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What is Differentiation and How Does it Work ?

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In this article we provide a basic review of the relationship between differentiation and profitability. In particular we address the misconception that the reward of differentiation must be a price premium. We conclude with the following:

> *Differentiation is when a firm/brand outperforms rival brands in the provision of a feature(s) such that it faces reduced sensitivity for other features (or one feature). Through not having to provide these other features the firm has an avenue to save costs. The firm benefits from the reduced sensitivity in terms of reduced directness of competition allowing it to capture a greater proportion of the value created by exchange.*

We observe that real world differentiation is a pervasive feature of modern markets, but seems to be largely due differences in distribution and awareness, and occasionally design. Brand level differentiation on functional features is less common due to competitive matching.

Introduction

Differentiation is an old concept (Chamberlin 1933; Robinson 1933; Smith 1956) and one that is very basic to modern views of markets and marketing, which perhaps begs the question: is this article necessary? Do strategists not already know the answers to the two questions in the title? Are not the answers common knowledge, plainly established in the marketing, economics, and strategy literatures? We would argue no. Differentiation is a concept, like many in the business literature, which has very fuzzy meaning(s). The term is usually used without reference to any formal definition, and there exist a number of alternative definitions, along with non-complementary operationalisations/measures. Even in industrial economics, a discipline where there is more of a tradition of providing formal statements of theoretical concepts, two eminent industrial economists felt compelled to write an article for the *Journal of Industrial Economics* titled

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"What is Product Differentiation, Really?" (Caves and Williamson 1985).

This article will make reference to that work, and others, as it seeks to explain what differentiation is. This article goes further though, to address a question which is fundamental to the strategy discipline, and of great interest to marketing and marketers: *how, and why, can differentiation allow a firm to earn superior profits ?* Again this would seem like a basic question, the answer to which should be well known. However, again we argue that this is not the case; most business people and academics simply inherently believe that it is better to be in a market where there is considerable differentiation than in a commodity market. This belief exists in spite of the fact that healthy profits have been earned in so called commodity industries such as mining and oil, and that agricultural commodities have been the basis of the wealth of a number of countries. Therefore, even though there is some apparent empirical support for this notion (eg Buzzell and Gale 1987 p.124) it would be wrong to infer that this belief is based simply on empirical observation.

The issue of whether differentiation leads to superior profits is clearly not solely an empirical question. Theory also impacts on empirical research because it affects how we choose to operationalise (measure) these two abstract concepts (*differentiation* and *superior profits*). Even if we observe a positive correlation between our measures of differentiation and profitability we need an explanation why. At present when theoretical explanations are called for they are varied, as the following examples illustrate (developed from an expert panel survey[2]).

- Differentiation makes the product desirable, therefore you will make more sales and more profit;
- Differentiation makes the product unique, therefore price comparisons are difficult and you can get away with charging a higher price;
- Differentiation means the offer is unique and highly valued, therefore demand will exceed supply and you can charge a higher price;
- Differentiation causes brand loyalty therefore marketing costs will be lower because it is cheaper to sell to existing customers.

We also consulted the literature to establish how the concept is usually defined and what the benefits are purported to be. We used a sample of current marketing management textbooks published since 1990. These excerpts are grouped into two themes, (a) relating to the reduction of price

[2] Colleagues (research and teaching staff) independently responded to the question "Why does differentiation potentially allow a firm to earn profits ?". They were requested not to discuss the question with others. The survey was conducted via email.

sensitivity; and (b) distinguishing the brand from competing offers / reducing the directness of competition. Obviously there is some overlap between these themes, but some authors, as we shall see, plainly emphasise one over the other. The results are shown in Table 1.

Table 1. Definitions and Explanations for the Link Between Differentiation and Profitability

Reduce Price Sensitivity / Earn a Price Premium
Baker (1996) cites Smith (1956): "product differentiation is concerned with bending of demand to the will of supply. It is an attempt to change the slope of the demand curve for the market offering of an individual supplier".
Mercer (1992) "[differentiation and focus] rely on using factors other than price to contain competition" (p184). "[differentiation is] the practical 'positioning' of products or services so that they are recognisably different from their competitors'" (p264). "The epitome of this process [product differentiation] is 'branding'". [proceeds to cite Watkins 1986]: "The firms' strategy is to make its products different from its competitors in such a way that customers can be convinced they are superior" "in general the more that products or services are differentiated the less direct the competition will be" (p173)
Boyd, Walker and Larreche (1995) "Over time competitors become more alike. The index of product differentiation [from PIMS studies] drops substantially from the growth to the decline stage. It is understandable why price differences between competing products also decline" (p 102).
Powers (1991) "The major thrust of a differentiation strategy is on the customers' perceived difference between the firms offering and that of the competition… Oftentimes, the differentiation strategy allows the firm to receive a higher price….. Differentiation strategies are usually the result of the seller's wishing to establish a firm market position or to insulate itself from price competition" (p119)
Dickson (1997) "Product differentiation is the act of distinguishing a product from its competitors on one or more basic performance or image features" (p 333) [under the heading "Product Differentiation"]: "the more distinct the image positioning and performance of a product or service on dimensions desired by the segment, the lower the price sensitivity of the segment will be" (p179) **Cont'd/…**

