EMERGENCE OF COMPETITIVE ADVANTAGE

How does competitive advantage emerge?

External sources of change e.g.:
- Changing customer demand
- Technological change

Internal sources of change

Resource heterogeneity among firms means differential impact

Some firms faster and more effective in exploiting change

Some firms have greater creative and innovative capability

COMPETITIVE STRATEGY

Industry trends, competitive conditions, emerging opportunities and threats

Capabilities and core competencies

Customer groups, needs, and product end-uses

Competitor actions and strategies
THE COMPONENTS OF VALUE ADDED

```
<table>
<thead>
<tr>
<th></th>
<th>Value Created</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer surplus</td>
<td></td>
</tr>
<tr>
<td>Producer’s profit</td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td></td>
</tr>
</tbody>
</table>
```

Value created = Consumer surplus + Producer’s profit

TYPES OF COMPETITIVE ADVANTAGE

COST ADVANTAGE

- Similar product at lower cost

DIFFERENTIATION ADVANTAGE

- Price premium from unique product

COMPETITIVE STRATEGY

- Offensive or defensive actions to create sustainable competitive advantage

STRATEGIC ADVANTAGE

<table>
<thead>
<tr>
<th>Uniqueness perceived by customer</th>
<th>Low cost position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broad target market</td>
<td>Differentiation</td>
</tr>
<tr>
<td>Narrow target segment</td>
<td>Cost leadership</td>
</tr>
</tbody>
</table>

FOCUS

- Focused differentiation
- Focused cost
COST LEADERSHIP

Likely to be attractive when:

- Economies of scale and learning economies are potentially significant but no firm seems to be exploiting them.
- Opportunities for enhancing the product’s perceived benefit are limited.
- Consumers are relatively price sensitive.

Value created = Consumer surplus + Producer’s profit

COST LEADERSHIP AND FIVE FORCES

- Can mitigate Supplier Power by:
  - Low cost position makes them better able to absorb cost increases.
  - More likely to make very large purchases which reduces chance of supplier power.

- Can frighten off New Entrants due to the need to:
  - Enter at large scale to be cost competitive.
  - Take time to move down the “Learning Curve.”

- Well positioned relative to Substitutes:
  - Can buy patents developed by potential substitutes.
  - Lower prices to maintain value position.

- Can mitigate Buyer Power by:
  - Driving prices for below competitors which may cause exit and shift power back to firm.

- Rivalry:
  - Competitors avoid price wars with Cost Leaders.

Notes
COST LEADERSHIP

RISKS
- All or nothing strategy
- Technological changes nullifies investments in cost minimization
- Rivals/new entrants duplicate low cost methods
- Limits firm’s ability to compete in other ways
- Cost differences narrow as market matures
- Erosion of advantage when pricing information available to customers increases

DIFFERENTIATION VS. COST LEADERSHIP

COST LEADERSHIP
- Acceptable quality at lowest cost
- Open significant and sustainable cost gap over other competitors
- Sustain advantage through superior management of key cost drivers
- Above average ROA with relatively low prices

BUT
- Must maintain proximity in quality
STRATEGIC COST ANALYSIS

IDENTIFY VALUE CHAIN
❖ Separate critical activities which
   • Represent significant percentage of operating cost
   • Performed by competitors in different ways

DIAGNOSE COST DRIVERS

DEVELOP SUSTAINABLE COMPETITIVE ADVANTAGE

IDENTIFY VALUE CHAIN
❖ Separate critical activities which
   • Represent significant percentage of operating cost
   • Performed by competitors in different ways

DIAGNOSE COST DRIVERS
❖ Structural
   • Economies of scale
   • Economies of scope
   • Experience
   • Process technology
   • Complexity
❖ Executional
   • Work force commitment
   • Capacity utilization
   • Plant layout
   • Product configuration
   • Linkages with buyers/suppliers
   • Organizational slack

DEVELOP SUSTAINABLE COMPETITIVE ADVANTAGE

Recent Approaches to Cost Reduction

Dramatic changes in strategy and structure to adjust to the business conditions of the 1990’s. Key elements:
❖ Plant closures
❖ Outsourcing
❖ Delayering and cuts in administrative staff

The fundamental rethinking and radical redesign of business processes to achieve dynamic improvements in performance, e.g.:
❖ Several jobs combined into one
❖ Steps of a process combined in natural order
❖ Minimizing steps, controls, and reconciliation
❖ Use case managers as single points of contact
❖ Hybrid centralization/ decentralization
BUSINESS-LEVEL/COMPETITIVE STRATEGY

STRATEGIC COST ANALYSIS

IDENTIFY VALUE CHAIN

DEVELOP SUSTAINABLE COMPETITIVE ADVANTAGE

Control cost drivers better than competitors
- Reduce costs in activity, holding revenues constant
- Increase revenues holding costs constant
- Reduce assets holding costs and revenues constant

