The Five Generic Competitive Strategies

Which One to Employ?

Competitive strategy is about being different. It means deliberately choosing to perform activities differently or to perform different activities than rivals to deliver a unique mix of value.

—Michael E. Porter

Winners in business play rough and don’t apologize for it. The nicest part of playing hardball is watching your competitors squirm.

—George Stalk Jr. and Rob Lachnauer

Strategy . . . is about first analyzing and then experimenting, trying, learning, and experimenting some more.

—Ian C. McMillan and Rita Gunther McGrath

The essence of strategy lies in creating tomorrow’s competitive advantages faster than competitors mimic the ones you possess today.

—Gary Hamel and C. K. Prahalad
This chapter describes the five basic competitive strategy options—which of the five to employ is a company’s first and foremost choice in crafting an overall strategy and beginning its quest for competitive advantage. A company’s competitive strategy deals exclusively with the specifics of management’s game plan for competing successfully—its specific efforts to please customers, its offensive and defensive moves to counter the maneuvers of rivals, its responses to whatever market conditions prevail at the moment, its initiatives to strengthen its market position, and its approach to securing a competitive advantage vis-à-vis rivals. Companies the world over are imaginative in conceiving competitive strategies to win customer favor. At most companies the aim, quite simply, is to do a significantly better job than rivals of providing what buyers are looking for and thereby secure an upper hand in the marketplace.

A company achieves competitive advantage whenever it has some type of edge over rivals in attracting buyers and coping with competitive forces. There are many routes to competitive advantage, but they all involve giving buyers what they perceive as superior value compared to the offerings of rival sellers. Superior value can mean a good product at a lower price; a superior product that is worth paying more for; or a best-value offering that represents an attractive combination of price, features, quality, service, and other appealing attributes. Delivering superior value—whatever form it takes—nearly always requires performing value chain activities differently than rivals and building competencies and resource capabilities that are not readily matched.

Core Concept
A competitive strategy concerns the specifics of management's game plan for competing successfully and securing a competitive advantage over rivals.

Core Concept
The objective of competitive strategy is to knock the socks off rival companies by doing a better job of satisfying buyer needs and preferences.
THE FIVE GENERIC COMPETITIVE STRATEGIES

There are countless variations in the competitive strategies that companies employ, mainly because each company's strategic approach entails custom-designed actions to fit its own circumstances and industry environment. The custom-tailored nature of each company's strategy makes the chances remote that any two companies—even companies in the same industry—will employ strategies that are exactly alike in every detail. Managers at different companies always have a slightly different spin on future market conditions and how to best align their company's strategy with these conditions; moreover, they have different notions of how they intend to outmaneuver rivals and what strategic options make the most sense for their particular company. However, when one strips away the details to get at the real substance, the biggest and most important differences among competitive strategies boil down to (1) whether a company’s market target is broad or narrow, and (2) whether the company is pursuing a competitive advantage linked to low costs or product differentiation. Five distinct competitive strategy approaches stand out:

1. A low-cost provider strategy—striving to achieve lower overall costs than rivals and appealing to a broad spectrum of customers, usually by underpricing rivals.
2. A broad differentiation strategy—seeking to differentiate the company’s product offering from rivals’ in ways that will appeal to a broad spectrum of buyers.
3. A best-cost provider strategy—giving customers more value for their money by incorporating good-to-excellent product attributes at a lower cost than rivals; the target is to have the lowest (best) costs and prices compared to rivals offering products with comparable attributes.

**Figure 5.1** The Five Generic Competitive Strategies: Each Stakes Out a Different Market Position

![Diagram](image_url)

4. A focused (or market niche) strategy based on low costs—concentrating on a narrow buyer segment and outcompeting rivals by having lower costs than rivals and thus being able to serve niche members at a lower price.

5. A focused (or market niche) strategy based on differentiation—concentrating on a narrow buyer segment and outcompeting rivals by offering niche members customized attributes that meet their tastes and requirements better than rivals' products.

Each of these five generic competitive approaches stakes out a different market position, as shown in Figure 5.1. Each involves distinctively different approaches to competing and operating the business. The remainder of this chapter explores the ins and outs of the five generic competitive strategies and how they differ.

LOW-COST PROVIDER STRATEGIES

Striving to be the industry's overall low-cost provider is a powerful competitive approach in markets with many price-sensitive buyers. A company achieves low-cost leadership when it becomes the industry's lowest-cost provider rather than just being one of perhaps several competitors with comparatively low costs. A low-cost provider's strategic target is meaningfully lower costs than rivals—but not necessarily the absolutely lowest possible cost. In striving for a cost advantage over rivals, managers must take care to include features and services that buyers consider essential—a product offering that is too frills-free sabotages the attractiveness of the company's product and can turn buyers off even if it is priced lower than competing products. For maximum effectiveness, companies employing a low-cost provider strategy need to achieve their cost advantage in ways difficult for rivals to copy or match. If rivals find it relatively easy or inexpensive to imitate the leader's low-cost methods, then the leader's advantage will be too short-lived to yield a valuable edge in the marketplace.

A company has two options for translating a low-cost advantage over rivals into attractive profit performance. Option 1 is to use the lower-cost edge to underprice competitors and attract price-sensitive buyers in great enough numbers to increase total profits. The trick to profitably underpricing rivals is either to keep the size of the price cut smaller than the size of the firm's cost advantage (thus reaping the benefits of both a bigger profit margin per unit sold and the added profits on incremental sales) or to generate enough added volume to increase total profits despite thinner profit margins (larger volume can make up for smaller margins provided the underpricing of rivals brings in enough extra sales). Option 2 is to maintain the present price, be content with the present market share, and use the lower-cost edge to earn a higher profit margin on each unit sold, thereby raising the firm's total profits and overall return on investment.

Illustration Capsule 5.1 describes Nucor Corporation's strategy for gaining low-cost leadership in manufacturing a variety of steel products.

The Two Major Avenues for Achieving a Cost Advantage

To achieve a low-cost edge over rivals, a firm's cumulative costs across its overall value chain must be lower than competitors' cumulative costs—and the means of achieving...
Nucor Corporation is the world's leading minimill producer of such steel products as carbon and alloy steel bars, beams, sheet, and plate; steel joists and joist girders; steel deck; cold finished steel; steel fasteners; metal building systems; and light gauge steel framing. In 2004, it had close to $10 billion in sales, 9,000 employees, and annual production capacity of nearly 22 million tons, making it the largest steel producer in the United States and one of the 10 largest in the world. The company has pursued a strategy that has made it among the world's lowest-cost producers of steel and has allowed the company to consistently outperform its rivals in terms of financial and market performance.

Nucor's low-cost strategy aims to give it a cost and pricing advantage in the commodity-like steel industry and leaves no part of the company's value chain neglected. The key elements of the strategy include the following:

- **Using electric arc furnaces where scrap steel and directly reduced iron ore are melted and then sent to a continuous caster and rolling mill to be shaped into steel products, thereby eliminating an assortment of production processes from the value chain used by traditional integrated steel mills.** Nucor's minimill value chain makes the use of coal, coke, and iron ore unnecessary; cuts investment in facilities and equipment (eliminating coke ovens, blast furnaces, basic oxygen furnaces, and ingot casters); and requires fewer employees than integrated mills.

- **Striving hard for continuous improvement in the efficiency of its plants and frequently investing in state-of-the-art equipment to reduce unit costs.** Nucor is known for its technological leadership and its aggressive pursuit of production process innovation.

- **Carefully selecting plant sites to minimize inbound and outbound shipping costs and to take advantage of low rates for electricity (electric arc furnaces are heavy users of electricity).** Nucor tends to avoid locating new plants in geographic areas where labor unions are a strong influence.

- **Hiring a nonunion workforce that uses team-based incentive compensation systems (often opposed by unions).** Operating and maintenance employees and supervisors are paid weekly bonuses based on the productivity of their work group. The size of the bonus is based on the capabilities of the equipment employed and ranges from 80 percent to 150 percent of an employee's base pay; no bonus is paid if the equipment is not operating. Nucor's compensation program has boosted the company's labor productivity to levels nearly double the industry average while rewarding productive employees with annual compensation packages that exceed what their union counterparts earn by as much as 20 percent. Nucor has been able to attract and retain highly talented, productive, and dedicated employees. In addition, the company's healthy culture and results-oriented self-managed work teams allow the company to employ fewer supervisors than what would be needed with an hourly union workforce.

