How Strategy *Shapes* Structure

Instead of letting the environment define your strategy, craft a strategy that defines your environment, say the authors of *Blue Ocean Strategy.* | **by W. Chan Kim and Renée Mauborgne**

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WHEN EXECUTIVES develop corporate strategy, they nearly always begin by analyzing the industry or environmental conditions in which they operate. They then assess the strengths and weaknesses of the players they are up against. With these industry and competitive analyses in mind, they set out to carve a distinctive strategic position where they can outperform their rivals by building a competitive advantage. To obtain such advantage, a company generally chooses either to differentiate itself from the competition for a premium price or to pursue low costs. The organization aligns its value chain accordingly, creating manufacturing, marketing, and human resource strategies in the process. On the basis of these strategies, financial targets and budget allocations are set.

The underlying logic here is that a company's strategic options are bounded by the environment. In other words, structure shapes strategy. This "structuralist" approach, which has its roots in the structure-conduct-performance paradigm of industrial organization economics[1], has dominated the practice of strategy for the past 30 years. According to it, a firm's performance depends on its conduct, which

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in turn depends on basic structural factors such as number of suppliers and buyers and barriers to entry. It is a deterministic worldview in which causality flows from external conditions down to corporate decisions that seek to exploit those conditions.

Even a cursory study of business history, however, reveals plenty of cases in which firms' strategies shaped industry structure, from Ford's Model T to Nintendo's Wii. For the past 15 years, we have been developing a theory of strategy, known as blue ocean strategy, that reflects the fact that a company's performance is not necessarily determined by an industry's competitive environment.[2] The blue ocean strategy framework can help companies systematically reconstruct their industries and reverse the structure-strategy sequence in their favor.

Blue ocean strategy has its roots in the emerging school of economics called endogenous growth[3], whose central paradigm posits that the ideas and actions of individual players can shape the economic and industrial landscape. In other words, strategy can shape structure. We call this approach "reconstructionist."

While the structuralist approach is valuable and relevant, the reconstructionist approach is more appropriate in certain economic and industry settings. Indeed, today's economic difficulties have heightened the need for a reconstructionist alternative. The first task of an organization's leadership, therefore, is to choose the appropriate strategic approach in light of the challenges the organization faces. Choosing the right approach, however, is not enough. Executives then need to make sure that their organizations are aligned behind it to produce sustainable performance. Most executives understand the mechanics of making the structuralist approach work, so this article will focus on how to align an organization behind the reconstructionist approach to deliver high and sustainable performance.

IDEA IN BRIEF

» **There are two types of strategy: structuralist strategies that assume that the operating environment is given and reconstructionist strategies that seek to shape the environment.**

» **In choosing which of the two is most appropriate for your organization, you need to consider environmental attractiveness, the capabilities and resources you can call on, and whether your organization has a strategic orientation for competing or for innovating. Diversified companies should be comfortable using both approaches.**

» **Whichever type of strategy is chosen, success will depend on creating an aligned set of strategy propositions targeted at three different sets of stakeholders: buyers, shareholders, and the people working for or with the organization.**

» **Where the approaches diverge is in the nature of their proper alignment. Structuralist strategies require that all propositions focus on delivering either low cost or differentiation. Reconstructionist strategy propositions aim to deliver both, as exemplified by the cases of the city-state of Dubai, Apple's iTunes, and the charity Comic Relief.**

What Is the Right Strategic Approach for You?

There are three factors that determine the right approach: the structural conditions in which an organization operates, its resources and capabilities, and its strategic mind-set. When the structural conditions of an industry or environment are attractive and you have the resources and capabilities to carve out a viable competitive position, the structuralist approach is likely to produce good returns (see the exhibit "Choosing the Right Strategic Approach"). Even in a not-so-attractive industry, the structuralist approach can work well if a company has the resources and capabilities to beat out the competition. In either case, the focus of strategy is to leverage the organization's core strengths to achieve acceptable risk-adjusted returns in an existing market.

But when conditions are unfavorable and they are going to work against you whatever your resources and capabilities might be, a structuralist approach is not a smart option. This often happens in industries characterized by excess supply, cutthroat competition, and low profit margins. In these situations, an organization should adopt a reconstructionist approach and build a strategy that will reshape industry boundaries.

