

Strategic and Operational Management (part 2 Formulation)

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Lecture 6

جامعة الجميع الذكية

MGM 630

Business Strategy:

Differentiation, Cost Leadership,
and Blue Oceans



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EVERYONE'S SMART UNIVERSITY

- 6.1 Business-Level Strategy: How to Compete for Advantage
- 6.2 Differentiation Strategy: Understanding Value Drivers
- 6.3 Cost-Leadership Strategy: Understanding Cost Drivers
- 6.4 Business-Level Strategy and the Five Forces: Benefits and Risks
- 6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership

1. Define business-level strategy and describe how it determines a firm's strategic position.
2. Examine the relationship between value drivers and differentiation strategy.
3. Examine the relationship between cost drivers and the cost-leadership strategy.
4. Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.
5. Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.
6. Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation

6.1 Business-Level Strategy: How to Compete for Advantage

Business-level strategy details the goal-directed actions managers take in their quest for competitive advantage when competing in a single product market. It may involve a single product or a group of similar products that use the same distribution channel. It concerns the broad question, “How should we compete?”

To formulate an appropriate business-level strategy, managers must answer the who, what, why, and how questions of competition:

- Who—which customer segments will we serve?
- What customer needs, wishes, and desires will we satisfy?
- Why do we want to satisfy them?
- How will we satisfy our customers' needs?

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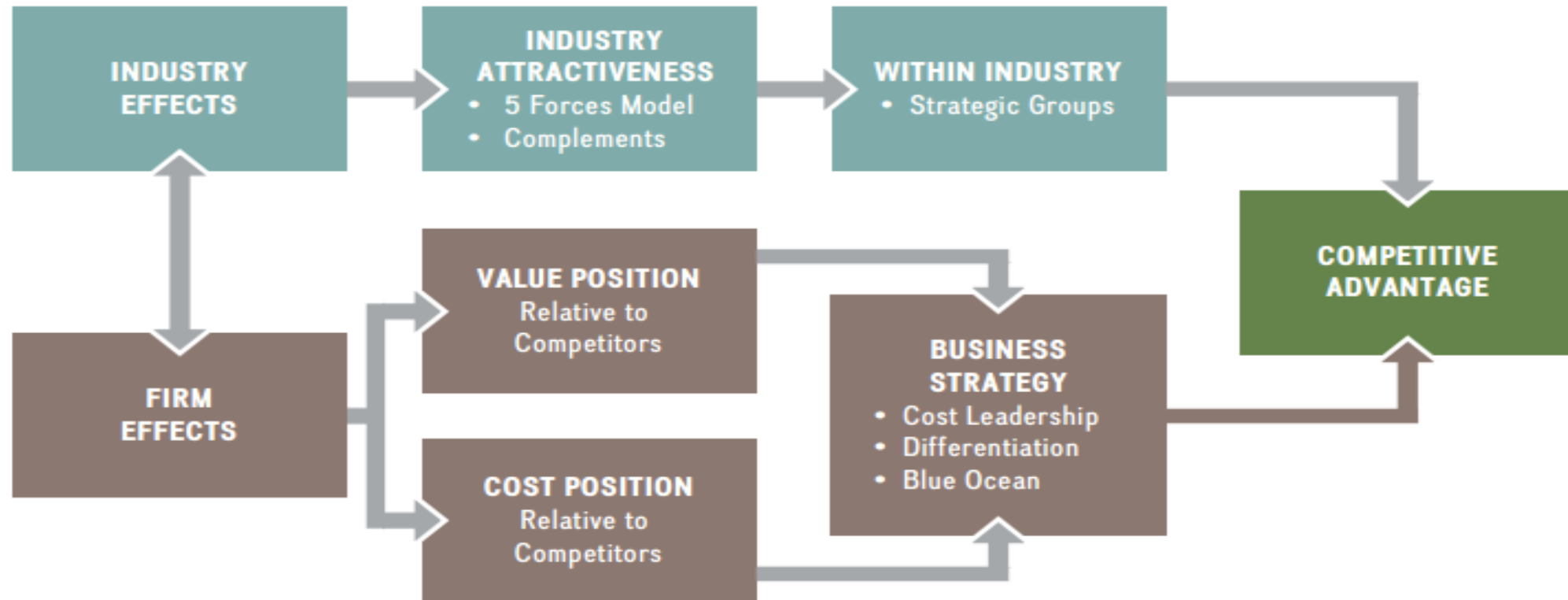
Business Strategy: Differentiation, Cost Leadership, and Blue Oceans

