Differentiation

Differentiation occurs if a company is unique in relation to its competitors in terms of something that has buyer value with lower price. Differentiation opens up the possibility for a company to offer products at lower prices than competitors, higher sales at existing prices or continuous sales in periods of seasonal demand (Todorović et al., 2000). Differentiation based competitive advantage can lead to above the average profitability if the price difference is higher than differentiation costs.

Although a company can be different from its competitors, that does not automatically imply that it is using differentiation as a basis for its competitive advantage, if the difference does not have buyer value. This means that a company should use its unique position in an industry having in mind differentiation costs and position duration.

Differentiation as a source of competitive advantage includes the shaping or adapting of the business process which will be the foundation for setting the company apart from its competitors. This means that differentiation is a tool used to offer customers something unique that other competitors cannot offer. Differentiation can be easily placed within value chain activities, where each continuous activity represents a source of differentiation.

Value chain activities, which make up a small percentage of total costs, can have a big impact on the degree of differentiation. A value chain adapted to strategic cost analysis does not have the potential to identify the activities which can be used a source of differentiation (Todorović et al., 2000). However, a value chain adapted to the analysis of differentiation requires a, perhaps, more delicate classification of particular activities and the aggregation of other activities estimated not to have a major effect on the degree of differentiation.

According to Michael Porter (1985), a company orienting towards low costs in all segments of business operations needs to utilise the distributor advantage (the difference in the achieved level of raw material supplies), the technological development (the difference in the achieved level of technological development), the production activities (the difference in the achieved level of production activities), the distribution system (the difference in the achieved level of the distribution systems) and sales activities (the difference in the achieved level of sales activities).

Differentiation sources can be looked for in every value chain activity conducted by its company. The difference among company is a consequence of special activities conducted by the company in creating value and the way it influences the customers. A company can be differentiated against competitors and against the competitive range. The competitive range is influenced by the possibility of the company to meet different buyer needs at different locations. In addition, the differentiation basis can be found in suppliers and distributors.

According to Michael Porter (1985), there are ten drivers of uniqueness:

- *Activity definition* – activities which can have a significant contribution to the company value chain configuration which will be capable of creating the basis for differentiation which will result in the future establishment of correlations.
- *Activity selection* – it includes the decision on selecting the activities that need to be done in the value chain to generate value which will result in created value after covering all the costs.
- *Activity bonding* – it includes the establishment of relations between activities in a company value chain or the relation with the value chain of the supplier or value chain of the distributor to form strong relationships.
- *The employment of timing* – determining when to conduct an activity in a company value chain to achieve notable cost reductions of activity conduction in a value chain.
- *The use of location* – which influences the configuration and reconfiguration of a value chain whose favourable utilisation can notably enhance the value chain activity configuration to benefit from the future prosperous effects.
- *Possible liaisons* – the existence of possible liaisons in the parent company which opens up the possibility of mutual activity conduction in a value chain forming a basis for value creations.
- *The learning effect* – the possibility of conducting activities in a far better way than before creating significant savings which were not considered before and which created a cost increase.
- *Vertical integration* – which represents a combination of different activities in a value chain with a company orientation towards using intern rather than extern transactions to generate above the average profitability.
- *Operation scale* – the scale of operations acting exclusively as a differentiating factor which can create value without generating any low cost features for the customers.
- *Institutional factors* – which particularly concern the development of good relations with the union and other important groups of interest which have a notable influence on the company and *vice versa*.

Independent of the existing or potential differentiation factors of a corporation, the buyer perception that something special is being offered is the foundation of a successful differentiation. Differentiation will lead to above the average profitability if the value created by the buyer surpasses the differentiation costs.

Michael Porter (1985) suggests the following phases needed for a corporation to create the differentiation foundation:

1 Identify the real customers and analyse the way customers rank shopping criteria.

2 Identify the buyer value chain and direct or indirect effects of the company on it.
3 Assess the cost of existing and potential sources of uniqueness in a company value chain.
4 Select a value chain activity configuration which forms the most valuable buyer differentiation with a relative ratio to differentiation costs.
5 Create the background for cost reduction in activities which do not affect the chosen differentiation forms.
6 Test the differentiation strategy to determine its sustainability from the aspect of sustainable competitive advantage.

The goal is to create a bigger difference between created buyer value and costs of creating the uniqueness of a value chain. Differentiation creates costs since uniqueness requires a better conduction of company value chain activities in relation to its competitors. However, it should be highlighted that different forms of differentiation created different costs. Generally, differentiation costs reflect the factors which account for activity cost of the activities which provide uniqueness. There are two types of relations between factors (Stern and Stalk, 1998): (1) Factors driving the uniqueness and (2) factors driving costs. For example, the factors that initiate uniqueness influence the factors that initiate costs and factors that initiate costs influence the factors that initiate uniqueness.

The basis of understanding the things that a buyer has is buyer value. A company can easily visualise the value chain of a buyer based on information on the influence of its product on its cost reduction. Differentiation is the factor that reduces buyer costs in many ways. A company creates added value for customers through premium price or a preference at the same level in two ways:

1 Reducing buyer costs;
2 Increasing buyer value.

If a company is capable of reducing costs for its buyer or to increase his value, the buyer is proportionally willing to accept the higher price of a product. Differentiation is possible in all types of industries, particularly in industries with various differences of products which are particularly valued by customers.

The sustainability of differentiation is at stake if the differentiation initiators are at risk since it eliminates the possibility of introducing premium prices. Differentiation as a source of competitive advantage can be sustainable in the long term if it is based on a complex set of differences which are hard to imitate by competitors, because the imitation of uniqueness leads to the loss of differentiation. According to Besanko et al. (1996), such