8 The Nature and Sources of Competitive Advantage

One Saturday afternoon in downtown Chicago, Milton Friedman, the famous free-market economist, was shopping with his wife.

"Look, Milton!" exclaimed Mrs. Friedman. "There's a $20 bill on the sidewalk!" "Don't be foolish, my dear," replied the Nobel laureate. "If that was a $20 bill, someone would have picked it up by now."

—ECONOMIST'S ANECDOTE OF DOUBTFUL AUTHENTICITY

OUTLINE

Introduction and Objectives

In this chapter, we integrate and develop the elements of competitive advantage that we have analyzed in prior chapters. Chapter 1 noted that a firm can earn superior profitability either by locating in an attractive industry or by establishing a competitive advantage over its rivals. Of these two, competitive advantage is the more important. As competition has intensified across almost all industries, very few industry environments can guarantee secure returns; hence, the primary goal of a strategy is to establish a position of competitive advantage for the firm.

Chapters 3 and 5 provided the two primary components of our analysis of competitive advantage. The last part of Chapter 3 analyzed the external sources of competitive advantage: customer requirements and the nature of competition determine the *key success factors* within a market. Chapter 5 analyzed the internal sources of competitive advantage: the potential for the firm's resources and capabilities to establish and sustain competitive advantage.

This chapter looks more deeply at competitive advantage. We focus on the dynamic relationship between competitive advantage and the competitive process. Competition provides the incentive for establishing advantage and is the means by which advantage is eroded. By understanding the characteristics of competition in a market we can identify the opportunities for competitive advantage.

By the time you have completed this chapter you will be able to:

- identify the circumstances in which a firm can create a competitive advantage over a rival;
- predict the potential for competition to erode competitive advantage through imitation;
- recognize how resource conditions create imperfections in the competitive process which offer opportunities for competitive advantage;
- distinguish the two primary types of competitive advantage: cost advantage and differentiation advantage;
- apply this analysis to assess the potential for a business strategy to establish and sustain competitive advantage given the characteristics of the industry setting.

The Emergence of Competitive Advantage

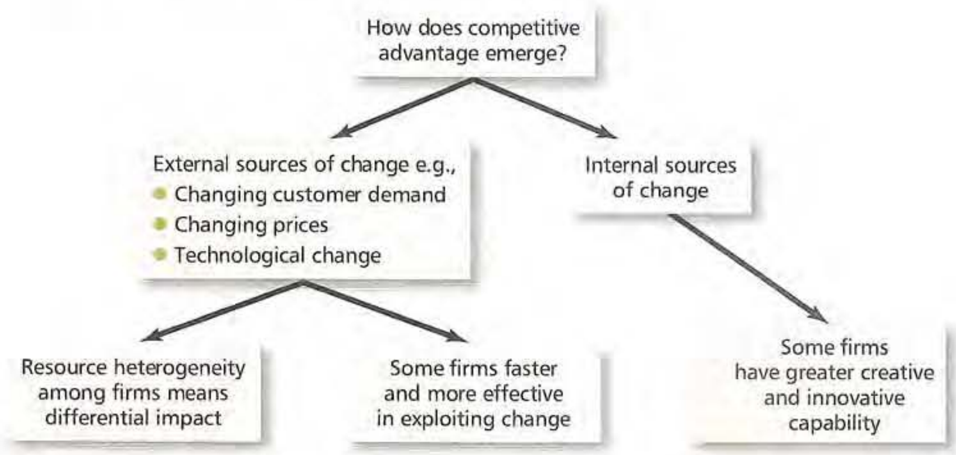
To understand how competitive advantage emerges, we must first understand what competitive advantage is. Most of us can recognize competitive advantage when we see it: Wal-Mart has a competitive advantage in discount retailing within the U.S.; Toyota has a competitive advantage in making mass-produced cars; SAP has a competitive advantage in enterprise resource planning (ERP) software. Yet, defining competitive advantage is troublesome. At a basic level we can define it as follows: "When two or more firms compete within the same market, one firm possesses a competitive advantage over its rivals when it earns (or has the potential to earn) a persistently higher rate of profit."

The problem here is that if we identify competitive advantage with superior profitability, why do we need the concept of competitive advantage at all? The key difference is that competitive advantage may not be revealed in higher profitability—a firm may forgo current profit in favor of investment in market share, technology, customer loyalty, or executive perks.[1]

External Sources of Change

In the long run, competition eliminates differences in profitability between competing firms—hence, competitive advantage is a disequilibrium phenomenon that is a consequence of change. The source of the change may be external or internal to the industry (see Figure 8.1). For an external change to create competitive advantage, the change must have differential effects on companies because of their different resources and capabilities or strategic positioning. For example, during 2000–4, General Motors' return on assets (ROA) was 14.0%; Toyota's was 8.1%. During 2004–7, General Motors' ROA was −5.2%; Toyota's was 7.6%. Over the period oil prices had tripled and demand had shifted away from the advanced industrialized countries. Toyota, with its fuel-efficient product range and superior distribution in emerging market countries, was the advantaged competitor.

