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Today’s business world is global, Internet driven, and obsessed with speed. The challenges it creates for strategic managers are often complex, ambiguous, and unstructured. Add to this the constant allegations of top management wrongdoings, ethical blunders, and skyrocketing executive compensation, and it is easy to see why firm leaders are under greater pressure than ever to respond to strategic problems quickly, decisively, and responsibly. Hence, the need for effective strategic management has never been more pronounced than it is today. This text presents a framework for addressing these immediate strategic challenges.

This chapter introduces the notion of strategic management, highlights its importance, and presents a five-step process for strategically analyzing an organization. The remaining chapters expand on the various steps in the process, with special emphasis on their application to ongoing enterprises.

1-1 What Is Strategic Management?

Strategy refers to top management’s plans to develop and sustain competitive advantage—a state whereby a firm’s successful strategies cannot be easily duplicated by its competitors—so that the organization’s mission is fulfilled. Following this definition, it is assumed that an organization has a plan, its competitive advantage is understood, and that its members understand the reason for its existence. These assumptions may appear self-evident, but many strategic problems can be traced to fundamental misunderstandings associated with defining the strategy. Debates over the nature of the organization’s competitive advantage, its mission, and whether a strategic plan is really needed can be widespread. Comments such as “We’re too busy to focus on developing a strategy” or “I’m not exactly sure what my company is really trying to accomplish” can be overheard in many organizations.

Strategic management is a broader term than strategy and is a process that includes top management’s analysis of the environment in which the organization operates prior to formulating a strategy, as well as the plan for implementation and control of the strategy. The difference between a strategy and the strategic management process is that the latter includes considering what must be done before a strategy is formulated through assessing the success of an implemented strategy. The strategic management process can be summarized in five steps, each of which is discussed in greater detail in subsequent chapters of the book (see Figure 1-1).

1. **External analysis:** Analyze the opportunities and threats or constraints that exist in the organization’s external environment, including industry and macroenvironmental forces.
2. **Internal analysis:** Analyze the organization’s strengths and weaknesses in its internal environment. Consider the appropriateness of its mission.
3. **Strategy formulation:** Formulate strategies that build and sustain competitive advantage by matching the organization’s strengths and weaknesses with the environment’s opportunities and threats.
4. **Strategy execution:** Implement the strategies that have been developed.
5. **Strategic control:** Measure success and make corrections when the strategies are not producing the desired outcomes.

Is it necessary to address these steps sequentially? The answer depends on one’s perspective. Outsiders analyzing a firm should apply a systematic approach that progresses through these steps in order. Doing so develops to a holistic understanding of the firm, its industry, and its strategic challenges.
In organizations, however, strategies are being formulated, implemented, and controlled simultaneously while external and internal factors are being assessed and reassessed. In addition, changes in one stage of the strategic management process will inevitably affect other stages as well. After a planned strategy is implemented, for example, it often requires modification as conditions change. Hence, because these steps are so tightly intertwined, insiders treat all of the steps as a single integrated, ongoing process.5

Consider the strategic management process at a fast-food restaurant chain. At any given time, top managers are likely assessing changes in consumer taste preferences and food preparation, analyzing the activities of competitors, working to overcome firm weaknesses, controlling remnants of a strategy implemented several years ago, implementing a strategy formulated several months ago, and formulating strategic plans for the future. Although each of these activities can
be linked to a distinct stage in the strategic management process, they occur simultaneously.

An effective strategy is built on the foundation of the organization’s **business model**, the mechanism whereby the organization seeks to earn a profit by selling its goods. In a general sense, all firms seek to produce a product or service and sell it at a price higher than its production and overhead costs, thereby generating a profit. A business model is stated in greater detail, however. For example, a magazine publisher might adopt a “subscription model,” an “advertising model,” or perhaps some combination of the two. Profits would be generated primarily from readers in the former case whereas they would come primarily from advertisers in the latter case. Needless to say, identifying a firm’s business model is rarely difficult at a basic level, but can become more complex when considering intricate details. Progressive firms often devise innovative business models that extract revenue—and ultimately profits—from sources not identified by competitors.

Developing a successful strategy for the firm is not an easy task. Realistically, a number of factors are typically associated with successful strategies, including the following:

1. Strategic managers thoroughly understand the competitive environment in which the organization competes.
2. Strategic managers understand the organization’s resources and how they translate into strengths and weaknesses.
3. The strategy is consistent with the mission and goals of the organization.
4. Plans for putting the strategy into action are designed with specificity before it is implemented.
5. Possible future changes in the proposed strategy (i.e., strategic control) are evaluated before the strategy is adopted.

Careful consideration of these factors reinforces the interrelatedness of the steps in the strategic management process. Each factor is most closely associated with one of the five steps, yet they fit together like pieces of a puzzle. The details associated with the success factors—and others—will be discussed in greater detail in future chapters.

