

Tactical vs. Strategic Approaches to Competitive Positioning -- An Example from the Telecommunications Industry

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Abstract

Many firms take actions which affect their competitive position without considering the longer-term, strategic consequences of those decisions. This is particularly true of many recent downsizing initiatives, which have tended to be "tactical" in the sense of being reactive, focusing on pieces of the business, and with short time horizons. This paper uses examples from a dynamic simulation model of a telecommunications company to illustrate the dangers of such a "tactical" approach to competitive positioning, and contrasts it to a more "strategic" approach which is anticipatory, holistic, and long-term in its viewpoint.

1. Introduction

2. Objectives

3. Methodology

4. Results

5. Discussion

6. Conclusion

Page 1

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Telecoms Face A Complex Set of Strategic Problems

Senior executives of telecommunications companies are faced with complex and important decisions as they contend with major changes in their industry. Competition is increasing substantially with the end of traditional monopolies, the corporatization and privatization of many PTTs, and the liberalization of key markets. The entry of ambitious, lower-cost, more agile competitors is overturning the *status quo*. Additional competition is coming from outside the telephony service industry, e.g., from cable TV operators. And a host of foreign competitors are invading their formerly protected home markets. These new competitors are attempting to "cherry pick" the established telecom's most profitable customers. Cozy international revenue-sharing agreements among the principal players are breaking down. New technological alternatives, e.g., radio in the local loop, are threatening their enormous infrastructure investment and eliminating barriers to entry.

Most of the established telecoms recognize the need to cut their costs dramatically. They have inherited public sector and monopolist inefficiencies, but now confront competitors with radically different cost structures. Their principal option is to down-size staff while seeking major productivity gains through massive investment in IT systems and re-engineering of key business processes. Senior executives feel great pressure to reduce costs quickly in the face of steadily declining prices. But there are governmental and consumer pressures to pass on efficiency gains via further price cuts.

The strategic challenges are made even more complex by conflicting regulatory policies and goals. Telecom regulators desire increased competition and are very concerned that new competitors be given a chance to succeed. Regulators fear that, allowed the opportunity, the dominant telecom will "abuse its monopoly power" to crush the new entrants. The objective of most regulators is to achieve a substantial reduction in the dominant player's market share. At the same time, many regulators are mandating price reductions, e.g., through "RPI-x" price policies which restrict price changes to less than the rate of inflation. But what if inflation is low, but "x" is high? If the rate of price reduction is too fast, the fledgling competitors may be hurt more than the established telecom. "RPI-x" pricing is intended to provide incentives for increased efficiency, since the profits from bringing costs down faster than prices -- in theory -- accrue to the benefit of the company. In fact, most regulators view substantial profits as "monopoly profits" and react by increasing "x."

And in an attempt to ensure the success of new competitors, regulators often "tilt the playing field" to their advantage. The dominant telecom generally is required to provide "essential public services" even if they are unprofitable, e.g., service to low volume users in remote areas. Competitors often are relieved of such obligations, nor are they usually required to pay a share of this "access deficit," until they become established. The dominant player often has restrictions on the products and services it may offer, e.g., cable TV, mobile, video on demand, while competitors are far less restricted. And the regulator generally requires the dominant telecom to offer competitors cheap, easy interconnection to its network.

Last, but hardly least, telecom executives must contend with the longer-term threat of "commoditization" of basic telephony services. This is driven by substantial, persistent overcapacity. It results in competition primarily on price and a steadily eroding return on assets in a very asset-intensive business. Under these circumstances, the incentives to continue investments in new technologies or products are low.

Tactical vs. Strategic Thinking

Some senior telecom executives do not have to be convinced that the future will be very different from anything that they, their colleagues, or their competitors have experienced. Others, perhaps out of preoccupation with immediate problems, act as though the future will be a familiar extrapolation of the past. In either case, there is a tendency to be reactive to the business environment -- not to begin serious thinking about the strategic implications of fundamental changes in the structure, regulation, competitive dynamics, technology, and products of the industry until actually confronted with such changes. At that late stage, the changes can be disorienting. Companies risk being unprepared, off balance, and vulnerable.

Ask a sample of telecom executives if they are thinking strategically about their company's future and you will get a resounding "yes!" "Of course we are." "That is our job." Then take a close look at what they actually are doing. The chances are you will find a tactical approach being taken to complex and important business problems. What are the key differences between tactical and true strategic thinking? And what practical difference does it make, for example in terms of corporate financial performance, whether senior executives take one approach or the other?

A tactical approach to complex business problems is characterized by:

- **reaction**, i.e., not taking the problem seriously until it becomes a crisis;
- **decomposition**, i.e., breaking the problem up into "manageable bits;"
- **over-simplification**, i.e., belief that a complex problem has a simple solution;
- **short time horizon**, e.g., expecting substantial change in 1-2 years; and
- reliance on linear, uni-functional, feed-forward, input-dominated models, e.g., **financial spreadsheets**.

A good example of tactical thinking is when a telecom relies exclusively on organizational down-sizing and "re-engineering" to restore its competitiveness.

