

Business Strategy: Differentiation, Cost Leadership, and Blue Oceans

Chapter Outline

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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 the 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.

JetBlue: "Stuck in the Middle"?

ENTREPRENEUR DAVID NEELEMAN, at the age of 25, 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, Neleman founded another airline, JetBlue Airways, in 1998. When Neleman 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.

JetBlue copied and improved upon many of SWA's cost-reducing activities. For example, it started by using just one type of airplane (the Airbus A320) to lower the costs of aircraft maintenance and pilot training. It also chose to fly point to point, directly connecting highly trafficked city pairs. In contrast, legacy airlines such as Delta, United, and American use a hub-and-spoke system; such systems connect many different locations via layovers at airport hubs. The point-to-point business model focuses on directly connecting fewer but more highly trafficked city pairs. This operating system lowers costs by not offering baggage transfers and schedule coordination with other airlines. In addition, JetBlue flew longer distances and transported 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 attempted to enhance its differential appeal by driving up its perceived value. Its intent was to combine high-touch—to enhance the customer experience—and high-tech—to drive down costs.

Some of JetBlue's 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 offers personal check-in and early boarding, free bag checking and priority bag retrieval after flight, and complimentary gourmet food and alcoholic beverages

in flight. It also features small private suites with a lie-flat bed up to 6 feet 8 inches long, a 15-inch high-resolution personal screen, and free in-flight high-speed Wi-Fi ("Fly-Fi"). JetBlue is also adding the newer Airbus 321 to its fleet, which scores significantly higher in customer satisfaction surveys than the older Airbus 320.

Also, because roughly one-third of customers prefer speaking to a live reservation agent, despite



Among high-profile incidents affecting JetBlue's overall reputation as a quality airline was the 2014 emergency landing at Long Beach Airport, after instruments identified a potentially overheated engine. Four passengers were injured in the evacuation.
© AP Photo/KABC-TV

a highly functional website for reservations and other travel-related services, JetBlue decided to employ stay-at-home parents in the United States instead of following industry best practice by outsourcing its reservation system to India. The company suggests this "home sourcing" is more productive than outsourcing; it also says that customers' appreciation of the reservation experience more than makes up for the wage differential between the United States and India. To sum it up, JetBlue's "Customer Bill of Rights" declares its dedication to "bringing humanity back to air travel."

Several high-profile incidents, however, damaged JetBlue's outstanding customer service record. In early 2007, JetBlue's reputation took a major hit: Several flights were delayed due to a snowstorm in which the airline kept passengers on board the aircraft; some sat on the tarmac for up to nine hours. Many wondered whether JetBlue was losing its magic touch. A few months later, David

Neeleman left JetBlue.¹ Another reputation-damaging incident for JetBlue occurred in 2010 when a flight attendant, upset because a passenger refused to apologize after striking him with luggage when disembarking the plane, allegedly used the airplane's PA system to hurl obscenities at passengers. Then, he grabbed a couple of cold beers from the galley, deployed and slid down the emergency escape chute, before disappearing in a terminal at New York's JFK airport and proceeding to drive home (where he was later arrested). In 2012, a JetBlue flight to Las Vegas was diverted to Texas because of the pilot's erratic behavior during the flight. Among other bizarre behavior, the mentally unstable pilot told the co-pilot that "we need to take a leap of faith," and that "we're not going to Vegas." The co-pilot locked the pilot out of the cockpit and diverted the flight to Texas, where it landed safely. The issue of pilot

mental health and the responsibilities of an airline have taken on new urgency in light of the 2015 deliberate crash into the French Alps of a Germanwings flight with 150 people on board by a co-pilot suffering from documented mental health issues.

For JetBlue, trying to combine a cost-leadership position with a differentiation strategy has meant that despite early years of competitive advantage, it is now struggling. As a consequence of several high-profile mishaps combined with the difficulty in resolving the trade-offs inherent in driving costs down while providing superior customer service and in-flight amenities, JetBlue has experienced a sustained competitive disadvantage since 2007.²

You will learn more about JetBlue by reading the chapter; related questions appear on page 200.

THE CHAPTERCASE illustrates how JetBlue ran into trouble by trying to combine 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.

JetBlue attempts to be both a cost leader and differentiator. Many firms that attempt to combine cost-leadership and differentiation strategies end up being *stuck in the middle*, that is, the managers 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. This common strategic failure contributed to JetBlue's sustained competitive disadvantage in recent years. Managers need to be aware to not end up being *stuck in the middle* between distinct strategic positions. A clear strategic position—either as differentiator or low-cost leader—can form the basis for competitive advantage.

This chapter, the first in Part 2 on strategy *formulation*, takes a close look at business-level 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* (see page 175) 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 in order 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 the Strategist."