Top managers make effective strategic decisions when they remain informed of issues that affect their industries, as well as the business world in general. Information vital to effective strategic decision making can be found in a variety of publications. In addition to the business sections of most major newspapers, publications such as *Fortune, Business Week, Industry Standard, Strategy+Business,* and *Wall Street Journal* report on a wide variety of strategic management topics (see Table 1-1). Not only are these concepts of interest to top managers, but they are also a concern for employees, supervisors, and middle managers of all organizations. An appreciation of the organization’s strategy helps all of its members relate their work assignments more closely to the direction of the organization.

Strategic management is not limited to for-profit organizations. Top managers of any organization, regardless of profit or nonprofit status, must understand the organization’s environment and its capabilities and develop strategies to assist the enterprise in attaining its goals. Drexel University President Constantine Papadakis, for example, is widely considered to be a leading strategic thinker among university top executives. The innovative Greek immigrant promotes Drexel through aggressive marketing, while campaigning for an all-digital library without books. In many respects, he manages the university in the same way that other executives manage profit-seeking enterprises. Interestingly, his salary in 2005 was about $900,000 per year—not including...
income from outside sources—making him one of the highest paid university presidents in the country.6

1-1a Intended and Realized Strategies
A critical challenge facing organizations is the reality that strategies are not always implemented as originally planned. Henry Mintzberg introduced two terms to help clarify the shift that often occurs between the time a strategy is formulated and the time it is implemented. An intended strategy, that which management originally planned, may be realized just as it was planned, in a modified form, or even in an entirely different form. Occasionally, the strategy that management intends is actually realized, but the intended strategy and the realized strategy, which is what management actually implements, usually differ.7 Hence, the original strategy may be realized with desirable or undesirable results, or it may be modified as changes in the firm or the environment become known.

The gap between the intended and realized strategies usually results from unforeseen environmental or organizational events, better information that was not available when the strategy was formulated, or an improvement in top management’s ability to assess its environment. Although it is important for managers to formulate responsible strategies based on a realistic and thorough assessment of the firm and its environment, things invariably change along the way. Hence, it is common for such a gap to exist, creating the need for constant strategic action if a firm is to stay on course. Instead of resisting modest strategic changes when new information is discovered, managers should search for new information and be willing to make such changes when necessary. This activity is part of strategic control, the final step in the strategic management process.

1-1b Scientific and Artistic Perspectives on Strategic Management
Top executives should take one of two different perspectives on the approach to strategic management. Most strategy scholars have endorsed a scientific perspective, whereby strategic managers are encouraged to systematically assess the firm’s external environment and evaluate the pros and cons of myriad alternatives before formulating strategy. The business environment is seen as largely objective, analyzable, and at least somewhat predictable. As such, strategic managers should follow a systematic process of environmental, competitive, and internal analysis and build the organization’s strategy on this foundation.

According to this perspective, strategic managers should be trained, highly skilled analytical thinkers capable of digesting a myriad of objective data and
translating it into a desired direction for the firm. “Strategy scientists” tend to minimize or reject altogether the role of imagination and creativity in the strategy process, and are not generally receptive to alternatives that emerge from any process other than a comprehensive, analytical approach.

Others, however, have a different view. According to the artistic perspective on strategy, the lack of environmental predictability and the fast pace of change render elaborate strategy planning as suspect at best. Instead, strategists should incorporate large doses of creativity and intuition in order to design a comprehensive strategy for the firm. Mintzberg’s notion of a craftsman—encompassing individual skill, dedication, and perfection through mastery of detail—embodies the artistic model. The strategy artist senses the state of the organization, interprets its subtleties, and seeks to mold its strategy like a potter molds clay. The artist visualizes the outcomes associated with various alternatives and ultimately charts a course based on holistic thinking, intuition, and imagination. “Strategy artists” may even view strategic planning exercises as time poorly spent and may not be as likely as those in the science school to make the effort necessary to maximize the value of a formal planning process.

This text acknowledges the validity of the artistic perspective but emphasizes the scientific view. Creativity and innovation are important and encouraged, but are most likely to translate into organizational success when they occur as part of a comprehensive approach to strategic management. Nonetheless, the type of formal, systematic strategic planning proposed in this text is not without its critics. Some charge that such models are too complex to apply, or that they apply only to businesses in highly certain environments. Others emphasize that the stages in the process are so closely interrelated and that considering them as independent steps may be counterproductive. Still others, such as Mintzberg, argue that planning models stifle the creativity and imagination that is central to formulating an effective strategy. Although these views have merit, the comprehensive, systematic model proposed herein is presented as a proper foundation for understanding the strategic management process. It does not, however, preclude the application of other approaches.

1-2 Influence on Strategic Management

The roots of the strategic management field can be traced to the 1950s when the discipline was originally called “business policy.” Today, strategic management is an eclectic field, drawing upon a variety of theoretical frameworks. Three prominent perspectives are summarized in Table 1-2 and discussed in this section.

