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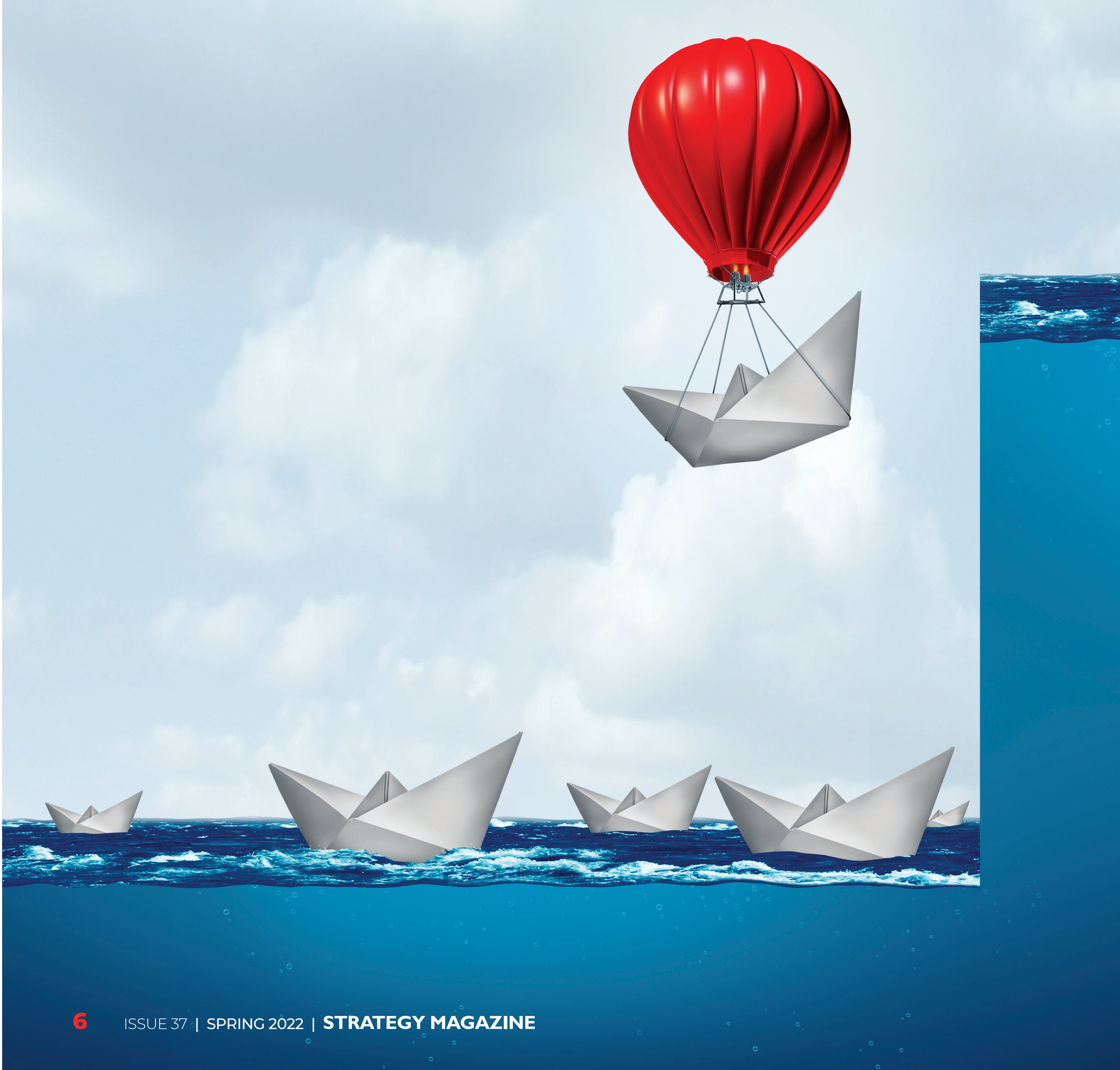