FIGURE 8.1 The emergence of competitive advantage



The extent to which external change creates competitive advantage and disadvantage depends on the magnitude of the change and the extent of firms' strategic differences. The more turbulent an industry's environment, the greater the number of sources of change and the greater the differences in firms' resources and capabilities, the greater the dispersion of profitability within the industry. In the world tobacco industry, the external environment is fairly stable and the leading firms pursue similar strategies with similar resources and capabilities. Hence, competitive advantages, as reflected in interfirm profit differentials, tend to be small. The toy industry, on the other hand, comprises a heterogeneous group of firms that experience unpredictable shifts in consumer preferences and technology. As a result, profitability differences are wide and variable.

Competitive Advantage from Responsiveness to Change

The competitive advantage that arises from external change also depends on firms' ability to respond to change. Any external change creates opportunities for profit, including opportunities for new business initiatives (what is known as *entrepreneurship*).

Responsiveness involves one of two key capabilities. The first is the ability to anticipate changes in the external environment. Thus, Nokia's ability to maintain market leadership in wireless handsets owes much to its anticipation of the shift in demand from advanced to emerging economies. The second is speed. An unexpected rain shower creates an upsurge in the demand for umbrellas. Those street vendors who are quickest to position themselves outside a busy railroad station will benefit most.

As markets become more turbulent and unpredictable, so speed of response through greater flexibility has become increasingly important as a source of competitive advantage. The first requirement for quick response capability is information. As conventional economic and market forecasting has become less effective, so companies rely increasingly on "early warning systems" through direct relationships with customers, suppliers and even competitors. The second requirement is short cycle times that allow information on emerging market developments to be acted upon speedily. In fashion retailing, fast response to emerging fashion trends is critical to success. Zara, the chain of retail clothing stores owned by the Spanish company Inditex, has pioneered leading-edge fashion clothes for budget-minded young adults through a tightly-integrated vertical structure that cuts the time between a garment's design and retail delivery to under three weeks (against an industry norm of three to six months.[2]

The notion of speed as a source of competitive advantage was pioneered by the Boston Consulting Group with its concept of *time-based competition*.[3] However, it was the advent of the internet, real-time electronic data exchange and wireless communication that facilitated radical improvements in response capability across the business sector as a whole.

Competitive Advantage from Innovation: "New Game" Strategies

The changes that create competitive advantage may also be generated internally through innovation. Innovation not only creates competitive advantage; it provides a basis for overturning the competitive advantage of other firms—Schumpeter's view of competition as "a gale of creative destruction." Although innovation is typically thought of as new products or processes that embody new technology, a key source of competitive advantage is *strategic innovation*— new approaches to doing business including new business models.

Strategic innovation typically involves creating value for customers from novel products, experiences, or modes of product delivery. Thus, in the retail sector competition is driven by a constant quest for new retail concepts and formats. This may take the form of: big-box stores with greater variety (Toys-R-Us, Home Depot); augmented customer service (Nordstrom) and novel approaches to display and store layout (Sephora in cosmetics).

Strategic innovation may also be based on redesigned processes and novel organizational designs:

- In the U.S. steel industry, Nucor achieved unrivaled productivity and flexibility by combining new process technologies, flat and flexible organizational structures and innovative management systems. Since 1997, it has been the biggest steel producer in the U.S.
- Southwest Airlines' point-to-point, no-frills airline service using a single type of plane and flexible, nonunion employees has made it the only consistently profitable airline in North America and the model for budget airlines throughout the world.
- Nike built its large and successful businesses on a business system that totally reconfigured the shoe industry's traditional value chain—notably by outsourcing manufacturing and concentrating upon design and marketing, and orchestrating a vast global network of producers, logistics providers and retailers.
- Apple Computer's resurgence during 2003-6 was the result of its reinvention of the recorded music business by combining an iconic MP3 player with its iTunes music download service.

How do we go about formulating innovative strategies? Strategic innovations tend to involve pioneering along one or more dimensions of strategy:

- New industries. Some companies launch products which create a whole new market. Xerox created the plain-paper copier industry; Freddie Laker pioneered budget air travel; Craig McCaw and McCaw Communications launched the mass market for wireless telephony. For Kim and Mauborgne, creating new markets is the purest form of blue ocean strategy—the creation of "uncontested market space."[4]
- New customer segments. Creating new customer segments for existing product concepts can also open up vast new market spaces. Apple did not invent the personal computer, but it launched the market for computers in the home. The video cassette recorder was developed by Ampex for use in television studios; Sony and Matsushita's innovation was in designing VCRs for domestic use. The success of the Nintendo Wii video games console has been based upon extending video gaming into new customer segments.
- New sources of competitive advantage. As Kim and Mauborgne acknowledge, most successful blue-ocean strategies do not launch whole new industries but introduce novel approaches to creating customer value. Thus, Dell's strategic