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.³ 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?⁴

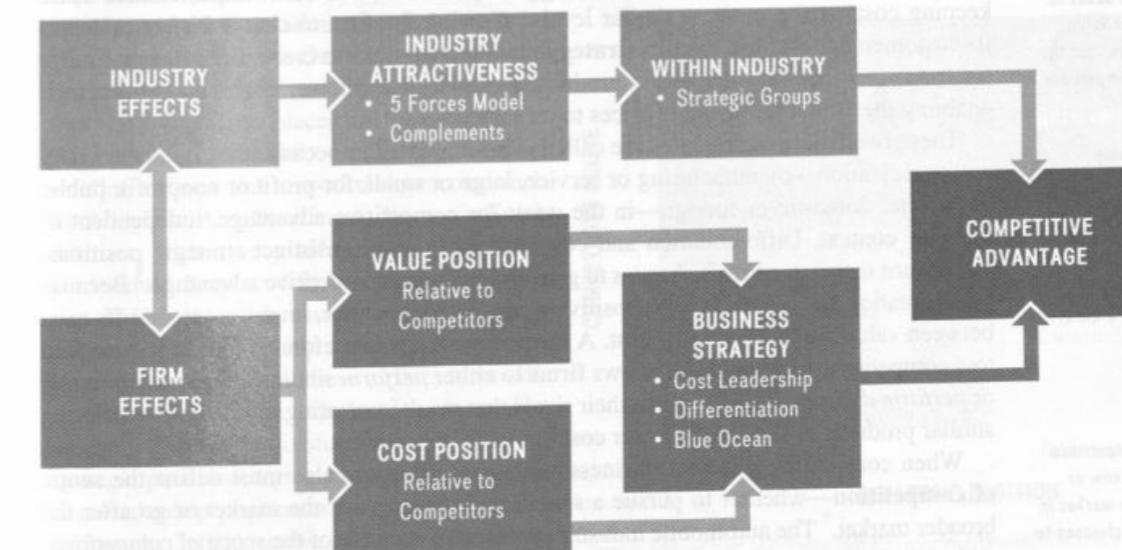
To formulate an effective business strategy, managers need to keep in mind that competitive advantage is determined jointly by *industry* and *firm* effects. As shown in Exhibit 6.1, one route to competitive advantage is shaped by *industry effects*, while a second route is determined by *firm effects*. 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

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.

EXHIBIT 6.1 / Industry and Firm Effects Jointly Determine Competitive Advantage



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.

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 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.

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

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 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.⁵ 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.⁶

When considering different business strategies, managers also must define the **scope of competition**—the size—narrow or broad—of the market in which a firm chooses to compete.⁷ 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

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

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.

providing *a car for every purse and purpose*. GM was one of the first to implement a multi-divisional structure in order to separate the brands into strategic business units, allowing each brand to create its unique strategic position (and 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 Motors, the maker of all-electric cars (featured in ChapterCase 3), 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. 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 high-end (all-electric) luxury cars.

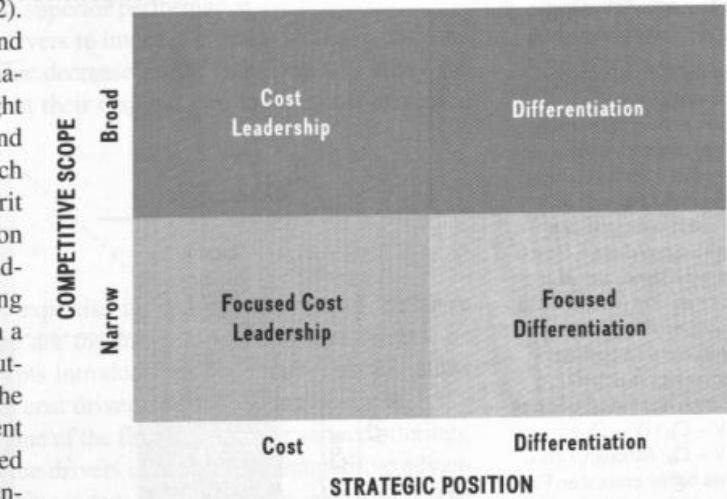
Now we can combine the dimensions describing a firm's strategic position (*differentiation vs. cost*) with the scope of competition (*narrow vs. broad*). As shown in Exhibit 6.2, by doing so we get the two major broad business strategies (*cost leadership* and *differentiation*), shown as the top two 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 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”—priced at several hundred dollars.

As discussed in ChapterCase 6, JetBlue attempted to combine a focused cost-leadership position with a focused differentiation position. Although initially successful, JetBlue has been consistently outperformed for the past few years by airlines that do not attempt to straddle different strategic positions, but rather have a clear strategic profile. 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 (and 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 the last few years. The reason is that JetBlue is 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

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.

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).

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 since the mid-2000s.

LO 6-2

Examine the relationship between value drivers and differentiation strategy.

