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COMPETITIVE STRATEGY

Techniques for Analyzing Industries and Competitors

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2
Generic Competitive Strategies

Chapter 1 described competitive strategy as taking offensive or defensive actions to create a defendable position in an industry, to cope successfully with the five competitive forces and thereby yield a superior return on investment for the firm. Firms have discovered many different approaches to this end, and the best strategy for a given firm is ultimately a unique construction reflecting its particular circumstances. However, at the broadest level we can identify three internally consistent generic strategies (which can be used singly or in combination) for creating such a defendable position in the long run and outperforming competitors in an industry. This chapter describes the generic strategies and explores some of the requirements and risks of each. Its purpose is to develop some introductory concepts that can be built upon in subsequent analysis. Succeeding chapters of this book will have much more to say about how to translate these broad generic strategies into more specific strategies in particular kinds of industry situations.

Three Generic Strategies

In coping with the five competitive forces, there are three potentially successful generic strategic approaches to outperforming other firms in an industry:

1. overall cost leadership
2. differentiation
3. focus.

Sometimes the firm can successfully pursue more than one approach as its primary target, though this is rarely possible as will be discussed further. Effectively implementing any of these generic strategies usually requires total commitment and supporting organizational arrangements that are diluted if there is more than one primary target. The generic strategies are approaches to outperforming competitors in the industry; in some industries structure will mean that all firms can earn high returns, whereas in others, success with one of the generic strategies may be necessary just to obtain acceptable returns in an absolute sense.

OVERALL COST LEADERSHIP

The first strategy, an increasingly common one in the 1970s because of popularization of the experience curve concept, is to achieve overall cost leadership in an industry through a set of functional policies aimed at this basic objective. Cost leadership requires aggressive construction of efficient-scale facilities, vigorous pursuit of cost reductions from experience, tight cost and overhead control, avoidance of marginal customer accounts, and cost minimization in areas like R&D, service, sales force, advertising, and so on. A great deal of managerial attention to cost control is necessary to achieve these aims. Low cost relative to competitors becomes the theme running through the entire strategy, though quality, service, and other areas cannot be ignored.

Having a low-cost position yields the firm above-average returns in its industry despite the presence of strong competitive forces. Its cost position gives the firm a defense against rivalry from competitors, because its lower costs mean that it can still earn returns after its competitors have competed away their profits through rivalry. A low-cost position defends the firm against powerful buyers because buyers can exert power only to drive down prices to the level of the next most efficient competitor. Low cost provides a defense against powerful suppliers by providing more flexibility to cope with input cost increases. The factors that lead to a low-cost position usually also provide substantial entry barriers in terms of scale economies or cost advantages. Finally, a low-cost position usually places the firm in a favorable position vis-à-vis substitutes relative to its competitors in the industry. Thus a low-cost position protects the firm against all five competitive forces because bargaining can only continue to erode profits until those of the next most efficient competitor are eliminated, and because the less efficient competitors will suffer first in the face of competitive pressures.

Achieving a low overall cost position often requires a high relative market share or other advantages, such as favorable access to raw materials. It may well require designing products for ease in manufacturing, maintaining a wide line of related products to spread costs, and serving all major customer groups in order to build volume. In turn, implementing the low-cost strategy may require heavy up-front capital investment in state-of-the art equipment, aggressive pricing, and start-up losses to build market share. High market share may in turn allow economies in purchasing which lower costs even further. Once achieved, the low-cost position provides high margins which can be reinvested in new equipment and modern facilities in order to maintain cost leadership. Such reinvestment may well be a prerequisite to sustaining a low-cost position.

The cost leadership strategy seems to be the cornerstone of Briggs and Stratton's success in small horsepower gasoline engines, where it holds a 50 percent worldwide share, and Lincoln Electric's success in arc welding equipment and supplies. Other firms known for successful application of cost leadership strategies to a number of businesses are Emerson Electric, Texas Instruments, Black and Decker, and Du Pont.

A cost leadership strategy can sometimes revolutionize an industry in which the historical bases of competition have been otherwise and competitors are ill-prepared either perceptually or economically to take the steps necessary for cost minimization. Harnischfeger is in the midst of a daring attempt to revolutionize the rough-terrain crane industry in 1979. Starting from a 15 percent market share, Harnischfeger redesigned its cranes for easy manufacture and service using modularized components, configuration changes, and reduced material content. It then established subassembly areas and a conveyorized assembly line, a notable departure from industry norms. It ordered parts in large volumes to save costs. All this allowed the company to offer an acceptable quality product and drop prices by 15 percent. Harnischfeger's market share has grown rapidly to 25 percent and is continuing to grow. Says Willis Fisher, general manager of Harnischfeger's Hydraulic Equipment Division:

> We didn't set out to develop a machine significantly better than anyone else but we did want to develop one that was truly simple to manufacture and was priced, intentionally, as a low cost machine.[1]

Competitors are grumbling that Harnischfeger has "bought" market share with lower margins, a charge that the company denies.