To formulate an effective business strategy, managers need to keep in mind that competitive advantage is determined jointly by industry and firm effects. As shown in Exhibit 6.1, one route to competitive advantage is shaped by industry effects, while a second route is determined by firm effects. As discussed in Chapter 3, an industry's profit potential can be assessed using the five forces framework plus the availability of complements. Managers need to be certain that the business strategy is aligned with the five forces that shape competition. They can evaluate performance differences among clusters of firms in the same industry by conducting a strategic-group analysis.

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EXHIBIT 6.1 / Industry and Firm Effects Jointly Determine Competitive Advantage



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Strategic position

A firm's business-level strategy determines its strategic position its strategic profile based on value creation and cost in a specific product market. A firm attempts to stake out a valuable and unique position that meets customer needs while simultaneously creating as large a gap as possible between the value the firm's product creates and the cost required to produce it. Higher value creation tends to require higher cost. To achieve a desired strategic position, managers must make strategic trade offs choices between a cost or value position.

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Managers must address the tension between value creation and the pressure to keep cost in check so as not to erode the firm's economic value creation and profit margin. A business strategy is more likely to lead to a competitive advantage if a firm has a clear strategic profile, either as differentiator or a low-cost leader.

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Generic business strategies

There are two fundamentally different generic business strategies—differentiation and cost leadership. **A differentiation strategy** seeks to create higher value for customers than the value that competitors create, by delivering products or services with unique features while keeping costs at the same or similar levels, allowing the firm to charge higher prices to its customers. **A cost-leadership strategy**, in contrast, seeks to create the same or similar value for customers by delivering products or services at a lower cost than competitors, enabling the firm to offer lower prices to its customers.

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These two business strategies are called generic strategies because they can be used by any organization—manufacturing or service, large or small, for-profit or nonprofit, public or private, domestic or foreign—in the quest for competitive advantage, independent of industry context. Differentiation and cost leadership require distinct strategic positions, and in turn increase a firm's chances to gain and sustain a competitive advantage. Because value creation and cost tend to be positively correlated, however, important trade-offs exist between value creation and low cost. A business strategy, therefore, is more likely to lead to a competitive advantage if it allows firms to either perform similar activities differently or perform different activities than their rivals that result in creating more value or offering similar products or services at lower cost.

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Now we can combine the dimensions describing a firm's strategic position (differentiation vs. cost) with the scope of competition (**narrow vs. broad**). As shown in Exhibit 6.2, by doing so we get the two major broad business strategies (cost leadership and differentiation), shown as the top two boxes in the matrix, and the focused version of each (shown as the bottom two boxes in the matrix). The focused versions of the two business strategies—focused cost-leadership strategy and focused differentiation strategy—are essentially the same as the broad generic strategies except that the competitive scope is narrower.

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EXHIBIT 6.2 / Strategic Position and Competitive Scope:
Generic Business Strategies



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6.2 Differentiation Strategy:

Understanding Value Drivers The goal of a differentiation strategy is to add unique features that will increase the perceived value of goods and services in the minds of consumers so they are willing to pay a higher price. Ideally, a firm following a differentiation strategy aims to achieve in the minds of consumers a level of value creation that its competitors cannot easily match. The focus of competition in a differentiation strategy tends to be on unique product features, service, and new product launches, or on marketing and promotion rather than price. **For example**, the carpet company Interface is a leader in sustainability and offers innovative products such as its Cool Carpet, the world's first carbon-neutral floor covering. Interface's customers reward it with a willingness to pay a higher price for its environmentally friendly products.