6.2 Differentiation Strategy: Understanding Value Drivers

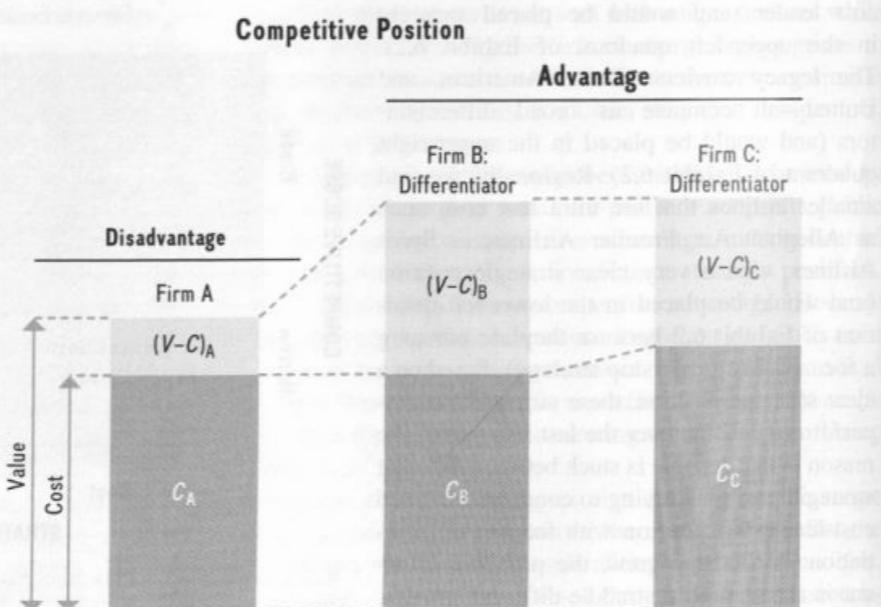
The goal of a differentiation strategy is to add unique features that will increase the perceived value of goods and services in the minds of consumers so they are willing to pay a higher price. Ideally, a firm following a differentiation strategy aims to achieve in the minds of consumers a level of 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. For example, the carpet company Interface is a leader in sustainability and offers innovative products such as its Cool Carpet, the world's first carbon-neutral floor covering. Interface's customers reward it with a willingness to pay a higher price for its environmentally friendly products.⁸

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,

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.



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 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.

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 managers 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.

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.



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
© Karsten Moran/Aurora Photos/Alamy

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' managers 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 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.

The introduction of AT&T U-verse is an example of leveraging complements to increase the perceived value of a service offering.¹⁵ AT&T's U-verse service bundles high-speed Internet access, phone, and TV services. Service bundles can be further enhanced by DVR capabilities that allow users to pause live TV, to record live TV shows, and to access video on demand. A DVR by itself is not very valuable, but included as a "free" add-on to subscribers, it turns into a complement that significantly enhances the perceived value of the service bundle. Leveraging complementary products allowed AT&T to break into the highly competitive television services market, significantly enhancing the value of its service offerings.

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,

PRODUCT FEATURES

One of the obvious but most important levers that managers 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 widest spectrum of possible users,"¹¹ OXO differentiates its kitchen utensils through its patent-protected ergonomically designed soft black rubber grips.

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.

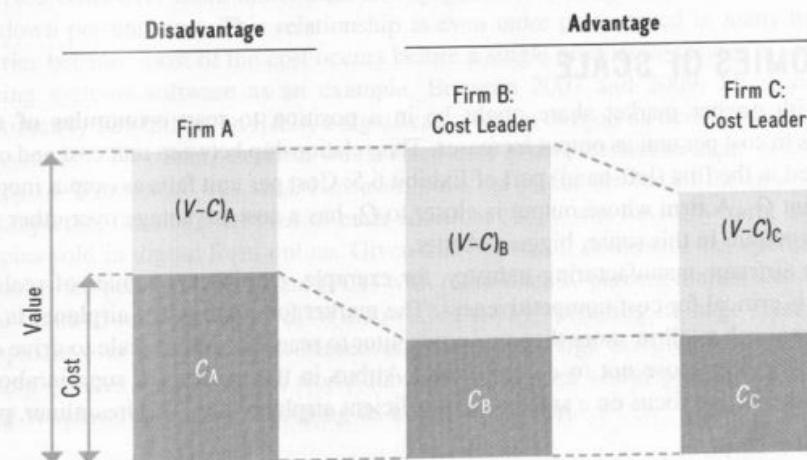
6.3 Cost-Leadership Strategy: Understanding Cost Drivers

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 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.

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, $(V - C)_A$.

Competitive Position



LO 6-3

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

EXHIBIT 6.4 /

Cost-Leadership Strategy: Achieving Competitive Advantage

Under a cost-leadership strategy, firms that can keep their cost 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.

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.

