

Market Strategy

The Business Plan's Cornerstone

Business is like war in one respect. If its grand strategy is correct, any number of tactical errors can be made and yet the enterprise proves successful.

—General Robert E. Wood

Strategy is not a detailed plan or program of instructions; it is a unifying theme that gives coherence to the actions and decisions of an individual or an organization.

—Robert M. Grant

All competitors who persist and survive have a unique advantage over all others . . . The more similar competitors are to each other, the more severe their competition.

—Bruce D. Henderson

Market strategy, also called *business strategy* and *competitive strategy*, is a business' game plan for besting rivals in the marketplace. It paints a picture in broad strokes of how the business will compete for customers and why it is expected to prosper. Rather than convey minute details, market strategy should be visionary. It should impart a sense of direction and explain the focal venture's competitive rationale.

This very important chapter introduces two views of strategy. However, its main topics are the nature and sources of competitive advantage and the connection between competitive advantage and market strategy.

STRATEGY FROM TWO PERSPECTIVES

Two views of strategy prevail in the business literature. One stems from game theory, the other derives from ecology. For the most part, the two views complement each other, and both highlight critical competitive issues.

Strategy and the Game of Business

Scholars have long considered business a competitive game to which game theory applies. From a game-theoretic perspective, strategy centers on choosing the best course of action in light of rivals' potential actions and reactions.¹

Game theory is most applicable to business when rivals compete in oligopolistic industries or markets, which are dominated by a small number of contenders. In such settings, the fates of contestants are highly intertwined, since any contestant's pricing, capacity, and promotion decisions generally have a much greater impact on market supply, demand, and profit margins than they would if contestants were numerous and small.²

From a game-theoretic perspective, decisions that should be made in light of rivals' potential moves and counter moves are strategic. Decisions that can be made safely without considering competitors' actions and reactions are tactical.³ Accordingly, decisions that materially affect pricing, capacity, and promotion expenditures are among those that tend to be strategic in oligopolistic settings, but become increasingly tactical as rivalry approaches perfect competition—competition among contestants so numerous and small that their individual actions have little bearing on industry or market conditions.⁴

Game theory has merits. But applying it to business decisions often is cumbersome, especially when the number of contestants exceeds two.

Strategy and Business Ecology

From an ecological point of view, the aim of market strategy is attaining and maintaining a prosperous fit between a business and its environment. In the business world, as in the biological world, only the fittest specimens survive within a locale. Of course, unlike plants and animals, executives may consciously try to shape the environments in which their enterprises operate.

The ecological notion of strategy, enriched with a few ideas from game theory, permeates much of the business literature and encapsulates how executives commonly think about strategy. Therefore, attaining and maintaining a prosperous fit between a business and its ever-changing environment is considered the purpose of market strategy throughout this book.

FIT AND COMPETITIVE ADVANTAGE

In business, as in nature, ability to thrive depends on competitive advantages, which protect incumbents from challengers and may facilitate invading rivals' turf. Although

competitive advantage sometimes enables one contestant to dominate all others, multiple contenders often thrive in business because their advantages differ and their offerings appeal to different customer segments. For example, one contestant may enjoy a quality advantage while another has a cost advantage that facilitates charging low, yet profitable, prices.

Competitive advantages vary greatly in scope. Some are sweeping, but most are fairly narrow. They afford advantages that are localized along product line, geographical, or other dimensions.⁵ The Coca-Cola name, for example, has been the most recognized brand on the planet for some time, which helped Coke gain worldwide distribution and keep poachers at bay. But even its power is limited—limited predominantly to soft drinks. In most product domains, including automobiles and consumer electronics, it has no value. Who would buy a Coca-Cola car or a Coca-Cola cell phone?

The geographic scope of competitive advantages often is limited, as well. R. C. Willey Home Furnishings, for instance, has outlets in Utah, Idaho, Nevada, and California. In northern Utah, the company operates eight stores and a huge distribution center. It realizes advertising, distribution, and other competitive advantages over its northern Utah rivals because it has more stores and larger stores, local media are more cost effective than national media in selling home furnishings, and the company can spread its media costs over more stores and much more sales volume than any of its local rivals. However, R. C. Willey's media cost advantages in northern Utah do not extend to any of its other markets. They are confined to a tiny speck of planet Earth.

The fact that many competitive advantages are quite limited in scope should give small companies hope. It means they are not doomed to be crushed by large rivals. However, industries generally afford some potential advantages that transcend local markets. For instance, in retailing, large regional and national chains usually are in better positions than much smaller contestants to take advantage of volume discounts and to exercise bargaining power when negotiating prices with vendors.

In the business literature and throughout this book, *competitive advantage* generally denotes an advantage whose economic value can be maintained or even strengthened for quite some time. It denotes an advantage that is sustainable and durable long enough to be worth having, although it need not be everlasting.

Sustainability

Imitation is the sincerest form of flattery, according to an old adage. If your venture is profitable, expect to be flattered. Expect aspiring imitators to set their sights on your market. Whether their forays are successful depends largely on your sustainable competitive advantages and the entry barriers they create.⁶ Competitive advantages and corresponding entry barriers may not discourage aspiring poachers completely, but they do impede invaders to varying degrees and afford incumbents some protection.

To realize their aims, imitators must (a) identify what to imitate, (b) have timely economical access to needed resources, and (c) exploit imitation without destroying profit potential. Advantages are sustainable to the extent that these requirements pose obstacles.

Transparency

Competitive advantage and success sometimes stem from a few obvious sources, such as a trusted brand name, trade secrets, patented discoveries, copyrighted innovations, or superior size. But often, a business' success factors are subtler. Competitive advantage and financial success frequently result from performing combinations of many obscure little tasks a little better than rivals or from cultivating a loyal clientele by consistently delighting customers and, thus, giving them no reason to shop around. Hence, identifying exactly what must be imitated can be difficult and error prone.

Sometimes, sources of advantage are so ambiguous that even company insiders cannot pinpoint them. Not knowing why an enterprise is successful helps conceal secrets from eager imitators. However, not knowing also can have undesirable consequences. For instance, by the time IBM fathomed that financial success in the PC business depended mostly on control over the operating system, it had ceded most of its profit potential to Microsoft. Companies may have difficulty duplicating their successes in new places or in later years because they do not fully understand the causes of earlier triumphs.

Accessibility

Aspiring imitators who have figured out what to copy need the resources and capabilities (R&Cs) to duplicate the targeted product, process, or strategy. To pose a serious threat, they must have economical and timely access to those R&Cs.

Some R&Cs are more difficult and costly to acquire than others. Some R&Cs, such as licenses, may be restricted by law, and teamwork, unlike standardized components, cannot be bought off the shelf or moved intact from one organization to another. Further, some R&Cs may be locked up contractually. Softsoap inventor Robert Taylor, for example, temporarily foiled aspiring poachers, including Procter & Gamble, by placing enough orders with the world's manufacturers of dispensing pumps to tie up global production capacity of such pumps for a year.⁷

Inferior access to distribution and communication channels commonly plague aspiring poachers. Such disadvantages limit their sales volume and hinder their ability to quickly gain the same economies that often favor incumbents.

Scarce mobile resources, such as copyrights or the services of some stellar executives, may be priced so high that most of the value they can create is appropriated by sellers rather than buyers. Resources are mobile to the extent that they can be moved from one organization to another without impairing their productivity. Immobile resources, in contrast, lose much of their effectiveness when uprooted. Some football stars, for example, shine only within a particular system and only while surrounded by a particular cast. They become ordinary players when traded and, hence, are not perfectly mobile resources. Strange as it may sound, land is mobile to the extent that no single use is decidedly more profitable than some others.

