Strategy: Core Concepts and Analytical Approaches

Chapter 5
The Five Basic Competitive Strategy Options: Which One to Employ?

Chapter Learning Objectives

1. **Learn what the five basic competitive strategies are and the type of competitive advantage each can produce.**
2. **Gain an understanding 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 company's product or service offering from the offerings of rivals**

The Key Topics Covered in Chapter 5

- The Five Basic Competitive Strategies
- Low-Cost Provider Strategies
- Broad Differentiation Strategies
- Focused Low-Cost Strategies
- Focused Differentiation Strategies
- Best-Cost Provider Strategies

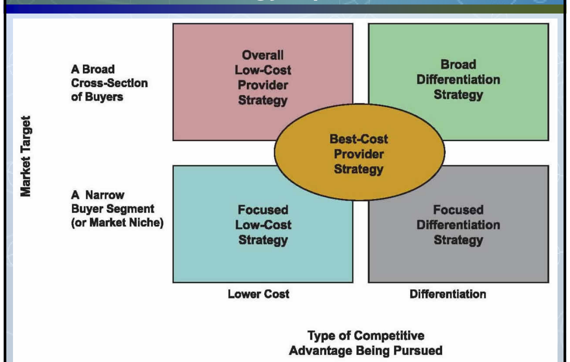
What Does the Term "Competitive Strategy" Refer To?

- A company's ***competitive strategy*** deals exclusively with the details of management's action plan to competing successfully:
  - Specific efforts to please customers
  - Offensive and defensive moves to counter the maneuvers of rivals
  - Responses to shifting market conditions,
  - Initiatives to strengthen the company's market position and achieve a particular kind of competitive advantage.
- ***Narrower in scope*** than business strategy
- The chances are very remote that any two companies—even companies in the same industry—will employ competitive strategies that are exactly alike. Why?
  - Because each company's situation is different
  - Because managers at different companies have a different spin on how best to try to compete successfully

The Five Basic Competitive Strategy Options

- The ***two biggest factors that distinguish one competitive strategy from another*** boil down to
  - ***Whether a company's market target is broad or narrow***
  - ***Whether the company is pursuing a competitive advantage linked to lower costs or differentiation.***
- These two factors give rise to ***five competitive strategy options***
  - A low-cost provider strategy
  - A broad differentiation strategy
  - A focused (or market niche) strategy based on low costs
  - A focused (or market niche) strategy based on differentiation
  - A best-cost provider strategy

Figure 5.1: The Five Basic Competitive Strategy Options



Low-Cost Provider Strategies

Keys to Success

- A low-cost provider's strategic target is meaningfully lower costs than rivals but not necessarily the absolutely lowest possible cost
  - ***Must include features and services*** that buyers consider ***essential***
  - A product offering that is ***too frills-free*** sabotages the attractiveness of the company's product
- Important to pursue cost-saving approaches that are ***difficult*** for rivals to ***copy or match***
  - When it is relatively easy or inexpensive for rivals to imitate the low-cost firm's methods, any resulting cost advantage quickly evaporates.

Translating a Low-Cost Advantage into Higher Profits: Two Options

- ***Option 1***: Use lower-cost edge to under-price competitors and attract price-sensitive buyers in enough numbers to increase total profits
- ***Option 2***: Refrain from using price cuts to steal sales and market share away from rivals,
  - Charge a price roughly equal to those of other low-priced rivals
  - Rely on the ability to earn a bigger profit margin per unit sold (because the company's costs per unit are below the unit costs of rivals) to earn higher total profits and return on investment than rivals.

