

valuable (V), rare (R), and costly to imitate (I). The firm must also be able to *organize (O) in order to capture the value of the resource.*

- A resource is valuable (V) if it allows the firm to take advantage of an external opportunity and/or neutralize an external threat. A valuable resource enables a firm to increase its economic value creation ($V - C$).
- A resource is rare (R) if the number of firms that possess it is less than the number of firms it would require to reach a state of perfect competition.
- A resource is costly to imitate (I) if firms that do not possess the resource are unable to develop or buy the resource at a comparable cost.
- The firm is organized (O) to capture the value of the resource if it has an effective organizational structure, processes, and systems in place to fully exploit the competitive potential.

LO 4-5 / Evaluate different conditions that allow a firm to sustain a competitive advantage.

- Several conditions make it costly for competitors to imitate the resources, capabilities, or competencies that underlie a firm's competitive advantage: (1) *better expectations of future resource value*, (2) *path dependence*, (3) *causal ambiguity*, (4) *social complexity*, and (5) *intellectual property (IP) protection*.
- These *barriers to imitation* are isolating mechanisms because they prevent rivals from competing away the advantage a firm may enjoy.

LO 4-6 / Outline how dynamic capabilities can enable a firm to sustain a competitive advantage.

- To sustain a competitive advantage, any fit between a firm's internal strengths and the external environment must be dynamic.
- *Dynamic capabilities* allow a firm to create, deploy, modify, reconfigure, or upgrade its resource base to gain and sustain competitive advantage in a constantly changing environment.

LO 4-7 / Apply a value chain analysis to understand which of the firm's activities in the process of transforming inputs into

outputs generate differentiation and which drive costs.

- The value chain describes the internal activities a firm engages in when transforming inputs into outputs.
- Each activity the firm performs along the horizontal chain adds incremental value and incremental costs.
- A careful analysis of the value chain allows managers to obtain a more detailed and fine-grained understanding of how the firm's economic value creation breaks down into a distinct set of activities that helps determine perceived value and the costs to create it.
- When a firm's set of distinct activities is able to generate value greater than the costs to create it, the firm obtains a profit margin (assuming the market price the firm is able to command exceeds the costs of value creation).

LO 4-8 / Identify competitive advantage as residing in a network of distinct activities.

- A strategic activity system conceives of a firm as a network of interconnected firm activities.
- A network of primary and supporting firm activities can create a strategic fit that can lead to a competitive advantage.
- To sustain a competitive advantage, firms need to hone, fine-tune, and upgrade their strategic activity systems over time, in response to changes in the external environment and to moves of competitors.

LO 4-9 / Conduct a SWOT analysis to generate insights from external and internal analysis and derive strategic implications.

- Formulating a strategy that increases the chances of gaining and sustaining a competitive advantage is based on synthesizing insights obtained from an internal analysis of the company's strengths (S) and weaknesses (W) with those from an analysis of external opportunities (O) and threats (T).
- The strategic implications of a SWOT analysis should help the firm to leverage its internal strengths to exploit external opportunities, while mitigating internal weaknesses and external threats.

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KEY TERMS

Activities (p. 112)	Intellectual property (IP) protection (p. 123)	Resource immobility (p. 114)
Capabilities (p. 110)	Isolating mechanisms (p. 120)	Resource stocks (p. 127)
Causal ambiguity (p. 122)	Organized to capture value (p. 118)	Resources (p. 110)
Core competencies (p. 110)	Path dependence (p. 121)	Social complexity (p. 123)
Core rigidity (p. 124)	Primary activities (p. 130)	Strategic activity system (p. 130)
Costly-to-imitate resource (p. 116)	Rare resource (p. 116)	Support activities (p. 130)
Dynamic capabilities (p. 126)	Resource-based view (p. 113)	SWOT analysis (p. 134)
Dynamic capabilities perspective (p. 127)	Resource flows (p. 127)	Tangible resources (p. 113)
Intangible resources (p. 113)	Resource heterogeneity (p. 114)	Valuable resource (p. 116)
		Value chain (p. 128)
		VRIO framework (p. 115)

DISCUSSION QUESTIONS

1. Why is it important to study the internal resources, capabilities, and activities of firms? What insights can be gained?
2. a. Conduct a value chain analysis for McDonald's. What are its primary activities? What are its support activities? Identify the activities that add the most value for the customer. Why? Which activities help McDonald's to contain cost? Why?
b. In the past few years, McDonald's has made a lot of changes to its menu, adding more healthy choices and more higher-priced items, such as those offered in McCafé (e.g., premium roast coffee, antibiotic-free chicken, and fruit smoothies), and has also enhanced its in-restaurant services (e.g., free, unlimited Wi-Fi; upgraded interiors). Did McDonald's new priorities—in terms of a broader, healthier menu and an improved in-restaurant experience—require changes to its traditional value chain activities? If so, how? Try to be as specific as possible in comparing the McDonald's from the recent past (focusing on low-cost burgers) to the McDonald's of today.
3. The resource-based view of the firm identifies four criteria that managers can use to evaluate whether particular resources and capabilities are core competencies and can, therefore, provide a basis for sustainable competitive advantage. Are these measures independent or interdependent? Explain. If (some of) the measures are interdependent, what implications does that fact have for managers wanting to create and sustain a competitive advantage?

ETHICAL/SOCIAL ISSUES

1. As discussed in this chapter, resources that are valuable, rare, and costly to imitate can help create a competitive advantage. In many cases, firms try to "reverse-engineer" a particular feature from a competitor's product for their own uses. It is common, for example, for smartphone manufacturers to buy the newest phones of their competitors and take them

apart to see what new components and features the models have implemented. However, this sort of corporate behavior does not stop with hardware products. With hundreds of millions of users and rapid growth, China is considered to be one of the most lucrative online markets worldwide. Baidu (baidu.com), a Chinese web services company, has allegedly adapted many of the search tools that Google uses. Baidu, however, modifies its searches inside China (its major market) to accommodate government guidelines. In protest over these same guidelines, in 2010 Google left the Chinese market and is running its Chinese search operations from Hong Kong. Google no longer censors its online searches as requested by the Chinese government. Baidu has an estimated 78 percent market share in online search in China, and Google less than 15 percent.⁵⁰

It is legal to take apart publicly available products and services and try to replicate them and

even develop work-arounds for relevant patents. But is it ethical? If a key capability protected by patents or trademarks in your firm is being reverse-engineered by the competition, what are your options for a response? Also, how do you evaluate Google's decision to move its servers to Hong Kong?

2. The chapter mentions that one type of resource flow is the loss of key personnel who move to another firm. Assume that the human resources department of your firm has started running ads and billboards for open positions near the office of your top competitor. Your firm is also running Google ads on a keyword search for this same competitor. Is there anything unethical about this activity? Would your view change if this key competitor had just announced a major layoff?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Brand valuations were mentioned in the chapter as a potential key intangible resource for firms. Some product brands are so well established the entire category of products (including those made by competitors) may be called by the brand name rather than the product type. In your small group, develop two or three examples of this happening in the marketplace. In any of the cases noted, does such brand valuation give the leading brand a competitive advantage? Or does it produce confusion in the market for all products or services in that category? Provide advice to the leading brand as to how the firm can strengthen the brand name.

//// Small Group Exercise 2

Strategy Highlight 4.1 explains the rise and fall of Groupon. The company's strategic vision was *to be the global leader in local commerce*, based on a core competency that could be described as

"local market-making." Numerous competitors took advantage of low barriers to entry and the easy imitation of Groupon's combined competency of some technology skills with sales skills, so that Groupon found its competitive advantage was only temporary. Groupon continues to compete but needs your advice on how to build dynamic capabilities that might help it pursue the vision of becoming a global leader in local commerce. How might Groupon reinvest or upgrade its technology and sales skills so it builds a global customer base? For example, are there new products or services that would meet the needs of global clients in each of the local markets? Should they try to compete with the newer "hyper-local" offerings or move in a different direction? Brainstorm ways that Groupon might add value for its customers. How might Groupon build relationships with clients that are more socially complex, making Groupon's competencies more difficult to imitate?

mySTRATEGY

Looking Inside Yourself: What Is My Competitive Advantage?

We encourage you to apply what you have learned about competitive advantage to your career. Spend a few minutes looking at yourself to discover your own competitive advantage. If you have previous work experience, these questions should be from a work environment perspective. If you do not have any work experience yet, use these questions to evaluate a new workplace or as strategies for presenting yourself to a potential employer.

1. Write down your own strengths and weaknesses. What sort of organization will permit you to really leverage your strengths and keep you highly engaged in your work (person–organization fit)? Do some of your weaknesses need to be mitigated through additional training or mentoring from a more seasoned professional?

2. Personal capabilities also need to be evaluated over time. Are your strengths and weaknesses different today from what they were five years ago? What are you doing to make sure your capabilities are dynamic?
3. Are some of your strengths valuable, rare, and costly to imitate? How can you organize your work to help capture the value of your key strengths (or mitigate your weaknesses)? Are your strengths specific to one or a few employers, or are they more generally valuable in the marketplace? In general, should you be making investments in your human capital in terms of company-specific or market-general skills?
4. As an employee, how could you persuade your boss that you could be a vital source of sustainable competitive advantage? What evidence could you provide to make such an argument?

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CHAPTER

6

Business Strategy: Differentiation, Cost Leadership, and Blue Oceans

Chapter Outline

- 6.1 Business-Level Strategy: How to Compete for Advantage
 - Strategic Position*
 - Generic Business Strategies*
- 6.2 Differentiation Strategy: Understanding Value Drivers
 - Product Features*
 - Customer Service*
 - Complements*
- 6.3 Cost-Leadership Strategy: Understanding Cost Drivers
 - Cost of Input Factors*
 - Economies of Scale*
 - Learning Curve*
 - Experience Curve*
- 6.4 Business-Level Strategy and the Five Forces: Benefits and Risks
 - Differentiation Strategy: Benefits and Risks*
 - Cost-Leadership Strategy: Benefits and Risks*
- 6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership
 - Value Innovation*
 - Blue Ocean Strategy Gone Bad: "Stuck in the Middle"*
- 6.6 Implications for Strategic Leaders

Learning Objectives

- LO 6-1 Define business-level strategy and describe how it determines a firm's strategic position.
- LO 6-2 Examine the relationship between value drivers and differentiation strategy.
- LO 6-3 Examine the relationship between cost drivers and cost-leadership strategy.
- LO 6-4 Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.
- LO 6-5 Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.
- LO 6-6 Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

CHAPTER CASE 6 /

JetBlue Airways: Finding a New Blue Ocean?

WHEN JETBLUE AIRWAYS took to the skies, founder David Neeleman set out to pursue a blue ocean strategy. This type of competitive strategy combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs in those two distinct strategic positions. How is this done, and where did Neeleman's ideas come from?

At the age of 25, the young entrepreneur co-founded Morris Air, a charter air service that in 1993 was purchased by Southwest Airlines (SWA). Morris Air was a low-fare airline that pioneered many cost-saving practices that later became standard in the industry, such as e-ticketing. After working as an airline executive for SWA, Neeleman went on to launch JetBlue in 2000. When Neeleman established JetBlue, his strategy was to provide

air travel at even lower costs than SWA. At the same time, he wanted to offer better service and more amenities than the legacy carriers such as American, Delta, or United. To sum it up, JetBlue's Customer Bill of Rights declares its dedication to bringing humanity back to air travel.

To implement a blue ocean strategy, JetBlue focused on lowering operating costs while driving up perceived customer value in its service offerings. In particular, JetBlue copied and improved upon many of SWA's cost-reducing activities. It initially used just one type of airplane (the Airbus A-320) to lower the costs of aircraft maintenance and pilot and crew training. It also chose to fly point to point, directly connecting highly trafficked city pairs. JetBlue specialized in transcontinental flights

connecting the East Coast (e.g., from its home base in New York) to the West Coast (e.g., Los Angeles). In contrast, legacy airlines such as American, Delta, or United use a hub-and-spoke system. This type of operating model connects many different locations via layovers at airport hubs. The point-to-point model focuses on directly connecting fewer but more highly trafficked city pairs. This model lowers costs by not offering baggage transfers and schedule coordination with other airlines. In addition, JetBlue flies longer distances and transports more passengers per flight than SWA, further driving down its costs. Initially, JetBlue enjoyed the lowest cost per available seat-mile (an

important performance metric in the airline industry) in the United States.