Reconfigure value chain

DIAGNOSE COST DRIVERS

DEVELOP SUSTAINABLE COMPETITIVE ADVANTAGE

VALUE CHAIN IN COST ANALYSIS:
AUTO MANUFACTURER

VALUE CHAIN ANALYSIS IN SCM FRAMEWORK

<table>
<thead>
<tr>
<th>PERSPECTIVE</th>
<th>Entire set of linked activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>COST DRIVER CONCEPT</td>
<td>Multiple cost drivers, each activity has set of unique drivers</td>
</tr>
<tr>
<td>COST CONTAINMENT PHILOSOPHY</td>
<td>Function of cost driver(s), exploit linkages with suppliers and buyers, exploit process linkages</td>
</tr>
<tr>
<td>INSIGHT FOR STRATEGIC DECISIONS</td>
<td>Advantage by controlling drivers better, make versus buy, reconfigure value chain</td>
</tr>
</tbody>
</table>

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SOUTHWEST AIRLINES

- Frequent, reliable departures
- No meals
- No seat assignments
- Limited passenger service
- No baggage transfers
- Limited use of travel agents
- Standardized fleet of 737s
- Low ticket price
- High aircraft utilization
- Lean, highly productive ground crew
- Flexible union contracts
- Employee stock ownership
- 15 minute gate turnaround
- High aircraft utilization
- Frequent, reliable departures

DIFFERENTIATION

Value created = Consumer surplus + Producer’s profit

DIFFERENTIATION

Likely to relative more attractive when:
- Typical customer willing to pay significant price premium
- Economies of scale or learning are significant and existing firms are exploiting them
- Differentiation significantly lowers rivalry and bargaining power of buyers and creates entry barriers
**DIFFERENTIATION AND FIVE FORCES**

- **Threat of New Entrants**
  - Can fend off New Entrants because of:
    - New products must overcome brand loyalty
    - Or be equal to performance at lower prices

- **Bargaining Power of Suppliers**
  - Can mitigate Supplier Power by:
    - Absorbing price increases due to higher margins
    - Passing on higher supplier prices because buyers are brand loyal

- **Rivalry**
  - Can mitigate Buyer Power because:
    - Well differentiated products reduce customer sensitivity to price increases
  - Brand loyalty overcomes much price competition

- **Threat of Substitute Products**
  - Well positioned relative to Substitutes in order to:
    - Brand loyalty tends to reduce new product trial and brand switching

**DIFFERENTIATION RISKS**

- Too high a price premium
- Buyers’ need for differentiation falls or shifts
- Overdifferentiation – attributes exceed needs of buyers
- Image blurring -- differentiating in many ways
- Consumers’ tastes and demand might change
- Different perceptions of differentiation between buyers and sellers
- Imitation by rivals

**DIFFERENTIATION**

- Select one or more needs that are valued by the buyer
- Achieve and sustain superior performance by meeting these needs better than competitors
- Successful differentiation leads to premium prices
  - Must maintain cost proximity
  - Must pick cost-effective forms of differentiation
  - BUT
BUSINESS-LEVEL/COMPETITIVE STRATEGY

Notes

POTENTIAL FOR DIFFERENTIATION: DEMAND SIDE

CUSTOMERS

By what criteria do customers choose?

Customer preferences: individual attributes and combination of attributes

What drives customer behavior?

Demographic, socio-economic and psychographic factors which correlate with customer behavior

Price premium that individual attributes can command

VALUE CHAIN IN DIFFERENTIATION

Construct value chain for firm and customers

Identify drivers of uniqueness in each activity

Select most promising differentiation variables

Locate links between value chain of firm and customer

VALUE CHAIN IN DIFFERENTIATION

Primary Activities

Support Activities

Firm Infrastructure (Celebrity CEO reinforces company image)

Human Resource Management (Training, quality orientation etc.)

Tech Dev: (Unique product features; patented prod. technology etc.)

Inbound Logistics (Quality/reliability of raw materials)

Operations (Cost efficient manufacturing/quality performance to product specifications)

Outbound Logistics (Fast delivery, efficient order processing)

Marketing and Sales (Advertising that enhances reputation, superior sales data)

Service (Courtesy, reliable repairs, post-sales service)

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BENEFIT DRIVERS IN DIFFERENTIATION

- Physical characteristics of the product itself
- Quantity and characteristics of the services or complementary goods the firms or its dealers offer
- Characteristics associated with sale or delivery of the good
- Characteristics that shape consumers’ perceptions or expectations of performance
- Subjective image of the product

FOCUS

STRATEGIC ADVANTAGE

Uniqueness perceived by customer | Low cost position

DIFFERENTIATION | COST LEADERSHIP

FOCUS

Narrow target segment

Strategic Target

Market Segments

Focused differentiator

Focused cost

Focused differentiation

Broad target market

Focused Differentiator

Broad Differentiator
BUSINESS-LEVEL/COMPETITIVE STRATEGY

FOCUS

Select narrow target segments with unusual needs
- Product features
- Geographic location
- Customer type