Approaches to Securing a Low-Cost Advantage

Approach 1

Do a better job than rivals of performing value chain activities more cost effectively

Approach 2

Revamp value chain to bypass cost-producing activities that add little value from the buyer's perspective

Approach 1: Cost-Efficient Management of Value Chain Activities

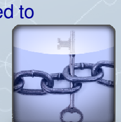
For a company to do a more cost-efficient job of managing its value chain than rivals, managers must pursue cost-saving opportunities in every part of the value chain, including

- Striving to capture all available scale economies
- 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 such costs as 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
- Improving product design and production techniques
- Pursuing ways to reduce labor costs
- Using online systems and sophisticated software to achieve operating efficiencies
- Using the company's bargaining power vis-à-vis suppliers to gain concessions
- Being alert to the cost advantages of outsourcing and vertical integration

Approach 2: Revamping the Value Chain

Options for reengineering a company's value chain to eliminate costly work steps and entirely bypass cost-producing value chain activities include

- Selling direct to consumers and cutting out the activities and costs of distributors and dealers
- Shifting to the use of technologies and/or information systems that bypass the need to perform certain value chain activities.
- Streamlining operations by eliminating low-value-added or unnecessary work steps
- Reducing materials handling and shipping costs by locating plants or warehouses close to customers.



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 its 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 real estate developers and owners of its store sites**
- **Manage and compensate its workforce in a manner to yield lower labor costs**

Nucor Corporation's Low-Cost Provider Strategy

- Key elements of Nucor's strategy
  - Use electric arc furnace technology to lower investment costs for facilities and equipment and eliminate many 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
  - Earned attractive profits for shareholders since 1966

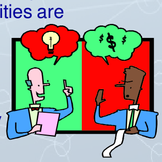
Key Characteristics of Southwest Airlines' Low-Cost Provider Strategy

- Mastery of fast turnarounds at gates (25 minutes vs. 45 minutes for rivals) allows
  - Planes to fly more hours per day
  - More flights to be scheduled per day with fewer aircraft
  - More revenue 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

Keys to Success in Achieving Low-Cost Leadership

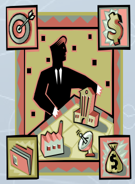
- Scrutinize each cost-creating activity, identifying factors that cause costs to be high or low
- Use knowledge about cost-determining factors to streamline or reengineer how activities are performed
- Engage all company personnel in continuous cost improvement
- Strive to operate with exceptionally small corporate staffs
- Spend aggressively on resources and capabilities that promise to drive costs out of the business



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 any of several eager sellers
- There are few ways to achieve differentiation that have value to buyers
- Most buyers use product in same ways
- Buyers incur low costs in switching their purchases from one seller to another
- Buyers are large and have significant power to bargain down prices
- Industry newcomers use introductory low prices to attract buyers and build customer base



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
- Relying on low cost methods that are easily imitated by rivals
- Becoming too fixated on reducing costs and ignoring
  - Buyer interest in additional features
  - Declining buyer sensitivity to price
  - Changes in how the product is used

Broad Differentiation Strategies

- The essence of a broad differentiation strategy is to ***offer unique product attributes that a wide range of buyers find appealing, valuable, and worth paying for***
- An attractive strategy when buyer needs and preferences are ***diverse***

Keys to Success

- Incorporate certain buyer-desired attributes into its product offering that
  - Will ***appeal to a broad range of buyers***
  - Will be ***different enough to stand apart*** from the product offerings of rivals
- ***Create a product offering that is strongly differentiated rather than weakly differentiated***

Benefits of Successful Differentiation

A product / service with unique, appealing attributes allows a firm to

- **Command a premium price** for its product, and/or
- **Increase unit sales** (because additional buyers are won over by the differentiating features), and/or
- **Gain buyer loyalty** to its brand (because some buyers are strongly bonded to the differentiating features of the company's product offering).

= ***Competitive Advantage***

Differentiation—The Road to Profits or Failure?

- Differentiation ***enhances profitability*** whenever a company's product can
  - command a sufficiently higher price

    or
  - produce sufficiently bigger unit 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 and/or
  - A company's approach to differentiation is easily copied or matched by its rivals.