Even when an industry is attractive, if existing players are well-entrenched and an organization does not have the resources and capabilities to go up against them, the structuralist approach is not going to produce high performance. In this scenario, the organization needs to build a strategy that creates a new market space for itself.

When structural conditions and resources and capabilities do not distinctively indicate one approach or the other, the right choice will depend on the organization's strategic mind-set. An organization with an innovative bent and sensitivity to the risks of missing future opportunities will be more successful in adopting a reconstructionist approach. Firms with a bias toward defending current strategic positions and a reluctance to venture outside familiar territory would do better with a structuralist approach.

The Three Strategy Propositions

Whichever approach is chosen, a strategy's success hinges on the development and alignment of three propositions: (1) a value proposition that attracts buyers; (2) a profit proposition that enables the company to make money out of the value proposition; and (3) a people proposition that motivates those working for or with the company to execute the strategy. Where the two approaches diverge is in the alignment of the propositions.

Let's first flesh out our definition of strategy. The value and profit propositions set out the content of a strategy – what a company offers to buyers and how it will benefit from that offering. The people proposition determines the quality of execution. The three strategy propositions correspond to the traditional activity system of an organization: The outputs of an organization's activities are value for the buyer and revenue for itself, and the inputs are the costs to produce them and the people to deliver them. Hence, we define strategy as the development and alignment of the three propositions to either exploit or reconstruct the industrial and economic environment in which an organization operates.

Unless a company creates a complete set of consistent propositions, it is unlikely to produce a high-performing and sustainable strategy. If, for instance, the value and profit propositions are strong, but the people proposition doesn't motivate employees or other constituencies, the organization may experience temporary but unsustainable success. This is the classic case of execution failure. Likewise, an organization that offers a motivating people proposition but lacks a strong value or profit proposition will find itself mired in poor performance. This is formulation failure.

Each proposition may need to address more than one group of stakeholders, as when successful strategy execution rests on the buy-in of not only an organization's employees but also groups outside it, such as supply chain partners. Similarly, a company in a business-to-business industry may have to formulate two value propositions: one for the customer and another for the customer's customers.

Now let's consider where the two approaches diverge. Under the structuralist approach, an organization's entire system of activities, and thus its strategy propositions, needs to be aligned with the distinctive choice of pursuing either differentiation or low cost, each being an alternative strategic position in an industry. A strategy is unlikely to be successful, for instance, if the value and profit propositions are aligned around differentiation but the people proposition is targeted at low cost. Under a reconstructionist strategy approach, high performance is achieved when all three strategy propositions pursue both differentiation and low cost. This alignment in support of differentiation and low cost enables a company to open new market space by breaking the existing value-cost trade-off. It allows strategy to shape structure. It is also alignment that leads to more sustainable strategy, for either approach. While one or two strategy propositions can be imitated, imitating all three, especially the people proposition, is difficult (see the exhibit, "Achieving Strategy Alignment").

It is the responsibility of an organization's top executives to make sure that each proposition is fully developed and all three are aligned. They alone are suited to this type of broad strategy work; executives with a strong functional bias – marketing, manufacturing, human resources, or other functions – tend to miss the larger strategy picture. The marketing team, for example, may dwell too much on the value proposition and pay insufficient heed to the other two. Similarly, executives with a manufacturing bias may neglect buyer needs or may treat people as a cost variable. If an organization's leadership is not mindful of these tendencies, it is unlikely to develop a full set of properly aligned strategy propositions.

Choosing the Right Strategic Approach

A structuralist approach is a good fit when:

- Structural conditions are attractive and the organization has the resources and capabilities to build a distinctive position
- Structural conditions are less than attractive but the organization has the resources and capabilities to outperform competitors

A reconstructionist approach is a good fit when:

- Structural conditions are attractive but players are well-entrenched and the organization lacks the resources or capabilities to outperform them
- Structural conditions are unattractive and they work against an organization irrespective of its resources and capabilities

When structural conditions and resources and capabilities do not distinctively indicate one approach or the other, the right choice will turn on the organization's strategic mind-set.