At the same time, JetBlue also enhanced its differential appeal by driving up its perceived value. Its mantra was to combine high-touch—to enhance the customer experience—and high-tech—to drive down costs. Because roughly one-third of customers prefer speaking to a live reservation agent, despite a highly functional website for reservations and other



JetBlue offers its Mint luxury experience, which includes a lie-flat bed up to 6 feet 8 inches long, a high-resolution personal screen, and free in-flight high-speed Wi-Fi, on many domestic U.S. routes. Other U.S. competitors offer such amenities only on very few routes.
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travel-related services, JetBlue decided to use work-from-home employees in the United States instead of following industry best practice by outsourcing its reservation system. Some of JetBlue's other value-enhancing features include high-end 100-seat Embraer regional jets with leather seats, free movie and television programming via DirecTV, XM Satellite Radio, along with friendly and attentive on-board service. Other amenities include its recently added Mint class, which is a luxury version of first-class travel. The Mint service features small private suites with a lie-flat bed up to 6 feet 8 inches long, a high-resolution personal screen, and free in-flight high-speed Wi-Fi ("Fly-Fi"). It also features other amenities such as personal check-in and early boarding, free bag checking

and priority bag retrieval after flight, and complimentary gourmet food and alcoholic beverages in flight.

For JetBlue, pursuing a blue ocean strategy by combining a cost-leadership position with a differentiation strategy resulted in a competitive advantage in its early years. Although the idea of combining different business strategies seems appealing, it is quite difficult to execute a cost-leadership and differentiation position at the same time. This is because cost leadership and differentiation are distinct strategic positions. Pursuing them simultaneously results in trade-offs that work against each other. For instance, higher perceived customer value (e.g., providing leather seats throughout the entire aircraft and free Wi-Fi) comes with higher costs. These trade-offs caught up with JetBlue. Between 2007 and 2015, the airline upstart faced severe turbulence after several high-profile mishaps (e.g., passengers stranded on the tarmac for hours after a snowstorm, emergency landings, erratic pilot and crew behaviors). These public relations disasters compounded the fundamental difficulty of resolving the need to limit costs while providing superior customer service and in-flight amenities.

This fundamental conflict was not apparent at first. In its early days, JetBlue could use value innovation to drive up perceived customer value even while lowering operating costs. The approach can work when an airline is small and connecting a few highly profitable city routes. But as the airline grew, its blue ocean strategy started to fray. As a consequence of such factors, JetBlue experienced a sustained competitive disadvantage for a number of years. The airline removed founder Neeleman as CEO in 2007. He left to found Azul, a Brazilian airline, in 2008. (In 2017 Azul was a publicly listed company on both the NYSE and the Sao Paulo exchanges with positive results; Azul is currently the third-largest airline in Brazil.)

Meanwhile, unable to overcome challenges in its profit and market share, the JetBlue board of directors in 2015 accepted the resignation of then CEO David Barger and appointed Robin Hayes to replace him. Formerly with British Airways for almost 20 years, Hayes wasted no time in sharpening JetBlue's strategic profile, doubling down on its blue ocean strategy as he attempted to lower operating costs while increasing perceived value creation. To drive down costs, he decided to add more seats to each plane, reducing legroom in coach (now on par with the legacy carriers). Other areas of cost savings included mainly aircraft maintenance and crew scheduling. At the same time, Hayes also expanded the Mint class offerings to many more flights, providing a product that customers love and that some other airlines lack.

JetBlue is also considering adding a new airplane (Airbus A-321) to its fleet, which scores significantly higher in customer satisfaction surveys than the older A-320. Although JetBlue already flies internationally by serving destinations in Central and South America as well as the Caribbean, Hayes is considering adding selected flights to Europe in the future. Flying non-stop to cities in Europe is now possible with new Airbus A-321. Flying longer, non-stop routes drives down costs. International routes, moreover, tend to be much more profitable than domestic routes because of less competition, for the time being.

JetBlue is now the sixth-largest airline in the United States, right after the "big four" (Delta, SWA, American, and United) and Alaska Airlines, which beat out JetBlue in acquiring Virgin America in 2016. Noteworthy is also that the "big four" airlines control more than 80 percent of the U.S. domestic market, so the industry is fairly concentrated.¹

You will learn more about JetBlue by reading this chapter; related questions appear in "ChapterCase 6 / Consider This . . ."

 **THE CHAPTERCASE** illustrates how JetBlue ran into trouble by pursuing two different business strategies at the same time—a *cost-leadership* strategy, focused on low cost, and a *differentiation* strategy, focused on delivering unique features and service. Although the idea of combining different business strategies seems appealing, it is quite difficult to execute a cost-leadership and differentiation position at the same time. This is because cost leadership and differentiation are distinct strategic positions. Pursuing them simultaneously results in trade-offs that work against each other. For instance, higher perceived customer value (e.g., providing leather seats throughout the entire aircraft and free Wi-Fi) comes with higher costs.

Many firms that attempt to combine cost-leadership and differentiation strategies end up being *stuck in the middle*. In this situation, strategic leaders have failed to carve out a clear *strategic position*. In their attempt to be everything to everybody, these firms end up being neither a low-cost leader nor a differentiator (thus the phrase *stuck in the middle* between

the two distinct strategic positions). This common strategic failure contributed to JetBlue's sustained competitive disadvantage during the 2007 to 2015 time period. Strategic leaders need to be aware to not end up being *stuck in the middle* between distinct business strategies. A clear strategic position—either as differentiator or low-cost leader—is more likely to form the basis for competitive advantage. Although quite attractive at first glance, a *blue ocean strategy* is difficult to implement because of the trade-offs between the two distinct strategic positions (low-cost leadership and differentiation), unless the firm is successful in *value innovation* that allows a reconciliation of these inherent trade-offs (discussed in detail later).

This chapter, the first in Part 2 on strategy *formulation*, takes a close look at business-level strategy, frequently also referred to as *competitive strategy*. It deals with *how* to compete for advantage. Based on the analysis of the external and internal environments (presented in Part 1), the second step in the *AFI Strategy Framework* is to formulate a business strategy that enhances the firm's chances of achieving a competitive advantage.

We begin our discussion of strategy formulation by defining *business-level strategy*, *strategic position*, and *generic business strategies*. We then look at two key generic business strategies: *differentiation* and *cost leadership*. We pay special attention to value and cost drivers that managers can use to carve out a clear strategic profile. Next, we relate the two business-level strategies to the external environment, in particular, to the five forces, to highlight their respective benefits and risks. We then introduce the notion of *blue ocean strategy*—using *value innovation* to combine a differentiation and cost-leadership strategic position. We also look at changes in competitive positioning over time before concluding with practical *Implications for Strategic Leaders*.

6.1 Business-Level Strategy: How to Compete for Advantage

Business-level strategy details the goal-directed actions managers take in their quest for competitive advantage when competing in a single product market.² It may involve a single product or a group of similar products that use the same distribution channel. It concerns the broad question, “How should we compete?” To formulate an appropriate business-level strategy, managers must answer the who, what, why, and how questions of competition:

- Who—which customer segments will we serve?
- What customer needs, wishes, and desires will we satisfy?
- Why do we want to satisfy them?
- How will we satisfy our customers' needs?³

To formulate an effective business strategy, managers need to keep in mind that competitive advantage is determined jointly by *industry* and *firm* effects. As shown in Exhibit 6.1, one route to competitive advantage is shaped by *industry effects*, while a second route is determined by *firm effects*. As discussed in Chapter 3, an industry's profit potential can be assessed using the five forces framework plus the availability of complements. Managers need to be certain that the business strategy is aligned with the five forces that shape competition. They can evaluate performance differences among clusters of firms in the same industry by conducting a strategic-group analysis. The concepts introduced in Chapter 4 are key in understanding firm effects because they allow us to look inside firms and explain why they differ based on their resources, capabilities, and competencies. It is also important to note that industry and firm effects are not independent, but rather they are *interdependent*, as shown by the two-pointed arrow connecting industry effects and firm effects in Exhibit 6.1. At the firm level, performance is determined by value and cost positions *relative* to competitors. This is the firm's *strategic position*, to which we turn next.

LO 6-1

Define business-level strategy and describe how it determines a firm's strategic position.

business-level strategy The goal-directed actions managers take in their quest for competitive advantage when competing in a single product market.

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EXHIBIT 6.1 / Industry and Firm Effects Jointly Determine Competitive Advantage



STRATEGIC POSITION

We noted in Chapter 5 that competitive advantage is based on the difference between the *perceived value* a firm is able to create for consumers (V), captured by how much consumers are willing to pay for a product or service, and the total cost (C) the firm incurs to create that value. The greater the *economic value created* ($V - C$), the greater is a firm's potential for competitive advantage. To answer the business-level strategy question of how to compete, managers have two primary competitive levers at their disposal: value (V) and cost (C).

A firm's business-level strategy determines its *strategic position*—its strategic profile based on value creation and cost—in a specific product market. A firm attempts to stake out a valuable and unique position that meets customer needs while simultaneously creating as large a gap as possible between the value the firm's product creates and the cost required to produce it. Higher value creation tends to require higher cost. To achieve a desired strategic position, managers must make **strategic trade-offs**—choices between a cost or value position. Managers must address the tension between value creation and the pressure to keep cost in check so as not to erode the firm's economic value creation and profit margin. As shown in the ChapterCase, JetBlue experienced a competitive disadvantage for a number of years because it was unable to effectively address the strategic trade-offs inherent in pursuing a cost-leadership *and* differentiation strategy at the same time. A business strategy is more likely to lead to a competitive advantage if a firm has a clear strategic profile, either as differentiator *or* a low-cost leader. A *blue ocean strategy* is only successful, in contrast, if the firm can implement some type of value innovation that reconciles the inherent trade-off between value creation and underlying costs.

strategic trade-offs Choices between a cost or value position. Such choices are necessary because higher value creation tends to generate higher cost.

differentiation strategy Generic business strategy that seeks to create higher value for customers than the value that competitors create, while containing costs.

GENERIC BUSINESS STRATEGIES

There are two fundamentally different generic business strategies—*differentiation* and *cost leadership*. A **differentiation strategy** seeks to create higher value for customers than the value that competitors create, by delivering products or services with unique features while

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keeping costs at the same or similar levels, allowing the firm to charge higher prices to its customers. A **cost-leadership strategy**, in contrast, seeks to create the same or similar value for customers by delivering products or services at a lower cost than competitors, enabling the firm to offer lower prices to its customers.

These two business strategies are called *generic strategies* because they can be used by any organization—manufacturing or service, large or small, for-profit or nonprofit, public or private, domestic or foreign—in the quest for competitive advantage, independent of industry context. Differentiation and cost leadership require distinct strategic positions, and in turn increase a firm's chances to gain and sustain a competitive advantage.⁴ Because value creation and cost tend to be positively correlated, however, important trade-offs exist between value creation and low cost. A business strategy, therefore, is more likely to lead to a competitive advantage if it allows firms to either *perform similar activities differently* or *perform different activities* than their rivals that result in creating more value or offering similar products or services at lower cost.⁵

When considering different business strategies, managers also must define the **scope of competition**—whether to pursue a specific, narrow part of the market or go after the broader market.⁶ The automobile industry provides an example of the *scope of competition*. Alfred P. Sloan, longtime president and CEO of GM, defined the carmaker's mission as providing a car for every purse and purpose. GM was one of the first to implement a multidivisional structure in order to separate the brands into strategic business units, allowing each brand to create its unique strategic position (with its own profit and loss responsibility) within the broad automotive market. For example, GM's product lineup ranges from the low-cost-positioned Chevy brand to the differentiated Cadillac brand. In this case, Chevy is pursuing a broad cost-leadership strategy, while Cadillac is pursuing a broad differentiation strategy. The two different business strategies are integrated at the corporate level at GM (more on *corporate strategy* in Chapters 8 and 9). On the other hand, Tesla, the maker of all-electric cars (featured in ChapterCase 1), offers a highly differentiated product and pursues only a small market segment. At this point, it uses a *focused differentiation strategy*. In particular, Tesla focuses on environmentally conscious consumers who are willing to pay a premium price. Going forward, Tesla is hoping to broaden its competitive scope with its new Model 3, priced at roughly half of the existing models (Model S sedan and Model X sport utility crossover). Taken together, GM's competitive scope is broad—with a focus on the mass automotive market—while Tesla's competitive scope is narrow—with a focus on all-electric luxury cars.

