CHAPTER 8

ECONOMICS OF STRATEGY: CREATING AND CAPTURING VALUE

CHAPTER SUMMARY

This chapter is the first of two chapters on strategy. It concentrates on the basic ways firms can create and capture value. Chapter 9 uses game theory to study strategic interactions among a small number of identifiable rival firms. Chapter 8 presents a framework for discussing how firms create value. It also discusses the conditions under which a firm can capture value (either by having market power or, in certain cases, having superior factors of production). The economics of diversification are examined, and a framework for strategy formulation is presented. A mini-case (Wal-Mart.com) highlights some of the issues in the chapter and the answers for the associated discussion questions are included below. Most managerial economics books focus on a very limited set of decisions (for example, pricing, input selection and output), taking the market product, and its characteristics, as given; they also assume that a firm produces only one product. This chapter uses basic economic principles to analyze a broader set of corporate policies.

CHAPTER OUTLINE

STRATEGY

VALUE CREATION

Production and Producer Transaction Costs
- Managerial Application—Dell Computers: Reducing Producer and Consumer Transaction Costs

Consumer Transaction Costs
- Managerial Application—Creating Value: Reducing Consumer Waiting Time
- Managerial Application—Reducing Consumer Transactions Costs: Kraft Lunchables
- Managerial Application—Terrorist Attacks Affect Value Creation in the Airline Industry

Other Ways to Increase Demand
- Product Quality
- Price of Complements
  - Historical Application—Giving Away Razors to Increase Demand for Blades
- Price of Substitutes
  - Managerial Application—Airlines Restrict Cell Phone Use

New Products and Services
- Managerial Application—Technology and Value

Cooperating to Increase Value
- Managerial Application—Advanced Photo System
Converting Organizational Knowledge into Value
Managerial Application—Sonic Drive-Ins Convert Wetware to Software

Opportunities to Create Value

CAPTURING VALUE
Market Power
Entry Barriers
Historical Application—Creating but Not Capturing Value: Eli Whitney
Degree of Rivalry
Managerial Application—Competition and the Number of Competitors
Threat of Substitutes
Managerial Application—Italian Textiles and Chinese Competition
Buyer and Supplier Power
Managerial Application—Sugar Prices

Market Power and Strategy
Superior Factors of Production
Producer Surplus Captured by Superior Assets
Second-Price Auctions
Team Production
Team Capabilities and Organizational Architecture
Managerial Application—Team Capabilities at Sharp Corporation
Academic Application—Flexible Manufacturing and Team Capabilities

A Partial Explanation for Wal-Mart’s Success
Managerial Application—Economic Profits without Market Power: A Summary of Key Concepts
Managerial Application—Walmart’s Strategy Proves Timely During the 2007 Holiday Season

All Good Things Must End
Managerial Application—Nomura Securities Company: It Is Not Easy to Remake a Business
Changing Fortunes
Polaroid’s Success and Ultimate Failure to Capture Value

ECONOMICS OF DIVERSIFICATION
Benefits of Diversification
Economies of Scope
Managerial Application—Wal-Mart Diversifies into the Traditional Grocery Store Business
Promoting Complements

Costs of Diversification
Managerial Application—McFocus at McDonald’s
Managerial Application—Proposed Megamerger Collapses in the Drug Industry

Management Implications
A Faulty Reason to Diversify
When Does Diversification Create Value?
Managerial Application: Philips Electronics
Managerial Application: Diversification Problems at Xerox
Who Captures the Gains from Diversification?

STRATEGY FORMULATION
Understanding Resources and Capabilities
Understanding the Environment
  Managerial Application—Faulty Analysis at Kodak
Combining Environmental and Internal Analyses
Strategy and Organizational Architecture
  Managerial Application—Strategy at Microsoft
  Managerial Application—A Retail Success Story and Luck
  Academic Application—Contemporary Approach to Strategy
Can All Firms Capture Value?