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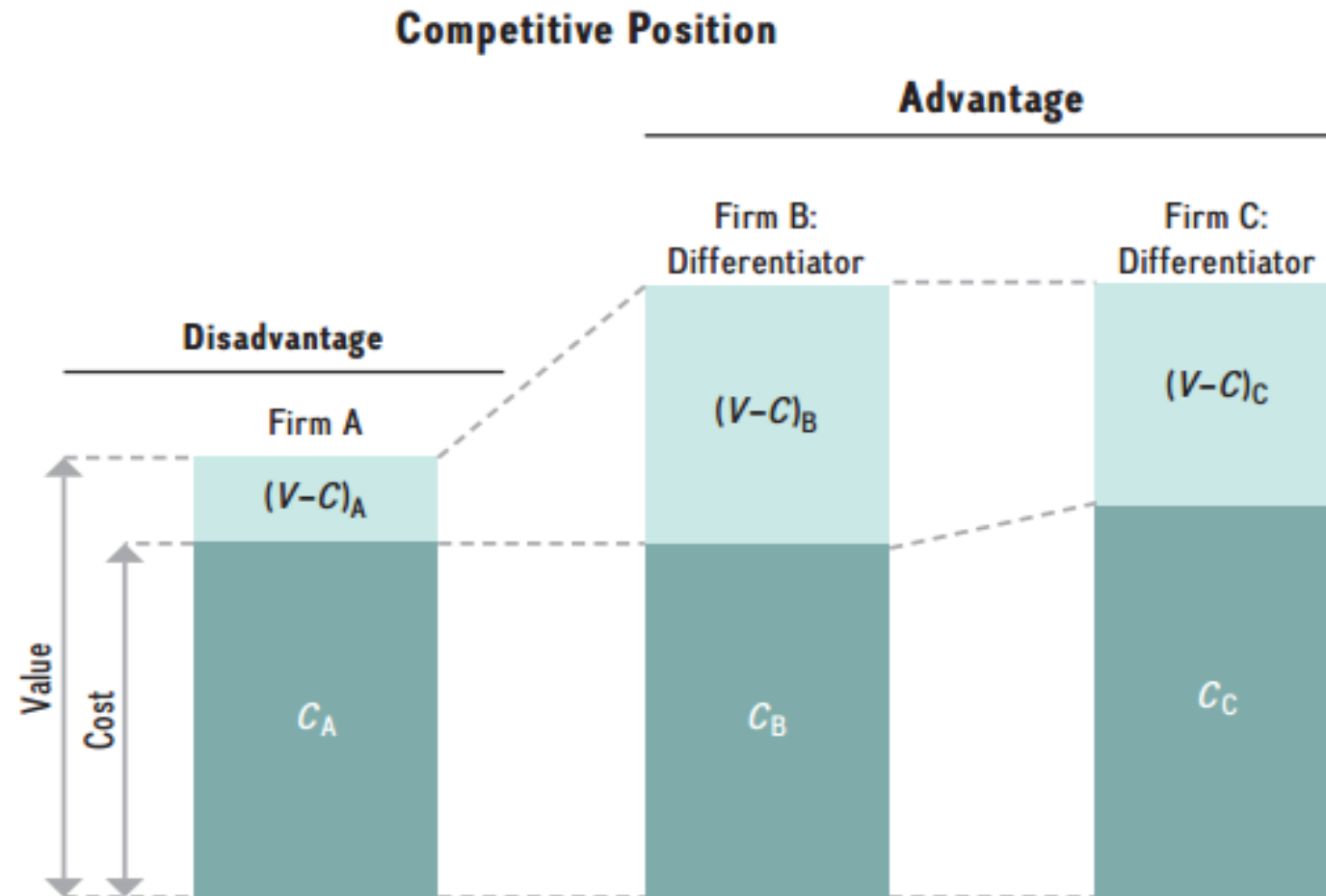
Differentiation, Cost Leadership, and Blue Oceans

A company that uses a differentiation strategy can achieve a competitive advantage as long as its economic value created ($V - C$) is greater than that of its competitors. Firm A in Exhibit 6.3 produces a generic commodity. Firm B and Firm C represent two efforts at differentiation. Firm B not only offers greater value than Firm A, but also maintains **cost parity**, meaning it has the same costs as Firm A. However, even if a firm fails to achieve cost parity (which is often the case because higher value creation tends to go along with higher costs in terms of higher-quality raw materials, research and development, employee training to provide superior customer service, and so on), it can still gain a competitive advantage if its economic value creation exceeds that of its competitors.

