PART FIVE

STRATEGY AND LEADERSHIP IN THE TWENTY-FIRST CENTURY

16 Strategic Elements of Competitive Advantage

LEARNING OBJECTIVES

16-1 Identify the forces that shape competition in an industry, and illustrate each force with a specific company or industry example.

16-2 Define *competitive advantage* and identify the key conceptual frameworks that guide decision makers in the strategic planning process.

16-3 Explain how a nation can achieve competitive advantage, and list the forces that may be present in a national "diamond."

16-4 Define *hypercompetitive industry* and list the key arenas in which dynamic strategic interactions take place.

CASE 16-1
IKEA

When IKEA founder Ingvar Kamprad passed away in early 2018 at the age of 91, the world lost a retailing legend and an icon of entrepreneurship. IKEA has been called "one of the most extraordinary success stories in the history of postwar European business." As an enterprising teenager in rural Sweden, Kamprad sold pencils and other merchandise by mail. He later bought an abandoned factory and began making furniture. The next step was opening a showroom in the town of Almhult. By the time of Kamprad's death, IKEA had evolved from its humble beginnings as a mail-order business into a $38 billion global furniture powerhouse with more than 400 stores in 49 countries (see Exhibit 16-1).

Today, the company's Billy bookcases, Ektorp sofas, and Hemnes bedroom suites are bestsellers, popular with students, young families, and other budget-conscious shoppers. Thrifty by nature, Kamprad flew economy class and took public transportation when he traveled. IKEA's success reflects Kamprad's "social ambition" of selling a wide range of stylish, functional home furnishings at prices so low that the majority of people can afford to buy them.

Kamprad's frugal ways also applied to the company's finances. To minimize tax liabilities, he split the company into two parts: Inter Ikea owns the brand and the concept, while Ikea Group runs the retailing operations. Both units are now headquartered in the Netherlands rather than Sweden, where taxes are higher. Ikea Group pays Inter Ikea a royalty fee for use of the brand; this somewhat unorthodox arrangement has attracted the attention of the European Commission's tax authorities.

The essence of marketing strategy is successfully relating the strengths of an organization to its environment. As the horizons of marketers have expanded from domestic to regional and global, so,

Exhibit 16-1 In 2018, IKEA celebrated the 20th anniversary of its entry into China. The Swedish company currently has 24 stores in China; the Xu Hui store in Shanghai is one of the top performers by revenues.
Source: WorldFoto/Alamy Stock Photo.

too, have the horizons of competitors. Global competition is the reality in almost every industry today—a fact of life that puts organizations under increasing pressure to master techniques for conducting industry analysis and competitor analysis and understanding competitive advantage at both the industry and the national levels. This chapter covers these topics in detail. For more on the way that top management at IKEA is accomplishing this feat, turn to the continuation of Case 16-1 at the end of the chapter.

16-1 Industry Analysis: Forces Influencing Competition

16-1 Identify the forces that shape competition in an industry, and illustrate each force with a specific company or industry example.

A useful way of gaining insight into competitors is through industry analysis. As a working definition, an *industry* can be defined as a group of firms that produce products that are close substitutes for each other. In any industry, competition works to drive down the rate of return on invested capital toward the rate that would be earned in the economist's "perfectly competitive" industry. Rates of return that are greater than this "competitive" rate will stimulate an inflow of capital either from new entrants or from existing competitors making additional investments. The global smartphone industry is a case in point: Apple's success with the iPhone prompted Samsung and other companies to enter this market. Rates of return below the competitive rate will result in withdrawal from the industry and a decline in the levels of activity and competition.

Harvard University's Michael E. Porter, a leading authority on competitive strategy, has developed a **five forces model** that explains competition in an industry. The five forces comprise the threat of new entrants, the threat of substitute products or services, the bargaining power of buyers, the bargaining power of suppliers, and the competitive rivalry among current members of the industry. In industries such as soft drinks, pharmaceuticals, and cosmetics, the favorable nature of the five forces has resulted in attractive returns for competitors. However, pressure from any of the forces can limit profitability, as evidenced by the recent fortunes of some competitors in the PC and semiconductor industries. A discussion of each of the five forces follows.

Threat of New Entrants

New entrants to an industry bring new capacity; a desire to gain market share and position; and, quite often, new approaches to serving customer needs. The decision to become a new entrant in an industry is often accompanied by a major commitment of resources. New players mean prices will be pushed downward and margins squeezed, resulting in reduced industry profitability in the long run. Porter describes eight major sources of barriers to entry, whose presence or absence determines the extent of threat by new industry entrants.[1]

The first barrier, **economies of scale**, refers to the decline in per-unit product costs as the absolute volume of production per period increases. Although the concept of scale economies is frequently associated with manufacturing, it is also applicable to research and development (R&D), general administration, marketing, and other business functions. Honda's efficiency at engine R&D, for example, results from the wide range of products it produces that feature gasoline-powered engines. When existing firms in an industry achieve significant economies of scale, it becomes difficult for potential new entrants to be competitive.

Product differentiation, the second major entry barrier, is the extent of a product's perceived uniqueness—in other words, whether it is a commodity. Differentiation can be achieved as a result of unique product attributes or effective marketing communications, or both. Product differentiation and brand loyalty "raise the bar" for would-be industry entrants who are required to make substantial investments in R&D or advertising. For example, Intel achieved differentiation and erected a barrier in the microprocessor industry with its "Intel Inside" advertising campaign and logo that appears on many brands of PCs.

A third entry barrier relates to *capital requirements*. Capital is required not only for manufacturing facilities (fixed capital), but also for financing R&D, advertising, field sales and service, customer credit, and inventories (working capital). The enormous capital requirements in such industries as pharmaceuticals, mainframe computers, chemicals, and mineral extraction present formidable entry barriers.

"Thirty years ago, you had to surmount two powerful barriers to entry. One was getting word out about your product without a massive advertising budget. And the second one was getting listed with one of the key retailers. Because of the digital change, once new entrants have the product, making it to market has become faster and cheaper."[2]

Mark Schneider, CEO, Nestlé, commenting on consumer use of e-commerce to bypass traditional retail channels

A fourth barrier to entry is the one-time *switching costs* resulting from the need to change suppliers and products. These might include retraining costs, ancillary equipment costs, the cost of evaluating a new source, and so on. The perceived cost to customers of switching to a new competitor's product may present an insurmountable obstacle, preventing industry newcomers from achieving success. For example, Microsoft's huge installed base of Windows operating systems and applications presented a formidable entry barrier to would-be competitors for many years.

A fifth barrier to entry is access to *distribution channels*. If channels are full or unavailable, the cost of entry is substantially increased because a new entrant must invest time and money to gain access to existing channels or to establish new channels. Some Western companies have encountered this barrier to market entry in Japan.

Government policy, the sixth barrier, is frequently a major entry barrier. In some cases, the government will restrict competitive entry. This is true in a number of industries, especially those outside the United States, that have been designated as "national" industries by their respective governments. Japan's postwar industrialization strategy was based on a policy of preserving and protecting national industries in their development and growth phases. The result was a market that proved difficult for non-Japanese competitors to enter, an issue that was targeted by U.S. President Bill Clinton's administration. During that era, American business executives in a wide range of industries urged adoption of a government policy that would reduce some of these barriers and open the Japanese market to more U.S. companies.

Established firms may also enjoy *cost advantages independent of scale economies* that present a seventh barrier to entry. Access to raw materials, a large pool of low-cost labor, favorable locations, and government subsidies are several examples.

Finally, expected *competitor response* can be a major entry barrier. If new entrants expect existing competitors to strongly oppose their entry into the market, the entrants' expectations about the rewards of entry will certainly be affected. Indeed, a potential competitor's belief that entry into an industry or market will be an unpleasant experience may serve as a strong deterrent to its participation. Bruce Henderson, former president of the Boston Consulting Group, used the term "brinkmanship" to describe a recommended approach for deterring competitive entry. Brinkmanship occurs when industry leaders convince potential competitors that any market-entry effort will be countered with vigorous and unpleasant responses. For example, Microsoft has used this approach many times to maintain its dominance in software operating systems and applications.

In the three decades since Porter first described the five forces model, the digital revolution appears to have altered the entry barriers in many industries. First and foremost, technology has lowered the cost for new entrants. For example, Barnes & Noble watched an entrepreneurial upstart, Amazon.com, storm the barriers protecting traditional brick-and-mortar booksellers. Amazon.com founder Jeff Bezos identified and exploited a glaring inefficiency in book distribution: Bookstores ship unsold copies of books back to publishers to be shredded and turned into pulp. Amazon.com's centralized operations and increasingly personalized online service enable customers to select from millions of different titles at discount prices and have them delivered to their homes within days. For a growing number of book-buying consumers, Amazon.com eclipses the value proposition of local bookstores that offer "only" a few thousand titles and gourmet coffee bars.

Barnes & Noble responded to the threat posed by Amazon.com by entering the online book market itself, even as it continues to be profitable in its traditional brick-and-mortar business. In the meantime, Bezos has repositioned Amazon.com as an Internet superstore selling electronics and general merchandise. Since Bezos founded Amazon.com in 1995, the company's annual sales have grown to more than $100 billion and it has expanded into new product lines, including CDs, DVDs, streaming movies and music, e-books, and the Echo smart speaker. The company has also entered the enterprise sector: Amazon Web Services, the cloud-computing unit, is a significant revenue source. Today, Amazon.com serves tens of millions of customers in more than 160 countries.

Threat of Substitute Products

A second force influencing competition in an industry is the threat of substitute products. The availability of substitute products places limits on the prices that market leaders can charge in an industry; high prices may induce buyers to switch to the substitute.

Once again, the digital revolution is dramatically altering industry structures in regard to substitute products. In addition to lowering entry barriers, the digital movement means that certain types of products can be converted to bits and distributed in pure digital form. For example, the development of the MP3 file format for music was accompanied by the increased popularity of peer-to-peer (p-to-p or P2P) file swapping among music fans. Napster and other online music services offered a substitute to consumers who were tired of paying $15 or more for a CD. Although a U.S. court severely curtailed Napster's activities, other services—including several outside the United States—sprang up in its place. The top players in the music industry were taken by surprise, and today, Sony Music Entertainment, Warner Music Group, and Universal Music Group are still struggling to develop new strategies in response to the changing business environment.

Bargaining Power of Buyers

In Porter's model, the term "buyers" refers to manufacturers (e.g., General Motors [GM]) and retailers (e.g., Walmart and Amazon) rather than consumers. The ultimate aim of such buyers is to pay the lowest possible price to obtain the products or services that they require. To achieve this goal, buyers try to drive down profitability in the supplier industry. First, however, the buyers have to gain leverage over their vendors.

One way they can do this is to purchase goods and services in such large quantities that supplier firms become highly dependent on the buyers' business. For example, Amazon has tremendous bargaining power over delivery companies. The reason is simple: In the United States alone, Amazon has roughly 44 percent of all Internet retail business. Second, when the suppliers' products are viewed as commodities—that is, as standard or undifferentiated—buyers are likely to bargain hard for low prices because many firms can meet their needs. Buyers will also bargain hard when the supplier industry's products or services represent a significant portion of the buying firm's costs. A fourth source of buyer power is the willingness and ability to achieve backward integration.

For example, because it purchases massive quantities of goods for resale, Walmart is in a position to dictate terms to any vendor wishing to distribute its products through the retail giant's stores. Walmart's influence also extends to the recorded music industry; the company refuses to stock CDs bearing parental advisory stickers for explicit lyrics or violent imagery. Recording artists who want their recordings to be sold by Walmart have the option of altering lyrics and song titles or deleting offending tracks. Likewise, artists are sometimes asked to change album cover art

Exhibit 16-2 Walmart refused to stock Green Day's politically charged CD *21st Century Breakdown*. More recently, the band has complied with Walmart's requirements, so that its newer releases are now carried by the retail giant. Slipknot, a Grammy-winning metal band from Des Moines, Iowa, has had a similar experience with Walmart.
Source: Hector Acevedo/ZUMAPRESS.com/ Alamy Stock Photo.

if Walmart deems it offensive. For example, the retailer wouldn't stock Green Day's *21st Century Breakdown* CD in 2009 after the band refused to alter some lyrics so the CD wouldn't carry a parental advisory sticker (see Exhibit 16-2). In 2017, Green Day changed its tune and released a "clean" version of its *¡Uno! ¡Dos! ¡Tres!* trilogy so that fans could purchase it at Walmart.[3]

> **"Walmart is the 800-pound gorilla. You're going to want to do more things for a customer who is growing as fast as Walmart is."[4]**
>
> Ted Taft, Meridian Consulting Group

Bargaining Power of Suppliers

Supplier power in an industry is the converse of buyer power. If suppliers have enough leverage over industry firms, they can raise prices high enough to significantly influence the profitability of their organizational customers. Several factors determine suppliers' ability to gain leverage over industry firms. First, suppliers will have the advantage if they are large and relatively few in number. Second, when the suppliers' products or services are important inputs to user firms, are highly differentiated, or carry switching costs, the suppliers will have considerable leverage over buyers. Suppliers will also enjoy bargaining power if alternative products do not threaten their business. A fourth source of supplier power is these companies' willingness and ability to develop their own products and brand names if they are unable to get satisfactory terms from industry buyers.