Now we can combine the dimensions describing a firm's strategic position (*differentiation versus cost*) with the scope of competition (*narrow versus broad*). As shown in Exhibit 6.2, by doing so we get the two major broad business strategies (*cost leadership* and *differentiation*), shown as the top two boxes in the matrix, and the *focused* version of each, shown as the bottom two boxes in the matrix. The focused versions of the two

cost-leadership strategy Generic business strategy that seeks to create the same or similar value for customers at a lower cost.

scope of competition The size—narrow or broad—of the market in which a firm chooses to compete.

EXHIBIT 6.2 / Strategic Position and Competitive Scope: Generic Business Strategies



SOURCE: Adapted from M.E. Porter (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

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focused cost-leadership strategy

Same as the cost-leadership strategy except with a narrow focus on a niche market.

focused differentiation strategy

Same as the differentiation strategy except with a narrow focus on a niche market.

business strategies—**focused cost-leadership strategy** and **focused differentiation strategy**—are essentially the same as the broad generic strategies *except* that the competitive scope is narrower. For example, the manufacturing company BIC pursues a focused cost-leadership strategy, designing and producing disposable pens and cigarette lighters at a low cost, while Mont Blanc pursues a focused differentiation strategy, offering exquisite pens—what it calls “writing instruments”—frequently priced at several hundred dollars.

As discussed in Chapter Case 6, JetBlue attempts to combine a focused cost-leadership position with a focused differentiation position. Although initially successful, JetBlue has been consistently outperformed for several years by airlines that do not attempt to straddle different strategic positions, but rather have a clear strategic profile as either a differentiator or a low-cost leader. For example, Southwest Airlines competes clearly as a broad cost leader (and would be placed squarely in the upper-left quadrant of Exhibit 6.2). The legacy carriers—Delta, American, and United—all compete as broad differentiators (and would be placed in the upper-right quadrant of Exhibit 6.2). Regionally, we find smaller airlines that are ultra low cost, such as Allegiant Air, Frontier Airlines, or Spirit Airlines, with a very clear strategic position. These smaller airlines would be placed in the lower-left quadrant of Exhibit 6.2 because they are pursuing a focused cost-leadership strategy. Based on a clear strategic position, these airlines have outperformed JetBlue over many years. The reason is that JetBlue appears to be stuck between different strategic positions, trying to combine a focused cost-leadership position with focused differentiation. As JetBlue grew, the problems inherent in an attempt to straddle different strategic positions grew more severe because JetBlue now attempts to also straddle the (broad) cost-leadership position with the (broad) differentiation position, thus trying to be everything to everybody. Being stuck in the middle of different strategic positions is a recipe for inferior performance and competitive disadvantage—and this is exactly what JetBlue has experienced between 2007 and 2015. Over the past few years, JetBlue has performed roughly on par with the industry average, as determined by the Dow Jones Airlines Index, including the big four airlines (American, Delta, SWA, and United) as well as smaller airlines such as Alaska Airlines, Allegiant Air, and Spirit. Part of JetBlue’s ability to close its performance gap is the highly successful rollout of the Mint experience, which offers first-class travel at a discount. Indeed, on routes where JetBlue offers its Mint experience (such as flying coast to coast), the legacy airlines have dropped their first-class prices significantly to be competitive with JetBlue. Many customers, however, feel that the Mint travel experience is superior to first-class travel on traditional airlines.⁷

LO 6-2

Examine the relationship between value drivers and differentiation strategy.

6.2 Differentiation Strategy: Understanding Value Drivers

The goal of a differentiation strategy is to add unique features that will increase the perceived value of goods and services in the minds of consumers so they are willing to pay a higher price. Ideally, a firm following a differentiation strategy aims to achieve in the minds of consumers a level of value creation that its competitors cannot easily match. The focus of competition in a differentiation strategy tends to be on unique product features, service, and new-product launches, or on marketing and promotion rather than price.

Several competitors in the bottled-water industry provide a prime example of pursuing a successful differentiation strategy.⁸ As more and more consumers shift from carbonated soft drinks to healthier choices, the industry for bottled water is booming—growing

about 10 percent per year. In the United States, the per person consumption of bottled water surpassed that of carbonated soft drinks for the first time in 2016. Such a fast-growing industry provides ample opportunity for differentiation. In particular, the industry is split into two broad segments depending on the sales price. Bottled water with a sticker price of \$1.30 or less per 32 ounces (close to one liter) is considered low-end, while those with a higher price tag are seen as luxury items. For example, PepsiCo's Aquafina and Coca-Cola's Dasani are considered low-end products, selling purified tap water at low prices, often in bulk at big-box retailers such as Walmart. On the premium end, PepsiCo introduced Lifewtr with a splashy ad during Super Bowl LI in 2017, while Jennifer Aniston markets Smartwater, Coca-Cola's premium water.

The idea of selling premium water is not new, however. Evian (owned by Danone, a French consumer products company) and Pellegrino (owned by Nestlé of Switzerland) have long focused on differentiating their products by emphasizing the uniqueness of their respective natural sources (Evian hails from the French Alps while Pellegrino comes from San Pellegrino Terme in Italy's Lombardy region). Recent entrants into the luxury segment for bottled water have taken the differentiation of their products to new heights. Some purveyors, such as Svalbardi, are able to charge super premium prices. At upscale retailer Harrods in London, a bottle of Svalbardi costs about \$100 for 25 ounces; the water, sold in a heavy glass bottle, hails from Norwegian icebergs some 4,000 years old. Ordering premium bottled water in the United States to accompany lunch has become a status symbol. Indeed, many restaurants now feature water lists besides the more traditional wine selection. "Energy waters" enhanced with minerals and vitamins are the fastest-growing segment. Although flavored waters make up less than 5 percent of the overall market for bottled water, they rack up 15 percent of total revenues. And this is nothing to be snuffed at: The market for bottled water globally reached some \$150 billion, and continues to grow fast. Although a free substitute can be had from most taps in industrialized countries, the success of many luxury brands in the bottled-water industry shows the power of differentiation strategy.

A company that uses a differentiation strategy can achieve a competitive advantage as long as its economic value created ($V - C$) is greater than that of its competitors. Firm A in Exhibit 6.3 produces a generic commodity. Firm B and Firm C represent two efforts at differentiation. Firm B not only offers greater value than Firm A, but also maintains *cost parity*, meaning it has the same costs as Firm A. However, even if a firm fails to achieve cost parity (which is often the case because higher value creation tends to go along with higher costs in terms of higher-quality raw materials, research and development, employee training to provide superior customer service, and so on), it can still gain a competitive advantage if its economic value creation exceeds that of its competitors. Firm C represents just such a competitive advantage. For the approach shown *either* in Firm B or Firm C, economic value creation, $(V - C)_B$ or $(V - C)_C$, is greater than that of Firm A $(V - C)_A$. Either Firm B or C, therefore, achieves a competitive advantage because it has a higher value gap over Firm A [$(V - C)_B > (V - C)_A$, or $(V - C)_C > (V - C)_A$], which allows it to charge a premium price, reflecting its higher value creation. To complete the relative



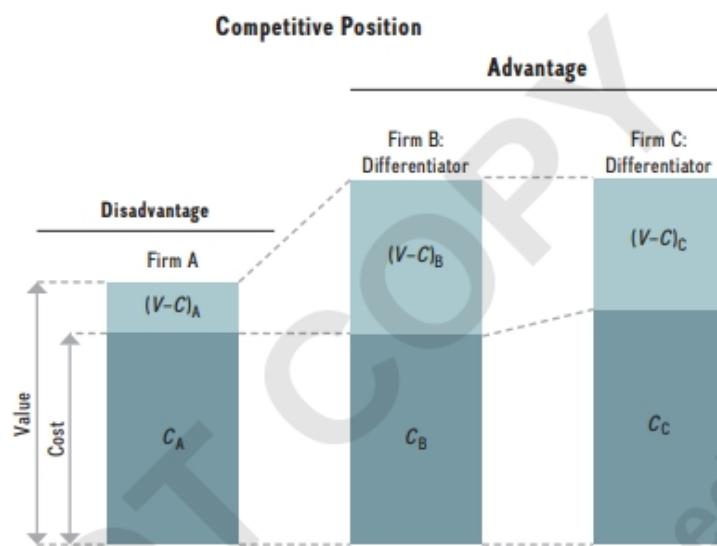
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EXHIBIT 6.3 /

Differentiation Strategy: Achieving Competitive Advantage

Under a differentiation strategy, firms that successfully differentiate their products enjoy a competitive advantage. Firm A's product is seen as a generic commodity with no unique brand value. Firm B has the same cost structure as Firm A but creates more economic value, and thus has a competitive advantage over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$. Although, Firm C has higher costs than Firm A and B, it still generates a significantly higher economic value than Firm A.



comparison, although both companies pursue a differentiation strategy, Firm B also has a competitive advantage over Firm C because although both offer identical value, Firm B has lower cost, thus $(V - C)_B > (V - C)_C$.

Although increased value creation is a defining feature of a differentiation strategy, managers must also control costs. Rising costs reduce economic value created and erode profit margins. Indeed, if cost rises too much as the firm attempts to create more perceived value for customers, its value gap shrinks, negating any differentiation advantage. One reason JetBlue could not maintain an initial competitive advantage was because it was unable to keep its costs down sufficiently. JetBlue's new management team immediately put measures in place to lower the airline's cost structure such as charging fees for checked bags and reducing leg space to increase passenger capacity on each of its planes. These cost-saving initiatives should increase its economic value creation.

Although a differentiation strategy is generally associated with premium pricing, managers have an important second pricing option. When a firm is able to offer a differentiated product or service and can control its costs at the same time, it is able to gain market share from other firms in the industry by charging a similar price but offering more perceived value. By leveraging its differentiated appeal of superior customer service and quality, for example, Marriott offers a line of different hotels: its flagship Marriott full-service business hotel equipped to host large conferences; Residence Inn for extended stay; Marriott Courtyard for business travelers; and Marriott Fairfield Inn for inexpensive leisure and family travel.⁹ Although these hotels are roughly comparable to competitors in price, they generally offer a higher perceived value. With this line of different hotels, Marriott can benefit from economies of scale and scope, and thus keep its cost structure in check. *Economies of scale* denote decreases in cost per unit as output increases (more in the next section when we discuss cost-leadership strategy). **Economies of scope** describe the savings that come from producing two (or more) outputs at less cost than producing each output individually, even though using the same resources and technology. This larger difference between cost and value allows Marriott to achieve greater economic value than its competitors, and thus to gain market share and post superior performance.

economies of scope Savings that come from producing two (or more) outputs at less cost than producing each output individually, despite using the same resources and technology.

Managers can adjust a number of different levers to improve a firm's strategic position. These levers either increase perceived value or decrease costs. Here, we will study the most salient *value drivers* that managers have at their disposal (we look at cost drivers in the next section).¹⁰ They are:

- Product features
- Customer service
- Complements

These value drivers are related to a firm's expertise in, and organization of, different internal value chain activities. Although these are the most important value drivers, no such list can be complete. Applying the concepts introduced in this chapter should allow strategic leaders to identify other important value and cost drivers unique to their business.