By comparison, a strategic approach is:

- **anticipatory**, i.e., seeks early warning of a problem and actions to mitigate its impacts;
- **holistic**, i.e., deals with all important dimensions of the problem simultaneously;
- **systematic**, i.e., recognizes the need for time-phased, multi-faceted solutions to complex problems;
- **long-term**, e.g., takes a 5-10 year horizon; and
- based on non-linear, multifunctional, feedback, **theory-rich models**, e.g., the **SMS-Telecom** model described below.

An example is a strategy that combines near-term cost-cutting in order to stabilize price competition, mid-term quality leadership in order to stop the erosion of market share, investment in

IT systems to improve productivity and protect longer-term profits, and development of new products in order to slow commoditization.

In the following section, a computer simulation model is used to demonstrate the strategic approach to complex issues facing the telecommunication services industry. Simulation tests contrast the effects of tactical vs. strategic thinking on the competitive position, market share, and profitability of a typical telecom.

Using a Model to Analyze Tactical vs. Strategic Approaches

The Telecom Model

As an example, we will use the case of a hypothetical, though typical, telecommunications market which is opened to competition. The former monopoly, which we shall call "Telecom," is faced with an aggressive, lower-priced competitor, especially in its lucrative business and long-distance call markets. Competition started in 1992, and thus far Telecom has lost 20% of its share of the lucrative business market. If Telecom continues in a "business as usual" manner, the prospects are for continued loss of share at these high-profit customers. Telecom will therefore be left with a smaller, less-profitable volume of business. How can Telecom develop a strategic approach to dealing with this competition? What are the consequences of failing to do so?

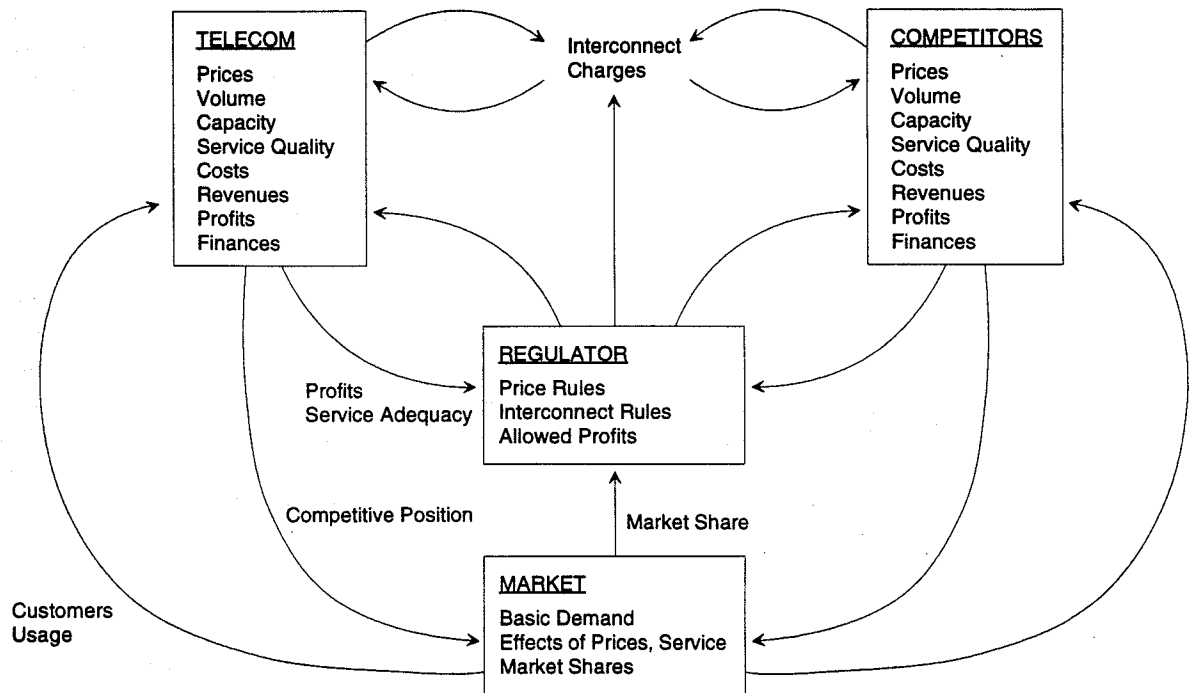
In order to analyze these questions, we have set up Pugh-Roberts Associates' Strategy Modeling System SMS -- *Telecom* to represent the hypothetical company (see Lyneis 1993). As illustrated in Figure 1, SMS -- *Telecom* is organized into four sectors:

1. Telecom Sector -- volume of business; acquisition and utilization of access and network capacity; service quality; pricing; costs, revenues, and profits; and financing.
2. Competitor Sector -- similar to Telecom, but a less detailed representation of one, aggregate competitor.
3. Market Sector -- basic demand for telephony services (lines, call volumes); effects of prices and service offerings; determination of market shares for Telecom and competitors.
4. Regulator Sector -- where appropriate, the setting of maximum prices or allowed profits; interconnect rules.