When imitative efforts progress slowly, imitators incur opportunity losses because they forfeit profits they would have earned had imitation progressed faster. However, their efforts usually can be accelerated only by increasing out-of-pocket costs.⁸

Exploitability

While markets are growing and capacity is limited, both innovators and imitators may thrive. But as capacity and supply catch up with demand, rivalry among contestants offering similar goods or services tends to intensify, incite price and promotion wars, and erode profit margins.

Imitation sometimes is easy, but unrewarding. Recall, for instance, that home furnishings giant R. C. Willey operates a spacious distribution center near Salt Lake City, Utah. Rivals could replicate the distribution center, but would be unable to generate the volume needed to realize savings.

Sometimes, markets are profitable for incumbents, yet too small to sustain additional contestants. Challenging incumbents in such markets is foolish, unless the challenger can displace at least one incumbent swiftly. Advantages that favor first entrants and discourage poaching are *preemptive advantages*. Kmart, for instance, elected to bypass many small cities already served by Walmart because it recognized Walmart's preemptive advantage. Kmart was the leading discounter at the time, but realized that challenging Walmart on its turf was unlikely to pay off.

A preemptive advantage often can be realized only as long as potential rivals recognize it and understand that they would gain nothing from mounting a challenge. Of course, competitors cannot be counted on to behave astutely. They sometimes pursue foolish, self-destructive strategies that devastate all contestants. Had Kmart challenged Walmart in its small-town markets, the consequences would have been dire for both challenger and incumbent.

Prior commitments that cannot be changed quickly or economically may discourage prospective imitators. For instance, Southwest Airlines entered the airline industry very successfully with an economical fleet that consisted entirely of Boeing 737 planes. Had competing major airlines, which had bought or leased diverse aircraft, tried to duplicate Southwest's fleet, they would have found the cost of dumping many of their planes and replacing them with Boeing 737s prohibitive.

Durability

An advantage may be sustainable, yet lose economic value. For instance, Shure may still have an advantage in producing high-quality phonograph cartridges. However, since the 1960s, reel-to-reel tapes, eight-track tape cartridges, audio cassettes, CDs, and MP3 technology have reduced the market for phonograph cartridges to a tiny niche. Consequently, superior phonograph technology is worth very little nowadays. Advantages are *durable* to the extent that they are sustainable and retain their economic value.

Summing Up

While sustainability focuses attention on threats from rivals, durability prompts consideration of threats from disruptive technologies, such as those that rendered typewriters, correction fluid, buggy whips, and phonograph cartridges obsolete and nearly irrelevant.

To the chagrin of incumbents, most competitive advantages lose potency sooner or later for any of the following reasons:

- Rivals duplicate or bypass the source of the advantage.
- Sustaining resources are used up and can be replaced, if at all, only at costs that eradicate the advantage. Patents, for example, expire and cannot be renewed.
- Rivals narrow gaps in brand trust. Dell and Compaq, for instance, quickly matched the level of trust buyers had in IBM PCs. More recently, the trust gap between Hyundai and Toyota shrank as questions about the safety of various Toyota models tarnished the Toyota brand.
- Cost gaps shrink as markets grow. Since average cost declines at a decreasing rate as volume increases, cost gaps may dwindle even when market share is maintained.
- As the world changes, the product to which the advantage applies loses usefulness and value, as did the buggy whip and the phonograph cartridge.

Nevertheless, the value of some advantages may increase for quite some time. Advantages rooted in trusted brand names, such as Coca-Cola and Nike, are among them. Cars sporting the Toyota badge were deemed inferior imports just a few decades ago. Today, Toyota and its flagship brand, Lexus, denote excellence and value, despite some recent complaints about safety and declining quality. Toyota's challenge is remedying the underlying causes of negative publicity before they inflict serious damage on the brand. Magnavox, RCA, and Zenith are among the many brands that have lost their luster. Once top names in consumer electronics, they have nearly disappeared and are no longer seen as leaders in quality or innovation.

Some scholars and executives doubt that advantages must be sustainable to be valuable. In fast-paced industries, they argue, *dynamic advantages* are needed to stay ahead of the crowd.⁹ They equate dynamic advantages with ability to move quickly from one unsustainable advantage to the next, thereby creating a steady stream of new advantages just in time to replace those that are fading. However, on close inspection, most dynamic advantages are not exotic new species at all. Instead, they stem from rather ordinary sustainable advantages. Intel, for example, managed to stay ahead of rivals by using knowledge gained from creating one generation of microprocessors to invent the next one. It was able to leap forward repeatedly just as competitors were about to catch up because it enjoyed sustainable learning and innovation advantages.

COMPETITIVE ADVANTAGE AND MARKET DEFINITION

Assessments of a business' advantages and competitive position generally are sensitive to the chosen product-market or industry definition. They may depend, for instance, on whether the market is defined as the US home furnishings market or the northern Utah

home furnishings market. Or, they could depend on whether demand for furniture, major appliances, home electronics, and floor coverings is deemed one market—the home furnishings market—or four separate markets.

If a market is defined too broadly, local advantages may be overlooked; if it is defined too narrowly, the power of local advantages may be overestimated. Both close-up and panoramic depictions of the competitive landscape may be needed to convey the competitive situation fully. Of course, perspective affects only what is revealed, not what is. Hence, changing perspective cannot overcome disadvantages, much less transform them into advantages.

PORTER'S GENERIC ADVANTAGES¹⁰

Michael E. Porter, the most lauded of the many contributors to the field of strategic management, surmised that, generically, all competitive advantages are either cost or differentiation advantages.

Cost Advantages

Total cost depends on (a) input prices, (b) efficiency in converting inputs into outputs, (c) the cost of developing or acquiring processing capabilities for converting inputs to outputs, and (d) distribution costs. Which components have the greatest impact depends on the type of business. Usually, relative costs—that is, costs in relation to rivals' costs—are more critical than absolute costs.

Typically, cost advantages can be gained only when customers find quality acceptable. When low cost stems from cutting corners, price usually must be slashed so deeply that little, if any, profit remains.

Competing on price against cost leaders is ill-advised. Consider Epson's folly, for example. Epson dominated the market for relatively inexpensive dot-matrix printers (DMPs) when it entered the laser printer market dominated by Hewlett-Packard (HP). Epson tried to lure customers away from HP by offering laser printers at lower prices even though HP's cost position was superior. By the time the dust settled, the market for DMPs had nearly vanished because the Epson-HP price war had made laser printers affordable and DMP print quality was grossly inferior. Milking its DMP business for a few more years may have been a better option for Epson than challenging HP head-on.

Cost advantages commonly stem from superior economies of scale, scope, or experience. They also may stem from bargaining power, ability to take advantage of volume discounts, or vertical integration. Often, they depend greatly on size.

Economies of Scale

Economies of scale derive mostly from spreading fixed cost over many units of the same type. For instance, if the cost of developing an office suite for PCs is \$100 million, and a million units of the suite are sold, then the average development cost per unit is \$100. But

if 100 million units are sold, then average development cost drops to a mere \$1. A firm that sold 100 million copies of its office suite would enjoy a huge cost advantage over one that sold only a million copies.

