

## Business Level Strategies

So far we have talked about three basic reasons why firm performance differs. We have talked about mission and goals, the external environment, especially the industry environment, and about VRIO firm resources. This chapter discusses the last piece of the puzzle, how do firms develop and deploy their resources given the external environment in any one particular market or industry?

In answering this question we'll describe three generic strategies. Three generic ways to describe a firm's business level strategy are low cost, differentiation, and focus. There are OTHER sets of generic strategies (see \_\_\_) but these are the three simplest. These three can also be further subdivided. However, given the trouble companies have just getting one of these three basic ones right, we'll keep our focus here and return to some finer distinctions in the last chapter. Keep in mind these are broad ways to think about how you are competing against your rivals in a *single* market or industry.

The **low cost strategy** emphasizes having the lowest *costs*, not necessarily the lowest *price*, in a market. A firm attempting to realize a low cost strategy should stress resources that facilitate efficiency. A firm that has successfully achieved a low cost position will have the lowest costs relative to competitors. A firm can use such a position to either lower its prices and gain market share and sales from rivals OR keep its prices at the present market level and make relatively more profit per unit sold. The key idea is that cost and price are independent choices, and this strategy is focused on cost.

The **differentiation strategy** focuses on developing a unique product or (equally useful) a perception of a unique product that customers are willing to pay a premium for. If a firm is not receiving a premium price for its goods or services it is NOT a differentiator. A firm seeking to follow a differentiation strategy should attempt to develop and enhance its resources that promote customer responsiveness, quality, and/or innovation. Note that costs are still important to a differentiator because it is possible that the costs of making the product unique will be greater than the premium consumers are willing to pay for it.

There is a third strategy called **focus**. A firm attempting to implement a focus strategy is serving the needs of a limited group or segment very well. Often times this is a remainder category for firms that clearly don't have a cost advantage of some type nor receive a premium price for their product. A firm with a focus strategy must carefully consider its target market and what they desire.

These three generic strategies were popularized by Michael Porter back in 1980. Shortly thereafter he made a video about them and highlighted Ivory soap as an example of low cost, American Airlines as a differentiator, and Cray Computer as a focuser. The fact that American Airlines has faced considerable difficulty and that Cray is no longer with us highlights how precarious any firm is in a competitive environment.

Finally, there is a fourth result that is not really a strategy but is helpful to view as one, **stuck in the middle**. A firm that is stuck in the middle is not succeeding in any one of the three strategies

very well. As a result, it usually loses out to successful differentiators and low cost firms. Getting “suck in the middle” is easy to do and it frequently occurs because a firm tries to switch between strategies or “be both low cost and differentiate.” Needless to say, being stuck in the middle is a bad thing.

As you can see, based on this framework, all firms have at least one business level strategy. Firm which are in multiple industries can have different business level strategies in each of their different markets. However, ALL firms have a business level strategy wither they intend it or not. If you ask a business executive what their strategy is and they say something like “make money” you can translate that as soon to be stuck in the middle.

**Alignment.** None of the three business level strategy is inherently better than the others. Successful firms have embodied each of them. The primary issue of concern for performance is therefore not which strategy the firm has taken but how well the firm has aligned its resources and capabilities on that strategy. Therefore, the key is not which strategy but how well the firm is ALIGNED on it. Alignment is simply defined as how well each aspect of the firm supports its business level strategy. So while business level strategies can be described in three ways they are conceptually evaluated based on alignment. In order to examine the importance of alignment in more detail we'll look at each of the strategies and how they are determined.

**Cost Leadership.** A cost leader is producing at an industry's lowest costs. Recall that efficiency is defined as output divided by input. Therefore, such a firm often strives to produce at large volumes to take advantage of economies of scale. It does this by targeting the average consumer knowing that while the product may not be exactly what each consumer wants, it has broad enough appeal to create demand for a large volume production. With is standardized stores and similar product mix, Wal-Mart is the epitome of a cost leader.

Efficiency provides the foundation for the cost leadership strategy. Efficiency is commonly obtained from each of the functional areas, economies of scale, and learning effects. Each functional area of the firm (e.g. marketing, production, etc.) is a potential source of efficiency. Does each one strive to reward more efficient production or the targeting of the largest market? Probably one of the most over looked functions is human resources, a quick check to see if a firm's incentive systems are in alignment with its strategy often proves quite insightful. If economies of scale, unit cost reductions as output expands, are present then there are opportunities for cost leadership to be especially effective. Similarly with learning effects, which represent cost savings from learning by doing. These also reduce costs, and unlike economies of scale, are often highly visible in service industries. For example H&R Block's tax preparers reap considerable learning economies from doing so many tax returns.

