

Economics of Strategic Behavior

B8216 January 2021 Block Week

January 3rd --- January 7th

PROFESSOR JACOPO PEREGO

A. ADMINISTRATIVE INFORMATION

Contact Information

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Office hours: Remote office hours via Zoom. Contact me to schedule a meeting

Required Materials

Bruce Greenwald and Judd Kahn (2005): *Competition Demystified* (CD)

Case studies, readings, and class handouts posted on Canvas.

B. COURSE DESCRIPTION

This course examines the underlying economics of successful business strategies, including:

- 1) The sources of long-run competitive advantage.
- 2) The dynamics of competition and competitive advantage.
- 3) Strategic interactions (competitive and/or cooperative) among firms.

Three characteristics distinguish our approach. First, we focus on fundamental strategic decisions that firms face rather than more detailed operation/managerial issues. Second, we seek broad principles that can be applied across many firms and markets, rather than anecdotal success stories or institutional details that apply only in limited cases or as a result of idiosyncratic factors. Finally, we develop these broad principles from the framework of microeconomic theory. As such, potential answers will be subjected to the rigor of economic analysis to test their validity and applicability.

The approach toward teaching and learning is primarily inductive. That is, you will learn the concepts and principles outlined above largely through examples – this is the essence of the case study method. The goal is to carefully study specific business situations and decisions with the goal of extracting broader principles about business strategy, which will then be available to you in a wide variety of managerial contexts. Class time will be split roughly 65/35 between case discussions and lectures.

Good cases are necessarily complex and ambiguous. In preparing for case discussions, you may find sorting through this complexity and ambiguity to be frustrating. The problems presented in the case discussion may not have one correct answer. However, there will generally be a set of insights and solutions that are better than others. And it is in working through the messy details to find these insights and solutions – both in your own preparation and in-class discussion – that the concepts and principles introduced in the readings and lectures will come alive and be enriched for you.

C. REQUIRED PREREQUISITES AND CONNECTION TO THE CORE

The learning in this course will utilize, build on, and extend concepts covered in the following core courses:

Core Course	Connection
Managerial Economics	<ol style="list-style-type: none">1. Understanding market competition and equilibrium thinking (in the short-run)2. Market equilibrium thinking (in the long-run) and barriers to entry3. Strategic Interaction among firms and Nash Equilibrium4. Pricing with market power
Strategy Formulation	<ol style="list-style-type: none">1. Creation of value vs. value capture2. Competing firms

Students will be expected to have mastered these concepts and be able to apply them in the course.

D. COURSE SCHEDULE

Class Schedule is preliminary and subject to change

Fundamentals of Strategy, Sources of Competitive Advantage

The first part of the course is focused on understanding the sources and dynamics of competitive advantages. It presents a simplified approach to business strategy, based on the notion that any long-run competitive advantage must rely on “barriers to entry.” Firms without competitive advantages should concentrate all their efforts on being efficient. Firms that do have competitive advantages need to design strategy with their competitors in mind.

Each segment represents about 3 hours of class time

Segment #	Topics Covered	Suggested Readings
Segment 1	Introduction, Competitive Advantage, Industry Analysis	CD Ch 1 to 3, Enterprise
Segment 2	Competitive Advantage (Demand Side), Platforms Markets	The Economist
Segment 3	Competitive Advantage (Supply Side)	LinkedIn, Aldi
Segment 4	Learning Curve, Vertical Integration, Mergers	Capital One, CD Chapters 5 and 6

Managing Strategic Interactions

After having developed the basic tools for the analysis of competitive advantage, we will use game theory as a framework for analyzing *shared* competitive advantages. The basic issue is simply this: when competitive advantage is shared with other firms, any action I take will generate a reaction by my competitors. How can I predict and incorporate those reactions in forming strategies so that I am not blindsided, and if possible, can even use them to my advantage? We will focus attention on two distinct strategic problems: Price Cooperation (Part II) and Strategic Entry (Part III). More

concretely, can I find a way to move away from mutually destructive price competition, toward win-win games? How do I enter an industry, or avoid entry by new competitors?