EXHIBIT 6.3 /

Differentiation
Strategy: Achieving
Competitive Advantage

Under a differentiation strategy, firms that successfully differentiate their products enjoy a competitive advantage. Firm A's product is seen as a generic commodity with no unique brand value. Firm B has the same cost structure as Firm A but creates more economic value, and thus has a competitive advantage over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$. Although, Firm C has higher costs than Firm A and B, it still generates a significantly higher economic value than Firm A.



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Firm C represents just such a competitive advantage. For the approach shown *either* in Firm B or Firm C, economic value creation, $(V - C)_B$ or $(V - C)_C$, is greater than that of Firm A $(V - C)_A$. Either Firm B or C, therefore, achieves a competitive advantage because it has a higher value gap over Firm A [$(V - C)_B > (V - C)_A$, or $(V - C)_C > (V - C)_A$], which allows it to charge a premium price, reflecting its higher value creation. To complete the relative comparison, although both companies pursue a differentiation strategy, Firm B also has a competitive advantage over Firm C because although both offer identical value, Firm B has lower cost, thus $(V - C)_B > (V - C)_C$.

Managers can adjust a number of different levers to improve a firm's strategic position. These levers either increase perceived value or decrease costs. Here, we will study the most salient value drivers that managers have at their disposal (we look at cost drivers in the next section). They are:

- Product features
- Customer service
- Complements

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1. Product features

One of the obvious but most important levers that managers can adjust is product features, thereby increasing the perceived value of the product or service offering. Adding unique product attributes allows firms to turn commodity products into differentiated products commanding a premium price. Strong R&D capabilities are often needed to create superior product features.



2. Customer service

Managers can increase the perceived value of their firms' product or service offerings by focusing on customer service.

3. Complements

When studying industry analysis in Chapter 3, we identified the availability of complements as an important force determining the profit potential of an industry. Complements add value to a product or service when they are consumed in tandem. Finding complements, therefore, is an important task for managers in their quest to enhance the value of their offerings.

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6.3 Cost-Leadership Strategy:

Understanding Cost Drivers The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors while offering adequate value. The cost leader, as the name implies, focuses its attention and resources on reducing the cost to manufacture a product or deliver a service in order to offer lower prices to its customers. The cost leader attempts to optimize all of its value chain activities to achieve a low-cost position. Although staking out the lowest-cost position in the industry is the overriding strategic objective, a cost leader still needs to offer products and services of acceptable value. As an example, GM and Korean car manufacturer Kia offer some models that compete directly with one another, yet Kia's cars tend to be produced at lower cost, while providing a similar value proposition

