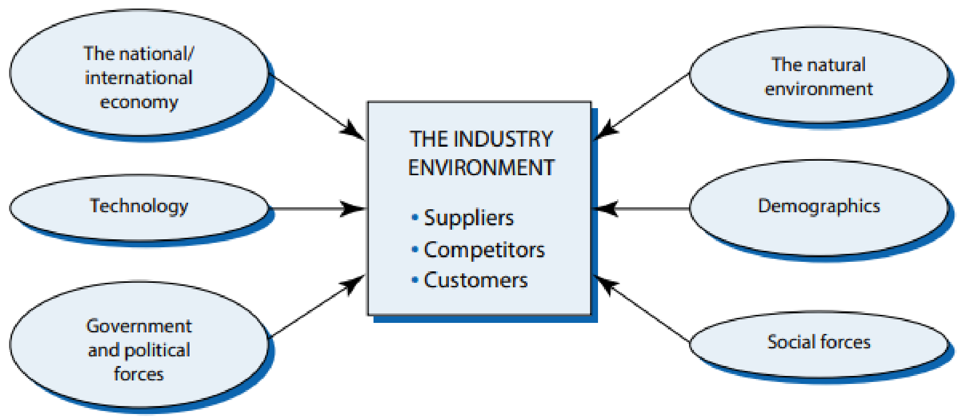
Business environment of a firm: all external influences that impact its decisions and performance. First is a framework or system to organize information (v.g.: PEST Analysis). We must establish what external environment's features are critical: customers, suppliers, competition… Thus, **the core of the firm's business environment is formed by itss relationship with customers, suppliers and competitors**. Other factors must be studied for their impact in these three core relationships.

FIGURE 3.1 From environmental analysis to industry analysis



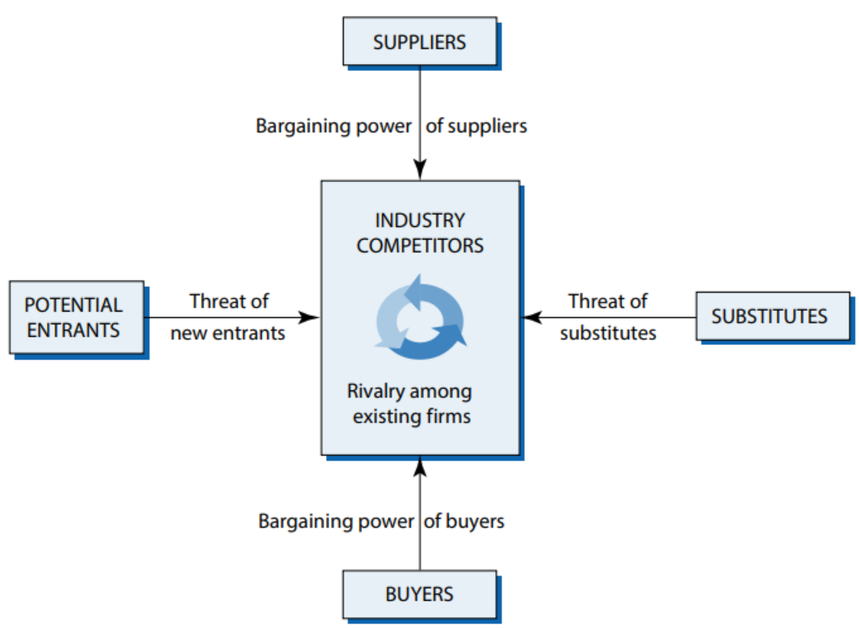
The profits earned by the firm are determined by: the value of product to customers, the intensity of competition and the bargaining power of the industry members relative to the suppliers.

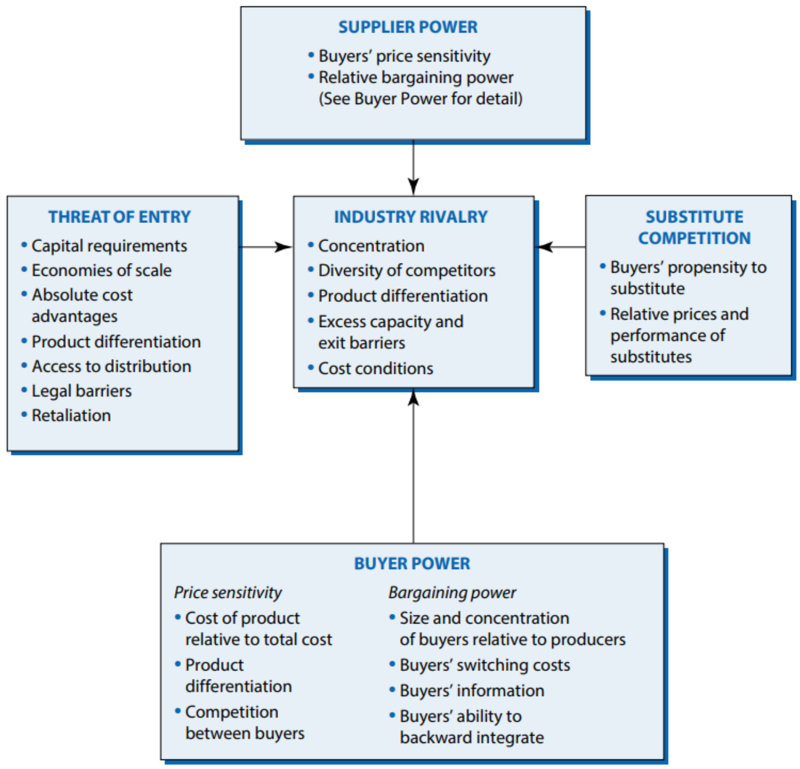
Structure, Conduct, Performance. Observing the industry structure makes us understand the price conduct and that leads to the performance of the industry.

Industry structure drives competitive behavior and determines profitability industrial organization economics, being the two reference points the monopoly and the perfect competition.

Porter's Five forces: horizontal forces are potential entrants, substitutes and existing rivalry firms; horizontal forces are suppliers and buyers.

FIGURE 3.2 Porter's five forces of competition framework





Threats of Entry

Main barriers to entry:

- Capital Requirements
- Economies of Scale
- Absolute Cost Advantages (v.g.: ownership of low cost sources of materials, learning)
- Product Differentiation (v.g.: brand recognition, customer loyalty)
- Access to Channels of Distribution
- Governmental & Legal Barriers
- Retaliation from Established Firms (v.g.: price cuts, sales promotion)

Rivalry Between Established Firms

Price Competition's intensity is derived from:

- Seller Concentration: number and size of the distribution firms competing within a market. Measured by the combined market share of the leading producers, or concentration ratio. Industry with small group of companies dominating it, the competition focus on advertising, promotion and new product development. As more firms dominate, the competition focuses more on price cutting.