innovation was an integrated system for ordering, assembling and distributing PCs, which permitted unprecedented customer choice and speedy fulfillment of orders. Cirque de Soleil has reinvented the circus business as a multimedia entertainment spectacle that meshes technology with highly developed acrobatic and choreographic capabilities.[5] McKinsey & Company show that a key element of strategic innovation—what they call new game strategy—involves reconfiguring the industry value chain in order to change the "rules of the game" within a market.[6] For example, Canon's successful penetration of the plain-paper copier market during 1973–6, was based upon a strategy that was radically different from that of the incumbent, Xerox. While Xerox's dominance was based upon large machines, which used dry toner and were leased to customers, Canon introduced small machines that used liquid toner and were sold outright to customers.[7] In their study of rejuvenation among mature firms, Charles Baden-Fuller and John Stopford observe that strategic innovation often involves combining performance dimensions that were previously viewed as conflicting. For example, Richardson, a U.K. kitchen knife producer, used an innovative design, process innovation, and a lean, entrepreneurial management to supply kitchen knives that combined price competitiveness, durability, sharpness, and responsive customer service.[8] However, according to Gary Hamel, even innovative strategies are subject to imitation. He argues that the most durable forms of competitive advantage are those that derive from management innovation such as Procter & Gamble's invention of modern brand management and Toyota's lean production system.[9]

Sustaining Competitive Advantage

Once established, competitive advantage is subject to erosion by competition. The speed with which competitive advantage is undermined depends on the ability of competitors to challenge either by imitation or innovation. Imitation is the most direct form of competition; thus, for competitive advantage to be sustained over time, barriers to imitation must exist. Rumelt uses the term *isolating mechanisms* to describe "barriers that limit the *ex post* equilibration of rents among individual firms."[10] The more effective these isolating mechanisms are, the longer competitive advantage can be sustained against the onslaught of rivals. In most industries the erosion of the competitive advantage of industry leaders is a slow process: interfirm profit differentials often persist for period of a decade or more.[11] However, as we discussed in Chapter 4 (see the section on "Dynamic Competition"), the advent of hypercompetition has accelerated the erosion of profit differentials.

To identify the sources of isolating mechanisms, we need to examine the process of competitive imitation. For one firm successfully to imitate the strategy of another, it must meet four conditions:

- *Identification.* The firm must be able to identify that a rival possesses a competitive advantage.
- *Incentive.* Having identified that a rival possesses a competitive advantage (as shown by above-average profitability), the firm must believe that by investing in imitation, it too can earn superior returns.

FIGURE 8.2 Sustaining competitive advantage: types of isolating mechanism

REQUIREMENT FOR IMITATION	*ISOLATING MECHANISM*
Identification	—*Obscure* superior performance
Incentives for imitation	—*Deterrence*: signal aggressive intentions to imitators —*Preemption*: exploit all available investment opportunities
Diagnosis	—Rely on multiple sources of competitive advantage to create *"causal ambiguity"*
Resource acquisition	—Base competitive advantage on resources and capabilities that are *immobile* and *difficult to replicate*

- *Diagnosis*. The firm must be able to diagnose the features of its rival's strategy that give rise to the competitive advantage.
- *Resource acquisition*. The firm must be able to acquire through transfer or replication the resources and capabilities necessary for imitating the strategy of the advantaged firm.

Figure 8.2 illustrates these stages and the types of isolating mechanism that exist at each stage.

Identification: Obscuring Superior Performance

A simple barrier to imitation is to obscure the firm's superior profitability. According to George Stalk of the Boston Consulting Group: "One way to throw competitors off balance is to mask high performance so rivals fail to see your success until it's too late."[12] In the 1948 movie classic *The Treasure of the Sierra Madre*, Humphrey Bogart and his partners went to great lengths to obscure their find from other gold prospectors.[13] The Mongolian gold rush of 2002–3 also featured secretive behavior as miners with positive test results sought to acquire exploration rights on nearby properties.[14]

For firms that dominate a niche market, one of the attractions of remaining a private company is to avoid disclosing financial performance. Few food processors realized just how profitable cat and dog food could be until the U.K. Monopolies Commission revealed that the leading firm, Pedigree Petfoods (a subsidiary of Mars Inc.) earned a return on capital employed of 47%.[15]

Avoiding competition through avoiding disclosure of a firm's profits is much easier for a private than a public company. For Mars Inc., the nondisclosure of financial results assited the firm in protecting the profitably of its pet food and confectionery businesses.