DIFFERENTIATION

The second generic strategy is one of differentiating the product or service offering of the firm, creating something that is perceived *industrywide* as being unique. Approaches to differentiating can take many forms: design or brand image (Fieldcrest in top of the line towels and linens; Mercedes in automobiles), technology (Hyster in lift trucks; MacIntosh in stereo components; Coleman in camping equipment), features (Jenn-Air in electric ranges); customer service (Crown Cork and Seal in metal cans), dealer network (Caterpillar Tractor in construction equipment), or other dimensions. Ideally, the firm differentiates itself along several dimensions. Caterpillar Tractor, for example, is known not only for its dealer network and excellent spare parts availability but also for its extremely high-quality durable products, all of which are crucial in heavy equipment where downtime is very expensive. It should be stressed that the differentiation strategy does not allow the firm to ignore costs, but rather they are not the primary strategic target.

Differentiation, if achieved, is a viable strategy for earning above-average returns in an industry because it creates a defensible position for coping with the five competitive forces, albeit in a dif-

[1] "Harneschfeger's Dramatic Pickup in Cranes," *Business Week*, August 13, 1979.

ferent way than cost leadership. Differentiation provides insulation against competitive rivalry because of brand loyalty by customers and resulting lower sensitivity to price. It also increases margins, which avoids the need for a low-cost position. The resulting customer loyalty and the need for a competitor to overcome uniqueness provide entry barriers. Differentiation yields higher margins with which to deal with supplier power, and it clearly mitigates buyer power, since buyers lack comparable alternatives and are thereby less price sensitive. Finally, the firm that has differentiated itself to achieve customer loyalty should be better positioned vis-à-vis substitutes than its competitors.

Achieving differentiation may sometimes preclude gaining a high market share. It often requires a perception of exclusivity, which is incompatible with high market share. More commonly, however, achieving differentiation will imply a trade-off with cost position if the activities required in creating it are inherently costly, such as extensive research, product design, high quality materials, or intensive customer support. Whereas customers industrywide acknowledge the superiority of the firm, not all customers will be willing or able to pay the required higher prices (though most are in industries like earthmoving equipment where despite high prices Caterpillar has a dominant market share). In other businesses, differentiation may not be incompatible with relatively low costs and comparable prices to those of competitors.

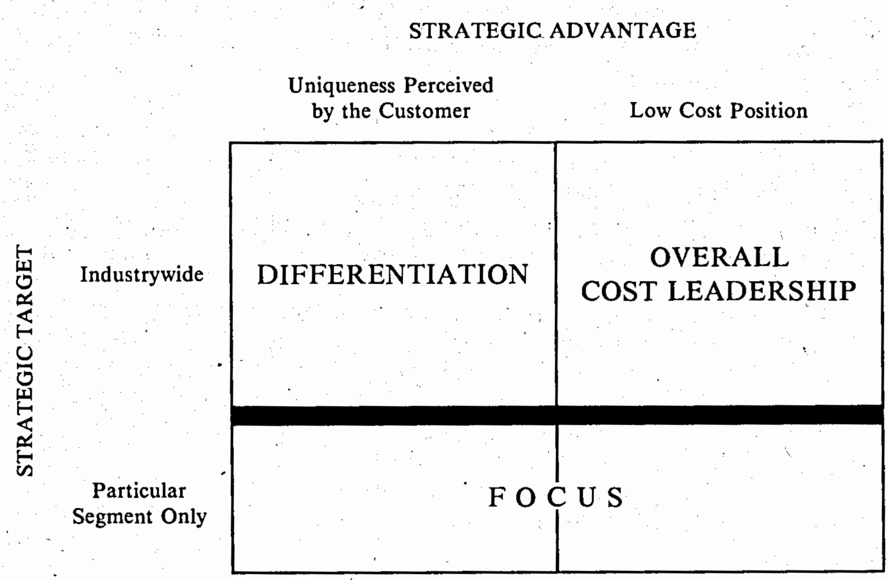
FOCUS

The final generic strategy is focusing on a particular buyer group, segment of the product line, or geographic market; as with differentiation, focus may take many forms. Although the low cost and differentiation strategies are aimed at achieving their objectives industrywide, the entire focus strategy is built around serving a particular target very well, and each functional policy is developed with this in mind. The strategy rests on the premise that the firm is thus able to serve its narrow strategic target more effectively or efficiently than competitors who are competing more broadly. As a result, the firm achieves either differentiation from better meeting the needs of the particular target, or lower costs in serving this target, or both. Even though the focus strategy does not achieve low cost or differentiation from the perspective of the market as a whole, it does achieve one or both of these positions vis-à-vis its narrow market target. The difference among the three generic strategies are illustrated in figure 2-1.