- Diversity of Competitors: similarity among competitors that enables the rival firms to avoid price competition.

- Product Differentiation

- Excess Capacity & Excess Capacity

- Cost Conditions: Economies of Scale and Ratio of Fixed to Variable Costs.

Bargaining Power of Buyers

Price Sensitivity

Bargaining Power:

- Size & Concentration of Buyers
- Buyer's Information
- Capacity of Vertical Integration: capacity of the buying firm to produce the bought good or service by itself

Analysis of the Bargaining Power of Suppliers is analogous to the one of Buyers, but now studying the industry as buyer.

Strategies to Alter Industry Structure

- Mergers & Acquisitions: less competitors, more economies of scale and bargaining power
- Customer Loyalty Build-Up: frequent-client schemes
- Increasing Barriers to Enter

Defining Industries

Industry: group of firms that supply a market

Industry Analysis views the industry profitability as determined by competition in two markets: the product market and the input one.

Main issue to stablish a firm's industry: Who is competing with whom? Considering a Ferrari's industry, if we say that buyers would substitute Ferrari only with other sports car, then Ferrari is part of the performance car industry. But, there can be substitutability on the supply side: volume car producers, as Ford, can produce in their facilities and distribute through their networks sport cars, so on the basis of supply-side substitutability, Ferrari is part of the broader automobile industry.

To determine geographical boundaries of the industry again we have to consider substitutability: if customers can and are willing to substitute cars available on different nations or if manufacturers are willing and able to divert their output among different countries, the market is global.

However, a firm's competitive environment is a continuum rather than a bounded space.

Success Factors

What customers want?

Basis on which customers choose between offerings → Key Success Factor

What does the firm need to survive competition?

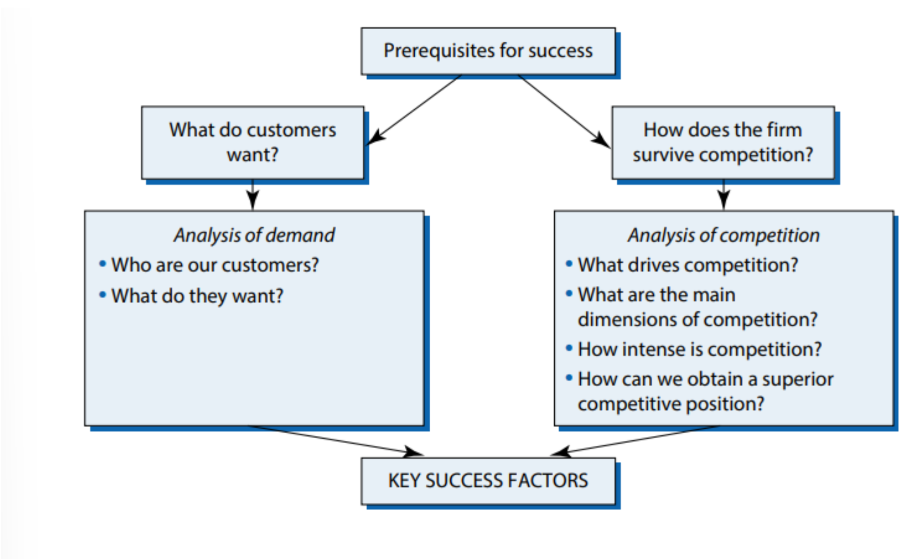


TABLE 3.2 Identifying key success factors: Steel, fashion clothing, and supermarkets

	What do customers want? (Analysis of demand)	How do firms survive competition? (Analysis of competition)	Key success factors
Steel	Low price Product consistency Reliability of supply Technical specifications	Intense price competition results from undifferentiated products, excess capacity, and high fixed costs. Survival requires cost efficiency and financial strength	Cost efficiency requires: large-scale plants, low-cost raw materials, rapid capacity adjustment Hi-tech small-scale plants viable with flexibility and high productivity Quality, and service can yield a price premium
Fashion clothing	Diversity of customer preferences Customers will pay premium for brand, style, exclusivity, and quality Mass market is highly price sensitive	Low barriers to entry and many competitors imply intense competition Differentiation offers price premium, but imitation is rapid	Combining differentiation with low costs Differentiation involves style, brand appeal, quality, and market responsiveness Cost efficiency requires manufacture where wages are low
Supermarkets	Low prices Convenient location Wide product range Quality produce, good service, ease of parking, pleasant ambience	Intensely price competitive Buying power essential for low costs	Low costs require operational efficiency, large-scale purchases, low wages Differentiation requires large stores, convenient location, meticulous in-store management

STRATEGY CAPSULE 3.4

Identifying Key Success Factors by Profitability Modeling: Airlines

Profitability, as measured by operating income per available seat-mile (ASM), is determined by three factors: yield, which is total operating revenues divided by the number of revenue passenger miles (RPMs); load factor, which is the ratio of RPMs to ASMs; and unit cost, which is total operating expenses divided by ASMs. Thus:

$$\frac{\text{Profit}}{\text{ASMs}} = \frac{\text{Revenue}}{\text{RPMs}} \times \frac{\text{RPMs}}{\text{ASMs}} - \frac{\text{Expenses}}{\text{ASMs}}$$

Some of the main determinants of each of these component ratios are the following:

- Revenue/RPMs
  - intensity of competition on routes flown
  - effective yield management to permit quick price adjustment to changing market conditions
  - ability to attract business customers
  - superior customer service.
- Load factor (RPMs/ASMs)
  - competitiveness and flexibility of prices
  - efficiency of route planning (e.g., through hub-and-spoke systems)
  - building customer loyalty through quality of service, frequent-flier programs
  - matching airplane size to demand for individual flights.
- Expenses/ASMs
  - wage rates and benefit levels
  - fuel efficiency of aircraft
  - productivity of employees (determined partly by their job flexibility)
  - load factors
  - level of administrative cost.

Summary

In Chapter 1, we established that a profound understanding of the competitive environment is a critical ingredient of a successful strategy. Despite the vast number of external influences that affect every business enterprise, our focus is the firm's industry environment that we analyze in order to evaluate the industry's profit potential and to identify the sources of competitive advantage.

The centerpiece of our approach is Porter's five forces of competition framework, which links the structure of an industry to the competitive intensity within it and to the profitability that it realizes. The Porter framework offers a simple yet powerful organizing framework for identifying the relevant features of an industry's structure and predicting their implications for competitive behavior.

The primary application for the Porter five forces framework is in predicting how changes in an industry's structure are likely to affect its profitability. Once we understand the drivers of industry profitability, we can identify strategies through which a firm can improve industry attractiveness and position itself in relation to these different competitive forces.