The important interactions among the sectors are also illustrated in the figure. Telecom's competitive position (based on prices, service quality, and service offerings) relative to competitor offerings drives the determination of market shares in the Market Sector. Prices and service offerings also affect the size of the market. Numbers of customers and usage then feed back to Telecom and the Competitor. The Regulator monitors information about profits, costs, and service adequacy from Telecom and Competitors, and market shares from the Market Sector, to establish or influence Telecom and Competitor pricing. Finally, interconnect charges are established through an interplay between Telecom, the Competitors, and the Regulator.

In taking a strategic view of the telecommunications business, SMS-*Telecom* focuses on the key cause-effect relationships which drive short-, mid- and long-term performance. For example, the model explicitly links the amount and technological characteristics of network capacity to utilization rates, cost efficiency, and service adequacy in the short-term, and to competitive position, market share, revenues, profitability, and thus return on investment in the mid-term. The model includes the

Figure 1: SMS - Telecom Model Architecture
STRATEGY MODELING SYSTEM



many factors that cause network utilization, costs, and service to vary over time. It reflects the way that network capacity combines with other factors (e.g., pricing, introduction of new services, staff experience levels, and growing customer sophistication), to determine Telecom's competitive position. And it "closes the loop" by indicating how capacity investments and pricing of network services affect: the competitor's utilization of Telecom's network; the cost and service differentials between Telecom and the competitor; the competitor's investment strategies; the competitor's rate of market penetration; and thus Telecom's future requirements for network capacity.

While taking a strategic view, *SMS-Telecom* represents important details:

1. Customer Classes -- Residential and Business
2. Products -- Access lines, local calls, long-distance calls, international calls, and other products and services
3. Capacity -- local access, local switching, trunk switching, transmission (further distinguishing between analog and digital, and copper and fiber as appropriate)
4. Employees -- Access installation and maintenance, switching maintenance, operator services, sales and billing, and administration

Several key concepts underlie the dynamics described in the following sections:

- *Competitive Position* -- an index combining the effects of price, service quality, and product features, all relative to the competition, on the attractiveness of a company's

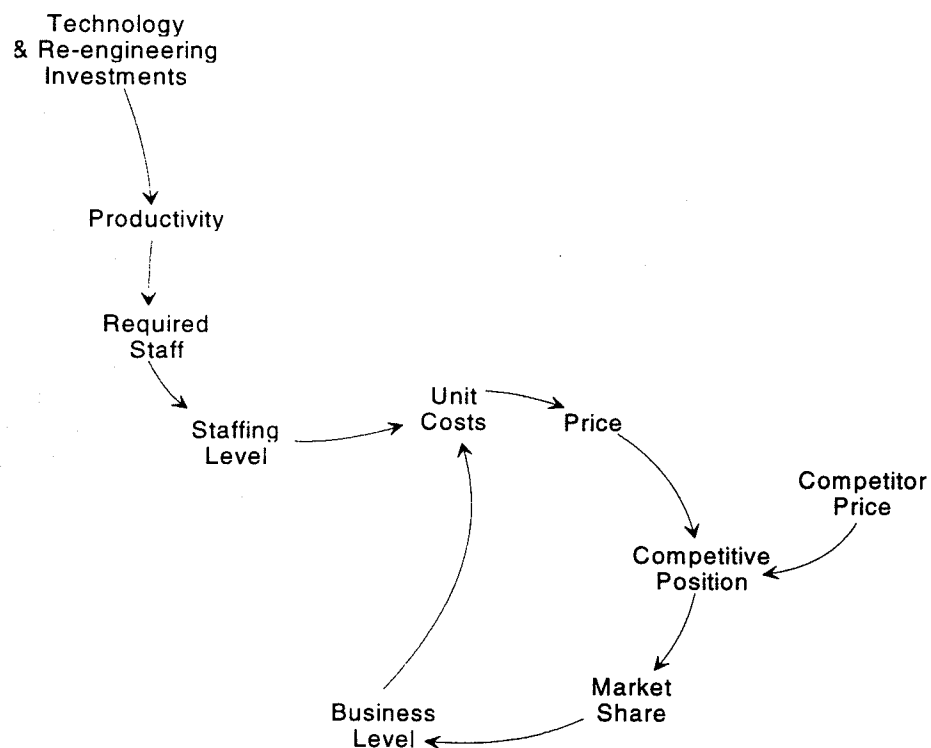
product offerings to the market; when its index is less than 1.0, Telecom loses market share, and conversely, it gains market share when the index is above 1.0; a competitive disadvantage in one area (e.g., price), can be offset with advantages in other areas (e.g., service).

- *Service Quality* -- a measure of Telecom's ability to satisfy customer requirements for installation, maintenance, and operator services, and to connect and deliver calls reliably; quality in each area is based on requirements for the service relative to Telecom's capacity (people, equipment, technology) to fulfill that service.
- *Productivity* -- The amount of service that can be provided per person-year of effort; productivity depends on experience, skill level, morale, and technology.
- *Competitive Response* -- competitors are assumed to price at a discount to Telecom's prices in order to achieve target penetration of selected markets; as penetration is achieved (and/or as time passes), competitors become increasingly concerned about achieving target profitability as well, and will reduce their discount accordingly.