SUMMARY

TEACHING THE CHAPTER

This chapter is the first in the text to apply the basic tools of microeconomics beyond their traditional applications to illustrate how firms can create value. The chapter relies on the fundamental tools presented in the early chapters (e.g., supply and demand graphs, short-run cost curves, etc.). However, it also makes use of a graph of firms’ reaction curves which is a more advanced concept. Figure 8.1 is a versatile graph that can be used to illustrate the examples covered in the first section of the chapter on value creation. It would be useful to refer back to this figure when discussing ways to create value and ask students to explain why the curves would change as the textbook suggests.

More than any other chapter, this chapter has a plethora of Managerial, Historical, and Academic Applications to illustrate the key points. Rather than lecturing on each of the concepts, these applications can be used to generate class discussion about the topics, which can then be covered more fully in lecture if there are remaining questions. They can also be used to encourage students to find other examples on their own of companies or industries that have had a similar experience. This chapter also refocuses on two important concepts that will be discussed later in the text: teams and organizational architecture. Several parts of this chapter can be reviewed later in the course once these concepts have been covered more fully in later chapters. The textbook authors have suggested a variety of cases that can be used in class to further discuss these concepts.
There are three *Analyzing Managerial Decisions* scenarios presented in this chapter. The first, “Investing in a New Restaurant Concept”, asks students to evaluate the market structure of the restaurant industry. Many of the relevant concepts are initially presented in Chapter 6, but the students should be sure to incorporate the additional insights they have gained from the material in this chapter. The second scenario, “Leaving New York City for the Farmlands of Illinois”, asks students to apply several different concepts from the chapter. First, they must identify the market structure of the market they wish to enter. Second, they must consider how they would create and capture value in order to be profitable. This scenario requires the students to fully understand the material to formulate their answer because they must consider how a variety of factors interact to determine the potential profitability of the investment. The final scenario, “Walmart.com”, provides a comprehensive example for students to work through that applies concepts from the entire chapter. This example would be useful as a group assignment that could also then be used for class discussion.

The Self-Evaluation Problems at the end of the chapter will give students an opportunity to determine whether they understand the quantitative aspects of the chapter, while the Review Questions focus more on application of the concepts in the chapter. These Review Questions are quite thorough and could easily be used in class to generate class discussion.

**REVIEW QUESTIONS**

8–1. Choose a company that markets computer products over the Internet (for example, through a web search). In what ways does the company create value? Is it likely to capture much of this value? Explain.

   The answer to this question depends on the example developed by the student. Internet companies often create value by reducing transaction costs. In discussing the potential to capture value, the student should focus on the effects of competition and whether this is likely to reduce the ability of the firm to capture profits.

8–2. Airbus and Boeing are two major producers of jumbo jets. Are these firms guaranteed to make high profits since there are only two large firms in the industry? Explain.

   No. Even if there are only two firms in the industry, they may compete vigorously to reduce prices and profits. This issue is discussed in more detail in chapter 6, and in particular in chapter 9 (on game theory).
8-3. The Watts Brewing Company owns valuable water rights that allow it to produce better beer than competitors. The company sells its beer at a premium and reports a large profit each year. Is this firm necessarily making economic profits? Explain.

No. Its advantage is that it owns a valuable but marketable asset. The firm may be only making normal profits given the opportunity cost of keeping the water rights itself rather than selling them to others in the marketplace. The company is more valuable because it owns the water rights. However, selling the rights to others might be the best way to capture this value.

8–4. What are team capabilities? Give examples of firms that appear to have them.

Because of the interdependencies among workers and assets, the value of the inputs as a “team” can sometimes be greater than the simple sum of the values if each worker and asset were employed at its next best use across other firms. Thus, it is possible that the overall firm will be more valuable than the sum of its parts. We characterize such a firm as having team production capabilities. Sharp is an example from the book. Many other examples exist.

8–5. Sun Resorts has a hotel on a Caribbean Island. It recently spent money to lobby the government to build a better airport and expand air service. Why did they do this? Do you think that Sun Resorts cares about how many airlines will serve the island? Explain.