When attempting to increase the perceived value of the firm's product or service offerings, managers must remember that the different value drivers contribute to competitive advantage *only if* their increase in value creation (ΔV) exceeds the increase in costs (ΔC). The condition of $\Delta V > \Delta C$ must be fulfilled if a differentiation strategy is to strengthen a firm's strategic position and thus enhance its competitive advantage.

PRODUCT FEATURES

One of the obvious but most important levers that strategic leaders can adjust is product features, thereby increasing the perceived value of the product or service offering. Adding unique product attributes allows firms to turn commodity products into differentiated products commanding a premium price. Strong R&D capabilities are often needed to create superior product features. In the kitchen-utensil industry, OXO follows a differentiation strategy, highlighting product features. By adhering to its philosophy of making products that are easy to use for the largest variety of possible users,¹¹ OXO differentiates its kitchen utensils through its patent-protected ergonomically designed soft black rubber grips.



CUSTOMER SERVICE

Managers can increase the perceived value of their firms' product or service offerings by focusing on customer service. For example, the online retailer Zappos earned a reputation for superior customer service by offering free shipping both ways: to the customer and for returns.¹² Zappos's strategic leaders didn't view this as an additional expense but rather as part of their marketing budget. Moreover, Zappos does not outsource its customer service, and its associates do not use predetermined scripts. They are instead encouraged to build a relationship of trust with each individual customer. There seemed to be a good return on investment as word spread through the online shopping community. Competitors took notice, too; Amazon bought Zappos for over \$1 billion.¹³

COMPLEMENTS

When studying industry analysis in Chapter 3, we identified the availability of complements as an important force determining the profit potential of an industry. Complements add value

Trader Joe's is a chain of more than 400 stores, half of which are in California and the rest in another 38 states plus Washington, D.C. The chain is known for good products, value for money, clerks in Hawaiian shirts—and great customer service. As just one example, stores happily stock local products as requested by their communities.¹⁴

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to a product or service when they are consumed in tandem. Finding complements, therefore, is an important task for managers in their quest to enhance the value of their offerings.

A prime example of complements is smartphones and cellular services. A smartphone without a service plan is much less useful than one with a data plan. Traditionally, the providers of phones such as Apple, Samsung, and others did not provide wireless services. AT&T and Verizon are by far the two largest service providers in the United States, jointly holding some 70 percent of market share. To enhance the attractiveness of their phone and service bundles, phone makers and service providers frequently sign exclusive deals. When first released, for instance, service for the iPhone was exclusively offered by AT&T. Thus, if you wanted an iPhone, you had to sign up for a two-year service contract with AT&T.

Google, a division of Alphabet, decided to offer the important complements of smartphones and wireless services in-house to attract more customers.¹⁵ Google offers high-end phones such as the Pixel 2 with cutting-edge artificial intelligence built in (via its Google Assistant) at competitive prices. It combines this with discounted high-speed wireless services in its Project Fi, a complementary offering. Working in conjunction with smaller wireless service providers such as Sprint and T-Mobile, Google provides seamless wireless services by stitching together a nationwide network of services based on available free Wi-Fi hotspots (such as at Starbucks) and cellular networks offered by Sprint or T-Mobile. This not only enables wide coverage, but also reduces data usage significantly because Google phones automatically switch to free Wi-Fi networks wherever available.

Project Fi is intended to drive more demand for Google's phone; sales have been lackluster thus far. Stronger demand for Google's phones locks more users into the Google ecosystem as its wireless services are available only with its own phones. This provides an example where complementary product and service offerings not only reinforce demand for one another, but also create a situation where network externalities can arise. As more users sign up for Project Fi, Google is able to offer faster and more reliable services (through investing more into the latest technology, such as 5G), making its network and with it its Google phones more attractive to more users, and so forth.

As you have just seen, the differentiation strategy covers a great deal of ground, so let's summarize what we have learned. By choosing the differentiation strategy as the strategic position for a product, managers focus their attention on adding value to the product through its unique features that respond to customer preferences, customer service during and after the sale, or effective marketing that communicates the value of the product's features. Although this positioning involves increased costs (for example, higher-quality inputs or innovative research and development activities), customers will be willing to pay a premium price for the product or service that satisfies their needs and preferences. In the next section, we will discuss how managers formulate a cost-leadership strategy.

LO 6-3

Examine the relationship between cost drivers and cost-leadership strategy.

6.3 Cost-Leadership Strategy: Understanding Cost Drivers

The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors while offering adequate value. The *cost leader*, as the name implies, focuses its attention and resources on reducing the cost to manufacture a product or on lowering the operating cost to deliver a service in order to offer lower prices to its customers. The cost leader attempts to optimize all of its value chain activities to achieve a low-cost position. Although staking out the lowest-cost position in the industry is the overriding strategic objective, a cost leader still needs to offer products and services of acceptable value. As an example, GM and Korean car manufacturer Kia offer some models that compete directly with one another, yet Kia's cars tend to be produced at lower cost, while providing a similar value proposition.

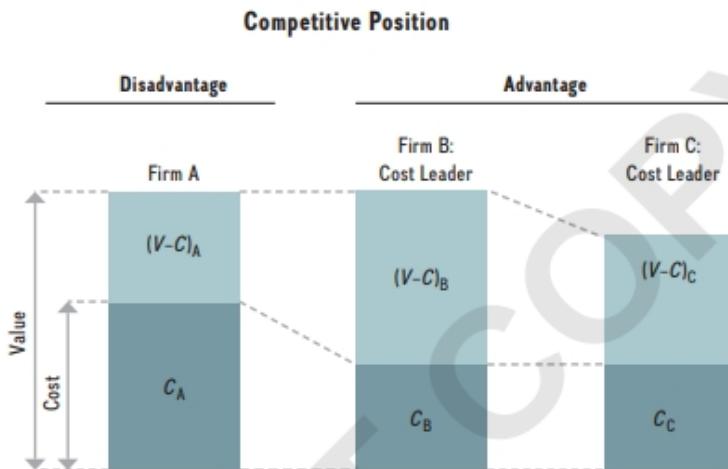


EXHIBIT 6.4 /

Cost-Leadership Strategy: Achieving Competitive Advantage

Under a cost-leadership strategy, firms that can keep their costs at the lowest point in the industry while offering acceptable value are able to gain a competitive advantage. Firm A has not managed to take advantage of possible cost savings, and thus experiences a competitive disadvantage. The offering from Firm B has the same perceived value as Firm A but through more effective cost containment creates more economic value (over both Firm A and Firm C because $(V - C_B) > (V - C_C) > (V - C_A)$). The offering from Firm C has a lower perceived value than that of Firm A or B and has the same reduced product cost as with Firm B; as a result, Firm C still generates higher economic value than Firm A.

A cost leader can achieve a competitive advantage as long as its economic value created ($V - C$) is greater than that of its competitors. Firm A in Exhibit 6.4 produces a product with a cost structure vulnerable to competition. Firms B and C show two different approaches to cost leadership. Firm B achieves a competitive advantage over Firm A because Firm B not only has lower cost than Firm A, but also achieves *differentiation parity* (meaning it creates the same value as Firm A). As a result, Firm B's economic value creation, $(V - C)_B$, is greater than that of Firm A, $(V - C)_A$. For example, as the low-cost leader, Walmart took market share from Kmart, which subsequently filed for bankruptcy.

What if a firm fails to create differentiation parity? Such parity is often hard to achieve because value creation tends to go along with higher costs, and Firm B's strategy is aimed at lower costs. A firm can still gain a competitive advantage as long as its economic value creation exceeds that of its competitors. Firm C represents this approach to cost leadership. Even with lower value (no differentiation parity) but lower cost, Firm C's economic value creation, $(V - C)_C$, still is greater than that of Firm A, $(V - C)_A$.

In both approaches to cost leadership in Exhibit 6.4, Firm B's economic value creation is greater than that of Firm A and Firm C. Yet, both firms B and C achieve a competitive advantage over Firm A. Either one can charge prices similar to its competitors and benefit from a greater profit margin per unit, or it can charge lower prices than its competition and gain higher profits from higher volume. Both variations of a cost-leadership strategy can result in competitive advantage. Although Firm B has a competitive advantage over both firms A and C, Firm C has a competitive advantage in comparison to Firm A.

Although companies successful at cost leadership must excel at controlling costs, this doesn't mean that they can neglect value creation. Kia signals the quality of its cars with a five-year, 60,000-mile warranty, one of the more generous warranties in the industry. Walmart offers products of acceptable quality, including many brand-name products.

The most important *cost drivers* that managers can manipulate to keep their costs low are:

- Cost of input factors.
- Economies of scale.
- Learning-curve effects.
- Experience-curve effects.

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However, this list is only a starting point; managers may consider other cost drivers, depending on the situation.

COST OF INPUT FACTORS

One of the most basic advantages a firm can have over its rivals is access to lower-cost input factors such as raw materials, capital, labor, and IT services. In the market for international long-distance travel, the greatest competitive threat facing U.S. legacy carriers—American, Delta, and United—comes from three fast-growing airlines located in the Persian Gulf states—Emirates, Etihad, and Qatar. These airlines achieve a competitive advantage over their U.S. counterparts thanks to lower-cost inputs—raw materials (access to cheaper fuel), capital (interest-free government loans), labor—and fewer regulations (for example, regarding nighttime takeoffs and landings, or in adding new runways and building luxury airports with swimming pools, among other amenities).¹⁶ To benefit from lower-cost IT services, the Gulf carriers also outsource some value chain activities such as booking and online customer service to India. Together, these distinct cost advantages across several key input factors add up to create a greater economic value creation for the Gulf carriers vis-à-vis U.S. competitors, leading to a competitive advantage (more on the Gulf carriers in Strategy Highlight 10.1).

ECONOMIES OF SCALE

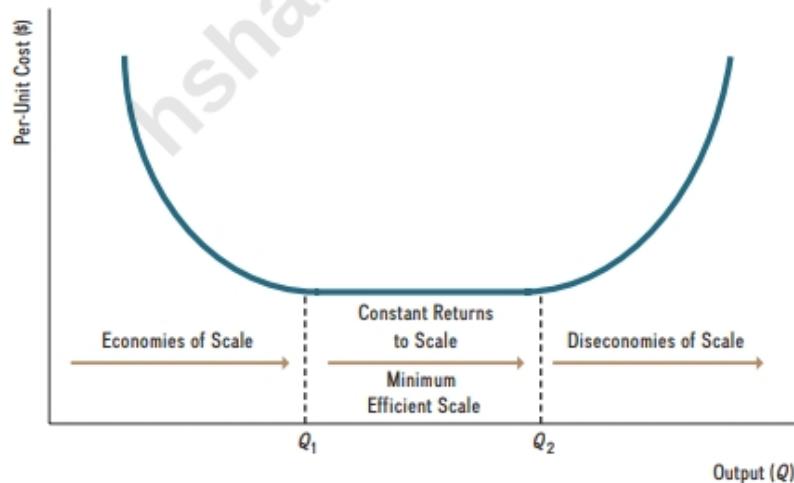
economies of scale Decreases in cost per unit as output increases.

Firms with greater market share might be in a position to reap **economies of scale**, decreases in cost per unit as output increases. This relationship between unit cost and output is depicted in the first (left-hand) part of Exhibit 6.5: Cost per unit falls as output increases up to point Q_1 . A firm whose output is closer to Q_1 has a cost advantage over other firms with less output. In this sense, bigger is better.

In the airframe-manufacturing industry, for example, reaping economies of scale and learning is critical for cost-competitiveness. The market for commercial airplanes is often not large enough to allow more than one competitor to reach sufficient scale to drive down unit cost. Boeing chose not to compete with Airbus in the market for superjumbo jets; rather, it decided to focus on a smaller, fuel-efficient airplane (the 787 Dreamliner, priced at roughly \$250 million) that allows for long-distance, point-to-point connections.