<table>
<thead>
<tr>
<th>Theoretical Perspective</th>
<th>Primary Influence on Firm Performance</th>
<th>How Perspective Is Applied to the Case Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial organization (IO) theory</td>
<td>Structure of the industry</td>
<td>Industry analysis portion of the external environment</td>
</tr>
<tr>
<td>Resource-based theory</td>
<td>Firm’s unique combination of strategic resources</td>
<td>Analysis of internal strengths and weaknesses</td>
</tr>
<tr>
<td>Contingency theory</td>
<td>Fit between the firm and its external environment</td>
<td>Strengths, weaknesses, opportunities, and threats (SWOT) analysis and SW/OT matrix</td>
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Industrial organization (IO), a branch of microeconomics, emphasizes the influence of the industry environment upon the firm. The central tenet of industrial organization theory is the notion that a firm must adapt to influences in its industry to survive and prosper; thus, its financial performance is primarily determined by the success of the industry in which it competes. Industries with favorable structures offer the greatest opportunity for firm profitability. Following this perspective, it is more important for a firm to choose the correct industry within which to compete than to determine how to compete within a given industry. Recent research has supported the notion that industry factors tend to play a dominant role in the performance of most firms, except for those that are the notable industry leaders or losers.

IO assumes that an organization’s performance and ultimate survival depend on its ability to adapt to industry forces over which it has little or no control. According to IO, strategic managers should seek to understand the nature of the industry and formulate strategies that feed off the industry’s characteristics. Because IO focuses on industry forces alone, strategies, resources, and competencies are assumed to be fairly similar among competitors within a given industry. If one firm deviates from the industry norm and implements a new, successful strategy, then other firms will rapidly mimic the higher performing firm by purchasing the resources, competencies, or management talent that have made the leading firm so profitable. Hence, although the IO perspective emphasizes the industry’s influence on individual firms, it is also possible for firms to influence the strategy of rivals, and in some cases even modify the structure of the industry.

Perhaps the opposite of the IO perspective, resource-based theory views performance primarily as a function of a firm’s ability to utilize its resources. Although environmental opportunities and threats are important, a firm’s unique resources comprise the key variables that allow it to develop a distinctive competence, enabling the firm to distinguish itself from its rivals and create competitive advantage. “Resources” include all of a firm’s tangible and intangible assets, such as capital, equipment, employees, knowledge, and information. An organization’s resources are directly linked to its capabilities, which can create value and ultimately lead to profitability for the firm. Hence, resource-based theory focuses primarily on individual firms rather than on the competitive environment.

If resources are to be used for sustained competitive advantage—a firm’s ability to enjoy strategic benefits over an extended time—those resources must be valuable, rare, not subject to perfect imitation, and without strategically relevant substitutes. Valuable resources are those that contribute significantly to the firm’s effectiveness and efficiency. Rare resources are possessed by only a few competitors, and imperfectly imitable resources cannot be fully duplicated by rivals. Resources that have no strategically relevant substitutes enable the firm to operate in a manner that cannot be effectively imitated by others, and thereby sustain high performance.

According to contingency theory, the most profitable firms are likely to be those that develop a beneficial fit with their environment. In other words, a strategy is most likely to be successful when it is consistent with the organization’s mission, its competitive environment, and its resources. Contingency theory represents a middle ground perspective that views organizational performance as the joint outcome of environmental forces and the firm’s strategic actions. Firms can become proactive by choosing to operate in environments where opportunities and threats match their strengths and weaknesses. Should the industry environment change in a way that is unfavorable to the firm, its top managers should consider leaving that industry and reallocating its resources to other, more favorable industries.
Each of these three perspectives has merit and has been incorporated into the strategic management process laid out in this text. The industrial organization view is seen in the industry analysis phase, most directly in Michael Porter’s “five forces” model. Resource-based theory is applied directly to the internal analysis phase and the effort to identify an organization’s resources that could lead to sustained competitive advantage. Contingency theory is seen in the strategic alternative generation phase, where alternatives are developed to improve the organization’s fit with its environment. Hence, multiple perspectives are critical to a holistic understanding of strategic management.21

1-3 Strategic Decisions

How does one think and act strategically, and who makes the decisions? The answers to these questions vary across firms and may also be influenced by factors such as industry, age of the firm, and size of the organization. In general, however, strategic decisions are marked by four key distinctions.

1. They are based on a systematic, comprehensive analysis of internal attributes and factors external to the organization. Decisions that address only part of the organization—perhaps a single functional area—are usually not considered to be strategic decisions.

2. They are long term and future oriented, but are built on knowledge about the past and present. Scholars and managers do not always agree on what constitutes the “long term,” but most agree that it can range anywhere from several years in duration to more than a decade.

3. They seek to capitalize on favorable situations outside the organization. In general, this means taking advantage of opportunities that exist for the firm, but it also includes taking measures to minimize the effects of external threats.

4. They involve choices. Although making win-win strategic decisions may be possible, most involve some degree of trade-off between alternatives, at least in the short run. For example, raising salaries to retain a skilled workforce can increase wages, and adding product features or enhancing quality can increase the cost of production. Such trade-offs, however, may diminish in the long run, as a more skilled, higher paid workforce may be more productive than a typical workforce, and sales of a higher quality product may increase, thereby raising sales and potentially profits. Decision makers must understand these complex relationships across the business spectrum.