In the tech world, Microsoft and Intel are two companies with substantial supplier power. Because about 90 percent of the world's more than 1 billion PCs run on Microsoft's operating systems and 80 percent use Intel's microprocessors, the two companies enjoy a great deal of leverage relative to Dell, Hewlett-Packard, and other computer manufacturers. Microsoft's industry dominance prompted both the U.S. government and the European Union to launch separate antitrust investigations of its business practices. Today, the tech world's focus is shifting to new electronic devices such as smartphones, netbooks, and tablets. Many of these new products use the Apple, Android, or Linux operating systems instead of Windows; the chips come from competitors such as Qualcomm and Texas Instruments. As these trends take hold, Microsoft and Intel will find their supplier power diminishing.[5]

> **"The only way to gain lasting competitive advantage is to leverage your capabilities around the world so that the company as a whole is greater than the sum of its parts. Being an international company—selling globally, having global brands or operations in different countries—isn't enough."[6]**
>
> David Whitwam, former CEO, Whirlpool

Rivalry among Competitors

Rivalry among firms refers to all the actions taken by firms in an industry to improve their positions and gain advantage over each other. Rivalry manifests itself in price competition, advertising battles, product positioning, and attempts at differentiation. To the extent that rivalry among firms forces companies to rationalize costs, it is a positive force. To the extent that it drives down prices (and therefore profitability) and creates instability in the industry, it is a negative factor.

Several factors can create intense rivalry. First, once an industry becomes mature, firms focus on market share and how it can be gained at the expense of other firms. Second, industries characterized by high fixed costs are always under pressure to keep production at full capacity to cover those costs. Once the industry accumulates excess capacity, the drive to fill capacity will push prices—and profitability—down. A third factor affecting rivalry is lack of differentiation or an absence of switching costs, which encourages buyers to treat the products or services as commodities and shop for the best prices. Again, this factor places downward pressure on prices and profitability. Fourth, firms with high strategic stakes in achieving success in an industry generally are destabilizing forces because they may be willing to accept below-average profit margins to establish themselves, hold their positions, or expand their operations.

16-2 Competitive Advantage

16-2 Define *competitive advantage* and identify the key conceptual frameworks that guide decision makers in the strategic planning process.

Competitive advantage exists when there is a match between a firm's distinctive competencies and the factors critical for success within its industry. Any superior match between a company's competencies and customers' needs permits the firm to outperform its competitors. Competitive advantage can be achieved in two ways. First, a firm can pursue a low-cost strategy that enables it to offer products at lower prices compared to competitors' products. Second, competitive advantage may be gained by differentiating products so that customers perceive them as having unique benefits, and perhaps as warranting a premium price. Note that both strategies have the same effect: They contribute to the firm's overall value proposition. Porter explored these issues in two landmark books, *Competitive Strategy* (1985) and *Competitive Advantage* (1990); the latter is widely considered to be one of the most influential management books in recent years.

Ultimately, customer perception decides the quality of a firm's strategy. Operating results such as sales and profits are measures that depend on the level of psychological value created for customers: The greater the perceived consumer value, the better the strategy. A firm may market a better mousetrap, but the ultimate success of the product depends on customers deciding for themselves whether to buy it. Value is like beauty: It's in the eye of the beholder. In sum, creating more value than the competition does achieves competitive advantage, and customer perception defines value.

Two different models of competitive advantage have received considerable attention. The first model offers "generic strategies," four routes or paths through which organizations choose to offer superior value and achieve competitive advantage. Critics of this model insist that generic strategies alone did not account for the astonishing success of many Japanese companies in the 1980s and 1990s. Thus, the second, more recent model, which is based on the concept of "strategic intent," proposes four different sources of competitive advantage. Both models are discussed in the following paragraphs.

Generic Strategies for Creating Competitive Advantage

In addition to the five forces model of industry competition, Porter has developed a framework of so-called generic business strategies based on the two types or sources of competitive advantage mentioned previously: *low cost* and *differentiation*. The relationship of these two sources with the scope of the target market served (narrow or broad) or product mix width (narrow or wide) yields four **generic strategies**: *cost leadership*, *product differentiation*, *cost focus*, and *focused differentiation*.

Generic strategies aiming at the achievement of competitive advantage or superior marketing strategy demand that a firm make choices. These choices concern the *type of competitive advantage* the firm seeks to attain (based on cost or differentiation) and the *market scope* or *product mix width* within which competitive advantage will be attained.[7] The nature of the choice between types of advantage and market scope is a gamble, and it is the nature of every gamble that it entails *risk*: By choosing a given generic strategy, a firm always risks making the wrong choice.

BROAD MARKET STRATEGIES: COST LEADERSHIP AND DIFFERENTIATION **Cost leadership** is competitive advantage based on a firm's position as the industry's low-cost producer, in broadly defined markets or across a wide mix of products. This strategy has achieved widespread appeal in recent years as a result of the popularization of the experience curve concept. In general, a firm that bases its competitive strategy on overall cost leadership must construct the most efficient facilities (in terms of scale or technology) and obtain the largest share of market so that its cost per unit is the lowest in the industry. These advantages, in turn, give the producer a substantial lead in terms of experience with building the product. Experience then leads to more refinements of the entire process of production, delivery, and service, which lead to further cost reductions.

Whatever its source, a cost leadership advantage can be the basis for offering lower prices (and more value) to customers in the late, more-competitive stages of the product life cycle. In Japan, companies in a range of industries—photography and imaging, consumer electronics and entertainment equipment, motorcycles, and automobiles—have achieved cost leadership on a worldwide basis.

"We're living in a very polarized world now. You're either an absolute price leader—you're a Ryanair, a Southwest Airlines, a Walmart, and you're just hugely efficient and you will not be touched on price or cost. Or you're over on the quality end of the market with the Guccis and the Pradas and you're a quality leader."[8]

Steve Ridgway, CEO of Virgin Atlantic Airways

Nevertheless, cost leadership will be a sustainable source of competitive advantage only if barriers exist that prevent competitors from achieving the same low costs. In an era of increasing technological improvements in manufacturing, manufacturers constantly leapfrog over one another in pursuit of lower costs. At one time, for example, IBM enjoyed the low-cost advantage in the production of computer printers. Then its Japanese rivals adopted the same technology and, after reducing production costs and improving product reliability, gained the low-cost advantage in the printer market. IBM fought back by constructing a highly automated printer plant in North Carolina, where the number of component parts was slashed by more than 50 percent and robots were used to snap many components into place. Despite these changes, IBM ultimately chose to exit the business.

When a firm's product has an actual or perceived uniqueness in a broad market, it is said to have achieved competitive advantage by **differentiation**. This can be an extremely effective strategy for defending market position and obtaining superior financial returns; unique products often command premium prices (see Exhibit 16-3). Examples of successful differentiation

Exhibit 16-3 Munich-based Siemens AG is a key global player in a variety of engineering sectors. Worldwide, public interest in energy-related issues has increased significantly. In 2011 the company's U.S. unit opened a new plant in Hutchinson, Kansas, to manufacture components for wind turbines.
Source: Siemens AG.

include Maytag in large home appliances, Caterpillar in construction equipment, and almost any successful branded consumer product. IBM traditionally has differentiated itself with a strong sales/service organization and the security of the IBM standard in a world of rapid obsolescence. Among athletic shoe manufacturers, Nike has positioned itself as the technological leader thanks to unique product features found in a wide array of shoes.

NARROW TARGET STRATEGIES: COST FOCUS AND FOCUSED DIFFERENTIATION The preceding discussion of cost leadership and differentiation considered only the impact on broad markets. By contrast, strategies to achieve a narrow-focus advantage target a narrowly defined market or customer. This advantage is based on an ability to create more customer value for a narrowly targeted segment and results from a better understanding of customer needs and wants. A narrow-focus strategy can be combined with either cost- or differentiation-advantage strategies. In other words, whereas a *cost focus* means offering low prices to a narrow target market, a firm pursuing *focused differentiation* will offer a narrow target market the perception of product uniqueness at a premium price.

Germany's *Mittelstand* companies (small and medium-sized firms) have been extremely successful in pursuing **focused differentiation** strategies backed by a strong export effort. The world of "high-end" audio equipment offers another example of focused differentiation. A few hundred small companies design speakers, amplifiers, and related hi-fi gear that cost thousands of dollars per component. While audio components represent a $21 billion market worldwide, annual sales in the high-end segment are only about $1.1 billion. American companies such as Audio Research, Conrad-Johnson, Krell, Mark Levinson, Martin-Logan, and Thiel dominate the segment, which also includes hundreds of smaller enterprises with annual sales of less than $10 million (see Exhibit 16-4). The state-of-the-art equipment that these companies offer is distinguished by superior craftsmanship and performance and is highly sought after by audiophiles in Asia (especially Japan and Hong Kong) and Europe. Even so, market growth has slowed in recent years, as technological advances have enabled makers of inexpensive gear to offer improved sound quality in their products. Also, many audiophiles are turning their attention to other components such as flat-screen televisions and multi-room wireless speaker systems.

The final strategy is **cost focus**, in which a firm's lower-cost position enables it to focus on a narrow target market and offer lower prices than the competition (see Exhibit 16-5). In the shipbuilding industry, for example, Polish and Chinese shipyards offer simple, standard vessel types at low prices that reflect low production costs.[9] Germany's Aldi, a no-frills "hard discounter" with grocery store operations in numerous countries, offers a very limited selection of household goods at extremely low prices. In 1976, Aldi opened its first U.S. stores in southeastern Iowa. It expanded slowly, opening a handful of stores each year. Private-label products help keep costs and prices down, allowing Aldi to expand in the key U.S. markets despite the recent poor economic climate. Recently, Aldi opened its first store in New York City.[10]

IKEA, the Swedish furniture company, has grown into a successful global company by using the cost-focus strategy (see Case 16-1). As George Bradley, president of Levitz Furniture in Boca Raton, Florida, noted a quarter century ago, "[IKEA] has really made a splash. They're going to capture their niche in every city they go into." Such a strategy can be risky. As Bradley explained, "Their market is finite because it is so narrow. If you don't want contemporary, knock-down furniture, it's not for you. So it takes a certain customer to buy it. And remember, fashions change."[11]

The issue of sustainability is central to this strategy concept. As noted, cost leadership is a sustainable source of competitive advantage only if barriers exist that prevent competitors from achieving the same low costs. Sustained differentiation depends on continued perceived value and the absence of imitation by competitors.[12] Several factors determine whether focus can be sustained as a source of competitive advantage. First, a cost focus is sustainable if a firm's competitors are defining their target markets more broadly. A company with a cost focus doesn't try to be all things to all people. Thus, competitors may diminish their advantage by trying to satisfy the needs of a broader market segment—a strategy that, by definition, means a blunter focus. Second, a firm's differentiation focus advantage is sustainable only if competitors cannot define the segment even more narrowly. Also, focus can be sustained if competitors cannot overcome barriers that prevent imitation of the focus strategy, and if consumers in the target segment do not migrate to other segments that the more focused company doesn't serve.

Exhibit 16-4 In keeping with the aesthetics of high-end audio gear, Theta Digital's Prometheus monoblock power amplifier is the epitome of classic, minimalist design. A pair of these beauties—one for each stereo channel—will set you back $12,000.
Source: Mr. Buzz Delano/Theta Digital.

Exhibit 16-5 For more than 100 years, Germany's Aldi has offered shoppers a tightly focused assortment of unbranded merchandise at very low prices in a no-frills setting. Now, taking a cue from its Trader Joe's unit in the United States, Aldi is making major improvements in its home-country market. German shoppers want more than low prices; they also want a nice ambience and a more appealing atmosphere.
Source: ZUMA Press Inc/Alamy Stock Photo.

