



Competitive Advantage

Creating and Sustaining Superior Performance

Michael E. Porter

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Rating

10 10 Applicability
10 Innovation
9 Style

Focus

Leadership & Management

Strategy

Sales & Marketing

Finance

Human Resources

IT, Production & Logistics

Career & Self-Development

Small Business

Economics & Politics

Industries

Global Business

Concepts & Trends

Take-Aways

- Competitive strategy is essential to a company's profitability and survival.
- Companies can find competitive advantage based on cost, differentiation or focus.
- Firms that are "stuck in the middle" generally lose to firms with cost advantages or superior differentiation.
- Interrelationships among business units can help create value through synergies.
- To understand costs, you must analyze your value chain.
- Companies face good and bad competitors.
- Most products are used in conjunction with complementary products (i.e., hardware and software). Make strategic choices about your firm's complementary products.
- Five factors shape an industry's profitability: suppliers, buyers, substitutes, new entrants and existing competitors.
- Every industry is vulnerable to substitution, that is, being supplanted by a competitor in "performing a particular function...for a buyer."
- Never attack an industry leader directly; retaliation is inevitable and the leader has powerful advantages.

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Relevance

What You Will Learn

In this summary, you will learn: 1) What competitive strategy is; and 2) What factors affect your organization's competitive strategy.

Review

This classic work on competition is indicative of the importance of Michael Porter's pivotal contributions to management literature. The book seems as fresh and relevant today as when it was first published more than a quarter-century ago. Porter, a professor at the Harvard Business School, is the author of 16 books, and a leading authority on competitive strategy and economic development. His ideas have guided economic policy worldwide, which may account for his nine honorary degrees and numerous awards. This book demonstrates the reasons for his influence. He provides a clear, deftly written, very accessible guide to developing and implementing competitive strategy. He covers the fundamentals of value chains, costs, differentiation, technology, substitution, synergies and more. *getAbstract* assumes that they told you in business school to reread this frequently as a management touchstone.

Summary

Types of Strategy

A company conducts activities that incur costs in hopes of generating value. Competitive advantage and profit depend on these linked activities in the value chain. Close attention to the value chain enables managers to identify the products or services that customers want most and will pay a premium to obtain. Corporations create competitive advantage by choosing which activities to engage in, and how and where. Your strategy is how you configure those activities.

Companies that decide to compete on the basis of cost arrange their activities differently from firms that decide to compete on the basis of differentiation. This way of looking at a company's competitive choices bridges what might otherwise be a gap between strategy and execution. Competitive advantage rests upon how well the strategy you choose to execute generates value. Companies can choose among three generic strategies to produce competitive advantage:

- **"Cost leadership"** – A firm may seek to become the lowest cost competitor, which it can achieve several ways, depending on its industry. Economies of scale, technology, raw materials and other factors can provide cost advantages. To become the low-cost competitor, a firm must understand and use the cost advantages that matter most in its particular industry. If a firm can achieve the industry's lowest costs and still charge average prices, it will perform better than the norm. However, it cannot pursue cost exclusively. Differentiation still matters. Customers must regard its products as being at least as good as those of its competitors. Otherwise, they will force further price cuts. Pursuing cost leadership is harder if your competition is striving for the same advantage. Cost warfare risks damaging a firm's profitability and an industry's structure.
- **"Differentiation"** – A company may seek to distinguish itself from its rivals by offering superior value, and particular service or product attributes. The various kinds of differentiation vary from industry to industry. Differentiation costs money. To outperform the industry average, a company that is trying to be different must be able to

"Competitors are both a blessing and a curse. Seeing them only as a curse runs the risk of eroding not only a firm's competitive advantage, but also the structure of the industry as a whole."

"Although value activities are the building blocks of competitive advantage, the value chain is not a collection of independent activities but a system of interdependent activities."

charge a premium price. The premium can't just compensate for higher costs; it also has to achieve higher margins. This means that the differentiator's total cost should be relatively close to its competitors' total costs. The firm must cut expenses in areas that do not impair its differentiating traits, such as the way it does something that customers value but that its competitors are not doing. An industry generally has just one cost leader, but several firms can pursue differentiation by emphasizing distinct attributes.