A Tactical Downsizing Approach to Competitive Pressures

Figure 2 illustrates the key dynamics of a downsizing approach to a lower-priced competitor. In order to reduce costs, Telecom makes investments in technology and "re-engineering" to improve productivity and thereby reduce the number of employees required to meet projected business levels. Actual staffing levels are reduced in parallel with the planned improvements in productivity. As a result, unit costs fall and prices can be reduced. Competitive position improves, and Telecom's market share stabilizes, or perhaps improves.

Figure 2: The Short-Term, Tactical Approach to a Lower-Priced Competitor



Figures 3 through 6 show simulated Telecom performance with this downsizing approach, compared to a “business as usual” Base Case. Investments are initiated in 1994 and employment levels reduced in parallel with expected productivity improvements (see Figure 3). As a result, unit costs fall (Figure 4), prices are reduced such that competitive position improves (Figure 5), and market share stabilizes (Figure 6). Downsizing appears successful. But what happens after 1996?

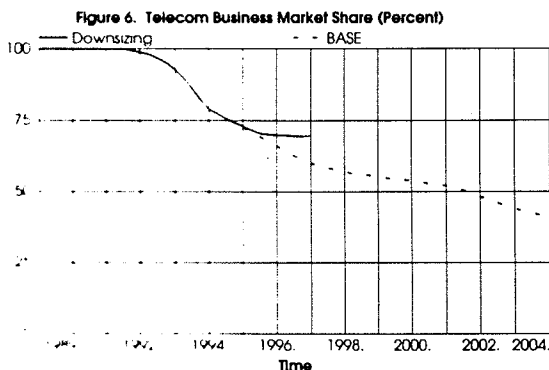
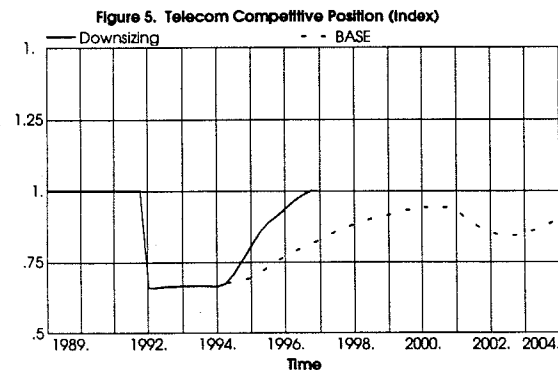
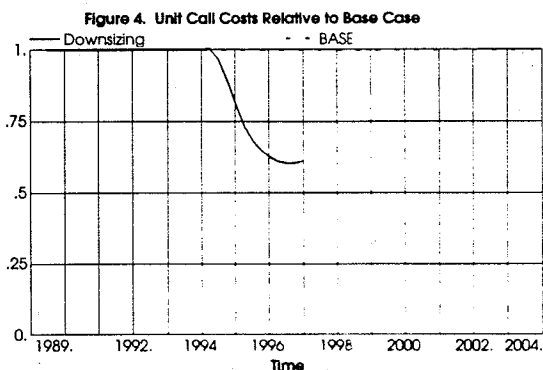
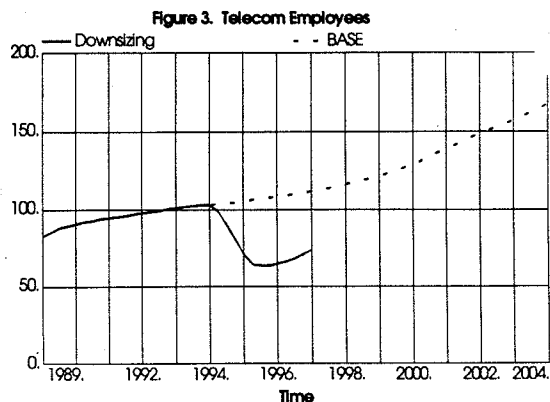
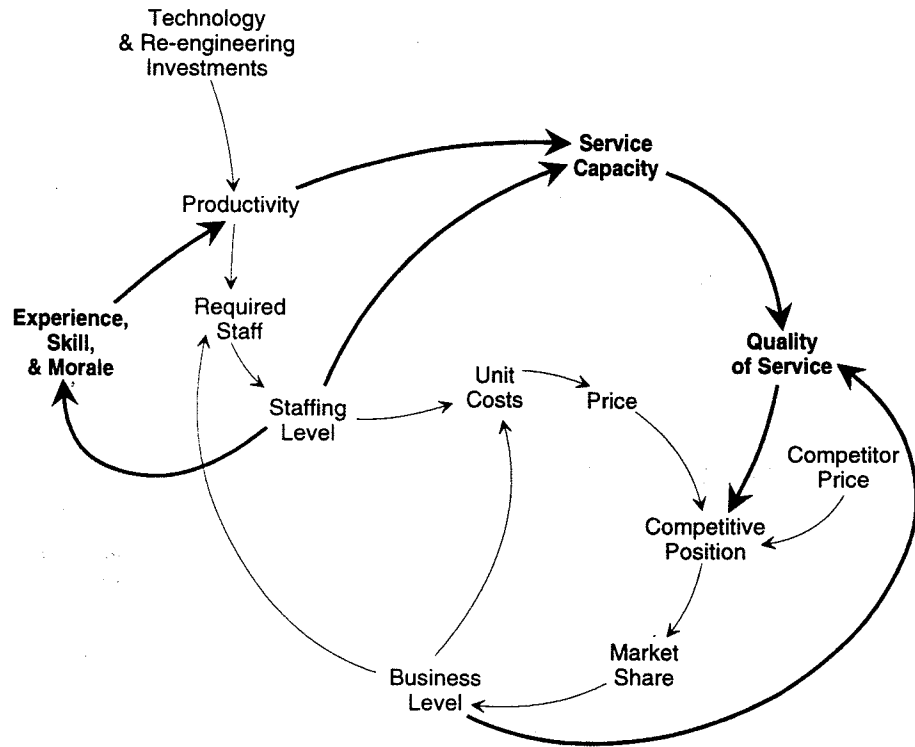