EXHIBIT 6.5 /

Economies of Scale, Minimum Efficient Scale, and Diseconomies of Scale



By 2017, it had built over 530 Dreamliners with more than 1,200 orders for the new airplane.¹⁷ Boeing can expect to reap significant economies of scale and learning, which will lower per-unit cost. At the same time, Airbus had delivered 210 A-380 superjumbos (sticker price: \$430 million) with more than 100 orders on its books.¹⁸ If both companies would have chosen to compete head-on in each market segment, the resulting per-unit cost for each airplane would have been much higher because neither could have achieved significant economies of scale (overall their market share split is roughly 50–50).

What causes per-unit cost to drop as output increases (up to point Q_1)? Economies of scale allow firms to:

- Spread their fixed costs over a larger output.
- Employ specialized systems and equipment.
- Take advantage of certain physical properties.

SPREADING FIXED COSTS OVER LARGER OUTPUT. Larger output allows firms to spread their fixed costs over more units. That is why gains in market share are often critical to drive down per-unit cost. This relationship is even more pronounced in many high-tech industries because most of the cost occurs before a single product or service is sold. Take operating systems software as an example. Microsoft spends over \$10 billion a year on research and development (R&D).¹⁹ Between 2011 and 2015, a good part of this was spent on developing Windows 10, its newest operating system software. This R&D expense was a fixed cost Microsoft had to incur before a single copy of Windows 10 was sold. However, once the initial version of the new software was completed, the marginal cost of each additional copy was basically zero, especially for copies sold in digital form online. Given that Microsoft dominates the operating system market for personal computers (PCs) with more than 90 percent market share, it expects to sell several hundred million copies of Windows 10, thereby spreading its huge fixed cost of development over a large output. Microsoft's huge installed base of Windows operating systems throughout the world allowed it to capture a large profit margin for each copy of Windows sold, after recouping its initial investment. Microsoft has high hopes for its newest operating system with the goal of bringing together not only PCs and mobile devices but also the Xbox One and other Windows devices. Microsoft's Windows 10 also drives sales for complementary products such as the ubiquitous Microsoft Office Suite made up of Word, Excel, PowerPoint, and Outlook, among other programs (as discussed in Chapter Case 5).

EMPLOYING SPECIALIZED SYSTEMS AND EQUIPMENT. Larger output also allows firms to invest in more specialized systems and equipment, such as enterprise resource planning (ERP) software or manufacturing robots. Tesla's strong demand for its new Model 3 sedan allows it to employ cutting-edge robotics in its Fremont, California, manufacturing plant to produce cars of the highest quality at large scale, and thus driving down costs.

TAKING ADVANTAGE OF CERTAIN PHYSICAL PROPERTIES. Economies of scale also occur because of certain physical properties. One such property is known as the *cube-square rule*: The volume of a body such as a pipe or a tank increases disproportionately more than its surface. This same principle makes big-box retail stores such as Walmart or The Home Depot cheaper to build and run. They can also stock much more merchandise and handle inventory more efficiently. Their huge size makes it difficult for department stores or small retailers to compete on cost and selection.

Look again at Exhibit 6.5. The output range between Q_1 and Q_2 in the figure is considered the **minimum efficient scale (MES)** to be cost-competitive. Between Q_1 and Q_2 , the returns to scale are constant. It is the output range needed to bring the cost per unit down as

minimum efficient scale (MES) Output range needed to bring down the cost per unit as much as possible, allowing a firm to stake out the lowest-cost position that is achievable through economies of scale.

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much as possible, allowing a firm to stake out the lowest-cost position achievable through economies of scale. With more than 10 million Prius cars sold since its introduction in 1997, Toyota has been able to reach the minimum efficient scale part of the per-unit cost curve. This allows the company to offer the car at a relatively low price and still make a profit.

The concept of minimum efficient scale applies not only to manufacturing processes but also to managerial tasks such as how to organize work. Due to investments in specialized technology and equipment (e.g., electric arc furnaces), Nucor is able to reach MES with much smaller batches of steel than larger, fully vertically integrated steel companies using older technology. Nucor's optimal plant size is about 500 people, which is much smaller than at larger integrated steelmakers such as U.S. Steel which often employ thousands of workers per plant.²⁰ Of course, minimum efficient scale depends on the specific industry: The average per-unit cost curve, depicted conceptually in Exhibit 6.5, is a reflection of the underlying production function, which is determined by technology and other input factors.

Benefits to scale cannot go on indefinitely, though. Bigger is not always better; in fact, sometimes bigger is worse. Beyond Q_2 in Exhibit 6.5, firms experience **diseconomies of scale**—increases in cost as output increases. As firms get too big, the complexity of managing and coordinating the production process raises the cost, negating any benefits to scale. Large firms also tend to become overly bureaucratic, with too many layers of hierarchy. They grow inflexible and slow in decision making. To avoid problems associated with diseconomies of scale, Gore Associates, maker of GORE-TEX fabric, Glide dental floss, and many other innovative products, breaks up its company into smaller units. Gore Associates found that employing about 150 people per plant allows it to avoid diseconomies of scale. It uses a simple decision rule:²¹ “We put 150 parking spaces in the lot, and when people start parking on the grass, we know it’s time to build a new plant.”²²

Finally, there are also physical limits to scale. Airbus is pushing the envelope with its A-380 aircraft, which can hold more than 850 passengers and fly up to 8,200 miles (enough to travel nonstop from Boston to Hong Kong at about 600 mph). The goal, of course, is to drive down the cost of the average seat-mile flown (CASM, a standard cost metric in the airline industry). It remains to be seen whether the A-380 superjumbo will enable airlines to reach minimum efficient scale or will simply be too large to be efficient. For example, boarding and embarking procedures must be streamlined to accommodate more than 850 people in a timely and safe manner. Many airports around the world need to be retrofitted with longer and wider runways to allow the superjumbo to take off and land.

Scale economies are critical to driving down a firm's cost and strengthening a cost-leadership position. Although managers need to increase output to operate at a minimum efficient scale (between Q_1 and Q_2 in Exhibit 6.5), they also need to be watchful not to drive scale beyond Q_2 , where they would encounter diseconomies. In sum, if the firm's output range is less than Q_1 or more than Q_2 , the firm is at a cost disadvantage; reaching an output level between Q_1 and Q_2 is optimal in regards to driving down costs. Monitoring the firm's cost structure closely over different output ranges allows managers to fine-tune operations and benefit from economies of scale.

LEARNING CURVE

Do learning curves go up or down? Looking at the challenge of learning, many people tend to see it as an uphill battle, and assume the learning curve goes up. But if we consider our productivity, learning curves go down, as it takes less and less time to produce the same output as we learn how to be more efficient—learning by doing drives down cost. As individuals and teams engage repeatedly in an activity, whether writing computer code, developing new medicines, or building submarines, they learn from their cumulative

diseconomies of scale Increases in cost per unit when output increases.

experience.²³ *Learning curves* were first documented in aircraft manufacturing as the United States ramped up production in the 1930s, before its entry into World War II.²⁴ Every time production was doubled, the per-unit cost dropped by a predictable and constant rate (approximately 20 percent).²⁵

It is not surprising that a learning curve was first observed in aircraft manufacturing. Highly complex, a modern commercial aircraft can contain more than 5 million parts, compared with a few thousand for a car. The more complex the underlying process to manufacture a product or deliver a service, the more learning effects we can expect. As cumulative output increases, managers learn how to optimize the process, and workers improve their performance through repetition.

TESLA'S LEARNING CURVE. Tesla's production of its Model S vehicle provides a more recent example, depicted in Exhibit 6.6, with the horizontal axis showing cumulative output in units and the vertical axis showing per-unit cost in thousands of dollars.²⁶

The California-based designer and manufacturer of all-electric cars made headlines in 2017 when its market capitalization overtook both GM and Ford. This was the first time in U.S. history that the most valuable U.S. car company is not based in Detroit, Michigan, but in Silicon Valley. In 2016, Tesla sold some 80,000 vehicles, while GM sold some 10 million. How can a start-up company that makes less than 1 percent as many vehicles as GM have a higher market valuation? The answer: Future expected growth. Investors bidding up Tesla's share price count on the maker of all-electric cars to sell millions of its new Model 3. When the Model 3 was announced in 2016, Tesla garnered some 400,000 preorders from future owners for a car that was not yet produced, let alone test-driven by any potential buyer.

Tesla's learning curve is critical in justifying such lofty stock market valuations, because as production volume increases, production cost per car falls, and the company becomes profitable. Based on a careful analysis of production reports for the Model S between 2012 and 2014²⁷, Exhibit 6.6 shows how Tesla was able to drive down the unit cost for each car as production volume ramped up. Initially, Tesla lost a significant amount of money on each Model S sold because of high upfront R&D spending to develop the futuristic

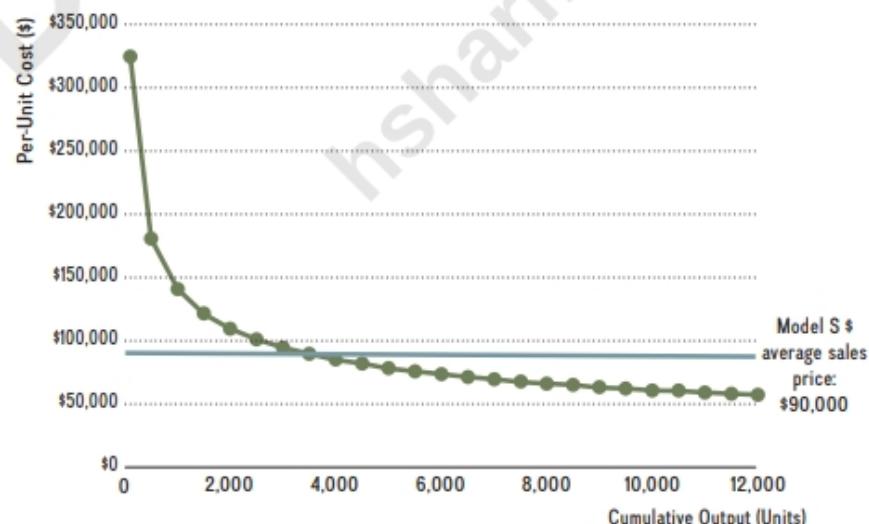


EXHIBIT 6.6 /

Tesla's Learning Curve
Producing the Model S

SOURCE: Depiction of functional relationship estimated in J. Dyer and H. Gregersen (2016), "Tesla's innovations are transforming the auto industry," *Forbes*, August 24.

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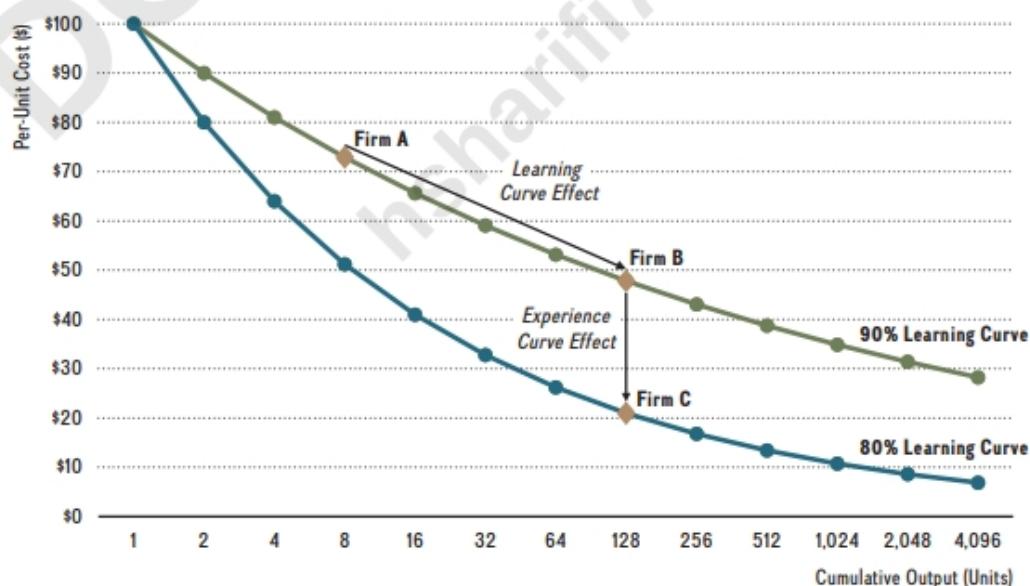
self-driving car. When producing only 1,000 vehicles, unit cost was \$140,000. As production volume of the Model S reached some 12,000 units per year (in 2014), unit cost fell to about \$57,000. Although still high, Tesla was able start making money on each car, because the average selling price for a Model S was about \$90,000.