Reduce Price Sensitivity / Earn a Price Premium
Keegan (**1995**) "competitive advantage may be achieved when a firm puruses a strategy of low costs… may also be gained by a strategy of differentiating products so that customers perceive unique benefits that justify a premium price" (p. 375)
Bradley (**1991**) "there are only two types of competitive advantage that a firm may possess: low cost or differentiation. A firm following a pure low-cost strategy will.. attract custom by offering lower prices. The firm which seeks to be unique …follows a strategy of differentiation and obtains a premium price… The firm that achieves .. such a difference will be an above average performer .. if its price premium exceeds the extra costs in being unique" (p. 103/104)
Distinguishing the Brand from Competition / Reducing the Directness of Competition
Kotler et al (1996) "Differentiation is the act of designing a set of meaningful differences to distinguish the compay's offer from competitors' offers" (p 365)
Guiltinan and Paul (1991) "differentiated positioning – this is a strategic option in which head to head competition is avoided by offering unique benefits. Rather than offer the same features, price, convenience or other attributes a manager employing this marketing strategy offers one or more *different* benefits. (p176) This is different to what is termed a "head to head strategy" where "a firm offers basically the same benefits as the competition but tries to outdo the competition"(p175). "A firm can attempt to acquire customers in three ways – head to head strategy, differentiated positioning, or niching"(p175)
Saunders, in Gower (1995) "The differentiator wins by offering a product or service which is unique or superior to competitors'"(p85)
Zikmund and d'Amico (1993) "A promotional campaign aimed at developing product differentiation focuses on some dimension of the product that competing brands or competing products do not offer or accents some way in which using the product provides some solution to a consumer problem" (p586)
Trout (2000) "since differentiation takes place in the mind, specialists .. can focus on one product, one benefit and one message. Eveready … didn't specialise. Duracell grabbed a brilliant name, pre-empted the "long lasting' attribute, and ran off with their business" (p. 131).

One can see from Table 1 that common themes in current literature are that differentiation can (a) reduce the directness of competition and (b) reduce price sensitivity. However we can also see that it is used in quite different ways, including being synonymous with *superiority*, as part of *marketing communication*, and as *offering something the competition does not offer*. We believe some of these are useful contributions, but there is scope for further understanding the concept and its association with profitability. Therefore our purpose of this article is to:

- to provide a formal definition of *differentiation*
- to explain how *differentiation* can possibly lead a firm to earn superior profits

In doing so we address some common incorrect beliefs that are introduced above. Namely,

- That the benefit of differentiation is a price premium.
- That differentiation must increase a firm's costs.

We also challenge the view that differentiation is an *optional* strategy, that is nevertheless chosen by most firms. Instead we observe that differentiation is a pervasive feature of modern markets and this is in spite of the main thrust of competitive activity being to match competitors' features rather than to be different.

A Basic Explanation of Differentiation

We begin with a basic definition of differentiation, necessary in order to begin discussion:

> Differentiation[3] exists when a firm's offering is preferred, on some buying occasions (or by some customers all of the time), over rival firms' offerings[4].

This preference presumes that there is some difference between brands and

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[3] This statement avoids the use of the older *product differentiation* term because the addition of the word product is unnecessary and has undesirable connotations. For instance, does product differentiation apply to services ? What if customers view the product as identical but have a preference for one firm's brand because of its after sales service ? Can product differentiation be achieved via distribution/availability ? Can loyalty schemes (eg Frequent Flyer programs) create product differentiation? Can price promotions create product differentiation? Using the formal definition provided above the answer to all these questions would be yes; the inclusion of the word "product" would make the answers less clear.

