Chapter 4 – Competitive Advantage – Cost and Differentiation

In this chapter 4, after analysing the environment and the internal resources and capabilities, we focus on the source of C.A. and its types (reading: chapter 8 GRANT 2011 book).

Three parts:
- The emergence of competitive advantage
- Sustaining C.A.
- Types of C.A.: Cost and Differentiation
Business Activity can be brokendown into...

Upstream (R+D+i)  |  Middle stream (Manufacturing)  |  Downstream (Services)

The Stan Shih Smile Curve (I)

The STAN SHIH SMILE CURVE

Value Added

Business Chain

VA
The Smile Curve: Breaking down Business Chain...

- **Upstream (R+D+i)**
  - Patent & Technology
  - High VA Making

- **Middle stream (Manufacturing)**
  - Assembly & Manufacturing
  - Low VA Making

- **Downstream (Services)**
  - Marketing & Branding & Services
  - High VA Making
The Smile Curve: Breaking down Business Chain...

- **High VA Making**
  - R+D+i
  - Tech Design
  - Key Parts & Component Suppliers

- **Low VA Making**
  - Assembly & Manufacturing

- **High VA Making**
  - Logistics & Distribution
  - Marketing Services
  - Branding
  - Education & Consulting
  - Sales after Service

VA

Upstream (R+D+i)

Middle stream (Manufacturing)

Downstream (Services)
The Smile Curve: The Sinking in the middle...

- Patent & Technology
- Assembly & Manufacturing
- Marketing & Branding & Services

VA (1980s & 1995)

The middle… … is sinking

VA (2000s - Present)

Upstream (R+D+i) | Middle stream (Manufacturing) | Downstream (Services)
Mapping Spanish Hidden Champions & Brand Champions

- **High VA Making**
  - Abantia
  - AUSA
  - Tapla
  - Dina Lager
  - Carra
  - SHAD
  - Rocada
  - Cosmic
  - Graphenea
  - MTG
  - Mace
  - Cerba

- **Low VA Making**
  - Pordamsa

- **High VA Making**
  - Mesoesthetic
  - Lekue
  - Buff
  - Robol
  - Ultragamagic

**Dimensions**
- VA (Vertical Axis)
- BC (Horizontal Axis)

**Stages**
- Upstream (R+D+i)
- Middle stream (Manufacturing)
- Downstream (Services)
1. The emergence of competitive advantage

But first, what is competitive advantage?

“When two or more firms compete within the same market, one firm possesses a competitive advantage over its rivals when it earns a persistent higher rate of profit”

(Are we talking about superior profitability? Almost... but the firm may delay current profit in favour of investment in market share, technology, customer loyalty, executive perks...)
Competitive Advantage

What are the main characteristics of a C.A?

- It must be something difficult to match – difícil de igualar.
- It has to be unique
- It must be possible to sustain it in time
- It must be superior to the competitors’

Examples of C.A.:

- Superior product quality
- Patents
- Brand, reputation
- Employees’ skills
- Location
- Customer knowledge
Chapter 4 – Competitive Advantage (C.A.) –

How does C.A. emerge?

- **External sources of change:**
  - changing customer demand
  - changing prices
  - technological change

- **Internal sources of change**
  - some firms have greater creative and innovative capability. Hibridación, xej.
Rule of thumb: more turbulent environment + greater differences in firms’ resources and capabilities = greater dispersion of profitability

**Example:**

- **Tobacco industry**: stable external environment + similar leading firms = small profit differences.
- **Toy industry**: unpredictable changes in demand, technology and fashion + leading firms diff strategies = huge profit differences.
Chapter 4 – Competitive Advantage (C.A.)–

Any external change creates an opportunity for profit.

• Who will benefit from it? The firm able to respond to change the fastest: *speed of response* is critical to exploit a new business opportunity.
As markets become increasingly turbulent, **responsiveness to external change** becomes + important as a source of C.A.
Chapter 4 – Competitive Advantage (C.A.) –

Example:

- Wal-Mart: business system that responds quickly to changes in demand. Decisions are taken at the store level. That means: low inventories, few stock-outs, few forced markdowns. That is their C.A.
- But what else? There has to be an internal reason. Initiative is rewarded and encouraged at all levels.

Ex. Conference on innovation...
Responsiveness means anticipated changes:

- One key resource: information.
- One key capability: flexibility.

Firms are learning to be less dependent on “conventional data and market analysis” and more dependent on “early warning systems”: direct relations with customers, suppliers and competitors. Ex. this week Avery: tapes in car doors

Ex. Dell Computers (order 9am delivered 9 pm following day; 10 days inventory) and Zara (3 weeks time new model delivery).
Chapter 4 – Competitive Advantage (C.A.) –

**Speed** through:
- manufacturing
- sales and distribution
- innovation

This is the C.A. of most Japanese industries.

This increased speed has become possible only through internet, real-time data exchange and business processes reengineering.

These changes have enabled companies to reduce cycle times drastically.
Chapter 4 – Competitive Advantage (C.A.)–

Competitive process as “creative destruction”

Strategic Innovation: new ideas and new knowledge that goes a lot further than just “product innovation” or “technology innovation”.