Because of these distinctions, strategic decision making is generally reserved for the top executive and members of the top management team. The chief executive is the individual ultimately responsible (and generally held responsible) for the organization’s strategic management, but this person rarely acts alone. Except in the smallest companies, the CEO relies on a team of top-level executives—including members of the board of directors, vice presidents, and various line and staff managers—all of whom play instrumental roles in strategically managing the firm. Generally speaking, the quality of strategic decisions improves dramatically when more than one capable executive participates in the process.22

The size of the team on which the top executive relies for strategic input and support can vary from firm to firm. Companies organized around functions such as marketing and production generally involve the heads of the functional departments in strategic decisions. Very large organizations often employ corporate-level strategic planning staffs and outside consultants to assist top executives in the process. The degree of involvement of top and middle managers in the strategic management process also depends on the personal philosophy of the CEO.23
Some chief executives are known for making quick decisions, whereas others have a reputation for involving a large number of top managers and others in the process.

Input to strategic decisions, however, need not be limited to members of the top management team. To the contrary, obtaining input from others throughout the organization, either directly or indirectly, can be quite beneficial. In fact, most strategic decisions result from the streams of inputs, decisions, and actions of many people. For example, an employee in a company’s research and development department attends a trade show where vendors discuss a new product or production process idea that seems relevant to the company. The employee relates the idea to the next level manager who, in turn, modifies and passes it along to a higher level manager. Eventually, the organization’s marketing and production managers discuss a version of the idea, and later present it to top management. The CEO ultimately decides to incorporate the idea into the ongoing strategic planning process. This example illustrates the indirect involvement of individuals throughout the organization in the strategic management process. Top management is ultimately responsible for the final decision, but this decision is based on a culmination of the ideas, creativity, information, and analyses of others (see Strategy at Work 1-1).

Ethics and social responsibility are also key concerns in strategic decision making. Simply stated, the moral components and social outcomes associated with a strategic decision, such as the effects of closing an existing production facility in search of lower costs abroad, should be considered alongside economic concerns. These issues are discussed in greater detail in Chapters 6 through 9 under the umbrella of strategy formulation (see Case Analysis 1-1).

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**STRATEGY AT WORK 1-1**

Strategic Decisions

Strategic decisions, by their nature, may be characterized by considerable risk and uncertainty. Unpredictable environmental changes can quickly threaten well-conceived plans. Most strategic decision makers clearly recognize this danger and learn to adapt. Here are two examples.

1. Like all air carriers, American Airlines facing a number of challenges: international terrorism, steadily rising costs, unstable national economies, uncertain volumes of domestic traffic, and protectionist threats to international traffic. In the face of these threats, CEO Robert Crandall suggests that senior managers rarely know the outcomes of these situations anyway and should be accustomed to dealing with the uncertainty associated with critical strategic decisions.

2. Bernard Food Industries Inc. is a fifty-three-year-old family-held business of more than 1,500 sugar-free, low-fat, and low-calorie food products. At first, the company sold most of its products to hospitals, nursing homes, and other such institutions. In 1996, however, Steve Bernard, the founder’s son, decided to expand the market. Although only a handful of companies were marketing such products at that time, Bernard viewed the Web as the future. The firm’s online subsidiary, eDietShop (www.diet-shop.com) performed extremely well and quintupled retail sales in the first two years and has continued to grow, developing into one of its industry’s leaders by the mid-2000s. As Bernard put it, “We didn’t turn to the Web because other people were doing it but because we knew where we wanted our business to go.”

Top managers face more complex strategic challenges today than ever before. Strategic management involves analysis of an organization’s external and internal environments, formulation and implementation of its strategic plan, and strategic control. These steps in the process are interrelated and typically done simultaneously in many firms.

A firm’s intended strategy often requires modification before it has been fully implemented due to changes in environmental and/or organizational conditions. Because these changes are often difficult to predict, substantial changes in the environment may transform an organization’s realized strategy into one that is quite different from its intended strategy.

The strategic management field has been influenced by such perspectives as industrial organization theory, resource-based theory, and contingency theory. Although they are based on widely varied assumptions about what leads to high performance, each of these perspectives has merit and contributes to an overall understanding of the field.

Strategy formulation is the direct responsibility of the CEO, who also relies on a team of other individuals, including the board of directors, vice presidents, and various managers. In its final form, a strategic decision is crafted from the streams of inputs, decisions, and actions of the entire top management team.

Key Terms

- business model
- competitive advantage
- contingency theory
- distinctive competence
- industrial organization
- intended strategy
- realized strategy
- resource-based theory
- strategic management
- strategy
- sustained competitive advantage
- top management team
Review Questions and Exercises

1. Is it necessary that the five steps in the strategic management process be performed sequentially? Why or why not?
2. What is the difference between an intended strategy and a realized strategy? Why is this distinction important?
3. How have outside perspectives influenced the development of the strategic management field?
4. Does the CEO alone make the strategic decisions for an organization? Explain.

