Our discussion about customers shows that all organizations must use their capabilities and core competencies (the *how*) to satisfy the needs (the *what*) of the target group of customers (the *who*) the firm has chosen to serve.

4-2 The Purpose of a Business-Level Strategy

The purpose of a business-level strategy is to create differences between the firm's position and those of its competitors.[36] To position itself differently from competitors, a firm must decide if it intends to *perform activities differently* or if it will *perform different activities*. Strategy defines the path that provides the direction of actions organizational leaders take to help their firm achieve success.[37] In fact, "choosing to perform activities differently or to perform different activities than rivals" is the essence of a business-level strategy.[38] Thus, the firm's business-level strategy is a deliberate choice about how it will perform the value chain's primary and support activities to create unique value. Indeed, in the current complex competitive landscape, successful use of a business-level strategy results from the firm learning how to integrate the activities it performs in ways that create superior value for customers.

The manner in which Southwest Airlines Co. has integrated its activities is the foundation for the firm's ability to use the cost leadership strategy successfully (we discuss this strategy later in the chapter). However, as required by the cost leadership strategy, Southwest Airlines also provides customers with a set of features they find to be acceptable along with a low cost for its services. The tight integration among Southwest's activities is a key source of the firm's ability, historically, to operate more profitably than do its primary competitors. Today, Southwest flies more passengers in the United States than any other airline.[39]

Southwest Airlines has configured the activities it performs into six areas of strategic intent—limited passenger service; frequent, reliable departures; lean, highly productive ground and gate crews; high aircraft utilization with few aircraft models; very low ticket prices; and short-haul, point-to-point routes between mid-sized cities and secondary airports. Individual clusters of tightly linked activities enhance the likelihood the firm will execute its cost leadership strategy successfully. For example, no meals, no seat assignments, and no baggage transfers form a cluster of individual activities that support the objective of offering limited passenger service.

Southwest's tightly integrated activities make it difficult for competitors to imitate the firm's cost leadership strategy. The firm's unique culture and customer service are sources of competitive advantage that rivals have been unable to imitate, although some tried and failed (e.g., US Airways' MetroJet subsidiary, United Airlines' Shuttle by United, Delta's Song, and Continental Airlines' Continental Lite). Hindsight shows that these competitors offered low prices to customers, but weren't able to operate at costs close to those of Southwest or to provide customers with any notable sources of differentiation, such as a unique experience while in the air. The key to Southwest's success has been its ability to maintain low costs across time while providing customers with *acceptable* levels of differentiation such as an engaging culture. Firms using the cost leadership strategy must understand that in terms of sources of differentiation accompanying the cost leader's product, the customer defines *acceptable*. Fit among activities is a key to the sustainability of competitive advantage for all firms, including Southwest Airlines. Strategic fit among the many activities is critical for competitive advantage. It is more difficult for a competitor to match a configuration of integrated activities than to imitate a particular activity such as sales promotion, or a process technology.[40]

Next, we discuss business models, which are part of a comprehensive business-level strategy.[41] While business models inform the development and use of the other types of strategies a firm may choose to implement, their primary use is with business-level strategies. The reason for this is that as noted previously in this chapter, a business-level strategy is the firm's core strategy—the one the firm forms to describe how it intends to compete against rivals on a day-to-day basis in its chosen product market. As part of a firm's business-level strategy, the chosen business model influences the implementation of strategy, especially in terms of the interdependent processes the firm uses during implementation.[42] Developing and integrating a business model and a business-level strategy increases the likelihood of company success.[43] We use a discussion of business models and their relationship with strategy as a foundation for then describing five types of business-level strategies firms may choose to implement.