The firm achieving focus may also potentially earn above-average returns for its industry. Its focus means that the firm either has a low cost position with its strategic target, high differentiation, or both. As we have discussed in the context of cost leadership and differentiation, these positions provide defenses against each competitive force. Focus may also be used to select targets least vulnerable to substitutes or where competitors are the weakest.

For example, Illinois Tool Works has focused on specialty markets for fasteners where it can design products for particular buyer needs and create switching costs. Although many buyers are uninterested in these services, some are. Fort Howard Paper focuses on a narrow range of industrial-grade papers, avoiding consumer products vulnerable to advertising battles and rapid introductions of new products. Porter Paint focuses on the professional painter rather than the do-it-yourself market, building its strategy around serving the professional through free paint-matching services, rapid delivery of as little as a gallon of needed paint to the worksite, and free coffee rooms designed to provide a home for professional painters at factory stores. An example of a focus strategy that achieves a low-cost

FIGURE 2-1. Three Generic Strategies



position in serving its particular target is seen in Martin-Brower, the third largest food distributor in the United States. Martin-Brower has reduced its customer list to just eight leading fast-food chains. Its entire strategy is based on meeting the specialized needs of the customers, stocking only their narrow product lines, order taking procedures geared to their purchasing cycles, locating warehouses based on their locations, and intensely controlling and computerizing record keeping. Although Martin-Brower is not the low-cost distributor in serving the market as a whole, it is in serving its particular segment. Martin-Brower has been rewarded with rapid growth and above-average profitability.

The focus strategy always implies some limitations on the overall market share achievable. Focus necessarily involves a trade-off between profitability and sales volume. Like the differentiate strategy, it may or may not involve a trade-off with overall cost position.

OTHER REQUIREMENTS OF THE GENERIC STRATEGIES

The three generic strategies differ in dimensions other than the functional differences noted above. Implementing them successfully requires different resources and skills. The generic strategies also imply differing organizational arrangements, control procedures, and inventive systems. As a result, sustained commitment to one of the strategies as the primary target is usually necessary to achieve success. Some common implications of the generic strategies in these areas are as follows:

Generic Strategy	Commonly Required Skills and Resources	Common Organizational Requirements
Overall Cost Leadership	Substained capital investment and access to capital Process engineering skills Intense supervision of labor Products designed for ease in manufacture Low-cost distribution system	Tight cost control Frequent, detailed control reports Structured organization and responsibilities Incentives based on meeting strict quantitative targets

Generic Strategy	Commonly Required Skills and Resources	Common Organizational Requirements
Differentiation	Strong marketing abilities Product engineering Creative flair Strong capability in basic research Corporate reputation for quality or technological leadership Long tradition in the industry or unique combination of skills drawn from other businesses Strong cooperation from channels	Strong coordination among functions in R&D, product development, and marketing Subjective measurement and incentives instead of quantitative measures Amenities to attract highly skilled labor, scientists, or creative people
Focus	Combination of the above policies directed at the particular strategic target	Combination of the above policies directed at the particular strategic target

The generic strategies may also require different styles of leadership and can translate into very different corporate cultures and atmospheres. Different sorts of people will be attracted.

Stuck in the Middle

The three generic strategies are alternative, viable approaches to dealing with the competitive forces. The converse of the previous discussion is that the firm failing to develop its strategy in at least one of the three directions—a firm that is "stuck in the middle"—is in an extremely poor strategic situation. This firm lacks the market share, capital investment, and resolve to play the low-cost game, the industrywide differentiation necessary to obviate the need for a low-cost position, or the focus to create differentiation or a low-cost position in a more limited sphere.

The firm stuck in the middle is almost guaranteed low profitability. It either loses the high-volume customers who demand low prices or must bid away its profits to get this business away from low-cost firms. Yet it also loses high-margin businesses—the cream—to the firms who are focused on high-margin targets or have achieved differentiation overall. The firm stuck in the middle also probably suffers from a blurred corporate culture and a conflicting set of organizational arrangements and motivation system.

