

Michael Porter's "Generic Strategies"

- Porter's five-forces model describes strategy as taking actions that create defensible positions in an industry.
- In general, the strategy can be offensive or defensive with respect to competitive forces.
- Defensive strategies take the structure of the industry as given, and position the company to match its strengths and weaknesses to it.
- In contrast, offensive strategies are designed to do more than simply cope with each of the competitive forces; they are meant to alter the underlying cause of such forces, thereby altering the competitive environment itself.

There are, of course, many specific strategies of each type (offensive or defensive), and identifying which is best depends on the circumstances. But Porter suggests 3 broad or generic strategies for creating a defensible position in the long-run and outperforming competitors.

1) Cost Leadership

- Cost leadership means having the lowest per-unit (i.e., average) cost in the industry – that is, lowest cost relative to your rivals.
- This could mean having the lowest per-unit cost among rivals in highly competitive industries, in which case returns or profits will be low but nonetheless higher than competitors
- Or, this could mean having lowest cost among a few rivals where each firm enjoys pricing power and high profits.
- Notice that cost leadership is defined independently of market structure.

Cost leadership is a defensible strategy because:

- I. It defends the firm against powerful buyers. Buyers can drive price down only to the level of the next most efficient producer.
- II. It defends against powerful suppliers. Cost leadership provides flexibility to absorb an increase in input costs, whereas competitors may not have this flexibility.
- III. The factors that lead to cost leadership also provide entry barriers in many instances. Economies of scale require potential rivals to enter the industry with substantial capacity to produce, and this means the cost of entry may be prohibitive to many potential competitors.

Achieving a low cost position usually requires the following resources and skills:

- I. Large up-front capital investment in new technology, which hopefully leads to large market share in the long-run, but may lead to losses in the short-run.
- II. Continued capital investment to maintain cost advantage through economies of scale and market share.
- III. Process innovation – developing cheaper ways to produce existing products.
- IV. Intensive monitoring of labor, where workers frequently have an incentive-based pay structure (i.e., a contract which includes some combination of a fixed-wage plus piece-rate pay).
- V. Tight control of overhead.

2) Differentiation

- Differentiating the product offering of a firm means creating something that is perceived industry wide as being unique.
- It is a means of creating your own market to some extent.
- There are several approaches to differentiation:
 - Different design
 - Brand image
 - Number of features
 - New technology

A differentiation strategy may mean differentiating along 2 or more of these dimensions.

Differentiation is a defensible strategy for earning above average returns because:

- I. It insulates a firm from competitive rivalry by creating brand loyalty; it lowers the price elasticity of demand by making customers less sensitive to price changes in your products.
- II. Uniqueness, almost by definition, creates barriers and reduces substitutes. This leads to higher margins, which reduces the need for a low-cost advantage.
- III. Higher margins give the firm room to deal with powerful suppliers.
- IV. Differentiation also mitigates buyer power since buyers now have fewer alternatives.

Achieving a successful strategy of differentiation usually requires the following:

- I. Exclusivity, which unfortunately also precludes market share and low cost advantage.
- II. Strong marketing skills.
- III. Product innovation as opposed to process innovation.
- IV. Applied R&D.
- V. Customer support.
- VI. Less emphasis on incentive based pay structure.

3) Focus or Niche Strategy

- Here we focus on a particular buyer group, product segment, or geographical market.
- Whereas low cost and differentiation are aimed at achieving their objectives industry wide, the focus or niche strategy is built on serving a particular target (customer, product, or location) very well.
- Note, however, that a focus strategy means achieving either a low cost advantage or differentiation in a narrow part of the market. For reasons discussed above, this creates a defensible position within that part of the market.

Stuck in the Middle:

- Failure to develop a strategy in one of these 3 directions is a firm that is “stuck in the middle.”
- This means you lack the market share, capital, and overhead control to be a cost leader, and lack the industry wide differentiation necessary to create margins which obviate the need for a low-cost position.
- Being “stuck” implies low profits as a rule: profits are bid away to compete with low cost producers; or, the firm loses high margin business to firms who achieve better differentiation.
- Classic examples of this problem are large, international airline companies, many of which are now bankrupt.
- Depending on a firm’s capabilities and resources, a “stuck” firm must gravitate toward either low cost (usually by buying market share) or focus or differentiation (which may mean decreasing market share).

Risks of each Strategy:

Each generic strategy is based on erecting different kinds of defences against the competitive forces, and hence they involve different risks.

1) Cost Leadership:

Maintaining cost leadership can be risky because:

- i. Innovations nullify past inventions and learning, and hence cost leadership requires continual capital investment to maintain cost advantage.
- ii. Exclusive attention to cost can blind firms to changes in product requirements.
- iii. Cost increases narrow price differentials and reduce ability to compete with competitors’ brand loyalty.

2) Differentiation:

Risks are:

- i. Cost differentiation between low cost firms and differentiating firms becomes too large to hold customer loyalty. Buyers trade-off features, service, or image for price.
- ii. Buyers need for differentiation falls.
- iii. Imitation decreases perceived differentiation.