

STRATEGY Core Concepts and Analytical Approaches
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The University of Alabama
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CHAPTER 5 The Five Generic Competitive Strategy Options: Which One to Employ?

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“Competitive strategy is about being different. It means deliberately choosing to perform activities differently or to perform different activities than rivals to deliver a unique mix of value.”

—Michael E. Porter
Professor, Harvard Business School

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“It is much better to make your own products obsolete than allow a competitor to do it.”

—Michael A. Cusamano and Richard W. Selby

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“The essence of strategy lies in creating tomorrow’s competitive advantages faster than competitors mimic the ones you possess today.”

—Gary Hamel and C. K. Prahalad

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“Winners in business play rough and don’t apologize for it. The nicest part of playing hardball is watching your competitors squirm.”

—George Stalk, Jr. and Rob Lachenauer

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Learning Objectives

1. Understand what distinguishes each of the five generic competitive strategies and the type of competitive advantage each can produce.
2. Gain command of why each of the five competitive strategies works better in certain market situations than in others.
3. Learn the major avenues for achieving a competitive advantage based on lower costs.
4. Learn the major avenues for achieving a competitive advantage based on differentiating a firm’s product or service offering from the offerings of rivals.
5. Understand the attributes of a best-cost provider strategy.

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Chapter 5 Roadmap

1. The Five Basic Competitive Strategies
2. Low-Cost Provider Strategies
3. Broad Differentiation Strategies
4. Focused Low-Cost Strategies
5. Focused Differentiation Strategies
6. Best-Cost Provider Strategies

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What Does the Term “Competitive Strategy” Refer To?

- Competitive strategy deals exclusively with the specifics of management's game plan for competing successfully:
 - ▶ Actions and approaches to please customers
 - ▶ Offensive and defensive moves to counter maneuvers of rivals
 - ▶ Responses to shifting market conditions
 - ▶ Initiatives to strengthen the firm's market position and achieve a particular kind of competitive advantage.
- Competitive strategy is narrower in scope than business strategy

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Why Do Competitive Strategies Differ Among Firms in the Same Industry?

- Managers at different firms have different views on:
 - ▶ How best to deal with competitive pressures and industry driving forces
 - ▶ What future market conditions will be like
 - ▶ What strategy specifics makes the most sense for their particular company in light of
 - Its resource strengths and competitive capabilities
 - Its company's resource weaknesses and competitive deficiencies
 - Its market opportunities
 - Its vulnerability to external threats
 - Its competitive strengths and weaknesses vis-à-vis rivals
 - The strategic vision, mission, core values, and performance targets that company managers have established

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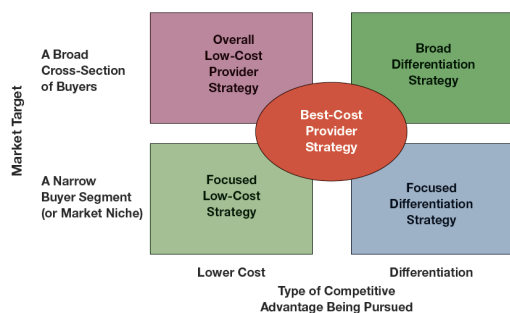
The Factors that Distinguish One Competitive Strategy from Another

- Two big factors distinguish one firm's competitive strategy from another
 - ▶ Whether a firm's market target is broad or narrow
 - ▶ Whether a firm is pursuing a competitive advantage linked to lower costs or differentiation
- These two factors give rise to five competitive strategy options for staking out a market position, competing against rivals, and striving to deliver superior value to customers
 - ▶ A low-cost provider strategy
 - ▶ A broad differentiation strategy
 - ▶ A focused low-cost strategy
 - ▶ A focused differentiation strategy
 - ▶ A best-cost provider strategy

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FIGURE 5.1 The Five Basic Competitive Strategy Options



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Low-Cost Provider Strategies

- A low-cost provider's strategic target is lower overall costs than rivals—but not necessarily the lowest possible costs.
 - ▶ In striving for a low-cost advantage over rivals, it is first necessary to incorporate features and services that buyers consider essential, then go all out to provide these at a lower cost than rivals.
 - ▶ A product offering that is too frills-free sabotages the attractiveness of the firm's product even if it is cheaper-priced.
- Keys to Success
 - ▶ Having good cost-reduction skills and capabilities
 - ▶ Pursuing long-term cost-saving approaches and capabilities that are difficult for rivals to copy or match

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Core Concept

A low-cost leader's basis for competitive advantage is **lower overall costs** than competitors.