Clark Equipment may well be stuck in the middle in the lift truck industry in which it has the leading overall U.S. and worldwide market share. Two Japanese producers, Toyota and Komatsu, have adopted strategies of serving only the high-volume segments, minimized production costs, and rock-bottom prices, also taking advantage of lower Japanese steel prices, which more than offset transportation costs. Clark's greater worldwide share (18 percent; 33 percent in the United States) does not give it clear cost leadership given its very wide product line and lack of low-cost orientation. Yet with its wide line and lack of full emphasis to technology Clark has been unable to achieve the technological reputation and product differentiation of Hyster, which has focused on larger lift trucks and spent aggressively on R&D. As a result, Clark's returns appear to be significantly lower than Hyster's, and Clark has been losing ground.[2]

The firm stuck in the middle must make a fundamental strategic decision. Either it must take the steps necessary to achieve cost leadership or at least cost parity, which usually involve aggressive investments to modernize and perhaps the necessity to buy market share, or it must orient itself to a particular target (focus) or achieve some uniqueness (differentiation). The latter two options may well involve shrinking in market share and even in absolute sales. The choice among these options is necessarily based on the firm's capabilities and limitations. Successfully executing each generic strategy involves different resources, strengths, organizational arrangements, and managerial style, as has been discussed. Rarely is a firm suited for all three.

Once stuck in the middle, it usually takes time and sustained effort to extricate the firm from this unenviable position. Yet there seems to be a tendency for firms in difficulty to flip back and forth over time among the generic strategies. Given the potential inconsistencies involved in pursuing these three strategies, such an approach is almost always doomed to failure.

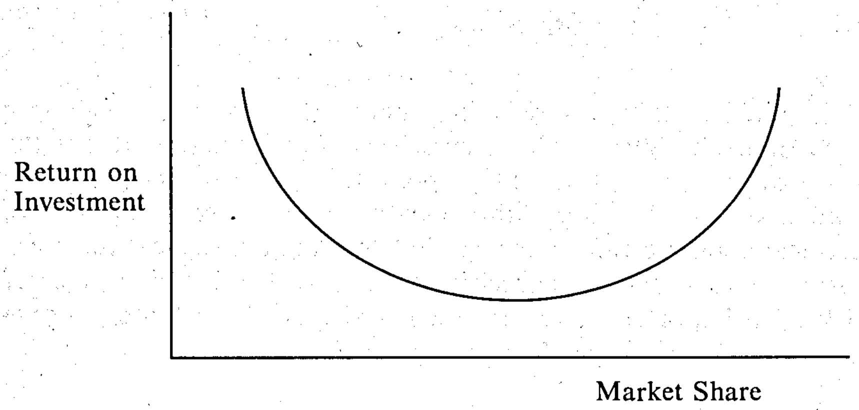
These concepts suggest a number of possible relationships between market share and profitability. In some industries, the prob-

[2]See Wertheim (1977).

lem of getting caught in the middle may mean that the smaller (focused or differentiated) firms and the largest (cost leadership) firms are the most profitable, and the medium-sized firms are the least profitable. This implies a U-shaped relationship between profitability and market share, as shown in Figure 2-2. The relationship in Figure 2-2 appears to hold in the U.S. fractional horsepower electric motor business. There GE and Emerson have large market shares and strong cost positions, GE also having a strong technological reputation. Both are believed to earn high returns in motors. Baldor and Gould (Century) have adopted focused strategies, Baldor oriented toward the distributor channel and Gould toward particular customer segments. The profitability of both is also believed to be good. Franklin is in an intermediate position, with neither low cost nor focus. Its performance in motors is believed to follow accordingly. Such a U-shaped relationship probably also roughly holds in the automobile industry when viewed on a global basis, with firms like GM (low cost) and Mercedes (differentiate) the profit leaders. Chrysler, British Leyland, and Fiat lack cost position, differentiation, or focus—they are stuck in the middle.

However, the U-shaped relationship in Figure 2-2 does not hold in every industry. In some industries, there are no opportunities for focus or differentiation—it's solely a cost game—and this is true in a number of bulk commodities. In other industries, cost is relatively unimportant because of buyer and product characteristics. In these kinds of industries there is often an inverse relationship between market share and profitability. In still other industries, competition is so intense that the only way to achieve an above-average return is

FIGURE 2-2



through focus or differentiation—which seems to be true in the U.S. steel industry. Finally, low overall cost position may not be incompatible with differentiation or focus, or low cost may be achievable without high share. For an example of the complex combinations that can result, Hyster is number two in lift trucks but is more profitable than several of the smaller producers in the industry (Allis-Chalmers, Eaton) who do not have the share to achieve either low costs or enough product differentiation to offset their cost position.