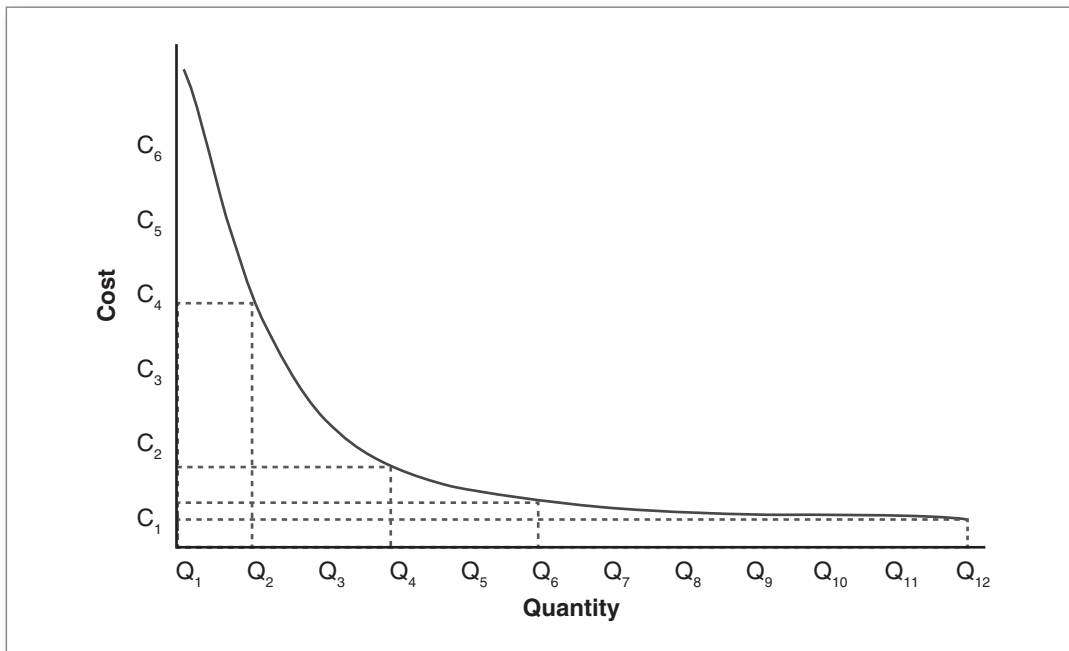
MS-Office, for example, outsells the equivalent WordPerfect office suite by more than 10 to one. Thus, Microsoft can outspend WordPerfect 10 to one on developing and promoting new versions, yet incur a lower average cost per copy. Obviously, Microsoft enjoys vastly superior scale economies.

Figure 2-1 depicts scale economies graphically. The cost curve shows that average cost per unit declines as the quantity, or volume, produced and sold increases. However, it declines at a decreasing rate.

Note that average cost at Q_2 is C_4 , which is substantially greater than average cost at Q_4 . Accordingly, a manufacturer capable of making and selling Q_4 units per year would enjoy a significant production cost advantage over a rival capable of making and selling only Q_2 units annually. However, if the market grew to three times its current size and contestants maintained their market shares, then the larger contestant would be at Q_{12} , while the smaller rival would be at Q_6 . At these volumes, the larger contestant's production cost advantage would be nearly insignificant.

Minimum efficient scale (MES) is reached when further increases in volume no longer reduce average cost appreciably. In the diagram, MES is roughly at Q_6 . MES for breweries is near 5 million barrels per annum. Therefore, increasing a brewery's capacity from 5 million

Figure 2-1 Scale and Average Cost



to 10 million barrels yields no significant production economies. Building two dispersed 5-million-barrel breweries would be wiser than building one 10-million-barrel facility, provided that construction costs are comparable. Average production cost would be nearly the same for the two configurations; however, the two-brewery configuration could reduce shipping costs greatly.

Coors unwisely built a 15-million-barrel brewery in Golden, Colorado. Once the market-share leader in 10 of the 11 Western states, Coors suffered severe delivery cost disadvantages in the most populous parts of the Western USA when Anheuser-Busch and Miller built breweries in California. Coors would have been better off with three dispersed 5-million-barrel facilities.¹¹

Scale economies often can be exploited at several levels, such as the local, regional, national, and global levels. For instance, recall that R. C. Willey Home Furnishings realizes store-level scale economies from its enormous outlets and, in northern Utah, also benefits from regional scale economies in advertising and logistics.

Scale economies often derive from technologies that cannot be employed feasibly in small-scale operations. R. C. Willey's immense distribution center is one example of such a technology. Roof truss manufacturing provides another example. At very low volumes, roof trusses are made most efficiently using very simple tools. However, when volume reaches a certain point, the average cost per truss can be reduced by investing in expensive labor-saving machinery.

Realizing scale economies often requires a high degree of standardization. Without standardization, Henry Ford's Model T would not have been possible and the prices Ford charged would have been far from profitable.

Since Mr. Ford's time, technological advances, such as robotics and refinements in modular construction, have enabled many firms to realize amazing production economies without having to make and market "one-size-fits-all" products. Such firms are said to have *mass customization* capabilities.¹² Early examples of using modular construction to achieve mass customization can be found in the PC industry. Dell, for instance, recognized quickly that PCs are merely assemblies of compatible modules, such as CPUs, video cards, storage media, and displays. Dell also recognized that letting customers choose the modules that fit their needs and pocketbooks would boost sales, but would not increase the company's production costs appreciably.

Economies of Scope

Economies of scope are realized when fixed costs are spread over dissimilar units—for instance, sedans and SUVs. They may be gained from sharing facilities, product platforms, distribution systems, knowledge, brand names, and other resources.¹³

Often, economies of scope are realized from reusing assets developed or acquired for one purpose to serve additional purposes. For example, the cost of developing a new product is reduced when knowledge gained from developing a previous product is reapplied. It also is reduced when a new product is launched under a trusted brand name.

Microsoft benefits from economies of scope when code written for one application is reused in a different application. The more coding costs can be spread over units of the same product, the greater the economies of scale. And the more coding costs can be spread over several different products, the greater the economies of scope.

Amazon.com, too, has benefitted from economies of scope. It began as an online bookstore. But CEO Jeff Bezos recognized that visitors to Amazon.com had needs beyond books. Further, knowledge gained from offering books online could be applied to selling other goods, software developed for selling books could be modified at little cost to cover a much broader mix of merchandise, and the Amazon brand had magnetism. In short, Bezos realized that many of his online bookstore's assets could be leveraged to realize economies of scope. The incremental cost of adding ever more items was nearly negligible, while prior expenditures on promotion, site development, and other activities could be spread over more sales volume. Whether the additional volume came from books, CDs, DVDs, or other products did not matter. Trusted brand names, like Amazon.com, take time and money to develop, but are common contributors to economies of scope because they often reduce the cost of successfully adding product lines, entering new geographic markets, or launching new products.

Economies of scope, like economies of scale, tend to decline at a decreasing rate. Accordingly, cost curves that depict economies of scope taper off much like the curve in Figure 2-1.

Quests for economies of scope are quests for synergy. *Synergy* denotes that the whole is more than the sum of its parts. For example, synergy is realized when, collectively, a company's several business units generate more profit than they would generate in total if they were independent firms.