4-3 Business Models and their Relationship with Business-Level Strategies

As is the case with strategy, there are multiple definitions of a business model.[44] The consensus across these definitions is that a **business model** describes what a firm does to create, deliver, and capture value for its stakeholders.[45] As explained in Chapter 1, stakeholders value related yet different outcomes. For example, for shareholders, the firm captures and distributes value to them in the form of a return on their investment. For customers, the firm creates and delivers value in the form of a product featuring the combination of price and features for which they are willing to pay. For employees, the firm creates and delivers value in the form of a job about which they are passionate as well as through which they have opportunities to develop their skills by participating in continuous learning experiences. In a sense then, a business model is a *framework* for how the firm will create, deliver, and capture value while a business-level strategy is the set of commitments and actions that yields the *path* a firm intends to follow to gain a competitive advantage by exploiting its core competencies in a specific product market. Understanding customers in terms of *who*, *what*, and *how* is foundational to developing and using successfully both a business model and a business-level strategy. [46]

Regardless of the business model chosen, those leading a company should view that selection as one that will require adjustment in response to conditions that change from time to time in the firm's external environment (e.g., an opportunity to enter a new region surfaces) and its internal environment (e.g., the development of new capabilities).[47] Particularly because it is involved primarily with implementing a business-level strategy, the operational mechanics of a business model should change given the realities a firm encounters while engaging rivals in marketplace competitions.

There is an array of different business models, from which firms select one to use.[48] A franchise business model, for example, finds a firm licensing its trademark and the processes it follows to create and deliver a product to franchisees. In this instance, the firm franchising its trademark and processes captures value by receiving fees and royalty payments from its franchisees.

McDonald's and Panera Bread both use the franchise business model. McDonald's uses the model as part of its cost leadership strategy while Panera Bread uses it to implement a differentiation strategy (we discuss both strategies in detail in the next major section). McDonald's' cost leadership strategy finds it using processes detailed in its franchise business model to deliver food items to its customers that are offered at a low price but with acceptable levels of differentiation. Customers receive acceptable levels of differentiation in terms of taste quality, service quality, the cleanliness of the firm's units, and

A **business model** describes what a firm does to create, deliver, and capture value for its stakeholders.

the value the customers believe they receive when buying McDonald's food.[49] (Additional information about McDonald's and its cost leadership strategy appear later in the chapter in a Strategic Focus.)

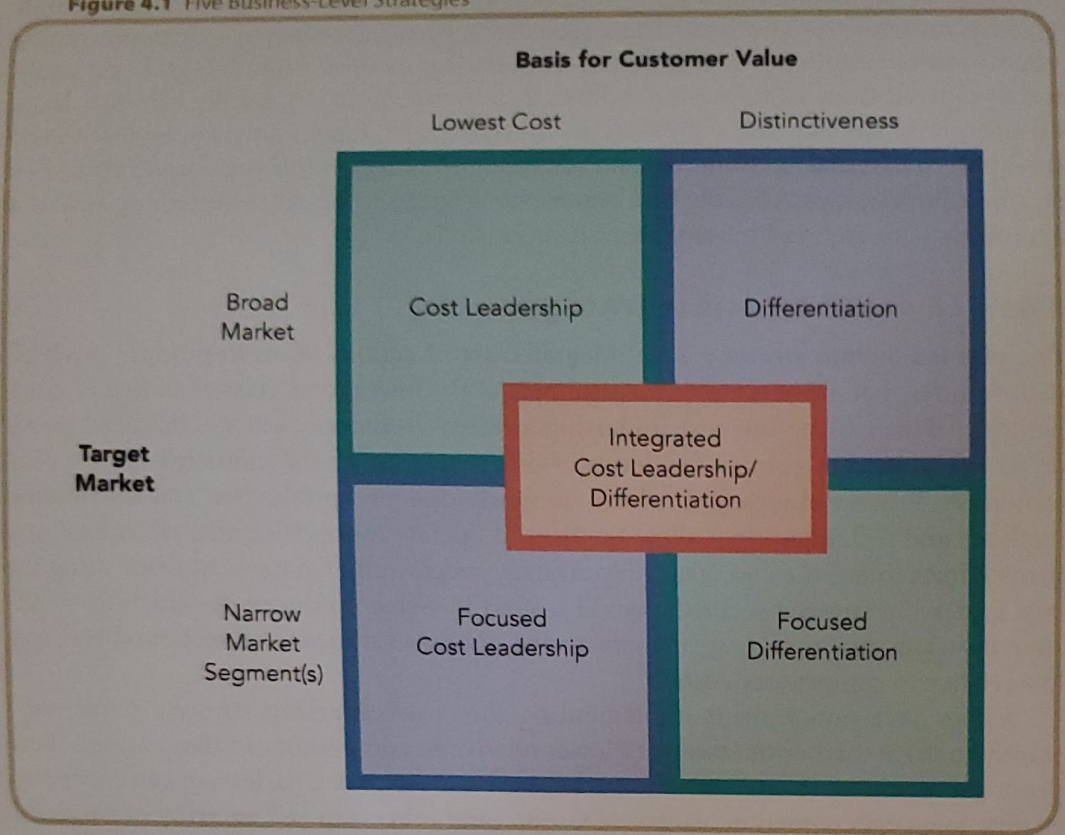
Panera Bread also uses a franchise business model, but its model differs from the McDonald's franchise business model. One difference is that a person can purchase a single McDonald's unit. This is not the case for Panera Bread: "Panera Bread does not sell single-unit franchises, so it is not possible to open just one bakery-café. Rather, we have chosen to develop by selling market areas which require the franchise developer to open a number of units, typically 15 bakery-cafes in a period of 6 years."[50] Operating in the fast-casual part of the restaurant industry (McDonald's operates in the fast food part of the industry), Panera implements the differentiation strategy to provide customers "with good food (that) they can feel good about."[51] Through the differentiation strategy, Panera uses a carefully designed set of processes to offer differentiated food items in a differentiated setting to provide customers with value for which they are willing to pay and at a cost that is acceptable to them. Thus, while McDonald's and Panera Bread use the same business model, the franchising business model these firms use differ in actions the firms take to implement different business-level strategies.