Airline service is a complement for Sun Resorts. Cheaper air service to the island increases the demand for Sun Resorts. Thus, Sun Resorts wants better airport service and lower airfares. Lower fares are more likely to result if there are several airlines that compete in serving the island. These concerns are clearly important to Sun Resorts.
8–6. Evaluate the following statement: “Business is war. Never consort with the enemy.”

Cooperating with competitors can sometimes create value. An example is Kodak and Fuji cooperating to adopt a common standard for the Advanced Photo System. Managers should consider possible cooperation with suppliers, customers, regulators, competitors, etc. in thinking about ways to create value. Also, while certain practices are illegal in certain countries, firms can sometimes capture value by cooperating to increase monopoly power (e.g., forming a cartel).

8–7. The Long-Drive Golf Company manufactures a new line of golf clubs. The Cushion Bag Company makes a special golf bag that protects the delicate shifts on these clubs. The respective prices are $P_c$ and $P_b$ for the clubs and bags. The marginal cost for producing either product is 100. Demand for each product is

\[ Q = 1000 - (P_c + P_b) \text{ when } P_c + P_b \leq 1000, 0, \text{ otherwise} \]

How will the two companies price the products if they do not cooperate? What are the resulting quantities and profits? What are the prices, quantities, and profits if the two companies price cooperatively? Explain why there is a difference.

In the noncooperative situation, each firm will take the other firm’s price as given. Demand for each firm is given by $P_j = (1000 - P_i^*) - Q$, where $P_i^*$ is the expectation of the other firm’s price. Setting marginal revenue equal to marginal cost of 100 yields an optimal quantity for each firm of $Q = 450 - 0.5P_i^*$. Substituting the overall demand curve ($Q = 1000 - (P_j + P_i)$) yields the following reaction curve for each firm: $P_j = 550 - 0.5P_i$. In equilibrium, both firms set the same price (since the problem is the same for both firms). The resulting prices are $367$ each for the clubs and the bags. The firms sell 267 bags and 267 sets of clubs. Profits are $71,201$ for each firm. Note that the answers might vary slightly due to rounding. If the firms price collectively, they will use the combined demand curve $P_T = 1000 - Q$, where $P_T$ is the combined prices of the two products. The marginal cost of producing the combination is 200. Setting marginal cost equal to marginal revenue yields a combined price of $600$ (e.g., $300$ for the bags and clubs, respectively). A total of 400 sets of clubs and bags are sold. The combined profits are $160,000$, which is greater than the combined profits under independent pricing of $142,402$. In the noncooperative situation each firm fails to consider the negative effect that raising its own price has on the other firm’s demand and profits. In cooperative pricing these cross effects are taken into account. This accounts for the difference in the outcome.
8–8. One CEO justified the merger of his soft-drink company with a machine tool company in the following manner: “This is a great merger. First the products are unrelated. Thus our company’s earnings volatility is likely to decrease. Second, our management team has proved that we are better managers than the former management team of the tool company, and thus we are likely to discover new ways to create and capture value within the tool company.” Evaluate this rationale.

It is true that the merger might reduce earnings volatility. However, shareholders can diversify on their own by buying shares in the two companies. Thus, it is not obvious that the merger of the two companies creates value (which is likely to involve higher transaction costs than simply having investors buy the shares on their own). While the company’s management team may be good in their industry, it is not obvious that they will have an advantage in competing in an unrelated industry. They are more likely to be able to exploit any special talents they have in a related business.

8–9. Pepsi produces Fritos and Lays potato chips in addition to its basic soft-drink products. Discuss potential ways that this business combination might increase value.

There may be economies of scope, such as in jointly marketing the products through Pepsi’s marketing channels (they are related products and sold to many of the same customers). Also, the products are complements and Pepsi can take this into account in their pricing.

8–10. The Strippling Drug Company has just obtained an important patent for a new drug that increases male virility and cures male pattern baldness at the same time. Does this imply that Strippling has a competitive advantage in producing the drug? Explain.

No. It might be better off for the company to sell the patent to another company that has more experience and scale for producing the new drug.