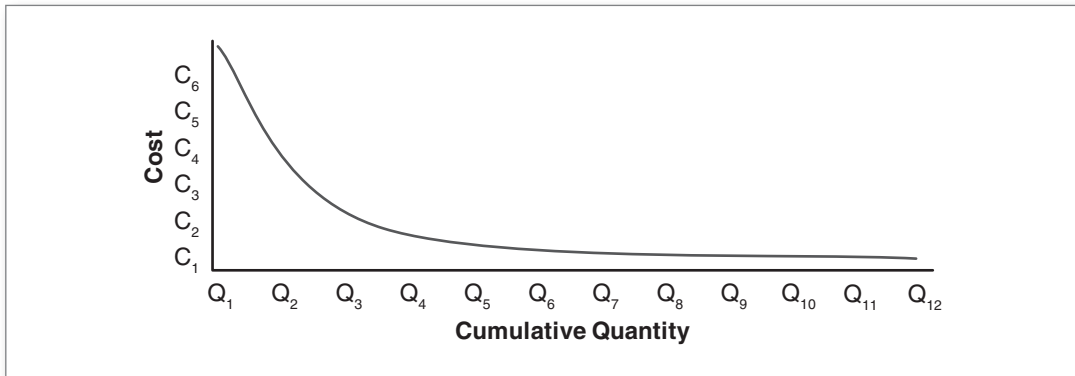
Synergy often is elusive, illusory, or negated by unforeseen side effects.¹⁴ For example, top executives of a leading forest products company thought experience gained from serving construction contractors would give the firm a synergetic edge in do-it-yourself home-improvement retailing. They discovered only gradually that dissimilarities between the two businesses overshadowed similarities and that combining the two businesses actually produced diseconomies of scope.¹⁵

Economies of Experience

Experience economies derive from experiential learning. The more units of a product a firm makes and sells over the course of time, the more apt it is to gain insights into making the product better, faster, or cheaper. Cumulative volume—the number of like units ever produced—is used widely as a surrogate metric for experiential learning. Like scale economies, experience economies taper off with volume. Hence, as shown in Figure 2-2, additional cumulative volume eventually reduces average cost very little.¹⁶ Perpetual market-share leaders are best positioned to realize both superior scale and experience economies because, while they are market share leaders, they generate the most annual and the most cumulative volume.

Bargaining Power and Volume Discounts

A buyer has bargaining power to the extent that a seller will make concessions to avoid losing the buyer. Like most other cost advantages, bargaining power tends to depend on size, especially relative size. Another size-related factor that often affects cost position is ability to take advantage of discounts offered for purchasing large quantities.

Figure 2-2 Experience and Incremental Cost

Vertical Integration

Vertical integration denotes participation at several contiguous levels of production or distribution. It is common when savings from integration exceed the cost of integration.¹⁷

Consider a firm that buys ingots from which it makes iron rods. The ingots are forged from molten iron, which must be cooled or must cool naturally before the ingots can be delivered to the customer. On delivery, the customer must reheat the ingots to shape them into rods. Obviously, cooling and reheating could be eliminated, and savings could be realized if ingot production and subsequent reshaping activities were closely integrated. Further, an integrated operation would enjoy a cost advantage over less efficient independent operations.

Differentiation Advantages

Differentiation refers to non-price differences among competing offerings. For instance, BMWs are differentiated from Porsches and Audis, and Joy is differentiated from Ivory dishwashing liquid, even though both detergents are P&G brands whose ingredients and packaging are identical, except for labeling, color, and scent. Gaining a differentiation advantage requires more than creating perceptible differences; it requires creating differences that customers value and challengers cannot imitate easily.

Bases of Differentiation

Offerings generally center on some core good or service, such as a car or car maintenance and repairs. However, most offerings also include ancillaries that afford differentiation opportunities. For instance, online offerings of Porter's *Competitive Strategy* are differentiated from offerings of the same book by brick-and-mortar bookstores. They are differentiated because online and traditional channels afford dissimilar shopping experiences. Cars are differentiated

not only in terms of physical attributes, such as styling, power, and fuel economy, but also in terms of buying experience, warranty, prestige, and resale value. Even simple commodities, such as roof trusses, may be differentiated by sellers via ancillary service attributes, such as delivery speed and reliability.¹⁸

Differentiation may center on functional or psychic benefits. Functional benefits, such as comfort and power, may differentiate one SUV from another; imagery with psychic appeal differentiates designer jeans from “ordinary” denims.

Customers often find several differentiated brands acceptable because perceived differences are unimportant to them or various differences are offsetting. Hence, car shoppers, for example, may be attracted to several makes and models whose styling and performance attributes differ markedly.

The value placed on particular differentiating attributes may depend on transient circumstances. For instance, restaurants are differentiated on the basis of cuisine and location. Although you may prefer some foods and restaurants over others, whether you have lunch tomorrow at a Mexican, Oriental, Italian, or some other type of restaurant may depend on what you had for lunch today, where you are when lunchtime rolls around, how much time you have for lunch, and who accompanies you.

Vertical and Horizontal Differentiation

Products adjudged to differ in quality and price, such as Hyundai and BMW or J.C. Penney and Nordstrom, are vertically differentiated, whereas products that differ in other aspects, such as Coke and Pepsi, are horizontally differentiated. Thus, BMW and Mercedes-Benz are horizontally differentiated from each other and vertically differentiated from Hyundai.

BMW's certainly cost more than comparable Hyundais, but Hyundais are more reliable than BMW's by some accounts. If Hyundais really are more reliable, then what justifies ascribing higher quality to BMW's?

Definitions of quality are slippery and varied. Among the most useful is one that distinguishes between must-be and attractive quality.¹⁹ *Must-be quality* refers to minimum acceptable levels of desired attributes and maximum acceptable levels of undesired attributes, excluding price. *Attractive quality* refers to valued inessential attributes other than price. In the minds of many car buyers, BMW's are sufficiently reliable, but possess attributes, such as higher brand status and agility, that afford superior overall quality. Price aside, few people would rather have a high-end Hyundai than a high-end BMW. But like beauty, quality often is in the eye of the beholder.

Illusory Functional Differentiation

Illusory functional differentiation promotes the misconception that functionally irrelevant attributes afford functional benefits. Folgers, for example, convinced many instant-coffee drinkers that coffee crystals lock in more flavor than coffee powder. Yet some independent scholarly research suggests Folgers instant coffee would taste no worse were it powdered.²⁰ Illusory functional differentiation often centers on mysterious inert ingredients—for example, “Now with X99,” whatever that is.

Feasibility of Differentiation

The feasibility of differentiation and the number of differentiation opportunities that a market affords depend notably on the performance of competing offerings, demand diversity, technology, and customer price sensitivity. Offerings that meet customer needs and expectations are favorably differentiated from those that do not. Thus, a car dealership whose service is subpar risks losing customers to more competent rivals and may even induce customers to switch brands when buying their next new car.

Demand is diverse to the extent that customer preferences differ and are so intense that buyers will pay premiums for goods or services that deliver more of what they want. The available price premium and the cost of differentiation determine which forms of differentiation are potentially profitable.

The cost of differentiation may depend on technology. For example, most clothing is offered in several standard sizes. Offering multiple sizes is viable for two reasons: Customers would rather pay a small premium to get clothes in approximately their size than settle for one standard size that fits few people well. Moreover, the premium they are willing to pay exceeds the cost of making several sizes. Only a small fraction of all clothing is custom tailored because few customers are willing to pay premiums sufficient to cover the cost of custom tailoring. However, expect further technological advances to make custom tailoring cheaper and less time-consuming for tailors and their customers.

Positioning

Positioning is entwined with differentiation and target marketing. It aims to mold perception and centers on imagery that facilitates distinguishing a brand favorably from competing brands in the minds of targeted customers. Some products are such that imagery and substance are inseparable. High fashions and expensive perfumes are among them.

Advertising and other marketing communications usually enter prominently into positioning. In their classic book, *Positioning: The Battle for Your Mind*, Al Ries and Jack Trout emphasized the importance of standing out from the crowd. Brands and ads that fail to stand out, they opined, get lost in the din and clutter of countless promotional messages vying for attention.²¹

Positioning commonly centers on one or more salient attributes and on making them determinant. *Salient attributes* are prominent features or benefits that matter appreciably to customers; *determinant attributes* are salient differences that affect choice. For example, airline passengers may deem safety salient. But safety is determinant in choosing an airline only if passengers perceive safety differences among carriers.

When a brand is differentiated, but the differentiating attributes are not salient, advertising may enhance their salience. For example, if a particular soft drink is caffeine-free, but potential buyers care little about this attribute, positioning may entail telling people why they should want caffeine-free beverages and framing competing brands contrastingly. Often, the aim of positioning is conveying what “our” brand is not. Thus, 7-Up once positioned itself as the “un-cola,” and politicians frequently depict opponents as corrupt insiders while portraying themselves as patriotic outsiders.