Types of Differentiation Themes

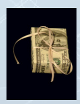
- ***Unique taste*** – Dr. Pepper, Listerine
- ***Multiple features*** – Microsoft Office, iPhone, iPod
- ***Wide selection*** and ***one-stop shopping*** – Home Depot, Amazon.com
- ***Superior service*** – FedEx
- ***Spare parts availability*** – Caterpillar
- ***Engineering design and performance*** – Mercedes, BMW
- ***Prestige and distinctiveness*** – Rolex
- ***Product reliability*** – Johnson & Johnson
- ***Quality manufacture*** – Karastan, Michelin, Toyota
- ***Technological leadership*** – 3M Corporation
- ***Top-of-line image*** – Gucci, Prada, and Starbucks

Differentiating Attributes Can Be Created at Many Value Chain Locations

- ***Differentiation opportunities can exist in activities all along an industry's value chain***
- A company can often assist its efforts to achieve differentiation by ***signaling the value of its product offering*** to buyers. ***Typical signals of value include***
  - A high price (in instances where high price implies high quality and performance)
  - More appealing or fancier packaging
  - Extensive ad campaigns (which impact a product's image and promote greater buyer awareness)
  - The luxuriousness and ambience of a seller's facilities (important for high-end retailers and for offices or other facilities frequented by customers)
  - The professionalism, appearance, and personalities of the seller's employees

When Is Signaling Value Important?

- ***Signaling value*** is particularly ***important*** in three instances:



  1. When the nature of differentiation is subjective or hard to quantify
  2. When buyers are making a first-time purchase and are unsure what their experience with the product will be, and
  3. When repurchase is infrequent and buyers need to be reminded of a product's value.

Achieving Competitive Advantage Via a Broad Differentiation Strategy

- Resourceful competitors ***can***, in time, ***clone almost any product or feature or attribute***
- To build ***sustainable competitive advantage*** via differentiation, ***a company usually needs to***
  - Incorporate product attributes and user features that lower the buyer's overall costs of using the company's product
  - Incorporate features that raise product performance
  - Incorporate features that enhance buyer satisfaction in noneconomic or intangible ways.
  - Deliver value to customers on the basis of competencies and competitive capabilities that rivals don't have or can't afford to match

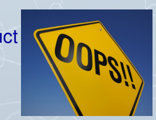
When a Differentiation Strategy Works Best

- There are many ways to differentiate a product that have value and please customers

- Buyer needs and uses of the product are diverse
- Few rivals are following a similar differentiation approach
- Technological change is fast-paced and competition revolves around rapidly evolving product features

Pitfalls to Avoid in Pursuing a Differentiation Strategy

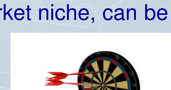
- The ability of competitors to quickly copy most or all of the appealing product attributes a company comes up with
- Buyers do not perceive the differentiating features as appealing or valuable or worth paying for
- Overspending on efforts to differentiate the product offering, thus eroding profitability



- Over-differentiating such that product features exceed buyers' needs
- Charging a price premium buyers perceive is too high
- Being timid and not striving to open up meaningful gaps in quality or service or performance features vis-à-vis the products of rivals

Focused (or Market Niche) Strategies

- What sets focused strategies apart from low-cost provider and broad differentiation strategies is ***concentrated 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.

Examples of Focus Strategies

- ***Community Coffee***
  - Specialty coffee retailer
- ***Animal Planet and History Channel***
  - Special interest Cable TV programs
- ***Porsche***
  - Sports cars
- ***Bandag***
  - Specialist in truck tire recapping
- ***Match.com***
  - Online dating service

Focused Low-Cost Strategies

- Focused low-cost strategies aim at securing a ***competitive advantage by serving buyers in the target market niche at a lower cost and lower price than rival competitors***
  - Are attractive if a firm can lower costs by limiting its customer base to a well-defined segment.
- The ***avenues to achieving a cost advantage*** over rivals are the same as for low-cost leadership:
  - ***Out-manage rivals in performing value chain activities cost effectively*** and/or
  - ***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