Gary Hamel, “Leading the revolution”

From the age of continuity to the age of revolution.
Chapter 4 – Competitive Advantage (C.A.) –

Gary Hamel, world's first "Management Lab." The MLab is a pioneering attempt to create a setting in which progressive companies and world renowned management scholars work together to co-create "tomorrow's best practices" today.

Goal: to radically accelerate the evolution of management knowledge and practice.

Source: www.garyhamel.com

Video: http://www.youtube.com/watch?v=TVX8XhiR1UY&playnext=1&list=PLC267070423129E89
Chapter 4 – Competitive Advantage (C.A.) –

BLUE OCEAN STRATEGY

http://www.youtube.com/watch?v=7SQDGBSjty4&feature=related

http://www.youtube.com/watch?v=HJH0g-EPGDs

Five Forces vs Blue Ocean

http://www.youtube.com/watch?v=V2b99iZviUk
Blue Ocean Strategy
CIRQUE DU SOLEIL—Cirque du Soleil successfully created a new, highly-profitable market within the ailing circus industry. The company’s management eliminated the main cost drivers of conventional circuses: the animals and the stars. At the same time they incorporated elements from opera, ballet and concerts.

The result was a totally new entertainment concept targeting former non-customers: adults happy to pay for good entertainment.

Caso DACIA 5000€ 80%2ª mano
Curves GYM: between Home exercise and a Traditional Women’s Health Club (fun, affordable, easy to use, peer support)
Barnes & Noble
Yellow Tail Wines: Yellow Tail was developed around the year 2000, originally marketed to export countries and became the number one imported wine to the USA by 2003. Young consumers in particular tend to avoid what they consider to be confusing and pretentious wine labels characteristic of some Old World wine bottles

SOUTHWEST AIRLINES

Southwest Airlines, a US company, made history as the world's first low-cost carrier. Southwest Airlines analysed alternative industries and created new benefits for their non-customers: cost-sensitive travellers who rather drive.

The Body Shop: The Body Shop ignored most glamorous aspects of the industry. Instead The Body Shop designed its image around functionality, reduced prices and modest packaging. Increased value was given to natural ingredients, a healthy lifestyle and ethical concerns.
New concepts – new business models.

For ex. In retail- **Experiencia de compra**: Sephora (freedom, beauty and pleasure), bookstores (browsing, relaxing, coffee), traveling, *can you think of any other?*

Continual reinvention of the **business model**.... ... but be clear and stable with what your strategy is. **Blog: five business models... or more!**
New concepts – new business models.
For ex. In retail- **Shopping experience:**

Read Strategy Capsule 8.1
Urban Outfitters
p. 217
Chapter 4 – Competitive Advantage (C.A.) –

2. Sustaining C.A.

Once established, C.A. is subject to erosion by competition (by imitation or by innovation)

“Barriers to imitation” must exist. These barriers are also called *isolating mechanisms*: barriers that limit the re-balancing of the difference in profitability. According to studies, the destruction of C.A. is slow, over a decade.

It gives time to consolidate and bring up new concept B4 they copy you.
Some sectors are easier to imitate: services in general; financial services in particular.

**First-mover advantage**: the initial occupant of a strategic position gains access to resources and capabilities and others cannot follow. Ex. Have a patent, technology, product or design no one has (even better, legally do not have access to it).

“Success breeds success”.

- Resources are scarce: establishment in Passeig Gracia, or highly specialised employees (Google)
- Patent license
- Reputation (W&F)
- Industry learning curve
Chapter 4 – Cost and Differentiation

Porter’s two generic strategies:

C.A. can be achieved in one of the following ways:

1. Supply identical product or service at a lower cost
   Cost advantage

2. Supply a product or service that is differentiated in such a way that the customer is willing to pay a price premium (that exceeds the cost of the differentiation)
   Differentiation advantage
Chapter 4 – Cost and Differentiation

- Similar product at lower cost → Cost advantage
- Price premium from unique product → Differentiation adv.
Chapter 4 – Cost and Differentiation

**Cost leadership**

the firm must find and exploit all sources of cost advantage and sell a standard, no-frills product.

**Differentiation**

the firm provides something unique beyond simply offering a low price.
Porter's Generic Strategies

<table>
<thead>
<tr>
<th>Competitive Scope</th>
<th>Competitive Advantage</th>
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<tbody>
<tr>
<td>Broad</td>
<td>Low Cost</td>
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<td></td>
<td>Overall Cost Leadership</td>
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<tr>
<td>Narrow</td>
<td>Higher Cost</td>
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<td>Differentiation</td>
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<td>Cost Focus</td>
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<td>Differentiation Focus</td>
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Porter's Generic Strategies
Porter generic strategies

1. Cost Leadership
2. Differentiation

3A. Cost Focus
3B. Differentiation Focus

Stuck in the Middle
Chapter 4 – Cost and Differentiation

Three generic strategies:
1. Cost leadership (Toyota, Ikea, Canon, Dell)
2. Differentiation (BA, Apple, Mercedes, Nike)
3. Focus (small companies, brand, innovation)

Important: need to define yourself. “Stuck in the middle” means for sure low profitability.