Structuralist:

- The organization has a bias toward defending current strategic positions and a reluctance to venture into unfamiliar territory

Reconstructionist:

- The organization has an orientation toward innovation and a willingness to pursue new opportunities

While managers are well-informed about the ways in which structure shapes strategy,[4] there is little knowledge of how to align the three propositions so that strategy can shape structure. In the next section of this article, we look at the city-state of Dubai to show how blue ocean strategy alignment enables an organization to reconstruct the environment. Dubai has redefined the role and activities of its government, yielding one of the fastest-growing economies in the world for two decades.

Achieving Blue Ocean Strategy Alignment

Dubai's success would have been unthinkable 30 years ago. Cement structures were virtually absent in its unforgiving desert. Job opportunities were dismal, and medical services were poor. People lived in huts thatched with palm fronds and tended sheep in relentless heat.

Yet strategic decisions by the emirate's leaders allowed Dubai to overcome seemingly insurmountable structural disadvantages. It has been an island of stability in a politically turbulent region. Only 5% of its revenues now come from oil and natural gas – down from 30% a decade ago. Indeed, Dubai is arguably the only Arab economy that has achieved substantial integration into the global economy outside the hydrocarbon sector and has emerged as a premier tourist and business destination across the globe. Although Dubai, like the rest of the world, is being buffeted by the global financial crisis, and its future depends on how it deals with that crisis, its reconstructionist blue ocean strategic move – aligning the three propositions around differentiation and low cost – has so far brought the emirate unprecedented profitable growth.

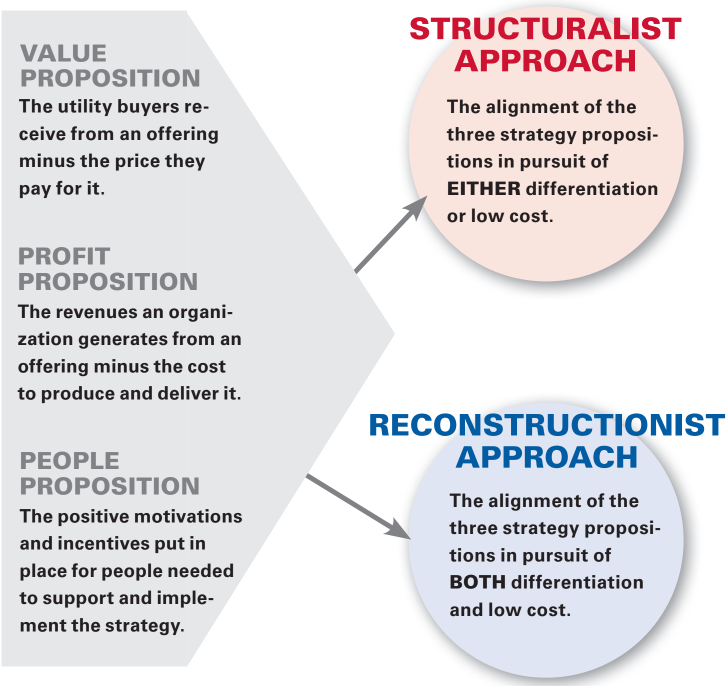
Dubai's value proposition has targeted foreign investors whose money fuels the state's economic development. Its profit proposition has allowed the government to benefit and extract revenues from those investors. Dubai's people proposition has motivated its own citizens and its external partners – foreign expatriates – to buy into the country's value and profit propositions and support its strategy.

The value proposition. At the heart of Dubai's success has been a value proposition to foreign investors that is unlike those of other emerging economies. The value proposition begins with a dozen world-class free zones with unbeatable incentives for investors. To achieve differentiation, the government allows 100% foreign ownership and free repatriation of capital and profits. To lower foreign investors' costs, it charges no import or re-export duties. The corporate tax rate for the first 15 to 50 years of operations is zero and can be extended.

To stand out further and simultaneously lower investors' costs, Dubai has also expedited its registration processes, allowing companies to get licensed to conduct business in under a half hour. All documentation is in English, and the emirate's transparent legal system is based on British law (even the chief justice is British). Dubai also offers world-class air, port, and shipping services to make the logistics of doing business more efficient.