Figure 7 shows some important mid-term dynamics which often result from the downsizing of a company. In order to reduce staffing levels, particularly of “white collar” employees, companies often provide incentive programs to avoid forced layoffs. But in many cases these incentive programs encourage the best people to leave the company -- i.e., those that can most readily find a job elsewhere and would like to be paid to start a new chapter in their careers. As a result, the company loses some its most experienced and highest skilled people.

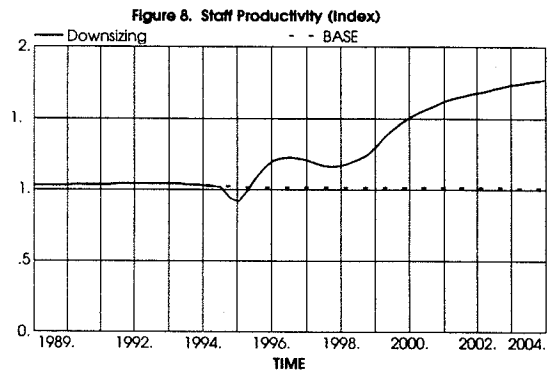
And for those that remain, the fear of forced layoffs and seemingly poor prospects in the company reduce morale. The combination of lower staff skills and experience and poor morale reduce productivity, such that Telecom's "service capacity" falls relative to the amount needed to meet customer requirements. Competitive position deteriorates because of a reduction in service quality, and market share begins to erode again. (As a real example, see Wall Street Journal 1992).

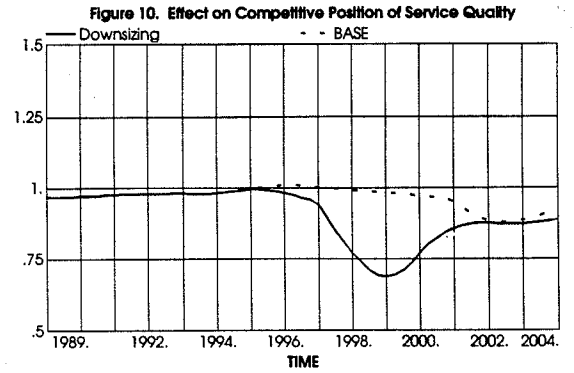
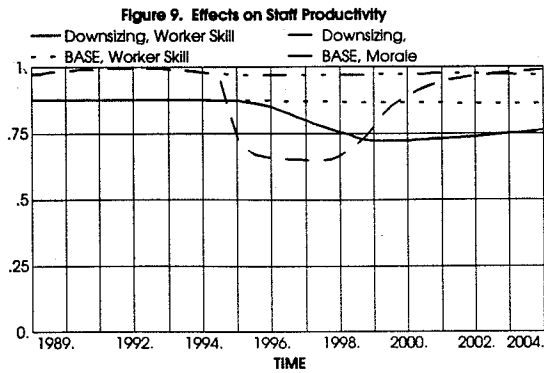
Figure 7: Mid-Term, Offsetting Effects of Downsizing