The relationship between production volume and per-unit cost for Tesla (depicted in Exhibit 6.6) suggests that it is an 80 percent learning curve. In an 80 percent learning curve, per-unit cost drops 20 percent every time output is doubled. Assuming a similar relationship holds for the Model 3 production, then per-unit cost would fall to \$16,000 per Model 3 with a cumulative production volume of 400,000 (which is the number of preorders Tesla received within one week of announcing this new vehicle). Although the Model 3 base price is pegged at \$35,000, the estimated average selling price is more like \$50,000 given additional features and eventual expiration of a \$7,500 federal tax credit for electric vehicles (when a manufacturer hits 200,000 units). Riding down an 80 percent learning curve, Tesla could make a profit of an estimated \$34,000 per Model 3. This would translate to a cumulative profit for Tesla of more than \$13.5 billion for the Model 3 preorders alone. This back-of-the-envelope calculation shows some of the rationale behind Tesla's market capitalization exceeding that of GM and Ford.

Taken together, this example highlights not only the power of the learning curve in driving down per-unit costs, but also how critical cost containment is in gaining a competitive advantage when pursuing a differentiation strategy as Tesla does.

DIFFERENCES IN LEARNING CURVES. Let's now compare different learning curves, and explore their implications for competitive advantage. The steeper the learning curve, the more learning has occurred. As cumulative output increases, firms move down the learning curve, reaching lower per-unit costs. Exhibit 6.7 depicts two different learning curves: a 90 percent and an 80 percent learning curve. In a 90 percent learning curve, per-unit cost drops 10 percent every time output is doubled. The steeper 80 percent learning curve

EXHIBIT 6.7 / Gaining Competitive Advantage through Leveraging Learning- and Experience-Curve Effects



indicates a 20 percent drop every time output is doubled (this was the case in the Tesla example above). It is important to note that the learning-curve effect is driven by increasing cumulative output within the existing technology over time. That implies that the only difference between two points on the same learning curve is the size of the cumulative output. The underlying technology remains the same. The speed of learning determines the slope of the learning curve, or how steep the learning curve is (e.g., 80 percent is steeper than a 90 percent learning curve because costs decrease by 20 percent versus a mere 10 percent each time output doubles). In this perspective, *economies of learning* allow movement down a *given* learning curve based on current production technology.

By moving further down a given learning curve than competitors, a firm can gain a competitive advantage. Exhibit 6.7 shows that Firm B is further down the 90 percent learning curve than Firm A. Firm B leverages *economies of learning* due to larger cumulative output to gain an advantage over Firm A. The only variable that has changed is cumulative output; the technology underlying the 90 percent learning curve remained the same.

Let's continue with the example of manufacturing airframes. To be more precise, as shown in Exhibit 6.7, Firm A produces eight aircraft and reaches a per-unit cost of \$73 million per aircraft.²⁸ Firm B produces 128 aircraft using the same technology as Firm A (because both firms are on the same [90 percent] learning curve), but given a much larger cumulative output, its per unit-cost falls to only \$48 million. Thus, Firm B has a clear competitive advantage over Firm A, assuming similar or identical quality in output. We will discuss Firm C when we formally introduce the impact of changes in technology and process innovation.

Learning curves are a robust phenomenon observed in many industries, not only in manufacturing processes but also in alliance management, franchising, and health care.²⁹ For example, physicians who perform only a small number of cardiac surgeries per year can have a patient mortality rate five times higher than physicians who perform the same surgery more frequently.³⁰ Strategy Highlight 6.1 features Dr. Devi Shetty of India who reaped huge benefits by applying learning-curve principles to open-heart surgery, driving down cost while improving quality at the same time!

Learning effects differ from economies of scale (discussed earlier) as shown:

- **Differences in timing.** Learning effects occur *over time* as output accumulates, while economies of scale are captured at *one point in time* when output increases. The improvements in Tesla's production costs, featured earlier, resulted from some 12,000 units in cumulative output, but it took two years to reach this volume (see Exhibit 6.6). Although learning can decline or flatten (see Exhibit 6.7), there are no *diseconomies to learning* (unlike *diseconomies to scale* in Exhibit 6.5).
- **Differences in complexity.** In some production processes (e.g., the manufacture of steel rods), effects from economies of scale can be quite significant, while learning effects are minimal. In contrast, in some professions (brain surgery or the practice of estate law), learning effects can be substantial, while economies of scale are minimal.

Managers need to understand such differences to calibrate their business-level strategy. If a firm's cost advantage is due to economies of scale, a manager should worry less about employee turnover (and a potential loss in learning) and more about drops in production runs. In contrast, if the firm's low-cost position is based on complex learning, a manager should be much more concerned if a key employee (e.g., a star engineer) was to leave.

EXPERIENCE CURVE

In the *learning curve* just discussed, we assumed the underlying technology remained constant, while only cumulative output increased. In the *experience curve*, in contrast, we now change the underlying technology while holding cumulative output constant.³¹

Strategy Highlight 6.1

Dr. Shetty: "The Henry Ford of Heart Surgery"



©Namas Bhojani

Open-heart surgeries are complex medical procedures and loaded with risk. While well-trained surgeons using high-tech equipment are able to reduce mortality rates, costs for cardiac surgeries in the United States have climbed. Difficult heart surgeries can cost \$100,000 or more. A heart surgeon in India has driven the costs down to an average of \$2,000 per heart surgery, while delivering equal or better outcomes in terms of quality.

Dr. Devi Shetty's goal is to be "the Henry Ford of heart surgery." Just like the great American industrialist who applied the learning curve to drive down the cost of an automobile to make it affordable, so Dr. Shetty is reducing the costs of health care and making some of the most complex medical procedures affordable to the world's poorest. A native of Mangalore, India, Dr. Shetty was trained as a heart surgeon at Guy's Hospital in London, one of Europe's best medical facilities. He first came to fame in the 1990s when he successfully conducted an open-heart bypass surgery on Mother Teresa, after she suffered a heart attack.

Dr. Shetty believes that the key to driving down costs in health care is not product innovation, but process innovation. He is able to drive down the cost of complex medical procedures from \$100,000 to \$2,000 not by doing one big thing, but rather by focusing on doing a thousand small things. Dr. Shetty is applying the concept of the learning curve to make a complex procedure routine and comparatively inexpensive. Part of the Narayana Health group, Dr. Shetty's hospital in Bangalore, India, performs so many cardiac procedures per year that doctors are able to get a great deal of experience quickly, which allows them to specialize in one or two complex procedures. The Narayana surgeons perform two or three procedures a day for six days a week, compared to U.S. surgeons who perform one or two procedures a day for five

days a week. The difference adds up. Some of Dr. Shetty's surgeons perform more specialized procedures by the time they are in their 30s than their U.S. counterparts will perform throughout their entire careers. This volume of experience allows the cardiac surgeons to move down the learning curve quickly, because the more heart surgeries they perform, the more their skills improve. With this skill level, surgical teams develop robust standard operating procedures and processes, where team members become experts at their specific tasks.

This expertise improves outcomes while the learning-curve effects of performing the same procedures over time also save money (see Exhibit 6.7). Other factors provide additional cost savings. At the same time, Dr. Shetty pays his cardiac surgeons the going rate in India, between \$10,000 and \$250,000 a year, depending on experience. Their U.S. counterparts earn two to three times the average Indian salary.

Dr. Shetty's health group also reduces costs through economies of scale. By performing thousands of heart surgeries a year, high fixed costs such as the purchase of expensive medical equipment can be spread over a much larger volume. The Narayana hospital in Bangalore has 1,000 beds (many times larger than the average U.S. hospital with 160 beds) and some 20 operating rooms that stay busy pretty much around the clock. This scale allows the Narayana heart clinic to cost-effectively employ specialized high-tech equipment. Given the large size of Dr. Shetty's hospital, he also has significant buying power, driving down the costs of the latest high-tech equipment from top-notch vendors such as GE. Wherever possible, Dr. Shetty sources lower-cost inputs such as sutures locally, rather than from the more expensive companies such as Johnson & Johnson. Further, the Narayana heart clinic shares common services, such as laboratories and blood bank and more mundane services such as catering, with the 1,400-bed cancer clinic next door. Taken together, all of these small changes result in significant cost savings, and so create a reinforcing system of low-cost value chain activities.

While many worry that high volume compromises quality, the data suggest the opposite: Narayana Health's medical outcomes in terms of mortality rate are equal to or even lower than the best hospitals in the United States. The American College of Cardiology frequently sends surgeons and administrators to visit the Narayana heart clinic. The college concluded that the clinic provides high-tech and high-quality care at low cost. Dr. Shetty now brings top-notch care at low cost to the masses in India. Narayana Health runs a chain of over 30 hospitals in 20 locations throughout India and performs some 100,000 heart surgeries a year.³²

In general, technology and production processes do not stay constant. *Process innovation*—a new method or technology to produce an existing product—may initiate a new and steeper curve. Assume that Firm C, on the same learning curve as Firm B, implements a new production process (such as lean manufacturing). In doing so, Firm C initiates an entirely new and steeper learning curve. Exhibit 6.7 shows this *experience-curve effect* based on a process innovation. Firm C jumps down to the 80 percent learning curve, reflecting the new and lower-cost production process. Although Firm B and Firm C produce the same cumulative output (each making 128 aircraft), the per-unit cost differs. Firm B's per-unit cost for each airplane, being positioned on the less-steep 90 percent learning curve is \$48 million.³³ In contrast, Firm C's per-unit cost, being positioned on the steeper 80 percent learning curve because of process innovation, is only \$21 million per aircraft, and thus less than half of that of Firm B. Clearly, Firm C has a competitive advantage over Firm B based on lower cost per unit (assuming similar quality).

Learning by doing allows a firm to lower its per-unit costs by moving down a given learning curve, while experience-curve effects based on process innovation allow a firm to leapfrog to a steeper learning curve, thereby driving down its per-unit costs.

In Strategy Highlight 6.1, we saw how Dr. Shetty leveraged learning-curve effects to save lives while driving down costs. One could argue that his Narayana Health group not only moved down a given learning curve using best industry practice, but it also jumped down to a new and steeper learning curve through process innovation. Dr. Shetty sums up his business strategy based on cost leadership: “Japanese companies reinvented the process of making cars (by introducing lean manufacturing). That’s what we’re doing in health care. What health care needs is process innovation, not product innovation.”³⁴

In a cost-leadership strategy, managers must focus on lowering the costs of production while maintaining a level of quality acceptable to the customer. If firms can share the benefits of lower costs with consumers, cost leaders appeal to the bargain-conscious buyer, whose main criterion is price. By looking to reduce costs in each value chain activity, managers aim for the lowest-cost position in the industry. They strive to offer lower prices than competitors and thus to increase sales. Cost leaders such as Walmart (“Every Day Low Prices”) can profit from this strategic position over time.

6.4 Business-Level Strategy and the Five Forces: Benefits and Risks

The business-level strategies introduced in this chapter allow firms to carve out strong strategic positions that enhance the likelihood of gaining and sustaining competitive advantage. The five forces model introduced in Chapter 3 helps managers assess the forces—threat of entry, power of suppliers, power of buyers, threat of substitutes, and rivalry among existing competitors—that make some industries more attractive than others. With this understanding of industry dynamics, managers use one of the generic business-level strategies to protect themselves against the forces that drive down profitability.³⁵ Exhibit 6.8 details the relationship between competitive positioning and the five forces. In particular, it highlights the benefits and risks of differentiation and cost-leadership business strategies, which we discuss next.