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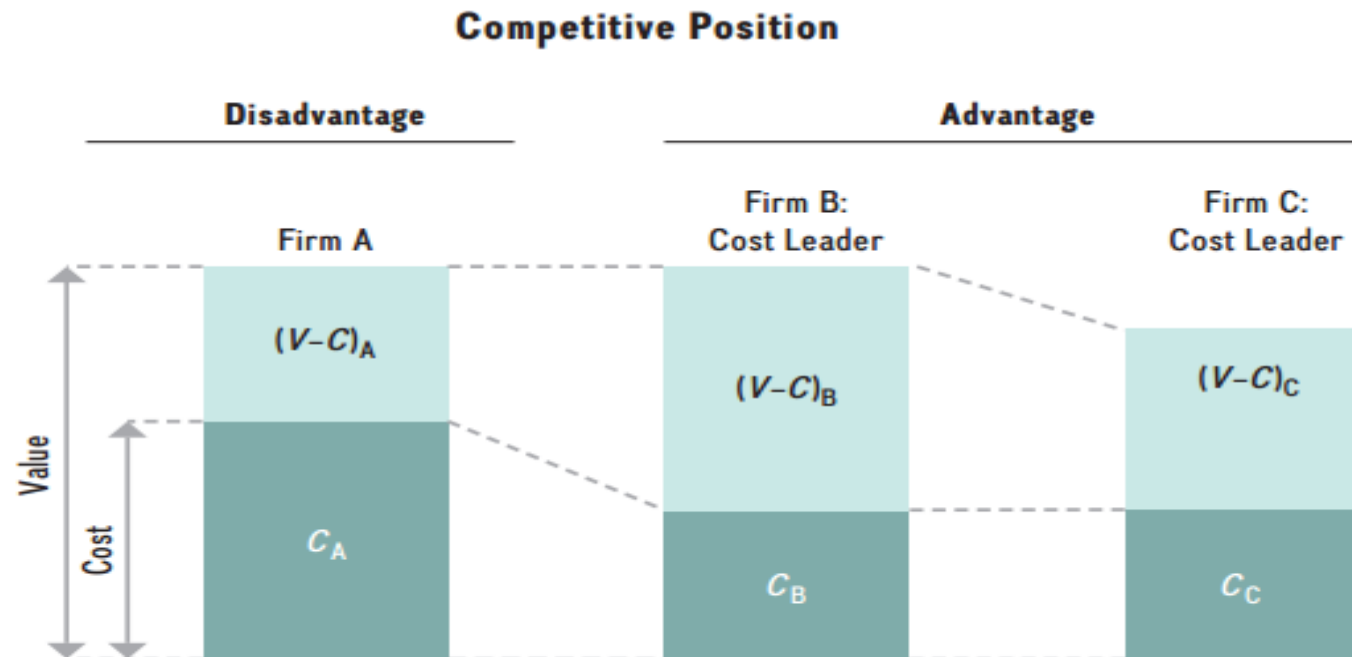
A cost leader can achieve a competitive advantage as long as its economic value created ($V - C$) is greater than that of its competitors. Firm A in Exhibit 6.4 produces a product with a cost structure vulnerable to competition. Firms B and C show two different approaches to cost leadership. Firm B achieves a competitive advantage over Firm A because Firm B not only has lower cost than Firm A, but also achieves differentiation parity (meaning it creates the same value as Firm A). As a result, Firm B's economic value creation, $(V - C)_B$, is greater than that of Firm A, $(V - C)_A$. For example, as the low-cost leader, Walmart took market share from Kmart, which subsequently filed for bankruptcy.

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bankruptcy.

What if a firm fails to create differentiation parity? Such parity is often hard to achieve because value creation tends to go along with higher costs, and Firm B's strategy is aimed at lower costs. A firm can still gain a competitive advantage as long as its economic value creation exceeds that of its competitors. Firm C represents this approach to cost leadership. Even with lower value (no differentiation parity) but lower cost, Firm C's economic value creation, $(V - C)_C$, still is greater than that of Firm A, $(V - C)_A$.



Cost-Leadership Strategy: Achieving Competitive Advantage

Under a cost-leadership strategy, firms that can keep their cost at the lowest point in the industry while offering acceptable value are able to gain a competitive advantage. Firm A has not managed to take advantage of possible cost savings, and thus experiences a competitive disadvantage. The offering from Firm B has the same perceived value as Firm A but through more effective cost containment creates more economic value (over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$). The offering from Firm C has a lower perceived value than that of Firm A or B and has the same reduced product cost as with Firm B; as a result, Firm C still generates higher economic value than Firm A.

Although companies successful at cost leadership must excel at controlling costs, this doesn't mean that they can neglect value creation. Kia signals the quality of its cars with a five-year, 60,000-mile warranty, one of the more generous warranties in the industry. Walmart offers products of acceptable quality, including many brand-name products. The most important cost drivers that managers can manipulate to keep their costs low are:

- Cost of input factors.
- Economies of scale.
- Learning-curve effects.
- Experience-curve effects.

6.4 Business-Level Strategy and the Five Forces: Benefits and Risks

The business-level strategies introduced in this chapter allow firms to carve out strong strategic positions that enhance the likelihood of gaining and sustaining competitive advantage. The five forces model introduced in Chapter 3 helps managers assess the forces—threat of entry, power of suppliers, power of buyers, threat of substitutes, and rivalry among existing competitors—that make some industries more attractive than others.

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With this understanding of industry dynamics, managers use one of the generic business-level strategies to protect themselves against the forces that drive down profitability. Exhibit 6.7 details the relationship between competitive positioning and the five forces. In particular, it highlights the benefits and risks of differentiation and cost-leadership business strategies, which we discuss next.