As with most of the tools for strategy analysis that we shall consider in this book, the Porter five forces framework is easy to comprehend. However, real learning about industry analysis and about the Porter framework in particular derives from its application. It is only when we apply the Porter framework to analyzing competition and diagnosing the causes of high or low profitability in an industry that we are forced to confront the complexities and subtleties of the model. A key issue is identifying the industry within which a firm competes and recognizing its boundaries. By employing the principles of substitutability and relevance, we can delineate meaningful industry boundaries.

Finally, our industry analysis allows us to make a first approach at identifying the sources of competitive advantage through recognizing key success factors in an industry.

I urge you to put the tools of industry analysis to work—not just in your strategic management coursework but also in interpreting everyday business events. The value of the Porter framework is as a practical tool—it helps us to understand the disparities in profitability between industries, to predict an industry will sustain its profitability into the future, and to recognize which strategies have the best potential for making money. Through practical applications, you will also become aware of the limitations of the Porter framework. In the next chapter, we will see how we can extend our analysis of industry and competition.

Evidence acknowledges that industry factors account for less than 20% of variation in return on assets among firms. However, industry analysis is not conditional upon the importance of inter or intra industry profitability differences; it is important to make strategic decisions. It is relevant for identifying competitive threats, attractive segments and sources of competitive advantage.

There could be competition beyond price competition.

This SCP Model is not applicable when the structure of the industry changes.

CHAPTER 4: Further Topics in Industry & Competitive Analysis

##Just Segmentation & Strategic Groups is important

4.1.Limits of Industry Analysis

4.1.2. Hypercompetition

The view of competition as a dynamic process that unleashes the forces of innovation in an industry changing its structure constantly raises the issue whether competitive behavior is an outcome of the industry structure or a determinant of it. The issue is the speed of structural change: if the transformation is rapid, the five forces analysis does not offer a stable basis for predicting competition nor profitability. However, in most industries the innovative process of creative destruction tends to be sluggish.

Nonetheless, the stability of industry structures is being eroded by the disruption of digital technologies and the intensification of international competition, leading to:

Hypercompetition: “intense and rapid competitive moves, in which competitors must move quickly to build new advantages and erode their rivals’ advantages”. Hypercompetition occurs in unstable industry structures.

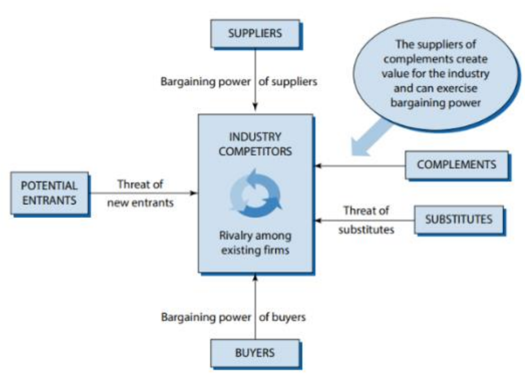
4.1.2.Winner-Takes-All Industries

In some industries, the disparities in profitability between firms are as great as to make industry attractiveness irrelevant. This is because market share confers massive competitive advantage due to positive feedback loops, the most important being network externalities. In this industries the market leader may scoop the entire profit pool. Complementary products play a central role in creating these network externalities,

4.2.Complements, Ecosystems & Business Models

4.2.1.Complements

Complements are missing in the Five Forces Analysis, but may be added to as a sixth force. They have the opposite effect of substitutes: increase the value of an industry’s product.



How is the value shared between the producers of different complementary products?

Where two products complement one another, profit accrues to the supplier that builds the stronger market position. They key is to achieve monopolization, differentiation and short supply of one's own product while encouraging competition, commoditization and excess capacity in complementary products. Apple sells a product which complementors, apps, are dominated by the fact the ownership of the iOS system and the Apple Store allowing the company to control the supply of apps. Also, print manufacturers' monopolize the ink cartridge of their printers.

In digital based technologies involve hardware, operating systems, applications and Internet connection. In these markets competition tend to be among platforms, that are the interfaces that link the component part of the systems. Each platform attracts complementors (v.g.: Amazon, products; Android, apps) and the availability of these complementors creates a powerful network externality: complementors favor the platform with the most users; users favor the platform with more complements.

4.2.2.Business Ecosystems

Business Ecosystem: community of organizations, institutions and individuals that impact the enterprise, emphasizing the codependencies among its members and the continual evolution of the system

Ecosystem Bottlenecks: activities that create significant customer value and can be dominated by the firm

4.2.3.Using Business Models to Manage Ecosystems

Business Model: simplified description of a business, specifying the core logic for creating value.

The reason that business models are useful is because strategy is often viewed too narrowly—business strategy in terms of cost or differentiation advantage, corporate strategy in terms of selecting sectors then managing linkages between them. Business models allow us to consider more complex business situations and envisage business opportunities more widely.

Traditionally, most enterprises are operated with fairly simple business models. For example, the typical business model for a consumer goods producer involves adding value to bought-in materials and components, then supplying the finished product to distributors.

Digital technologies have caused the emergence of more complex business ecosystems that offer opportunities for more diverse business models. As established industries are disrupted by digital technologies, the challenge for traditional firms is to find business models to replace those rendered obsolete by new competition. Travel agents have transitioned from being commission-based retailers to providing customized, fee-based services to travelers; newspapers have experimented with different online revenue models: free content/paid advertising, “freemium” (free access to basic content; charges for premium content), metered access, or variants on these

4.2.4.Business Ecosystems: Value Capture Model

Value Capture Model / Value-Based Strategy / Bi-Form Models: strategy framework that combines both breadth and analytic rigor. This framework envisages the firm within a broad network of transacting parties. The approach then establishes boundaries for the amount of value that the firm can appropriate, being the upper limit determined by the amount of value that the firm creates within its current network, which is the amount by which the total value within the network would diminish if the firm left; and the lower limit determined by the amount of value that the firm could add to an alternative network.

Firm’s strategic decisions are about investment in resources and capabilities that influence the value it captures. These decisions are related to:

- Increase the value available to the firm by increasing the maximum value the firm adds either to its network or to an alternative network
- Actions that determine how much value the members of the network are willing to give up to the firm

4.3.Competitive Interaction

4.3.1.Game Theory

Interdepence: fundamental feature of strategic situations, it is the fact that decisions made by any one player are dependent on the actual and anticipated decisions of the other players

Game Theory points five types of strategic behavior influencing competitive business outcomes:

- Cooperation: there is no simple dichotomy between competition and cooperation. There is a desire from competitors to cluster together.