Each segment represents about 3 hours of class time

Part II: Price Cooperation and Industry Equilibria

Segment #	Topics Covered	Suggested Readings
Segment 5	Strategic Interactions, Market Structure, Price Wars	Albert Heijn Game Theory Hand Out CD Chapter 8
Segment 6	Competition and Cooperation, Dynamic Incentives	Philip Morris
Segment 7	Antitrust I, Horizontal Differentiation	General Mills
Segment 8	Guest Lecture I, Strategic Entry	International Paper, CarMax

Each segment represents about 3 hours of class time

Part III: Strategic Entry

Segment #	Topics Covered	Suggested Readings
Segment 9	Guest Lecture II, Strategic Entry	Pratt & Whitney, Red Bull
Segment 10	Antitrust II, Strategic Entry, Data	Microsoft
Segment 11	Strategic Entry, Data, Wrap Up	S Group, Tesla

Exam Day: January 14th 9am -- Due date January 15th 6pm. Individual, not timed.

E. COURSE REQUIREMENTS AND GRADING

The final grade will be based on:

Class Participation (45% - Individual/Type B)

Class participation is essential in order for you to get the maximum benefit from the course. To create proper incentives, your final grade depends on your class participation. Your class participation grade will be based on two metrics: (1) engagement and (2) contributions.

- (1) *Engagement*. During class and in-between classes, you will be asked to complete small tasks. The fraction of tasks that you complete determine your engagement grade. These tasks include:

Online Quizzes. For most sessions, there will be an online quiz posted on Canvas, to be completed *before* the beginning of the session. Questions are multiple-choice and/or require you to write a paragraph justifying your answer. Grading is based on the thoughtful completion of each of the quizzes. Your answers may be used in class and you may be called to discuss them.

PollEverywhere. During most sessions, students will be asked to answer questions via PollEverywhere. Your answers will be used in class and you may be called to discuss them. Your PollEverywhere answers are also used implicitly, to track attendance.

- (2) *Contributions*. Your in-class contributions are expected to be: *Relevant*: Are your comments related to the case and to the comments of others? Do they move the discussion forward? Do they bring clarity to the general discussion? *Fact-Based*: Have you used specific data from the case, from readings, or from personal experience to support the assertions that you are making?

Cold Calling. In addition to your voluntary participation, I regularly select a few students at random to open and/or lead the case discussion.

I ask that you deal with the cases as you find them; do not seek outside or post-case data on the firm or industry. Of course, if you already know things about the case, from previous experience, this can be very useful in case discussions. Please let me know about it in advance, and I will make a point to call on you at the appropriate time.

Case discussion constitutes more than half the class time, so there will be ample opportunity for each of you to participate. If you feel that you are preparing well but that I am not calling on you enough, please let me know so that I can address the problem.

Final exam (55% – Individual/Type B)

Take-home, open-book exam. Date: **Thursday Jan 14th, starting from 9am**. The exam must be submitted on Canvas **by Friday 15th, 6pm**.

After our final session, on Jan 8th, you will receive a case study. You will have one week to read it and review the class material. On Jan 15th at 9am, you will receive the exam questions. Some of these questions refer to the general topics that we discussed in class. Some other questions, instead, refer to the specifics of the case study that was distributed.

Once you have received the questions, you are not allowed to discuss the case and/or exam questions with other students in the class (until submission deadline).

F. PREPARATION QUESTIONS

You can use these questions to prepare for class discussions.

Enterprise

- Analyze Enterprise's strategy and competitive position. Why has Enterprise been so successful?
- How attractive is the car-rental industry in terms of long-term profitability?

Aldi

- Discuss the main elements of Aldi's strategy. Does this strategy result in a cost advantage in the discount grocery segment relative to Walmart?
- Does Aldi have a (sustainable) competitive advantage in the US? Yes or no?
- How should Walmart react to Aldi's expansion? Should they imitate some of the key choices of Aldi's? Should they go to a price war to stop Aldi's expansion?