Clearly, Dubai has provided a package for foreign investors that is both differentiated and low cost, and it is this combination that has fueled Dubai's strong growth. Compare its value proposition for foreign investors with that of Shanghai, China's biggest commercial center (see the exhibit "Dubai's Value Proposition"). Shanghai imposes a complex and opaque legal system on foreign investors and requires incoming companies to be familiar with China's norms, customs, and politics. Although Shanghai is one of the largest and fastest-growing economies in the world, Dubai has outperformed it on many measures.

Achieving Strategy Alignment



The profit proposition. How does Dubai generate revenues to support the state, given that corporate and personal taxes are negligible? It has done so by finding differentiated ways of generating revenues while also lowering its cost structure. Unlike other Arab governments, Dubai's has been run like a large business enterprise. Its ruler, Sheikh Mohammed bin Rashid al-Maktoum, is frequently quoted as saying, "What's good for business is good for Dubai." Instead of exploiting conventional income channels such as corporate and personal taxes, which would discourage foreign investors, the government has invested in the infrastructure that supports the investors' activities – shipping and port services, transport, tourism, aviation, real estate development, export commerce, and telecommunications. These investments have allowed the government to directly profit from its unique, low-cost value proposition.

One example is DP World, 80% owned by the government through Dubai World. DP World operates the Jebel Ali port and complex in Dubai, where more than 6,000 companies are based. Another is Nakheel, wholly owned by Dubai and now one of the world's biggest real estate developers. Nakheel is slated to develop half of all residential construction projects in the emirate over the next 10 years, allowing the government to profit from the housing needs of foreign employees. And with its ownership of Emirates Airlines, the government makes money on the high volume of business travelers and cargo flowing into Dubai. In serving foreign investors, the government's businesses have acquired the expertise to build global operations that generate yet more money. DP World, for instance, now operates over 50 ports in 31 countries. The result has been strong revenue growth for the state and a global reputation for quality.

Dubai's profit proposition has been not just differentiated: Economic development and government profitability are bolstered by the simultaneous pursuit of low costs. In Dubai, expatriates always remain expatriates: Some 80% of its growing population is now foreign. By restricting citizenship, the government has kept its social liabilities to a minimum. What's more, having made the strategic decision to become a part of United Arab Emirates, Dubai does not need its own military, diplomatic corps, or monetary agency. Abu Dhabi, the UAE capital and possessor of vast oil reserves, bears most of the costs of maintaining the federal government. These factors have combined to form a profit proposition that breaks the existing value-cost trade-off. (See the exhibit "Dubai's Profit Proposition.")

The people proposition. Dubai has become a cosmopolitan state with more than 1 million people from over 100 countries around the globe. With the onslaught of foreigners, many of them from the West and Asia, how has Dubai preserved its Arab traditions and fostered social tolerance in its citizens? And with no social benefits or citizenship rights to offer, how did Dubai attract the foreign talent central to the government's ability to execute its strategy? By creating people propositions for both constituencies that have delivered differentiated value and lower costs. The people proposition embraces both economic and emotional factors, because these factors can either bring value to people or be a significant cost to their livelihoods.

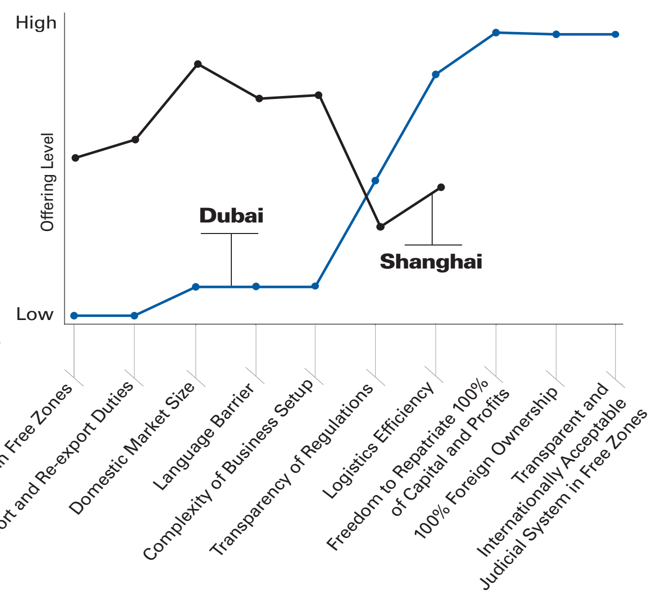
Let's look first at the people proposition for citizens. They have access to a generous social security system and are virtually guaranteed a government job. They receive extensive state