Positioning efforts can succeed only if the *marketing mix* sends a coherent message. Taking *product* to encompass goods and services, marketing mix decisions can be categorized usefully as choices about the product and its pricing, promotion, and distribution.²² If customers are to consider a product exclusive and chic, for example, merely advertising it as such is insufficient. The product itself, its price, and the channels through which it is distributed must reinforce the desired image. Some makers of high-end products, including Omega watches, have been perturbed to find their brands being sold by unauthorized discounters, such as Costco. Distribution through discount channels, they realize, is inconsistent with the message they want their marketing mix to convey.²³

A Word of Caution

As technological advances reduce differentiation costs, tailoring offerings precisely to small segments becomes cheaper and more feasible. Consequently, mass marketers are apt to become increasingly vulnerable to more focused challengers. Nevertheless, anticipated benefits from differentiation often fail to materialize for any of several reasons:

- Differentiation may not reduce price shopping or enhance revenue sufficiently to offset differentiation costs.
- Differences may matter much less to customers than sellers expect.
- Mistakenly, executives may deem differentiation a substitute for operating efficiency.
- Executives may not see that differentiation affords protection from poachers only if it is resistant to imitation or fills a niche whose profit potential is too small to attract challengers.

OPERATIONAL EFFECTIVENESS AND COMPETITIVE ADVANTAGE²⁴

Porter asserted that strategy is about being different, making astute tradeoffs, and choosing profitable paths not available to actual or potential rivals. *Operational effectiveness*, in contrast, is about doing what rivals do, only better. He thought of firms that create maximal value for costs incurred as operating on the productivity frontier. Firms on the *productivity frontier* excel on operational effectiveness by employing the best practices available. Moreover, until applicable practices and technologies advance, they can create greater value only by incurring higher costs.

Professor Porter recognized the importance of operational effectiveness, but never considered it an element of strategy or a source of sustainable competitive advantage. Strategy, he maintained steadfastly, is not about doing better what others do less well. Instead, it is about doing things uniquely to deliver unique value. He argued further that processes and systems that underlie superior operational effectiveness are highly imitable and, thus, seldom account for superior long-term performance.

Greenwald and Kahn disagreed.²⁵ They noted that most firms operate far below the productivity frontier and simply do not have the skills or the will to narrow gaps appreciably

between actual and potential operational effectiveness. Seemingly, then, firms that rise above operational mediocrity may stay ahead of rivals for years.

Although the debate over operational effectiveness as competitive advantage has not been settled, it has drawn attention to the following:

- Competing by doing different things than competitors (e.g., selling direct rather than through retailers) differs from competing by doing like things, only better.
- Insofar as strategy is about gaining and maintaining competitive advantages, a business plan is strategic only if it proposes a profitable course of action that rivals cannot adopt easily, if at all.
- Porter may have overestimated the ease with which high levels of operational effectiveness can be attained.

Box 2-1

Operational Effectiveness or Strategy: Which Accounts for Southwest Airlines' Success?

From its very beginning, Southwest Airlines performed the same basic function as all airlines: It flew people to distant destinations. However, it generally did so at lower prices than competing airlines and generally did so by offering fewer frills, such as meals in flight and baggage transfer. To realize additional savings, Southwest used secondary airports when possible, even though they offered passengers only limited access to connecting flights.

Throughout its history, the company has been more profitable than any other airline, which raises the question, Why? Is Southwest's success attributable to superior operational effectiveness or to strategy?

From Porter's perspective, Southwest owes its success predominantly to strategy. Its founders chose wisely to focus on price-sensitive travelers; hence, the company bought only Boeing 737s, deliberately offered less service than larger carriers, and split savings with customers. To match Southwest's operating cost advantage, established rivals would have had to replace most of their planes with Boeing 737s and cut services. Had they done so, their savings in operating costs would have been overshadowed by capital expenditures on new planes. Further, business and other upscale patrons would have defected in droves to remaining full-service carriers.

Hence, larger rivals were powerless to stifle Southwest's poaching and found replicating Southwest's strategy infeasible. Southwest may have performed some activities much like rivals, only better. But the company succeeded mainly because it performed its functions differently than rivals and provided customer value not offered by competing carriers. Southwest's strategy illustrates Porter's contention that strategy is about being different and making profitable tradeoffs not available to rivals.

Source: M. E. Porter, "What Is Strategy?" *Harvard Business Review*, November–December, 1996, pp. 61–78.

COMPETITIVE ADVANTAGE FROM ANOTHER ANGLE

Like his colleague Michael Porter, Harvard's Pankaj Ghemawat was interested in understanding the determinants of competitive position and profitability.²⁶ After analyzing more than 100 businesses, he concluded that competitive advantages and disadvantages are rooted primarily in three factors: size, access, and what amounts to flexibility.

Size

Size affects competitive position largely via bargaining power and economies of scale, scope, and experience. Since these concepts have been explained already, little more need be said about them.

Network externalities, not yet explained, can create and protect size advantages. They exist when the number of adopters affects a product's value to customers. Telephones, for example, were useless until a user network materialized. But once the network was established, being without a phone was unthinkable.

Network externalities often prompt diverse stakeholders to clamor for industry standards, which may be decreed by government agencies, agreed to by key members of a trade group, or spawned by market forces. Such standards are desirable because they afford compatibility (e.g., between software and hardware) and reduce some risks that customers, developers, manufacturers, and distributors incur. For example:

- One can only imagine what television viewers would have to endure if the broadcasting industry were free to choose its transmission formats.
- Before MS-Office emerged as the unofficial, or *de facto*, standard for office suites, several incompatible formats were used widely, which impeded exchanges of electronic documents.
- Buying a high-definition DVD player and DVDs was much riskier before Bluray emerged as the *de facto* industry standard and HD-DVD vanished. Earlier, VHS became the *de facto* videotape standard, leaving Betamax customers with obsolete equipment and tapes. VHS gained momentum slowly at first, but the difference in market share between VHS and Betamax eventually reached a tipping point after which Betamax disappeared almost overnight.

Unfortunately, industry standards do not always embody the best available technology. Further, they often impede innovation and protect incumbents from more advanced and less expensive substitutes. For example, many software developers knew they could create a better operating system (OS) than Microsoft's DOS, the industry standard for more than a decade. Yet, DOS was not challenged seriously until IBM launched OS/2, which prompted Microsoft to accelerate its development of Windows. DOS had no serious rivals for so long because independent developers knew that network externalities, switching costs, and Microsoft's army of lawyers would stifle their efforts.

Switching costs, which also protect incumbents from poachers, are exemplified by the cost of moving from one OS to another. For example, the monetary switching costs of changing from Microsoft's dominant Windows OS to Linux include the cost of Linux, which may be negligible, and the cost of replacing much software, which may be substantial.

Switching costs are not confined to monetary expenditures. They also encompass the likes of opportunity costs, performance compromises, and relearning time. For instance:

- Passengers who have collected frequent-flier credits from one airline incur opportunity costs whenever they switch to competing airlines.
- New software that offers arcane advanced features sometimes compromises performance because it is slower, has more bugs, or has more complex menus than simpler predecessors.
- Changing suppliers may entail revising ordering procedures, learning new tracking protocols, and worrying about the new vendor's reliability.