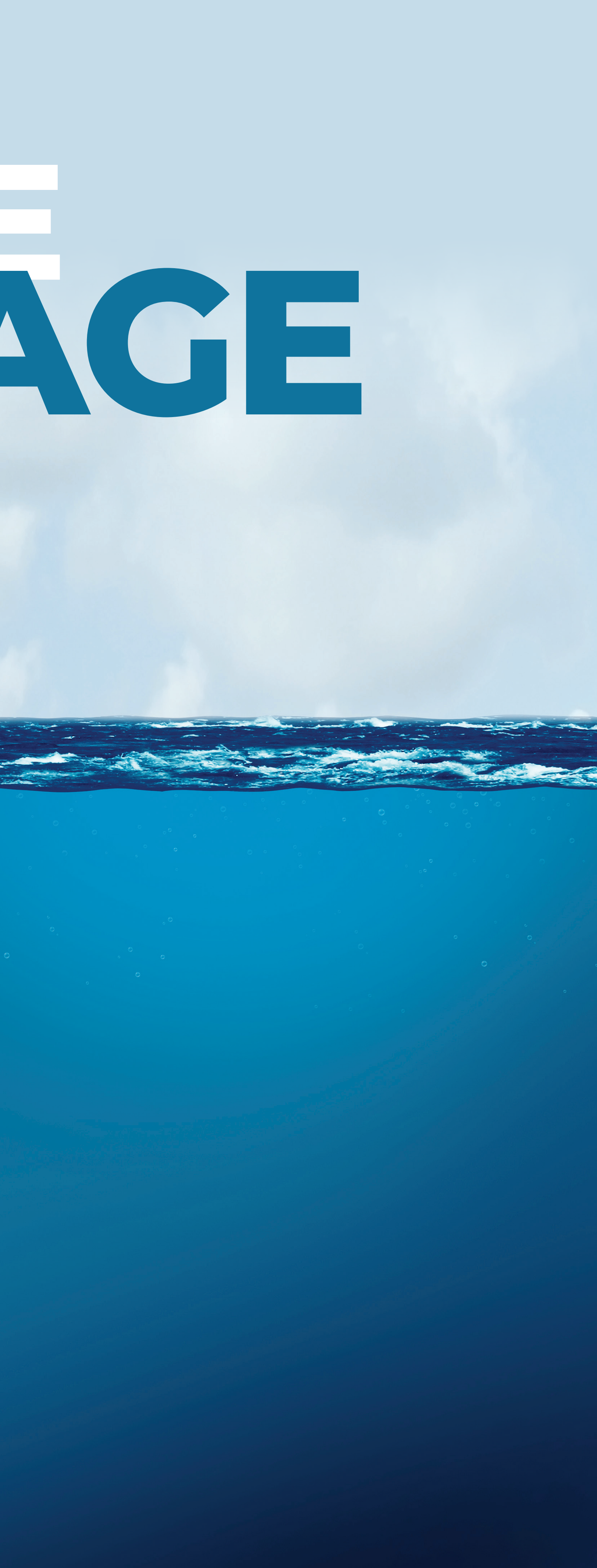

BY **LEONARDO CRUZ JR.**

The business strategy discipline has made great strides since the word “strategy” began to creep into corporate vocabulary after World War II. Starting with Bruce Henderson, who founded the Boston Consulting Group in 1963, and perhaps reaching its crescendo with Harvard Business School professor Michael Porter and his famous works on *Competitive Strategy* and *Competitive Advantage,* the business strategy discipline “eclipses any other change worked in the intellectual landscape of business over the past 50 years.”[1] Yet, in spite of all the academic literature and current fanfare on strategy and competitive advantage, few executive leaders truly demonstrate what good strategy and a keen development of competitive advantages look like. And in a world where the service economy accounts for a growing proportion of global economic output, industry consolidation continues to concentrate market power, and technological disruption obliterates legacy value chains, it is crucial that corporate executives develop a sophisticated understanding of how strategy and competitive advantages can shape their economic destinies. Indeed, these trends suggest a future with higher industry profitability, and a greater dispersion of winners and losers therein. Therefore, relative company performance and value creation may depend more on the quality of corporate decision making than ever before. The objective of this article is thus to help business leaders pursue optimal corporate strategies and to take advantage of opportunities to create sustainable competitive advantages.