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

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

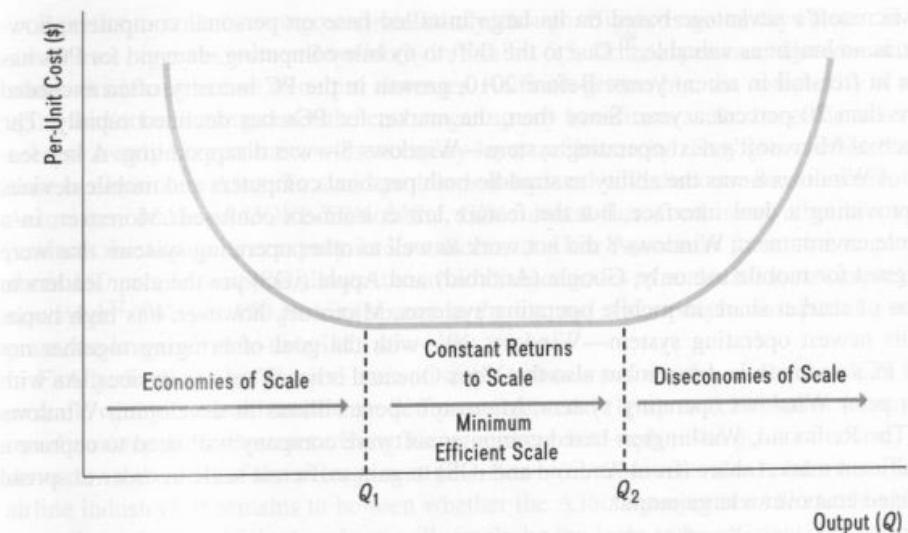


EXHIBIT 6.5 /

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

at roughly \$250 million) that allows for long-distance, point-to-point connections. By 2015, it had built over 250 Dreamliners with more than 1,000 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 over 150 A380 superjumbos (sticker price: \$430 million) with more than 310 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. Between 2007 and 2009, Microsoft spent approximately \$25 billion on R&D, a significant portion of it on its new Windows 7 operating system.¹⁹ This R&D expense was a fixed cost Microsoft had to incur before a single copy of Windows 7 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 sold several hundred million copies of Windows 7, thereby spreading its huge fixed cost of development over a large output. Moreover, Microsoft's large 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's advantage based on its large installed base on personal computers, however, is no longer as valuable.²⁰ Due to the shift to mobile computing, demand for PCs has been in free-fall in recent years. Before 2010, growth in the PC industry often exceeded more than 20 percent a year. Since then, the market for PCs has declined rapidly. The launch of Microsoft's next operating system—Windows 8—was disappointing. A key feature of Windows 8 was the ability to straddle both personal computers and mobile devices by providing a dual interface, but the feature left consumers confused. Moreover, in a mobile environment, Windows 8 did not work as well as other operating systems that were designed for mobile use only; Google (Android) and Apple (iOS) are the clear leaders in terms of market share in mobile operating systems. Microsoft, however, has high hopes for its newest operating system—Windows 10—with the goal of bringing together not only PCs and mobile devices but also the Xbox One and other Windows devices. As with each prior Windows operating system, Microsoft spent billions in developing Windows 10. The Redmond, Washington-based computer software company will need to capture a significant market share (from Android and iOS) to gain sufficient scale in order to spread its fixed cost over a large output.

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. As discussed in Chapter Case 3, Tesla's strong demand for its Model S sedan allowed it to employ cutting-edge robotics in its Fremont, California, manufacturing plant to produce cars of the highest quality at large scale.

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, Best Buy, The Home Depot, and Toys "R" Us 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)** in order 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 much as possible, allowing a firm to stake out the lowest-cost position achievable through economies of scale. If the firm's output range is less than Q_1 or more than Q_2 , the firm is at a cost disadvantage.

With more than 6 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 employs thousands of workers per plant).²¹ 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.

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.

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 raises the cost, negating any benefits to scale. Large firms 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:²² “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.”²³

Finally, there are also physical limits to scale. Airbus is pushing the envelope with its A380 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 A380 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 will need to be retrofitted with longer and wider runways to allow the superjumbo to take off and land.

Taken together, *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. 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