Practice Quiz

True or False

1. A strategy seeks to develop and sustain competitive advantage.
2. Strategic management refers to formulating successful strategies for an organization.
3. Each step in the strategic management process is independent so that changes in one step will not substantially affect other steps.
4. The intended strategy and the realized strategy can never be the same.
5. Whereas industrial organization theory emphasizes the influence of industry factors of firm performance, resource-based theory emphasizes the role of firm factors.
6. Strategic decisions are made solely by and are ultimately the responsibility of the chief executive alone.

Multiple Choice

7. Strategies are formulated in the strategic management stage that occurs immediately after
   A. the assessment of internal strengths and weaknesses.
   B. implementation of the strategy.
   C. control of the strategy.
   D. none of the above
8. The strategy originally planned by top management is called the
   A. grand strategy.
   B. realized strategy.
   C. emergent strategy.
   D. none of the above
9. The notion that successful firms tend to be the ones that adapt to influences in their industries is based on
   A. industrial organization theory.
   B. resource-based theory.
   C. contingency theory.
   D. none of the above
10. The notion of distinctive competence is consistent with
    A. industrial organization theory.
    B. resource-based theory.
    C. contingency theory.
    D. none of the above
11. In order to contribute to sustained competitive advantage, firm resources should be
    A. valuable and rare.
    B. not subject to perfect imitation.
    C. without strategically relevant resources.
    D. all of the above.
12. Which of the following is not a characteristic of strategic decisions?
    A. They are long term in nature.
    B. They involve choices.
    C. They do not involve trade-offs.
    D. All of the above are characteristics of strategic decisions.
Notes

4. Based on Wright et al., Strategic Management.
24. Wright et al., Strategic Management.
The airline industry is a tough place to make a buck: too many competitors, price-sensitive customers, high capital intensity, boom-or-bust cyclicality, powerful suppliers, and often intransigent unions. Nevertheless, Herb Kelleher, the cofounder and chairman of Southwest Airlines, created the sort of value that any company leader would envy. From its start in 1971, Southwest has grown into the fourth-largest airline in the United States, with 30 consecutive years of profitability, in an industry in which no other company has been profitable for even five straight years. Total shareholder returns during that period were almost double the returns for the S&P 500. Southwest has managed to accrue a market capitalization larger than that of the rest of the American airlines combined. Major competitors have tried to imitate Southwest with clones. Many entrepreneurial startups in the United States and Europe, including JetBlue and Ryanair, cite Southwest as their inspiration.

Southwest's achievements are widely attributed to its relentless focus. From the start, Southwest's strategy has been to draw travelers not from other airlines, but from cars, buses, and trains, by providing them the least expensive and fastest service available. To support the strategy, the company determined to fly only one type of airplane, the Boeing 737, and to substitute linear flying for the hub-and-spoke model that has prevailed in the industry. But at the center of Southwest's success are its culture and employees. “Your spirit,” says Mr. Kelleher, a man fabled for his willingness to party hard with his staff, is “the most powerful thing of all.”

In recognition of the inspiration he provides all who study and practice strategy, for his philosophy and perspectives on strategy and success in this chapter's strategy+business reading.

Herb Kelleher: The Thought Leader Interview

The cofounder and chairman of Southwest Airlines tells why a firm's people are everything.

By Chuck Lucier

The airline industry is a tough place to make a buck: too many competitors, price-sensitive customers, high capital intensity, boom-or-bust cyclicality, powerful suppliers, and often intransigent unions. Nevertheless, Herb Kelleher, the cofounder and chairman of Southwest Airlines, created the sort of value that any company leader would envy.

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In recognition of the inspiration he provides all who study and practice strategy, for his contributions in redefining how companies think about strategy, and for his achievements in redefining an industry, in November 2003 Mr. Kelleher was granted the Lifetime Achievement Award by the Strategic Management Society (SMS), the prestigious global association of academic and corporate strategists.

At the SMS annual meeting in Baltimore, Md., where Mr. Kelleher accepted the award, strategy+business contributing editor and “Breakthrough Thoughts” co-columnist Chuck Lucier led a spirited public conversation with Mr. Kelleher about Southwest’s success.

S+B: Let’s start with some words from your award. You made an “audacious commitment” to putting employees first, customers second, and shareholders third. How did you get away with that for 20 years?

KELLEHER: When I started out, business school professors liked to pose a conundrum: Which do you put first, your employees, your customers, or your shareholders? As if that were an unanswerable question. My answer was very easy: You put your employees first. If you truly treat your employees that way, they will treat your customers well, your customers will come back, and that’s what makes your shareholders happy. So there is no constituency at war with any other constituency. Ultimately, it’s shareholder value that you’re producing.

S+B: A dollar invested at Southwest’s 1972 initial public offering is worth $1,400 today. Does that come solely from putting your employees first?

KELLEHER: We have been successful because we’ve had a simple strategy. Our people have bought into it.

Our people fully understand it. We have had to have extreme discipline in not departing from the strategy. We basically said to our people, there are three things that we're interested in. The lowest costs in the industry—that can't hurt you, having the lowest costs. The best customer service—that's a very important element of value. We said beyond that we're interested in intangibles—a spiritual infusion—because they are the hardest things for your competitors to replicate. The tangible things your competitors can go out and buy. But they can't buy your spirit. So it's the most powerful thing of all.