Creates products valued most highly by buyers in the target segment
Configure the organization to serve only targeted segments
- Sacrifice incremental business

FOCUS

Risks

- Widening cost differences between firm and other broad competitors
- Change in customer requirements
- Competitors find sub-markets
- Segment attracts larger, more powerful competitors

IMPLICATIONS FOR FUNCTIONAL STRATEGIES

<table>
<thead>
<tr>
<th>COST LEADERSHIP</th>
<th>DIFFERENTIATION</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product/Marketing Strategies</strong></td>
<td><strong>Productions/Operations strategies</strong></td>
</tr>
<tr>
<td>Standardized products</td>
<td>Mass-production to exploit economies of scale</td>
</tr>
<tr>
<td>Narrow price cost margins</td>
<td>Capacity added behind demand</td>
</tr>
<tr>
<td>Little product promotion and advertising</td>
<td>Products made to inventory – tight controls</td>
</tr>
<tr>
<td>Modest post-sale service</td>
<td>Willingness to sacrifice scale for customization</td>
</tr>
<tr>
<td>Customized products</td>
<td>Flexible response to unpredictable demand</td>
</tr>
<tr>
<td>Emphasis on building product image</td>
<td>Capacity added in anticipation of demand</td>
</tr>
<tr>
<td>Extensive post-sale service</td>
<td>Products made to order</td>
</tr>
<tr>
<td>Generous warranties</td>
<td></td>
</tr>
</tbody>
</table>

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**IMPLICATIONS FOR FUNCTIONAL STRATEGIES**

<table>
<thead>
<tr>
<th>Engineering and Design</th>
<th>COST LEADERSHIP</th>
<th>DIFFERENTIATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Product designed for manufacturability</td>
<td>• Designed to create benefits for customers or lower their costs</td>
<td></td>
</tr>
<tr>
<td>RAD</td>
<td>• Emphasis on process innovations rather than basic research</td>
<td>• Emphasis on product innovations and basic research</td>
</tr>
<tr>
<td>HRM/ Organization/ Control</td>
<td>• Managerial style characterized by formal procedures and hierarchy</td>
<td>• Less formal managerial style</td>
</tr>
<tr>
<td></td>
<td>• Tight administrative systems emphasizing control</td>
<td>• Few formal procedures</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Greater flexibility to promote entrepreneurship</td>
</tr>
</tbody>
</table>

**MUTUALLY EXCLUSIVE?**

*Generic strategies are often inconsistent with one another*

*Firm pursuing multiple generic strategies risks becoming stuck in the middle*

**BUT**

*More than one generic strategy possible*

- Lopsided share advantage
- Advantage to exploit interrelationships
- Capable competitors ultimately force choice

**COMPETITIVE STRATEGY**

**STRATEGIC ADVANTAGE**

- **DISTRIBUTION**
  - uniqueness perceived by customer
  - low cost position

- **STUCK IN THE MIDDLE**
  - differentiation
  - cost leadership

- **FOCUSED**
  - focused differentiation
  - focused cost

- **NARROW TARGET SEGMENT**

- **BROAD TARGET MARKET**
BUILDUP AND EROSION OF COMPETITIVE ADVANTAGE

TIME

Buildup Period | Benefit Period | Erosion Period

Strategic moves successful in producing competitive advantage | Size of advantage achieved | Imitation, duplication and attacks by rivals erode advantage

COMPARATIVE ADVANTAGE: EROSION

- Imitation
- Substitution
  - Technological shifts
  - Change in tastes
- Hold-up
  - Owners of specialized assets appropriate value
- Slack
  - Overconfidence

PREVENTING EROSION

- Constant improvements/ being a “moving target”
- Making it difficult for imitator to acquire requisite resources
  - Legal restrictions
  - Superior access to inputs/customers
  - Scale economies
- Updating sources of competitive advantage
- Deterrence
  - Credible threats
  - Preemption
HYPERCOMPETITION AND COMPETITIVE ADVANTAGE

Returns from a Sustained Competitive Advantage
Launch

Firm continues to move on to the next advantage
Exploitation
Counterattack

Time (years)
5 10 15

SUSTAINING COMPETITIVE ADVANTAGE

Requirement
Identification
Incentives for imitation
Diagnosis
Resource acquisition

Isolating Mechanism
- Obscure superior performance
- Deterrence: signal aggressive intentions to imitators
- Preemption: exploit all available investment opportunities
- Rely on multiple sources of competitive advantage to create "causal ambiguity"
- Base competitive advantage on resources that are immobile and difficult to replicate

SUSTAINING COMPETITIVE ADVANTAGE

TYPE OF INNOVATION
Process Innovation
Product Innovation
Transaction Innovation

FORM
- Employment of new methods of producing and delivering goods and services
- Introduction of new goods and services
- Use of new methods of buying, selling and contracting for goods and services