[4] We use "preference" to mean behavioural preference, i.e. choice in competitive markets, rather than attitudinal preference.

that buyers react to these differences. Without this preference brands would be perfectly substitutable. There would be no need for more than one brand in a product category, and this is what the market would immediately lapse to should any one brand gain the slightest price or quality/feature advantage over the others.

Importantly our definition does not stipulate product feature differences – as we discuss later, product heterogeneity may lead to differentiation and it may not. Differentiation can also occur without product feature differences between brands. The mainstream marketing reality is that brand choice is a trivial concern because, for consumers, the feature differences between competitive brands are not great. Whether it is Ford or Chrysler, Kodak or Fuji, either will usually do. Purchase preference certainly exists but it is often a function of *salience* (each buyer knows some brands better than others), *habit* ("this is the one we usually buy") and/or *availability* ("this one has my size"), rather than product differences between the brands.

The issues of how or why this difference in preference comes about, and why it should be associated with the potential to earn economic profits are explored in this article.

Conventional Thought on Differentiation and Profits

Several disciplines have had a long standing interest in profit differentials. The Strategy discipline is concerned with why some firms are able to earn greater profits than rivals on a sustained basis. Industrial economics is essentially concerned with why some industries are able to earn higher average profits than others on a sustained basis (and the associated welfare implications).

Both of these disciplines have seen differentiation as a potential cause of these profit differentials, and marketers as a potential cause of the differentiation. The argument that marketing activities increase firm profitability has been welcomed by business people; less welcome has been the industrial economists' attribution/accusation that marketing causes sub-optimal (social) efficiency differentials between industries, in other words that it reduces society's welfare.

Strategy, industrial economics, and marketing appear to be in agreement as to why differentiation might lead to greater profits. Stated simply the rationale is that differentiation can allow a firm to command higher prices. We have seen this as a common theme in marketing management, but it is also common in other disciplines: strategic management - Thompson and Strickland (1995 p. 126); industrial economics - Scherer (1990 p. 360) and mainstream economics - Jackson and McConnell (1988). Now while most managers and students accept this statement as valid at face value, it is clearly an incomplete explanation, or at least one full of unstated assumptions. As any accountant knows, price does not equal revenue (price x volume = revenue) and revenue does not equal profit (revenue less costs = profit). Therefore the degree to which differentiation results in higher prices must be linked to the alteration in revenue it provides, relative to the costs incurred or decreased as a result. Viewing higher price as the prime reward for differentiation will lead to myopic strategic decision making. This is because - as we will see - differentiation can help the firm to de-sensitise customers to *various* features (not only price) that might otherwise be costly or difficult to deliver.

According to industrial economics the ability to command higher prices depends on either collusive practice and/or the erection of barriers to new entrants, with differentiation cast as a potentially formidable barrier (e.g., Bain 1965). Industrial economics research seeking to explain persistent industry profit differences has endeavoured to show a link between high differentiation in an industry and high barriers to entry with corresponding high average levels of profitability (e.g., Comanor and Wilson 1967; Bain 1971). Such research is questionable because differentiation has usually been operationalised by industrial economists as the *advertising to sales ratio* (Koch 1980). While advertising might increase differentiation, it also often seeks to reduce perceived differences between competing brands. For example, Microsoft's advertising to reduce the perception that the MacOS is more user friendly that Windows. Also, such research ignores the very substantial differentiation efforts undertaken by sales representatives in many low advertising industries. Such an operationalisation of industry differentiation level appears to be measuring (or at least confounding) the effect of a scale barrier of entry rather than the extent or effect of differentiation itself.

More precise conceptualisations (of differentiation) should result in better operationalisations. We now discuss the economic definition of product differentiation and show why the achievement of a price premium is the most widely accepted (though inadequate) explanation for differentiation leading to superior profits.

What is "Product Differentiation"?

Product differentiation has been described as a well defined theoretical concept in economics that rests on two conditions (Caves and Williamson 1985). Firstly, that buyers consider that brands within a product-market are close substitutes, but poor substitutes for brands in other product-markets. Secondly, that the brands within the product-market are sufficiently imperfect substitutes that firms face downwardly sloping demand curves for their brand[5].