As mentioned, there are multiple kinds of business models, such as the subscription model. In this instance, the business model finds a firm offering a product to customers on a regular basis such as once-per-month, once-per-year, or upon demand. Netflix uses a subscription business model as does Blue Apron, a firm founded on the belief that the way food is grown and distributed is complicated, making it difficult for families to make "good" choices about what they eat. Blue Apron delivers food directly to consumers, eliminating the "middleman" by doing so. The firm partners with farmers who are committed to sustainable production processes "to raise the highest-quality ingredients." Thus, Blue Apron combines the differentiation strategy with a subscription model to create, deliver, and capture value for the stakeholders (e.g., customers, suppliers, employees, and local communities) with whom the firm interacts while implementing its business-level strategy.[52] Other business models that also support the use of any of the five generic business-level strategies we discuss next include the following: (1) a freemium model (here the firm provides a basic product to customers for free and earns revenues and profits by selling a premium version of the service—examples include Dropbox and MailChimp); (2) an advertising model (where for a fee, firms provide advertisers with high-quality access to their target customers—Google and Pinterest are examples of firms using this business model); and (3) a peer-to-peer model (where a business matches those wanting a particular service with those providing that service—two examples are Task Rabbit and Airbnb).

4-4 Types of Business-Level Strategies

Firms choose between five business-level strategies to establish and defend their desired strategic position against competitors: *cost leadership, differentiation, focused cost leadership, focused differentiation,* and *integrated cost leadership/differentiation* (see Figure 4.1). Each business-level strategy can help the firm establish and exploit a *competitive advantage* (either lowest cost or distinctiveness) as the basis for how it will create value for customers within a particular *competitive scope* (broad market or narrow market). How firms integrate the activities they complete within each business level strategy demonstrates how they differ from one another.[53] For example, firms have different activity maps, and thus, a Southwest Airlines activity map differs from those of competitors JetBlue, United Airlines, American Airlines, and so forth. Superior integration of activities increases the

Figure 4.1 Five Business-Level Strategies



Source: Based on M. E. Porter, 1998, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York: The Free Press; D. G. Sirmon, M. A. Hitt, & R. D. Ireland, 2007, Managing firm resources in dynamic environments to create value: Looking inside the black box, *Academy of Management Review*, 32: 273–292; D. G. Sirmon, M. A. Hitt, R. D. Ireland, & B. A. Gilbert, 2011, Resource orchestration to create competitive advantage: Breadth, depth and life cycles effects, *Journal of Management*, 37: 1390–1412.

likelihood a firm will develop an advantage relative to competitors as a path to earning above-average returns.