- **Heavily emphasizing consistent product quality and has rigorous quality systems.**

- **Minimizing general and administrative expenses by maintaining a lean staff at corporate headquarters (fewer than 125 employees) and allowing only four levels of management between the CEO and production workers. Headquarters offices are modestly furnished and located in an inexpensive building. The company minimizes reports, paperwork, and meetings to keep managers focused on value-adding activities—Nucor is noted not only for its streamlined organizational structure but also for its frugality in travel and entertainment expenses—the company's top managers set the example by flying coach class, avoiding pricey hotels, and refraining from taking customers out for expensive dinners.**

In 2001–2003, when many U.S. producers of steel products were in dire economic straits because of weak demand for steel and deep price discounting by foreign rivals, Nucor began acquiring state-of-the-art steelmaking facilities from bankrupt or nearly bankrupt rivals at bargain-basement prices, often at 20 to 25 percent of what it cost to construct the facilities. This has given Nucor much lower depreciation costs than rivals having comparable plants.

Nucor management's outstanding execution of its low-cost strategy and its commitment to drive down costs throughout its value chain has allowed it to compete aggressively on price, earn higher profit margins than rivals, and grow its business at a considerably faster rate than its integrated steel mill rivals.

*Source: Company annual reports, news releases, and Web site.*
the cost advantage must be durable. There are two ways to accomplish this:

1. Do a better job than rivals of performing value chain activities more cost-effectively.
2. Revamp the firm’s overall value chain to eliminate or bypass some cost-producing activities.

Let’s look at each of the two approaches to securing a cost advantage.

**Cost-Efficient Management of Value Chain Activities**  For a company to do a more cost-efficient job of managing its value chain than rivals, managers must launch a concerted, ongoing effort to ferret out cost-saving opportunities in every part of the value chain. No activity can escape cost-saving scrutiny, and all company personnel must be expected to use their talents and ingenuity to come up with innovative and effective ways to keep costs down. All avenues for performing value chain activities at a lower cost than rivals have to be explored. Attempts to outmanage rivals on cost commonly involve such actions as:

1. *Striving to capture all available economies of scale.* Economies of scale stem from an ability to lower unit costs by increasing the scale of operation—there are many occasions when a large plant is more economical to operate than a small or medium-size plant or when a large distribution warehouse is more cost efficient than a small warehouse. Often, manufacturing economies can be achieved by using common parts and components in different models and/or by cutting back on the number of models offered (especially slow-selling ones) and then scheduling longer production runs for fewer models. In global industries, making separate products for each country market instead of selling a mostly standard product worldwide tends to boost unit costs because of lost time in model changeover, shorter production runs, and inability to reach the most economic scale of production for each country model.

2. *Taking full advantage of learning/experience curve effects.* The cost of performing an activity can decline over time as the learning and experience of company personnel builds. Learning/experience curve economies can stem from debugging and mastering newly introduced technologies, using the experiences and suggestions of workers to install more efficient plant layouts and assembly procedures, and the added speed and effectiveness that accrues from repeatedly picking sites for and building new plants, retail outlets, or distribution centers. Aggressively managed low-cost providers pay diligent attention to capturing the benefits of learning and experience and to keeping these benefits proprietary to whatever extent possible.

3. *Trying to operate facilities at full capacity.* Whether a company is able to operate at or near full capacity has a big impact on units costs when its value chain contains activities associated with substantial fixed costs. Higher rates of capacity utilization allow depreciation and other fixed costs to be spread over a larger unit volume, thereby lowering fixed costs per unit. The more capital-intensive the business, or the higher the percentage of fixed costs as a percentage of total costs, the more important that full-capacity operation becomes because there’s such a stiff unit-cost penalty for underutilizing existing capacity. In such cases, finding ways to operate close to full capacity year-round can be an important source of cost advantage.

4. *Pursuing efforts to boost sales volumes and thus spread such costs as R&D, advertising, and selling and administrative costs out over more units.* The more units
a company sells, the more it lowers its unit costs for R&D, sales and marketing, and administrative overhead.

5. Improving supply chain efficiency. Many companies pursue cost reduction by partnering with suppliers to streamline the ordering and purchasing process via online systems, reduce inventory carrying costs via just-in-time inventory practices, economize on shipping and materials handling, and ferret out other cost-saving opportunities. A company with a core competence (or better still a distinctive competence) in cost-efficient supply chain management can sometimes achieve a sizable cost advantage over less adept rivals.

6. Substituting the use of low-cost for high-cost raw materials or component parts. If the costs of raw materials and parts are too high, a company can either substitute the use of lower-cost items or maybe even design the high-cost components out of the product altogether.

7. Using online systems and sophisticated software to achieve operating efficiencies. Data sharing, starting with customer orders and going all the way back to components production, coupled with the use of enterprise resource planning (ERP) and manufacturing execution system (MES) software, can make custom manufacturing just as cheap as mass production—and sometimes cheaper. Online systems and software can also greatly reduce production times and labor costs. Lexmark used ERP and MES software to cut its production time for inkjet printers from four hours to 24 minutes. Southwest Airlines uses proprietary software to schedule flights and assign flight crews cost-effectively.

8. Adopting labor-saving operating methods. Examples of ways for a company to economize on labor costs include the following: installing labor-saving technology, shifting production from geographic areas where labor costs are high to geographic areas where labor costs are low, avoiding the use of union labor where possible (because of work rules that can stifle productivity and because of union demands for above-market pay scales and costly fringe benefits), and using incentive compensation systems that promote high labor productivity.

9. Using the company’s bargaining power vis-à-vis suppliers to gain concessions. Many large enterprises (e.g., Wal-Mart, Home Depot, the world’s major motor vehicle producers) have used their bargaining clout in purchasing large volumes to wrangle good prices on their purchases from suppliers. Having greater buying power than rivals can be an important source of cost advantage.

10. Being alert to the cost advantages of outsourcing and vertical integration. Outsourcing the performance of certain value chain activities can be more economical than performing them in-house if outside specialists, by virtue of their expertise and volume, can perform the activities at lower cost. Indeed, outsourcing has in recent years become a widely used cost-reduction approach. However, there can be times when integrating the activities of either suppliers or distribution channel allies can allow an enterprise to detour suppliers or buyers who have an adverse impact on costs because of their considerable bargaining power.

In addition to the above means of achieving lower costs than rivals, managers can also achieve important cost savings by deliberately opting for an inherently economical strategy keyed to a frills-free product offering. For instance, a company can bolster its attempts to open up a durable cost advantage over rivals by:

- Having lower specifications for purchased materials, parts, and components than rivals do. Thus, a maker of personal computers (PCs) can use the cheapest
hard drives, microprocessors, monitors, DVD drives, and other components it can find so as to end up with lower production costs than rival PC makers.

- Distributing the company’s product only through low-cost distribution channels and avoiding high-cost distribution channels.
- Choosing to use the most economical method for delivering customer orders (even if it results in longer delivery times).

These strategy-related means of keeping costs low don’t really involve “outmanaging” rivals, but they can nonetheless contribute materially to becoming the industry’s low-cost leader.

**Revamping the Value Chain to Curb or Eliminate Unnecessary Activities**

Dramatic cost advantages can emerge from finding innovative ways to cut back on or entirely bypass certain cost-producing value chain activities. There are six primary ways companies can achieve a cost advantage by reconfiguring their value chains:

1. **Cutting out distributors and dealers by selling directly to customers.** Selling directly and bypassing the activities and costs of distributors or dealers can involve (1) having the company’s own direct sales force (which adds the costs of maintaining and supporting a sales force but may well be cheaper than accessing customers through distributors or dealers) and/or (2) conducting sales operations at the company’s Web site (Web site operations may be substantially cheaper than distributor or dealer channels). Costs in the wholesale/retail portions of the value chain frequently represent 35–50 percent of the price final consumers pay. There are several prominent examples in which companies have instituted a sell-direct approach to cutting costs out of the value chain. Software developers allow customers to download new programs directly from the Internet, eliminating the costs of producing and packaging CDs and cutting out the host of activities, costs, and markups associated with shipping and distributing software through wholesale and retail channels. By cutting all these costs and activities out of the value chain, software developers have the pricing room to boost their profit margins and still sell their products below levels that retailers would have to charge. The major airlines now sell most of their tickets directly to passengers via their Web sites, ticket counter agents, and telephone reservation systems, allowing them to save hundreds of millions of dollars in commissions once paid to travel agents.

2. **Replacing certain value chain activities with faster and cheaper online technology.** In recent years the Internet and Internet technology applications have become powerful and pervasive tools for conducting business and reengineering company and industry value chains. For instance, Internet technology has revolutionized supply chain management, turning many time-consuming and labor-intensive activities into paperless transactions performed instantaneously. Company procurement personnel can—with only a few mouse clicks—check materials inventories against incoming customer orders, check suppliers’ stocks, check the latest prices for parts and components at auction and e-sourcing Web sites, and check FedEx delivery schedules. Various e-procurement software packages streamline the purchasing process by eliminating paper documents such as requests for quotations, purchase orders, order acceptances, and shipping notices. There’s software that permits the relevant details of incoming customer orders to be instantly shared with the suppliers of needed parts and components. All this facilitates
just-in-time deliveries of parts and components and matching the production of parts and components to assembly plant requirements and production schedules, cutting out unnecessary activities and producing savings for both suppliers and manufacturers. Retailers can install online systems that relay data from cash register sales at the check-out counter back to manufacturers and their suppliers. Manufacturers can use online systems to collaborate closely with parts and components suppliers in designing new products and shortening the time it takes to get them into production. Online systems allow warranty claims and product performance problems involving supplier components to be instantly relayed to the relevant suppliers so that corrections can be expedited. Online systems have the further effect of breaking down corporate bureaucracies and reducing overhead costs. The whole back-office data management process (order processing, invoicing, customer accounting, and other kinds of transaction costs) can be handled fast, accurately, and with less paperwork and fewer personnel.