The theoretical conditions which would produce differentiation were first discussed by Chamberlin (1933). Caves and Williamson (1985) discuss the two current economic models that describe the structural situations necessary to bring about product differentiation. In an empirical study they found support for both models causing product differentiation (brands facing *downward sloping demand curves*). The first set of conditions can be termed the bundle of benefits model, developed from work by Rosen (1974) and Lancaster (1979; 1984). Differentiation is said to be brought about by brand heterogeneity with brands being made of distinctive bundles of attributes. Also necessary is market heterogeneity where customers vary in their tastes, that is, they vary in the benefit they derive for these different attribute bundles. Relative prices determine the bundle of attributes (brand) a buyer chooses among those offered. Although each buyer may make discrete switches between brands as relative prices change, buyers generally differ in their reservation prices for a given configuration. Therefore, downward sloping demand curves are likely to result when the preferences of individual buyers are aggregated.

The other theoretical model which would result in product differentiation (downward sloping demand curves) is based on variations in information and transaction costs, developed from work by Stigler (1961) and Nelson (1970; 1974; 1975; 1981) among others. The result again is differences in consumer behaviour and different perceptions of brands, even if consumers held identical underlying preferences/tastes. Although less well developed than the attribute models a considerable amount of attention is now being devoted to information economics, which is illuminating the manner in which competition operates (see Akerlof 1970; Shapiro 1982; Fombrun and Shanley 1990; Wernerfelt 1990). In particular, the apparent ability of brand awareness and brand salience to affect brand choice without necessarily influencing brand attribute perceptions is gaining attention in marketing and consumer behaviour literature[6] (see Hoyer and Brown 1990; Nedungadi 1990; Macdonald and Sharp 2000).

Both of these models require variation in the market demand structure in order to support the variation in products (ie, different features) – if everyone's tastes are the same then differences in product features won't be

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[5] Downward sloping demand curves simply being consequence of a brand's customers having preference for a brand but not "100% loyalty", each has a different "reservation price" a measure of the degree of enticement required to shift their preference to another brand.

[6] This is one reason why we use the term preference in a behavioural sense, see footnote 1. A consumer may "prefer" brand x over another simply because they are aware of brand x and not the other offering.

supported by the market. An unusual proposition is to use the term product differentiation to describe an *alternative* strategy to that of offering differentiated products to particular segments (Smith 1956; Wind 1978). Dickson and Ginter (1987) provide an analysis of this proposition which concludes that such a use of the term really refers to firms' attempting "demand function modification", that is, the changing of consumer tastes such that they move closer towards favouring the distinctive attribute bundle of a particular product. The effect of "demand function modification" can be to either increase or decrease the amount of demand variation/heterogeneity within the market.

Differentiation and Price: The Legacy of the Neo-Classical Economic Perspective

Most views on product differentiation are based upon neo-classical economic theory. It is thus normal to construct all analyses with price and product clearly segregated. The conceptualisation of product differentiation subsumes firms "facing a downwards sloping demand curve". The suggested objective of product differentiation is to reduce the substitutability by competing offerings and so steepen the slope of the demand curve. By doing so, the firm is said to be able to enjoy higher prices with a less than corresponding reduction in volume, hence it is potentially able to earn superior profits. Its customers are less sensitive to price rises or to competitors' price drops.

The separation of "product" attributes from the attribute of price encourages the view that offering low prices is a fundamentally different form of differentiation to that of differentiating on "other features". In this vein, the former industrial economist, Michael Porter's (1980) definition that a firm (or more correctly, brand) is differentiated "when it provides something unique that is valuable to buyers beyond simply offering a low price" is quoted frequently, reinforcing the view that price can not be used to differentiate. Yet paradoxically other moves to reduce the costs of purchase for a customer (eg home delivery for takeaway pizza) are classed as differentiation attempts. There does not appear to be a valid justification to distinguish price from other features of an offering. It follows then that differentiation is not an *optional* strategy for superior profits as is popularly thought (e.g. Porter 1980; Dess and Davis 1984; Porter 1985; Narver and Slater 1990).

This discussion raises the question, why have economists (and others) always equated price as a dependent variable in their discussions of the nature of differentiation, when it appears sensible to include it as a component ? The reason can be traced back to the objectives of economics itself. Economics has always been concerned with the efficient allocation of scarce resources. The question of how resources should be allocated was answered by whether resource use attracted an inflow of money - the mode of exchange - from the marketplace sufficient to cover costs and earn at least normal profits. If an entrepreneur allocated resources to a particular sector of the economy, the efficacy of that decision would be reflected in whether consumers would “vote” with their spending dollars, that is, sacrifice monetary value for value in goods or services.

This, together with the fact that price is easily measurable and highly divisible, led to the implicit assumption that price, or the financial aspect of purchase cost, was the sole measure of value “exchanged” between buyers and sellers: a sum of money for an equivalent value of goods. It was a logical step, then, to construct measures of resource allocation (supply and demand curves) based on price and quantity.