Dubai Strategy Propositions

The strategy canvas is an analytical framework we developed in our research on blue ocean strategy, which can be used to express an organization's three strategy propositions. The horizontal axis captures the range of factors organizations offer. The vertical axis depicts the offering level. The strategic profile is a graphic depiction of an organization's relative performance across these key factors. Here we present the strategic profiles for Dubai's three strategy propositions versus those of other emerging markets and Arab economies.

Dubai's Value Proposition

Shanghai was used as a strategic reference to show how Dubai's value proposition has been compelling to foreign investors despite its much smaller domestic market size.



assistance, including medical care, sickness and maternity benefits, child care, free or subsidized education, pensions, unemployment benefits, and in some instances housing and disability benefits, all of which have vastly improved their quality of life.

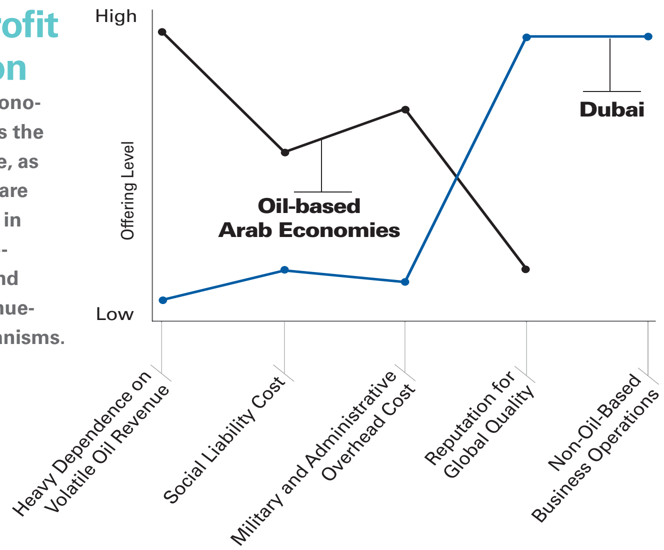
At the same time, the government has taken measures to preserve Dubai's culture and heritage, in part by promoting virtual boundaries between citizens and foreigners. Citizens receive free plots of land from the government along with interest-free loans or grants to build homes on the outskirts of the city. Their children go to nearby Arabic schools that provide Islamic religious teachings along with modern education. Here, traditional Arab values and cultural norms take center stage. And thanks to a small citizen population and revenues from business investments, the welfare of the people has been funded by the government at no cost to them. (See the exhibit "Dubai's People Proposition for Citizens.")

Dubai's people proposition for expatriates has been equally compelling. Zero income tax has made their already generous income even more attractive. Housing is also relatively cheap; a recent study revealed that luxury real estate in Dubai costs one-fifth to one-third less than it does in other major commercial centers. Dubai differentiates itself from developing countries like China and India by allowing foreigners to own their properties outright. As these incentives have attracted foreigners, a multicultural environment has sprung up; almost anyone can find a part of their home country experience in Dubai – French wines, Indian saris, Japanese sushi. It even boasts the world's largest indoor ski facility. Dubai's people proposition, in short, has offered foreign talent a rich and unique experience at a low cost.

As Dubai's case illustrates, aligning the three strategy propositions creates reinforcing synergies. With a compelling low-cost and differentiated value proposition, Dubai has attracted foreign businesses, and in serving them has found new and lucrative ways of making money. And because its value and people propositions have attracted foreigners in such numbers, Dubai has been able to create a cosmopolitan environment that is an appealing holiday destination and residence in its own right. Finally, the profit proposition has allowed Dubai to reduce government overhead and use its business revenues to both reinvest in the businesses, thereby giving foreign investors more reason to go there, and provide its own citizens a quality of life their ancestors could not have imagined. Of course, these synergies can be weakened by an external shock like today's global financial crisis. But if and when Dubai succeeds in recovering from the downturn, they will regain strength.