Focused Differentiation Strategies

- A focused strategy keyed to differentiation aims at securing a competitive advantage with a product offering carefully designed to appeal to the unique preferences and needs of a narrow well-defined group of buyers
- Successful use of a focused differentiation strategy depends on
  - The existence of ***a buyer segment that is looking for special product attributes*** or seller capabilities and
  - A firm's ability to create ***a product offering that stands apart from the offerings of rivals*** competing 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

Examples of Focused Differentiation Strategies

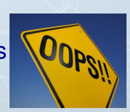
- Godiva Chocolates
- Rolls-Royce
- Haägen-Dazs
- W. L. Gore (the maker of Gore-Tex)
- CGA, Inc. (a specialist in providing insurance to cover the cost of lucrative hole-in-one prizes at golf tournaments)
- Fezzari (a specialist in high-end custom road bikes)

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

A focused strategy becomes increasingly attractive as more of the following conditions are met:

- Focuser has resources and capabilities to effectively serve an attractive niche
- 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
- Focuser can draw upon customer goodwill and loyalty to defend against ambitious challengers

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 potential for the preferences and needs of niche members to shift over time toward the product attributes desired by the majority of buyers (niche fades into the overall market)
- Segment becomes so attractive it becomes crowded with rivals, causing segment profits to be splintered

Best-Cost Provider Strategies

- 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*** the sometimes great mass of ***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

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 these attributes compared to rivals with similar-caliber product offerings

- To profitably employ a best-cost provider strategy, a company ***must have the capability to incorporate attractive upscale attributes at a lower cost than those rivals with comparable upscale product offerings***

A Best-Cost Provider's Competitive Advantage

- The competitive advantage of a best-cost provider is ***lower costs than rivals in incorporating upscale attributes.***
- This low-cost advantage puts a company in a position to underprice rivals whose products have similar upscale attributes and still earn attractive profits (provided the price discount is not so large as to squeeze profit margins)

It is usually not difficult to entice buyers away from rivals with an equally good product at a more economical price

How a Best-Cost Strategy Differs from a Low-Cost Strategy

- Being a best-cost provider is different from being a low-cost provider ***because the additional upscale attributes in a best-cost provider's product offering entail additional costs*** (that a low-cost provider can avoid by offering buyers a basic product with few frills).
- ***The two strategies are aimed at different buyers***
  - The target market for a best-cost provider is ***value-conscious buyers***—buyers looking for appealing extras and functionality at an appealingly low price.
  - The target market for a low-cost provider is ***price-conscious buyers***—buyers looking for a basic product at a bargain basement price)

When a Best-Cost Provider Strategy Works Best

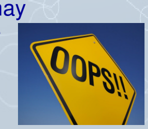
- A best-cost provider strategy works best in markets where
  - Product differentiation is the norm
  - Attractively large numbers of value-conscious buyers can be induced to purchase midrange products rather than
    - The cheap basic products of low-cost producers or
    - The expensive products of top-of-the-line differentiators

- Best-cost provider strategies also work well in recessionary times when great masses of buyers become value-conscious

Unless a company has the resources, know-how, and capabilities to incorporate upscale product or service attributes at a lower cost than rivals, adopting a best-cost strategy is ill-advised.

The Big Risk of a Best-Cost Provider Strategy

- A ***best-cost provider*** may get ***squeezed between strategies of firms using low-cost and high-end differentiation strategies***
  - ***Low-cost leaders*** may be able to ***siphon customers*** away with a ***lower price***
  - ***High-end differentiators*** may be able to ***steal customers*** awaywith ***better product attributes***




Successful Competitive Strategies Are Resource-Based
Successful competitive strategies are underpinned by 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 succeed with a differentiation strategy, a company must have the resource capabilities to incorporate unique attributes into its product offering that buyers will find appealing, valuable, and worth paying for
Successful focus strategies require the capability to do an outstanding job of satisfying the needs and expectations of buyers in the target market niche
Success in employing a best-cost strategy requires the resource capabilities to incorporate upscale product or service attributes at a lower cost than rivals