of cost advantage and differentiation to improve our standing in the eyes of customers in a way that allows us to make more money than the businesses with which we compete? How big is a niche, and how is it to be defined?

The structural analysis was a starting, not a finishing point; it was largely descriptive, not prescriptive. I thought that perhaps Porter's second book would fill the gap, but it did not. To be fair, no one else has written compellingly about these issues. What is missing is a comprehensive account of heterogeneous competition between businesses to supplement Porter's structural analysis of industries (which economists call industrial organisation) — in other words, a fourth leg to economics, which consolidates and systematises what we know about how businesses really compete, to add to microeconomics, macroeconomics and industrial organisation. I hope that this book represents a valid step on that path, introducing concepts and techniques that can form part of this new fourth leg within economics called the Economics of Strategic Diversity (ESD), which sets out the fundamentals of heterogeneous competition and provides a richer, thicker account of how businesses make money from competitive success. How can this goal of a fourth leg be achieved?

Few would deny that there are a number of concepts and tools that managers can apply in day-to-day contexts to help them make better strategic choices for their businesses. These tools and concepts help to explain why some businesses make much more money than others. Many of them, in one guise or another, are familiar either to a smart CEO or to the senior practitioners in strategy consulting firms. Unfortunately, few consulting partners or chief executives have the time or patience necessary to articulate on paper some of the concepts and tools that they have found most useful in their careers. To make matters worse, from time to time senior personnel are seduced into a faddish preoccupation with a particular technique (such as the experience curve, time-based management or total quality) in order to win client business. This book attempts to address this situation.

My purpose is to elucidate various strategic concepts and insights relevant to an explanation of heterogeneous competition, gathered over a period of more than twenty-five years working as an advisor and as an entrepreneur in a wide range of companies, industries and countries. Some readers, though, may ask how they can be assured of the conclusions drawn in this book when they are not supported by statistical analysis of empirical studies using large data samples. Not only does this statistical approach to management research present enormous practical difficulties, but it also presupposes that this is a sensible method to adopt.

The answer is that the conclusions are supported by insight and reason, are causally persuasive and have explanatory power. Unlike microeconomics, which typically deals with idealisations, in strategy we are dealing with specific, real situations that cannot be analytically rendered by washing them in a sea of statistical data. Instead, we may make headway through conceptual analysis, as our colleagues do who are psychologists, philosophers or anthropologists. Developing a perceptive account of strategy that fully explains heterogeneous competition entirely from inferences based upon available business statistics would be like trying to develop an account of justice based upon crime numbers.

Throughout the book I talk about businesses rather than firms, departments, divisions, companies, corporations, ventures and entities. This not only avoids ambiguities introduced by ownership and structure, but also serves to focus the discussion on the people, activities and resources that collectively supply customers with products or services and deal with competitors. Businesses compete, and those working within a business usually have a very clear sense as to how their business competes and what it does and does not comprise. It seems sensible therefore to articulate competitive strategy in terms of businesses. This focus on businesses does not preclude that some of the concepts and tools discussed will also be relevant to public organisations, non-profits and government agencies.

From the outset, it has been my intention to avoid making the book overly lengthy, while still including relevant examples and linking the narrative to the established business literature. Where possible I have used slightly disguised versions of favourite analyses and displays taken from actual client situations. To this end the book does not include a large number of structured cases for class exercises and discussion, which risk rapid obsolescence. Instead, I hope the book will stimulate critical thinking on the part of the reader about strategic issues facing the businesses that he or she is involved in. For this to be successful, I assume that the reader is a strategist and has good underlying familiarity with the prevailing notions of strategy, perhaps gained from working in either a strategic or business development role in a company or a consultancy, or perhaps as an entrepreneur.

One final point: too much of what is taught as "strategy" is overly grandiose and normative, targeted at the opulent, ponderous realm of the large multinational corporation. What is said here about strategy is intended to hold true for businesses large and small, new or old.

The book is structured in two main parts. After the introductory chapter, Part 1 aims to provide a rigorous account of the five key strategic building blocks that underpin an analysis of heterogeneous competition. In straightforward language these conceptual anchors aim to answer five related questions: (i) How do you define your business correctly? (ii) How do you develop a way of carrying out your business that creates value for your customers? (iii) What advantages do you enjoy compared to your competitors in carrying out business your way? (iv) How does that competitive advantage give rise to sustainable profits? and (v) How do we judge whether those profits, in relation to the resources used up by the business, are sufficient to keep investors happy?