LO 6-4

Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

DIFFERENTIATION STRATEGY: BENEFITS AND RISKS

A differentiation strategy is defined by establishing a strategic position that creates higher perceived value while controlling costs. The successful differentiator stakes out a unique strategic position, where it can benefit from imperfect competition (as discussed in Chapter 3) and command a premium price. A well-executed differentiation strategy reduces rivalry among competitors.

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EXHIBIT 6.8 Competitive Positioning and the Five Forces: Benefits and Risks of Differentiation and Cost-Leadership Business Strategies

Competitive Force	Differentiation		Cost Leadership	
	Benefits	Risks	Benefits	Risks
Threat of entry	<ul style="list-style-type: none">• Protection against entry due to intangible resources such as a reputation for innovation, quality, or customer service	<ul style="list-style-type: none">• Erosion of margins• Replacement	<ul style="list-style-type: none">• Protection against entry due to economies of scale	<ul style="list-style-type: none">• Erosion of margins• Replacement
Power of suppliers	<ul style="list-style-type: none">• Protection against increase in input prices, which can be passed on to customers	<ul style="list-style-type: none">• Erosion of margins	<ul style="list-style-type: none">• Protection against increase in input prices, which can be absorbed	<ul style="list-style-type: none">• Erosion of margins
Power of buyers	<ul style="list-style-type: none">• Protection against decrease in sales prices, because well-differentiated products or services are not perfect imitations	<ul style="list-style-type: none">• Erosion of margins	<ul style="list-style-type: none">• Protection against decrease in sales prices, which can be absorbed	<ul style="list-style-type: none">• Erosion of margins
Threat of substitutes	<ul style="list-style-type: none">• Protection against substitute products due to differential appeal	<ul style="list-style-type: none">• Replacement, especially when faced with innovation	<ul style="list-style-type: none">• Protection against substitute products through further lowering of prices	<ul style="list-style-type: none">• Replacement, especially when faced with innovation
Rivalry among existing competitors	<ul style="list-style-type: none">• Protection against competitors if product or service has enough differential appeal to command premium price	<ul style="list-style-type: none">• Focus of competition shifts to price• Increasing differentiation of product features that do not create value but raise costs• Increasing differentiation to raise costs above acceptable threshold	<ul style="list-style-type: none">• Protection against price wars because lowest-cost firm will win	<ul style="list-style-type: none">• Focus of competition shifts to non-price attributes• Lowering costs to drive value creation below acceptable threshold

SOURCES: Based on M.E. Porter (2008), "The Five Competitive Forces That Shape Strategy," *Harvard Business Review*, January; and M.E. Porter (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

A successful differentiation strategy is likely to be based on unique or specialized features of the product, on an effective marketing campaign, or on intangible resources such as a reputation for innovation, quality, and customer service. A rival would need to improve the product features as well as build a similar or more effective reputation in order to gain market share. The threat of entry is reduced: Competitors will find such intangible advantages time-consuming and costly, and maybe impossible, to imitate. If the source of the differential appeal is intangible rather than tangible (e.g., reputation rather than observable product and service features), a differentiator is even more likely to sustain its advantage.

Moreover, if the differentiator is able to create a significant difference between perceived value and current market prices, the differentiator will not be so threatened by

increases in input prices due to powerful suppliers. Although an increase in input factors could erode margins, a differentiator is likely able to pass on price increases to its customers as long as its value creation exceeds the price charged. Since a successful differentiator creates perceived value in the minds of consumers and builds customer loyalty, powerful buyers demanding price decreases are unlikely to emerge. A strong differentiated position also reduces the threat of substitutes, because the unique features of the product have been created to appeal to customer preferences, keeping them loyal to the product. By providing superior quality beverages and other food items combined with a great customer experience and a global presence, Starbucks has built a strong differentiated appeal. It has cultivated a loyal following of customers who reward it with repeat business.

The viability of a differentiation strategy is severely undermined when the focus of competition shifts to price rather than value-creating features. This can happen when differentiated products become commoditized and an acceptable standard of quality has emerged across rival firms. Although the iPhone was a highly differentiated product when introduced in 2007, touch-based screens and other once-innovative features are now standard in smartphones. Indeed, Android-based smartphones hold some 82 percent market share, while Apple's iOS phones hold about 18 percent.³⁶ Several companies including Google; Samsung and LG, both of South Korea; and low-cost leader Huawei of China are attempting to challenge Apple's ability to extract significant profits from the smartphone industry based on its iPhone franchise. A differentiator also needs to be careful not to overshoot its differentiated appeal by adding product features that raise costs but not perceived value in the minds of consumers. For example, any additional increase in screen resolution beyond Apple's retina display cannot be detected by the human eye at a normal viewing distance. Finally, a differentiator needs to be vigilant that its costs of providing uniqueness do not rise above the customer's willingness to pay.

COST-LEADERSHIP STRATEGY: BENEFITS AND RISKS

A cost-leadership strategy is defined by obtaining the lowest-cost position in the industry while offering acceptable value. The cost leader, therefore, is protected from other competitors because of having the lowest cost. If a price war ensues, the low-cost leader will be the last firm standing; all other firms will be driven out as margins evaporate. Since reaping economies of scale is critical to reaching a low-cost position, the cost leader is likely to have a large market share, which in turn reduces the threat of entry.

A cost leader is also fairly well isolated from threats of powerful suppliers to increase input prices, because it is more able to absorb price increases through accepting lower profit margins. Likewise, a cost leader can absorb price reductions more easily when demanded by powerful buyers. Should substitutes emerge, the low-cost leader can try to fend them off by further lowering its prices to reinstall relative value with the substitute. For example, Walmart tends to be fairly isolated from these threats. Walmart's cost structure combined with its large volume allows it to work with suppliers in keeping prices low, to the extent that suppliers are often the party that experiences a profit-margin squeeze.

Although a cost-leadership strategy provides some protection against the five forces, it also carries some risks. If a new entrant with new and relevant expertise enters the market, the low-cost leader's margins may erode due to loss in market share while it attempts to learn new capabilities. For example, Walmart faces challenges to its cost leadership. Dollar General stores, and other smaller low-cost retail chains, have drawn customers who prefer a smaller format than the big box of Walmart. The risk of replacement is particularly pertinent if a potent substitute emerges due to an innovation. Leveraging ecommerce, Amazon has become a potent substitute and thus a powerful threat to many brick-and-mortar retail outlets including Barnes & Noble, Best Buy, The Home Depot, and even Walmart. Powerful

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suppliers and buyers may be able to reduce margins so much that the low-cost leader could have difficulty covering the cost of capital and lose the potential for a competitive advantage.

The low-cost leader also needs to stay vigilant to keep its cost the lowest in the industry. Over time, competitors can beat the cost leader by implementing the same business strategy, but more effectively. Although keeping its cost the lowest in the industry is imperative, the cost leader must not forget that it needs to create an acceptable level of value. If continuously lowering costs leads to a value proposition that falls below an acceptable threshold, the low-cost leader's market share will evaporate. Finally, the low-cost leader faces significant difficulties when the focus of competition shifts from price to non-price attributes.

We have seen how useful the five forces model can be in industry analysis. None of the business-level strategies depicted in Exhibit 6.2 (cost leadership, differentiation, and focused variations thereof) is inherently superior. The success of each depends on context and relies on two factors:

- How well the strategy leverages the firm's internal strengths while mitigating its weaknesses.
- How well it helps the firm exploit external opportunities while avoiding external threats.

There is no single correct business strategy for a specific industry. The deciding factor is that the chosen business strategy provides a strong position that attempts to maximize economic value creation and is effectively implemented.

blue ocean
strategy Business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs.

6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership

So far we've seen that firms can create more economic value and the likelihood of gaining and sustaining competitive advantage in one of two ways—either increasing perceived consumer value (while containing costs) or lowering costs (while offering acceptable value).



Canny managers may use value innovation to move to blue oceans, that is, to new and uncontested market spaces. Shown here is the famous "blue hole" just off Belize.

©Mileny/Getty Images RF

Should managers try to do both at the same time? To accomplish this, they would need to integrate two different strategic positions: differentiation *and* low cost.³⁷ In general the answer is *no*. Managers should not pursue this complex strategy because of the inherent trade-offs in different strategic positions, unless they are able to reconcile the conflicting requirements of each generic strategy.

To meet this challenge, the strategy scholars Kim and Mauborgne advance the notion of a **blue ocean strategy**, which is a business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs in those two distinct strategic

positions.³⁸ They use the metaphor of an ocean to denote market spaces. *Blue oceans* represent untapped market space, the creation of additional demand, and the resulting opportunities for highly profitable growth. In contrast, *red oceans* are the known market space of existing industries. In *red oceans* the rivalry among existing firms is cut-throat because the market space is crowded and competition is a zero-sum game. Products become commodities, and competition is focused mainly on price. Any market share gain comes at the expense of other competitors in the same industry, turning the oceans bloody red.

A blue ocean strategy allows a firm to offer a differentiated product or service at low cost. As one example of a blue ocean strategy, consider Trader Joe's, the grocer introduced

earlier in the chapter. Trader Joe's had much lower costs than Whole Foods (prior to its 2017 acquisition by Amazon) for the same market of patrons desiring high value and health-conscious foods, and the chain scores exceptionally well in customer service and other areas. When a blue ocean strategy is successfully formulated and implemented, investments in differentiation and low cost are not substitutes but are complements, providing important positive spill-over effects. A successfully implemented blue ocean strategy allows firms two pricing options: First, the firm can charge a higher price than the cost leader, reflecting its higher value creation and thus generating greater profit margins. Second, the firm can lower its price below that of the differentiator because of its lower-cost structure. If the firm offers lower prices than the differentiator, it can gain market share and make up the loss in margin through increased sales.

VALUE INNOVATION

For a blue ocean strategy to succeed, managers must resolve trade-offs between the two generic strategic positions—low cost and differentiation.³⁹ This is done through **value innovation**, aligning innovation with total perceived consumer benefits, price, and cost (also see the discussion in Chapter 5 on *economic value creation*). Instead of attempting to out-compete your rivals by offering better features or lower costs, successful value innovation makes competition irrelevant by providing a leap in value creation, thereby opening new and uncontested market spaces.

Successful value innovation requires that a firm's strategic moves lower its costs and also increase the perceived value for buyers (see Exhibit 6.9). Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors that the firm's industry rivals compete on. Perceived buyer value is increased by raising existing key success factors and by creating new elements that the industry has not offered previously. To initiate a strategic move that allows a firm to open a new and uncontested market space through value innovation, managers must answer the four key questions below when formulating a blue ocean business strategy.⁴⁰ In terms of achieving successful value innovation, note that the first two questions focus on lowering costs, while the other two questions focus on increasing perceived consumer benefits.

Value Innovation—Lower Costs

1. *Eliminate*. Which of the factors that the industry takes for granted should be eliminated?
2. *Reduce*. Which of the factors should be reduced well below the industry's standard?

Value Innovation—Increase Perceived Consumer Benefits

3. *Raise*. Which of the factors should be raised well above the industry's standard?
4. *Create*. Which factors should be created that the industry has never offered?

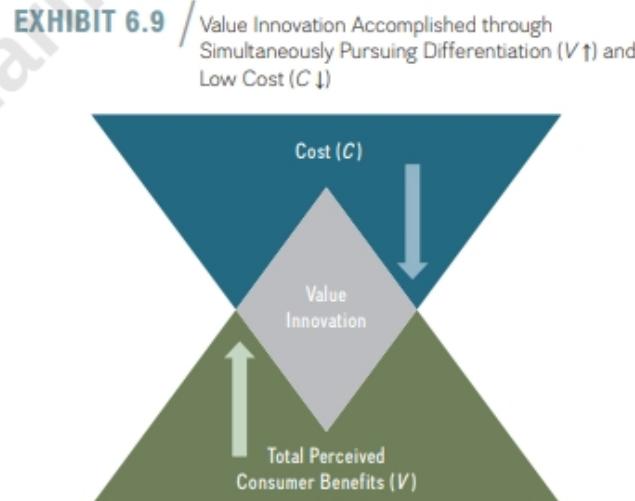
The international furniture retailer IKEA, for example, has used value innovation based on the *eliminate-reduce-raise-create* framework to initiate its own blue ocean and to achieve a sustainable competitive advantage.⁴¹

LO 6-5

Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

value innovation The simultaneous pursuit of differentiation and low cost in a way that creates a leap in value for both the firm and the consumers; considered a cornerstone of blue ocean strategy.