Some people confuse learning effects, which are real, with something that looks and sounds similar but is actually very different - the experience curve. Probably no other strategy concept is more misused and misapplied than the experience curve. When first developed by the Boston Consulting Group, the experience curve was nothing more than an observed decline in unit costs over the life of a product. Therefore, it was an INDUSTRY not a FIRM measure. Some people discuss the experience curve when they mean the learning curve - which is simply the graphical illustration of the marginal gains from learning by doing - and vice versa. Therefore, you must

be careful and check the axis of the graphs as they are two very different ideas. A true experience curve will have accumulated industry production on the X axis. So the cost reductions shown by the experience curve are general to an *industry*, i.e. individual firm technology has leaked out and diffused into an industry. This is common as a firm can simply hire workers from a competitor to learn techniques that are not trade secrets. The idea of the experience curve is just a generalization of examples that have occurred in many industries. I advise ignoring it completely. If you must use it, realize it offers little insight other than a general guide for how fast costs have declined in the past in an industry.

Cost leadership is a powerful and frequently announced business level strategy. However, it is undermined by technological change, loss of focus on customers, and imitation of a cost advantage some other way. For example, what determines the slope of an economy of scale curve? Technology, how work is done. Therefore, economies of scale may increase or decrease with technological change rendering earlier cost advantages obsolete. Even worse, radical technological change might occur that totally supplants how the product or service is currently produced, e.g. machine made ice versus natural ice. Not paying attention to customers can also undermine a cost leadership strategy. While focusing on efficiency it is very easy to ignore customer demands and supply only what is most efficient. While this can work when demand is very high, e.g. Henry Ford's famous dictum about "any color you want as long as it's black," it can lead to a firm's downfall if competitors have nearly matched a cost advantage and can offer more product diversity. This is in fact how Alfred Sloan and General Motors overtook Ford. Finally, it is possible for other firms to imitate another firm's cost advantage some how. The most common example is the use of low cost foreign labor coupled with low trade barriers. However, government intervention or subsidies are also possible examples.

**Differentiation.** In a differentiation strategy firms attempt to have their products be perceived as unique in order to obtain a premium price. Brand loyal customers are often a sign that this strategy is working. There are numerous examples of this, Rolex vs. Casio watches, t-shirts from Wal-Mart versus Abercrombie and Fitch. While the underlying foundation of differentiation is not as well understood as cost leadership, generally any aspect of the product or service a customer is willing to pay a premium for is the foundation of this strategy. Therefore, firms seeking to implement this strategy should focus on quality, innovation, and/or customer responsiveness. Innovation is especially common and useful to differentiators and firms should take special efforts to not punish failure since most innovations, e.g. new products, fail.

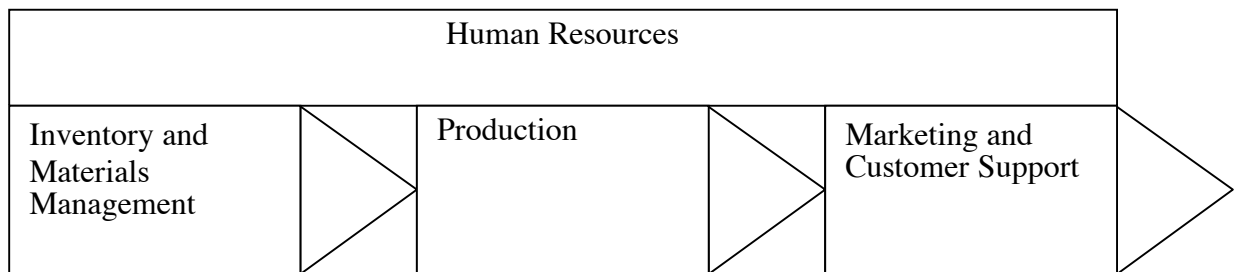
There are many potential threats to differentiation. Perhaps the most common is that over time consumers cease to value the difference they were willing to pay a premium for earlier. The demise of many direct sales forces in the personal computer industry is a great example of this. Why pay extra for a sales rep when anyone can go online and order a PC? Sometimes a differentiator will become too successful and wind up turning their product into a commodity. For example, Aspirin used to be a brand name for Bayer. While this extreme is uncommon, lesser examples of commoditization occur. Finally, there are many opportunities for copy cats and counterfeit products. One merely needs to sample the wares from vendors along Canal Street in New York City to see the huge risk of people purchasing the "image" of a brand name product for a fraction of its actual price.