**S+B: Not to deny the importance of intangibles, but what's the source of Southwest's cost advantage?**

**KELLEHER:** The cost advantage is very important because we started out with a philosophy that we were going to charge low fares, come hell or high water. We were going to enable more people to fly. It didn’t matter whether we had competition or not. In other words, we just said we're a different type of cat. When we get a load factor that gets into the 70 or 75 percent range over an appreciable period of time, we don't increase fares. We add flights and put additional seats in. So if you come from that basic position, that is what you are, then of course you have to have low costs.

Now, how do you get low costs? Through a lot of things, including the inspiration that you give your people, their productivity, the fact that they feel that they're doing something that is really significant and that they enjoy. If you take all of Southwest's compensation together—wage rates, profit sharing, the full 401(k) match, the stock options that our people have—Southwest employees are the most highly compensated people in the airline industry. One of our pilots just retired with $8 million in his profit-sharing account. Now, you have to do well to produce that.

**Meeting Life’s Needs**

**S+B: A compensation scheme based on stock is great when the company is doing well. But when the stock doesn't do well, you can have a motivation problem.**

**KELLEHER:** Absolutely, that is a risk. So we don’t just give people stock options. We have an educational team that goes around and explains to them what stock options are, how they work, the fact that it’s a longer-term investment. From 1990 to 1994, the airline industry as a whole lost $13 billion. Southwest Airlines was profitable during that entire time, but our stock was battered. Eighty-four percent of our employees continued with Southwest Airlines stock during that four-year period. That’s the kind of confidence and faith that you have to engender, so people have a longer-term view, and they're not trying to outplay the market every day.

**S+B: Virtually all of the major U.S. airlines have tried to copy you at some point. None of them has come remotely close. What’s so hard? It looks like it ought to be a pretty simple model.**

**KELLEHER:** We've had many airlines that professed that they were going to be low-fare carriers. There’s only one problem: They had high costs. You can do that, but Chapter 11 is your destiny.

I think the difficulty for them is the cultural aspect of it. That cannot be duplicated. One of the things that demonstrates the power of people is when the United Shuttle took out after us in Oakland. They had all the advantages. I mean, they had first-class seats for those who don’t want to fly anything but first class. They had a global frequent flyer program, which we did not have. They probably spent $25 million or $30 million on their advertising campaign. I probably have something like a thousand letters at my office that tell you why they finally receded from Oakland. Those letters say, “Herb, I tried them, but I just like your people more, so I’m back.” Don’t ever doubt, in the customer service business, the importance of people and their attitudes.

**S+B: So now we’re back to the intangibles—the “spirit” competitors can’t go buy. How does a company create a culture like that?**

**KELLEHER:** We used to have a corporate day. Companies would come in from around the world and they were interested in how we hired, trained, that sort of thing. Then we'd say, “Treat your people well and they'll treat you well,” and then they'd go home disappointed. It was too simple.

**S+B: Or too hard.**

**KELLEHER:** Or too hard—because it’s a vast mosaic with thousands of little pieces that you have to keep putting in place every day. It’s not a programmatic thing. It can’t be. It has to come from the heart, not the head. If it’s programmatic, everybody will know that and say, “Hell, they’re not sincere; they don’t really care, they’re just telling us that they care.” It has to be a continuous stream of one-on-one communication, not like you sit down and say, “Boy, communication is pretty important.
Let’s really communicate for the next six months and then move on to what’s really significant. It has to be part of your fabric; it has to be something that you do really as a product of your soul.

I’ll give you an illustration of why this works, if I might. When the industry was deregulated. I sat down with our very, very creative advertising agency, GSD&M, from Austin. (We call them “Greed, Sex, Drugs, and Money.”) They said, “Okay, now we have deregulation, Herb. Airlines can fly wherever they want to. What’s different about Southwest Airlines?” I said, “Our people are different.” That’s where the “Spirit of Southwest” campaign was born. That could have been a huge risk because we were telling the world on television, radio, newspapers that our people are different and they’re better and they’re special and they welcome customers. We ran that campaign for probably six or seven years and never had anybody write in and say, “You’re wrong. Your people are not special.” Which I think demonstrates that they are.

S+B: Is that why Southwest flight attendants sing?

KELLEHER: Southwest flight attendants sing because they want to. We don’t program our flight attendant training to teach people to sing or tell jokes. What we say is, “If that is your basic personality, feel free to go ahead and do it.” We’re not trying to train you to be anything different from what you really are. If singing buoyed up your heart, makes you feel good, go ahead and do it. We have tried to say to our people, “You don’t have to put on a mask, you don’t have to be an automaton when you come to work. You can just be yourself.” Wasn’t it Robert Frost who said, “Isn’t it a shame that people’s minds work furiously until they get to work?” Well, that’s because they feel that they become artificial and constrained by the workplace.

S+B: One of your values in the mission statement is humility as a corporation. With all of your wonderful results, is Southwest really humble?