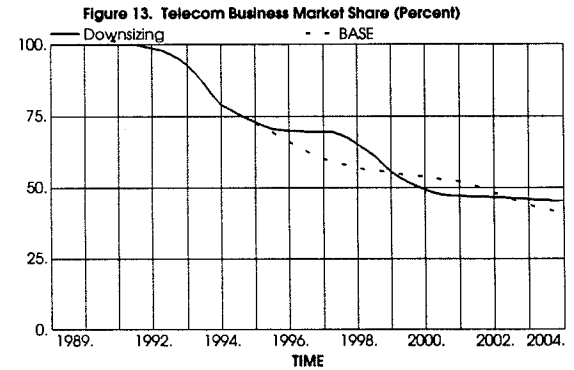
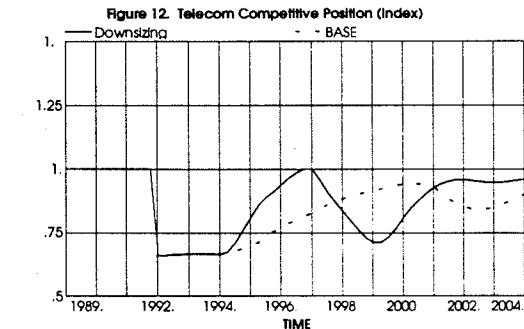
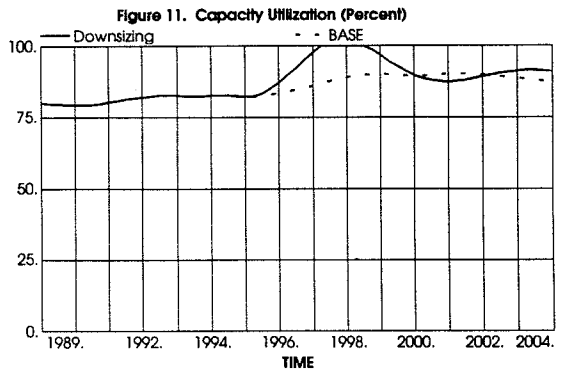
This downsizing is tactical, rather than strategic, and it is implemented in a way that actually weakens the ability of the company to compete in the longer term. It is a uni-dimensional response, based on a primarily financial model. It is implemented with too short a time horizon. And it is viewed as "the solution" rather than as a key component of a much more comprehensive strategy.

Figures 8 through 14 show simulation output corresponding to these dynamics. After a brief delay (the investments do not have an immediate effect), productivity improves (Figure 8). However, it stops increasing after 1996, and even falls for a year or so, because of the adverse effects of morale and staff skill (Figure 9). Because expected productivity gains did not fully materialize, the staff reductions diminish Telecom's service capacity. As a result, capacity falls short of customer requirements and service quality deteriorates (Figure 10).

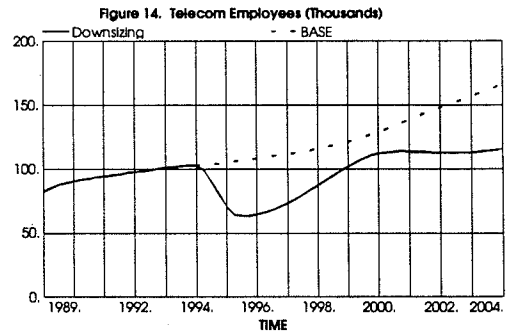




Service capacity also falls short of customer requirements because the reversal of recent market share trends means that growth in business volume exceeds the levels forecast when capacity was planned. As a result, utilization rates increase, causing failed calls, poor operator service, and delayed installations and maintenance (Figure 11).



Therefore, in spite of the improvement in costs, competitive position declines (Figure 12), and the erosion of market share resumes (Figure 13). And because of the reduced productivity, Telecom ends up having to increase employment levels (Figure 14). Downsizing, implemented without regard to these secondary and tertiary impacts (i.e., "tactically"), produces short-term cost savings, but long-term problems.