To answer each question requires the application of an associated strategic concept: (i) the relevant *strategic ecology* allows you to define your business correctly; (ii) how you conduct your business is described by your *business model*; (iii) by careful crafting of a distinctive business model you can create a *route to competitive advantage*; (iv) that competitive advantage will allow sustainable profits that arise from *economic rents* to compensate you for the use of resources; and (v) the ensuing *return on resources* will determine whether investors are happy or not with the performance of your business, and hence the value of your business. How do these questions and concepts tie together into chapters?

Chapter 1 provides an introduction and justification for ESD, which can help make up for the inadequacy of the other fields of traditional economics in explaining the behaviour of businesses. At the heart of ESD is the general observation that, for businesses, a strategy is a coherent and consistent pattern of action expressed through a business model leading to the appropriation of sustained economic rents. Chapter 2 then explains the relevance of knowing the correct strategic ecology in defining a business and its relevant competitors. Having established an understanding of the strategic ecology and the competitors relevant to a business, Chapter 3 makes explicit how the behaviour and configuration of this business can be described by its business model, and that what is meant by a business model can be made explicit using matrix algebra. For those less comfortable with matrices, it suffices to say that one can define business models explicitly in a manner that resembles chemical formulae or genetic codes. In making the models explicit, it does not require that all managers in a business share exactly the same model: there may be some cognitive element contributed by the manager. But if different managers have different perspectives on the business model of their business, these matrix methods at least have the merit of making the differences apparent. Furthermore, one can use these matrix methods to show how managers modify these formulae or codes that describe how they compete in their business, just as scientists do in clever chemistry or genetic engineering. These codes also provide a formal means of incorporating the resource-based and positioning views of strategy as separable parts of the business model. But what is the point of creating and enhancing these business models?

The answer is spelt out in Chapter 4, which explains how managers can refine and exploit business models so that they establish competitive control of resources. As the chapter makes clear, there are many ways that businesses can formulate strategy to confer a competitive advantage. Competitive advantages in turn give rise to sustained economic rents that justify the business's use of resources and can be used to reward investors. Chapter 5 reveals that the principal type of rent is an opportunity rent that arises from heterogeneous competition, as opposed to the more familiar, monopolistic, oligopolistic and innovation rents that are well developed and described in traditional economics. But how does a manager know whether these rents are enough to keep investors happy?

Chapter 6 sheds some light on this question by outlining how resource margins (i.e. the return on resources), which measure the rents obtained in relation to the resources consumed, can be happily integrated into modern financial theory to provide a robust measure of strategic valuation that meshes strategy, accounting, microeconomics and finance. Resource margins provide a practical handle on what makes investors happy.

The five strategic concepts covered in Part 1 form the cornerstones of this account of ESD. I make no claim that this is a fully comprehensive account of heterogeneous competition, but I do believe that the concepts outlined are among the primary building blocks necessary for an account to be adequate, and the treatment in this book is the first to attempt to integrate them.

Part 2 deals with how these strategic concepts, embedded in various analytical techniques and tools, can illuminate strategy practice. The reader will note the intention is not to deconstruct each practice (such as mergers and acquisitions) into a mechanistic, detailed Airfix blueprint constructed from variants of the five strategic concepts. Business situations are too varied and subtle to allow this. Instead, I hope to illustrate how the five preliminary strategic concepts of Part 1 can be put to work through the techniques and the tools actually used in real situations — in fact, the practical application came first, and their success led me to think about the underlying strategy concepts that ensured they worked.

Chapter 7 explains how a successful business can continue to develop by exploitation of new business ecosystems adjacent to its starting base. This chapter analyses the conceptual linkages that underpin the related trilogy of strategic ecology, adjacency and synergy. The linkages between these concepts arise from the fact that the criteria we use to assess that two businesses are different (strategic ecology), form the basis also for explaining the extent to which the two businesses are the same (adjacency), and for determining what the businesses have in common (synergy).

Effective corporate strategy makes the value of the whole corporation greater than the sum of the values of its parts. Chapter 8 develops this notion of corporate strategy by showing how it is possible to extract greater sustained economic rents from a set of businesses than the businesses would generate on a stand-alone basis. Chapter 9 describes a number of techniques and tools to help corporations to add value to their constituent businesses: portfolio profiles, retrospective scenario-based valuation, mergers and acquisitions (M&A) selection methods and valuation grids.

Start-up strategy is explained in the penultimate Chapter 10, where an explicit distinction is made between the strategy to build a new business and the strategy of the business that is built.

The book concludes with a final summary chapter, Chapter 11, but each chapter also ends with a conclusion, a summary of key points and a small number of questions to be considered by the reader.

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