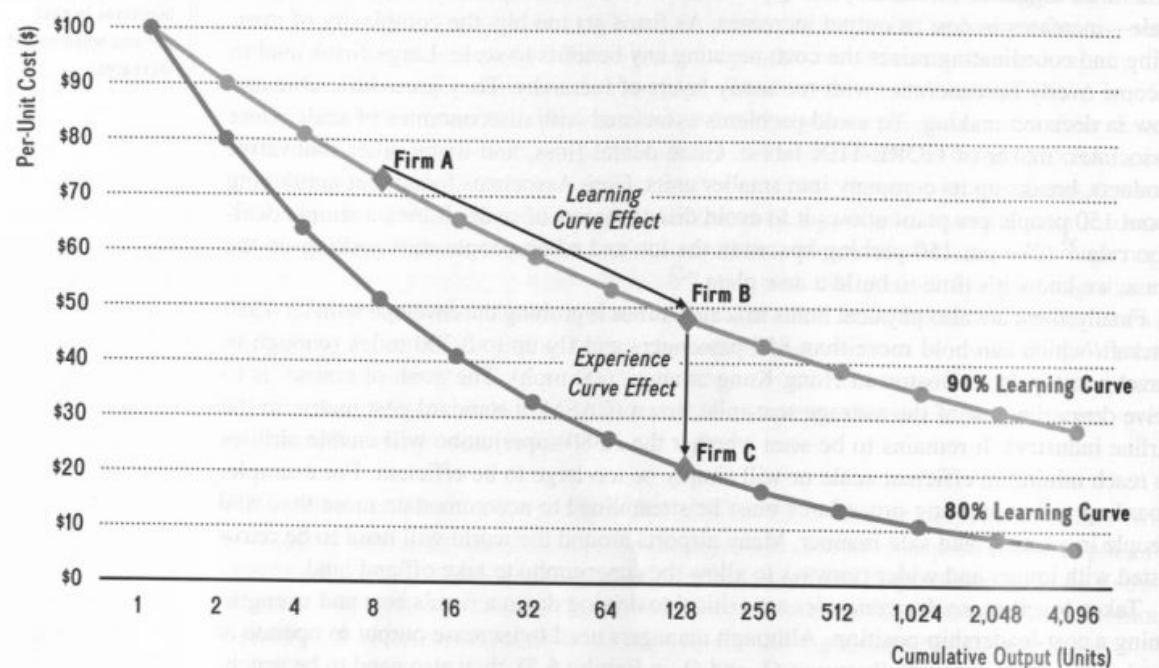
Do learning curves go up or down? Looking at the challenge of learning, many people tend to see it as an uphill battle, and assume the learning curve goes up. But if we consider our productivity, learning curves go down, as it takes less and less time to produce the same output as we learn how to be 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 experience.²⁴ Learning curves were first documented in aircraft manufacturing as the United States ramped up production in the 1930s, prior to its entry into World War II.²⁵ Every time production was doubled, the per-unit cost dropped by a predictable and constant rate (approximately 20 percent).²⁶ This important relationship is captured in Exhibit 6.6, where we see two different learning curves. The steeper the learning curve, the more learning has taken place. As cumulative output increases, firms move down the learning curve, reaching lower per-unit costs.

In particular, Exhibit 6.6 depicts 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 indicates a 20 percent drop every time output is doubled (this was the case in the aircraft manufacturing 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

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

EXHIBIT 6.6

Gaining Competitive Advantage through Leveraging Learning- and Experience-Curve Effects



perspective, economies of learning allow movement down a *given* learning curve based on current production technology.

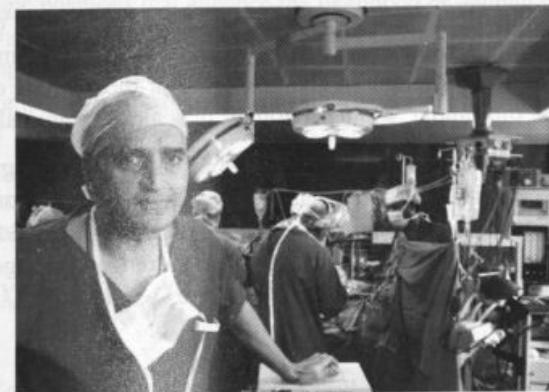
By moving further down a given learning curve than competitors, a firm can gain a competitive advantage. For example, Exhibit 6.6 shows that Firm B is further down the 90 percent learning curve than Firm A. Firm B leverages economies of learning due to larger cumulative output to gain an advantage over 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 6.6, Firm A produces eight aircraft and reaches a per-unit cost of \$73 million per aircraft.²⁷ 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.)

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.

Learning curves are a robust phenomenon that have been observed in many industries, not only in manufacturing processes but also in alliance management, franchising, and health care.²⁸ 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.²⁹ 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!

Strategy Highlight 6.1

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



Dr. Devi Shetty
© 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 1,000 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 6.6). Other factors provide more cost savings. At the same time, Dr. Shetty pays his cardiac surgeons the going rate in India, between \$110,000 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 and some 20 operating rooms that stay busy pretty much around the clock, many times larger than the average U.S. hospital with 160 beds. 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.³⁰

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. Although learning can decline or flatten (see Exhibit 6.6), 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 researcher) 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

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 6.6 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.³² 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.”³³

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. Thus they strive to offer lower prices than competitors and to attract increased 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

LO 6-4

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

EXHIBIT 6.7 / 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 • Protection against non-price attributes 	<ul style="list-style-type: none"> • Focus of competition shifts to non-price attributes • Lowering costs to drive value creation below acceptable threshold

Source: 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).

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.

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 first introduced in 2007, touch-based screens and other once-innovative features are now standard in smartphones. Indeed, Android-based smartphones held more than 80 percent market share in 2015, while Apple's iOS held 15 percent.³⁵ Several companies including Samsung and low-cost leader Xiaomi 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 who 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. The Dollar Store has 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 e-commerce, 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 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.