Creating Competitive Advantage via Strategic Intent

An alternative framework for understanding competitive advantage focuses on competitiveness as a function of the pace at which a company implants new advantages deep within its organization. This framework identifies **strategic intent**, growing out of ambition and obsession with winning, as the means for achieving competitive advantage. Writing in the *Harvard Business Review*, Gary Hamel and C. K. Prahalad note:

> Few competitive advantages are long lasting. Keeping score of existing advantages is not the same as building new advantages. The essence of strategy lies in creating tomorrow's competitive advantages faster than competitors mimic the ones you possess today. An organization's capacity to improve existing skills and learn new ones is the most defensible competitive advantage of all.[13]

This approach is founded on the principles espoused by W. Edwards Deming, who stressed that a company must commit itself to continuing improvement if it expects to be a winner in a competitive struggle. For years, Deming's message fell on deaf ears in the United States, while the Japanese heeded his message and benefited tremendously. Japan's most prestigious business award is named after Deming. Eventually, however, U.S. auto manufacturers responded, and Detroit's current resurgence is evidence that those automakers have made much progress.

The significance of Hamel and Prahalad's framework becomes evident when comparing Caterpillar and Komatsu. As noted earlier, Caterpillar is a classic example of differentiation: The company became the largest manufacturer of earthmoving equipment in the world because it was fanatical about quality and service. Caterpillar's success as a global marketer has enabled it to achieve a 40 percent share of the worldwide market for earthmoving equipment, more than half of which represents sales to developing countries. The differentiation advantage was achieved with product durability, global spare parts service (including guaranteed parts delivery anywhere in the world within 48 hours), and a strong network of loyal dealers.

Over the last several decades, Caterpillar has faced a very challenging set of environmental pressures. Many of Caterpillar's plants were closed by a lengthy strike in the early 1980s; a worldwide recession at the same time caused a downturn in the construction industry. This hurt companies that were Caterpillar customers. In addition, the strong dollar gave a cost advantage to foreign rivals.

Compounding Caterpillar's problems was a new competitive threat from Japan. Komatsu was the world's number 2 construction equipment company and had been competing with Caterpillar in the Japanese market for years. Komatsu's products were generally acknowledged to offer a lower level of quality. The rivalry took on a new dimension after Komatsu adopted the slogan "*Maru-c*," meaning "encircle Caterpillar." Emphasizing quality and taking advantage of low labor costs and the strong dollar, Komatsu surpassed Caterpillar to become number 1 in earthmoving equipment in Japan and made serious inroads in the United States and other markets. Even after it achieved world-class quality, Komatsu continued to develop new sources of competitive advantage. For example, new-product development cycles were shortened and manufacturing was rationalized. Caterpillar struggled to sustain its competitive advantage because many customers found that Komatsu's combination of quality, durability, and lower price created compelling value. Yet even as the recession and a strong yen put new pressure on Komatsu, the company sought new opportunities by diversifying into machine tools and robots.[14]

The Komatsu/Caterpillar saga illustrates the fact that global competitive battles can be shaped by factors other than the pursuit of generic strategies. Many firms have gained competitive advantage by *disadvantaging* rivals through "competitive innovation." Hamel and Prahalad define *competitive innovation* as "the art of containing competitive risks within manageable proportions" and identify four successful approaches used by Japanese competitors: *building layers of advantage*, *searching for loose bricks*, *changing the rules of engagement*, and *collaborating*.

LAYERS OF ADVANTAGE A company faces less risk in competitive encounters if it has a wide portfolio of advantages. Successful companies steadily build such portfolios by establishing layers of advantage on top of one another. Komatsu is an excellent example of this approach. Another is the TV industry in Japan. By 1970, Japan was not only the world's largest producer of black-and-white TV sets, but also well on its way to becoming the leader in producing color sets. The main competitive advantage for such companies as Matsushita at that time was low labor costs.

Because they realized that their cost advantage might be temporary, Japanese companies added another layer of *quality and reliability* advantages by building plants large enough to serve world markets. Much of this output did not carry the manufacturer's brand name. For example, Matsushita Electric sold products to other companies such as RCA, which then marketed them under their own brand names. Matsushita was pursuing a simple idea: A product sold was a product sold, no matter whose label it carried.[15]

To build the next layer of advantage, Japanese firms spent the 1970s investing heavily in marketing channels and Japanese brand names to gain recognition. This strategy added yet another layer of competitive advantage: the *global brand franchise*—that is, a global customer base. By the late 1970s, channels and brand awareness were established well enough to support the introduction of new products that could benefit from global marketing—VCRs and photocopy machines, for example. Finally, many companies have invested in *regional manufacturing* so their products can be differentiated and better adapted to customer needs in individual markets.

The process of building layers illustrates how a company can move along the value chain to strengthen its competitive advantage. The Japanese companies began with manufacturing (an upstream value activity) and moved on to marketing (a downstream value activity) and then back upstream to basic R&D. All of these sources of competitive advantage represent mutually reinforcing layers that accumulate over time.

LOOSE BRICKS A second approach takes advantage of the "loose bricks" left in the defensive walls of competitors whose attention is narrowly focused on a market segment or a geographic area to the exclusion of others. For example, Caterpillar's attention was focused elsewhere when Komatsu made its first foray into the Eastern Europe market. Similarly, Taiwan's Acer prospered by following founder Stan Shih's strategy of approaching the world computer market from the periphery. Shih's inspiration was the Asian board game *Go*, in which the winning player successfully surrounds opponents. Shih gained experience and built market share in countries overlooked by competitors such as IBM and Compaq. By the time Acer was ready to target the United States in earnest, it was already the number 1 PC brand in key countries in Latin America, Southeast Asia, and the Middle East.

Intel's loose brick was its narrow focus on complex microprocessors for PCs. The world's biggest chip maker in terms of sales, it currently commands approximately 80 percent of the global market for PC processors. However, even as it built its core business, demand for non-PC consumer electronics products began to explode. The new non-PC products, such as set-top boxes for televisions, digital cameras, smartphones, and tablets, require chips that are cheaper and use less power than those produced by Intel. Competitors such as LSI Logic and Arm Holdings recognized the opportunity and beat Intel into an important new market. Intel has responded by developing new chips incorporating 3D technology that use half as much power as current designs.[16]

CHANGING THE RULES A third approach involves **changing the rules of engagement** and refusing to play by the rules set by industry leaders. For example, in the copier market, IBM and Kodak imitated the marketing strategies used by market leader Xerox. Meanwhile, Canon, a Japanese challenger, wrote a new rulebook.

While Xerox built a wide range of copiers, Canon built standardized machines and components, reducing manufacturing costs. While Xerox employed a huge direct-sales force, Canon chose to distribute its copiers through office-product dealers. Canon also designed serviceability and reliability into its products, so that it could rely on dealers when service was needed rather than incurring the expense required to create a national service network. In addition, the company decided to sell rather than lease its machines, freeing the company from the burden of financing the lease base. In another major departure, Canon targeted its copiers at secretaries and department managers rather than at the heads of corporate duplicating operations.[17]

Canon introduced the first full-color copiers and the first copiers with "connectivity"—the ability to print images from such sources as video camcorders and computers. The Canon example shows how an innovative marketing strategy—with fresh approaches to the product, pricing, distribution, and selling—can lead to overall competitive advantage in the marketplace. Canon is not invulnerable, however: In 1991, Tektronix, a U.S. company, leapfrogged past Canon in the color copier market by introducing a plain-paper color copier that offered sharper copies at a much lower price.[18]

COLLABORATING A final source of competitive advantage is using know-how developed by other companies. Such *collaboration* may take the form of licensing agreements, joint ventures, or partnerships. History has shown that Japanese firms have excelled at using the collaborating strategy to achieve industry leadership. One of the legendary licensing agreements of modern business history is Sony's licensing of transistor technology from AT&T's Bell Labs subsidiary in the 1950s for $25,000. This agreement gave Sony access to the transistor and allowed the company to become a world leader. Building on its initial successes in the manufacturing and marketing of portable radios, Sony has grown into a superb global marketer whose name is synonymous with a wide assortment of high-quality consumer electronics products.

More recent examples of Japanese collaboration are found in the aircraft industry. Today, Mitsubishi Heavy Industries and other Japanese companies manufacture airplanes under license to U.S. firms and also work as subcontractors for aircraft parts and systems. Many observers fear that the future of the American aircraft industry may be jeopardized as the Japanese gain technological expertise. The next section discusses various examples of "collaborative advantage."[19]

16-3 Global Competition and National Competitive Advantage

◀ **16-3** Explain how a nation can achieve competitive advantage, and list the forces that may be present in a national "diamond."

An inevitable consequence of the expansion of global marketing activities is the growth of competition on a global basis.[20] In industry after industry, global competition is a critical factor affecting success. As Yoshino and Rangan have explained, **global competition** occurs when a firm takes a global view of competition and sets about maximizing profits worldwide, rather than on a country-by-country basis. If, when expanding abroad, a company encounters the same rival in market after market, then it is engaged in global competition.[21] In some industries, global companies have virtually excluded all other companies from their markets. An example is the detergent industry, in which three companies—Colgate, Unilever, and Procter & Gamble—dominate an increasing number of detergent markets in Latin America and the Pacific Rim. Many companies can make a quality detergent, but brand-name muscle and the skills required for quality packaging overwhelm the local competition in market after market.[22]

The automobile industry has also become fiercely competitive on a global basis. Part of the reason for the initial success of foreign automakers in the United States was the reluctance—or inability—of U.S. manufacturers to design and manufacture high-quality, inexpensive small cars. The resistance of U.S. manufacturers was based on the economics of car production: Bigger cars equaled bigger profits. Under this formula, small cars meant smaller unit profits. Sadly, U.S. car manufacturers mostly ignored the increasing preference of U.S. drivers for smaller cars, a classic case of ethnocentrism and management myopia. European and Japanese manufacturers always offered cars smaller than those made in the United States, in part because market conditions were much different: less space, higher taxes on engine displacement and fuel, and greater market interest in functional design and engineering innovations.

First Volkswagen, and then Japanese automakers such as Nissan and Toyota, discovered a growing demand for their cars in the U.S. market. For most of the past 20 years, the Toyota Camry has been the best-selling passenger car in North America. Ironically, the Camry plants are located in Kentucky and Indiana, and Cars.com rates the Camry as "the most American car" in its American-Made Index! But the competitive environment continues to evolve. Today, South Korea's Hyundai and Kia have joined the ranks of world-class automakers. Meanwhile, Korea's Automobile Journalist Association named Camry the "Korea Car of the Year" for 2013; however, those Korea-bound Camrys come from U.S. plants. Doubly ironic! And, as noted in Case 13-1, Volkswagen's drive to become the world's top automaker has faltered in the face of an emissions-cheating scandal.

The effect of global competition has been highly beneficial to consumers around the world. In the two examples cited, detergents and automobiles, consumers have benefited. In Central America, detergent prices have fallen as a result of global competition. Global automakers provide consumers with the models, performance, and price characteristics they want. If smaller, lower-priced imported cars had not been available, it is unlikely that Detroit's manufacturers would have responded as quickly to the changing market conditions. What is true for automobiles in the United States is true for every product category around the world: Global competition expands the range of products available and increases the likelihood that consumers will get what they want.

The downside of global competition is its impact on the producers of goods and services. Global competition creates value for consumers, but it also has the potential to destroy jobs and profits. When a company—Toyota, for example—offers consumers in other countries a better product at a lower price, it takes customers away from domestic firms such as GM. Unless the domestic firm can create new sources of value and find new customers, the jobs and livelihoods of the domestic supplier's employees are threatened.

This section addresses the following issue: Why is a particular nation a good home base for specific industries? Why, for example, is the United States the home base for the leading competitors in tablets and smartphones, software, credit cards, and filmed entertainment? Why is Germany home to so many world leaders in printing presses, chemicals, and luxury cars? Why are so many leading pharmaceutical, chocolate/confectionery, and trading companies located in Switzerland? How does one account for Italy's success in wool textiles, knitwear, and apparel?

Harvard professor Michael E. Porter explored these issues in his groundbreaking 1990 book *The Competitive Advantage of Nations*. The book was hailed as a valuable guide for shaping national policies on competitiveness. According to Porter, the presence or absence of particular attributes in individual countries influences industry development, not just the ability of individual firms to create core competencies and competitive advantage.[23] Porter describes these attributes in terms of a national "diamond." You can visualize these attributes relative to a baseball diamond: Demand conditions are on "first base"; firm strategy, structure, and rivalry occupy "second base"; factor conditions are on "third base"; and related and supporting industries are at "home plate." The diamond shapes the environment in which firms compete. Activity in any one of the four points of the diamond impacts all the other points, and vice versa.

Factor Conditions

Factor conditions comprise a country's endowment with resources. Those resources may have been created or inherited. *Basic factors* may be inherited or created without much difficulty; because they can be replicated in other nations, they are not sustainable sources of **national advantage**. Specialized factors, by contrast, are more advanced and provide a more sustainable source for advantage. Porter describes five categories of factor conditions: human, physical, knowledge, capital, and infrastructure.