3. **Streamlining operations by eliminating low-value-added or unnecessary work steps and activities.** Examples include using computer-assisted design techniques, standardizing parts and components across models and styles, having suppliers collaborate to combine parts and components into modules so that products can be assembled in fewer steps, and shifting to an easy-to-manufacture product design. At Wal-Mart, some items supplied by manufacturers are delivered directly to retail stores rather than being routed through Wal-Mart’s distribution centers and delivered by Wal-Mart trucks; in other instances, Wal-Mart unloads incoming shipments from manufacturers’ trucks arriving at its distribution centers directly onto outgoing Wal-Mart trucks headed to particular stores without ever moving the goods into the distribution center. Many supermarket chains have greatly reduced in-store meat butchering and cutting activities by shifting to meats that are cut and packaged at the meat-packing plant and then delivered to their stores in ready-to-sell form.

4. **Relocating facilities so as to curb the need for shipping and handling activities.** Having suppliers locate facilities adjacent to the company’s plant or locating the company’s plants or warehouses near customers can help curb or eliminate shipping and handling costs.

5. **Offering a frills-free product.** Deliberately restricting a company’s product offering to the essentials can help the company cut costs associated with snazzy attributes and a full lineup of options and extras. Activities and costs can also be eliminated by incorporating fewer performance and quality features into the product and by offering buyers fewer services. Stripping extras like first-class sections, meals, and reserved seating is a favorite technique of budget airlines like Southwest, Ryanair (Europe), easyJet (Europe), and Gol (Brazil).

6. **Offering a limited product line as opposed to a full product line.** Pruning slow-selling items from the product lineup and being content to meet the needs of most buyers rather than all buyers can eliminate activities and costs associated with numerous product versions and wide selection.

Illustration Capsule 5.2 describes how Wal-Mart has managed its value chain in the retail grocery portion of its business to achieve a dramatic cost advantage over rival supermarket chains and become the world’s biggest grocery retailer.

**Examples of Companies That Revamped Their Value Chains to Reduce Costs**

Iowa Beef Packers (IBP), now a subsidiary of Tyson Foods, pioneered the
Wal-Mart has achieved a very substantial cost and pricing advantage over rival supermarket chains both by revamping portions of the grocery retailing value chain and by out-managing its rivals in efficiently performing various value chain activities. Its cost advantage stems from a series of initiatives and practices:

- Instituting extensive information sharing with vendors via online systems that relay sales at its check-out counters directly to suppliers of the items, thereby providing suppliers with real-time information on customer demand and preferences (creating an estimated 6 percent cost advantage). It is standard practice at Wal-Mart to collaborate extensively with vendors on all aspects of the purchasing and store delivery process to squeeze out mutually beneficial cost savings. Procter & Gamble, Wal-Mart's biggest supplier, went so far as to integrate its enterprise resource planning (ERP) system with Wal-Mart's.

- Pursuing global procurement of some items and centralizing most purchasing activities so as to leverage the company's buying power (creating an estimated 2.5 percent cost advantage).

- Investing in state-of-the-art automation at its distribution centers, efficiently operating a truck fleet that makes daily deliveries to Wal-Mart's stores, and putting assorted other cost-saving practices into place at its headquarters, distribution centers, and stores (resulting in an estimated 4 percent cost advantage).

- Striving to optimize the product mix and achieve greater sales turnover (resulting in about a 2 percent cost advantage).

- Installing security systems and store operating procedures that lower shrinkage rates (producing a cost advantage of about 0.5 percent).

- Negotiating preferred real estate rental and leasing rates with real estate developers and owners of its store sites (yielding a cost advantage of 2 percent).

- Managing and compensating its workforce in a manner that produces lower labor costs (yielding an estimated 5 percent cost advantage).

Altogether, these value chain initiatives give Wal-Mart an approximately 22 percent cost advantage over Kroger, Safeway, and other leading supermarket chains. With such a sizable cost advantage, Wal-Mart has been able to underprice its rivals and become the world's leading supermarket retailer in little more than a decade.


development of a cheaper value chain system in the beef-packing industry. The traditional cost chain involved raising cattle on scattered farms and ranches; shipping them live to labor-intensive, unionized slaughtering plants; and then transporting whole sides of beef to grocery retailers whose butcher departments cut them into smaller pieces and packaged them for sale to grocery shoppers. IBP revamped the traditional chain with a radically different strategy: It built large automated plants employing nonunion workers near cattle supplies. Near the plants it arranged to set up large feed lots (or holding pens) where cattle were fed grain for a short time to fatten them up prior to slaughter. The meat was butchered at the processing plant into small, high-yield cuts. Some of the trimmed and boned cuts were vacuum-sealed in plastic casings for further butchering in supermarket meat departments, but others were trimmed and/or boned, put in plastic-sealed ready-to-sell trays, boxed, and shipped to retailers. IBP's strategy was to increase the volume of prepackaged, "case-ready" cuts that retail grocers could unpack from boxes and place directly into the meat case. In addition, IBP provided meat retailers with individually wrapped quick-frozen steaks, as well as
precooked roasts, beef tip, and meatloaf selections that could be prepared in a matter of minutes. Iowa Beef’s inbound cattle transportation expenses, traditionally a major cost item, were cut significantly by avoiding the weight losses that occurred when live animals were shipped long distances just prior to slaughter. Sizable major outbound shipping cost savings were achieved by not having to ship whole sides of beef, which had a high waste factor. Meat retailers had to do far less butchering to stock their meat cases. IBP value chain revamping was so successful that the company became the largest U.S. meatpacker.

Southwest Airlines has reconfigured the traditional value chain of commercial airlines to lower costs and thereby offer dramatically lower fares to passengers. Its mastery of fast turnarounds at the gates (about 25 minutes versus 45 minutes for rivals) allows its planes to fly more hours per day. This translates into being able to schedule more flights per day with fewer aircraft, allowing Southwest to generate more revenue per plane on average than rivals. Southwest does not offer in-flight meals, assigned seating, baggage transfer to connecting airlines, or first-class seating and service, thereby eliminating all the cost-producing activities associated with these features. The company’s fast, user-friendly online reservation system facilitates e-ticketing and reduces staffing requirements at telephone reservation centers and airport counters. Its use of automated check-in equipment reduces staffing requirements for terminal check-in.

Dell has created the best, most cost-efficient value chain in the global personal computer industry. Whereas Dell’s major rivals (Hewlett-Packard, Lenovo, Sony, and Toshiba) produce their models in volume and sell them through independent resellers and retailers, Dell has elected to market directly to PC users, building its PCs to customer specifications as orders come in and shipping them to customers within a few days of receiving the order. Dell’s value chain approach has proved cost-effective in coping with the PC industry’s blink-of-an-eye product life cycle. The build-to-order strategy enables the company to avoid misjudging buyer demand for its various models and being saddled with quickly obsolete excess components and finished-goods inventories—all parts and components are obtained on a just-in-time basis from vendors, many of which deliver their items to Dell assembly plants several times a day in volumes matched to the Dell’s daily assembly schedule. Also, Dell’s sell-direct strategy slices reseller/retailer costs and margins out of the value chain (although some of these savings are offset by the cost of Dell’s direct marketing and customer support activities—functions that would otherwise be performed by resellers and retailers). Partnerships with suppliers that facilitate just-in-time deliveries of components and minimize Dell’s inventory costs, coupled with Dell’s extensive use of e-commerce technologies further reduce Dell’s costs. Dell’s value chain approach is widely considered to have made it the global low-cost leader in the PC industry.

The Keys to Success in Achieving Low-Cost Leadership

To succeed with a low-cost-provider strategy, company managers have to scrutinize each cost-creating activity and determine what factors cause costs to be high or low. Then they have to use this knowledge to keep the unit costs of each activity low, exhaustively pursuing cost efficiencies throughout the value chain. They have to be proactive in restructuring the value chain to eliminate nonessential work steps and low-value activities. Normally, low-cost producers work diligently to create cost-conscious corporate cultures that feature broad employee participation in continuous cost improvement efforts and limited perks and frills for executives. They strive to operate with exceptionally small corporate staffs to keep administrative costs to a minimum.
Many successful low-cost leaders also use benchmarking to keep close tabs on how their costs compare with rivals and firms performing comparable activities in other industries.