Successful low-cost leaders are exceptionally good at finding ways to drive costs out of their businesses and using their low-cost advantage over rivals to achieve better profitability than rivals.

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Translating a Low-Cost Advantage into Higher Profits

- Option 1:
 - ▶ Use the lower-cost edge to underprice competitors and attract price-sensitive buyers in great enough numbers to increase total profits
- Option 2:
 - ▶ Charge a price comparable to other low-priced rivals, be content with the resulting sales volume and market share, and rely upon the low-cost edge over rivals to earn a bigger profit margin per unit sold, thereby boosting the firm's total profits and return on investment.

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The Two Major Avenues for Achieving a Cost Advantage

Approach 1: Be more cost efficient than rivals	Do a better job than rivals of performing value chain activities more cost efficiently
Approach 2: Revamp the value chain	Revamp the firm's value chain to eliminate costly work steps and/or bypass certain cost-producing value chain activities altogether

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Approach 1: Manage Value Chain Activities Very Cost Efficiently

- Avenues for performing value chain activities at lower cost than rivals:
 - ▶ Striving to capture all available economies of scale
 - ▶ Taking full advantage of experience and learning-curve effects
 - ▶ Trying to operate facilities at full capacity
 - ▶ Pursuing efforts to boost sales volumes and thus spread outlays for R&D, advertising, and selling and administrative costs out over more units
 - ▶ Improving supply chain efficiency
 - ▶ Substituting the use of low-cost for high-cost raw materials or component parts whenever there's little or no sacrifice in product quality or product performance
 - ▶ Improving product design and employing cost-saving production techniques
 - ▶ Using online systems and sophisticated software to achieve operating efficiencies
 - ▶ Pursuing ways to boost labor productivity, reduce workforce size, and otherwise trim compensation costs
 - ▶ Using the company's bargaining power vis-à-vis suppliers to gain concessions
 - ▶ Being alert to the cost advantages of outsourcing and vertical integration

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In Addition: Adopt Strategy Elements That Are Economical and Lead to Lower Costs Than Rivals

- Have lower specifications for purchased materials, parts, and components than rivals
- Strip frills and features from the company's product offering that are not highly valued by price-sensitive or bargain-hunting buyers
- Offer a limited selection or few versions of a product line by deleting slow-selling items and being content to meet the needs of most buyers rather than all buyers
- Distribute the firm's product only through low-cost distribution channels and avoid high-cost distribution channels
- Use the most economical method for delivering customer orders (even if it results in longer delivery times)

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Approach 2: Revamping the Value Chain

- Reengineer the value chain to eliminate costly work steps and bypass cost-producing value chain activities:
 - ▶ Sell direct to consumers to cut out the activities and costs of distributors and dealers
 - ▶ Shift to the use of technologies and/or information systems that bypass the need to perform certain value chain activities
 - ▶ Streamline operations by eliminating low-value-added or unnecessary work steps and activities
 - ▶ Have suppliers locate their plants or warehouses close to a firm's own facilities to reduce materials handling and shipping costs

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Wal-Mart's Approach to Managing Its Value Chain

- Institute extensive information sharing with vendors via online systems
- Pursue global procurement of some items and centralize most purchasing activities
- Invest in state-of-the-art automation at the company's distribution centers
- Strive to optimize the product mix and achieve greater sales turnover
- Install security systems and store operating procedures that lower shrinkage rates
- Negotiate preferred real estate rental and leasing rates with owners of store sites
- Manage and compensate the workforce in a manner that leads to lower labor costs

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Nucor Corporation's Low-Cost Provider Strategy

- Key Elements of Nucor's Strategy
 - ▶ Use electric arc furnaces to lower investment costs and eliminate expensive steps in making steel products from scratch
 - ▶ Use incentive compensation to achieve high productivity and low labor costs per ton produced
 - ▶ Locate plants close to customers to keep shipping costs down
- Cost Advantages and Bottom-line Results
 - ▶ Lower capital investment and operating costs
 - ▶ Ability to charge lower prices than traditional steel companies using make-it-from-scratch technology
 - ▶ Consistently good profitability in an industry where profits have often been terrible