The desire to avoid competition may be so strong as to cause companies to forgo short-run profits. The *theory of limit pricing*, in its simplest form, postulates that a firm in a strong market position sets prices at a level that just fails to attract entrants.[16]

Deterrence and Preemption

A firm may avoid competition by undermining the incentives for imitation. If a firm can persuade rivals that imitation will be unprofitable, it may be able to avoid competitive challenges. In Chapter 4 we discussed strategies of deterrence and the role of signaling and commitment in supporting them.[17]

As we have seen, reputation is critically important in making threats credible. Brandenburger and Nalebuff argue that in the aspartame market, NutraSweet's aggressive price war against the Holland Sweetener Company deterred other would-be entrants.[18]

A firm can also deter imitation by preemption—occupying existing and potential strategic niches to reduce the range of investment opportunities open to the challenger. Preemption can take many forms:

- Proliferation of product varieties by a market leader can leave new entrants and smaller rivals with few opportunities for establishing a market niche. Between 1950 and 1972, for example, the six leading suppliers of breakfast cereals introduced 80 new brands into the U.S. market.[19]
- Large investments in production capacity ahead of the growth of market demand also preempt market opportunities for rivals. Monsanto's heavy investment in plants for producing NutraSweet ahead of its patent expiration was a clear threat to would-be producers of generic aspartame.
- Patent proliferation can protect technology-based advantage by limiting competitors' technical opportunities. In 1974, Xerox's dominant market position was protected by a wall of over 2000 patents, most of which were not used. When IBM introduced its first copier in 1970, Xerox sued it for infringing 22 of these patents.[20]

The ability to sustain competitive advantage through preemption depends on the presence of two imperfections of the competitive process. First, the market must be small relative to the minimum efficient scale of production, such that only a very small number of competitors is viable. Second, there must be first-mover advantage that gives an incumbent preferential access to information and other resources, putting rivals at a disadvantage.

Diagnosing Competitive Advantage: "Causal Ambiguity" and "Uncertain Imitability"

If a firm is to imitate the competitive advantage of another, it must understand the basis of its rival's success. In most industries there is a serious identification problem in linking superior performance to the strategic decisions that generate that performance. Consider the remarkable success of Wal-Mart in discount retailing.

For Wal-Mart's struggling competitor, Sears Holdings (owner of the Kmart chain of discount stores), it is easy to point to the differences between Wal-Mart and itself. As one Wal-Mart executive commented: "Retailing is an open book. There are no secrets. Our competitors can walk into our stores and see what we sell, how we sell it, and for how much." The difficult task is to identify which differences are the critical determinants of superior profitability. Is it Wal-Mart's store locations (typically in small towns with little direct competition)? Its tightly integrated supply chain? Its unique management system? The information system that supports Wal-Mart's logistics and decision-making practices? Or is it a culture built on traditional rural American values of thrift and hard work?

The problem for Kmart/Sears and other wannabe Wal-Marts is what Lippman and Rumelt refer to as *causal ambiguity*.[21] The more multidimensional a firm's competitive advantage and the more it is based on complex bundles of organizational capabilities, the more difficult it is for a competitor to diagnose the determinants of success. The outcome of causal ambiguity is *uncertain imitability*: where there is ambiguity associated with the causes of a competitor's success, any attempt to imitate that strategy is subject to uncertain success.

Recent research suggests that the problems of strategy imitation may run even deeper. We observed in Chapter 5 that capabilities are the outcome of complex combinations of resources and that different capabilities interact to confer competitive advantage. However, work in complementarity among firms' activities suggests that these interactions extend across the whole range of management practices.[22] Where these linkages are tight, complexity theory—NK modeling in particular—predicts that within a particular competitive environment a number of "fitness peaks" will appear, each associated with a unique combination of strategic variables.[23] Michael Porter and Nicolaj Siggelkow quote Urban Outfitters as an example of a unique "activity system" (see Strategy Capsule 8.1).[24] If company success is the outcome of a complex configuration of strategy, structure, management systems, personal leadership, and host of business processes, the implication is that imitation may well be impossible.

STRATEGY CAPSULE 8.1

Urban Outfitters

During the three years to January 2009, Urban Outfitters Inc., which comprises 130 Urban Outfitters stores (together with Anthropologie and Free People chains), has grown at an average of 20% annually and earned a return on equity of 21%. The company describes itself as

> *targeting well-educated, urban-minded, young adults aged 18 to 30 through its unique merchandise mix and compelling store environment . . . We create a unified environment in our stores that establishes an emotional bond with the customer. Every element of the environment is tailored to the aesthetic preferences of our target customers. Through creative design, much of the existing retail space is modified to incorporate a mosaic of fixtures, finishes*

and revealed architectural details. In our stores, merchandise is integrated into a variety of creative vignettes and displays designed to offer our customers an entire look at a distinct lifestyle.

According to Michael Porter and Nicolaj Siggelkow, Urban Outfitters offers a set of management practices that is both distinctive and highly interdependent. The urban-bohemian-styled product mix, which includes clothing, furnishings and gift items are displayed within bazaar-like stores each of which have a unique design. To encourage frequent customer visits, the layout of each store is changed every two weeks, creating a new shopping experience whenever customers return. Emphasizing community with its customers, it foregoes traditional forms of advertising in favor of blogs and word-of-mouth transmission. Each practice makes little sense on its own, but together they represent a distinctive, integrated strategy. Attempts to imitate Urban Outfitters' competitive advantage would most likely fail because of the difficulty of replicating every aspect of the strategy then integrating them in the right manner.