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EXHIBIT 6.7 / Competitive Positioning and the Five Forces: Benefits and Risks of Differentiation and Cost-Leadership Business Strategies

Competitive Force	Differentiation		Cost Leadership	
	Benefits	Risks	Benefits	Risks
Threat of entry	Protection against entry due to intangible resources such as a reputation for innovation, quality, or customer service	- Erosion of margins - Replacement	Protection against entry due to economies of scale	- Erosion of margins - Replacement
Power of suppliers	Protection against increase in input prices, which can be passed on to customers	Erosion of margins	Protection against increase in input prices, which can be absorbed	Erosion of margins
Power of buyers	Protection against decrease in sales prices, because well-differentiated products or services are not perfect imitations	Erosion of margins	Protection against decrease in sales prices, which can be absorbed	Erosion of margins
Threat of substitutes	Protection against substitute products due to differential appeal	Replacement, especially when faced with innovation	Protection against substitute products through further lowering of prices	Replacement, especially when faced with innovation
Rivalry among existing competitors	Protection against competitors if product or service has enough differential appeal to command premium price	- Focus of competition shifts to price - Increasing differentiation of product features that do not create value but raise costs - Increasing differentiation to raise costs above acceptable threshold	Protection against price wars because lowest-cost firm will win	- Focus of competition shifts to non-price attributes - Lowering costs to drive value creation below acceptable threshold

Source: Based on M.E. Porter (2008), "The five competitive forces that shape strategy," *Harvard Business Review*, January and M.E. Porter (1980), *Competitive Strategy*.

1. Differentiation strategy: benefits and risks

A successful differentiation strategy is likely to be based on unique or specialized features of the product, on an effective marketing campaign, or on intangible resources such as a reputation for innovation, quality, and customer service. A rival would need to improve the product features as well as build a similar or more effective reputation in order to gain market share. The threat of entry is reduced: Competitors will find such intangible advantages time-consuming and costly, and maybe impossible, to imitate. If the source of the differential appeal is intangible rather than tangible (e.g., reputation rather than observable product and service features), a differentiator is even more likely to sustain its advantage.

2. Cost Leadership Strategy: benefits and risks

A cost-leadership strategy is defined by obtaining the lowest-cost position in the industry while offering acceptable value. The cost leader, therefore, is protected from other competitors because of having the lowest cost. If a price war ensues, the low-cost leader will be the last firm standing; all other firms will be driven out as margins evaporate. Since reaping economies of scale is critical to reaching a low-cost position, the cost leader is likely to have a large market share, which in turn reduces the threat of entry.

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A cost leader is also fairly well isolated from threats of powerful suppliers to increase input prices, because it is more able to absorb price increases through accepting lower profit margins. Likewise, a cost leader can absorb price reductions more easily when demanded by powerful buyers. Should substitutes emerge, the low-cost leader can try to fend them off by further lowering its prices to reinstall relative value with the substitute.

6.5 Blue Ocean Strategy:

Combining Differentiation and Cost Leadership So far we've seen that firms can create more economic value and their likelihood of gaining and sustaining competitive advantage in one of two ways—either increasing perceived consumer value (while containing costs) or lowering costs (while offering acceptable value). Should managers try to do both at the same time? To accomplish this, they would need to integrate two different strategic positions: differentiation and low cost.

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In general the answer is no. Managers should not pursue this complex strategy because of the inherent trade-offs in different strategic positions, unless they are able to reconcile the conflicting requirements of each generic strategy.

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To meet this challenge, the strategy scholars Kim and Mauborgne advance the notion of a blue ocean strategy, which is a business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs in those two distinct strategic positions. They use the metaphor of an ocean to denote market spaces. Blue oceans represent untapped market space, the creation of additional demand, and the resulting opportunities for highly profitable growth. In contrast, red oceans are the known market space of existing industries.

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In red oceans the rivalry among existing firms is cut-throat because the market space is crowded and competition is a zero-sum game. Products become commodities, and competition is focused mainly on price. Any market share gain comes at the expense of other competitors in the same industry, turning the oceans bloody red

1. Value innovation

For a blue ocean strategy to succeed, managers must resolve trade-offs between the two generic strategic positions—low cost and differentiation. This is done through value innovation, aligning innovation with total perceived consumer benefits, price and cost. Instead of attempting to out-compete your rivals by offering better features or lower costs, successful value innovation makes competition irrelevant by providing a leap in value creation, thereby opening new and uncontested market spaces.