6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership

So far we've seen that firms can create more economic value and their 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). 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.³⁶ 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.³⁷ 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 regional grocer introduced earlier in the chapter. Trader Joe's has much lower costs than Whole Foods 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.³⁸ 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,

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

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.

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.)

© Mlenny/Getty Images RF



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 at the same increase the perceived value for buyers (see Exhibit 6.8). Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors that the firm's rivals in their industry 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.³⁹ 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.⁴⁰

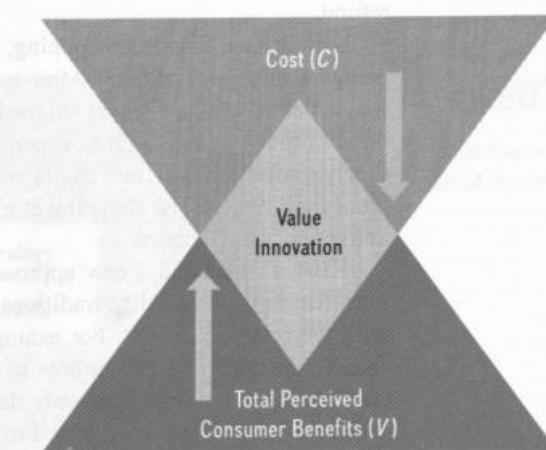
ELIMINATE. IKEA eliminated several taken-for-granted competitive elements: salespeople, expensive but small retail outlets in prime urban locations and shopping malls, long wait after ordering furniture, after-sales service, and other factors. In contrast, IKEA displays its products in a warehouse-like 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 super-sized stores near major metropolitan areas.

REDUCE. Because of its do-it-yourself business model from furniture selection, transporting it home, 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

LO 6.5

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

EXHIBIT 6.8 / Value Innovation Accomplished through Simultaneously Pursuing Differentiation ($V \uparrow$) and Low Cost ($C \downarrow$)



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).



Inside IKEA's self-service warehouse
© Alex Segre/Alamy

items, each with a detailed tag explaining the item in detail. 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. The customer strolls through a predetermined path winding through the fully furnished showrooms. She 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 notepad). The tag also indicates the location in the warehouse where the customer can pick up the item. After paying for the items, the customer transports the products in IKEA's signature flat-packs and assembles the furniture. The customer has 90 days to return items for a full refund.

In traditional furniture shopping, the customer visits a small retail outlet where salespeople swarm around him. After a purchase, the customer has to wait generally a few weeks before the furniture is shipped to his house. This is because many furniture makers do not produce items such 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 its 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. 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 to meet that goal, including a profit margin. 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: It provides on-site child care; it features a restaurant offering delicious food options including Swedish delicatessen such as smoked salmon at low prices;

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

stores have 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 in order 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 as follows: "Designing beautiful-but-expensive products is easy. Designing beautiful products that are inexpensive and functional is a huge challenge."⁴¹ 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 up 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"

LO 6-6

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

Although appealing in a theoretical sense, a blue ocean strategy can be quite difficult to translate into reality. The reason is that differentiation and cost leadership are distinct strategic positions that require important trade-offs.⁴² 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 6.9 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.

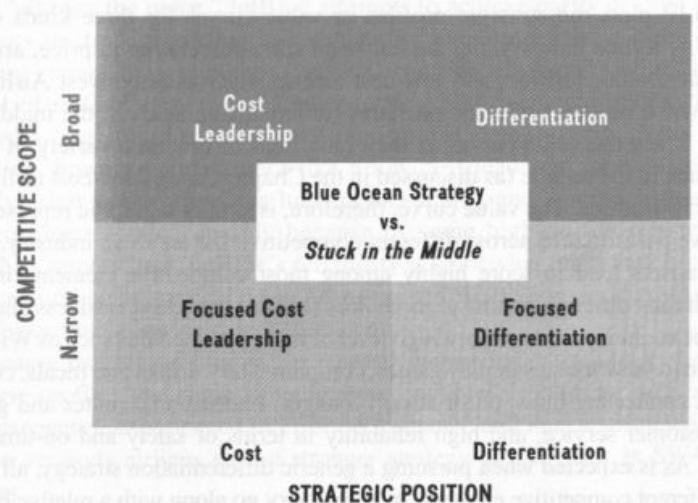


EXHIBIT 6.9 /

Value Innovation vs.
Stuck in the Middle

Strategy Highlight 6.2

How JCPenney Sailed Deeper into the Red Ocean

JCPenney under its (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. CEO 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 wholesale 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 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 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.⁴³