- Deterrence: it is to impose costs on other players for actions deemed to be undesirable. The effectiveness of any deterrent depends on it being credible. If the deterrent is costly or unpleasant for the threatening party, it will lack credibility. Also, deterrence only will work if the adversaries can be deterred.

- Commitment: it involves the elimination of strategic options. It is binding an organization to a future course of action. Once Airbus had decided to build its A380 superjumbo, it was critical to signal its commitment to the project. During 2000–02, Airbus spent heavily on advertising the plane, even before completing the design phase, in order to encourage airlines to place orders and discourage Boeing from developing a rival plane. Commitments to aggressive competition are called hard commitments; the ones for moderate competition, soft commitments.

- Change of Game Structure: creative strategies may change the structure of the competitive game. Thus, establishing alliances and agreements with competitors can increase the value of the game by increasing the size of the market and building combined strength against possible entrants. There may be many opportunities for converting win–lose (or even lose–lose) games into win–win games through cooperative strategies.

- Signaling: competitive reactions depend on how the competitors perceives its rival's initiative. Signaling is the selective communication of information or misinformation to competitors or customers designed to influence their perceptions and hence provoke or suppress certain reactions. Threats are credible when backed by reputation.

As with all our theories and frameworks, game theory is useful not because it gives us answers but because it can help us understand business situations. Game theory provides a set of tools that allows us to structure our view of competitive interaction. By identifying the players in a game, the decision choices available to each, and the implications of each combination of decisions, we have a systematic framework for exploring the dynamics of competition. Most importantly, by describing the structure of the game we are playing, we have a basis for suggesting ways of changing the game and thinking through the likely outcomes of such changes.

4.3.2.Competitors Analysis

In highly concentrated industries, the dominant feature of a company's competitive environment is likely to be the behavior of its closest rivals.

Competitive Intelligence: systematic collection and analysis of information about rivals for informing decision making. It has three purposes:

- Forecast competitor's future strategies and decisions
- Predict competitor's likely reactions to firm's initiatives
- Determine how competitor's behavior can be influenced

Four-part framework for predicting competitor behavior:

- Competitor's Current Strategy
- Competitor's Objectives: if the primary goal is market share, the firm will tend to be more aggressive than if the goal is profitability

- Competitor’s Assumptions about the Industry: beliefs that managers hold about the industry and the success factors within it. These beliefs tend to be stable
- Competitor’s Resources & Capabilities

4.4.Segmentation & Strategic Groups

4.4.1.Segmentation Analysis

Segmentation: the process of disaggregating industries. The purpose of segmentation analysis is to identify attractive segments, select strategies and determine how many segments to serve. The process has five stages:

I. Identify Key Variables: Segmentation variables relate to the characteristics of customers and the product. Typically, segmentation analysis generates too many variables, so there is the need to reduce these to two or three. To do this, we have to (1) Identify the most strategically significant segmentation variables, and (2) Combine segmentation variables closely correlated.

II. Construct Segmentation Matrix: Once the variables are selected and discrete categories are determined for each, the individual segments can be identified using a matrix.

III. Analyze Segment Attractiveness: Profitability within a segment is determined by the same forces that determine the profitability within an industry. There are some differences: substitutes comes from other industries or other segments of the same industry; threats to entry come also from producers established in other segments of the same industry; and the barriers that protect the segment from the entry of other players from different segments of the same industry are called Barriers to Mobility.

IV. Identify Segment’s Key Success Factors

V. Select Segment Scope: The firm must decide whether to be a segment specialist or to compete across multiple segments

4.4.2.Strategic Groups

Strategic Group: Group of firms in an industry following the same or similar strategy along the strategic dimensions. These dimensions might include product range, geographical breadth, choice of distribution channels, product quality, degree of vertical integration, choice of technology, etc. For example, the airline industry has two main strategic groups: legacy carriers and low-cost carriers.

Summary

The purpose of this chapter has been to go beyond the basic analysis of industry structure, competition, and profitability presented in Chapter 3 to consider the dynamics of competitive rivalry and the internal complexities of industries.

In terms of industry and competitive analysis, we have extended our strategy toolkit in several directions:

- We have recognized the limitations of conventional industry analysis. These include: the limited impact of industry upon firm profitability, the role of competition in transforming industries through a process of creative destruction, and the emergence of "winner-take-all" industries.
- We have extended our analysis of industry and competition to take account of complementary products—especially in industries where these complementarities give rise to network externalities, platform-based competition, and business ecosystems.
- We have become familiar with two approaches to analyzing competitive interactions between close rivals: (a) game theory which, despite its technical rigor, offers penetrating insights into competition, bargaining, and the design of winning strategies and (b) competitor analysis which provides a less formal approach to understanding competitors and predicting their behavior.
- We have examined the microstructure of industries and markets using segmentation analysis and strategic group analysis to understand industries at a more detailed level and to select advantageous strategic positions.

BLUE OCEAN STRATEGY

Structuralist View or Environmental Determinism: Industrial Organization (IO) Economics suggests a causal flow from market structure to conduct and performance. Market structure is given by supply and demand conditions and it shapes sellers' and buyers' conducts, which determines performance of firms.

Blue Oceans

Aspect of strategy that involves, instead of competing, creating a new market space where there are no competitors, called "blue ocean".

Red oceans are the traditional conception of industry, where firms compete directly for profits.

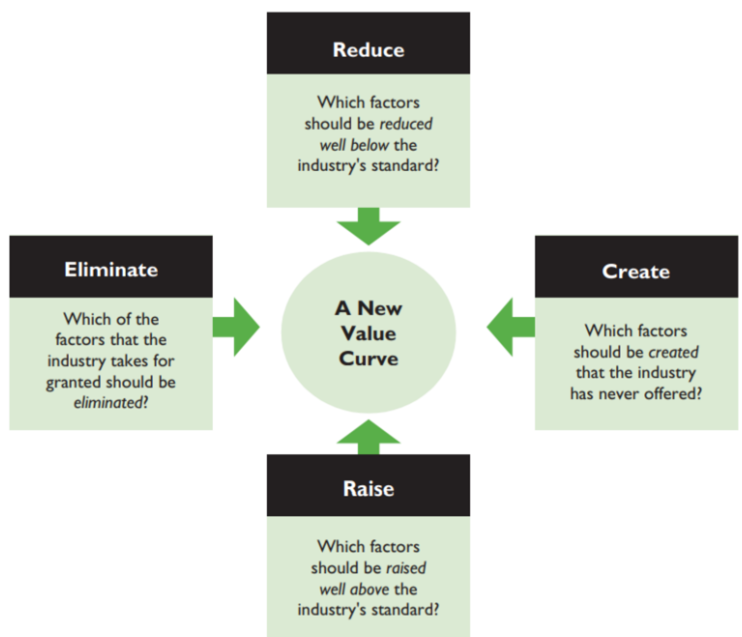
Blue oceans are defined by untapped market space, demand creation and the opportunity for highly profitable growth. Usually they are created from within red oceans by expanding ixisting industry boundaries. In these oceans competition is irrelevant because the rules are waiting to be set.