COMPETITIVE STRATEGY AND COMPETITIVE ADVANTAGE

Michael Porter’s concepts of competitive strategy and competitive advantage are breathtakingly comprehensive and are taught in every business school around the world. According to the author, competitive strategy involves how a company decides to position itself against the five fundamental forces that drive industry profitability: direct rivalry, buyer leverage, supplier leverage, threat of substitution, and the threat of new entry. These forces determine the overall attractiveness of the industry, and corporate strategy involves how to manage a company within that economic environment. Competitive advantage, on the other hand, determines *relative* positioning *within* an industry. In other words, how can a company generate more value than industry rivals? As the five forces determine industry attractiveness, the company value chain – or the discrete activities a company chooses to perform – explains superior performance within that industry.[2]

Yet, the theoretical comprehensiveness of Porter's work can often lead to complexity in application. Bruce Greenwald, the Robert Heilbrunn Professor Emeritus of Finance and Asset Management at Columbia Business School, in his aptly titled book *Competition Demystified*, helped simplify the task of incorporating strategic thinking by clarifying when strategy matters and how to identify and develop sustainable competitive advantages. According to Greenwald, barriers-to-entry (note the alignment to one of Porter's five forces: "threat of new entry") are essentially synonymous with competitive advantages.[3] Though Porter's four other forces are still important in influencing total industry profitability, and value chains can help identify key differences in value creation among competitors, understanding barriers-to-entry and competitive advantages are far more important in strategic planning. In other words, competitive advantages themselves usually explain most of both industry and company profitability. The task of corporate executives, then, is to understand whether competitive barriers exist in their current or potential markets, whether their own companies are protected by those competitive advantages, and how to manage with or without them.

In practical terms, competitive strategy and competitive advantage can be described as how a business decides to position itself relative to its market structure. This position can be explained through Porter's value chain framework. Competitive advantage, in turn, describes competitive barriers that prevent competition from eroding economic profitability. This competitive advantage (or competitive advantages) is not infinite. In fact, according to Greenwald, there are only three advantages that really matter[4]:

1. Economies of scale: Cost advantages, that benefit large-scale incumbent firms, where fixed costs make up a large proportion of total costs and consequently, make it difficult for entrants to reach minimum viable scale. For example, leading manufacturing or distribution companies (i.e. those with dominant relative market share) with high fixed costs relative to the size of the markets they address, make it prohibitively expensive for potential competitors to match their scale.
2. Supply advantages: These are cost advantages due to favorable access to key inputs, proprietary technology, or proprietary experience. For example, geographical advantages in limited, prime retail real-estate locations or strategically placed major hubs for airlines provide access to potential customers that is hard for new competitors to replicate. Proprietary technology may also be a strong input advantage if protected by patents or trade secrets.

IN PRACTICAL TERMS, COMPETITIVE STRATEGY AND COMPETITIVE ADVANTAGE CAN BE DESCRIBED AS HOW A BUSINESS DECIDES TO POSITION ITSELF RELATIVE TO ITS MARKET STRUCTURE.

3. Demand advantages: Access to market demand that is inaccessible to competitors, usually due to high switching costs, search costs, habit formation, or network externalities. For example, vertical software-as-a-service providers may provide non-standardized, mission critical services that require substantial time, money, and effort to replace. Additionally, the software platform may be reinforced by network effects, or positive network externalities that increase the platform's value to users as more users or suppliers are added.

These three competitive advantages are often not mutually exclusive. In fact, many companies exhibit some, or all, of these advantages at once. Apple Inc., for example, can outspend in research and development, can protect their technology through patents, and enjoy customer captivity through network effects on its App Store platform.

Some may argue that regulatory and technological factors also act as competitive barriers, but these factors only matter to the extent they affect barriers to entry and the other four structural forces.

HOW TO GAIN A COMPETITIVE ADVANTAGE?

As competitive strategy and competitive advantage are tied together, perhaps a first step for corporate leadership in developing strategy is to identify the presence or absence of competitive barriers to competition. In facing competitive markets where barriers to entry are minimal, operational excellence is a good focus for corporate strategy. This involves optimizing a company's cost structure and performing operating functions better than the competition – a strict control of operating costs and a focus on the best quality. Indeed, even in the absence of competitive advantages, some firms can perform better simply by outcompeting competition on costs or performance. Institutionalizing a cost-focused, quality-driven culture through training and proper incentives may be difficult to replicate, providing temporarily high returns until competition can react. For example, local restaurants vary widely in their profitability due to simple operational factors – service levels, consistency in experience, and cleanliness. By focusing on cost minimization and higher quality across these functions, and by emphasizing employee training, some restaurants can significantly improve profitability simply by doing things better than their competition.