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Key Characteristics of Southwest Airlines' Low-Cost Provider Strategy

- Mastery of fast turnarounds at boarding gates (25 minutes versus 45 minutes for rivals) allows:
 - ▶ Planes to fly more hours per day
 - ▶ More flights to be scheduled per day with fewer aircraft
 - ▶ More revenue to be generated per plane on average than rivals
- Elimination of several services results in cost savings:
 - ▶ In-flight meals
 - ▶ Assigned seating
 - ▶ Baggage transfer to connecting airlines
 - ▶ First-class seating and service
- Fast, user-friendly online reservation system:
 - ▶ Facilitates e-ticketing
 - ▶ Reduces staffing requirements at telephone reservation centers and airport counters

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The Keys to Being a Successful Low-Cost Provider

- Scrutinize each cost-creating activity to determine what factors cause costs to be high or low
- Use knowledge about cost-determining factors to streamline or reengineer how activities are performed
- Engage all company personnel in continuous cost improvement
- Use benchmarking to keep close tabs on how the firm's costs compare with its rivals and other firms performing comparable activities in other industries
- Strive to operate with exceptionally small corporate staffs
- Spend aggressively on resources and capabilities that promise to drive costs out of the business

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When a Low-Cost Provider Strategy Works Best

- A low-cost provider strategy becomes increasingly appealing and competitively powerful when:
 - ▶ Price competition among rival sellers is vigorous
 - ▶ The products of rival sellers are essentially identical and supplies are readily available from several eager suppliers
 - ▶ It is hard to achieve product differentiation in ways that buyers value
 - ▶ Most buyers use different brands of the product in same ways
 - ▶ Buyers incur low costs in switching purchases from one seller to another
 - ▶ A big fraction of the industry's sales are made to large-volume buyers with significant power to bargain down prices
 - ▶ Industry newcomers use introductory low prices to attract buyers and build a customer base

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Pitfalls to Avoid in Pursuing a Low-Cost Provider Strategy

- Getting carried away with overly aggressive price cutting to win sales and market share away from rivals
 - ▶ Reducing price does not lead to higher total profits unless the incremental gain in total revenues exceeds the incremental increase in total costs
- Failing to emphasize cost advantages that can be kept proprietary or that relegate rivals to playing catch-up
 - ▶ The value of a cost advantage depends on achieving cost savings that are hard for rivals to copy or otherwise overcome
- Becoming too fixated on reducing costs and ignoring:
 - ▶ Growing buyer interest in added features or service or a more upscale product
 - ▶ Declining buyer sensitivity to price
 - ▶ New developments that alter how buyers use the product

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Beware of Charging a Price That Is Too Low

- Reducing price does not lead to higher total profits *unless the incremental gain in total revenues exceeds the incremental increase in total costs.*
- Low price, by itself, is not always appealing to buyers—a low-cost provider's product offering must always contain enough attributes to be attractive to prospective buyers.

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Broad Differentiation Strategies

- Broad Differentiation Strategies
 - ▶ Entail offering unique product attributes that a wide range of buyers find appealing, valuable, and worth paying for
 - ▶ Are attractive when buyer needs and preferences are too diverse to be fully satisfied by a single, standardized product offering
- Keys to Success
 - ▶ Incorporating buyer-desired attributes into product offering that:
 - Will appeal to a broad range of buyers
 - Will be different enough to stand apart from rival product offerings
 - ▶ Creating a product offering that is strongly differentiated rather than weakly differentiated from the offerings of rivals

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Core Concept

The essence of a **broad differentiation strategy** is to offer unique product attributes that a wide range of buyers find appealing and worth paying for.

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Benefits of a Successful Differentiation Strategy

- A product/service with unique, appealing attributes can create a competitive advantage for a firm and allow it to do one or more of the following:
 - ▶ Command a premium price for its product (because many buyers believe the unique attributes are worth the extra price)
 - ▶ Increase unit sales (because additional buyers are won over by the differentiating features)
 - ▶ Gain buyer loyalty to its brand (because some buyers really like the differentiating features and bond with the company and its products)

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Is Differentiation the Road to Profits or to Failure?