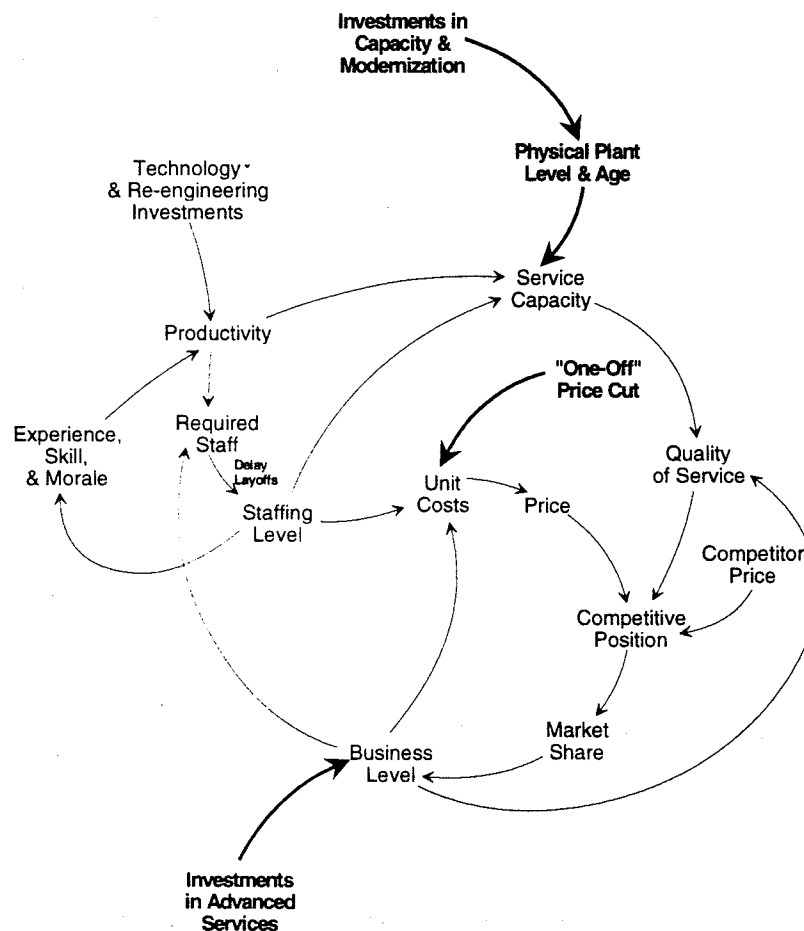


A Strategic Investment Approach to Competitive Pressures

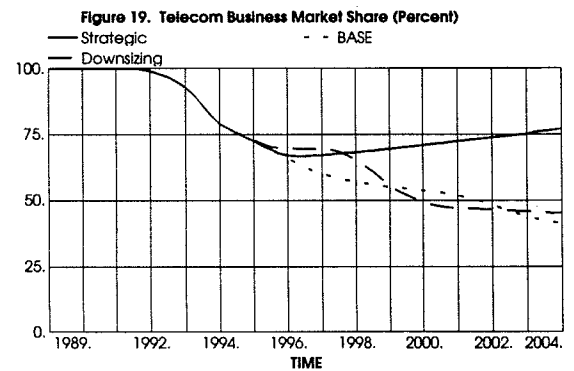
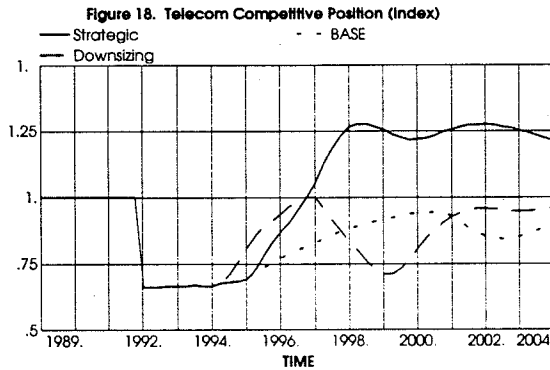
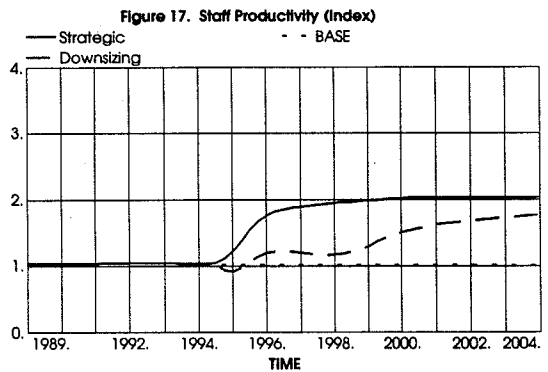
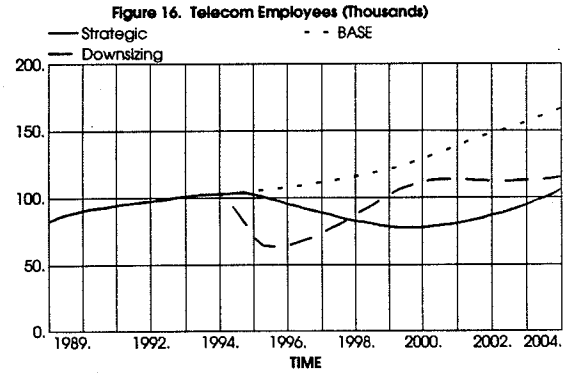
A strategic approach to competitive pressures recognizes that effective solutions must consider the interactions between parts of the business, and anticipate competitor actions. It further recognizes the need for time-phased, multi-faceted solutions and a long-term view, for example, the need for short-term investments, even at the expense of profitability, to build the foundation for a sustainable competitive advantage in the future. As an example, elements of a strategic approach, illustrated in Figure 15, might include:

- Investments in productivity enhancing technologies and “re-engineering” as in the tactical approach, but with actual staff downsizing achieved mostly through normal attrition in order to mitigate the morale, experience, and skill effects described above;
- Investments in advanced services and products that generate additional growth and higher market share than otherwise, thereby soaking up the surplus staff created by the productivity investments; and
- Investments in plant capacity in anticipation of the additional growth resulting from Telecom’s initiatives.