But while low-cost providers are champions of frugality, they are usually aggressive in investing in resources and capabilities that promise to drive costs out of the business. Wal-Mart, one of the foremost practitioners of low-cost leadership, employs state-of-the-art technology throughout its operations—its distribution facilities are an automated showcase, it uses online systems to order goods from suppliers and manage inventories, it equips its stores with cutting-edge sales-tracking and check-out systems, and it sends daily point-of-sale data to 4,000 vendors. Wal-Mart’s information and communications systems and capabilities are more sophisticated than those of virtually any other retail chain in the world.

Other companies noted for their successful use of low-cost provider strategies include Lincoln Electric in arc welding equipment, Briggs & Stratton in small gasoline engines, Bic in ballpoint pens, Black & Decker in power tools, Stride Rite in footwear, Beaird-Poulan in chain saws, and General Electric and Whirlpool in major home appliances.

**When a Low-Cost Provider Strategy Works Best**

A competitive strategy predicated on low-cost leadership is particularly powerful when:

1. **Price competition among rival sellers is especially vigorous**—Low-cost providers are in the best position to compete offensively on the basis of price, to use the appeal of lower price to grab sales (and market share) from rivals, to win the business of price-sensitive buyers, to remain profitable in the face of strong price competition, and to survive price wars.

2. **The products of rival sellers are essentially identical and supplies are readily available from any of several eager sellers**—Commodity-like products and/or ample supplies set the stage for lively price competition; in such markets, it is less efficient, higher-cost companies whose profits get squeezed the most.

3. **There are few ways to achieve product differentiation that have value to buyers**—When the differences between brands do not matter much to buyers, buyers are nearly always very sensitive to price differences and shop the market for the best price.

4. **Most buyers use the product in the same ways**—With common user requirements, a standardized product can satisfy the needs of buyers, in which case low selling price, not features or quality, becomes the dominant factor in causing buyers to choose one seller’s product over another’s.

5. **Buyers incur low costs in switching their purchases from one seller to another**—Low switching costs give buyers the flexibility to shift purchases to lower-priced sellers having equally good products or to attractively priced substitute products. A low-cost leader is well positioned to use low price to induce its customers not to switch to rival brands or substitutes.

6. **Buyers are large and have significant power to bargain down prices**—Low-cost providers have partial profit-margin protection in bargaining with high-volume buyers, since powerful buyers are rarely able to bargain price down past the survival level of the next most cost-efficient seller.

7. **Industry newcomers use introductory low prices to attract buyers and build a customer base**—The low-cost leader can use price cuts of its own to make it harder
A low-cost provider is in the best position to win the business of price-sensitive buyers, set the floor on market price, and still earn a profit. for a new rival to win customers; the pricing power of the low-cost provider acts as a barrier for new entrants.

As a rule, the more price-sensitive buyers are, the more appealing a low-cost strategy becomes. A low-cost company’s ability to set the industry’s price floor and still earn a profit erects protective barriers around its market position.

The Pitfalls of a Low-Cost Provider Strategy

Perhaps the biggest pitfall of a low-cost provider strategy is getting carried away with overly aggressive price cutting and ending up with lower, rather than higher, profitability. A low-cost/low-price advantage results in superior profitability only if (1) prices are cut by less than the size of the cost advantage or (2) the added gains in unit sales are large enough to bring in a bigger total profit despite lower margins per unit sold. A company with a 5 percent cost advantage cannot cut prices 20 percent, end up with a volume gain of only 10 percent, and still expect to earn higher profits.

A second big pitfall is not emphasizing avenues of cost advantage that can be kept proprietary or that relegate rivals to playing catch-up. The value of a cost advantage depends on its sustainability. Sustainability, in turn, hinges on whether the company achieves its cost advantage in ways difficult for rivals to copy or match.

A third pitfall is becoming too fixated on cost reduction. Low cost cannot be pursued so zealously that a firm’s offering ends up being too features-poor to generate buyer appeal. Furthermore, a company driving hard to push its costs down has to guard against misreading or ignoring increased buyer interest in added features or service, declining buyer sensitivity to price, or new developments that start to alter how buyers use the product. A low-cost zealot risks losing market ground if buyers start opting for more upscale or features-rich products.

Even if these mistakes are avoided, a low-cost competitive approach still carries risk. Cost-saving technological breakthroughs or the emergence of still-lower-cost value chain models can nullify a low-cost leader’s hard-won position. The current leader may have difficulty in shifting quickly to the new technologies or value chain approaches because heavy investments lock it in (at least temporarily) to its present value chain approach.

BROAD DIFFERENTIATION STRATEGIES

Core Concept
The essence of a broad differentiation strategy is to be unique in ways that are valuable to a wide range of customers.

Differentiation strategies are attractive whenever buyers’ needs and preferences are too diverse to be fully satisfied by a standardized product or by sellers with identical capabilities. A company attempting to succeed through differentiation must study buyers’ needs and behavior carefully to learn what buyers consider important, what they think has value, and what they are willing to pay for. Then the company has to incorporate buyer-desired attributes into its product or service offering that will clearly set it apart from rivals. Competitive advantage results once a sufficient number of buyers become strongly attached to the differentiated attributes.

Successful differentiation allows a firm to:
- Command a premium price for its product, and/or
- Increase unit sales (because additional buyers are won over by the differentiating features), and/or
Chapter 5  The Five Generic Competitive Strategies

- Gain buyer loyalty to its brand (because some buyers are strongly attracted to the differentiating features and bond with the company and its products).

Differentiation enhances profitability whenever the extra price the product commands outweighs the added costs of achieving the differentiation. Company differentiation strategies fail when buyers don’t value the brand’s uniqueness and when a company’s approach to differentiation is easily copied or matched by its rivals.

Types of Differentiation Themes

Companies can pursue differentiation from many angles: a unique taste (Dr Pepper, Listerine); multiple features (Microsoft Windows, Microsoft Office); wide selection and one-stop shopping (Home Depot, Amazon.com); superior service (FedEx); spare parts availability (Caterpillar); engineering design and performance (Mercedes, BMW); prestige and distinctiveness (Rolex); product reliability (Johnson & Johnson in baby products); quality manufacture (Karastan in carpets, Michelin in tires, Toyota and Honda in automobiles); technological leadership (3M Corporation in bonding and coating products); a full range of services (Charles Schwab in stock brokerage); a complete line of products (Campbell’s soups); and top-of-the-line image and reputation (Ralph Lauren and Starbucks).

The most appealing approaches to differentiation are those that are hard or expensive for rivals to duplicate. Indeed, resourceful competitors can, in time, clone almost any product or feature or attribute. If Coca-Cola introduces a vanilla-flavored soft drink, so can Pepsi; if Ford offers a 50,000-mile bumper-to-bumper warranty on its new vehicles, so can Volkswagen and Nissan. If Nokia introduces cell phones with cameras and Internet capability, so can Motorola and Samsung. As a rule, differentiation yields a longer-lasting and more profitable competitive edge when it is based on product innovation, technical superiority, product quality and reliability, comprehensive customer service, and unique competitive capabilities. Such differentiating attributes tend to be tough for rivals to copy or offset profitably, and buyers widely perceive them as having value.

Where along the Value Chain to Create the Differentiating Attributes

Differentiation is not something hatched in marketing and advertising departments, nor is it limited to the catchalls of quality and service. Differentiation opportunities can exist in activities all along an industry’s value chain; possibilities include the following:

- Supply chain activities that ultimately spill over to affect the performance or quality of the company’s end product. Starbucks gets high ratings on its coffees partly because it has very strict specifications on the coffee beans purchased from suppliers.
- Product R&D activities that aim at improved product designs and performance features, expanded end uses and applications, more frequent first-on-the-market victories, wider product variety and selection, added user safety, greater recycling capability, or enhanced environmental protection.
- Production R&D and technology-related activities that permit custom-order manufacture at an efficient cost; make production methods safer for the

Easy-to-copy differentiating features cannot produce sustainable competitive advantage; differentiation based on competencies and capabilities tend to be more sustainable.
environment; or improve product quality, reliability, and appearance. Many manufacturers have developed flexible manufacturing systems that allow different models and product versions to be made on the same assembly line. Being able to provide buyers with made-to-order products can be a potent differentiating capability.

- **Manufacturing activities** that reduce product defects, prevent premature product failure, extend product life, allow better warranty coverages, improve economy of use, result in more end-user convenience, or enhance product appearance. The quality edge enjoyed by Japanese automakers stems partly from their distinctive competence in performing assembly-line activities.

- **Distribution and shipping activities** that allow for fewer warehouse and on-the-shelf stockouts, quicker delivery to customers, more accurate order filling, and/or lower shipping costs.

- **Marketing, sales, and customer service activities** that result in superior technical assistance to buyers, faster maintenance and repair services, more and better product information provided to customers, more and better training materials for end users, better credit terms, quicker order processing, or greater customer convenience.