HUMAN RESOURCES The quantity of workers available, the skills possessed by these workers, the wage levels, and the overall work ethic of the workforce together constitute a nation's human resources factor. Countries with a plentiful supply of low-wage workers have an obvious advantage in the production of labor-intensive products. Conversely, such countries may be at a disadvantage when it comes to the production of sophisticated products requiring highly skilled workers capable of working without extensive supervision.

PHYSICAL RESOURCES The availability, quantity, quality, and cost of land, water, minerals, and other natural resources determine a country's or region's physical resources. As Porter discusses in *The Competitive Advantage of Nations*, Italy's strength as an exporter is due in part to clusters of successful industries including textiles and apparel; glass, ceramics, and stone products; and many others (see Exhibit 16-6). A country's size and location are also included in this category, because proximity to markets and sources of supply, as well as transportation costs, are strategic considerations. These factors are important advantages—or disadvantages—to industries dependent on natural resources. Brazil is a case in point. With a large landmass, temperate climate, and abundant water supply, Brazil is a leading producer of agricultural commodities, including coffee, soybeans, and sugar.

KNOWLEDGE RESOURCES When a significant portion of a country's population has scientific, technical, and market-related knowledge, that nation is considered to be endowed with knowledge

Exhibit 16-6 Impruneta, a city in the Italian province of Florence, is a source of top-quality terracotta. The high iron content of the area's clay means that the finished pieces can withstand temperatures as low as –20°F. Many artisan designs are rolled by hand, including those imported for the U.S. market by Seibert & Rice.
Source: Seibert & Rice.

resources. The presence of this factor is usually a function of the number of research facilities and universities—both government and private—operating in the country. This factor is important to success in sophisticated products and services, and to doing business in sophisticated markets. This factor speaks directly to Germany's leadership in chemicals; today, BASF is the world's largest producer of chemicals. For the past 200 years, Germany has been home to top university chemistry programs, advanced scientific journals, and apprenticeship programs.

CAPITAL RESOURCES Countries vary in the availability, amount, cost, and types of capital available to their industries. A nation's savings rate, interest rates, tax laws, and government deficit all affect the availability of this factor. The advantage enjoyed by industries in countries with low capital costs versus those located in nations with relatively high capital costs is sometimes decisive. Firms paying high capital costs are frequently unable to stay in a market where the competition comes from a nation with low capital costs. Those firms with a low cost of capital can keep their prices low and force the firms paying high costs to either accept low returns on investment or leave the industry.

INFRASTRUCTURE RESOURCES Infrastructure includes a nation's banking system, health care system, transportation system, and communications system, as well as the availability and cost of using these systems. More sophisticated industries are more dependent on advanced infrastructures for success.

Competitive advantage accrues to a nation's industry if the mix of factors available to the industry is such that it facilitates pursuit of a generic strategy (i.e., low-cost production or the production of a highly differentiated product or service). Nations that have selective factor *disadvantages* may also indirectly create competitive advantage. For example, the absence of suitable labor may force firms to develop forms of mechanization or automation that give the nation an advantage. High transportation costs may motivate firms to develop new materials that are less expensive to transport.

Demand Conditions

The nature of home demand conditions for the firm's or industry's products and services is important because it determines the rate and nature of improvement and innovation by the firms in the nation. **Demand conditions** are the factors that either train firms for world-class competition or fail to adequately prepare them to compete in the global marketplace. Four characteristics of home demand are particularly important to the creation of competitive advantage: the composition of home demand, the size and pattern of the growth of home demand, rapid home-market growth, and the means by which a nation's home demand pushes or pulls the nation's products and services into foreign markets.

ENTREPRENEURIAL LEADERSHIP, CREATIVE THINKING, AND THE GLOBAL STARTUP

Italian Entrepreneurs Combine Fashion and Function, Part 1: Leonardo del Vecchio, Luxottica

As Michael Porter notes in *The Competitive Advantage of Nations*:

> Entrepreneurship thrives in Italy, feeding rivalry in existing industries and the formation of clusters. Italians are risk takers. Many are individualistic and desire independence. They aspire to have their own company. They like to work with people they know well, as in the family, and not as part of a hierarchy. . . . Recently, the entrepreneur has become celebrated in Italy, and a number of business magazines are full of nothing but profiles of successful entrepreneurs. (p. 447)

Leonardo del Vecchio is an entrepreneur. He developed an innovative approach to an existing product and, in 1961, founded a company that manufactures and markets it. By applying the basic tools and principles of modern marketing, del Vecchio has achieved remarkable success.

Del Vecchio grew up in an orphanage, but today he is one of Europe's richest men. His insight: Although eyeglasses are critical for vision, they also reflect the wearer's personality. As a product, then, eyeglass frames serve two purposes; one is functional, the other is aesthetic. This insight fueled the growth of del Vecchio's company, Luxottica, and turned it into the world's top producer of eyeglass frames.

Luxottica has 78,000 employees worldwide, and is vertically integrated. It designs and manufactures frames in its own factories, and also is involved in distribution through fully owned chains such as Sunglass Hut, LensCrafters, and Pearle Vision (see Exhibit 16-7). It owns top eyewear brands including Oakley, Ray-Ban, and Vogue. The company also produces frames under license for a veritable who's who of luxury brands: Burberry, Dolce & Gabbana, Donna Karan, Prada, Ralph Lauren, Versace, and many others. Ray-Ban is Luxottica's biggest-selling brand, with more than €2 billion ($2.2 billion) in sales each year.

By 2016, Luxottica commanded nearly 14 percent of the $90 billion global eyewear market. However, demographic trends and new industry entrants are presenting significant opportunities and challenges. Following the departure of longtime chief executive Andrea Guerra, Leonardo del Vecchio, at the age of 80, returned to the company he founded.

In 2017, Del Vecchio announced that Luxottica was merging with Essilor, a lens manufacturer based in France. The new company, Essilor-Luxottica, will have annual revenues of €15 billion (about $17.5 billion) and market products in 150 countries. Commenting on the deal, Del Vecchio said, "We have the brand. What was missing was the quality of the lenses." Another plus: Essilor has been granted several patents for connected glasses. A new product, MyEye, consists of frames equipped with a camera and earphones so that users can listen to scanned text while doing something else.

Meanwhile, other entrepreneurial startups have recognized new opportunities in the eyewear sector. Italia Independent is a brand created by Lapo Elkann, a billionaire heir to the family that owns Ferrari. It's been said that Elkann's company created the "mass cool" segment. Italia Independent is known for using innovative materials such as carbon fiber in its frames; the brand is especially popular with Millennials.

Sources: Rachel Sanderson, "The Far-Sighted Dealmaker of Milan," *Financial Times* (January 21–22, 2017), p. 7; Michael Stothard and Rachel Sanderson, "Luxottica and Essilor Set out Their €50bn Growth Vision," *Financial Times* (January 17, 2017), p. 15; Rachel Sanderson, "Let's Launch in . . . Milan, Italy," *Financial Times* (June 29, 2016), p. 12; Rachel Sanderson, "Designers Open Eyes to Latest Fashion Spectacle," *Financial Times* (April 9–10, 2016), p. 12; Bill Emmott, *Good Italy, Bad Italy: Why Italy Must Conquer Its Demons to Face the Future* (New Haven, CT: Yale University Press, 2012), Chapter 7; Christina Passariello, "Fitting Shades for Chinese," *The Wall Street Journal* (April 21, 2011), p. B5; Rachel Sanderson, "The Real Value of Being 'Made in Italy,'" *Financial Times* (January 19, 2011); Emanuela Scarpellini, *Material Nation: A Consumer's History of Modern Italy* (New York, NY: Oxford University Press, 2011); David Segal, "Is Italy Too Italian?" *The New York Times* (August 1, 2010), p. B1; Michael E. Porter, *The Competitive Advantage of Nations* (New York, NY: Free Press, 1990), Chapter 8.

Exhibit 16-7 Luxottica, the world's leading eyewear manufacturer, also owns and operates retail chains in key global markets. Generally speaking, customers in the United States tend to emphasize function (e.g., brands such as Ray-Ban and Oakley) and are somewhat more conservative and traditional in their tastes. By contrast, European and Asian customers share the desire for an emotional connection with the things they buy—including eyeglass frames. The company is ramping up efforts to expand in Brazil, India, Turkey, and China.

Source: Kris Tripplaar/SIPA/Newscom.

COMPOSITION OF HOME DEMAND This demand element determines how firms perceive, interpret, and respond to buyer needs. Competitive advantage can be achieved when the home demand sets the quality standard and gives local firms a better picture of buyer needs, at an earlier time, than the perspective that is available to foreign rivals. This advantage is enhanced when home buyers pressure the nation's firms to innovate quickly and frequently. The basis for advantage is the fact that the nation's firms can stay ahead of the market when the firms are more sensitive and more responsive to home demand and when that demand, in turn, reflects or anticipates world demand.

SIZE AND PATTERN OF GROWTH OF HOME DEMAND These are important only if the composition of the home demand is sophisticated and anticipates foreign demand. Large home markets offer opportunities to achieve economies of scale and learning while dealing with familiar, comfortable markets. There is less apprehension about investing in large-scale production facilities and expensive R&D programs when the home market is sufficient to absorb the increased capacity. If the home demand accurately reflects or anticipates foreign demand, and if the firms do not become content with serving just the home market, the existence of large-scale facilities and programs will be an advantage in global competition.

RAPID HOME-MARKET GROWTH Rapid growth in the local market is yet another incentive to invest in and adopt new technologies faster and to build large, efficient facilities. The best example of this factor is seen in Japan, where rapid home-market growth provided the incentive for Japanese firms to invest heavily in modern, automated facilities. *Early home demand*, especially if it anticipates international demand, gives local firms the advantage of getting established in an industry sooner than their foreign rivals. Equally important is *early market saturation*, which puts pressure on a company to expand into international markets and innovate. Market saturation is especially important if it coincides with rapid growth in foreign markets.

MEANS BY WHICH A NATION'S PRODUCTS AND SERVICES ARE PUSHED OR PULLED INTO FOREIGN COUNTRIES The issue here is whether a nation's people and businesses go abroad and then demand the home nation's products and services in those second countries. For example, when the U.S. auto companies set up operations in foreign countries, the auto parts industry followed. The same is true for the Japanese auto industry. Similarly, when overseas demand for the services of U.S. engineering firms skyrocketed after World War II, those firms, in turn, established demand for U.S. heavy construction equipment. This provided an impetus for Caterpillar to establish foreign operations.

A related issue is that of a nation's people going abroad for training, pleasure, business, or research. After returning home, they are likely to demand the products and services with which they became familiar while abroad. Similar effects can result from professional, scientific, and political relationships between nations. Those involved in the relationships begin to demand the products and services of the recognized leaders.

It is the interplay of demand conditions that produces competitive advantage. Of special importance are those conditions that lead to initial and continuing incentives to invest and innovate and to continuing competition in increasingly sophisticated markets.

Related and Supporting Industries

A nation has an advantage when it is home to globally competitive companies in business sectors that comprise **related and supporting industries**. Globally competitive supplier industries provide inputs to downstream industries. The latter, in turn, are likely to be globally competitive in terms of price and quality, thereby gaining competitive advantage from this situation. Downstream industries will have easier access to these inputs and the technology that produced them, and to the managerial and organizational structures that made them competitive. Access is a function of proximity in terms of both physical distance and cultural similarity. It is not the inputs themselves that give advantage, but rather the *contact* and *coordination* with the suppliers, which give home-country firms the opportunity to structure the value chain so that linkages with suppliers are optimized. These opportunities may not be available to foreign firms.

Similar advantages are present when globally competitive, related industries operate within a nation. In such a case, opportunities are available for coordinating and sharing value chain activities. Consider, for example, the opportunities for sharing between computer hardware manufacturers and software developers. Related industries also create "pull through" opportunities, as described previously. For example, non-U.S. sales of PCs from Hewlett-Packard, Lenovo, Dell, Acer, and others have bolstered demand for software from Microsoft and other U.S. companies. Porter notes that the development of the Swiss pharmaceuticals industry can be attributed, in part, to Switzerland's large synthetic dye industry; the discovery of the therapeutic effects of dyes, in turn, led to the development of pharmaceutical companies.[24]

Firm Strategy, Structure, and Rivalry

The **nature of firm strategy, structure, and rivalry** is the final determinant of a nation's diamond. Domestic rivalry in a single national market is a powerful influence on competitive advantage. The PC industry in the United States is a good example of how a strong domestic rivalry keeps an industry dynamic and creates continual pressure to improve and innovate. The rivalry among Dell, Hewlett-Packard, and Apple forces all the players to develop new products, improve existing ones, lower costs and prices, develop new technologies, and continually improve quality and service to keep customers happy. Rivalry with foreign firms, by contrast, may lack this intensity. Domestic rivals have to fight each other not just for market share, but also for employee talent, R&D breakthroughs, and prestige in the home market. Eventually, strong domestic rivalry will push firms to seek international markets to support their expansions in scale and R&D investments, as the case of Japan amply demonstrates. In contrast, the absence of significant domestic rivalry can engender complacency in the home firms and eventually cause them to become noncompetitive in the world markets.