EXHIBIT 6.9



SOURCE: Adapted from C.W. Kim and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston, MA: Harvard Business School Publishing).

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ELIMINATE. IKEA eliminated several taken-for-granted competitive elements: salespeople, expensive but small retail outlets in prime urban locations and shopping malls, long wait after ordering furniture, after-sales service, and other factors. In contrast, IKEA displays its products in a warehouse-like setting, thus reducing inventory cost. Customers serve themselves and then transport the furniture to their homes in IKEA's signature flat-packs for assembly. IKEA also uses the big-box concept of locating supersized stores near major metropolitan areas (please refer to the discussion of "Taking Advantage of Certain Physical Properties" under "Economies of Scale" in Section 6.3).

REDUCE. Because of its do-it-yourself business model regarding furniture selection, delivery, and assembly, IKEA drastically reduced the need for staff in its mega-stores. Strolling through an IKEA store, you encounter few employees. IKEA also reduced several other taken-for-granted competitive elements: 25-year warranties on high-end custom furniture, high degree of customization in selection of options such as different fabrics and patterns, and use of expensive materials such as leather or hardwoods, among other elements.

RAISE. IKEA raised several competitive elements: It offers tens of thousands of home furnishing items in each of its big-box stores (some 300,000 square feet, roughly five football fields), versus a few hundred at best in traditional furniture stores; it also offers more than furniture, including a range of accessories such as place mats, laptop stands, and much more; each store has hundreds of rooms fully decorated with all sorts of IKEA items, each with a detailed tag explaining the item. Moreover, rather than sourcing its furniture from wholesalers or other furniture makers, IKEA manufactures all of its furniture at fully dedicated suppliers, thus tightly controlling the design, quality, functionality, and cost of each product.

IKEA also raised the customer experience by laying out its stores in such a way that customers see and can touch basically all of IKEA's products, from wineglasses (six for \$2.99) to bookshelves (for less than \$100).

CREATE. IKEA created a new way for people to shop for furniture. Customers stroll along a predetermined path winding through the fully furnished showrooms. They can compare, test, and touch all the things in the showroom. The price tag on each item contains other important information: type of material, weight, and so on. Once an item is selected, the customer notes the item number (the store provides a pencil and paper). The tag also indicates the location in the warehouse where the customer can pick up the item in IKEA's signature flat-packs. After paying, the customer transports the products and assembles the furniture. The customer has 90 days to return items for a full refund.

In traditional furniture shopping, customers visit a small retail outlet where salespeople swarm them. After a purchase, the customer has to wait generally a few weeks before the furniture is shipped because many furniture makers do not produce items, such



Each IKEA store has a large self-service warehouse section.
©Alex Segre/Namy Stock Photo

as expensive leather sofas, unless they are paid for in advance. Finely crafted couches and chairs cost thousands of dollars (while IKEA's fabric couches retail for \$399). When shopping at a traditional furniture store, the customer also pays for delivery of the furniture.

IKEA also created a new approach to pricing its products. Rather than using a “cost plus margin approach” like traditional furniture stores when pricing items, IKEA begins with the retail price first. For example, it sets the price for an office chair at \$150, and IKEA’s designers figure out how to meet this goal, which includes a profit margin. They need to consider the chair from start to finish, including not only design but also raw materials and the way the product will be displayed and transported. Only then will products go into production.

IKEA also created several other new competitive elements that allow it to offer more value to its customers: Stores provide on-site child care, include a cafeteria serving delicious food options including Swedish delicatessen such as smoked salmon at low prices, and offer convenient and ample parking, often in garages under the store, where escalators bring customers directly into the showrooms.

Taken together, with all these steps to eliminate, reduce, raise, and create, IKEA orchestrates different internal value chain activities to reconcile the tension between differentiation and cost leadership to create a unique market space. IKEA uses innovation in multiple dimensions—in furniture design, engineering, and store design—to solve the trade-offs between value creation and production cost. An IKEA executive highlights the difficulty of achieving value innovation as follows: “Designing beautiful-but-expensive products is easy. Designing beautiful products that are inexpensive and functional is a huge challenge.”⁴² IKEA leverages its deep design and engineering expertise to offer furniture that is stylish and functional and that can be easily assembled by the consumer. In this way, IKEA can pursue a blue ocean strategy based on value innovation to increase the perceived value of its products, while simultaneously lowering its cost and offering competitive prices. It opened a new market serving a younger demographic than traditional furniture stores. When young people the world over move into their own apartment or house, they frequently furnish it from IKEA.

BLUE OCEAN STRATEGY GONE BAD: “STUCK IN THE MIDDLE”

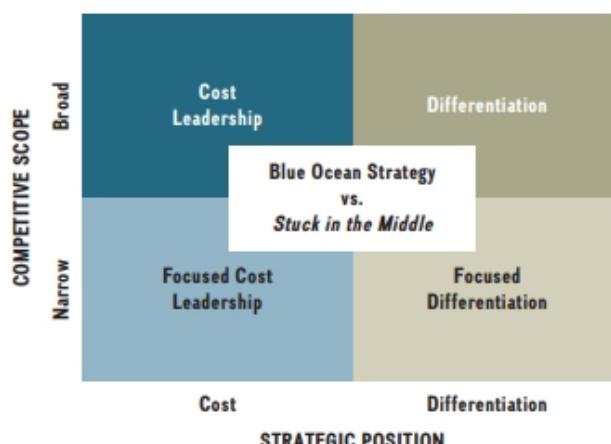
Although appealing in a theoretical sense, a blue ocean strategy can be quite difficult to translate into reality. Differentiation and cost leadership are distinct strategic positions that require important trade-offs.⁴³ A blue ocean strategy is difficult to implement because it requires the reconciliation of fundamentally different strategic positions—differentiation and low cost—which in turn require distinct internal value chain activities (see Chapter 4) so the firm can increase value and lower cost at the same time.

Exhibit 6.10 suggests how a successfully formulated blue ocean strategy based on *value innovation* combines both a differentiation and low-cost position. It also shows the consequence of a blue ocean strategy gone bad—the firm ends up being *stuck in the middle*, meaning the firm has neither a clear differentiation nor a clear cost-leadership profile. Being *stuck in the middle* leads to inferior performance and a resulting competitive disadvantage. Strategy Highlight 6.2 illustrates how JCPenney failed at a blue ocean strategy and ended up in the red ocean of cut-throat competition.

LO 6-6

Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

EXHIBIT 6.10 / Value Innovation vs. Stuck in the Middle



Strategy Highlight 6.2

How JCPenney Sailed Deeper into the Red Ocean

JCPenney under former CEO Ron Johnson learned the hard way how difficult it is to change a strategic position. When hired as JCPenney's CEO in 2011, Johnson was hailed as a star executive. He was poached from Apple, where he had created and led Apple's retail stores since 2000. Apple's stores are the most successful retail outlets globally in terms of sales per square foot. No other retail outlet, not even luxury jewelers, achieves more.

Once on board with JCPenney, Johnson immediately began to change the company's strategic position from a cost-leadership to a *blue ocean strategy*, attempting to combine the cost-leadership position with a differentiation position. In particular, he tried to reposition the department store more toward the high end by providing an improved customer experience and more exclusive merchandise through in-store boutiques. Johnson ordered all clearance racks with steeply discounted merchandise, common in JCPenney stores, to be removed. He also did away with JCPenney's long-standing practice of mailing discount coupons to its customers. Rather than following industry best practice by testing the more drastic strategic moves in a small number of selected stores, Johnson implemented them in all 1,800 stores at once. When one executive raised the issue of pretesting, Johnson bristled and responded: "We didn't test at Apple." Under his leadership, JCPenney also got embroiled in a legal battle with Macy's because of Johnson's attempt to lure away homemaking maven Martha Stewart and her exclusive merchandise collection.

The envisioned blue ocean strategy failed badly, and JCPenney ended up being stuck in the middle. Within 12 months with Johnson at the helm, JCPenney's sales dropped by 25 percent. In a hypercompetitive industry such as retailing where every single percent of market share counts, this was a landslide. In 2013, JCPenney's stock performed so poorly it was dropped from the S&P 500 index. Less than 18 months into his new job, Johnson was fired. Myron Ullman, his predecessor, was brought out of retirement as a temporary replacement.

JCPenney failed at its attempted blue ocean strategy and instead sailed deeper into the *red ocean* of bloody competition. This highlights the perils of attempting a blue ocean



JCPenney's new CEO, Marvin Ellison, is charged with turning the 115-year-old industry icon around. With a strong background in operations management and leadership skills honed at The Home Depot, he is focusing on lowering JCPenney's cost structure while increasing perceived value offered to its customers.
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strategy because of the inherent trade-offs in the underlying generic business strategies of cost leadership and differentiation. As a result, JCPenney continues to experience a sustained competitive disadvantage as of this writing. In the decade preceding 2015, JCPenney underperformed the wider stock market (measured in the S&P 500 index) by almost 150 percentage points, with the gap widening over time. To turn around the 115-year-old company, the board appointed Marvin Ellison as CEO in 2015. Ellison came to JCPenney from The Home Depot, where he excelled as a strong leader focused on effective operations. In an attempt to stem losses, JCPenney closed some 140 retail stores across the United States out of a total of 1,000 outlets in 2017.⁴⁴

THE STRATEGY CANVAS The **value curve** is the basic component of the **strategy canvas**. It graphically depicts a company's relative performance across its industry's factors of competition. A strong value curve has focus and divergence, and it can even provide a kind of tagline as to what strategy is being undertaken or should be undertaken.

Exhibit 6.11 plots the strategic profiles or value curves for three kinds of competitors in the U.S. airline industry. On the left-hand side, descending in price, are the legacy carriers (for example, Delta), JetBlue, and finally low-cost airlines such as Southwest Airlines (SWA). We also show the different strategic positions (differentiator, stuck in the middle, and low-cost leader) and trace the value curves as they rank high or low on a variety of parameters. JetBlue is stuck in the middle (as discussed in the ChapterCase). Low-cost airlines follow a cost-leadership strategy. The value curve, therefore, is simply a graphic representation of a firm's relative performance across different competitive factors in an industry.

Legacy carriers tend to score highly among most competitive elements in the airline industry, including different seating class choices (such as first class, business class, economy comfort, basic economy, and so on), a high level of in-flight amenities such as Wi-Fi, personal video console to view movies or play games, complimentary drinks and meals, coast-to-coast coverage via connecting hubs, plush airport lounges, international routes and global coverage, high customer service, and high reliability in terms of safety and on-time departures and arrivals. As is expected when pursuing a generic differentiation strategy, all these scores along the different competitive elements in an industry go along with a relative higher cost structure.

In contrast, the low-cost airlines tend to hover near the bottom of the strategy canvas, indicating low scores along a number of competitive factors in the industry, with no assigned seating, no in-flight amenities, no drinks or meals, no airport lounges, few if any international routes, low to intermediate level of customer service. A relatively lower cost structure goes along with a generic low-cost leadership strategy.

This strategy canvas also reveals key strategic insights. Look at the few competitive elements where the value curves of the differentiator and low-cost leader diverge.

value curve Horizontal connection of the points of each value on the strategy canvas that helps strategic leaders diagnose and determine courses of action.

strategy canvas Graphical depiction of a company's relative performance vis-à-vis its competitors across the industry's key success factors.

EXHIBIT 6.11 / Strategy Canvas of JetBlue vs. Low-Cost Airlines and Legacy Carriers