- Differentiation enhances profitability whenever a firm's product can:
 - ▶ Command a sufficiently higher price or produce sufficiently bigger sales to more than cover the added costs of achieving the differentiation
- Broad differentiation strategies fail when
 - ▶ Buyers don't value the brand's uniqueness
 - ▶ A firm's approach to differentiation is easily copied or matched by its rivals.

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Options for Differentiating

- **Unique taste** – Dr. Pepper, Listerine
- **Multiple features** – Microsoft Office, iPhone, iPod, iPad
- **Wide selection** and **one-stop shopping** – Amazon.com
- **Superior service** – FedEx
- **Engineering design and performance** – Mercedes, BMW
- **Prestige and distinctiveness** – Rolex
- **Product reliability** – Johnson & Johnson
- **Quality manufacture** – Michelin, Honda
- **Technological leadership** – 3M Corporation
- **Full range of services** – Charles Schwab
- **Wide selection** – Campbell's soups
- **High-fashion design** – Gucci and Chanel

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Ways to Manage Value Chain Activities That Enhance Differentiation

Differentiation opportunities can exist in activities all along an industry's value chain:

- Collaborating with suppliers to create product attributes important to customers
- Emphasizing new product R&D and product innovation
- Pursuing continuous quality improvements
- Investing in production-related R&D, strive for technological advances, and implement better production techniques
- Increased emphasis on marketing, and brand-building activities
- Boosting the number and/or caliber of customer services
- Improving distribution and delivery capabilities
- Emphasizing human resource management activities that improve the skills, expertise, and knowledge of company personnel

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Signaling the Value of a Firm's Differentiated Product Offering to Buyers

- Stronger differentiation is achieved by sending signals to buyers that a product offering has value
- Signaling value is particularly useful when:
 - ▶ The differentiating attributes are subjective or not easy to demonstrate or intangible
 - ▶ Buyers are making a first-time purchase and are unsure what their experience with the product will be
 - ▶ Repurchase is infrequent and buyers need to be reminded of a product's value

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How Is Value Signaled to Buyers?

- Typical signals of value include:
 - ▶ A high price that implies quality or performance
 - ▶ More appealing or fancier packaging
 - ▶ Extensive product's image ad campaigns that promote greater buyer awareness
 - ▶ The luxuriousness and ambience of high-end retailers and sales sites frequented by customers
 - ▶ The professionalism, appearance, and personalities of the seller's employees

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Achieving Competitive Advantage Via a Broad Differentiation Strategy

- To build sustainable competitive advantage via differentiation, a firm must do one or more of the following:
 - ▶ Focus on continuous product innovation
 - ▶ Incorporate product attributes and user features that lower the buyer's overall costs of using the firm's product
 - ▶ Incorporate features that raise product performance and deliver added value to the buyer/end-user
 - ▶ Incorporate features that enhance buyer satisfaction in noneconomic or intangible ways
 - ▶ Deliver value to customers through competencies and competitive capabilities that rivals do not have or cannot afford to match

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When a Differentiation Strategy Works Best

- Buyer needs and uses of the product are diverse
- There are many ways to differentiate the product or service and many buyers perceive these differences as having value
- Few rivals are following a similar differentiation approach
- Technological change is fast-paced and market competition revolves around rapidly evolving product features

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Pitfalls to Avoid in Pursuing a Differentiation Strategy

- Differentiating on appealing product attributes that competitors can readily copy
- Differentiation that produces an unenthusiastic response on the part of buyers
- Overspending to differentiate the firm's product offering that erodes profitability
- Failing to achieve meaningful differences in quality, service or performance features vis-à-vis rival products
- Adding frills and extra features that exceed the needs and use patterns of most buyers
- Charging a price premium buyers perceive as too high

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Pursuing a Differentiation Strategy: Three Principles to Keep in Mind

1. A differentiating feature that works well is a magnet for imitators
2. Over-differentiating and overcharging are fatal strategy mistakes
3. Small differences among the product offerings of rival firms may not be important to buyers—a good differentiation strategy must aim at strong rather than weak product differentiation

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Focused (or Market Niche) Strategies

- Focused strategies concentrate attention on a narrow piece of the total market
- The target segment, or market niche, can be defined by:
 - ▶ Geographic uniqueness
 - ▶ Specialized requirements in using the product
 - ▶ Special product attributes that appeal only to those buyers that comprise the market niche