It is true that purchase price (money paid) is a highly visible “cost” or impost to the buyer; and is also easily understandable as value in exchange to the seller. In other words, the buyer *parts with* something and the seller *receives* something. *Ceterus paribus* a reduction in purchase price means less value in exchange for the seller and more value in exchange for the buyer.

In contrast, some other variables which influence demand, such as advertising for example, could certainly be seen as a cost to the seller to undertake, but unlike price not something that the buyer parted with, or which if reduced, would not increase any benefits to the buyer (other than if the firm chose to channel the money it saved on advertising to lower prices, an approach seen by many economists as highly desirable). Therefore a variable such as advertising was not seen as comprising value in exchange, particularly for the buyer, indeed the presence of such variables was seen as an “imperfection”. This meant that the other components of an offer which influenced demand (such as advertising, or style) did not fit with the neoclassical economist’s notion of efficient resource allocation and so were not included in the supply/demand equation.

However, there are components (other than price) to any offering which are both “costs” to the buyer and constitute value either preserved or given away by the seller. To continue the example, advertising, or more correctly its effect, can be seen as a component of value in a purchase that both the buyer and seller “part with” or “give up” in exchange. A buyer may choose to forego the value(s) provided by a luxurious brand image, for example hedonistic pleasure, reassurance, or self projection/signalling, in favour of other features such as quicker service or shorter travel time provided elsewhere[7]. The seller parts with advertising funds and other expenses to

[7] This is not to say that these are mutually exclusive or that a firm cannot offer both. They may merely be aspects of competing offerings which competitors choose to emphasise.

create a luxurious brand image in an effort to attract custom. The more this costs the seller to undertake, the less value the seller is able to preserve in exchange. Alternatively the buyer might forego the value of quick service, a cost among other costs, to obtain a luxurious brand image.

In other words, from a customer's perspective, price is only one aspect of the cost of purchase and/or consumption, and many other features of the offering contribute to the cost of gaining the benefits which are desired. These costs include delivery, ease of use, and after sales service.

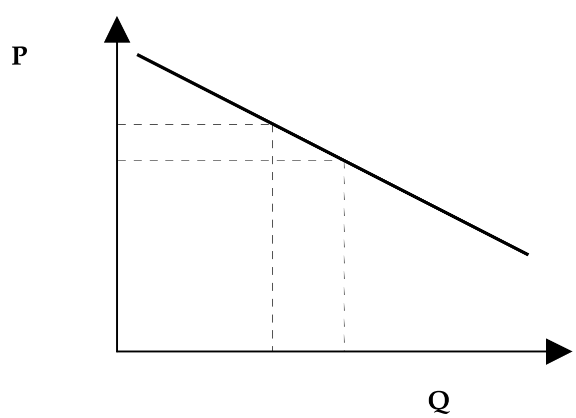
From the firm's perspective price is often thought to be different from "other features" because of its relationship to profitability via the profit margin, but expenditure or savings on "other features" has the same relationship. A firm may gain extra custom from offering quicker service, for example, but this can have the same effect on company profit margins as lowering price.

Similarly, distinguishing between firms that differentiate on price and firms that differentiate on "other features", as Porter (1980; 1985) did, appears problematic. The obvious consequence is a demarcation between up-market and down-market offerings. This implies, according to Porter's framework, that the middle ground is associated with a low profitability "stuck-in-the-middle" strategy. Porter stated this was likely to occur if the firm had neither a clear differentiation advantage leading to premium prices, or did not have a clear cost advantage, often synonymous with very low prices. However, this does not appear to fit the empirical world where many "down-market" firms are poor profit performers as are many "up-market" firms, and the middle ground can be occupied by firms earning superior profits. The other implication of this widely adopted framework is that differentiation must increase costs (since differentiation is the alternative to low costs); a viewpoint echoed by many marketing authors (e.g. Bradley 1991 ch. 4; Mason and Ezell 1993 ch. 3; Saunders 1995) and also strategic management scholars (eg. Pearce and Robinson 1991 ch. 7 ; Wheelan and Hunger 1998 ch. 5). Yet evidence shows that many firms achieve low costs yet also have differentiation strategies (Miller and Freisen 1986).

