Business Policy & Strategy
Dr. Richard C. Insinga, April 2011

Lecture #7

Plan for Lecture #7

- Key points from Lecture #6
- Topics for tonight
  - Porter's Chapter 16 – Entry into New Businesses
  - Article – McDonough et al's *Integrating Innovation Style and Knowledge into Strategy*
  - Book – Kelley's *The Ten Faces of Innovation*

Key Points from Lecture #6

- Capacity additions are more complex decisions than the relatively simple analytical financial analysis of discounted cash flow and net present value.
  - The financial analysis is the correct way to analyze such decisions, but it is the inputs to that analysis which are the main problem.
  - Uncertainty about the future and the need to make reasonably good estimates of demand, competitors, revenues and costs of the firm, and the possibility of technological changes or new entrants make such estimates of the inputs to the financial analysis quite difficult.
- The criteria for a good strategy is not in the form, but in its effect on the success of the business. And that success depends more on the abilities of management to implement the strategy than it does on the perceived quality of the wording of the strategy itself.

Key Points from Lecture #6 (cont'd)

- Companies need to be able to "see what's next" in terms of innovations in order to remain successful in their industry.
  - Existing companies are good at dealing with sustainable innovations, which make marginal improvements in their existing products or processes.
  - Existing companies have a great deal of difficulty in dealing with disruptive innovations, which are sometimes referred to as "game changers." Such innovations have the potential to disrupt the status quo of an industry, resulting in loss of revenues to the newly emerging industry.
- Though a successful existing company may make prudent decisions regarding its existing business investments, if it does not invest in the potentially disruptive innovation, it will only later find that the innovation has taken away a substantial portion of its existing business.

Key Points from Lecture #6 (cont'd)

- Companies need to be better predictors of emerging innovations that may become disruptive innovations and to employ strategies to co-opt those innovations for themselves in order to mitigate the damage that they might cause.
- In the adoption process for a new technology innovation (or any disruptive innovator), there is a chasm that must be crossed in order for the innovation to succeed.
  - The chasm is between the early adopters and the early majority.
- The Catch-22 of this situation is that the Early Majority is cautious and wants good references before buying the new innovation's product, and to the Early Majority, the Early Adopters are not good references. The **only good** reference for someone in the Early Majority is **another** member of the Early Majority.

Key Points from Lecture #6 (cont'd)

- A "Catch-22" is a situation in which there is no way to succeed. The book "Crossing the Chasm" recommends taking a niche strategy, with a great deal of incentives involved, in order to establish a beachhead (sometimes called a "toe hold") in the Early Majority so that those who use the new innovative product can provide good references to others in that group.
- The phrase "Catch-22" comes from Joseph Heller's novel by the same name.
- In Heller's book, there was only one catch to getting out of having to go into combat and that was Catch-22.
  - A person could get out of combat if they were insane, but
    - Catch-22 specified that a concern for one's safety in the face of dangers that were real and immediate was the process of a rational mind.

Key Points from Lecture #6 (cont'd)

- Orr is a fictional character in the classic novel. Orr is a bomber pilot in the squadron who is continually being shot down and having to crash land in the sea. He did not want to fly more missions.

- Orr was really crazy and could be grounded. All he had to do was ask; but as soon as he did, he would no longer be crazy and would have to fly more missions. Orr would be crazy to fly more missions and sane if he didn't want to, but if he didn't want to fly them, he was sane and had to fly them.

- That was the Catch-22.

- Note: A "catch" is something that prevents one from getting what one wants.

Entry into New Businesses

- The economics of entry rests on some fundamental market forces that are operating whenever entry occurs.
- If these market forces work perfectly, in the economist's sense, then *no entry decision can ever yield an above-average return on investment*.
- This startling statement is the key to analyzing the economics of entry.

Entry into New Businesses (cont'd)

- There are two ways to enter:
  - Through internal development or joint venture, or
  - Through acquisition
- Joint ventures raise essentially the same economic issues as a single company's entry into a new market.
  - Although joint ventures create complicated questions about the division of efforts between the partners and who has effective control.
- We examine each of the two ways in turn.

Entry into New Businesses (cont'd)
Entry through Internal Development

- Entry through internal development involves the creation of a new business entity in an industry.
- The first important point in analyzing internal development is that it requires the firm to confront directly the two sources of entry barriers into an industry:
  - Structural entry barriers, and
  - The expected reaction of incumbent firms.