Very important: low cost does not mean your product is not differentiated.

Most industries:
- One market leader low-cost but also effectively differentiated (IKEA)
- Ability to balance low-cost with quality and technology
- Smaller rivals - focus
Focus examples

**Focus Cost**: “me too’s”, Bershka, low cost hairdresses, hotels on the motorway, Tata Nano (below €2,000)

**Focus Differentiation**: Ferrari, Singapore Airlines, luxurious goods
Chapter 4 – Cost and Differentiation

NEXT DAY:
1. Cost leadership
2. Differentiation
3. Focus A. Cost / B. Differentiation
5. The strategy clock: Bowman’s strategic options
Chapter 4 – Cost Advantage (book chapter 9)


The importance of market share: if an industry can expand its output more than competitors, they can move down the experience curve: widening cost differential.

Firms should put prices not on the basis of current prices but of anticipated costs (not full-cost pricing but penetration pricing).

Maximising volume by (a) offering a broad product range and (b) expanding internationally rather than restricting sales to domestic market.
Chapter 4 – **Cost Advantage**

**The sources of cost advantage**
What are the factors that determine a firm’s cost position?
**Seven drivers of cost advantage:**

1. Economies of scale
2. Economies of learning
3. Production techniques
4. Product design
5. Input costs
6. Capacity Utilization
7. Residual efficiency

Photocopy Figure 9.1- p231: drivers of cost advantage
Case: IBM – Process Reengineering
Chapter 4 – Cost Advantage

1. Economies of scale

   More production, lower unit cost. Typically associated with manufacturing – but not necessarily. Minimum Efficiency Plant Size (MEPS). Fig. 9.2 – p232

   - Technical input –output relationships
   - Indivisibilities (advertising for ex). Fig. 9.3 -p233
   - Specialization: more efficiency, more training, less time loss. Division of labour.

Ex. Marketing is the cause why consumer goods are dominated by a few giants.
Chapter 4 – Cost Advantage

2. Economies of learning

- Cost reduction is based on members of the organisation learning how to do things.
- Repetition develops skills and routines.
- The more complex the product or service, the greater the potential for learning.
- Documenting solutions as a base for learning.
Chapter 4 – Cost Advantage

3. Production techniques

Re-engineering of the business processes (BPR – Business Process Reengineering) – if we could start from afresh, how would we do it?

• Combining several jobs in one
• Allow workers to make decisions
• Performing steps of a process in a natural order
• Make sense of processes
• Reduce checks and controls
• Appoint a single point of contact in the org.
• Centralization vs. Decentralization – balance.
Chapter 4 – Cost Advantage

4. Product design

Cars are built in “platforms”.
Platforms can be re-used for other models.
Services can also be designed for efficiency of production...
ex. Budget Hotels in low-cost locations, identical furniture, cleaning and maintenance.
Chapter 4 – **Cost Advantage**

5. Input costs

The question is: how to lower input costs?

- Location differences (rent, labour, materials, etc)
- Ownership of low-cost supplies
- Non-union labour (?)
- Bargaining buying power (Wal Mart)
Chapter 4 – Cost Advantage

6. Capacity Utilization

What’s the problem?

*Underutilization in periods low demand: fixed costs have to be absorbed.* Airlines, Theme Parks: all fixed costs

*Overcapacity: shift work / outsourcing /

Ratio of fixed to variable costs

Fast and flexible capacity adjustment: ex. Caterpillar announced in Jan 2008 cutting 20 000 jobs. That very same day they declared sales had gone up.

Distinguish between cyclical and structural overcapacity.
Chapter 4 – **Cost Advantage**

7. Residual efficiency

Why an industry has a lower cost per unit than the competitor? Six reasons before plus ... *sth else*.

The “*organizational fat*” or “*X-inefficiency*” (inefficiency, organizational slack, institutionalised inefficiencies, demotivation, lack of management, micro-management, etc).

Eliminating excess costs is very difficult. Ex. Estevia firm.

**IBM case – exercise in class**
Chapter 4 – Cost Advantage

In order to:
- Maximise shareholder wealth
- Divest poorly performing assets
- Boost financial performance
- Eliminate inefficiencies
- Increase accountability
- Increase speed in decision making

Some times, need to apply radical cost surgery-

1. Plant closures
2. Outsourcing components and services
3. Employment reductions (fire or lay off workers)
4. Delayering - reduce administrative overhead
Chapter 4 – Cost Advantage

Radical cost surgery- it requires normally:
Re-centralization of power
Radical cost reduction
Empowerment at high level
Avoid extensive negotiation
Sometimes through a high level Task Force
Chapter 4 – Differentiation

**Differentiation**: concerned with how a firm competes, the way in which it offers something unique to customers.

BMW means quality. Volvo means safety.

**Segmentation**: a feature of the market.

Differentiation: the demand side – what our customers want
Differentiation: the supply side – our capability

Case Study, the *percolator*. 