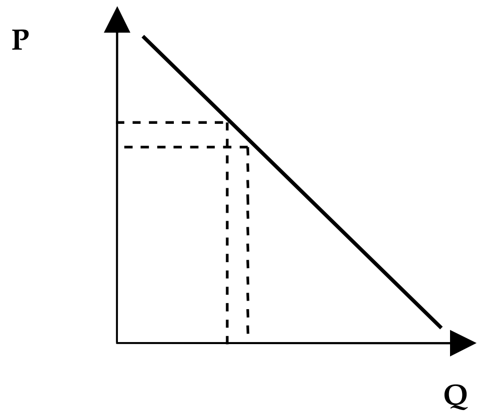
As we have stated differentiation has been very much associated with obtaining a price premium. This is intuitively attractive in helping to explain increased profitability but it is overly simplistic. Just as price premiums have been rejected as ways of measuring brand equity (Blackett 1991), price premiums are an inadequate way of measuring differential advantage. Many offerings do not have generic equivalents from which the premium can be calculated. Does a Mars bar sell at a price premium? A premium over what? Decisions to sell at a low or a high price depend upon the firms desire for sales volume and other strategic considerations and so will often not serve as an identifier of profitability. Obviously the relationship between price and profit depends on cost. Very often firms opt for lower prices which will in turn lower their selling costs (e.g., advertising and costs of gaining distribution), and so in this situation, low price can certainly not be tied to low profitability or vice versa. Can any offering which sells at more than the average within the category be said to have a differential advantage? What if it is over-priced and sales are poor? Do brands priced "below product category average" have no differential advantage (e.g., Bi-Lo – a low-priced Australian supermarket brand, Wal-Mart, Daihatsu)? In the 1990s, in many industries, there has been a trend towards realistic pricing of leading brands (e.g., Proctor and Gamble's "everyday low pricing" policy). These brands/firms can certainly still be said to possess a differential advantage because they have a collection of features which is attractive to buyers and which earns superior profits for their owners.

Almost any unique bundle of features will have some customers who are willing to pay a high price for it. The actual price a firm charges depends on which customers, and how many, it desires (together with cost constraints). Sometimes it is more profitable to give discounts to gain business, other times it is more profitable to change some other feature of the offering. The simple point is that the more similar a firm's offering to that of a competitor the greater the need to change *something*. There are many routes to differentiation and changing the monetary cost of acquisition (price) is just one of them. The strategy discipline needs to move to a less restrictive definition of differentiation - one that sees it simply as the development of loyalty, or more correctly, customer preference for one offering over another.

As discussed, the traditional idea of differentiation being able to deliver a price premium is derived from demand curve analysis. Differentiation results in some customers having a preference for the offering (assuming the differentiation matches some demand heterogeneity which exists in the market) and they are therefore less sensitive to price drops of competing offers. The firm (or rather the brand) therefore faces a steeper demand curve:



Small changes in price result in large changes in quantity demanded



The steeper the demand curve the smaller the change in quantity demanded after any price change i.e. demand for the brand is less price sensitive

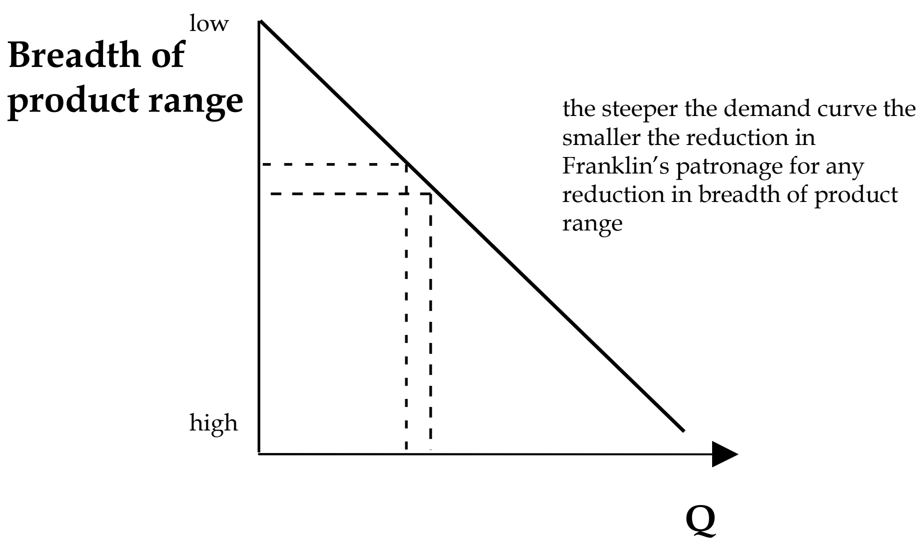
This analysis is mathematically elegant, but it simplifies the true effects of differentiation and has had the effect of misleading decades of practitioners and academics. The implication that a price premium is the reward of differentiation is a gross simplification. Customers, if they value the firm's offer will be less sensitive to aspects of competing offers, and price may, and may not, be one of these aspects. This can be illustrated easily with the example of Franklins, for many years, a star performer amongst Australian supermarket chains. Franklins was differentiated, appealing to a particular market demand, one which highly values low financial costs of purchase (i.e., the price sensitive segment) but is less concerned about other features, and it is this latter aspect which allows for the possibility of successful (profitable) differentiation. Franklins enjoyed sales from this segment because the customers in this segment have a lower sensitivity to other features of the typical supermarket: availability of parking, range of products, width of supermarket aisles (ease of shopping). Franklins only stocked dry goods (i.e. no fresh food), which are served straight out of their packing boxes, the range is limited, and the stores themselves were typically small and cramped. The point of this example is that Franklins did not enjoy reduced price sensitivity because of its differentiation[8]. Its customers are still highly price sensitive, and on a simple price-demand curve it would not show a highly sloping demand curve. Franklins benefited not from reduced sensitivity to price, but reduced sensitivity to other features of the offering. Its sales were translated into healthy profits because it operates within a market segment sensitive to factors which Franklins was in a good position to satisfy; this segment also being insensitive to other factors which Franklins