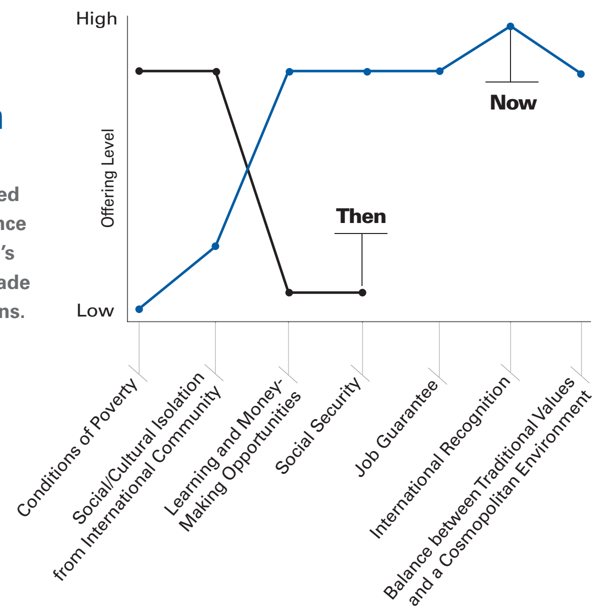
Dubai's Profit Proposition

Oil-based Arab economies were used as the strategic reference, as these economies are most comparable in terms of their geopolitical, social, and government revenue-generating mechanisms.



Dubai's People Proposition for Citizens

Dubai's past was used as a strategic reference to depict how Dubai's new strategy has made a difference to citizens.



Blue ocean strategy alignment applies not just to governments but to companies and nonprofit organizations as well (see "Comic Relief's Alignment of the Three Strategy Propositions" for more on how it works in the nonprofit sector).

When Strategy Is Not Aligned

Our research suggests that failure to align the three strategy propositions is a key reason why many market-creating innovations fail to become sustainable businesses. Think of the online music provider Napster. Founded in 1999, it had pulled in more than 80 million registered users with its value proposition: simple, easy-to-use software that allowed music files to be indexed, searched, and freely shared across computers throughout the world. Yet within a year, Napster was under siege.

Record labels, worried that the free sharing of music would destroy their sales, approached Napster to work out a revenue-sharing model that would benefit both sides. But excitement over its spectacular growth prevented Napster from appreciating that it needed a people proposition aimed at this critical constituency. Instead of working to build a win-win arrangement with the labels, Napster belligerently declared that it would advance with or without the industry's support. The rest is history: Napster was forced to shut down under a barrage of copyright-infringement suits before it had developed a profit proposition to benefit from its huge user base. Without three aligned strategy propositions, Napster's market-creating innovation failed to deliver commercial success.

Contrast Napster's actions with those of Apple, which launched the iTunes Music Store in 2003 and in the space of five years became the number one music seller in America. Like Napster, iTunes offered a compelling value proposition: Its online music store allowed buyers to freely browse more than 200,000 songs, including exclusive tracks, listen to 30-second samples, and download an individual song for 99 cents or an entire album for $9.99. Moreover, iTunes guaranteed high sound quality along with intuitive navigation, search, and browsing functions.

But Apple did not stop there. It built an attractive people proposition for the five major music companies. From the get-go, Apple gained the support of BMG, EMI Group, Sony, Universal Music Group, and Warner Bros. Records by ensuring that music was downloaded with proper copyright protection and paying the music companies 65 cents for every song downloaded. And because iTunes not only

Comic Relief's Alignment of the Three Strategy Propositions

Comic Relief, a UK fundraising charity, was created in 1985. In 20 years it achieved 96% national brand awareness in an oversaturated industry and has now raised more than £550 million in the UK alone, drawing funds from wealthy donors, low-income families, and even children. It reshaped the world of charity fundraising.