Sources: Urban Outfitters Inc. 10-K Report to January 31, 2009 (Washington: SEC, 2008); M.E. Porter and N. Siggelkow, "Contextuality Within Activity Systems and Sustainable Competitive Advantage," *Academy of Management Perspectives* 22 (May 2008): 34–56.

One of the challenges for the would-be imitator is deciding which management practices are generic best practices and which are "contextual"—complementary with other management practices. For example, if we consider Sears Holdings' deliberation of which of Wal-Mart's management practices to imitate in its Kmart stores, some practices (for example, employees required to smile at customers, point-of-sale data transferred direct into the corporate database) are likely to be generically beneficial. Others, such as Wal-Mart's "everyday low prices" pricing policy, low advertising sales ratio, and hub-and-spoke distribution are likely to be beneficial only when combined with other practices.[25]

Acquiring Resources and Capabilities

Having diagnosed the sources of an incumbent's competitive advantage, the imitator can mount a competitive challenge only by assembling the resources and capabilities necessary for imitation. As we saw in Chapter 5, a firm can acquire resources and capabilities in two ways: it can buy them or it can build them. The period over which a competitive advantage can be sustained depends critically on the time it takes to acquire and mobilize the resources and capabilities needed to mount a competitive challenge.

There is little to add here to the discussion of transferability and replicability in Chapter 5. The ability to buy resources and capabilities from outside factor markets depends on their transferability between firms. Even if resources are mobile, the market for a resource may be subject to *transaction costs* including search costs, negotiation costs, and contract enforcement costs. Transaction costs are greater for highly differentiated (or "idiosyncratic") resources.[26]

The alternative to buying a resource or capability is to create it through internal investment. As we noted in Chapter 5, where capabilities are based on organizational routines, accumulating the coordination and learning required for their efficient operation can take considerable time.

Businesses that require the integration of a number of complex, team-based routines may take years to reach the standards set by industry leaders. General Motors' attempt to transfer team-based, lean production from its NUMMI joint venture with Toyota at Fremont, California, to the GM Van Nuys plant 400 miles to the south involved complex management problems that remained unsolved two years later.[27]

Conversely, where a competitive advantage does not require the application of complex, firm-specific resources, imitation is often fast. In financial services, most new products are copied quickly by competitors. *Collateralized debt obligations*, the derivative securities that played a central role in the financial crisis of 2008 were developed first by Drexel Burnham Lambert. During the late 1990s, several leading investment banks began issuing CDOs and by 2005 the annual volume of new CDOs exceeded $500 billion.[28]

A key issue for would-be imitators is the extent to which first-mover advantage exists within the market. The idea of first-mover advantage is that the initial occupant of a strategic position or niche gains access to resources and capabilities that a follower cannot match. This is either because the first-mover is able to preempt the best resources, or can use early entry to build superior resources and capabilities.[29] We shall return to the issue of first-mover advantage when we consider competitive advantage in emerging and technology-based industries (Chapter 12).

Competitive Advantage in Different Market Settings

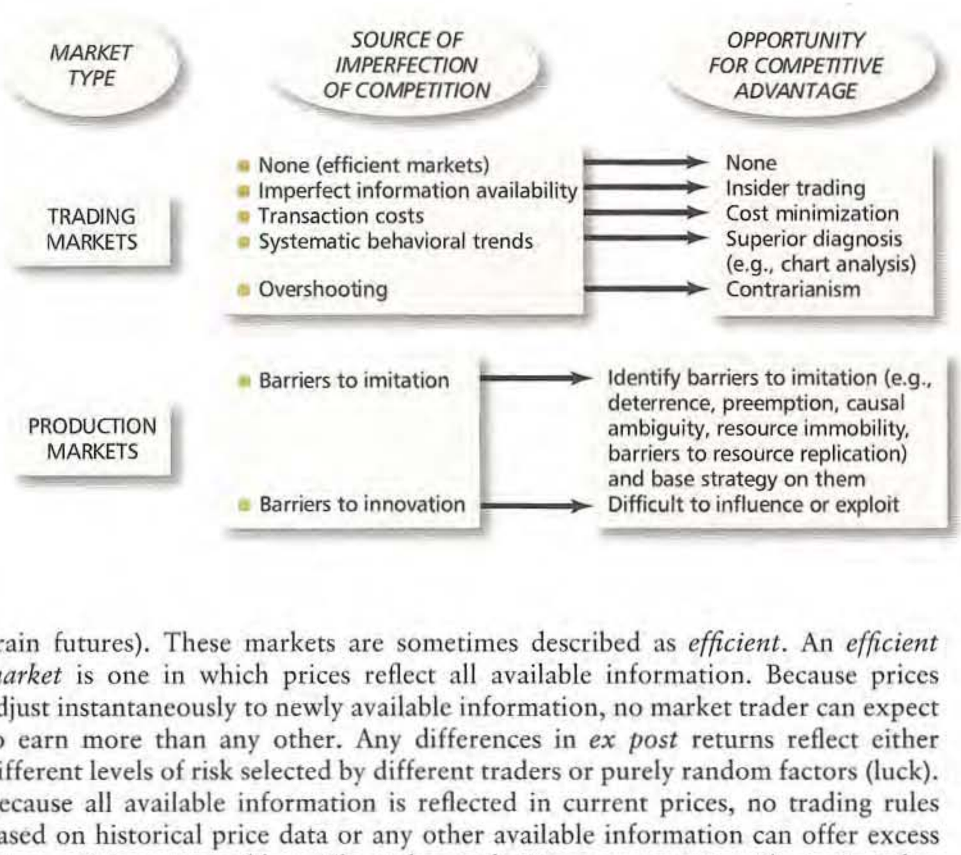
To identify opportunities for establishing and sustaining competitive advantage requires that we understand the competitive process in the specific market. For competitive advantage to exist, there must be some imperfection of competition. To understand these imperfections in the competitive process, we need to identify the types of resources and capabilities necessary to compete and the circumstances of their availability.