Network externalities and switching costs have greatly affected the viability and competitive positions—advantage, parity, and disadvantage—of contestants vying in markets for PC operating systems, office software, VCRs, and DVD players. They work in your favor when they deter your customers from defecting, but work against you when they discourage a competitor's customers from switching to your offering. Strong network externalities in conjunction with high switching costs spawn so-called *winner-take-all competitive environments*—environments that, sooner or later, are dominated for some time by one contestant or one technology.²⁷

Microsoft's time as the OS leader may be coming to an end. Indeed, a new battle over the *de facto* OS standard and much, much more appears to be brewing. The apparent point of attack is the market for mobile devices, which is strong, growing, and not dominated by Microsoft. In fact, Microsoft's power within the mobile devices sphere is rather limited. Apple, Google, Samsung, and other giants that clash with Microsoft on various fronts surely see mobile devices as Microsoft's most vulnerable flank.

Apple's mobile devices, for example, include iPhones, iPads, and iPods, all of which are built on the same basic platform, use the same operating system, and have nearly identical user interfaces. Thus, users of one such device can easily figure out how to use the others. Further, MacBooks, Apple's notebook computers, have much in common with the company's other mobile devices and its desktop computers; iTunes, iTunes Radio, and iCloud are services that bring Apple hardware to life; and iTV, when used in conjunction with other Apple devices and services, can be the hub of home entertainment.

Apple's apparent dream is that the common threads that interconnect Apple devices and services, will inspire Apple customers to become total Apple customers—customers who stick with Apple all the way in fulfilling their communications and entertainment needs. Considering that, not long ago, Microsoft successfully leveraged its OS advantages to attain dominance in office suits and Internet browsers, Apple's dream may not be far-fetched.

Of course, Samsung, Google, and several other formidable contenders have similar hopes and dreams. Which contestant, if any, will succeed in realizing its objectives remains to be seen. Microsoft may again come out on top. Even though its initial efforts to alleviate threats posed by rivals' mobile devices and various other flanking maneuvers have not been impressive, the company is still a strong contender and still has potent defenses, including a Windows phone, a Windows tablet PC, and easy mobile access to the dominant MS-Office.

Access

Access to customers and vital inputs, such as knowledge, materials, and technologies, usually differs among contestants and, therefore, usually affects competitive position. Some, but not all, access advantages depend on size. For example, opportunities to develop genuine relationships with customers and realize attendant advantages do not seem to favor large contestants.

Often, superior access to channels and end-users stems from determined efforts to forge enduring bonds with channel partners and end users. Forging such bonds and gaining attendant relationship advantages requires understanding customers and building brand equity by delivering promised benefits. Accordingly, the IBM name still opens doors to corporate offices, and Nike comes to mind first when most people think of athletic shoes. Trusted brand names reduce perceived risk and inspire confidence. Each customer encounter with a brand either builds or erodes trust and brand equity.

Access advantages often stem from successful preemptive maneuvers that cut rivals off from vital output or input markets. Recall that Walmart was the first chain of its kind to enter isolated towns big enough to support one and only one large general merchandise store. Thus, Walmart preempted Kmart in such markets, even though Kmart was bigger and stronger at the time.

Still, size and muscle flexing are far from irrelevant in gaining access advantages. For instance, by some accounts, Microsoft gained superior access to office suite customers by convincing PC makers that the nearly indispensable Windows OS would be readily available on a timely basis only to makers who agreed to ship their PCs with MS-Office installed. Once MS-Office became the market-share leader, network externalities tightened Microsoft's grip on the market for office suites.

Flexibility

Flexibility refers to the strategic latitude a company enjoys. The following particulars, which interact or overlap to varying degrees, can affect flexibility.

Liquidity denotes the ease with which resources can be exchanged, transferred, transformed, or modified without losing value. Cash is very liquid; knowledge and machinery, in contrast, sometimes are tied so closely to specific products (e.g., phonograph cartridges) that they become nearly worthless as technologies or customer needs change.

Firms would like their resources to be liquid so that "wrong" resources can be turned into "right" resources whenever necessary. But they also want to earn superior profits, which

usually requires committing resources in ways that reduce liquidity. For instance, circa 1990, both IBM and Microsoft were intent on creating the OS of the future. IBM invested heavily in OS/2, while Microsoft poured resources into Windows. In effect, both firms transformed relatively liquid resources (e.g., cash and programmers) into sunk costs that could be recovered only by winning the OS war. Microsoft realized that winning hinged on the availability of compatible applications. Thus, Microsoft quickly introduced Windows software that relegated then pacesetters WordPerfect and Lotus to also-rans.

Sticky commitments arise from decisions that cannot be reversed easily; *shackling commitments* are extremely sticky. Such commitments are exemplified by long-term contracts and investments in specialized assets that can be liquidated only at prices far below their cost or book value. For instance, recall that Southwest Airlines has been strongly committed ever since its founding to operating Boeing 737s. The Boeing 737 is economical, and using only one type of plane pays dividends in terms of training and maintenance costs. Major rivals, in contrast, have invested in fleets of more diverse aircraft. For the most part, Southwest has prospered, while rivals have struggled.

Differences in performance would seem to have given rivals ample reasons for abandoning their strategies, business models, and fleets in favor of emulating Southwest. However, major rivals were shackled to their motley fleets and ways of doing business, at least in the short run, because emulating Southwest was prohibitively expensive.

Image dilemmas arise when firms that have cultivated high-quality brands are threatened by new entrants offering low-end substitutes. Such incumbents cannot afford to ignore newcomers, and they cannot risk destroying brand equity by offering cheap versions under established brand names. Creating a new low-priced brand, sometimes called a *fighting brand*, is a common solution. Accordingly, Paper Mate developed its Write Bros. pen to combat Bic, and Coors created Keystone beer to reclaim sales lost to bargain brands. Several airlines have tried to thwart Southwest by launching fighting brands, such as Continental Lite.

Overextension limits strategic options. Overextended firms have too many irons in the fire and, thus, may find their resources spread too thin to defend every position. When under attack on several fronts, their only viable option is to concede some turf to competitors and concentrate on defending the rest of the empire.

Fear may deter firms of all sizes from aggressive actions. Small companies may fear reprisals from larger competitors, while large companies may fear government intervention or inciting price wars from which no combatant would benefit.

Inertia can prevent even the best organizations from making dramatic changes quickly. It may be exacerbated by employees' self-interests, dysfunctional mindsets, or shackling commitments. Often, inertia not only impedes the implementation of change, but also blinds executives to emerging opportunities, threats, and internal maladies that necessitate change.

Discriminatory external constraints can arise from public policy. For example, antitrust laws that allowed Heileman to acquire several regional brewers stood in the way of Anheuser-Busch and Miller when they tried to absorb the very same companies earlier. They also may arise from public awareness. For instance, Nike and other major shoe companies once were under heavy public pressure to humanize their Asian operation while the

transgressions of inconspicuous rivals escaped notice. Further, various government agencies issue permits, licenses, and the like of which only a limited number may be available and for which only certain firms qualify.

PORTER'S GENERIC STRATEGIES²⁸

Business strategies, Porter submitted, differ not only in terms of advantage, cost or differentiation; they also differ with regard to competitive scope, broad or narrow. Competitive scope denotes the domain in which an advantage is pursued or deployed. Products, customer characteristics, and geography are common bases for delimiting competitive scope. Major contenders in the beer industry, for example, may seek production, purchasing, and advertising cost advantages on a national or even an international scale. Microbreweries, in contrast, aim to differentiate their brands from “ordinary” beer in the minds and mouths of self-designated connoisseurs and tend to focus on local or regional niches.

Taken as two dimensions, competitive advantage (cost or differentiation) and competitive scope (broad or narrow) define four fundamental strategies, known widely as *generic strategies*.²⁹ The following paragraphs explain each one briefly.