- **“Focus”** – A focused strategy targets specific industry segments, ignoring all others. The buyers in these segments must have individualistic requirements, so that the focus area becomes a genuine competitive advantage. The strategy of focusing works best when your competitors are not meeting a segment's needs.

Firms become “stuck in the middle” when they fail to select and stick to a particular strategy. Laker Airways, for example, started out with a price-sensitive strategy. However, it lost its focus and ended up bankrupt. Generally speaking, adopting more than one of these three strategies is quite difficult, unless your company assigns different strategies to different business units. In some cases, however, cost and differentiating strategies may be compatible, such as when:

- Competitors have not made clear strategic choices and are mired in trying to decide.
- Market share and relationships heavily influence cost.
- A firm innovates in a unique, powerful way.

Companies must take industry wide factors into consideration, not just to determine cost and differentiation strategies, but to assess the five elements that affect the money-making ability of any industry: its suppliers, buyers, substitutes, new entrants and existing competitors. A competitor that steps in to offer customers a substitute service or product is a particular threat. Structural changes in an industry can also undermine a firm's competitive strategy. K-mart did well challenging Sears on cost, only to be challenged in turn by discounters with differentiation or focus strategies. To secure a superior position in its industry, a firm must be able to sustain its strategy, even in the face of substitutions and other threats. Cost leaders may lose their advantage if their competitors also cut costs. Differentiators may lose their edge if buyers stop caring about their specific difference. Focusers may find that their strategy is unsustainable if competitors with a broader aim target their niche. Each strategy places its own demands on an organization, and an organization's individual culture can make a given strategy more or less suitable.

“The Value Chain”

The value chain consists of a firm's activities, which fall into two categories: primary (i.e. production and sales) or support (i.e. human resources). Each category includes direct, indirect and quality assurance activities, some of which are linked. Such linkages occur when one activity affects another, such as product design and cost of servicing. A firm may create competitive advantages by making the most of such links. A manufacturer's value chain affects its customers' value chains. In fact, that relationship is a source of differentiation. The scope of competition helps to determine the nature of the value chain. Scope may refer to segments served, vertical integration, geographic reach or industry presence. This has tremendous applicability. Even your household has a value chain.

Cost and Competitiveness

You must understand your value chain to analyze costs. First, your company has to define its value chain. Then it can determine the costs that are assigned to each activity. Ten factors drive cost:

“Although value activities are the building blocks of competitive advantage, the value chain is not a collection of independent activities but a system of interdependent activities.”

“While competitors can surely be threats, the right competitors can strengthen rather than weaken a firm's competitive position.”

“Industries are most stable when firms are mutually good competitors – the segment one competitor focuses on is profitable for it but not of interest to the other, for example.”

“Industry segmentation is necessary to address the central question of competitive scope within an industry, or what segments of an industry a firm should serve and how it should serve them.”

"When facing considerable uncertainty, firms tend to select strategies that preserve flexibility, despite the costs in...required resources or diminished competitive position."

"Defensive strategy aims to lower the probability of attack, divert attacks to less threatening avenues or lessen their intensity."

"Instead of increasing competitive advantage per se, defensive strategy makes a firm's competitive advantage more sustainable."

"The cardinal rule in offensive strategy is not to attack head-on with an imitative strategy, regardless of the challenger's resources or staying power."

1. **Scale** – Scale can cost money, (i.e., by driving up the cost of materials) or it may save money by lowering the costs per unit.
2. **Learning** – As firms learn new and better ways to work, costs may drop.
3. **Capacity** – How your company uses its available skills, budgets, materials, workforce, logistical support and energies will increase or decrease costs.
4. **Value chain linkages** – Some activities may affect the cost of other activities.
5. **Relationships** – Relationships with other businesses or business units (such as shared service centers) affect costs.
6. **Integration** – Vertical integration, on one hand, or outsourcing, on the other, offer opportunities for cost reduction.
7. **Timing** – First movers may have a cost advantage in learning and in branding; late movers may benefit from the first mover's R&D or may develop better technology.
8. **Policies** – Firms make policy decisions about services, delivery, target customers, human resources and many other areas. These decisions affect cost.
9. **Site** – A firm may choose to locate its production, administration or other activities in an area with taxation, real estate, labor or material cost advantages.
10. **Institutions** – Regulations, unions, taxes and other institutional factors drive costs.