When selecting a business-level strategy, firms evaluate two types of potential competitive advantages: "lower cost than rivals or the ability to differentiate and command a premium price that exceeds the extra cost of doing so."[54] Lower costs result from the firm's ability to perform activities differently than rivals; being able to differentiate indicates the firm's capacity to perform different (and valuable) activities. Thus, based on the nature and quality of its internal resources, capabilities, and core competencies, a firm seeks to form either a cost competitive advantage or a distinctiveness competitive advantage as the basis for implementing its business-level strategy.[55]

Two types of target markets are broad market and narrow market segment(s) (see Figure 4.1). Firms serving a broad market seek to use their capabilities to create value for customers on an industry-wide basis. A narrow market segment means that the firm intends to serve the needs of a narrow customer group. With focus strategies, the firm "selects a segment or group of segments in the industry and tailors its strategy to serving them to the exclusion of others."[56] Buyers with special needs and buyers located in specific geographic regions are examples of narrow customer groups. As shown in Figure 4.1, a firm could also strive to develop a combined low cost/distinctiveness value creation approach as the foundation for serving a target customer group that is larger than a narrow market segment but not as comprehensive as a broad (or industry-wide) customer group. In this instance, the firm uses the integrated cost leadership/differentiation strategy.

None of the five business-level strategies shown in Figure 4.1 is inherently or universally superior to the others. The effectiveness of each strategy is contingent on the opportunities and threats in a firm's external environment and the strengths and weaknesses derived from its resource portfolio. It is critical, therefore, for the firm to select a business-level strategy that represents an effective match between the opportunities and threats in its external environment and the strengths of its internal organization based on its core competencies. After the firm chooses its strategy, it should consistently emphasize actions that are required to implement it successfully.

4-4a Cost Leadership Strategy

The **cost leadership strategy** is an integrated set of actions taken to produce products with features that are acceptable to customers at the lowest cost, relative to that of competitors.[57] Firms using the cost leadership strategy commonly sell standardized goods or services, but with competitive levels of differentiation, to the industry's most typical customers. Process innovations, which are newly designed production and distribution methods and techniques that allow the firm to operate more efficiently, are critical to a firm's efforts to use the cost leadership strategy successfully. Commonly, firms using the cost leadership strategy scour the world to find low-cost producers to which they outsource various functions (e.g., manufacturing goods) as a means of keeping their costs low relative to competitors' costs.[58]

As we have noted, firms implementing the cost leadership strategy strive constantly to drive their costs lower and lower relative to competitors so they can sell their products to customers at a low and perhaps the lowest cost. Charles Schwab competes against low-cost competitor Vanguard Group (and others) to sell an array of financial products. Both firms offer numerous "passively managed" rather than "actively managed" funds to customers. Recently, Schwab claimed that the costs of its market cap index mutual funds were "lower than comparable competitor funds with the lowest investment minimums."[59] To offer a source of differentiation that customers wanting to buy low-cost products with acceptable levels of differentiation would find interesting, Schwab announced in January of 2018 that the expense ratio it would charge for three new equity index funds would be zero until June 30, 2018. At that time, the expense ratios for the three new funds would increase from zero to .04 or .05 percent.[60] Along with Vanguard and other competitors such as Fidelity, Schwab also offers commission-free ETF (exchange-traded funds) trades for a number of its ETFs. As an example of a source of differentiation, waiving Schwab's standard trade commission of $4.95 per transaction for a number of ETFs allows customers to save money when buying the firm's products. Now the fifth largest U.S. ETF sponsor, analysts suggest that "one of the primary reasons Schwab has been able to ascend to the upper echelon of ETF issuers in terms of size is the provider's willingness to compete with and in many cases beat rival sponsors when it comes to low fees."[61]

As primary activities, inbound logistics (e.g., materials handling, warehousing, and inventory control) and outbound logistics (e.g., collecting, storing, and distributing products to customers) often account for significant portions of the total cost to produce some products. Research suggests that having a competitive advantage in logistics creates more value with a cost leadership strategy than with a differentiation strategy.[62]

The **cost leadership strategy** is an integrated set of actions taken to produce products with features that are acceptable to customers at the lowest cost, relative to that of competitors.

Thus, cost leaders seeking competitively valuable ways to reduce costs may want to concentrate on the primary activities of inbound logistics and outbound logistics. An example of this is the decision by a number of low-cost producers to outsource their manufacturing operations to low-cost firms with low-wage employees (e.g., China).[63] However, outsourcing also makes the firm more dependent on suppliers over which they may have little control. Because of this, firms analyze outsourcing possibilities