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Examples of Focused (or Market Niche) Strategies

- Animal Planet, History Channel, and other special interest cable TV channels
- Porsche and Ferrari in high-end sports cars
- Bandag (a specialist in recapped truck tires)
- Match.com (an online dating service)
- Tiffany and Cartier in high-end jewelry
- Rolex in watches
- Microbreweries
- Bed-and-breakfast inns

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Focused Low-Cost Strategies

- Seek competitive advantage by serving a target market niche at a lower cost and lower price than rivals
- Are attractive when a firm can lower its costs significantly by limiting its customer base to a well-defined segment
- Achieve a cost advantage over rivals by:
 - ▶ Managing value chain activities more cost effectively than rivals
 - ▶ Finding innovative ways to bypass certain value chain activities

The difference between a low-cost provider strategy and a focused low-cost strategy is the size of the buyer group being targeted.

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Examples of Focused Low-Cost Strategies

- Budget motel chains
 - ▶ Motel 6, Sleep Inn, Super 8, and Days Inn
- The producers and retailers of private-label goods
- The makers of generic prescription drugs
- The makers of economically-priced replacement ink cartridges for printers (which carry a substantially lower price tag than those offered by the original manufacturers of name brand printers)

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Focused Differentiation Strategies

- Aim at securing a competitive advantage with a product offering designed to appeal to the unique preferences and needs of a narrow well-defined group of buyers
- Depend on
 - ▶ A buyer segment looking for special product attributes or seller capabilities
 - ▶ A firm's ability to create a product offering that stands apart from the offerings of rivals in the same target market niche

The difference between a broad differentiation strategy and a focused differentiation strategy is the size of the buyer group being targeted.

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Examples of Focused Differentiation Strategies

- Godiva Chocolates



- Haägen-Dazs



- Rolls-Royce



- W. L. Gore
(the maker of Gore-Tex)



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When a Focused Low-Cost or Focused Differentiation Strategy Is Attractive

- The target niche is big enough to be profitable and offers good growth potential
- Industry leaders do not view having a presence in the niche as crucial to their own success
- It is costly or difficult for multi-segment competitors to meet the specialized needs of niche members
- Few other rivals are specializing in same target niche (a condition that reduces the risk of segment overcrowding)
- The industry has many different niches and segments, thereby allowing a focuser to pick a competitively attractive niche suited to its resource strengths and capabilities
- The focuser can draw upon customer goodwill and loyalty to defend against ambitious challengers

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The Risks of a Focused Low-Cost or Focused Differentiation Strategy

- Competitors find effective ways to match a focuser's capabilities in serving niche
- The preferences and needs of niche members shift over time causing the niche to fade into the overall market
- A segment is so attractive that entry of new rivals results in overcrowding, thereby intensifying rivalry and splintering segment profits

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Best-Cost Provider Strategies

- Stake out a middle ground:
 - Between pursuing a low-cost advantage and a differentiation advantage
 - Between appealing to the broad market as a whole and a narrow market niche
- Are aimed squarely at *value-conscious buyers looking for a good-to-very-good product or service at an economical price*



The Objective

Deliver *superior value* by meeting or exceeding buyer expectations on product attributes and beating their price expectations

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Core Concept

The competitive advantage of a best-cost provider is lower costs than rivals in incorporating upscale attributes (appealing features or functionality or quality or more satisfying customer service), thereby putting the company in a position to underprice rivals whose products have similar upscale attributes.

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The Standout Traits of Best-Cost Provider Strategies

- The essence of a best-cost provider strategy is giving customers more value for the money by:
 - Satisfying buyer desires for appealing features/performance/quality/service
 - Charging a lower price for attributes than its rivals
- To profitably employ a best-cost provider strategy, a firm must incorporate attractive upscale attributes at lower costs than its rivals

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A Best-Cost Provider's Competitive Advantage

- A best-cost provider's competitive advantage is its lower costs in incorporating upscale attributes than rivals
 - ▶ This low-cost advantage allows a firm to underprice rivals and still earn attractive profits (provided the size of the price discount does not squeeze profit margins)

Competitive Strategy Principle	It is usually not difficult to entice buyers away from rivals with an equally good product at a more economical price
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How a Best-Cost Strategy Differs from a Low-Cost Strategy