It is not the number of domestic rivals that is important, but rather the intensity of the competition and the quality of the competitors that make the difference. In addition, a fairly high rate of new business formation is necessary to create new competitors and prevent the older companies from becoming too comfortable with their market positions and products and services. As noted earlier in the discussion of the five forces model, new industry entrants bring new perspectives and new methods to the market. They frequently define and serve new market segments that established companies have failed to recognize.

Differences in management styles, organizational skills, and strategic perspectives also create advantages and disadvantages for firms competing in different types of industries, as do differences in the intensity of domestic rivalry. In Germany, for example, company structure and management style tend to be hierarchical. Managers tend to come from technical backgrounds and to be most successful when dealing with industries that demand highly disciplined structures, such as chemicals and precision machinery. Italian firms, in contrast, tend to look like, and be run like, small family businesses that stress customized over standardized products, niche markets, and substantial flexibility in meeting market demands.

Well known and highly esteemed in its own country, India's Tata Group participates in a variety of industries, including heavy vehicles, cars, department stores, and tea. Now the group's management team is hoping to maintain that brand image as an international strategy is implemented. Historically, Tata's Group's competitive advantage was based on scouring the globe to find the lowest-cost, highest-quality production inputs—be they raw materials or skilled labor—and then selling them in the global marketplace at a substantial profit. Not every deal works out as planned, however. In 2006, for example, the Group's Taj Hotels Resorts and Palaces subsidiary bought the Ritz-Carlton Hotel in Boston for $170 million and renamed it Taj Boston. A decade later, in 2016, a local real estate investment group, New England Development, agreed to buy Taj Boston. The price? A reported $125 million.

There are two final external variables to consider in the evaluation of national competitive advantage—chance and government.

Chance

Chance events may sometimes play a role in shaping the competitive environment. Chance events are occurrences that are beyond the control of firms, industries, and usually governments. Included in this category are such issues as wars and their aftermaths; major technological breakthroughs; sudden, dramatic shifts in a factor or an input cost, like an oil crisis; dramatic swings in exchange rates; and so on.

Chance events are important because they create major discontinuities in technologies that allow nations and firms that were not competitive to leapfrog over former competitors and become competitive—perhaps even leaders—in the changed industry. For example, the development of microelectronics allowed many Japanese firms to overtake U.S. and German firms in industries that had been based on electromechanical technologies—areas traditionally dominated by the Americans and Germans.

From a systemic perspective, the importance of chance events lies in the fact that they alter conditions in the diamond. The nation with the most favorable "diamond," however, will be the one most likely to take advantage of these chance events and convert them into competitive advantage. For example, Canadian researchers were the first to isolate insulin, but they could not convert this breakthrough into a globally competitive product. In contrast, firms in the United States and Denmark were able to make that conversion because of their respective national "diamonds."

Government

Although it is often argued that government is a major determinant of national competitive advantage, in actuality, government is not a determinant but rather an influence on determinants. Government influences determinants by virtue of its roles as a buyer of products and services and a maker of policies on labor, education, capital formation, natural resources, and product standards. It also influences determinants through its role as a regulator of commerce—for example, by telling banks and telephone companies what they can and cannot do.

By reinforcing determinants in industries where a nation has competitive advantage, government improves the competitive position of the nation's firms. Governments devise legal systems that influence competitive advantage by means of tariffs and nontariff barriers and laws requiring local content and labor. In the United States, for example, the dollar's decline over the past decade has been due, in part, to a deliberate policy to enhance U.S. export flows and stem imports. In other words, government can improve or lessen competitive advantage, but it cannot create it.

16-4 Current Issues in Competitive Advantage

◀ **16-4** Define *hypercompetitive industry* and list the key arenas in which dynamic strategic interactions take place.

Porter's work on national competitive advantage has stimulated a great deal of further research. The Geneva-based World Economic Forum issues an annual report ranking countries in terms of their competitiveness. The Lausanne, Switzerland–based International Institute for Management Development (IMD) compiles similar rankings. In a recent study by IMD, the United States ranked first, thanks to big tech companies such as Amazon, Apple, Facebook, Google, and Netflix (see Table 16-1). Fine Swiss watches, Novartis and other pharmaceutical firms, and food-giant Nestlé are a few of the sources of Switzerland's competitiveness in the runner-up position.[25]

Hypercompetitive Industries

In a book published in the mid-1990s, Dartmouth College professor Richard D'Aveni suggested that the Porter strategy frameworks fail to adequately address the dynamics of competition in the 1990s and the new millennium.[26] D'Aveni took a different approach in analyzing issues related to competitive advantage. He noted that the business environment at the time was characterized by short product life cycles, short product design cycles, new technologies, and globalization. All of these factors and forces interacted to undermine market stability. The result? An escalation and acceleration of competitive forces.

In light of these changes, D'Aveni believed the goal of strategy was shifting from sustaining advantages to disrupting advantages. The limitation of the Porter models, D'Aveni argued, is that they are static; that is, they provide a snapshot of competition at a given point in time. Acknowledging that Hamel and Prahalad broke new ground in recognizing that few advantages are sustainable, D'Aveni aimed to build upon their work to shape "a truly dynamic approach to the creation and destruction of traditional advantages." D'Aveni used the term **hypercompetition** to describe a dynamic competitive world in which no action or advantage can be sustained for long. In such a world, D'Aveni argued, "everything changes" because of the dynamic maneuvering and strategic interactions by hypercompetitive firms such as Microsoft and Gillette.

According to D'Aveni's model, competition unfolds in a series of dynamic strategic interactions in four areas: cost and quality, timing and know-how, entry barriers, and deep pockets. Each of these arenas is "continuously destroyed and recreated by the dynamic maneuvering of hypercompetitive firms." Also, according to D'Aveni, the only source of a truly sustainable competitive

ENTREPRENEURIAL LEADERSHIP, CREATIVE THINKING, AND THE GLOBAL STARTUP

Italian Entrepreneurs Combine Fashion and Function, Part 2
Diego Della Valle, Tod's; Mario Moretti Polegato, Geox

Diego Della Valle is an entrepreneur. He developed an innovative approach to an existing product and then leveraged his family's business to manufacture and market it. By applying the basic tools and principles of modern marketing, Della Valle and his family have achieved remarkable success.

As is true with many entrepreneurs, Della Valle's idea was based on his recognition that "there had to be a better way." While visiting the United States as a young man, he spotted "these strange, very badly made shoes from Portugal" at a flea market in New York. They were marketed as a driving accessory. Diego brought a pair back to Italy and showed his father, Dorino. The elder Della Valle thought they were "horrible" and told his son to throw them away. Dorino Della Valle then reconsidered. His son says, "He changed the way we think about shoes. In the past, expensive shoes were rigid, heavy. So he had the idea of making them soft, to fit like a glove, using the best quality leather."

Today, Tod's S.p.A., the family business that was started in the 1920s, is closely identified with its iconic driving shoe. Called the Gommino, each pair requires 35 pieces of leather and 100 steps to fabricate. Integral to the design is the Leo Clamp, a decorative band across the front of the shoe. Prices start at about $350 per pair. The company's strategic focus extends to handbags as well; total annual sales are $1 billion. CEO Diego Della Valle says, "We want to guarantee our customers we're giving them the best." The CEO continues, "Pure Italian style is identifiable anywhere in the world. When I am walking in Central Park, I recognize the Italians because an Italian, even when he jogs, he's dressed perfect."

One of the company's most recent endeavors was a collaboration with five young designers whose backgrounds include art and architecture. Each designer created a limited-edition version of the Gommino. The project, called Looking at Tod's Leo, was headed by Italian architect Giulio Cappellini. One group created a shoe with leather that had been treated to give the impression it was marble; other teams incorporated unusual materials including ceramics and wood.

The need to maintain a quality image is one reason that all Tod's production—including six sewing factories—takes place in Italy. Analyst Davide Vimercati notes, "Tod's is proof that if you manage your brand consistently and you build brand equity over the years, you reach a stage where demand remains strong, even in tough times."

Della Valle is keenly aware that the world of luxury fashion is being impacted by the digital revolution. For many consumers—especially younger ones—brand loyalty is being replaced by the urge to buy "the next big thing" online. Even as Tod's embraces classic designs, Della Valle is leveraging social media. Streams of its catwalk shows attract millions of viewers.

Another Italian entrepreneur, Mario Moretti Polegato, is targeting a very different aspect of the shoe market—the mass-market footwear segment. Polegato's strategic insight was simple: Shoes with conventional rubber soles are bad for your feet! While on a business trip to Las Vegas, Polegato went for a run in the Nevada desert. When he got back to his hotel, his feet were bruised and sweaty. It occurred to him that holes in the soles would allow feet to breathe. As Polegato recalls, "I went looking for breathable soles in sports shops all around Italy, and I couldn't find them. I thought, 'Is it possible that nobody has thought of this yet?' And nobody had."

Of course, it hardly makes sense to walk around with holes in one's shoes, because they let in dirt and water. So Polegato was faced with a technological challenge: how to make a waterproof shoe with holes in the soles. Polegato persevered, and today the Geox brand's signature product is mid-price casual shoes with perforations in the soles that allow feet to "breathe." How? A special membrane based on Japanese technology makes each shoe waterproof but allows sweat to evaporate (see Exhibit 16-8. In short, "The shoe that breathes!" To keep prices competitive, much of the production is outsourced to low-wage countries such as Romania. Polegato has clearly hit upon a successful strategy: Today there are more than 30,000 Geox employees worldwide, and the company has more than 1,000 stores.

Sources: Rachel Sanderson, "Tod's Owner Diego Della Valle: 'Millennials Are Not for Everyone,'" *Financial Times* (February 15, 2018), p. 23; Stephen Doig, "If the Shoe Fits: Tod's at Salone de Mobile," *The Telegraph* (April 15, 2016), p. 9; Rachel Sanderson, "'Move over, We Will Do It,'" *Financial Times* (September 23, 2015), p. 10; Liz Alderman, "A Shoemaker That Walks But Never Runs," *The New York Times* (October 10, 2010), p. B1; Vincent Boland, "Italy's Entrepreneur with Sole," *Financial Times* (April 22, 2009), p. 17; "Employment, Italian Style," *The Wall Street Journal* (June 26, 2012), p. A14.

Exhibit 16-8 Geox's competitive advantage stems from a patented technology that allows for "breathability" in the soles of its shoes. "Respira!"
Source: george photo cm/Shutterstock.

TABLE 16-1 The World's Most Competitive Countries

Rank	Country
1.	United States
2.	Switzerland
3.	Hong Kong
4.	Sweden
5.	Singapore
6.	Norway
7.	Canada
8.	United Arab Emirates
9.	Germany
10.	Qatar

advantage is a company's ability to manage its dynamic strategic interactions with competitors by means of frequent movements and counter-movements that maintain a relative position of strength in each of the four arenas (see Table 16-2).

COST AND QUALITY Competition in the first arena, cost and quality, occurs via seven dynamic strategic interactions: price wars, quality and price positioning, "the middle path," "cover all niches," outflanking and niching, the move toward an ultimate value marketplace, and escaping from the ultimate value marketplace by restarting the cycle. D'Aveni cites the global watch industry as an example of hypercompetitive behavior in the cost and quality arena. In the 1970s, the center of the watch industry shifted from its traditional home in Switzerland to Japan as the Japanese created high-quality quartz watches that could be sold cheaply.

In the early 1980s, the merger of two Swiss companies to form Société Suisse Microélectronique et d'Horlogerie SA (SMH) was followed by a highly automated manufacturing innovation that allowed a quartz movement to be integrated into a stylish plastic case. As a result of this innovation and a strong marketing effort in support of the Swatch brand, the center of the watch industry shifted back to Switzerland. In 2013, for the company's 30th anniversary, Swatch announced the Sistem51, the world's first watch built entirely by automation. The Sistem51 line currently produces 4,000 watches per day.[28]

Today, the Swatch Group is the world's largest watchmaker (see Exhibit 16-9). The watch industry continues to be highly segmented, with prestige brands competing on reputation and exclusivity; as with many other luxury goods, higher prices are associated with higher perceived quality. In the low-cost segment, brands compete on price and value.