KELLEHER: No question. I constantly have warned our people over the years that, as we became bigger and more successful, our primary potential enemy was ourselves, not our competitors. Getting cocky, getting complacent, thinking that the world was our oyster, disregarding our competitors, both new and old. I think humility is very important in keeping your eye on the carrot, keeping focused outwardly instead of inwardly, and knowing when you have to change. An investor in the airline industry some years ago that I was talking to said, “Southwest Airlines is the most humble and disciplined airline that I deal with.” I said, “The two go together.”

S+B: Why do they go together?

KELLEHER: Because you can’t really be disciplined in what you do unless you are humble and open-minded. Humility breeds open-mindedness — and really, what we try to do is establish a clear and simple set of values that we understand. That simplifies things; that expedites things. It enables the extreme discipline I mentioned in describing our strategy. When an issue comes up, we don’t say we’re going to study it for two and a half years. We just say, “Southwest Airlines doesn’t do that. Maybe somebody else does, but we don’t.” It greatly facilitates the operation of the company.

For example, we bought Morris Air. They were a Salt Lake City carrier with only about 14 or 16 airplanes. We were much larger. When we paid a visit to their headquarters, I told our people, “When you get there, shut up. You can ask questions. But you cannot lecture. You cannot tell people the way they ought to do things. You know why? Because we’re on a learning expedition. Let the Morris Air people tell us. They’re new, they’re young, they’re fresh, they’re untrammeled. Let them tell us the ideas that they have.” And we got some fabulous ideas as a consequence of it, and basically that’s the value of humility.

Growth and Change

S+B: You’ve grown from a few people to more than 34,000. How much did growth change the way you manage Southwest?

KELLEHER: It didn’t really. Your tactics change, but your basic strategy does not. Our mission statement is eternal. Our mission statement deals solely with people. That never changes — in any way, shape, or form. The focus of Southwest Airlines has always been on its people, regardless of how large we grew. Everybody would keep saying to me, “Wait until you get to a thousand, wait until you get to 5,000, wait until you get to 10,000” — as if there was some bright line when you go over from the humanistic and entrepreneurial into the totally managerial. There is no such line in dealing with your people. Making them happy with what they’re doing, making them proud of what they’re doing, putting them in a position where they’re telling their grandchildren...
that Southwest Airlines gave me a greater reach than I ever would have had by myself – that continues to be effective whether you’ve got 5,000, 15,000, or 35,000.

One of the things that we do is continue to emphasize that we value our people as people, not just as workers. Any event that you have in your life that is celebratory in nature or brings grief you hear from Southwest Airlines. If you lose a relative, you hear from us. If you’re out sick with a serious illness, you hear from us, and I mean by telephone, by letter, by remembrances from us. If you have a baby, you hear from us. What we’re trying to say to our people is, “Hey, wait a second, we value you as a total person, not just between eight and five.”

**S+B:** A lot of things are changing in the industry that might undermine the strategy you have followed for a long time. For example, you’re doing transcontinental flights. Does that require big changes in what you do?

**KELLEHER:** No. I’ll tell you, that was an interesting exercise because basically we’ve always tried to be empiricists and not theorize about what people want. When we started flying longer haul, even our own people would say, “Herb, you’ve got to have meals.” We’ve got to do this and we’ve got to do that. I said, “I’m not sure, but let’s just start flying and see.” Well, here are these people from Nashville who want to fly to Los Angeles. It costs them $1,200 less round trip, which gives them a lot of money to buy a dinner at Chasen’s, and they save two hours of their time because they don’t go through a hub. You think they care whether we have airline meals? That’s another thing that we tried to do over the years: ready, fire, aim. In our business, where capital assets travel at over 500 miles an hour, you don’t have a lot of time to fool around with aiming, because by the time you’re finished aiming, somebody else will already be there. So get out there, do it, and clean up the mistakes afterward.

**S+B:** There’s a big market opportunity in Europe. Haven’t you missed the boat there?

**KELLEHER:** It wasn’t a boat that we ever wanted to get on. It’s just way beyond our competence. International service has lots of complications. You’re dealing with different cultures. You’re dealing with currency exchanges. Compared with going into Raleigh-Durham and operating at 84.3 percent load factor on opening day, it’s much more complex. We would have to vary our fleet. We have had most of the European carriers coming to Southwest Airlines and saying, “We have to be competitive for the first time in a long time. What should we do?” We said, “First of all, find out what your customers want. Basically, you have dictated to your customers. Would they prefer to give up the babysitting service in Frankfurt in order to get a $15 reduction in fares?” The startups in Europe like Ryanair also asked our opinion about what they could do and how they could do it.

It was interesting because 15 or 20 years ago there was the assumption that Southwest Airlines...
could succeed with things in the United States that Europeans would not accept in Europe. I said that’s exactly what everybody told me when Southwest started: that people in the U.S. would not accept it. Well, you have to educate people as to the value of what you’re providing. Obviously Ryanair and easyJet are very successful. I think you’ll see more and more of that kind of activity not only on the continent but also in Central America, South America, and Asia.