- Upscale product attributes in a best-cost provider's offering entail added costs that a low-cost provider avoids by offering a basic product with few frills
- The two strategies are aimed at different buyers:
 - ▶ Best-cost provider's target market is value-conscious buyers looking for valued extras and utility at an appealingly low price
 - ▶ Low-cost provider's target market is price-conscious buyers seeking a basic product at a bargain price

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When a Best-Cost Provider Strategy Works Best

- Product differentiation is the norm in the market
- Value-conscious buyers can be induced to purchase mid-range products rather than
 - ▶ The cheap basic products of low-cost producers
 - ▶ The expensive products of top-of-the-line differentiators
- Masses of buyers have become value-conscious in recessionary times
- Adopting a best-cost strategy is ill-advised unless a firm can incorporate upscale product or service attributes at a lower cost than rivals

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The Big Risk of a Best-Cost Provider Strategy

- A best-cost provider may get squeezed between rivals using low-cost and high-end differentiation strategies
 - ▶ Low-cost providers siphon customers away with a lower price
 - ▶ High-end differentiators steal customers away with better product attributes
- A best-cost provider must
 - ▶ Offer buyers better product attributes to justify a price above what low-cost leaders are charging
 - ▶ Achieve significantly lower costs in providing upscale features to outcompete high-end differentiators on the basis of a lower price

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Questions for Simulation Company Co-Managers

- Which of the five generic competitive strategies has your firm decided to pursue?
- Have you studied rival firms to determine which competitive strategies they pursuing? How many other rivals have opted to pursue a strategy similar to your company's strategy?
- Are too many other rivals pursuing a competitive strategy similar to your company's strategy, resulting in segment overcrowding and splintered profits? If so, should your company look at the merits of shifting to a different strategic group?
- Which rival firms have obscure or muddled or unclear strategies—perhaps because their management teams are pursuing inconsistent or confused actions or are changing strategies every year (because the strategies they have pursued have produced weak results)?
- Are companies with shifting or unclear strategies likely to keep experimenting until they find a strategy that works well enough to stick with for a while?

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Questions for Simulation Company Co-Managers

- After each decision round, should your management team closely study the data in the Competitive Intelligence Reports for the purposes of
 - ▶ Tracking the number of companies that appear to be pursuing low-cost, differentiation, and best-cost strategies—and most especially those companies that have a strategy similar to your company's strategy and are in your strategic group?
 - ▶ Learning what rivals did in the prior year to fine-tune or overhaul their strategies?
 - ▶ Using the above analysis to make some guestimates about what close rivals are likely to do next and thereby better craft your own strategic moves for the upcoming decision round?
- If you are not currently doing these things, shouldn't you start doing them immediately? How can you hope to outwit and outmaneuver rivals if you are not carefully studying what they are doing?

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Tips for Company Co-Managers

- Commit to a basic competitive strategy and aggressively pursue the competitive advantage potential it offers.
- Avoid “getting stuck in the middle” by mixing the five strategies and not achieving a clear-cut competitive edge.
- Consider switching to a different strategy if
 - ▶ “Too many” rivals have adopted much the same strategy and your firm finds itself in a strategic group that is “overcrowded”
 - ▶ Rivals pursuing much the same strategy as your firm are effectively blocking your company's path to achieving better overall business results
 - ▶ Opportunities are more promising in a different strategic group

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Successful Competitive Strategies Are Resource-Based

- Successful strategies rely on an appropriate set of resources, know-how, and competitive capabilities
 - ▶ A low-cost provider must have the resource strengths and capabilities to keep costs below those of competitors.
 - ▶ To pursue a differentiation strategy, a firm must have the resource capabilities to incorporate unique attributes into its product offering that buyers will find appealing, valuable, and worth paying for.
 - ▶ Focus strategies require the resources and capabilities to outcompete rivals in satisfying the needs and expectations of buyers in the target market niche.
 - ▶ A best-cost strategy requires resource capabilities to incorporate upscale product or service attributes at a lower cost than rivals.

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Core Concept

No firm's competitive strategy is likely to result in good performance or sustainable competitive advantage unless the firm has a competitively valuable collection of resource strengths, competencies, and capabilities and unless its strategy is aimed squarely at capitalizing on these resources, competencies, and capabilities.

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