"The three digital giants [Apple, Facebook, and Google] have signaled to Hollywood that they are serious about entering a television landscape that Netflix and Amazon shook up just a few years ago. Their arrival will make an already hypercompetitive industry even more ferocious."[27]

John Koblin, media reporter, *The New York Times*

TIMING AND KNOW-HOW The second arena for hypercompetition is based on organizational advantages derived from timing and know-how. As described by D'Aveni, a firm that has the skills to be a "first mover" and arrive first in a market has achieved a *timing advantage*. A *know-how advantage* is the technological knowledge—or other knowledge of a new method of doing business—that allows a firm to create an entirely new product or market.[29]

D'Aveni identifies six dynamic strategic interactions that drive competition in this arena: capturing first-mover advantages, imitation and improvement by followers, creating impediments to imitation, overcoming the impediments, transformation or leapfrogging, and downstream vertical integration. As the consumer electronics industry has globalized, Sony and its competitors have exhibited hypercompetitive behavior in this second arena. Sony has an enviable history of first-mover achievements based on its know-how in audio technology: first pocket-sized transistor radio, first consumer videocassette recorder (VCR), first portable personal stereo, and first compact disc player.

Although each of these innovations literally created an entirely new market, Sony fell victim to the risks associated with being a first mover. The second dynamic strategic interaction—imitation and improvement by followers—can be seen in the successful efforts of JVC and Matsushita in the late 1970s to enter the home VCR market a few months after Sony's Betamax launch. VHS

TABLE 16-2 Dynamic Strategic Interactions in Hypercompetitive Industries

Arena	Dynamic Strategic Interaction
1. Cost and quality	1. Price wars
	2. Quality and price positioning
	3. "The middle path"
	4. "Cover all niches"
	5. Outflanking and niching
	6. The move toward an ultimate value marketplace
	7. Escaping from the ultimate value marketplace by restarting the cycle
2. Timing and know-how	1. Capturing first-mover advantages
	2. Imitation and improvement by followers
	3. Creating impediments to imitation
	4. Overcoming the impediments
	5. Transformation or leapfrogging
	6. Downstream vertical integration
3. Entry barriers	1. Building a geographic stronghold by creating and reinforcing entry barriers
	2. Targeting the product market strongholds of competitors in other countries
	3. Incumbents make short-term counter-responses to guerrilla attacks
	4. Incumbents realize they must respond fully to the invaders by making strategic responses to create new hurdles
	5. Competitors react to new hurdles
	6. Long-run counter-responses via defensive or offensive moves
	7. Competition between the incumbent and entrant is exported to entrant's home turf
	8. An unstable standoff between the competitors is established
4. Deep pockets	1. "Drive 'em out"
	2. Smaller competitors use courts or Congress to derail deep-pocketed firm
	3. Large firm thwarts antitrust suit
	4. Small firms neutralize the advantage of the deep pocket
	5. The rise of a countervailing power

technology offered longer recording times and was the dominant consumer format worldwide until the advent of the DVD era.

After years of moves and countermoves among Sony and its imitators, Sony progressed to downstream vertical integration with the 1988 purchase of CBS Records for $2 billion and then, later, the purchase of Columbia Pictures. The acquisitions, which represent the sixth dynamic strategic interaction, were intended to complement Sony's core "hardware" businesses (e.g., TVs, VCRs, and hi-fi equipment) with "software" (e.g., videocassettes and CDs). However, Matsushita quickly imitated Sony by paying $6 billion for MCA Inc. Initially, neither Sony nor Matsushita proved successful at managing their acquisitions. More recently, however, Sony Pictures Entertainment has enjoyed huge successes with the *Spider-Man* movies and *Spectre*, the 2015 James Bond film.

Sony is also facing serious challenges to its core electronics businesses. The digital revolution rendered Sony's core competencies in analog audio technology obsolete. The company must develop new know-how resources if it is to continue to lead in the Information Age. Sony has found technological leaps harder to achieve, as evidenced by the fact that Apple's iPod is now the world's best-selling portable music player. Sony was also slow to grasp the speed with which consumers would embrace flat-panel TV technology; its home entertainment and sound businesses

Exhibit 16-9 Swatch Group has been an Official Partner of the Venice Biennale International Art Exposition for the past several years. Swatch often commissions new styles from well-known artists. Nick Hayek, the son of Swatch founder Nicolas Hayek, is the company's current CEO. Nayla Hayek, Nick's sister, is the group's chairwoman. Swatch recently introduced a new mechanical watch, the Sistem51. Each watch is produced by automated machines in less than 30 seconds.
Source: Fabrice Coffrini/AFP/Getty Images.

have been losing money for years. In fact, a hedge fund manager has called for top management to spin off a portion of the entertainment business to boost profitability.[30]

Hypercompetition is showing up in other ways, too. For example, after 20 years on the market, sales of Sony's Handycam camcorders started to decline. Meanwhile, an inexpensive device called the Flip from startup Pure Digital Technologies quickly became a best seller after its launch in 2006. Belatedly, Sony rolled out the Webbie Internet-ready camcorder. During the product's development, the U.S.-based marketing director for the design team asked Tokyo for permission to make the camcorder available in orange and purple—colors that the team thought would appeal to American consumers.[31] Today, of course, most consumers use their smartphones to capture and share video images, rendering stand-alone camcorder devices unnecessary.

ENTRY BARRIERS Industries in which barriers to entry have been built up constitute the third arena in which hypercompetitive behavior is exhibited. As described earlier in the chapter, these barriers may include economies of scale, product differentiation, capital investments, switching costs, access to distribution channels, cost advantages other than scale, and government policies. D'Aveni describes how aggressive competitors erode these traditional entry barriers via eight strategic interactions. For example, a cornerstone of Dell's global success in the PC industry is a direct-sales approach that bypasses dealers and other distribution channels.

The first dynamic strategic interaction arises as a company builds a geographic "stronghold" by creating and reinforcing barriers. After securing a market—especially the home-country market—competitors begin to seek markets outside their initial stronghold. Thus, the second dynamic strategic interaction takes place when companies target the product market strongholds of competitors in other countries. Honda's geographic expansion outside Japan with motorcycles and automobiles—a series of forays utilizing guerrilla tactics—is a case in point. The third dynamic strategic interaction develops when incumbents make short-term counter-responses to the guerrilla attacks. Strong incumbents may try to turn back the invader with price wars, factory investment, or product introductions; alternatively, they may adopt a wait-and-see attitude before responding. In the case of both Harley-Davidson and the Detroit-based U.S. auto industry, management originally underestimated and rationalized away the full potential of the threat from Honda and other Japanese companies. Realizing that its company was a weak incumbent, Harley-Davidson management then had little choice but to appeal for government protection from the new competitors. The resulting "breathing room" allowed Harley to put its house in order. Similarly, the U.S. government heeded Detroit's pleas for relief and imposed tariffs and quotas on Japanese auto imports. This move gave the Big Three time to develop higher-quality, fuel-efficient models to offer U.S. consumers.

The fourth dynamic strategic interaction occurs when the incumbent realizes it must respond fully to the invader by making strategic responses to create new hurdles. U.S. automakers, for example, waged a PR campaign urging U.S. citizens to "Buy American." The fifth dynamic strategic interaction takes place when competitors react to these new hurdles. In an effort to circumvent import quotas as well as co-opt the "Buy American" campaign, the Japanese automakers built plants in the United States. The sixth dynamic strategic interaction consists of long-run counter-responses to the attack via defensive or offensive moves. GM's 1990 introduction of Saturn is a good illustration of a well-formulated and -executed defensive move. As the second decade of the twenty-first century continues, GM is launching another defensive move: In an effort to defend its Cadillac nameplate from Lexus, Acura, and Infiniti, GM is developing a global strategy for Cadillac.

Competition in the third arena may then continue to escalate; in the seventh dynamic strategic interaction, competition between the incumbent and the entrant is exported to the entrant's home turf. President Clinton's threat of trade sanctions against Japanese automakers in 1995 was intended to send a message that Japan needed to open its auto market. In 1997, GM intensified its assault on Japan by exporting right-hand-drive Saturns to the Japanese market. The eighth and final dynamic strategic interaction in this arena consists of an unstable standoff between the competitors. Over time, the stronghold erodes as entry barriers are overcome, leading competitors to the fourth arena.

As the preceding discussion shows, the irony and paradox of the hypercompetition framework is that to achieve a sustainable advantage, companies must seek a series of *unsustainable* advantages! In this sense, the model proposed by D'Aveni is in agreement with that offered by the late Peter Drucker, who long counseled that the roles of marketing are innovation and the creation of new markets. Innovation begins with abandonment of the old and obsolete. Sumantra Ghoshal and Christopher Bartlett make a similar point in *The Individualized Corporation*:

> Managers are forced to refocus their attention from a preoccupation with defining defensible product-market positions to a newly awakened interest in how to develop the organizational capability to sense and respond rapidly and flexibly to change. . . . Managers worldwide have begun to focus less on the task of forecasting and planning for the future and more on the challenge of being highly sensitive to emerging changes. Their broad objective is to create an organization that is constantly experimenting with appropriate responses, then is able to quickly diffuse the information and knowledge gained so it can be leveraged by the entire organization. The age of strategic planning is fast evolving into the era of organizational learning.[32]

Likewise, D'Aveni urges managers to reconsider and reevaluate the use of old strategic tools and maxims. Overcommitment to a given strategy or course of action carries dangers, he warns, because the flexible, unpredictable player may have an advantage over the inflexible, committed opponent. D'Aveni notes that, in hypercompetition, pursuit of generic strategies results in short-term advantage, at best. The winning companies are the ones that successfully move up the ladder of escalating competition, rather than the ones that lock into a fixed position. D'Aveni is also critical of the five forces model. The best entry barrier, he argues, is one that maintains the initiative, instead of mounting a defensive attempt to exclude new entrants.

The Flagship Firm: The Business Network with Five Partners

According to Professors Alan Rugman and Joseph D'Cruz, Porter's model is too simplistic given the complexity of today's global environment.[33] To remedy what they see as that model's shortcomings, Rugman and D'Cruz have developed an alternative framework based on business networks that they call the **flagship model**. Japanese vertical *keiretsu* and Korean *chaebol* have succeeded, Rugman and D'Cruz argue, by adopting strategies that are mutually reinforcing within a business system and by fostering a collective long-term outlook among partners in the system. Moreover, the authors note, "long-term competitiveness in global industries is less a matter of rivalry between firms and more a question of competition between business systems."

A major difference between the flagship model and Porter's model is that the latter is based on the notion of corporate individualism and individual business transactions. For example, as discussed previously, Microsoft's tremendous supplier power allows it to dictate to, and even prosper at the expense of, the computer manufacturers it supplies with operating systems and applications. The flagship model, by contrast, is evident in the strategies of Ford, Volkswagen, and other global automakers; Sweden's IKEA and Italy's Benetton are additional examples.

Luciano Benetton is one of four siblings who founded the Italian fashion company that bears the family's name. Luciano recently stepped down as chairman of the Benetton Group and turned over control of the company to son Alessandro. The change comes as Benetton faces increased competition from fleet-footed global rivals such as Sweden's Hennes & Mauritz (H&M) and Spain's Zara. Some industry observers note that Benetton's business model, which involves partnerships with regional sales agents, will need to be adjusted to reflect the business environments in key emerging markets such as China and India (see Exhibit 16-10).

In the model developed by Rugman and D'Cruz, the flagship firm is at the center of a collection of five partners; together, they form a business system that consists of two types of relationships. The flagship firm provides the leadership, vision, and resources to "lead the network in a successful global strategy." *Key suppliers* perform some value-creating activities, such as manufacturing of critical components, better than the flagship. Together with the flagship firm, these suppliers form a network relationship, with a sharing of strategies, resources, and responsibility for the success of the network. Other suppliers, in contrast, are kept at "arm's length."

Likewise, the flagship has network relationships with *key customers* and more traditional, arm's-length commercial relationships with *key consumers*. In the case of Volkswagen, for example, dealers are its key customers while individual car buyers are its key consumers; in other words, strictly speaking, Volkswagen sells to dealers, and dealers sell to consumers. Similarly, Benetton's key customers are its retail outlets while the individual clothes shopper is the key consumer.

Selected competitors are companies with which the flagship develops alliances, such as those described at the end of Chapter 9. The fifth partner is the *non-business infrastructure* (NBI), composed of universities, governments, trade unions, and other entities that can supply the network with intangible inputs such as intellectual property and technology. In the flagship model, flagship firms often play a role in the development of a country's industrial policy.