Value proposition. Traditional fundraising charities use feelings of guilt and pity to pull in donations, focus on securing and recognizing large gifts from high-income older donors, and solicit funds year-round. Comic Relief, by contrast, uses a breakthrough approach, Red Nose Day, that combines a day of outrageous community "fun"draising with a star-studded comedy telethon, Red Nose Night. Participants need only buy a red nose for £1 or raise money by doing silly antics that friends sponsor. Even the tiniest donation is valued and recognized. Comic Relief creates this unique experience only every two years to prevent people from feeling bored or hassled. Its value proposition allows donors to make a huge difference while having a great time, at a low cost. Today, Red Nose Day is virtually a national holiday in the UK.

Profit proposition. Comic Relief has an unbeatable profit engine. Red Nose Night, although it's an extravaganza, doesn't cost a penny: The network, the studios, and the stars donate their services. And Red Nose Day likewise has very low costs as the public does the bulk of the fundraising. Unlike traditional UK charities, Comic Relief avoids large advertising costs, thanks to the widespread media attention that Red Nose Day generates. And because Comic Relief makes grants to other charities, rather than introducing competing programs into an already crowded market, its costs are low, creating a differentiated, low-cost profit proposition.

People proposition. With a small number of motivated staff members who are inspired by its value proposition, Comic Relief's people proposition focuses on the public, corporate sponsors, and celebrities whose buy-in is needed to make the value and profit propositions sustainable. The organization gives these constituencies a strong sense of pride and belonging, and a chance to better the world while having fun – at little or no financial cost. Corporate sponsors and celebrities also receive tremendous positive free publicity. The differentiated, low-cost people proposition appeals to those of every socioeconomic stratum.

earned money for every song downloaded but also drove sales of Apple's already popular iPod, it created a reinforcing cycle of profit across the two platforms. The alignment across iTunes's value, profit, and people propositions not only ushered in a new era of music but is sufficiently hard to imitate that to date no other online music store has been able to establish a firm footing in the industry.

The Napster/iTunes story is all too common. Although innovations aimed at creating new markets clearly have strategic importance for an organization's profitable growth, we all know that many of them result in only temporary success or fail outright. Just ask yourself this question: Which company pioneered or created the video recorder? When we ask MBA and executive audiences this question, the answer is almost always Sony or JVC. When we ask which company first developed the personal computer, the answer is almost always IBM or Apple. These are, of course, the wrong answers. The video recorder was created by a company called Ampex. The PC was created by a company called MITS (Micro Instrumentation and Telemetry Systems). We remember Apple, IBM, Sony, and JVC because they are the ones that first achieved strategy alignment and with it commercial success, establishing their brands in that market space. In 20 years time, what company will we remember as the pioneer of online music, Apple or Napster?

The key lesson here is that managers should not get too excited about innovation per se. It is just the beginning. The real difference between success and failure is strategy alignment. Until executives learn this lesson, billions of dollars will continue to be wasted on market-creating innovations that fail.

The Leadership Challenge

With an increasing number of businesses, governments, and nonprofits facing unattractive environmental and structural conditions, leaders can no longer afford to follow the common practice of letting structure drive strategy in all situations. The economic challenges organizations face today only underscore the importance of understanding how strategy can shape structure. That is not to say, however, that the structuralist approach is no longer relevant. Take any company with multiple businesses. Different business units face different structural conditions with different resources and capabilities and have different strategic mind-sets; a structuralist approach will be a better fit for some units, while a reconstructionist approach will be more appropriate for others. The two strategy schools' assumptions and theories are distinct, and neither is sufficient to deal with the diverse and changing structural and business conditions that organizations face today and in the future. The challenge for leaders, therefore, is to ensure that a robust debate takes place on what the right strategic approach for each business should be and then to enter into the spirit of the framework to develop the right strategy for that unit – be it a structuralist competitive strategy model or a reconstructionist blue ocean strategy model.

Are you and your organization ready for that?

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Notes

1. See *Industrial Market Structure and Economic Performance*, F. M. Sherer (Chicago: Rand McNally, 1970)

2. See *Blue Ocean Strategy,* W. Chan Kim and Renée Mauborgne (Harvard Business Press, 2005).

3. See, for example, Paul Romer, "The Origins of Endogenous Growth," *Journal of Economic Perspectives*, vol. 8 (Winter 1994).

4. See Michael Porter, "What Is Strategy?" HBR (November–December, 1996); and *Competitive Advantage*, (Free Press, 1985).