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

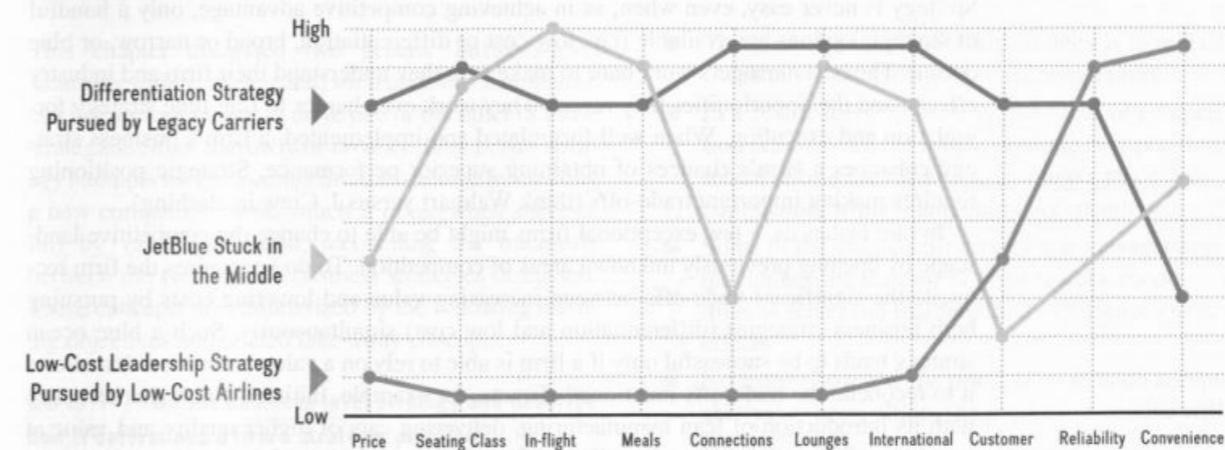
strategy canvas
Graphical depiction of a company's relative performance vis-à-vis its competitors across the industry's key success factors.

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 6.10 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 (think Delta), JetBlue, and low-cost airlines such as Southwest Airlines (SWA). We also show the different strategic positions (differentiator, stuck in the middle, and low-cost leader). 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 high price.

EXHIBIT 6.10 / Strategy Canvas of JetBlue vs. Low-cost Airlines and Legacy Carriers.



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 low price 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. Interestingly, some cost leaders (e.g., SWA) score much higher than some differentiators (e.g., Delta) in terms of reliability and convenience, offering frequent point-to-point connections to conveniently located airports, often in or near city centers. This key divergence between the two strategies explains why generic cost leaders have frequently outperformed generic differentiators in the U.S. airline industry. Overall, both value curves show a consistent pattern representative of a more or less clear strategic profile as either differentiation or low-cost leader.

Now look at JetBlue's value curve. Rather than being consistent such as the differentiation or low-cost value curves, the JetBlue value curve follows a zigzag pattern and is thus "all over the place." JetBlue attempts to achieve parity or even out-compete differentiators in the U.S. airline industry along the competitive factors such as different seating classes (e.g., the high-end Mint offering discussed in the ChapterCase), higher level of in-flight amenities, higher-quality beverages and meals, plush airport lounges, and a large number of international routes (mainly with global partner airlines). JetBlue, however, looks more like a low-cost leader in terms of the ability to provide only a few connections via hubs domestically, and it recently has had a poor record of customer service, mainly because of some high-profile missteps as documented in the ChapterCase. JetBlue's reliability is somewhat mediocre, but it does provide a larger number of convenient point-to-point flights than a differentiator such as Delta, but fewer than a low-cost leader such as SWA.

A value curve that zigzags across the strategy canvas indicates a lack of effectiveness in its strategic profile. The curve visually represents how JetBlue is *stuck in the middle* and as a consequence experienced inferior performance and thus a sustained competitive disadvantage vis-à-vis airlines with a stronger strategy profile such as SWA and Delta, among others.

6.7 Implications for the Strategist

Strategy is never easy, even when, as in achieving competitive advantage, only a handful of strategic options are available (i.e., low cost or differentiation, broad or narrow, or blue ocean). The best managers work hard to make sure they understand their firm and industry effects, and the opportunities they reveal. They work even harder to fine-tune strategy formulation and execution. When well-formulated and implemented, a firm's business strategy enhances a firm's chances of obtaining superior performance. Strategic positioning requires making important trade-offs (think Walmart versus J. Crew in clothing).

In rare instances, a few exceptional firms might be able to change the competitive landscape by opening previously unknown areas of competition. To do so requires the firm reconcile the significant trade-offs between increasing value and lowering costs by pursuing both business strategies (differentiation and low cost) simultaneously. Such a blue ocean strategy tends to be successful only if a firm is able to rely on a value innovation that allows it to reconcile the trade-offs mentioned. Toyota, for example, initiated a new market space with its introduction of lean manufacturing, delivering cars of higher quality and value at lower cost. This value innovation allowed Toyota a competitive advantage for a decade or more, until this new process technology diffused widely. JC Penney, on the other hand, stumbled and found itself failing on most fronts, resulting in a competitive disadvantage.