Our initial discussion of the nature of business in Chapter 1 identified two types of value-creating activity: trading and production. Trading involves arbitrage across space (trade) and time (speculation). Production involves the physical transformation of inputs into outputs. These different types of business activity correspond to different market types: trading markets and production markets (see Figure 8.3). We begin with a discussion of a special type of trading market: an efficient market.

Efficient Markets: The Absence of Competitive Advantage

In Chapter 3, we introduced the concept of perfect competition. Perfect competition exists where there are many buyers and sellers, no product differentiation, no barriers to entry or exit, and free flow of information. In equilibrium, all firms earn the competitive rate of profit, which equals the cost of capital. The closest real-world examples of perfect competition are financial and commodity markets (for example, the markets for securities, foreign exchange and

FIGURE 8.3 Competitive advantage in different industry settings: trading and production



grain futures). These markets are sometimes described as *efficient*. An *efficient market* is one in which prices reflect all available information. Because prices adjust instantaneously to newly available information, no market trader can expect to earn more than any other. Any differences in *ex post* returns reflect either different levels of risk selected by different traders or purely random factors (luck). Because all available information is reflected in current prices, no trading rules based on historical price data or any other available information can offer excess returns: it is not possible to "beat the market" on any consistent basis. In other words, competitive advantage is absent.

The absence of competitive advantage in efficient markets can be linked to resource availability. If financial markets are efficient, it is because only two types of resource are required to participate—finance and information. If both are equally available to all traders, there is no basis for one to gain competitive advantage over another.

Competitive Advantage in Trading Markets

For competitive advantage to exist, imperfections (or "inefficiencies") must be introduced into the competitive process. In trading markets, several types of imperfection to the competitive process create opportunities for competitive advantage.

Imperfect Availability of Information Financial markets (and most other trading markets) are subject to imperfect availability of information. This provides opportunities for competitive advantage through superior access to information. Trading on the basis of privileged private information is a key source of advantage in markets for traded goods and securities—although such trading is affected by legal restrictions on "insider trading." Insider information creates advantage but the advantage is often short lived: once detected insider trading tends to be imitated by other market participants.

Transaction Costs If markets are efficient except for the presence of transaction costs, then competitive advantage accrues to the traders with the lowest transaction costs. In stock markets, low transaction costs are attained by traders who economize on research and market analysis and achieve efficient portfolio diversification. John Bogle estimated that actively managed U.S. mutual funds underperformed the market index by about 2.5% annually—roughly equal to the funds' costs of transactions and administration.[30] Bogle's Vanguard S&P 500 Index fund with transaction and operating costs of 0.5% annually has outperformed 90% of U.S. equity mutual funds.

Systematic Behavioral Trends If the current prices in a market fully reflect all available information, then price movements are caused by the arrival of new information and follow a random walk.[31] If, however, other factors influence price movements, there is scope for a strategy that uses insight into how prices really do move. Some stock market anomalies are well documented, notably the "small firm effect," the "January effect," and "weekend effects." More generally, there is evidence that prices in financial markets follow systematic patterns that result from "market psychology", allowing trends and turning points to be deduced from past data. Chart analysis uses patterns of price movements—such as "support and resistance levels," "head and shoulders," "double tops," "flags," and "candlesticks"—as prediction tools. Despite mixed evidence on the success of chart analysis in financial markets,[32] systematic behavior among market participants offers opportunity for competitive advantage by traders with superior skill in diagnosing such behavior.