In non-competitive markets, strategy becomes even more important. In monopoly markets (i.e., markets dominated by a single company), it is good practice for executives to deeply understand what their competitive advantages are, the boundaries of those advantages, and how to manage those competitive advantages effectively. Walmart, for example, has long dominated local physical retail, but primarily in certain US geographies where it benefits from scale in logistics and distribution. In its international segment, where its advantages are not as strong, returns on capital have been less than stellar.

The same understanding is also required for oligopolistic markets where a few companies dominate. Game theory dynamics are important in these markets and it helps if those companies try to coexist and rationally split up the profitability among themselves. In video streaming, for example, Netflix, Disney, and YouTube might decide to reduce the overlap in their content offerings to lessen head-on competition. The key is to play well and minimize strategic redundancies.

For companies in markets that are protected by scale barriers, executives can determine exactly where their scale matters. High fixed costs within a limited market are more attractive than high fixed costs where a market is growing or is excessively large. It is also important for scaled incumbents to protect their customer base by making it prohibitively difficult for competition to achieve minimum viability by capturing enough market share in the first place. This may involve matching any competitor's attempts to steal market share – matching prices, features, and additional service offerings quickly.

For companies with supply advantages, unfortunately, proprietary patents or licenses are subject to external forces such as government policies, which are not always influenced or controlled by the companies themselves. Control of key resources is also rare, but if critical resources such as prime real estate locations and key inputs enable favorable access to demand, corporate executives can try to protect that access. Steep learning curves, know-how, and technical experience, protected through non-compete agreements and trade secrets, are good ways to preserve these input advantages. If not, competition may simply rehire a company's employees and recreate their experiential advantages.

Companies with demand advantages can concentrate on maximizing switching or search costs and increasing the frequency of customer usage. In vertical software-as-a-service, for example, adding customized modules and a data repository can boost customer time spent on the platform. This increases the difficulty in finding comparable replacement software and therefore exceedingly difficult to migrate to another provider. The greater these costs are, the stronger the customer captivity will be.

Distribution channels also matter. Therefore, locking up favorable distribution through long term contracts or partnerships are good practices for executives. For example, Align Technology, makers of Invisalign, captured orthodontists as a primary channel for marketing and distributing clear teeth aligners, betting that clear aligners are best sold through orthodontic professionals versus direct channels. They currently dominate their segment.

Demand advantages can work even better when combined with economies of scale. For example, companies with scale in research and development, and whose product or service is perceived as mission critical that involves a significant amount of up-front training, make it extraordinarily difficult for competitors to match their software research and development budget and convert customers. By finding ways to increase customer switching, maximize effective research and development spending, and enhance the mission criticality of their offerings, the total costs of defection would be too high relative to the current value proposition the customer enjoys.

Alternatively, supply advantages can be combined with scale or demand advantages. It is possible to have scale in distribution, for example, and also have strategic distribution locations. Or as is the case with biotech firms, scale in research and development budgets combined with government patent protection enable companies to have greater success in achieving FDA drug approval and reap the rewards for a regulated period of time. Additionally, companies may benefit from both supply advantages and demand advantages. The Coca-Cola Company, for example, has substantial scale in distribution and keeps its famous soda's recipe a closely guarded secret.

CONCLUSION

It is clear that today's world is increasingly more complex and dynamic since Michael Porter first introduced competitive strategy. However, this paper argues that a revivification of corporate strategy, and the development of competitive advantages, is more essential than ever. Corporate playbooks that rely on the status quo might miss opportunities to optimize resource allocation to capture future value creation. At worst, companies whose value chains are disrupted, yet remain economically viable, may earn average returns simply by reconfiguring their activities and focusing on cost control. At best, companies could take advantage of the reflow of economic value by emphasizing new points of value creation caused by shifts in structural forces, or maneuvering to create new value across activities ignored by their competitors. Superior corporate leadership could reveal itself not only in how executives envision where future value may be found, but by crafting creative strategies that fully maximize their share of that value.

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