The Differentiation Advantage

To differentiate, a firm must produce some unique value other than lower prices. Firms may drive differentiation through:

- **Policy** – Corporate decisions about services, technology, materials, quality, products, human resources, information and other factors can create differentiation.
- **Value chain linkages** – Activities at one point in the value chain can affect the performance of other activities, for example, you can make fast deliveries only if you process orders quickly.
- **Timing** – The first-mover and late-mover advantages also apply to differentiation.
- **Site** – The location of retail outlets or other activity centers may create customer value.
- **Relationships** – Business units may share a service department or a sales force to meet a broad spectrum of customer needs.
- **Scale** – Scale means different things to customers in different industries. The ability to rent or return a Hertz car anywhere in the U.S. is an advantage of scale. However, in some industries, massive scale may make it difficult to serve niche markets.
- **Institutions** – Unions and other institutions may affect a firm's ability to differentiate.

Technology

Technology can drive competitiveness. However, technology is not valuable in and of itself. It is important only so far as it is a source of competitive advantage in a company or of structural change in an industry. Technology matters to competitive advantage in that it affects cost or differentiation opportunities. It matters to industry structure when it diffuses throughout an industry and changes the way competitors deliver value. In such cases, technology may not be an advantage to any single firm, but it may lower costs or increase profits for all the firms in the industry. Note that widespread imitation may destabilize the industry's structure.

Competitors

Having competitors – good ones or bad ones – can improve a company's competitiveness. Good competitors may help to cushion a firm's use of its capacity from volatile or seasonal demand. They may provide a standard against which a firm can differentiate. They may serve segments that the firm prefers not to serve, but that it might have to serve if the

competitor didn't exist. Competition might let a low-cost producer charge a little more, because those prices would still look low in comparison to the competitor. Good competitors may also foster strong industry structures, help markets develop and create barriers to entry for challengers. Firms with good competitors should not attack them and may be better off not attempting to take their market share. Attack only bad competitors.

"Horizontal organization does not seek to eliminate or replace decentralization. The logic of decentralization is sound and some diversified firms, in fact, have failed to decentralize enough."

Industry Segments

Industries have distinct groups with separate needs and priorities. Creating a focus-based strategy requires defining, analyzing and distinguishing the segments in your industry, including markets, customers and products. These segments create competitive advantage if they affect costs, differentiation or value chain configuration.

Substitutes and Synergies

Substitution is a force to reckon with in every industry. Firms need to be aware of products or services that can give their customers similar values. For example, both trucks and trains can deliver goods, and a buyer's value chain may accommodate either. Buyers will change from one alternative to another when the benefit of switching is higher than the cost of the move. Competitors may promote switching, while incumbents seek to prevent it. Their strategies will be each other's mirror opposites.

"Competitive advantage grows fundamentally out of the value a firm is able to create for its buyers."

The word "synergy" has fallen on hard times, chiefly because companies did not understand and use it properly. In fact, interrelationships among business units can help create value. Firms need to manage horizontally, and develop strategies that take advantage of the relationships among their business units. For example, companies can reduce costs by sharing such activities as design, logistics, procurement or marketing. Diversified firms face a challenge in coordinating the activities and strategies of various business units in a way that builds competitive advantage.

To define a horizontal strategy, firms need to map relationships both within and beyond their boundaries, and to understand how these interrelationships affect their competitive advantage. Complementary products, that is, those used in conjunction with the firm's own products (like hardware and software), represent a type of interrelationship that merits particular attention. Some complementary products will matter greatly to strategy; others will not. Strategic approaches for dealing with complementary firms include controlling, bundling and cross-subsidizing. However, organizational obstacles may make it hard to reap the competitive advantage of interrelationships.

"Potential sources of competitive advantage are everywhere in a firm. Every department, facility, branch office and other organizational unit has a role that must be defined and understood."

Uncertainty

To a greater or lesser extent, all companies must deal with uncertain environments at one time or another. Scenario planning can be a powerful tool for identifying possible futures and selecting appropriate strategies. Regardless of whether your firm leans toward a defensive or offensive strategy, don't ever launch an attack on the industry leader by imitating the leader's own strategy.

About the Author

Michael E. Porter is the Bishop William Lawrence University Professor in the Institute for Strategy and Competitiveness at the Harvard Business School, and an international authority on strategy and economic development. He has published 16 books and more than 100 articles.