Overshooting One well-documented behavioral aberration is the propensity towards "herd behavior" where imitative trading and converging expectations cause prices to overshoot.[33] The implication is that competitive advantage can be gained, in the short term, by following the herd—"momentum trading." In the long run, overshooting is corrected by an opposite corrective movement, offering opportunity for a *contrarian* strategy. The world's richest man, Warren Buffett, is a prominent contrarian who is "fearful when others are greedy, and greedy when others are fearful."

Competitive Advantage in Production Markets

The transitory nature of competitive advantage in trading markets is a result of the characteristics of the resources required to compete: finance and information. Finance is a relatively homogeneous resource that is widely available. Information, although highly differentiated, is transferable easily and at very low cost; hence, the competitive advantage it offers tends to be fleeting.

Production markets are quite different. Production activities require complex combinations of resources and capabilities and these resources and capabilities are highly differentiated. The result, as we have noted, is that each producer possesses a unique combination of resources and capabilities. The greater the heterogeneity of firms' endowments of resources and capabilities, the greater the potential for competitive advantage. In the European electricity generating industry, the growing diversity of players—utilities (GdF, ENEL, Iberdrola), oil and gas majors (Shell, Eni), independent power producers (AES, Powergen), and wind power generators—has expanded opportunities for competitive advantage and widened the profit differentials between them.

Differences in resource endowments among firms also influence the erosion of competitive advantage. Where firms possess very similar bundles of resources and capabilities, imitation of the competitive advantage of the incumbent firm is most likely. Where resource bundles are highly differentiated, competition is more likely to be through distinctive strategies that substitute the incumbent's competitive advantage.[34] For example:

- In video game consoles, Nintendo, with a very different resource base from Sony and Microsoft, gained market leadership with a distinctive strategy for its *Wii* console.
- In the U.S. airline industry, newcomer Virgin America has drawn upon its distinctive resources and capabilities to position itself differently from either the "legacy airlines" (American, United) and the low-cost carriers (Southwest, AirTran).

Since substitute competition can come from many directions its deterrence requires building defenses on multiple fronts—including commitments to key stakeholders.[35]

Types of Competitive Advantage: Cost and Differentiation

A firm can achieve a higher rate of profit (or potential profit) over a rival in one of two ways: either it can supply an identical product or service at a lower cost, or it can supply a product or service that is differentiated in such a way that the customer is willing to pay a price premium that exceeds the additional cost of the differentiation. In the former case, the firm possesses a cost advantage; in the latter, a differentiation advantage. In pursuing cost advantage, the goal of the firm is to become the cost leader in its industry or industry segment. Cost leadership requires that the firm "must find and exploit all sources of cost advantage . . . [and] . . . sell a standard, no-frills product."[36] Differentiation by a firm from its competitors is achieved "when it provides something unique that is valuable to buyers beyond simply offering a low price."[37] Figure 8.4 illustrates these two types of advantage.

The two sources of competitive advantage define two fundamentally different approaches to business strategy. A firm that is competing on low cost is distinguishable from a firm that competes through differentiation in terms of market positioning, resources and capabilities, and organizational characteristics. Table 8.1 outlines some of the principal features of cost and differentiation strategies.

FIGURE 8.4 Sources of competitive advantage

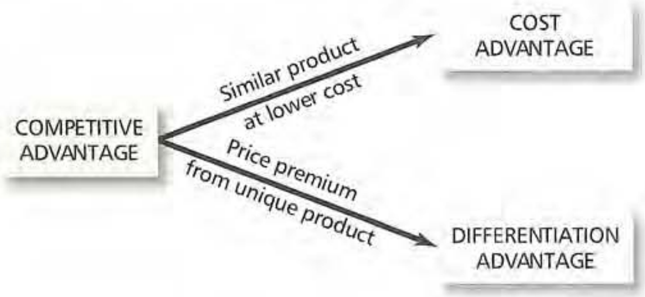


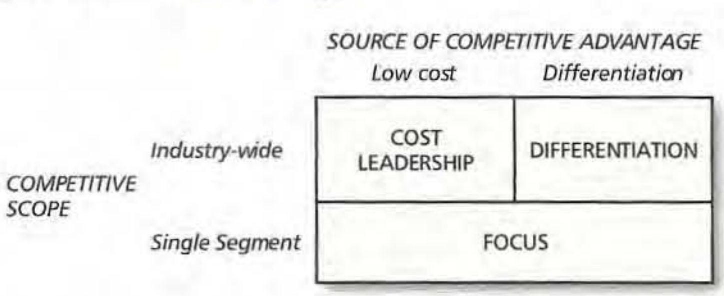
TABLE 8.1 Features of cost leadership and differentiation strategies

Generic strategy	Key strategy elements	Resource and organizational requirements
Cost leadership	Scale-efficient plants Design for manufacture Control of overheads and R&D Process innovation Outsourcing (especially overseas) Avoidance of marginal customer accounts	Access to capital Process engineering skills Frequent reports Tight cost control Specialization of jobs and functions Incentives linked to quantitative targets
Differentiation	Emphasis on branding advertising, design, service, quality, and new product development	Marketing abilities Product engineering skills Cross-functional coordination Creativity Research capability Incentives linked to qualitative performance targets