[8] A peer reviewer claimed that Franklins " **did not** offer differentiation" because it does not "offer something unique that is valuable ...beyond simply offering low price". This illustrates the ingrained association between differentiation and price premiums that this article endeavours to refute.

chose not to satisfy (thus saving costs) and was not in a good position to satisfy.

Profit from Reduced Sensitivity

This view of differentiation can be illustrated with modified demand curves, which substitutes price for other features of the offering, eg breadth of product range (Franklins had a smaller product (and brand) range than most of its competitors).



The implications of this example are not limited to firms that target price sensitive consumers. A firm will benefit from reduced sensitivity to any feature that incurs costs to deliver. It is therefore strategically sensible to differentiate on an aspect of the offer which some customers value (that the firm has some advantage in delivering) and that results in decreased sensitivity to something that is relatively costly for the firm to deliver (or expressed another way, relatively cheap for competitors to deliver).[9]

To re-cap, profits flow from being able to mitigate the effects of competition, being different is a **pre-requisite** for this, and the closer other firm's marketing efforts are to one's own the more intense is the competition one faces and the potential for earning "monopoly" profits are reduced. To

[9] It thus makes little sense to say that one firm has a cost advantage over another without specifying in relation to what. Certainly it costs more to deliver a Porsche to the market than it does a Volkswagen but Porsche may still have a cost advantage over Volkswagen in producing and marketing Porsches (but not necessarily any other type of car).

understand competitive advantage and why some firms earn more profits than others a framework is needed for understanding the ways in which firms make themselves (their brands) different from each other and how this impacts on the volume they sell, the price they are able to obtain, and the costs of providing this difference. Sometimes being very different is a route to profits, it certainly mitigates the effects of competition, but it can also limit market share. Differentiation is a necessary but not sufficient condition for above average profitability.

Differentiation has a positive effect on profits when the difference that is valued by the market is cheap/easy for the firm to deliver. Downward sloping demand curves (whether they are constructed with price or any other feature on the Y axis) do not guarantee superior profits. Reduced sensitivity to a feature provides the firm with little benefit if that feature is not costly to deliver. Similarly, excelling in the delivery of a feature (the differentiation basis) is of little advantage if the firm is not better equipped than competitors to provide that feature. In other words a firm's resource differentials matter just as much as the differentials in firm offerings. Market demand structure also matters. Profits are derived not only from the degree of reduced sensitivity to features provided better by competitors but from the number of customers which have this reduced sensitivity. Reducing customer sensitivity to price is only one of *numerous* ways in which firms can gain in profits - depending on the match between their asset base and the attributes they choose to differentiate on.

Differentiation in the Real World

Given that there are multiple avenues for differentiation, and the many features that a firm can decide to over or under perform in providing, one might expect markets to be full of wildly differentiated brands. But we observe two factors that change this picture.

Firstly, differences in customer awareness, brand familiarity, knowledge of product features, situational factors and distribution all combine with habits (e.g., brand loyalty) and variety seeking to produce brand preferences. So differentiation becomes a fundamental aspect of most markets, even if firms do not try to differentiate their brands. This differentiation is often buying situation specific rather than being a permanent feature of the brand, eg, sometimes the store is closest to the customer, sometimes it is not (dependent on where the customer is at the time).