Boards and CEOs
S+B: I’d like to get your views on some cross-industry issues. How much has the CEO’s job changed in the last 20 years? How much do you think it will change in the future?
KELLEHER: I think the CEO’s job has changed a lot in the last 20 years. I don’t say that it’s necessarily for the better or the worse, but there has been a significant change. I think that CEOs of substantial companies have now become public figures, whether they want to be or not. You might as well acknowledge that. With all the media coverage of companies, you’re going to be in the limelight. You’re going to have to be able to respond to the media. You’re going to have to be able to address the public. That’s different.

Also, of course, as we’ve gotten more complex in America, we have become more regulated. So you spend a lot more of your time dealing with various governmental agencies than you did in the past. When I started practicing law, I would estimate that 5 percent of our total practice involved some kind of interface with the government in one of its myriad forms – local, state, or national. When I stopped practicing law, it was about 60 percent. I think that’s just a manifestation of what’s happened in business – that the regulatory aspects of it are now much more important than they used to be, and you have to know how to deal with those because that is a fact of life.

S+B: What about the relationship with the board? With changes in governance, Sarbanes-Oxley, and so forth, how is that going to shift?
KELLEHER: That’s not really a problem. If you were running your company right, if you weren’t trying to deceive someone, if you were basically making judgments that were intended to tell the public as closely as you could exactly what your earnings were, then Sarbanes-Oxley and the New York Stock Exchange regulations are just minor addenda to what you’re already doing. It may take you a little more time. It may cost you a little more money to comply. But it’s not unduly burdensome.

The primary thing I’m concerned about is that the new compliance focus distracts your board of directors, and this is relatively new. When you see that your board is now spending three hours focusing on regulatory issues and a half hour on the company’s business and what it plans to do, you have the feeling that perhaps it’s taking people away from focusing on results and achievement, at least on an interim basis.

Another thing that concerns me is the impact on internal controls. I’ve asked several heads of big accounting concerns, “What’s going to be your criteria of what’s material and immaterial?” Business judgment has to enter into it. Years ago, our internal audit department concluded that some passengers were defrauding us. So audit went out and bought a $300,000 system and hired two people to operate and maintain it. So I asked them, “How much are we losing here?” They said $18,000. I said, “Let them steal $18,000. We’re spending $65,000 a year to keep people from stealing $18,000.”

It reminds me of a fellow who owned a chain of theaters in Texas. He had a manager of 17 years standing, and went in and fired him one day. The guy says, “After 17 years and this enormous success that we have had, how can you fire me?” The owner said, “Well, for the first 15 years you were stealing $800 a month, and you were worth that. But lately you’ve been stealing $1,200 a month, and you’re not worth that.” So I hope we don’t just surrender business judgment and say that every little thing that goes awry from the accounting standpoint is as important as every other thing that might go awry. That concerns me a little bit.

S+B: I think boards play two very different roles. On the one hand, they play the role of cop: “Boy, this thing is out of control, it’s not working very well. We need to find a new CEO.” On the other hand, they help management by offering advice and counsel and by playing a sounding-board role. Are we in danger of losing the sounding-board role?
KELLEHER: I’m concerned about that. It’s not that I rebel against any of the changes that have been made, because I think in and of themselves they are salutary and not particularly burdensome. But I am a little bit worried about the psychological reaction to them. I was talking to a CEO in Dallas probably a month ago and he said, “I formulated a new strategic paper. It proposes that
my company go into another business. I’ve been trying to present it to the board during the last two meetings, but we were so preoccupied with compliance issues and fear of noncompliance that I haven’t been able to present it to the board.”

Training Entrepreneurs

S+B: You funded the Herb Kelleher Center for Entrepreneurship at the University of Texas. Why?

KELLEHER: Because I think it’s very important to Texas and to our country that we preserve our entrepreneurial spirit. As you get bigger and things get more complex, I think there is more of a tendency to get mired in the details, to get mired in the bureaucratic aspects of things and the hierarchical aspects of things. One of the things I always tried to do was to keep the entrepreneurial spirit alive at Southwest Airlines, even as we grew bigger and more complex. That’s where the job creation is coming from. It’s from the small businesses, not big businesses.

S+B: What would you like business schools to be doing better?

KELLEHER: By and large, our business schools, at least in the United States, are doing a far better job today than perhaps they were doing 30 years ago. Now, business schools are actually talking about entrepreneurship, perhaps kindling that spark in their students. They’re focusing more on dealing with employees and how you achieve good relationships with your employees. They teach more about customer service and how to do customer service. They’ve gotten away from pure financial analysis and planning, to some extent, which I think is very important if you’re going to have a well-rounded CEO.

S+B: What advice would you give brand-new CEOs if they wanted to have the kind of success you’ve had?

KELLEHER: First of all, they have to focus intently upon what’s important and what’s unimportant, not be trapped in bureaucracy and hierarchy. Be results- and mission-oriented. Keep it as simple as they possibly can, so that the values and the destination of the organization are well understood by all the people that are part of it so that they can feel that they are truly participants in it. I don’t know whether it was Calvin Coolidge or Bianca Jagger who said — they’re both thin, that’s why I get them confused — “the business of business is business.” We’ve always said, “The business of business is people.”

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