Cost Leadership (Cost Advantage, Broad Scope)

Walmart, the behemoth in general merchandise and grocery retailing, is among America's most prominent cost leaders. Its cost advantages are traceable partly to innovative supply-chain management, but they also stem from economies of scale, scope, and experience. Further, Walmart enjoys unparalleled bargaining power, which enables Walmart to exact the lowest possible prices from vendors.

Cost Focus (Cost Advantage, Narrow Scope)

Cost-focus strategies often are viable when rivals overserve a portion of the market and when rivals can serve market niches only by incurring high opportunity costs. Southwest Airlines' entry strategy was an extremely successful cost-focus strategy that targeted travelers eager to trade frills for lower fares. Discount retailers and discount motel chains are among the many other businesses that, also, have found profitable niches within markets that rivals overserved or could not serve without incurring prohibitive opportunity costs.

Differentiation (Differentiation Advantage, Broad Scope)

The success of differentiation strategies hinges on developing a distinctive offering that a large customer segment finds so attractive that it will pay a premium more than sufficient to cover the cost of making the offering special. But to generate a profit premium, an offering must not be readily imitable. Offerings that are readily imitable are always vulnerable to poaching.

Differentiation Focus (Differentiation, Narrow Scope)

Differentiation-focus strategies often work when a market segment that is not very price sensitive is underserved. For instance, Cray's supercomputers filled a niche within a market dominated by less powerful IBM machines. Differentiation focus also is exemplified by retailers that serve small local markets. Due to location and reputation, a mom-and-pop truck stop, for example, may enjoy a differentiation focus advantage within narrow geographic bounds. Locally, it may have greater customer appeal than facilities run by large chains.

Box 2-2

Are Undifferentiated Offerings Viable?

The laws of economics and probability suggest that, among undifferentiated and identically priced offerings, each one has an equal chance of being selected by potential buyers. Therefore, if your offering is one of five very similar offerings that are priced identically and compete for the same customers, you should expect a market share around 20 percent.

Of course, any rival whose average cost is lower than yours could undercut your price and put you out of business. For that very reason, success is achieved more often by relying on differentiation, rather than random chance, to attract and retain customers.

Offerings rarely are totally undifferentiated. Even McDonald's restaurants, which look the same and have nearly identical menus, are differentiated by location. Many offerings are differentiated mostly in the minds of customers. For instance, customers are inclined to consider satisfactory products they have purchased repeatedly safe and, thus, are apt to prefer them over substitutes—even substitutes that are somewhat better by objective performance measures.

EXTREME DIFFERENTIATION FOCUS: ONE-TO-ONE STRATEGY

As portrayed in much of the strategic marketing and management literature, competitive advantages are relative strengths that facilitate serving some broad or narrow-target segment better than rivals can serve it. Such portrayals depict customers not as individuals, but as homogeneous clusters. Customers within a segment are considered virtually identical, especially in terms of needs and preferences. Thus, many a market strategy aims to capture the patronage of entire segments in one fell swoop.

One-to-one marketing affords a different perspective. Insofar as it focuses sharply on each individual customer, it is an extreme form of differentiation focus strategy intent on cultivating a relationship, or loyalty, advantage one customer at a time.³⁰ Loyal customers are those who stay, despite rivals' efforts to pry them away. They are immensely valuable assets.³¹

Not all steady customers are genuinely loyal. Sometimes, steady customers are *hostages*—dissatisfied patrons who have not yet found a more attractive alternative. They bolt at the first opportunity. High switching costs facilitate hostage taking.

In contrast to hostages, delighted customers are loyal entirely by choice. Often, they become *apostles* who eagerly recommend the goods, services, and vendors that delight them.³² Social media have greatly magnified their capacity to impact sales and profits.

To fully appreciate the potential importance of cultivating loyalty by delighting customers, consider the dog-grooming business. As in many other lines of enterprise, cost advantages are elusive in dog grooming because factors that usually underlie cost advantages, such as scale economies, are nearly irrelevant. Location may afford a grooming parlor a differentiation advantage within a locality because nearby residents value convenient access. And names such as “Econo Clips,” “Pampered Pet,” and “Shears on Wheels” suggest that some differentiation on factors other than location is possible. However, all means of differentiating groomers appear highly imitable at first glance and, therefore, unlikely to afford groomers much protection from poachers. Seemingly, any newcomer could easily replicate what established groomers offer.

If customers had no memory or reason to become loyal patrons then, indeed, many a business would find sustainable differentiation advantages out of reach. Fortunately, various psychological comfort factors, especially familiarity and trust, foster customer loyalty. Dog owners, for example, become increasingly comfortable with a groomer each time the grooming experience is positive. The more comfortable they become, the less likely they are to switch, and the more apt they are to recommend the groomer to friends. Thus, cultivating trust and feelings of familiarity and allegiance is not only effective in retaining customers and fortifying barriers that protect a business from poachers; it also facilitates acquiring new customers and adding services that appeal to current customers. A groomer, for example, might add pet daycare and boarding services.

Although one-to-one marketing centers on the needs and preferences of individual customers, the means of delighting each customer may be quite similar. For instance, they may boil down to providing prompt, competent, courteous service to every customer every time. A loyal clientele is the cumulative result of such consistency.

Attempts to market familiarity, trust, and other endearing qualities en masse are common. Many car dealers, for example, endeavor to engender familiarity and trust by advertising frequently on television, sometimes by featuring the smiling faces and folksy pitches of the owner’s kin. Their aim is to convey, “You know us; you can trust us!” Mass mailings disguised as personal correspondence are another favorite device. Still, cultivating familiarity and trust one customer at a time usually works best. Each transaction that meets or exceeds expectations increases confidence in the seller and the seller’s offerings, reduces perceived risk, and strengthens the customer’s reasons for coming back rather than going elsewhere.

STRATEGIC DECISIONS, COMMITMENT, AND TIMING

Strategic decisions are intended to secure competitive advantages. They generally require commitments that cannot be reversed or altered freely.³³

Webvan's short and tragic history illustrates the connection between strategy and commitment vividly. In an attempt to corner the market for online grocery shopping, Webvan committed to a capital-intensive strategy that relied heavily on automated state-of-the-art warehouses.³⁴ Shopping online for groceries, its founders were convinced, soon would be as common and widespread as shopping online for books, music, and myriad other items. Hoping to preempt potential rivals, they moved swiftly to fill what they thought was a rapidly expanding void. Amazon's amazing growth inspired them.

Unfortunately, Webvan's strategy was grounded in serious misconceptions, which became evident to executives and investors only after nearly a billion dollars had been spent. Most of the money was unrecoverable because it was invested in specialized equipment that could not be sold for anything close to its purchase price. Webvan went broke, and fortunes were lost.³⁵

When strategic decisions should be made depends greatly on their reversibility, the time they require to take effect, and the window of opportunity. If major business decisions could be implemented immediately and their impact were instantaneous, then the need for planning would nearly evaporate. But decisions to raise capital, for example, do not generate funds on the spot, nor do decisions to expand create new capacity or additional customers overnight.

Sticky commitments from which no appreciable payoff is expected for quite some time lie at the core of many strategic business decisions, which explains why sound strategic business planning is vital. Making strategic commitments too soon limits flexibility unnecessarily, and making them too late forfeits opportunities to grow or nip threats before they do irreparable damage.

Other factors that affect the timing of strategic decisions include the anticipated moves and countermoves of actual and potential rivals. For instance, Webvan's founders moved aggressively and swiftly into online grocery retailing because they believed their window of opportunity was brief. If not Webvan, they thought, then very soon someone else would dominate online grocery retailing, whose immediate potential they overestimated greatly.

REMEMBER THIS

Strategic business planning entails making critical decisions presently in anticipation of their future consequences in an uncertain world. Market strategy, also called *business strategy* and *competitive strategy*, is the business plan's cornerstone. It delineates where and how the business will compete for customers and why it is expected to prosper.