Managers need keen understanding of the sources of differentiation and the activities that drive uniqueness to evaluate various differentiation approaches and design durable ways to set their product offering apart from those of rival brands.

**The Four Best Routes to Competitive Advantage via a Broad Differentiation Strategy**

While it is easy enough to grasp that a successful differentiation strategy must entail creating buyer value in ways unmatched by rivals, the big issue in crafting a differentiation strategy is which of four basic routes to take in delivering unique buyer value via a broad differentiation strategy. Usually, building a sustainable competitive advantage via differentiation involves pursuing one of four basic routes to delivering superior value to buyers.

One route is to **incorporate product attributes and user features that lower the buyer's overall costs of using the company's product.** Making a company's product more economical for a buyer to use can be done by reducing the buyer's raw materials waste (providing cut-to-size components), reducing a buyer's inventory requirements (providing just-in-time deliveries), increasing maintenance intervals and product reliability so as to lower a buyer's repair and maintenance costs, using online systems to reduce a buyer's procurement and order processing costs, and providing free technical support. Rising costs for gasoline have dramatically spurred the efforts of motor vehicle manufacturers worldwide to introduce models with better fuel economy and reduce operating costs for motor vehicle owners.

A second route is to **incorporate features that raise product performance.** This can be accomplished with attributes that provide buyers greater reliability, ease of use, convenience, or durability. Other performance-enhancing options include making the company's product or service cleaner, safer, quieter, or more maintenance-free than rival brands. Cell phone manufacturers are in a race to introduce next-generation phones with trendsetting features and options.
A third route to a differentiation-based competitive advantage is to incorporate features that enhance buyer satisfaction in noneconomic or intangible ways. Goodyear’s Aquatread tire design appeals to safety-conscious motorists wary of slick roads. Rolls Royce, Ralph Lauren, Gucci, Tiffany, Cartier, and Rolex have differentiation-based competitive advantages linked to buyer desires for status, image, prestige, upscale fashion, superior craftsmanship, and the finer things in life. L. L. Bean makes its mail-order customers feel secure in their purchases by providing an unconditional guarantee with no time limit: “All of our products are guaranteed to give 100 percent satisfaction in every way. Return anything purchased from us at any time if it proves otherwise. We will replace it, refund your purchase price, or credit your credit card, as you wish.”

The fourth route is to deliver value to customers by differentiating on the basis of competencies and competitive capabilities that rivals don’t have or can’t afford to match. The importance of cultivating competencies and capabilities that add power to a company’s resource strengths and competitiveness comes into play here. Core and/or distinctive competencies not only enhance a company’s ability to compete successfully in the marketplace but can also be unique in delivering value to buyers. There are numerous examples of companies that have differentiated themselves on the basis of capabilities. Because Fox News and CNN have the capability to devote more air time to breaking news stories and get reporters on the scene very quickly compared to the major networks, many viewers turn to the cable networks when a major news event occurs. Microsoft has stronger capabilities to design, create, distribute, and advertise an array of software products for PC applications than any of its rivals. Avon and Mary Kay Cosmetics have differentiated themselves from other cosmetics and personal care companies by assembling a sales force numbering in the hundreds of thousands that gives them direct sales capability—their sales associates can demonstrate products to interested buyers, take their orders on the spot, and deliver the items to buyers’ homes. Japanese automakers have the capability to satisfy changing consumer preferences for one vehicle style versus another because they can bring new models to market faster than American and European automakers.

**The Importance of Perceived Value and Signaling Value**

Buyers seldom pay for value they don’t perceive, no matter how real the unique extras may be. Thus, the price premium commanded by a differentiation strategy reflects the value actually delivered to the buyer and the value perceived by the buyer (even if not actually delivered). Actual and perceived value can differ whenever buyers have trouble assessing what their experience with the product will be. Incomplete knowledge on the part of buyers often causes them to judge value based on such signals as price (where price connotes quality), attractive packaging, extensive ad campaigns (i.e., how well-known the product is), ad content and image, the quality of brochures and sales presentations, the seller’s facilities, the seller’s list of customers, the firm’s market share, the length of time the firm has been in business, and the professionalism, appearance, and personality of the seller’s employees. Such signals of value may be as important as actual value (1) when the nature of differentiation is subjective or hard to quantify, (2) when buyers are making a first-time purchase, (3) when repurchase is infrequent, and (4) when buyers are unsophisticated.
When a Differentiation Strategy Works Best

Differentiation strategies tend to work best in market circumstances where:

- *Buyer needs and uses of the product are diverse*—Diverse buyer preferences present competitors with a bigger window of opportunity to do things differently and set themselves apart with product attributes that appeal to particular buyers. For instance, the diversity of consumer preferences for menu selection, ambience, pricing, and customer service gives restaurants exceptionally wide latitude in creating a differentiated product offering. Other companies having many ways to strongly differentiate themselves from rivals include the publishers of magazines, the makers of motor vehicles, and the manufacturers of cabinetry and countertops.

- *There are many ways to differentiate the product or service and many buyers perceive these differences as having value*—There is plenty of room for retail apparel competitors to stock different styles and quality of apparel merchandise but very little room for the makers of paper clips, copier paper, or sugar to set their products apart. Likewise, the sellers of different brands of gasoline or orange juice have little differentiation opportunity compared to the sellers of high-definition TVs, patio furniture, or breakfast cereal. Unless different buyers have distinguishably different preferences for certain features and product attributes, profitable differentiation opportunities are very restricted.

- *Few rival firms are following a similar differentiation approach*—The best differentiation approaches involve trying to appeal to buyers on the basis of attributes that rivals are not emphasizing. A differentiator encounters less head-to-head rivalry when it goes its own separate way in creating uniqueness and does not try to outdifferentiate rivals on the very same attributes—when many rivals are all claiming “Ours tastes better than theirs” or “Ours gets your clothes cleaner than theirs,” the most likely result is weak brand differentiation and “strategy overcrowding”—a situation in which competitors end up chasing the same buyers with very similar product offerings.

- *Technological change is fast-paced and competition revolves around rapidly evolving product features*—Rapid product innovation and frequent introductions of next-version products not only provide space for companies to pursue separate differentiating paths but also heighten buyer interest. In video game hardware and video games, golf equipment, PCs, cell phones, and MP3 players, competitors are locked into an ongoing battle to set themselves apart by introducing the best next-generation products—companies that fail to come up with new and improved products and distinctive performance features quickly lose out in the marketplace. In network TV broadcasting in the United States, NBC, ABC, CBS, Fox, and several others are always scrambling to develop a lineup of TV shows that will win higher audience ratings and pave the way for charging higher advertising rates and boosting ad revenues.

The Pitfalls of a Differentiation Strategy

Differentiation strategies can fail for any of several reasons. *A differentiation strategy is always doomed when competitors are able to quickly copy most or all of the appealing product attributes a company comes up with.* Rapid imitation means that no rival
achieves differentiation, since whenever one firm introduces some aspect of uniqueness that strikes the fancy of buyers, fast-following copycats quickly reestablish similarity. This is why a firm must search out sources of uniqueness that are time-consuming or burdensome for rivals to match if it hopes to use differentiation to win a competitive edge over rivals.

A second pitfall is that the company’s differentiation strategy produces a ho-hum market reception because buyers see little value in the unique attributes of a company’s product. Thus, even if a company sets the attributes of its brand apart from the brands of rivals, its strategy can fail because of trying to differentiate on the basis of something that does not deliver adequate value to buyers (such as lowering a buyer’s cost to use the product or enhancing a buyer’s well-being). Anytime many potential buyers look at a company’s differentiated product offering and conclude “So what?” the company’s differentiation strategy is in deep trouble—buyers will likely decide the product is not worth the extra price, and sales will be disappointingly low.

The third big pitfall of a differentiation strategy is overspending on efforts to differentiate the company’s product offering, thus eroding profitability. Company efforts to achieve differentiation nearly always raise costs. The trick to profitable differentiation is either to keep the costs of achieving differentiation below the price premium the differentiating attributes can command in the marketplace (thus increasing the profit margin per unit sold) or to offset thinner profit margins per unit by selling enough additional units to increase total profits. If a company goes overboard in pursuing costly differentiation efforts and then unexpectedly discovers that buyers are unwilling to pay a sufficient price premium to cover the added costs of differentiation, it ends up saddled with unacceptably thin profit margins or even losses. The need to contain differentiation costs is why many companies add little touches of differentiation that add to buyer satisfaction but are inexpensive to institute. Upscale restaurants often provide valet parking. Ski resorts provide skiers with complimentary coffee or hot apple cider at the base of the lifts in the morning and late afternoon. FedEx, UPS, and many catalog and online retailers have installed software capabilities that allow customers to track packages in transit. Some hotels and motels provide free continental breakfasts, exercise facilities, and in-room coffeemaking amenities. Publishers are using their Web sites to deliver supplementary educational materials to the buyers of their textbooks. Laundry detergent and soap manufacturers add pleasing scents to their products.