Reconstructionist View: blue ocean strategy based on te view that market boundaries and industry structure are not given and can be reconstructed by the action and beliefs of industry players.

In the reconstructionist view, there is scarcely any attractive or unattractive industry per se because the level of industry attractiveness can be altered through companies' conscientious effort of reconstruction.

To discover blue oceans one must focus on the demand side of the substitutes. For example, a firm from the wine industry in the U.S. focused on the consumers from the beer industry, its substitute industry, to understand why they did not consume wine and try to make the product more appealing to current non-customers, so they can create a new market with no set rules nor competition.

To reconstruct buyer value elements, there is a four action framework that asks four key questions to challenge an industry's strategic logic and business model:



1. Question the factors that companies have long competed on. Often these factors are taken for granted even though they no longer have value or may be detracting value.
2. Determine whether products or services have been over-designed in the race to match and beat competition.
3. Uncover and eliminate compromises that the industry forces customer to make
4. Discover new sources of value for buyers and create new demand, shift strategic pricing

It is by pursuing the first two, eliminating and reducing, that a company gains insights into how to drop its cost structure.

5.1.The Role of Resources & Capabilities in Strategy Formulation

Strategy is concerned with matching a firm's resources and capabilities to the opportunities that arise in the external environment. As firm's industry environments become more unstable, internal resources and capabilities rather than external markets offer more secure basis of strategy. Additionally, competitive advantages rather than industry attractiveness are the primary source of profitability.

5.1.1.Basing Strategy on Resources & Capabilities

The potential for capabilities to be the roots of competitiveness, te source of new products and the foundation of strategy. Microsoft's software development, marketing and partnering capabilities allowed the firm to expand from operating systems (v.g.: Windows) to applications (v.g.: Office), Internet Services (v.g.: Xbox Live) and cloud base computer services (v.g.: Azure). The focus is not on the products or industries, but on the capacity of the firm to fulfill demand for anything related to what they can make. For example, Kodak might have let its photographic business to decline while developing applications of its chemical-based capabilities.

5.1.2.Resources & Capabilities as Source of Profit

Establishing a competitive advantage through the development and deployment of resources and capabilities has become the primary goal of strategy.

There are two kind of profit: the ones arising from market power, monopoly rents (industry attractiveness); and the ones arising from superior resources, Ricardian rents (competitive advantages). When the primary strategic concern was industry selection and positioning, companies tended to adopt similar strategies. The resource-based view recognizes that each company possesses a unique collection of resources and capabilities that must be exploited to generate profitability.

5.2.Identifying Resources & Capabilities

FIGURE 5.3 The links between resources, capabilities, and competitive advantage

Resources: productive assets owned by the firm.

Capabilities: what the firm can do.

5.2.1.Identifying Resources

Three main types of resources:

- Tangible: financial resources and physical assets that are valued on the firm's balance sheet. However, usually, because of accounting conventions, they are misvalued. Nonetheless, the goal of resources analysis is not to value the company's tangible resources but to understand their potential to get profitability. There are two main routes to create additional value from tangible resources:

I. What opportunities exist for economizing their use? Can we use fewer resources to support the same level of business or can current resources support more level?

II. Can existing assets be redeployed more profitably?

- Intangible: intangible resources are intangible assets listed or non-listed in the balance sheet of the company. They tend to be misvalued. They include things like the brands, trademarks, copyrights, trade secrets, etc. Also, relationships and organizational culture can be considered resources.

- Human: skills and productive effort offered by an organization's employees. They do not appear in balances of the firm because the firm does not own its employees, it purchases their services. However, the stability of employment relationships make human resources part of the strategic resources of the firm.

5.2.2.Identifying Organizational Capabilities

Resources are not productive on their own. To perform a task, resources must work together.

Organizational Capability: firm's capacity to deploy resources for a desired end results.

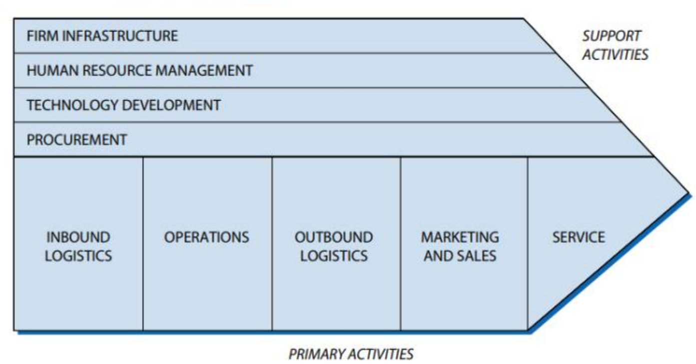
Distinctive Competences / Core Capabilities: capabilities fundamental to a firm's strategy and performance

Two approaches to classify and disaggregate the firm's activities:

- Functional Analysis: identifies organizational capabilities within each of the firm's functional areas → Firm's functions include operations, purchasing, logistics, supply chain management, design, engineering, new product development, etc.

- Value Chain Analysis: identifies a sequential chain of the main activities the firm undertakes. Porter's generic value chain distinguishes between Primary Activities (those involved with the trains formation of inputs and interface with the customer) and Support Activities. These activities can be disaggregated to provide a more detailed identification of the firm's activities and the capabilities that correspond to each activity.

FIGURE 5.4 Porter's value chain



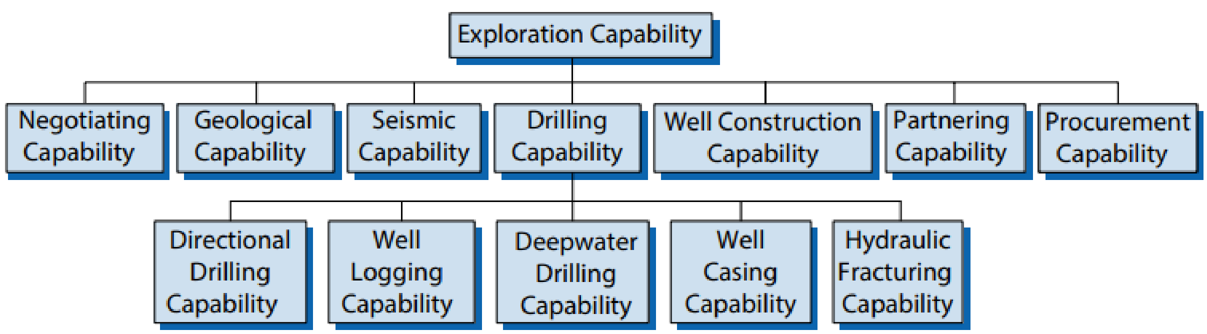
However, both approaches fail to identify the Core Capabilities. To look beyond generic capabilities to uncover those that are unique requires insight and judgment. A careful examination of an organization's history can be revealing. In reviewing an organization's successes and failures over time, do patterns emerge and what do these patterns imply about the capabilities that underlie them?