Benetton's success in the global fashion industry illustrates the flagship model. Benetton is the world's largest purchaser of wool, and its centralized buying enables the company to reap scale economies. The core activities of cutting and dyeing are retained in-house, and Benetton has made substantial investments in computer-assisted design and manufacturing. However, Benetton is linked to approximately 400 subcontractors that produce finished garments in exclusive supply relationships with the company. In turn, a network of 80 agents who find investors, train managers, and assist with merchandising link the subcontractors to the 6,000 Benetton retail shops. As Rugman and D'Cruz note, "Benetton is organized to reward cooperation and relationship building and the company's structure has been created to capitalize on the benefits of long-term relationships."

Exhibit 16-10 The Benetton Group embodies many of the qualities of entrepreneurial enterprises that thrive in northern Italy's Veneto region.
Source: Agence Opale/Alamy Stock Photo.

Blue Ocean Strategy

One of the most important recent strategy frameworks was proposed by Professors Renée Mauborgne and Kim Chan. In books and articles devoted to the "Blue Ocean Strategy," the authors define two categories of competitive spaces: red oceans and blue oceans. Red oceans are, in essence, existing markets or industries with well-defined boundaries where the "rules" are understood by all players. By contrast, blue oceans are markets or industries that do not currently exist.[34]

Mauborgne and Chan advise company executives to avoid getting bloodied in a "red ocean" of cost cutting and imitation. A far better choice, they assert, is for a company to create a new space, a blue ocean of "uncontested market space," where hypercompetitive forces don't operate. The authors cite eBay as one example: Founder Pierre Omidyar created a completely new industry. Cirque du Soleil is another example; in this instance, however, founder Guy Laliberté innovated within the boundaries of an existing industry—the circus. Likewise, while Sony and Microsoft were ramping up speed and power with their PlayStation and Xbox gaming systems, Nintendo created a blue ocean with the low-tech, lower-priced Wii console and family-oriented games. Launched in 2006, Wii emphasized "fun, magic, and joy" rather than processing power.[35]

Additional Research on Competitive Advantage

Other researchers have challenged Porter's thesis that a firm's home-base country is the main source of core competencies and innovation. For example, Indiana University Professor Alan Rugman has argued that the success of companies based in small economies such as Canada and New Zealand stems from the "diamonds" found in a particular set or combination of home and related countries. For example, a company based in an EU nation may rely on the national "diamond" of one of the 27 (or 26, post-Brexit) other EU members. Similarly, one impact of the North American Free Trade Agreement (NAFTA) on Canadian firms is to make the U.S. "diamond" relevant to competency creation. Rugman argues that, in such cases, the distinction between the home nation and the host nation becomes blurred. He proposes that Canadian managers must look to a "double-diamond" and assess the attributes of both Canada and the United States when formulating corporate strategy.[36] In other words, for smaller countries, the nation is not the relevant unit of analysis in formulating strategy. Rather, corporate strategists must look beyond the nation to the region or to sets of closely linked countries.

Other critics have argued that Porter generalized inappropriately from the American experience, while confusing industry-level competition with trade at the national level. In the *Journal of Management Studies*, Howard Davies and Paul Ellis assert that nations can, in fact, achieve sustained prosperity without becoming innovation driven; these authors also note the absence of strong diamonds in the home bases of many global industries.[37]

As for Michael Porter, his views on corporate strategy and competitive advantage have evolved during the last three decades. In a 1997 interview with the *Financial Times*, he emphasized the difference between operational efficiency and corporate strategy. The former, in Porter's view, concerns improvement via time-based competition or total quality management; the latter entails "making choices." Porter explains, "'Choice' arises from doing things differently from the rival. And strategy is about trade-offs, where you decide to do this and not that. Strategy is the deliberate choice not to respond to some customers, or choosing which customer needs you are going to respond to." Porter is not convinced of the validity of competitive advantage models based on core competency or hypercompetitive industries. Instead, he suggests, a nation has an advantage when it is home to globally competitive companies in business sectors that are related and supporting industries.

In 2008, Porter revisited his five forces model in an article in the *Harvard Business Review*. Despite all the changes and challenges brought about in the world's markets by the global financial crisis, Porter believes his model is as relevant and robust as ever. As he told the *Financial Times* in 2011, the five forces are

> more and more and more fundamentally important and visible, because a lot of the barriers and the distortions that would blunt or mitigate these distortions and the need for strategy and competitive advantage . . . have been swept away.

The factors contributing to this, Porter says, are globalization, increased transparency of information, and the reduction in trade barriers.[38]

Summary

In this chapter, we focused on the factors that help industries and countries achieve *competitive advantage*. According to Porter's *five forces model*, industry competition is a function of the threat of new entrants, the threat of substitutes, the bargaining power of suppliers and buyers, and the rivalry among existing competitors. Managers can use Porter's *generic strategies* model to conceptualize possible sources of competitive advantage. A company can pursue broad market strategies of *cost leadership* and *differentiation* or the more targeted approaches of *cost focus* and *focused differentiation*. Rugman and D'Cruz have developed a framework known as the *flagship model* to explain how networked business systems have achieved success in global industries. In regard to pursuing competitive advantage, Hamel and Prahalad have proposed an alternative framework that grows out of a firm's *strategic intent* and use of competitive innovation. A firm can build *layers of advantage*, search for *loose bricks* in a competitor's defensive walls, *change the rules of engagement*, or *collaborate with competitors* and utilize their technology and know-how.

Today, *global competition* is a reality in many industry sectors. Thus, competitive analysis must be carried out on a global scale. Global marketers, however, must also have an understanding of national sources of competitive advantage. Porter has described four determinants of *national advantage. Factor conditions* include human, physical, knowledge, capital, and infrastructure resources. *Demand conditions* include the composition, size, and growth pattern of home demand. The rate of home-market growth and the means by which a nation's products are pulled into foreign markets also affect demand conditions. The final two determinants are the presence of *related and supporting industries* and the *nature of firm strategy, structure, and rivalry*. Porter notes that chance and government actions also influence a nation's competitive advantage. Porter's work has been the catalyst for promising new research into strategy issues, including D'Aveni's work on *hypercompetition*, Rugman's *double-diamond framework* for national competitive advantage, and Mauborgne and Chan's *blue ocean* framework.

Discussion Questions

16-1. Outline Porter's five forces model of industry competition. How are the various barriers to entry relevant to global marketing?
16-2. With competition increasing among institutions of higher learning, how should a university utilize the layers of advantage strategy?
16-3. What are the benefits and downsides of global competition?
16-4. How can a nation achieve competitive advantage?
16-5. According to current research on competitive advantage, what are some of the shortcomings of Porter's model?
16-6. What is the relationship between the "Blue Ocean Strategy" framework and the notion of competitive advantages?

CASE 16-1 *(Continued refer to page 523)*

IKEA

IKEA's Business Model

The store exteriors are painted bright blue and yellow, Sweden's national colors. Shoppers view furniture on the main floor in scores of realistic-looking settings arranged throughout the cavernous warehouses. At IKEA, shopping is a self-service activity. Store layouts ensure that visitors have ample opportunity to drop grab-and-go impulse purchases into their $.99 blue Frakta shopping bags as they browse each showroom and write down the names of desired items.

The lower level of a typical IKEA store contains a restaurant, a housewares department, a grocery store called the Swede Shop, a supervised play area for children, and a baby care room. Finally, after shoppers have paid for their purchases on the lower level, they pick up their furniture and drive away.

Most furniture is in "flat pack" kit form; one of the cornerstones of IKEA's low-cost strategy is having customers take their purchases home in their own vehicles and assemble the furniture themselves. Kamprad arrived at this crucial insight early in his career after watching an employee at the original Almhult store take the legs off a table and tuck them under the tabletop so the unit would be easier to transport.

Over the years, IKEA has become integrated into global consumer culture. Kamprad's insight about the advantages of selling knocked-down furniture has given rise to something called the "Ikea effect." Writing in the *Journal of Consumer Psychology*, a team of researchers showed that successfully completing a task such as assembling IKEA furniture leads to perceptions of high value by the consumer. French fashion house Balenciaga even paid IKEA the ultimate compliment by recreating the Frakta bag as a luxury item. Balenciaga's blue "Arena Extra-Large Shopper" carries a price tag of $2,145!

IKEA's unconventional approach to the furniture business has enabled it to rack up impressive growth in an industry in which overall sales have been flat. Sourcing furniture from a network of more than 1,600 suppliers in 55 countries helps the company maintain its low-cost, high-quality position. During the 1990s, IKEA expanded into Central and Eastern Europe. Because consumers in those regions had relatively little purchasing power, the stores offered a smaller selection of goods; some furniture was designed specifically for the cramped living styles typical in former Soviet bloc countries.

Europe

Throughout Europe, IKEA benefits from the perception that Sweden is a source of high-quality products and efficient service. Currently, Germany and the United Kingdom are IKEA's top two markets; Germany is the company's largest market, with 50 stores. The United Kingdom represents IKEA's fastest-growing market in Europe. Although Brits initially viewed the company's less-is-more approach as cold and "too Scandinavian," they were eventually won over. IKEA currently has 18 stores in the United Kingdom, and plans call for opening more in this decade. As Allan Young, creative director of London's St. Luke's advertising agency, noted, "IKEA is anticonventional. It does what it shouldn't do. That's the overall theme for all IKEA ads: liberation from tradition."

Japan

In 2005, IKEA opened two stores near Tokyo; more stores are on the way as the company expands in Asia. IKEA's first attempt to develop the Japanese market in the mid-1970s resulted in failure. Why? As Tommy Kullberg, former chief executive of IKEA Japan, explained, "In 1974, the Japanese market from a retail point of view was closed. Also, from the Japanese point of view, I do not think they were ready for IKEA, with our way of doing things, with flat packages and asking the consumers to put things together and so on." However, demographic and economic trends are much different today. After years of recession, consumers are seeking alternatives to paying high prices for quality goods. Also, IKEA's core customer segment—post–baby boomers in their thirties—grew nearly 10 percent between 2000 and 2010. In Japan, IKEA will offer home delivery and an assembly service option.

India and China

India presents special challenges for IKEA. Although a 2012 law allows 100 percent foreign ownership of retail operations, the regulations also mandate that approximately one-third of foreign retail sales revenues must come from items sourced locally. That target must be reached within five years after a company opens its first store. Finding locally made products has proved to be a difficult task; Ikea's procurement teams have found chemical contaminants in various housewares, ranging from table-tops to dinner plates.

Some global companies, including Carrefour and Walmart, have abandoned plans to operate retail stores in India. IKEA opened its first store in 2018; that means the company has until 2023 to comply with the sourcing regulations. The company's managers understand that they will have to find ways to offer shoppers in India even lower prices on merchandise if they are to attract masses of customers. If the India launch is successful, it may pave the way for additional store openings in low-income areas such as sub-Saharan Africa.

In keeping with IKEA's standardized global retail concept, the Chinese stores are spacious and clean. All locations feature restaurants where visitors can enjoy Swedish meatballs and other meal items. In some cases, the restaurants have also become a favorite meeting place for dating clubs that allow older Chinese to socialize.

> **"The ideal IKEA leader is not the great flamboyant personalities but leaders that fit into the IKEA down-to-earth culture of humbleness."[39]**
>
> Steen Kanter, former IKEA executive

Leadership Challenges and the Drive for Sustainability

The first two decades of the twenty-first century have been difficult for IKEA. The euro's strength dampened financial results, as did the economic downturn in Central Europe. The company faces increasing competition from hypermarkets, "do-it-yourself" home-improvement chains such as Lowe's and Wickes, and supermarkets that are expanding into home furnishings. The growing popularity of e-commerce is another threat. Across a variety of retail sectors, consumer behavior is also changing.

During his tenure as IKEA's CEO from 1999 to 2009, Anders Dahlvig stressed three areas for improvement: product assortment, customer service, and product availability. By the time Mikael Ohlsson was named CEO in 2009, he had spent several years running the company's operations in Canada. It was there that he pioneered the idea of "home visits," during which company representatives stop by customer's homes to see how furniture and furnishings fit into their lives. Ohlsson also stressed sustainability and safe working conditions at factories in Bangladesh and elsewhere.

One takeaway: a realization that a straight product extension strategy, while economical, didn't always work. For example, Ohlsson noticed that IKEA's sheets and mattresses didn't fit beds in North America. Likewise, European-style drinking glasses were deemed too small; shoppers bought vases instead and used them as glasses! That's why, today, between 20 and 30 percent of IKEA's products are adapted to local market preferences.