**Focus.** The focus strategy is limiting your appeal to a narrow group and attempting to meet their needs exceptionally well. Probably the most common basis for a focus strategy is geography. However, the key remains alignment. What does your targeted customer group value? Do you need to have low costs because they are so price sensitive or can you be so customer responsive that they are willing to pay average or above prices for your products or services.

**Stuck in the Middle.** A firm that is not performing well is probably trying to do some elements of cost leadership coupled with some elements of differentiation. Hence the term stuck in the middle. This strategy is embarrassingly common. The key to escape is to pick a strategy and align on it.

**Low Cost and Differentiation?** Some strategy scholars like to say that you can do both a low cost and a differentiation strategy. I used to say this was impossible. However, with the internet coupled with globalization, coupled with sophisticated data processing and marketing techniques I have to concede that it may not be impossible any more. However, I would say it is still extremely difficult and rather than successfully implementing both simultaneously you'd be better served to pick one and then see if you can do the other as well. Trying to do both from the start will still probably get you stuck in the middle.

**Alignment and the Value Chain.** A value chain is a graphical representation of the firm that divides it up into its component parts, such as its functions. Most value chains start with the inputs into the firm and follow them until they emerge from the firm as a finished output. For internal analysis, a value chain can be useful in looking for valuable resources that are possessed by a firm that might otherwise be overlooked. For business level strategy a value chain is even more important because it is an easy way to check and see if the firm is aligned on its presumed business level strategy. Here is a very simple value chain with three primary functions – inventory, production, and marketing - and one support function (HR).



**First Mover Advantage**

First mover advantage is not a business level strategy per se but it is so commonly talked about as a business strategy that we should discuss it here. First mover advantage suggests that the firm that is first to the market with a good or service will be successful. This is probably the most abused, mistaken, and over rated “business strategy” in the universe. In almost every industry, the firm credited with being first and being successful today wasn’t the first. Microsoft didn’t offer the first PC operating system. Proctor and Gamble’s Pampers were not the first disposable diaper. So NEVER assume that being the first mover is the path to business success.

Being the first mover is advantageous if and ONLY if you can get at least one of these three advantages: preempt scarce assets, create customer switching costs, or gain a reputational advantage. If by moving early you can gain a scarce asset, such as a corner location at a busy intersection for a gas station, then being an early mover can lead to firm success. Similarly, if you can create switching costs for consumers to move to a competitor's products then being an early mover offers advantages. However, switching costs are quite rare. Finally, if you can gain some type of reputational advantage that customers will be willing to pay a premium for, then being an early mover makes sense.

However, even if you get one or more of these three advantages, by being an early mover you get all three disadvantages of being an early mover – risk, inertia, and free riders. First, keep in mind that something like 90% of new products fail. So there is considerable risk with being the first mover, maybe no one wants what you're offering. Second, even if your product is successful, new entrants will show up with products that are probably slightly better than yours (or that cost less). You will have to fight inertia (recall business failure) in bringing out better versions of your product or meeting the challenges of the subsequent entrants. Finally, keep in mind that as the first mover you are educating consumers about the value and benefits of your product/service. However, later entrants not only probably have improved products, they don't need to convince consumers that the product is useful, only that their version is better/cheaper than yours. So this is an additional disadvantage of being an early mover.

Therefore, a strategy of being the first or an early mover should be considered most carefully. A firm that does so always gets all three of the disadvantages while rarely being assured of even one of the advantages. A lot of evidence seems to suggest that being a "quick follower" might be preferred to being an early mover. In a way, the advantages of being a later mover are the converse of the disadvantages of being an early one. You have less risk, can imitate rather than innovate, and have less potential for inertia.

**A Note on Business Models.** The rise of the internet has renewed discussion of the idea of business models. A business model is simply the firm's approach to creating and capturing value for the customer. For example, Wal-Mart buys huge quantities of items, distributes them to their stores, and sells them at a mark up to us. The TV networks create programming but rather than directly charge us for it, they rely on advertisers to pay for the opportunity to insert mini-programs (ads) into their programming schedule.<sup>1</sup> While potentially important, business models are distinct from business strategy and in many ways more fundamental and basic to the existence or rationale of the firm.

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<sup>1</sup> Though they do often charge the cable networks to carry their programming. For example at the time of this writing ESPN charges cable companies about \$2.35 per subscriber, so we do pay indirectly.