Other common pitfalls and mistakes in crafting a differentiation strategy include:

- **Overdifferentiating so that product quality or service levels exceed buyers’ needs.** Even if buyers like the differentiating extras, they may not find them sufficiently valuable for their purposes to pay extra to get them. Many shoppers shy away from buying top-of-the-line items because they have no particular interest in all the bells and whistles; for them, a less deluxe model or style makes better economic sense.

- **Trying to charge too high a price premium.** Even if buyers view certain extras or deluxe features as nice to have, they may still conclude that the added cost is excessive relative to the value they deliver. A differentiator must guard against turning off would-be buyers with what is perceived as price gouging. Normally, the bigger the price premium for the differentiating extras, the harder it is to keep buyers from switching to the lower-priced offerings of competitors.

- **Being timid and not striving to open up meaningful gaps in quality or service or performance features vis-à-vis the products of rivals.** Tiny differences
between rivals' product offerings may not be visible or important to buyers. If a company wants to generate the fiercely loyal customer following needed to earn superior profits and open up a differentiation-based competitive advantage over rivals, then its strategy must result in strong rather than weak product differentiation. In markets where differentiators do no better than achieve weak product differentiation (because the attributes of rival brands are fairly similar in the minds of many buyers), customer loyalty to any one brand is weak, the costs of buyers to switch to rival brands are fairly low, and no one company has enough of a market edge that it can get by with charging a price premium over rival brands.

A low-cost provider strategy can defeat a differentiation strategy when buyers are satisfied with a basic product and don't think extra attributes are worth a higher price.

BEST-COST PROVIDER STRATEGIES

Core Concept
The competitive advantage of a best-cost provider is lower costs than rivals in incorporating upscale attributes, putting the company in a position to underprice rivals whose products have similar upscale attributes.

Best-cost provider strategies aim at giving customers more value for the money. The objective is to deliver superior value to buyers by satisfying their expectations on key quality/features/performance/service attributes and beating their expectations on price (given what rivals are charging for much the same attributes). A company achieves best-cost status from an ability to incorporate attractive or upscale attributes at a lower cost than rivals. The attractive attributes can take the form of appealing features, good-to-excellent product performance or quality, or attractive customer service. When a company has the resource strengths and competitive capabilities to incorporate these upscale attributes into its product offering at a lower cost than rivals, it enjoys best-cost status—it is the low-cost provider of an upscale product.

Being a best-cost provider is different from being a low-cost provider because the additional upscale features entail additional costs (that a low-cost provider can avoid by offering buyers a basic product with few frills). As Figure 5.1 indicates, best-cost provider strategies stake out a middle ground between pursuing a low-cost advantage and a differentiation advantage and between appealing to the broad market as a whole and a narrow market niche. From a competitive positioning standpoint, best-cost strategies are thus a hybrid, balancing a strategic emphasis on low cost against a strategic emphasis on differentiation (upscale features delivered at a price that constitutes superior value).

The competitive advantage of a best-cost provider is its capability to include upscale attributes at a lower cost than rivals whose products have comparable attributes. A best-cost provider can use its low-cost advantage to underprice rivals whose products have similar upscale attributes—it is usually not difficult to entice customers away from rivals charging a higher price for an item with highly comparable features, quality, performance, and/or customer service attributes. To achieve competitive advantage with a best-cost provider strategy, it is critical that a company have the resources and capabilities to incorporate upscale attributes at a lower cost than rivals. In other words, it must be able to (1) incorporate attractive features at a lower cost than rivals whose products have similar features, (2) manufacture a good-to-excellent quality product at a lower cost than rivals with good-to-excellent product quality, (3) develop a product that delivers good-to-excellent performance at a lower cost than rivals whose products also entail good-to-excellent performance, or (4) provide attractive customer service at a lower cost than rivals who provide comparably attractive customer service.
What makes a best-cost provider strategy so appealing is being able to incorporate upscale attributes at a lower cost than rivals and then using the company’s low-cost advantage to underprice rivals whose products have similar upscale attributes.

The target market for a best-cost provider is value-conscious buyers—buyers that are looking for appealing extras at an appealingly low price. Value-hunting buyers (as distinct from buyers looking only for bargain-basement prices) often constitute a very sizable part of the overall market. Normally, value-conscious buyers are willing to pay a fair price for extra features, but they shy away from paying top dollar for items having all the bells and whistles. It is the desire to cater to value-conscious buyers as opposed to budget-conscious buyers that sets a best-cost provider apart from a low-cost provider—the two strategies aim at distinguishably different market targets.

When a Best-Cost Provider Strategy Works Best

A best-cost provider strategy works best in markets where buyer diversity makes product differentiation the norm and where many buyers are also sensitive to price and value. This is because a best-cost provider can position itself near the middle of the market with either a medium-quality product at a below-average price or a high-quality product at an average or slightly higher price. Often, substantial numbers of buyers prefer midrange products rather than the cheap, basic products of low-cost producers or the expensive products of top-of-the-line differentiators. But unless a company has the resources, know-how, and capabilities to incorporate upscale product or service attributes at a lower cost than rivals, adopting a best-cost strategy is ill advised—a winning strategy must always be matched to a company’s resource strengths and capabilities.

Illustration Capsule 5.3 describes how Toyota has applied the principles of a best-cost provider strategy in producing and marketing its Lexus brand.

The Big Risk of a Best-Cost Provider Strategy

A company’s biggest vulnerability in employing a best-cost provider strategy is getting squeezed between the strategies of firms using low-cost and high-end differentiation strategies. Low-cost providers may be able to siphon customers away with the appeal of a lower price (despite their less appealing product attributes). High-end differentiators may be able to steal customers away with the appeal of better product attributes (even though their products carry a higher price tag). Thus, to be successful, a best-cost provider must offer buyers significantly better product attributes in order to justify a price above what low-cost leaders are charging. Likewise, it has to achieve significantly lower costs in providing upscale features so that it can outcompete high-end differentiators on the basis of a significantly lower price.

FOCUSED (OR MARKET NICHE) STRATEGIES

What sets focused strategies apart from low-cost leadership or broad differentiation strategies is concentrated attention on a narrow piece of the total market. The target segment, or niche, can be defined by geographic uniqueness, by specialized requirements in using the product, or by special product attributes that appeal only to niche members. Community Coffee, the largest family-owned specialty coffee retailer in the United States, is a company that focused on a geographic market niche; despite having a national market share of only 1.1 percent, Community has won a 50 percent share of the coffee business in supermarkets in southern Louisiana in competition
Illustration Capsule 5.3
Toyota’s Best-Cost Producer Strategy for Its Lexus Line

Toyota Motor Company is widely regarded as a low-cost producer among the world’s motor vehicle manufacturers. Despite its emphasis on product quality, Toyota has achieved low-cost leadership because it has developed considerable skills in efficient supply chain management and low-cost assembly capabilities, and because its models are positioned in the low-to-medium end of the price spectrum, where high production volumes are conducive to low unit costs. But when Toyota decided to introduce its new Lexus models to compete in the luxury-car market, it employed a classic best-cost provider strategy. Toyota took the following four steps in crafting and implementing its Lexus strategy:

- Designing an array of high-performance characteristics and upscale features into the Lexus models so as to make them comparable in performance and luxury to other high-end models and attractive to Mercedes, BMW, Audi, Jaguar, Cadillac, and Lincoln buyers.
- Transferring its capabilities in making high-quality Toyota models at low cost to making premium-quality Lexus models at costs below other luxury-car makers. Toyota’s supply chain capabilities and low-cost assembly know-how allowed it to incorporate high-tech performance features and upscale quality into Lexus models at substantially less cost than comparable Mercedes and BMW models.
- Using its relatively lower manufacturing costs to underprice comparable Mercedes and BMW models. Toyota believed that with its cost advantage it could price attractively equipped Lexus cars low enough to draw price-conscious buyers away from Mercedes and BMW and perhaps induce dissatisfied Lincoln and Cadillac owners to switch to a Lexus. Lexus’s pricing advantage over Mercedes and BMW was sometimes quite significant. For example, in 2006 the Lexus RX 330, a midsized SUV, carried a sticker price in the $36,000–$45,000 range (depending on how it was equipped), whereas variously equipped Mercedes M-class SUVs had price tags in the $50,000–$65,000 range and a BMW X5 SUV could range anywhere from $42,000 to $70,000, depending on the optional equipment chosen.
- Establishing a new network of Lexus dealers, separate from Toyota dealers, dedicated to providing a level of personalized, attentive customer service unmatched in the industry.