CHAPTERCASE 6 / Consider This ...

Early in its history JetBlue achieved a competitive advantage based on *value innovation*. In particular, JetBlue was able to drive up perceived customer value while lowering costs. This allowed it to carve out a strong strategic position and move to a non-contested market space. This implies that no other competitors in the U.S. domestic airline industry were able to provide such value innovation at that point in time. Rather than directly competing with other airlines, JetBlue created a blue ocean.

Although JetBlue was able to create an initial competitive advantage, it was unable to sustain it over time. Because JetBlue failed in reconciling the strategic trade-offs inherent in combining differentiation and cost leadership, it was unable to continue its blue ocean strategy, despite initial success. Since 2007 JetBlue experienced a sustained competitive disadvantage, at one point in 2014 lagging the S&P 500 index by more than 100 percentage points.

A new leadership team CEO Robin Hayes put in place in early 2015 is attempting to reverse this trend. The new team made quick changes to improve the airline's flagging profitability. It decided to start charging \$50 per checked bag instead of offering it as a free service. Moreover, it also removed the additional legroom JetBlue was famous for in the industry, adding 10 percent more seats on its airplanes. It remains to be seen if JetBlue's strategic repositioning will be successful.



Questions

- Despite its initial success, why was JetBlue unable to sustain a blue ocean strategy?
- JetBlue's chief marketing officer, Marty St. George, was asked by *The Wall Street Journal*, "What is the biggest marketing challenge JetBlue faces?" His response: "We are flying in a space where our competitors are moving toward commoditization. We have taken a position that air travel is not a commodity but a services business. We want to stand out, but it's hard to break through to customers with that message."
 - Given St. George's statement, which strategic position is JetBlue trying to accomplish: differentiator, cost leader, or blue ocean strategy? Explain why.
 - Which strategic moves has the new CEO, Robin Hayes, put in place? Do these moves correspond to St. George's understanding of JetBlue's strategic position? Why or why not? Explain.
- Consider JetBlue's value curve in Exhibit 6.10. Why is JetBlue experiencing a competitive advantage? What recommendations would you offer to JetBlue to strengthen its strategic profile? Be specific.

TAKE-AWAY CONCEPTS

This chapter discussed two generic business-level strategies: *differentiation* and *cost leadership*. Companies can use various tactics to drive one or the other of those strategies, either narrowly or broadly. *Blue ocean strategy* attempts to find a competitive advantage by creating a new competitive area, which it does (when successful) by value innovation, reconciling the trade-offs between the two generic business strategies discussed. These concepts are summarized by the following learning objectives and related take-away concepts.

LO 6-1 / Define business-level strategy and describe how it determines a firm's strategic position.

- Business-level strategy determines a firm's strategic position in its quest for competitive advantage when competing in a single industry or product market.
- Strategic positioning requires that managers address strategic trade-offs that arise between value and cost, because higher value tends to go along with higher cost.
- Differentiation and cost leadership are distinct strategic positions.
- Besides selecting an appropriate strategic position, managers must also define the scope of competition—whether to pursue a specific market niche or go after the broader market.

LO 6-2 / Examine the relationship between value drivers and differentiation strategy.

- The goal of a differentiation strategy is to increase the perceived value of goods and services so that customers will pay a higher price for additional features.
- In a differentiation strategy, the focus of competition is on value-enhancing attributes and features, while controlling costs.
- Some of the unique value drivers managers can manipulate are product features, customer service, customization, and complements.
- Value drivers contribute to competitive advantage only if their increase in value creation (ΔV) exceeds the increase in costs, that is: $(\Delta V) > (\Delta C)$.

LO 6-3 / Examine the relationship between cost drivers and the cost-leadership strategy.

- The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors.
- In a cost-leadership strategy, the focus of competition is achieving the lowest possible cost position, which allows the firm to offer a lower price than competitors while maintaining acceptable value.
- Some of the unique cost drivers that managers can manipulate are the cost of input factors, economies of scale, and learning- and experience-curve effects.
- No matter how low the price, if there is no acceptable value proposition, the product or service will not sell.

LO 6-4 / Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

- The five forces model helps managers use generic business strategies to protect themselves against the industry forces that drive down profitability.
- Differentiation and cost-leadership strategies allow firms to carve out strong strategic positions, not only to protect themselves against the five forces, but also to benefit from them in their quest for competitive advantage.
- Exhibit 6.7 details the benefits and risks of each business strategy.

LO 6-5 / Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

- To address the trade-offs between differentiation and cost leadership at the business level, managers must employ *value innovation*, a process that will lead them to align the proposed business strategy with total perceived consumer benefits, price, and cost.
- Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors on which the firm's industry rivals compete.
- Increasing perceived buyer value is primarily achieved by raising existing key success factors and by creating new elements that the industry has not yet offered.
- Managers track their opportunities and risks for lowering a firm's costs and increasing perceived value vis-à-vis their competitors by use