Hierarchy of Capabilities: organizational capabilities involve coordinated behavior among organizational members. Hence, the capabilities of an organization may be viewed as a hierarchical system in which lower-level capabilities are integrated to form higher-level ones.

For most companies, the higher-level capabilities constitute the core competences. These higher-level capabilities tend to be cross-functional.

Dynamic Capabilities: proposed to be the highest level of capability, they are capabilities that allow the

FIGURE 5.5 Organization capabilities as a hierarchy of integration: The case of oil and gas exploration

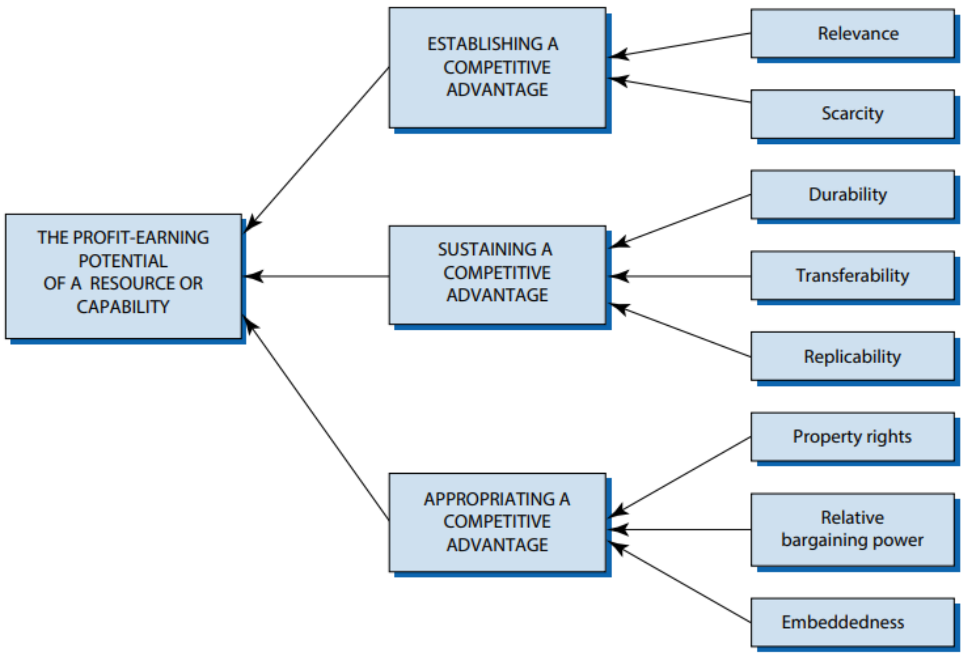


modification and adaption of lower-level operational and functional capabilities.

5.3.Appraising Resources & Capabilities

5.3.1.Appraising the Strategic Importance of Resources & Capabilities

FIGURE 5.6 Appraising the strategic importance of resources and capabilities



Establishing Competitive Advantage:

- Relevant resource or capability to the key success factors in the market
- Scarcity of resources or capability makes them competitive advantages

Sustaining Competitive Advantage:

- Durability
- Replicability & Transferability: competitive advantages tend to be eroded by the transferability of the resources and capabilities in which they are based. If the resource or capability is imitable or salable, it will be eroded.

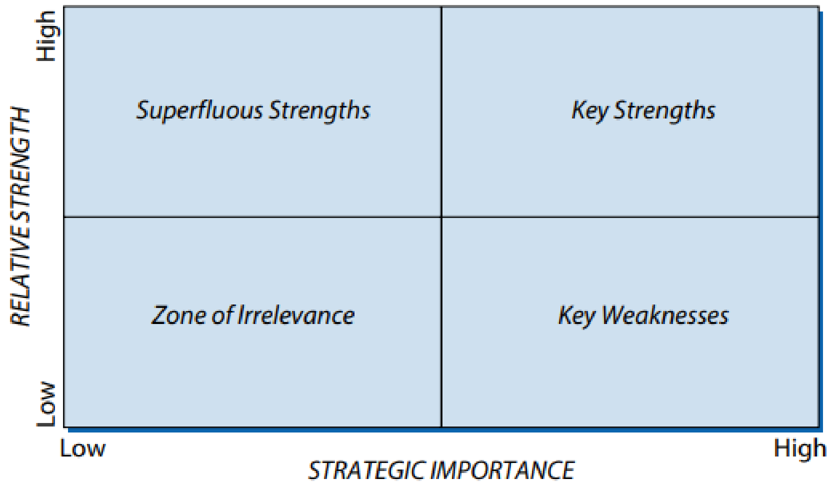
Appropriating the Returns to the Competitive Advantage: who wins the returns made from the competitive advantage? Usually, the owner. However, ownership might not be clear. In human-capital-intense industry there is a struggle between shareholders and key employees for the rent emerged from the superior capabilities.

5.3.2.Appraising Relative Strength

It is required to appraise the firm's resources and capabilities relative to those of the competitors.

Benchmarking: process of comparing one's processes and performance with those of other companies. The use of it is based on the evidence that difference in productivity among firms in the same industry rely upon differences in management practices. This process is useful when comparing functional capabilities, no idiosyncratic ones

The framework for appraising resources and capabilities



5.4.Developing Strategy Implications

- Exploit Key Strengths

- Manage Key Weakness:
  - > Convert Key Weakness into a Strength in the long term
  - > Outsource
  - > Virtue out of Weakness (v.g.: Harley Davidson’s old engines)

- Deal with Superfluous Strength:
  - > Selective Divestment
  - > Generate a Differentiation out of it
  - > Convert into a Key Strength

CHAPTER 7: Sources & Dimensions of Competitive Advantage

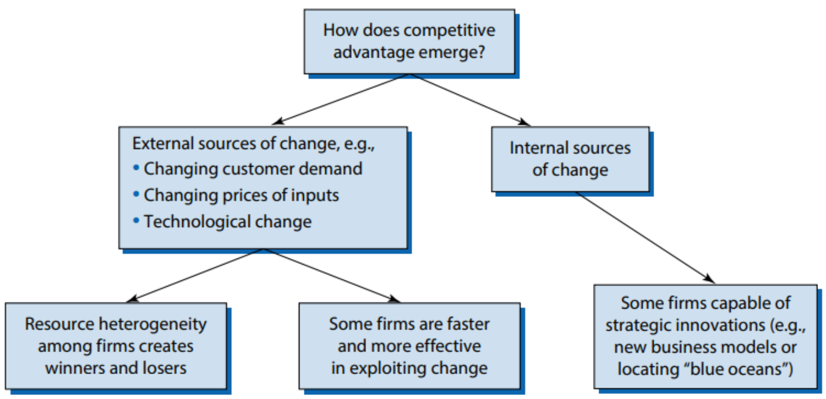
7.1.How is Competitive Advantage Established?