Lexus models have consistently ranked first in the widely watched J. D. Power & Associates quality survey, and the prices of Lexus models are typically several thousand dollars below those of comparable Mercedes and BMW models—clear signals that Toyota has succeeded in becoming a best-cost producer with its Lexus brand.

against Starbucks, Folger's, Maxwell House, and asserted specialty coffee retailers. Community Coffee’s geographic version of a focus strategy has allowed it to capture sales in excess of $100 million annually by catering to the tastes of coffee drinkers across an 11-state region. Examples of firms that concentrate on a well-defined market niche keyed to a particular product or buyer segment include Animal Planet and the History Channel (in cable TV); Google (in Internet search engines); Porsche (in sports cars); Cannondale (in top-of-the-line mountain bikes); Domino’s Pizza (in pizza delivery); Enterprise Rent-a-Car (a specialist in providing rental cars to repair garage customers); Bandag (a specialist in truck tire recapping that promotes its recaps aggressively at over 1,000 truck stops), CGA Inc. (a specialist in providing insurance to cover the cost of lucrative hole-in-one prizes at golf tournaments); Match.com (the world’s largest online dating service); and Avid Technology (the world leader in digital technology products to create 3D animation and to edit films, videos, TV broadcasts, video games, and audio recordings). Microbreweries, local bakeries, bed-and-breakfast inns, and local owner-managed retail boutiques are all good examples of enterprises that have scaled their operations to serve narrow or local customer segments.
A *Focused Low-Cost Strategy*

A focused strategy based on low cost aims at securing a competitive advantage by serving buyers in the target market niche at a lower cost and lower price than rival competitors. This strategy has considerable attraction when a firm can lower costs significantly by limiting its customer base to a well-defined buyer segment. The avenues to achieving a cost advantage over rivals also serving the target market niche are the same as for low-cost leadership—outmanage rivals in keeping the costs of value chain activities contained to a bare minimum and search for innovative ways to reconfigure the firm’s value chain and bypass or reduce certain value chain activities. The only real difference between a low-cost provider strategy and a focused low-cost strategy is the size of the buyer group that a company is trying to appeal to—the former involves a product offering that appeals broadly to most all buyer groups and market segments whereas the latter at just meeting the needs of buyers in a narrow market segment.

Focused low-cost strategies are fairly common. Producers of private-label goods are able to achieve low costs in product development, marketing, distribution, and advertising by concentrating on making generic items imitative of name-brand merchandise and selling directly to retail chains wanting a basic house brand to sell to price-sensitive shoppers. Several small printer-supply manufacturers have begun making low-cost clones of the premium-priced replacement ink and toner cartridges sold by Hewlett-Packard, Lexmark, Canon, and Epson; the clone manufacturers dissect the cartridges of the name-brand companies and then reengineer a similar version that won’t violate patents. The components for remanufactured replacement cartridges are acquired from various outside sources, and the clones are then marketed at prices as much as 50 percent below the name-brand cartridges. Cartridge remanufacturers have been lured to focus on this market because replacement cartridges constitute a multibillion-dollar business with considerable profit potential given their low costs and the premium pricing of the name-brand companies. Illustration Capsule 5.4 describes how Motel 6 has kept its costs low in catering to budget-conscious travelers.

A *Focused Differentiation Strategy*

A focused strategy keyed to differentiation aims at securing a competitive advantage with a product offering carefully designed to appeal to the unique preferences and needs of a narrow, well-defined group of buyers (as opposed to a broad differentiation strategy aimed at many buyer groups and market segments). Successful use of a focused differentiation strategy depends on the existence of a buyer segment that is looking for special product attributes or seller capabilities and on a firm’s ability to stand apart from rivals competing in the same target market niche.

Companies like Godiva Chocolates, Chanel, Gucci, Rolls-Royce, Häagen-Dazs, and W. L. Gore (the maker of Gore-Tex) employ successful differentiation-based focused strategies targeted at upscale buyers wanting products and services with world-class attributes. Indeed, most markets contain a buyer segment willing to pay a big price premium for the very finest items available, thus opening the strategic window for some competitors to pursue differentiation-based focused strategies aimed at the very top of the market pyramid. Another successful focused differentiator is Trader Joe’s, a 150-store East and West Coast “fashion food retailer” that is a combination gourmet deli and grocery warehouse. Customers shop Trader Joe’s as much for entertainment as for conventional grocery items—the store stocks out-of-the-ordinary culinary treats like raspberry salsa, salmon burgers, and jasmine fried rice,
Motel 6 caters to price-conscious travelers who want a clean, no-frills place to spend the night. To be a low-cost provider of overnight lodging, Motel 6 (1) selects relatively inexpensive sites on which to construct its units (usually near interstate exits and high-traffic locations but far enough away to avoid paying prime site prices); (2) builds only basic facilities (no restaurant or bar and only rarely a swimming pool); (3) relies on standard architectural designs that incorporate inexpensive materials and low-cost construction techniques; and (4) provides simple room furnishings and decorations. These approaches lower both investment costs and operating costs. Without restaurants, bars, and all kinds of guest services, a Motel 6 unit can be operated with just front-desk personnel, room cleanup crews, and skeleton building-and-grounds maintenance.

To promote the Motel 6 concept with travelers who have simple overnight requirements, the chain uses unique, recognizable radio ads done by nationally syndicated radio personality Tom Bodett; the ads describe Motel 6’s clean rooms, no-frills facilities, friendly atmosphere, and dependably low rates (usually under $40 a night).

Motel 6’s basis for competitive advantage is lower costs than competitors in providing basic, economical overnight accommodations to price-constrained travelers.

As well as the standard goods normally found in supermarkets. What sets Trader Joe’s apart is not just its unique combination of food novelties and competitively priced grocery items but also its capability to turn an otherwise mundane grocery excursion into a whimsical treasure hunt that is just plain fun.

Illustration Capsule 5.5 describes Progressive Insurance’s focused differentiation strategy.

**When a Focused Low-Cost or Focused Differentiation Strategy Is Attractive**

A focused strategy aimed at securing a competitive edge based on either low cost or differentiation becomes increasingly attractive as more of the following conditions are met:

- The target market niche is big enough to be profitable and offers good growth potential.
- Industry leaders do not see that having a presence in the niche is crucial to their own success—in which case focusers can often escape battling head-to-head against some of the industry’s biggest and strongest competitors.
- It is costly or difficult for multisegment competitors to put capabilities in place to meet the specialized needs of buyers comprising the target market niche and at the same time satisfy the expectations of their mainstream customers.
- The industry has many different niches and segments, thereby allowing a focuser to pick a competitively attractive niche suited to its resource strengths and capabilities. Also, with more niches, there is more room for focusers to avoid each other in competing for the same customers.
Progressive Insurance has fashioned a strategy in auto insurance focused on people with a record of traffic violations who drive high-performance cars, drivers with accident histories, motorcyclists, teenagers, and other so-called high-risk categories of drivers that most auto insurance companies steer away from. Progressive discovered that some of these high-risk drivers are affluent and pressed for time, making them less sensitive to paying premium rates for their car insurance. Management learned that it could charge such drivers high enough premiums to cover the added risks, plus it differentiated Progressive from other insurers by expediting the process of obtaining insurance and decreasing the annoyance that such drivers faced in obtaining insurance coverage. Progressive pioneered the low-cost direct sales model of allowing customers to purchase insurance online and over the phone.

Progressive also studied the market segments for insurance carefully enough to discover that some motorcycle owners were not especially risky (middle-aged suburbanites who sometimes commuted to work or used their motorcycles mainly for recreational trips with their friends). Progressive’s strategy allowed it to become a leader in the market for luxury-car insurance for customers who appreciated Progressive’s streamlined approach to doing business.

In further differentiating and promoting Progressive policies, management created teams of roving claims adjusters who would arrive at accident scenes to assess claims and issue checks for repairs on the spot. Progressive introduced 24-hour claims reporting, now an industry standard. In addition, it developed a sophisticated pricing system so that it could quickly and accurately assess each customer’s risk and weed out unprofitable customers.

By being creative and excelling at the nuts and bolts of its business, Progressive has won a 7 percent share of the $150 billion market for auto insurance and has the highest underwriting margins in the auto-insurance industry.


- Few, if any, other rivals are attempting to specialize in the same target segment—a condition that reduces the risk of segment overcrowding.
- The focuser has a reservoir of customer goodwill and loyalty (accumulated from having catered to the specialized needs and preferences of niche members over many years) that it can draw on to help stave off ambitious challengers looking to horn in on its business.