Value propositions, discussed in the next chapter, link the attributes of offerings to targeted customers' needs and preferences. Effective value propositions center on distinctive benefits that targeted customers value highly (e.g., BMW's performance and handling) or on benefits in relation to price (e.g., Lexus' affordable luxury). Targeted customers should be the people and organizations your business can serve profitably and better than rivals can serve them.

Typical market strategies reflect one of the following options:

- Offer satisfactory goods or services while keeping costs and prices low (e.g., Walmart and Southwest Airlines).
- Charge premium prices for premium goods or services (e.g., Nordstrom).
- Offer “average” goods and services, charge average prices, and incur average costs.

Many businesses settle for the third option, which usually is least profitable. Small businesses often fail because their offerings cannot fetch premium prices and costs incurred per dollar of revenue generated cannot be reduced sufficiently to compete with larger, more cost-efficient rivals.

Ability to prosper depends on competitive advantages, which protect incumbents from challengers and may facilitate invading rivals’ turf. Most competitive advantages have narrow ranges insofar as they apply only to a few products or to small patches of geography. Further, multiple contenders often thrive within a market because their advantages differ and their offerings appeal to different customer segments.

At times, competitive advantage stems from obvious sources, such as a trusted brand name, trade secrets, patented discoveries, copyrighted innovations, or superior size that imparts superior bargaining power and scale economies. But frequently, it results from performing combinations of many obscure little tasks a little better than rivals or from cultivating a loyal clientele by consistently delighting customers.

Most market strategies entail segmenting markets, choosing target segments, and proceeding on the premise that customers who comprise a segment are essentially alike. One-to-one marketing, in contrast, focuses sharply on gaining a customer loyalty advantage one customer at a time. It entails recognizing customer individuality and delighting each potentially profitable customer every time.

Competitive advantages are sustainable to the extent that they cannot be negated readily by imitation or substitution. Advantages are durable to the extent that they are sustainable and do not lose economic value. Sustainability focuses attention on threats from rivals; durability prompts consideration of threats from disruptive technologies, such as those that killed the buggy whip.

Porter reduced competitive advantages to two basic types: cost and differentiation. Most cost advantages stem from size. Among them are those realized from superior economies of scale, scope, or experience; superior bargaining power; greater ability to take advantage of volume discounts; and vertical integration. Differentiation advantages stem from non-price differences and from doing things uniquely to deliver unique value. Accordingly, effective differentiation requires more than creating perceptible differences; it requires creating functional or psychic differences that customers value. Marketing channels and communications can be as instrumental in differentiating offerings as physical and functional product attributes. Thus, distribution differentiates books offered on Amazon.com, for example, from identical titles sold in conventional bookstores.

The feasibility of differentiation and the number of viable differentiation opportunities that a market affords depend on the performance of competing offerings, demand diversity,

technology, and buyer price sensitivity. Although some competitive advantages, such as trusted brand names, may become stronger over time, most erode.

When strategic decisions should be made depends greatly on their reversibility, the time they require to take effect, and the window of opportunity. Making strategic commitments too soon limits flexibility unnecessarily; making them too late forfeits opportunities to grow or nip threats before they do irreparable damage. For a rich historical lesson on business strategy, see the following mini case: “Ford’s Model T: A Classic Lesson in Strategy.”

MINI CASE: FORD’S MODEL T—A CLASSIC LESSON IN STRATEGY

Henry Ford was an avid tinkerer who wanted to engineer, produce, and sell cars profitably. His best chance of succeeding, he came to realize, required creating a cheap, but good, automobile that America’s workers could afford.

Mr. Ford introduced the world to his Model T in 1908. It remained in production for two decades and, by 1918, accounted for half the cars in the USA.

His fundamental strategy was this: Profit from offering working-class Americans a good affordable car; make cars much more affordable by reducing manufacturing costs and settling for a modest profit per car, which will spur demand and generate high profits in total. Mr. Ford sensed the following and proceeded accordingly:

- Nearly every American worker wanted a car, but very few could afford one.
- Millions of workers would buy affordable cars.
- Production efficiency could be improved greatly.
- The first company to build an affordable car would be in the best position to steadily reduce costs and secure a cost advantage.
- Limiting profit to a few dollars per car would generate the maximum total profit, since modest margins make cars more affordable and increases sales volume.

In sum, he envisioned a huge underserved mass market for good cheap cars, consisting mostly of workers rather than the upper classes.

Turning his vision into reality required figuring out how the cost of building a car could be reduced dramatically. With much help, he succeeded by designing a car that could be mass produced and in developing the necessary production technology. Henry Ford did not invent the assembly line; however, he realized ahead of rivals how the right product design, assembly-line manufacturing, and mass-produced precision parts could be combined to make his goals attainable and his Model T strategy feasible. Later, he realized that many of his company’s skills and capabilities applied not only to making cars, which induced him to try his hand at designing and manufacturing airplanes.

Although Mr. Ford did not have every detail worked out before producing his first Model T, he did have a vision and a cogent answer to the question, Why will this venture succeed? It will succeed because the Model T will be the affordable car for which American workers

long. It will be affordable due to its design and the means by which it will be produced. Economies of scale will help drive costs down as sales volume increases, making it increasingly difficult for rivals to compete against the Model T on price.

Scientists would call this explanation a *theory*. Though plausible, Ford's theory was grounded in several critical hypotheses that, at the time of the Model T's launching, were untested. Had they been untrue, they would have rendered the Ford strategy invalid. Among them are the conjectures that many more Americans wanted cars, but could not afford them, and that manufacturing costs could be reduced greatly. Mr. Ford's support for these hypotheses consisted mostly of confidence in his personal observations, insights gained from experience, and belief in himself as an engineer.

Henry Ford's obsession with cost built the Ford Motor Company. However, by the mid-1920s, the Model T had grown old, which allowed General Motors to overtake Ford.

Mini Case Questions

1. Which of Porter's generic strategies did Henry Ford implement?
2. How did standardization affect the Model T's success?
3. Should Mr. Ford have changed his strategy over the years? If so, how?
4. Michael Porter cautioned against pursuing low-cost and differentiation advantages simultaneously. Would the Ford Motor Company have been better off if Mr. Ford had tried to pursue both advantages at the same time?
5. Did Ford ever enjoy a real strategic advantage, or does superior operating effectiveness alone account for the Model T's success?
6. Both the Ford Motor Company and Webvan were founded on the basis of a few critical assumptions. Henry Ford got rich, and Webvan's founders lost a fortune. Does luck alone account for the fact that Mr. Ford's assumptions were mostly correct while the Webvan group's were fatally flawed? If not, why not?

Questions for Review and Discussion

1. What is the purpose of strategy?
2. What does competitive advantage have to do with strategy?
3. How do sustainable and durable advantages differ?
4. What must aspiring imitators do to imitate an offering or a strategy successfully?
5. Is land a mobile or an immobile resource? Briefly explain.
6. How did Michael Porter categorize competitive advantages?

7. What is meant by “scope of an advantage”? Does the concept apply to more than geography? Explain.
8. Why does Michael Porter not consider superior operational effectiveness a potential source of sustainable competitive advantage? Do you agree with him? Why or why not?
9. What is the difference between must-be and attractive quality? May both types of quality differentiate an offering? Explain.
10. What affects the feasibility of differentiation?
11. Why might differentiation fail to enhance profits?
12. How do network externalities and switching costs affect (a) the intensity of rivalry and (b) innovation?
13. What are sticky commitments, and how do they affect ability to compete?
14. What is the nature of the advantage that one-to-one marketing aims to create?

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