The Economist

- What explains the success of The Economist thus far? Why has it managed to succeed while so many other magazines are struggling?
- How was The Economist able to increase prices and circulation at the same time?
- What are the main industry threats that The Economist should be sensitive to? What are the main opportunities that it could take advantage of?

Capital One

- What, if any, competitive advantages does Capital One have?
- Are these advantages sustainable into the future?
- As head of Capital One, what would be your strategic priorities?

LinkedIn

- Consider the market in which LinkedIn operates. Who are the company's customers?
- For each set of customers that you have identified in the previous question, what affects their willingness-to-pay (WTP)?
- Describe LinkedIn's pricing strategy and its rationale? How is this market different from a "standard," i.e. one-sided market? Explain.

Microsoft

- What, if any, competitive advantages does Google enjoy in search? Are these competitive advantages sustainable?
- What, if any, are the strategic reasons for Microsoft to challenge Google in search?
- Does Microsoft have a competitive advantage in search? What market share do they need to be profitable? Do you think they will be successful?

Car Max

- Using data from the case, provide a comprehensive industry analysis of the car retailing industry, focusing both on the new-car segment and the used-car segment. Which segment do you think is more attractive?
- Discuss the main elements of CarMax's entry strategy. How does it affect consumers' willingness-to-pay? How does it influence costs? In terms of execution, what aspect of CarMax's strategy is the hardest to replicate for a competitor?
- Does CarMax have a sustainable competitive advantage in the used-car market? How much room does CarMax have to grow?

Philip Morris

- Using data from the case, provide a comprehensive industry analysis of the tobacco industry during the 80s.
- Now compare this industry with the segment of the car rental industry in which Enterprise operated in the 80s. From a competitive perspective, how is PM's position different from Enterprise's? What is the first-order difference between these two industries?
- What accounts for Philip Morris' dramatic shift in strategy in April 1993? What are its goals?

Albert Heijn

- Using data from the case, provide a comprehensive industry analysis of the food retail industry in the Netherlands at the beginning of the 2000s.
- What kind of competitive advantage did Albert Heijn have at the beginning of the 2000s?
- In your opinion, what is the strategic goal (if any) in Albert Heijn's dramatic price cut in October 2003?

General Mills

- Provide an estimate of the cost of entry, namely initial investment in fixed costs to reach MES, for the RTE Cereal industry in the 80s.
- Using the framework developed in class, explain why the RTE Cereal industry has been Why has RTE cereal been such a profitable business in the 80s?
- Describe the role of the price leader in this industry. More generally, what industry problem does a price leader solve?

Pratt and Whitney

- Qualitatively describe the cash flow that is generated by a new engine program for a company like P&W. How come that competition drives engine producers to sell their products at a loss?
- How feasible do you think it is for P&W and GE to coordinate on a better industry equilibrium. Is cooperation so hard in this industry? Explain why.

- Assume PW has decided to go ahead with the GTF technology, how should it proceed?

S-Group

- What kind of competitive advantage does S-Group enjoy in Finland? Explain.
- How feasible would it be for S Group to replicate its business model outside of Finland?
- What barriers to entry does Amazon face in entering the market and competing with S Group? What can S Group do to increase these barriers in anticipation of Amazon's expansion into Finland?

Red Bull

- Describe Red Bull entry in the US market. What kind of strategy did the company adopt to successfully enter the market?
- Was it a strategic mistake for Coke to let Red Bull freely enter the US market? Did coke have any competitive advantage to fight off the new entrant? If so, what were the sources of such an advantage?
- How was Monster able to catch up with Red Bull? Why didn't Red Bull react more aggressively to Monster's entry?

Tesla

- Should BMW expect Tesla to grow into a strong direct competitor like Audi (versus Tesla being either limited to a niche or a flash in the pan)? Is Tesla at a competitive advantage or disadvantage? How will that evolve?
- What do you think of Tesla's entry strategy? What barriers did it have to overcome? How did it manage to do so? Will other firms follow in Tesla's footsteps?
- How do you expect the industry to evolve?