There is *no single relationship* between profitability and market share, unless one conveniently defines the market so that focused or differentiated firms are assigned high market shares in some narrowly defined industries and the industry definitions of cost leadership firms are allowed to stay broad (they must because cost leaders often do not have the largest share in every submarket). Even shifting industry definition cannot explain the high returns of firms who have achieved differentiation industrywide and hold market shares below that of the industry leader.

Most importantly, however; shifting the way the industry is defined from firm to firm begs the question of deciding which of the three generic strategies is appropriate for the firm. This choice rests on picking the strategy best suited to the firm's strengths and one least replicable by competitors. The principles of structural analysis should illuminate the choice, as well as allow the analyst to explain or predict the relationship between share and profitability in any particular industry. I will discuss this issue further in Chapter 7, where structural analysis is extended to consider the differing positions of firms within a particular industry.

Risks of the Generic Strategies

Fundamentally, the risks in pursuing the generic strategies are two: first, failing to attain or sustain the strategy; second, for the value of the strategic advantage provided by the strategy to erode with industry evolution. More narrowly, the three strategies are predicated on erecting differing kinds of defenses against the competitive forces, and not surprisingly they involve differing types of risks. It is important to make these risks explicit in order to improve the firm's choice among the three alternatives.

RISKS OF OVERALL COST LEADERSHIP

Cost leadership imposes severe burdens on the firm to keep up its position, which means reinvesting in modern equipment, ruthlessly scrapping obsolete assets, avoiding product line proliferation and being alert for technological improvements. Cost declines with cumulative volume are by no means automatic, nor is reaping all available economies of scale achievable without significant attention.

Cost leadership is vulnerable to the same risks, identified in Chapter 1, of relying on scale or experience as entry barriers. Some of these risks are

- technological change that nullifies past investments or learning;
- low-cost learning by industry newcomers or followers, through imitation or through their ability to invest in state-of-the-art facilities;
- inability to see required product or marketing change because of the attention placed on cost;
- inflation in costs that narrow the firm's ability to maintain enough of a price differential to offset competitors' brand images or other approaches to differentiation.

The classic example of the risks of cost leadership is the Ford Motor Company of the 1920s. Ford had achieved unchallenged cost leadership through limitation of models and varieties, aggressive backward integration, highly automated facilities, and aggressive pursuit of lower costs through learning. Learning was facilitated by the lack of model changes. Yet as incomes rose and many buyers had already purchased a car and were considering their second, the market began to place more of a premium on styling, model changes, comfort, and closed rather than open cars. Customers were willing to pay a price premium to get such features. General Motors stood ready to capitalize on this development with a full line of models. Ford faced enormous costs of strategic readjustment given the rigidities created by heavy investments in cost minimization of an obsolete model.

Another example of the risks of cost leadership as a sole focus is provided by Sharp in consumer electronics. Sharp, which has long followed a cost leadership strategy, has been forced to begin an aggressive campaign to develop brand recognition. Its ability to sufficiently undercut Sony's and Panasonic's prices was eroded by cost increases and U.S. antidumping legislation, and its strategic position was deteriorating through sole concentration on cost leadership.

RISKS OF DIFFERENTIATION

Differentiation also involves a series of risks:

- the cost differential between low-cost competitors and the differentiated firm becomes too great for differentiation to hold brand loyalty. Buyers thus sacrifice some of the features, services, or image possessed by the differentiated firm for large cost savings;
- buyers' need for the differentiating factor falls. This can occur as buyers become more sophisticated;
- imitation narrows perceived differentiation, a common occurrence as industries mature.

The first risk is so important as to be worthy of further comment. A firm may achieve differentiation, yet this differentiation will usually sustain only so much of a price differential. Thus if a differentiated firm gets too far behind in cost due to technological change or simply inattention, the low cost firm may be in a position to make major inroads. For example, Kawasaki and other Japanese motorcycle producers have been able to successfully attack differentiated producers such as Harley-Davidson and Triumph in large motorcycles by offering major cost savings to buyers.

RISKS OF FOCUS

Focus involves yet another set of risks:

- the cost differential between broad-range competitors and the focused firm widens to eliminate the cost advantages of serving a narrow target or to offset the differentiation achieved by focus;
- the differences in desired products or services between the strategic target and the market as a whole narrows;
- competitors find submarkets *within* the strategic target and outfocus the focuser.