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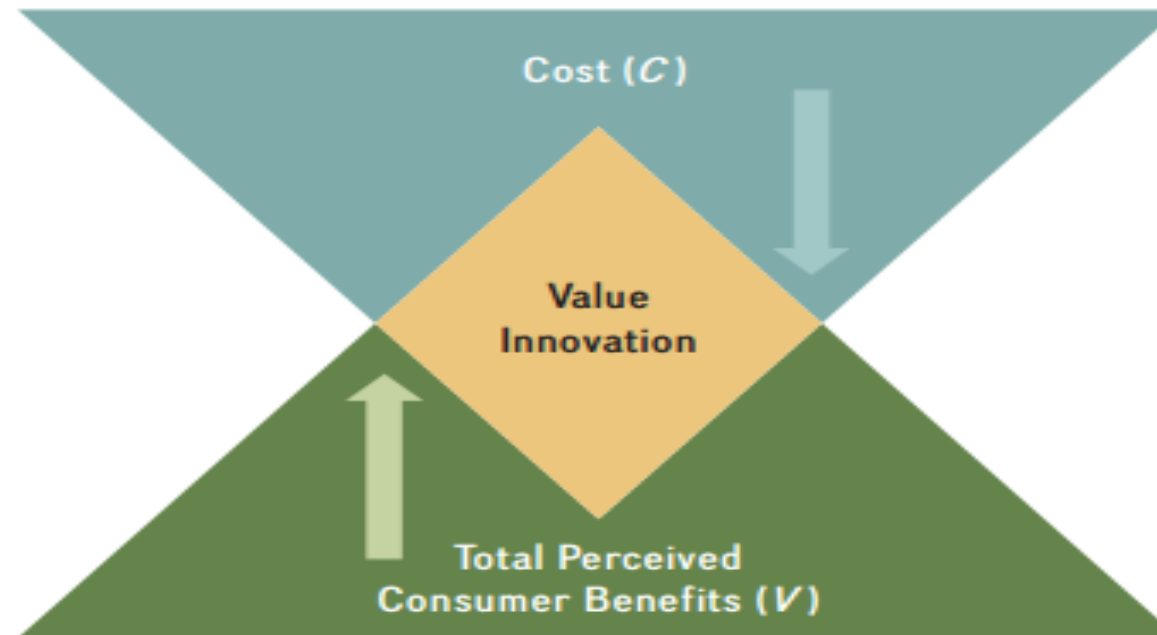
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Successful value innovation requires that a firm's strategic moves lower its costs and at the same increase the perceived value for buyers (see Exhibit 6.8). Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors that the firm's rivals in their industry compete on. Perceived buyer value is increased by raising existing key success factors and by creating new elements that the industry has not offered previously.

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EXHIBIT 6.8 / Value Innovation Accomplished through
Simultaneously Pursuing Differentiation ($V \uparrow$)
and Low Cost ($C \downarrow$)



Source: Adapted from C.W. Kim and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston, MA: Harvard Business School Publishing).

2. Blue ocean strategy gone bad: “Stuck in The Middle”

Although appealing in a theoretical sense, a blue ocean strategy can be quite difficult to translate into reality. The reason is that differentiation and cost leadership are distinct strategic positions that require important trade-offs. A blue ocean strategy is difficult to implement because it requires the reconciliation of fundamentally different strategic positions—differentiation and low cost—which in turn require distinct internal value chain activities (see Chapter 4) so the firm can increase value and lower cost at the same time.

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Exhibit 6.9 suggests how a successfully formulated blue ocean strategy based on value innovation combines both a differentiation and low-cost position. It also shows the consequence of a blue ocean strategy gone bad—the firm ends up being stuck in the middle, meaning the firm has neither a clear differentiation nor a clear cost-leadership profile. Being stuck in the middle leads to inferior performance and a resulting competitive disadvantage.

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EXHIBIT 6.9 /

Value Innovation vs.
Stuck in the Middle

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The **value curve** is the basic component of the **strategy canvas**. It graphically depicts a company's relative performance across its industry's factors of competition. A strong value curve has focus and divergence, and it can even provide a kind of tagline as to what strategy is being undertaken or should be undertaken.

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Chapter 6