Competitive Advantage: firm's potential to earn a higher rate of profit than its direct competitors. It is a disequilibrium phenomenon that is created by change and, once established, it sets in motion the competitive process that leads to its destruction

7.1.1.External Sources of Competitive Advantage

External changes create competitive advantage when they have differential effects on companies because of their different resources and capabilities or strategic positioning (v.g.: reducing subsidies for

FIGURE 7.1 The emergence of competitive advantage



renewable energy will enhance the competitive advantage of power producers that use fossil fuels).

External changes create entrepreneurial opportunities that will accrue to the firms that exploit them effectively. Entrepreneurial responsiveness involves:

- Anticipation
- Agility, as quick responses has become an important source of competitive advantage

7.1.2.Internal Sources of Competitive Advantage

Creative Destruction: innovator creates competitive advantage through innovation and this undermines previously established competitive advantage

Strategic Innovation: new approaches to serving customers and competing with rivals

Business Model Innovation: introduction of novel approaches to creating and/or capturing value within an industry. Three generic types:

- New Industry Models: reconfigurations of the conventional industry's value chain (v.g.: Zara's vertically integrated fast fashion)
- New Revenue Models: changing value proposition, target audience or pricing strategy
- New Enterprise Models: reconfiguring enterprise boundaries and partner relationships (v.g.: Apple's creation of a new model for the smartphone business)

7.2.How is Competitive Advantage Sustained?

To sustain competitive advantages, barriers to imitation must exist.

Isolation Mechanisms: barriers that prevent erosion of a business' superior profitability. The process to erode a competitive advantages starts by identifying it, having an incentive to imitate it, be able to diagnose the source of it, and be able to acquire the resources and capabilities to imitate it. At each stage, there can be created isolation mechanisms:

- Identification → Obscure Superior Performance (v.g.: avoiding disclosure of financial performance)

- Incentives for Imitation → Deterrence (s making threats that competitive incursions will be resisted vigorously) & Preemption (occupying existing and potential strategic niches to reduce the range of investment opportunities open to the challenger)

- Diagnosis → Use multiple sources of competitive advantages to create causal ambiguity (when a firm's competitive advantage is multidimensional and is based on complex bundles of resources and capabilities, it is difficult for rivals to diagnose the success of the leading firm) & uncertain imitability

- Resource Acquisition → Base competitive advantage upon resources and capabilities that are immobile and difficult to replicate

7.3.Cost Advantage

Differentiation Advantage: supply a differentiated good so the customer is willing to pay a price premium that exceeds the additional cost of the differentiation

FIGURE 7.4 Sources of competitive advantage

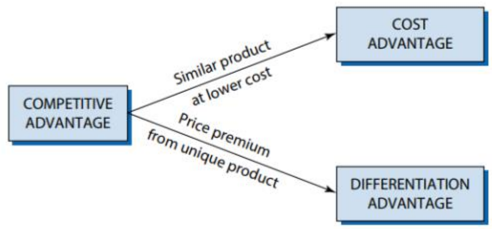
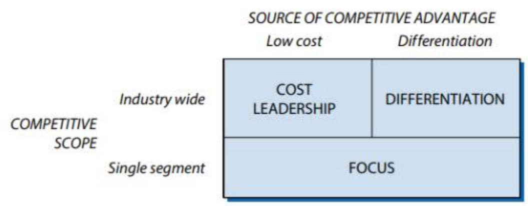


FIGURE 7.5 Porter's generic strategies

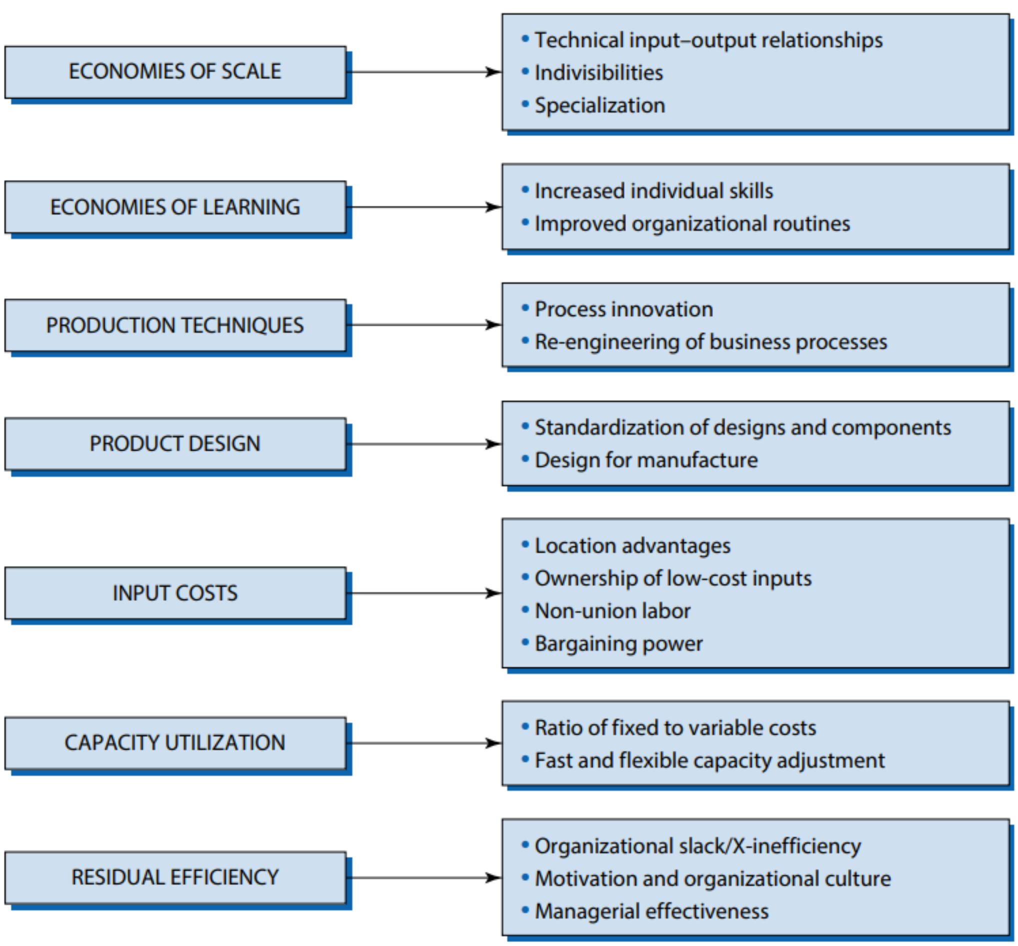


Cost Advantage: become the cost leader in its industry by supplying the good or service at a lower cost