The advantages of focusing a company’s entire competitive effort on a single market niche are considerable, especially for smaller and medium-sized companies that may lack the breadth and depth of resources to tackle going after a broad customer base with a “something for everyone” lineup of models, styles, and product selection. eBay has made a huge name for itself and very attractive profits for shareholders by focusing its attention on online auctions—at one time a very small niche in the overall auction business that eBay’s focus strategy turned into the dominant piece of the global auction industry. Google has capitalized on its specialized expertise in Internet search engines to become one of the most spectacular growth companies of the past 10 years. Two hippie entrepreneurs, Ben Cohen and Jerry Greenfield, built Ben & Jerry’s Homemade into an impressive business by focusing their energies and resources solely on the superpremium segment of the ice cream market.
The Risks of a Focused Low-Cost or Focused Differentiation Strategy

Focusing carries several risks. One is the chance that competitors will find effective ways to match the focused firm’s capabilities in serving the target niche—perhaps by coming up with products or brands specifically designed to appeal to buyers in the target niche or by developing expertise and capabilities that offset the focuser’s strengths. In the lodging business, large chains like Marriott and Hilton have launched multibrand strategies that allow them to compete effectively in several lodging segments simultaneously. Marriott has flagship hotels with a full complement of services and amenities that allow it to attract travelers and vacationers going to major resorts, it has J. W. Marriot hotels usually located in downtown metropolitan areas that cater to business travelers; the Courtyard by Marriott brand is for business travelers looking for moderately priced lodging; Marriott Residence Inns are designed as a home away from home for travelers staying five or more nights; and the 530 Fairfield Inn locations cater to travelers looking for quality lodging at an affordable price. Similarly, Hilton has a lineup of brands (Conrad Hotels, Doubletree Hotels, Embassy Inn Hotels, Hampton Innns, Hilton Hotels, Hilton Garden Inns, and Homewood Suites) that enable it to operate in multiple segments and compete head-to-head against lodging chains that operate only in a single segment. Multibrand strategies are attractive to large companies like Marriott and Hilton precisely because they enable a company to enter a market niche and siphon business away from companies that employ a focus strategy.

A second risk of employing a focus strategy is the potential for the preferences and needs of niche members to shift over time toward the product attributes desired by the majority of buyers. An erosion of the differences across buyer segments lowers entry barriers into a focuser’s market niche and provides an open invitation for rivals in adjacent segments to begin competing for the focuser’s customers. A third risk is that the segment may become so attractive it is soon inundated with competitors, intensifying rivalry and splintering segment profits.

THE CONTRASTING FEATURES OF THE FIVE GENERIC COMPETITIVE STRATEGIES: A SUMMARY

Deciding which generic competitive strategy should serve as the framework for hanging the rest of the company’s strategy is not a trivial matter. Each of the five generic competitive strategies positions the company differently in its market and competitive environment. Each establishes a central theme for how the company will endeavor to outcompete rivals. Each creates some boundaries or guidelines for maneuvering as market circumstances unfold and as ideas for improving the strategy are debated. Each points to different ways of experimenting and tinkering with the basic strategy—for example, employing a low-cost leadership strategy means experimenting with ways that costs can be cut and value chain activities can be streamlined, whereas a broad differentiation strategy means exploring ways to add new differentiating features or to perform value chain activities differently if the result is to add value for customers in ways they are willing to pay for. Each entails differences in terms of product line, production emphasis, marketing emphasis, and means of sustaining the strategy—as shown in Table 5.1.
<table>
<thead>
<tr>
<th>Table 5.1</th>
<th>Distinguishing Features of the Five Generic Competitive Strategies</th>
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<tbody>
<tr>
<td></td>
<td>Low-Cost Provider</td>
</tr>
<tr>
<td>Strategic target</td>
<td>A broad cross-section of the market</td>
</tr>
<tr>
<td>Basis of competitive advantage</td>
<td>Lower overall costs than competitors</td>
</tr>
<tr>
<td>Product line</td>
<td>A good basic product with few frills (acceptable quality and limited selection)</td>
</tr>
<tr>
<td>Production emphasis</td>
<td>A continuous search for cost reduction without sacrificing acceptable quality and essential features</td>
</tr>
<tr>
<td>Marketing emphasis</td>
<td>Try to make a virtue out of product features that lead to low cost</td>
</tr>
<tr>
<td>Keys to sustaining the strategy</td>
<td>Economical prices/ good value</td>
</tr>
</tbody>
</table>

...
Thus, a choice of which generic strategy to employ spills over to affect several aspects of how the business will be operated and the manner in which value chain activities must be managed. Deciding which generic strategy to employ is perhaps the most important strategic commitment a company makes—it tends to drive the rest of the strategic actions a company decides to undertake.

One of the big dangers in crafting a competitive strategy is that managers, torn between the pros and cons of the various generic strategies, will opt for stuck-in-the-middle strategies that represent compromises between lower costs and greater differentiation and between broad and narrow market appeal. Compromise or middle-ground strategies rarely produce sustainable competitive advantage or a distinctive competitive position—a well-executed, best-cost producer strategy is the only compromise between low cost and differentiation that succeeds. Usually, companies with compromise strategies end up with a middle-of-the-pack industry ranking—they have average costs, some but not a lot of product differentiation relative to rivals, an average image and reputation, and little prospect of industry leadership. Having a competitive edge over rivals is the single most dependable contributor to above-average company profitability. Hence, only if a company makes a strong and unavering commitment to one of the five generic competitive strategies does it stand much chance of achieving sustainable competitive advantage that such strategies can deliver if properly executed.

**Key Points**

Early in the process of crafting a strategy company managers have to decide which of the five basic competitive strategies to employ—overall low-cost, broad differentiation, best-cost, focused low-cost, or focused differentiation.

In employing a low-cost provider strategy and trying to achieve a low-cost advantage over rivals, a company must do a better job than rivals of cost-effectively managing value chain activities and/or find innovative ways to eliminate or bypass cost-producing activities. Low-cost provider strategies work particularly well when the products of rival sellers are virtually identical or very weakly differentiated and supplies are readily available from eager sellers, when there are not many ways to differentiate that have value to buyers, when many buyers are price sensitive and shop the market for the lowest price, and when buyer switching costs are low.

Broad differentiation strategies seek to produce a competitive edge by incorporating attributes and features that set a company’s product/service offering apart from rivals in ways that buyers consider valuable and worth paying for. Successful differentiation allows a firm to (1) command a premium price for its product, (2) increase unit sales (because additional buyers are won over by the differentiating features), and/or (3) gain buyer loyalty to its brand (because some buyers are strongly attracted to the differentiating features and bond with the company and its products). Differentiation strategies work best in markets with diverse buyer preferences where there are big windows of opportunity to strongly differentiate a company’s product offering from those of rival brands, in situations where few other rivals are pursuing a similar differentiation approach, and in circumstances where companies are racing to bring out the most appealing next-generation product. A differentiation strategy is doomed when competitors are able to quickly copy most or all of the appealing product attributes a company comes up with, when a company’s differentiation efforts meet with a ho-hum or “so what” market reception, or when a company erodes profitability by overspending on efforts to differentiate its product offering.
Best-cost provider strategies combine a strategic emphasis on low cost with a strategic emphasis on more than minimal quality, service, features, or performance. The aim is to create competitive advantage by giving buyers more value for the money—an approach that entails matching close rivals on key quality/service/features/performance attributes and beating them on the costs of incorporating such attributes into the product or service. A best-cost provider strategy works best in markets where buyer diversity makes product differentiation the norm and where many buyers are also sensitive to price and value.

A focus strategy delivers competitive advantage either by achieving lower costs than rivals in serving buyers comprising the target market niche or by developing specialized ability to offer niche buyers an appealingly differentiated offering than meets their needs better than rival brands. A focused strategy based on either low cost or differentiation becomes increasingly attractive when the target market niche is big enough to be profitable and offers good growth potential, when it is costly or difficult for multi-segment competitors to put capabilities in place to meet the specialized needs of the target market niche and at the same time satisfy the expectations of their mainstream customers, when there are one or more niches that present a good match with a focuser’s resource strengths and capabilities, and when few other rivals are attempting to specialize in the same target segment.

Deciding which generic strategy to employ is perhaps the most important strategic commitment a company makes—it tends to drive the rest of the strategic actions a company decides to undertake and it sets the whole tone for the pursuit of a competitive advantage over rivals.

**Exercises**

1. Go to [www.google.com](http://www.google.com) and do a search for “low-cost producer.” See if you can identify five companies that are pursuing a low-cost strategy in their respective industries.

2. Using the advanced search function at [www.google.com](http://www.google.com), enter “best-cost producer” in the exact-phrase box and see if you can locate three companies that indicate they are employing a best-cost producer strategy.

3. Go to BMW’s Web site ([www.bmw.com](http://www.bmw.com)) click on the link for BMW Group. The site you find provides an overview of the company’s key functional areas, including R&D and production activities. Explore each of the links on the Research & Development page—People & Networks, Innovation & Technology, and Mobility & Traffic—to better understand the company’s approach. Also review the statements under Production focusing on vehicle production and sustainable production. How do these activities contribute to BMW’s differentiation strategy and the unique position in the auto industry that BMW has achieved?

4. Which of the five generic competitive strategies do you think the following companies are employing (do whatever research at the various company Web sites might be needed to arrive at and support your answer):
   a. The Saturn division of General Motors
   b. Abercrombie & Fitch
   c. Amazon.com
   d. Home Depot
   e. Mary Kay Cosmetics
   f. USA Today