Figure 15: A Strategic Approach



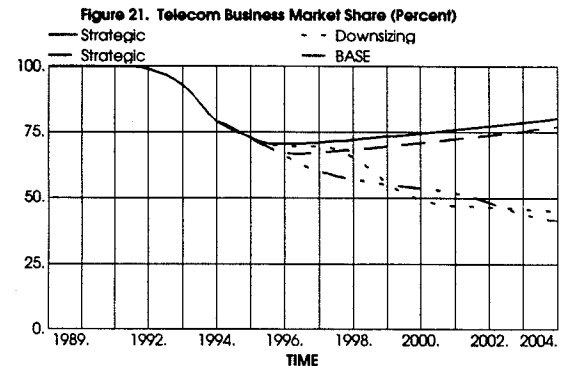
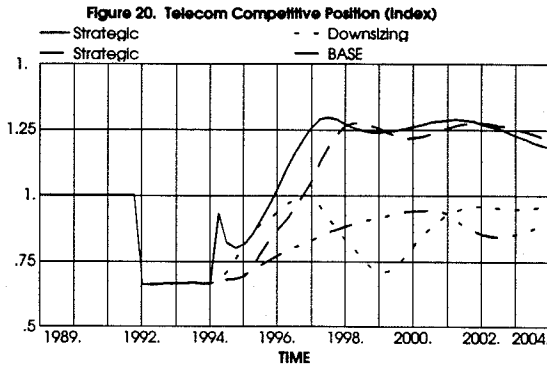
Figures 16 through 19 show simulation output corresponding to this strategic approach. As shown in Figure 16, staff downsizing occurs much more slowly. Therefore productivity improves significantly as a result of the investments (Figure 17), without the negative quality and morale impacts of the tactical approach. Because downsizing is implemented over a longer period, however, unit costs fall more slowly such that the improvement in competitive position is delayed (Figure 18). But, investments in capacity and holding on to staff avoid the drop in service quality, and investments in advanced services and products push Telecom's competitive position above that of the competition. While market share drops a little further in the near term than with the tactical downsizing, the strategic approach produces a permanent turnaround and increase in share (Figure 19).



A Strategic Pricing Approach to Competitive Pressures

In light of the delayed improvement in competitive position, Telecom might employ a short-term, strategic price reduction to targeted market segments (here business customers, for long distance and international calls) in combination with the strategic investments described above. This approach is another form of investment, as it sacrifices some short-term profits in order to minimize loss of market share while the longer-term investments take effect.

Figure 20 shows the simulated behavior of Telecom taking a 35% price cut in these targeted markets starting in 1994. Telecom's competitive position improves immediately, but then falls back somewhat *as competitors respond*. It gradually improves again as Telecom's cost reduction and investment initiatives take hold, and competitors give up the fight. On balance, market share improves somewhat versus the strategic investment approach alone (Figure 21), while profits are also somewhat higher.



The degree of success of the strategic pricing strategy depends in large part on the competitive situation facing Telecom. In most startup competitive situations, competitors generally price at a discount to Telecom in order to achieve market penetration. The actual price a competitor charges is less important than the size of the discount. Therefore, within reason, competitors tend to try to maintain the discount necessary to achieve penetration regardless of what Telecom does with its prices. We have done a number of simulation experiments varying this situation, and have concluded that the strategic price-cutting described here is most successful when:

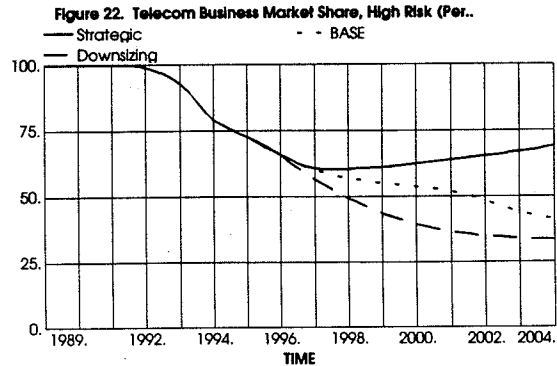
- Competitors are past the initial roll-out stage, have gained some market share, and are therefore becoming more concerned about profitability and the absolute level of their prices;
- Competitors do not have much spare capacity, and therefore are less eager to enter a price war to gain further share (in contrast to when they have lots of spare capacity, and therefore need additional volumes, almost at any price, to fill that capacity and drive down unit costs).

If these conditions are not met, competitors maintain a discount to Telecom's price, and the price cut merely throws away profits without achieving any market share benefit.

Risk Analyses

In the above experiments, we assumed that planned investments produced the expected return in a timely fashion. What would happen if investment benefits are delayed (by two years), cost more to achieve (50%), and there are greater morale and experience effects (50%)? How do the tactical and strategic approaches perform in this environment?

Figure 22 shows that in a "high-risk" environment, the strategic approach is even more essential. In fact, tactical downsizing in this environment does not produce even a short-term improvement in market share.



The Bottom Line

The difference between a strategic and tactical approach to competitive positioning will have a significant impact on the long-term market and financial prospects of a company. In this example, the strategic approach produced a 35 percentage point (near doubling) of market share to key customers in 2004 over the tactical approach, and a \$9 billion improvement in cumulative profits over the 10 year period from 1994 to 2004 (a 30% improvement).

Conclusion

To prosper, a company must continually learn and adapt. *Anticipation* is the key! This is fundamentally a human process, involving a significant shift in corporate culture. Staff at many levels must understand, have confidence in, and be committed to the need to operate the business differently. It also is, necessarily, a top-down process. Especially in a large company, the senior executives must take the initiative in thinking creatively and questioning the "conventional wisdom." For additional discussion of organizational learning, see Weil 1990.

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