7.3.1. Source of Cost Advantage

Seven principal determinants of a firm's unit costs relative to its competitors, or cost drivers:

FIGURE 7.7 The drivers of cost advantage



7.3.2.Using Value Chain to Analyze Costs

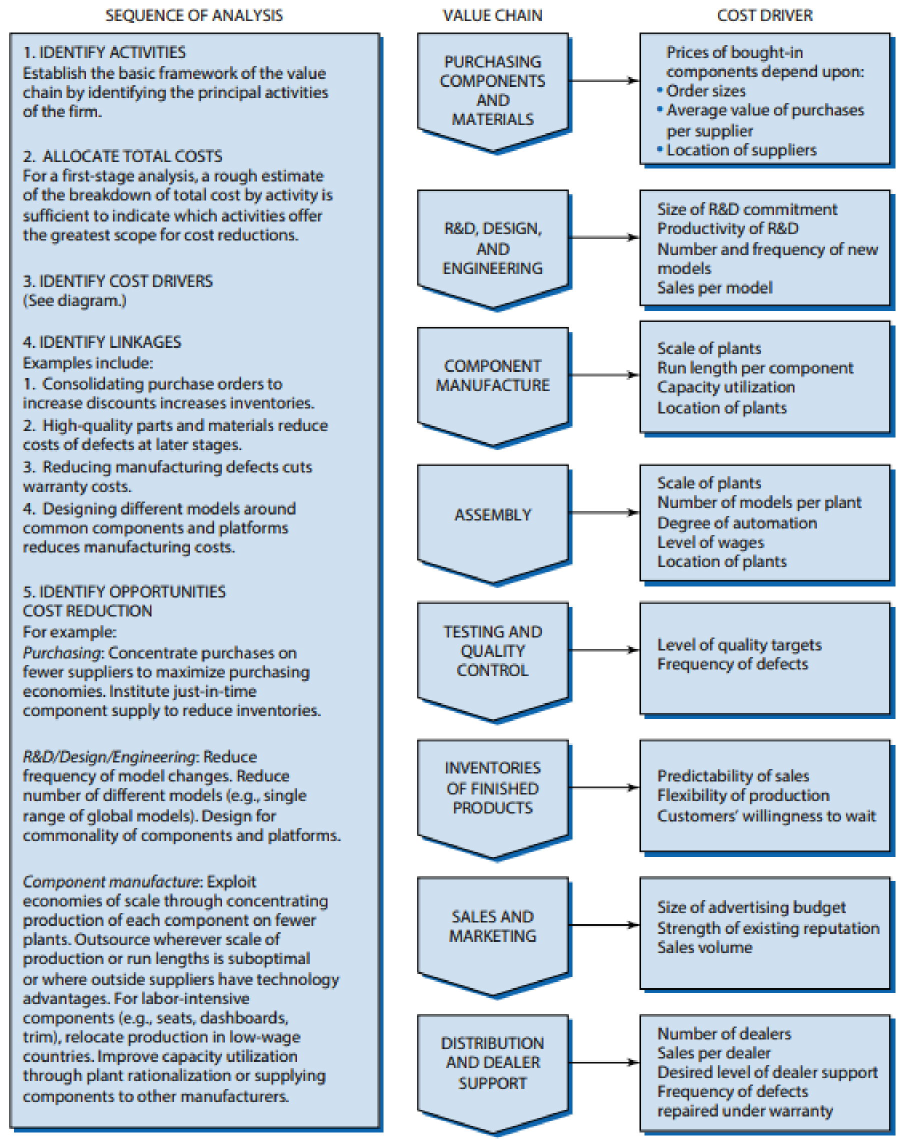
Value Chain Analysis of costs seeks to identify

- Relative importance of each activity to the total cost
- Cost drivers for each activity and the comparative efficiency
- How costs in one activity influence in another
- Which activity should be outsourced and which insourced

It compromises the following stages:

I. Disaggregate the firm into separate activities
II. Estimate the cost that each activity contributes to the total cost
III. Identify each activity's cost drivers
IV. Identify linkages between the costs of each activity and the others activities
V. Identify cost reduction opportunities

FIGURE 7.10 Using the value chain in cost analysis: An automobile manufacturer



7.4.Differentiation Advantage

A firm differentiates itself from its competitors "when it provides something unique that is valuable to buyers beyond simply offering a lower price." Occurs when the price of a premium exceeds the cost of providing the differentiation.

Differentiation is not only about offering different product features, is about identifying and understanding every interaction between the firm and its customers and asking how these could be enhanced or changed in order to deliver additional value (v.g.: Cemex, leader supplier of cement, has differentiated itself through ensuring that always delivers on time, against 34% of the times, average of the industry. Even commodities can be differentiated).

Differentiation strategies are not about pursuing uniqueness for its own sake, but understanding how to meet the customer needs differently. Thus, there are two requirements for differentiation:

- On the supply side, the firm has to be aware of its resources and capabilities through which it can create uniqueness and serve better than its competitors
- On the demand side, the key is insight into customers, their needs and preferences.

Differentiation encompasses:

- Tangible Differentiation: observable characteristics of a product or service, including complements as the delivery, after-sale service, accessories, etc.
- Intangible Differentiation: social, emotional, psychological an esthetic criteria. It includes too the desire for status, exclusivity, individuality, security and community.

7.4.1.Analyzing the Demand Side of Differentiation

Understanding customer needs requires the analysis of customer preferences. Techniques include:

- Multidimensional Scaling (MDS): compares competing products in terms of attributes
- Conjoint Analysis: measures the strength of customer preferences for different products which then allows consumer preference for a hypothetical new product to be predicted.
- Hedonic Price Analysis: views products as bundles of underlying attributes and then uses regression analysis to estimate the implicit market price for each attribute

7.4.2.Analyzing the Supply Side of Differentiation

Product Integrity: consistency of a firm’s differentiation. It is the extent to which a product achieve total balance of numerous product characteristics. Internal integrity refers to consistency between the function and the structure of the product. External integrity is the measure of how well a product’s function, structure and semantics fits into customers’ values, objectives, lifestyle, identity, etc.