By combining the two types of competitive advantage with the firm's choice of scope—broad market versus narrow segment—Michael Porter has defined three generic strategies: cost leadership, differentiation, and focus (see Figure 8.5). Porter views cost leadership and differentiation as mutually exclusive strategies. A firm that attempts to pursue both is "stuck in the middle":

> 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 from the low-cost firms. Yet it also loses high-margin business—the cream—to the firms who are focused on high-margin targets or have achieved differentiation overall. The firm that is stuck in the middle also probably suffers from a blurred corporate culture and a conflicting set of organizational arrangements and motivation system.[38]

FIGURE 8.5 Porter's generic strategies



In practice, few firms are faced with such stark alternatives. Differentiation is not simply an issue of "to differentiate or not to differentiate." All firms must make decisions as to which customer requirements to focus on and where to position their product or service in the market. A cost leadership strategy typically implies a narrow-line, limited-feature, standardized offering. However, such a positioning does not necessarily imply that the product or service is an undifferentiated commodity. In the case of IKEA furniture and Southwest Airlines, a low-price, no-frills offering is also associated with clear market positioning and a unique brand image. The VW Beetle shows that a low-cost, utilitarian, mass-market product can achieve cult status. At the same time, firms that pursue differentiation strategies cannot be oblivious to cost.

In most industries, market leadership is held by a firm that maximizes customer appeal by reconciling effective differentiation with low cost—Toyota in cars, McDonald's in fast food, Nike in athletic shoes. In many industries, the cost leader is not the market leader but is a smaller competitor with minimal overheads, nonunion labor and cheaply acquired assets. In oil refining, the cost leaders tend to be independent refining companies rather than integrated giants such as ExxonMobil or Shell. In car rental, the cost leader is more likely to be Rent-A-Wreck (a division of Bundy American Corporation) rather than Hertz or Avis. Simultaneously pursuing differentiation, cost efficiency and innovation was a key element in the global success of Japanese companies in cars, motorcycles, consumer electronics and musical instruments. Reconciling different performance dimensions has been facilitated by new management techniques. For example, total quality management has refuted the perceived tradeoff between quality and cost.

Summary

Making money in business requires establishing and sustaining competitive advantage. Both these conditions for profitability demand profound insight into the nature and process of competition within a market. Competitive advantage depends critically on the presence of some imperfection in the competitive process—under perfect competition, profits are transitory. Our analysis of the imperfections of the competitive process has drawn us back to the resources and capabilities that are required to compete in different markets and to pursue different strategies. Sustaining competitive advantage depends on the existence of *isolating mechanisms*: barriers to rivals' imitation of successful strategies. The greater the difficulty that rivals face in accessing the resources and capabilities needed to imitate or substitute the competitive advantage of the incumbent firm, the greater the sustainability of that firm's competitive advantage. Hence, one outcome of our analysis is to reinforce the argument made in Chapter 5: the characteristics of a firm's resources and capability are fundamental to its strategy and its performance in decision making and long-term success.

In the next two chapters, we analyze the two primary dimensions of competitive advantage: cost advantage and differentiation advantage. In both of these areas we emphasize the importance of a deep understanding of both the firm and its industry environment. To this end, it is useful to disaggregate the firm into a series of separate but interlinked activities. A useful and versatile framework for this purpose is the value chain, which is an insightful tool for understanding the sources of competitive advantage in an industry, for assessing the competitive position of a particular firm, and for suggesting opportunities to enhance a firm's competitiveness.

Self-Study Questions

1. Figure 8.1 implies that stable industries, where firms have similar resources and capabilities, offer less opportunity for competitive advantage than industries where change is rapid and firms are heterogeneous. Think of an example of each of these two types of industry. Is there any evidence that interfirm profit differences are wider in the more dynamic, heterogeneous industry than in the more stable, homogeneous industry?

2. Apple has been successful in dominating the market for both MP3 players with its iPod and for music downloads with its iTunes service. Can Apple sustain its leadership in these markets? How?

3. Illy, the Italian-based supplier of quality coffee and coffee-making equipment, is launching an international chain of gourmet coffee shops. What advice would you offer Illy for how it can best build competitive advantage in the face of Starbucks' market leadership?

4. Do you believe that some mutual funds ("unit trusts" in British parlance) can deliver consistently superior returns (once adjusted for risk)? If so, what is the basis for such superior performance and what can fund managers do to achieve superior performance?

5. Target (the U.S. discount retailer), H&M (the Swedish fashion clothing chain) and Primark (the U.K. discount clothing chain) have pioneered "cheap chic"—combining discount store prices with fashion appeal. What are the principal challenges of designing and implementing a "cheap chic" strategy? Design a "cheap chic" strategy for a company entering another market, e.g. restaurants, sports shoes, cosmetics, or office furniture.