Peter Agnefjäll, the company's chief executive from 2013 to 2017, retreated from his predecessor's goal of opening as many as 25 new stores per year. Agnefjäll continued the company's sustainability initiatives, including ideas such as leasing kitchens to consumers. As Steve Howard, chief sustainability officer, has said, "We want a smarter consumption, and maybe people are less attached to ownership." Management has set a revenue target of €50 billion by 2020; reaching that target will be a key goal for new CEO Jesper Brodin.

One challenge for Brodin: Getting potential customers who live in urban areas to drive to IKEA stores, which are typically located away from city centers. Top management must also deal with the trend among Millennial and Gen Z customers to shun car ownership. As an experiment, the company opened a pop-up store in central Stockholm that features only kitchens. Customers can make appointments for design consultations. Consumer response has been very positive, and the program has been extended to include a bedroom pop-up in Madrid.

Some observers question IKEA's sustainability bona fides, noting that its low-priced furniture contributes to a "throw it away" mentality when a piece breaks. Critics also point out that requiring customers to drive long distances to and from the stores can contribute to environmental pollution. Howard responds to such criticism by noting, "People have needs to be met—they need wardrobes, sofas, kitchens. The most important thing is to meet those needs in the most sustainable way possible." For example, in France, one factory sources half its wood from recycled IKEA products that are ground up and repurposed as bookshelves, tables, and other new products.

Discussion Questions

16-7. Review the characteristics of global and transnational companies described in Chapter 1. Based on your reading of the case, would IKEA be described as a global firm or a transnational firm?

16-8. In Chapter 11, it was noted that managers of IKEA stores have a great deal of discretion when it comes to setting prices. In terms of the ethnocentric/polycentric/regiocentric/geocentric (EPRG) framework, which management orientation is in evidence at IKEA?

16-9. What does it mean to say that, in terms of Porter's generic strategies, IKEA pursues a strategy of "cost focus"?

Sources: Richard Milne, "What Will Ikea Build Next?" [Cover story], *Financial Times Magazine* (February 3–4, 2018), pp. 12–15+; Preetika Rana, "Ikea's India Bet Hits Thicket of Rules," *The Wall Street Journal* (February 24, 2016), pp. A1, A14; Richard Milne, "Ikea Store Planners Think outside the Big Box," *Financial Times* (December 5–6, 2015), p. 14; Richard Milne, "Ikea Looks to Be Sitting Comfortably Again," *Financial Times* (September 11, 2015), p. 14; Richard Milne, "Against the Grain," *Financial Times* (November 14, 2012), p. 7; Richard Milne, "IKEA Eyes Kitchen Recycling in Green Push," *Financial Times* (October 23, 2012), p. 19; Mei Fong, "IKEA Hits Home in China," *The Wall Street Journal* (March 3, 2006), pp. B1, B4; Richard Tomkins, "How IKEA Has Managed to Treat Us Mean and Keep Us Keen," *Financial Times* (January 14–15, 2006), p. 7; Kerry Capell, "IKEA: How the Swedish Retailer Became a Global Cult Brand," *BusinessWeek* (November 14, 2005), pp. 96–106; Theresa Howard, "IKEA Builds on Furnishings Success," *USA Today* (December 29, 2004), p. 3B; Mariko Sanchanta, "IKEA's Second Try at Japan's Flat-Pack Fans," *Financial Times* (March 4, 2004), p. 11; Paula M. Miller, "IKEA with Chinese Characteristics," *The China Business Review* (July–August, 2004), pp. 36–38; Christopher Brown-Humes, "An Empire Built on a Flat Pack," *Financial Times* (November 24, 2003), p. 8.

CASE 16-2

"Everything Is Awesome, Everything Is Cool" at LEGO

When Jørgen Vig Knudstorp stepped down as the CEO of LEGO in January 2017, he was widely regarded as one of the world's best corporate leaders. After becoming CEO in 2004, Knudstorp had moved quickly to turn around the fortunes of the maker of the iconic children's play blocks.

The LEGO Company is a $5 billion global business built out of the humblest of materials: interlocking plastic toy bricks. From its base in Billund, Denmark, the family-owned LEGO empire extends around the world and has at times included theme parks, clothing, and computer-controlled toys. Each year, the company produces approximately 15 billion molded plastic blocks as well as tiny human figures to populate towns and operate gizmos that spring from the imaginations of young people (see Exhibit 16-11). LEGO products, which are especially popular with boys, are available in more than 130 countries; in the key North American market, the company's overall share of the construction-toy market has been as high as 85 percent.

Kjeld Kirk Kristiansen, the grandson of the company's founder as well as the main shareholder, served as CEO from 1979 until 2004. Kristiansen says that LEGO products stand for "exuberance, spontaneity, self-expression, concern for others, and innovation." (The company's name comes from the Danish phrase *leg godt*, which translates as "play well.") Kristiansen also attributes his company's success to the esteem the brand enjoys among parents. "Parents consider LEGO not as just a toy company but as providing products that help learning and developing new skills," he says.

LEGO has always been an innovator. For example, Mybots was a $70 toy set that included blocks with computer chips embedded to provide lights and sound. A $200 Mindstorms Robotics Invention System allows users to build computer-controlled creatures. To further leverage the LEGO brand, the company also formed alliances with Walt Disney Company and Lucasfilms, creator of the popular *Star Wars* series. For several years, sales of licensed merchandise relating to the popular *Harry Potter* and *Star Wars* movie franchises sold extremely well.

The company has not always enjoyed nonstop success. After a disappointing Christmas 2003 season, LEGO was left with millions of dollars' worth of unsold goods. The difficult retail situation was compounded by the dollar's weakness relative to the Danish krone; LEGO posted a record loss of $166 million for 2003. The company then unveiled a number of new initiatives aimed at restoring profitability. A new line, Quattro, consisting of large, soft bricks, was targeted directly at the preschool market. Clikits was a line of pastel-colored bricks targeted at young girls who want to create jewelry.

In 2004, after LEGO had posted several years of losses, Jørgen Vig Knudstorp succeeded Kristiansen as LEGO's chief executive. Knudstorp convened a task force consisting of company executives and outside consultants to review the company's operations and business model. The task force discovered that LEGO's sources of competitive advantage—creativity, innovation, and superior quality—were also sources of weakness. The company had become overly complex, with 12,500 stock-keeping units (SKUs), a palette of 100 different block colors, and 11,000 suppliers.

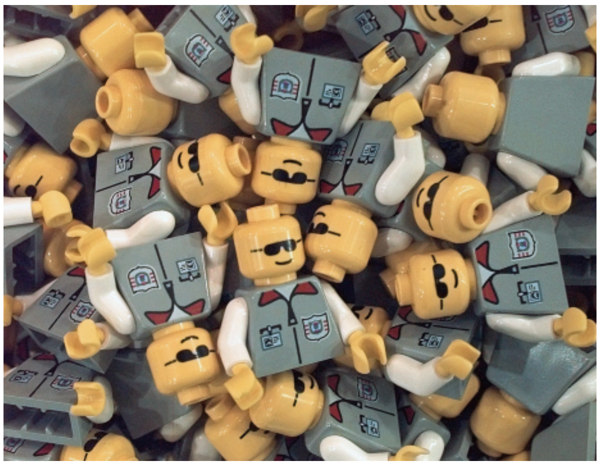

Exhibit 16-11
Source: Amy Sancetta/Associated Press.

Acknowledging that the company's forays into theme parks, children's clothing, and software games had been the wrong strategy, Knudstorp launched a restructuring initiative known as "Shared Vision." Within a few months, cross-functional teams collaborated to reduce the number of SKUs to 6,500; the number of color options was slashed by 50 percent. Production was outsourced to a Singaporean company with production facilities in Mexico and the Czech Republic, resulting in the elimination of more than 2,000 jobs. The theme parks and computer games businesses were sold.

Knudstorp also decided to focus on the company's retail customers, including Toys 'R' Us, Metro, Karstadt, and Galeria. After surveying these customers, Knudstorp and his task force learned that the customers do not require express product deliveries. This insight prompted a change to once-weekly deliveries of orders that are placed in advance. The result: improved customer service and lower costs. In the three-year period from 2005 to 2008, on-time deliveries increased by 62 percent to 92 percent. LEGO also logged improvements in other key performance indicators such as package quality and quantity. In 2008, LEGO was awarded the European Supply Chain Excellence Award in the category "Logistics and Fulfillment."

In terms of competitive advantage, Knudstorp has noted, "A bucket of bricks is the core of the core." Still, he adds, "There's more to being a global successful company than being able to build a plastic brick." Evidence of the company's magic touch can be found in LEGO Friends, a new theme targeting girls that has sold extremely well. One advantage of the new line: Because it was developed in-house, LEGO does not have to pay licensing fees.

Moreover, the company's forays into video games such as *Lego Batman 2*, *The Lego Ideas Book* and other children's books, and TV series on the Cartoon Network have proved successful as well. *The Lego Movie*, released in 2014, was a global blockbuster with ticket sales of nearly $500 million.

By 2015, under Knudstorp's capable leadership, LEGO ranked as the world's number 1 toymaker, ahead of industry heavyweights Mattel and Hasbro. In less than a decade, LEGO's revenues had tripled, and its net profit soared. Knudstorp credits his brief stint as a trainee kindergarten teacher with helping him hone his leadership skills. One key decision as the new CEO: listening to a marketing executive who advocated focusing on "back-to-basics" toys such as fire engines and police stations.

In 2015, after a three-year development process, Knudstorp launched *Lego Dimensions*. This product represented LEGO's first attempt to target a game category known as "toys-to-life." The $100 game kit can be used in conjunction with the Sony PlayStation, Microsoft Xbox, or Nintendo Wii consoles. The game also comes with several hundred pieces for building a controller, plus Batman, Gandalf, and Wyldstyle. The game incorporates *Doctor Who*, *Back to the Future*, and a variety of other popular TV and motion picture brands.

Going forward, Knudstorp will be chairman of LEGO and head up a new entity, LEGO Brand Group. According to Knudstorp, "The LEGO Brand Group will focus on things that are additive and are not being done today." One challenge facing Bali Padda, the new CEO, is to sustain the explosive pace of sales and earnings growth achieved by his predecessor.

Discussion Questions

16-10. Jørgen Vig Knudstorp became CEO of LEGO in 2004. Assess the key strategic decisions he made, including outsourcing and divesting the theme parks.

16-11. LEGO's movie-themed products, keyed to popular film franchises such as *Harry Potter*, *Lord of the Rings*, and *Spider-Man*, include detailed construction plans. Do you think this is the right strategy?

16-12. Using Porter's generic strategies framework, assess LEGO in terms of the company's pursuit of competitive advantage.

16-13. What risk, if any, is posed by LEGO's movement into multimedia categories such as video games and television?

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17 Leadership, Organization, and Corporate Social Responsibility

LEARNING OBJECTIVES

17-1 Identify the names and nationalities of the chief executives at five global companies discussed in the text.

17-2 Describe the different organizational structures that companies can adopt as they grow and expand globally.

17-3 Discuss the attributes of lean production, and identify some of the companies that have been pioneers in this organizational form.

17-4 List some of the lessons regarding corporate social responsibility that global marketers can take away from Starbucks' experience with Global Exchange.

CASE 17-1
A Changing of the Guard at Unilever

Unilever, the global food and consumer packaged goods powerhouse, markets a brand portfolio that includes such well-known names as Axe, Ben & Jerry's, Dove, Hellmann's, Lipton, and Magnum. The company has approximately 167,000 employees and 2016 sales of €52.7 billion (about $60 billion); Unilever can trace its roots, in part, to the northern English town of Port Sunlight on the River Mersey. There, in 1888, Lever Brothers founder William Hesketh Lever created a garden village for the benefit of his employees.

Before retiring at the end of 2008, Unilever Group chief executive Patrick Cescau wanted to reconnect the company with its heritage of sustainability and concern for the environment. These and other values reflect Unilever's philosophy of "doing well by doing good." One example: the "Campaign for Real Beauty," which was launched by managers at the company's Dove brand. To prepare for their first presentation to management, Dove team members videotaped interviews with teen girls who talked about the pressures they felt to conform to a certain look and body type. The interviewees included Cescau's daughter as well as the daughters of Unilever's directors.

Later, when the CEO recalled watching the video, he explained, "It suddenly becomes personal. You realize your own children are impacted by the beauty industry, and how stressed they are by this image of unattainable beauty which is imposed on them every day." The Dove team was given the green light to launch a new advertising campaign based on this insight; in the years since, Dove has won numerous awards and accolades for the positive body image campaign.

Cescau's vision of "doing well by doing good" manifested itself in other ways, too. For example, he guided the company's detergent business toward using fewer chemicals and less water, plastic,