Secondly, there are few substantial feature differences between brands. This is because firms work very hard to match their competitors. If any brand brings out a product variant that is different (eg, airbags, a caffeine-free version, a new colour) competitors quickly add this to their brand's portfolio of variants (Ehrenberg, Barnard, and Scriven 1997).

Therefore we have the situation akin to differentiation being "everywhere and nowhere". Substantial and meaningful product feature differences between brands is not as common as one might expect. Brands typically enjoy some differentiation, usually from things other than product feature differences, but this differentiation is more a market feature than a brand specific feature. Firms may strive for extra differentiation for their brand but the second point noted above (imitation) makes this difficult. In addition many firms are wary about being too different: no firm wants to "cut itself off" from part of the market. Being "cut off" can be a consequence of offering something that appeals to a segment (and hence not others).

This view of differentiation is supported by recent research on segmentation and price elasticities. Competitive brand user profiles do not appear to differ, that is to say, brands sell to much the same types of buyers (Kennedy and Ehrenberg 2000). If brands were substantially differentiated then we might expect some differences in the types of buyers they appealed to. Likewise price elasticities seem remarkably consistent between brands with a predictable difference between large and small brands (Scriven and Ehrenberg 1999).

If some brands in a category were more or less differentiated than other brands we should see some partitioning in the market, where some brands competed less, or more, closely. The widespread fit of the Dirichlet model of repeat-purchase, which assumes no partitioning, is solid empirical evidence than partitioning is rare and slight. This is supported by the widespread fit of the 'Duplication of Purchase law' (Ehrenberg 2000).

Therefore, we have a picture where brands are differentiated, but the degree of differentiation is fairly standard within the product category. Each brand competes with the same 'closeness' to any other brand.

This is not to say that there are not reasonably common examples of *across buying situation* differentiation, that is, brands that are preferred for the same reason by buyers in different buying situations. Our Franklins example earlier is such an example and in most categories there are competitive brands at slightly different price/quality points. Other than this, major functional differences between brands are unusual because most functional differences can be copied. Even patented technological advantages seem to be matched extraordinarily quickly. An interesting observation we make (one that deserves some empirical investigation) is that many of the cases of relatively enduring *across buying situation* differentiation seem to involve differences in design. For example, Apple's iMac, Alessi kitchenware, Volkswagon's VeeDub, and Herman Miller's Aeron chair. Perhaps this is because design is a subjective thing and competitors are unwilling to copy something that is not universally liked. Alternatively, perhaps it is because quality design is extraordinarily difficult to match – good creativity is genuinely original.

Conclusion

In this article we explained why differentiation is a necessary, but not sufficient condition to earning superior profits. In doing so we have clarified some misconceptions concerning the mechanism through which this profit is achieved, i.e., it need not be via a price premium. We have presented a view of differentiation that is about making the offer different in response to differences in demand (demand heterogeneity). This may be achieved through altering any aspect of the offering (not just produce features), including the financial cost of acquisition (i.e., price charged).

Along the way we have refuted a number of widely held, or at least widely published beliefs:

- differentiation is synonymous with product feature differences (page 744)
- the reward of successful differentiation is simply a price premium (pages 743 and 745)
- differentiation is primarily a function of advertising to sales ratios (page 745)
- differentiation always results in higher costs (page 749)
- differentiation is optional, rather than being a pre-requisite, for earning economic profits (page 747)

The purpose of this article is to move strategy thinking beyond its simplistic view of the nature of differentiation. The explanation of differentiation and how it works can be summarised as:

> Differentiation is when a firm/brand outperforms rival brands in the provision of a feature(s) such that it faces reduced sensitivity for other features (or one feature), through not having to provide these other features the firm has an avenue to save costs. The firm benefits from the reduced sensitivity in terms of reduced directness of competition allowing it to capture a greater degree of exchange value.

Thus differentiation provides a firm with something of a "mini" or weak monopoly. However, as a final note, we reject (in line with Hunt and Morgan (1995)) the pejorative connotations of the term "monopoly". Differentiation is not a sign of sub-optimal markets, nor of socially undesirable firm strategy, but is a natural reaction to heterogeneous market demands and heterogeneous firm resources. A lack of differentiation could mean less customer utility and sub-optimal utilisation of firm (society's) resources. But this seldom if ever happens, instead differentiation is a pervasive and almost unavoidable aspect of real competitive markets.

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