Entry into New Businesses (cont'd)
Entry through Internal Development

- Many capital budgeting treatments of the entry decision neglect the cost of retaliation and therefore overestimate the potential returns for the new entrant.
- Another factor that is often neglected is the effect of the entrant's new capacity on the supply-demand balance.
  - If the entrant's addition to industry capacity is significant, its efforts to fill its plant will mean that at least some other firms will have excess capacity.

Entry into New Businesses (cont'd)
Entry through Internal Development

- The entrant through internal development must pay the price of overcoming structural entry barriers and face the risk that existing firms will retaliate.
  - The cost of overcoming structural barriers involves up-front investments and start-up costs.
  - The risk of retaliation can be viewed as an additional cost of entry, equal to the magnitude of the adverse affects of retaliation, for example:
    - Lower prices and escalated marketing costs.

Entry into New Businesses (cont'd)

Entry through Internal Development

- Assuming the potential entrant will properly analyze the elements of the entry decision, where is internal development entry most likely to be attractive?
- The answer flows from the basic framework of structural analysis.
  - The expected profitability of firms in an industry depends of the strength of the five forces.

Entry into New Businesses (cont'd)
Entry through Internal Development

- If an industry is *stable*, or *in equilibrium*, the expected profits of entrants should just reflect the height of the structural barriers to entry and the legitimate expectations of entrants about retaliation.
- The potential entrant, calculating its expected profits, should find that they are normal, or average profits, even though the profits of current industry firms are high.
  - The difference in profits is due to having to bear the costs of entry into the industry.

Entry into New Businesses (cont'd)

Entry through Internal Development

- But not all industries are in equilibrium.
- In new, rapidly growing industries, the competitive structure is usually not well established and the costs of entry may be much less than for later entrants.
- Going firms in that industry may have limits on the rate at which they can grow.
- However, a firm should not enter a new industry just because it is new.
  - Entry will not be justified unless a full structural analysis leads to the prediction of above-average profits.

Entry into New Businesses (cont'd)
Entry through Internal Development

- Some common approaches to entry, which rest on various concepts for overcoming entry barriers more cheaply than other firms, are as follows:
  - Reduce product costs
  - Buy in with low prices in the short run
  - Offer a superior product
  - Discover a new niche
  - Introduce a marketing innovation
  - Use piggybacked distribution

Entry into New Businesses (cont'd)
Entry through Acquisition

- Entry through acquisition is subject to a completely different analytical framework than entry through internal development because the acquisition does not add a new firm to the industry in a direct sense.
- The critical point is the recognition that *the price of an acquisition is set in the market for companies*.
  - The market is where owners of companies are the sellers and acquiring companies are the buyers.

Entry into New Businesses (cont'd)
Entry through Acquisition

- An efficient market for companies works to *eliminate any above-average profits* by making an acquisition.
  - If a company has sound management and attractive future prospects, its price will be bid up in the market.
  - Conversely, if its future is dim or if it requires massive infusions of capital, its sales price will be low, taking into account the reduced outlook and costs of keeping the company profitable.
- To the extent that the market for companies is working efficiently, then, the price of an acquisition will eliminate most of the potential for excess returns for the buyer.

Entry into New Businesses (cont'd)
Entry through Acquisition

- Contributing to the market's efficiency is the fact that the seller usually has the option of keeping the company and operating the business.
  - In some situations, the seller has compelling reasons to sell and is thereby vulnerable to accepting whatever price the market for companies offers.
- This analysis suggests that it is quite difficult to win at the acquisition game.

Entry into New Businesses (cont'd)
Entry through Acquisition

- The price of an acquisition will be lowest when the seller feels the greatest compulsion to sell, because of the following for example:
  - The seller has estate problems
  - The seller needs capital quickly
  - The seller has lost key management or sees no successors for existing management
  - The seller perceived capital constraints to growth
  - The seller recognizes its managerial weaknesses.

Entry into New Businesses (cont'd)

Entry through Acquisition

- In the preceding discussion, the perfect market for companies takes away the prospects for above-average profits, but there are imperfections in the market for companies, such as:
  - The buyer has superior information
  - The number of bidders is low
  - The condition of the economy is bad
  - The selling company is sick
  - The seller has objectives other than maximizing the price received for the company
    - For example, the continued good name and reputation of the company, the way that employees will be treated, whether the seller's management will be retained, or how much the buyer will interfere in the business if the owner plans to stay.