A model approach

Generating strategic options by Adrian Sims

The use of models to gain competitive advantage

Michael Porter’s Three Generic Strategy model is one of the best known in strategic management. However in the Management Accounting – Business Strategy exam, few marks are awarded just for explaining such a model. Candidates must also be able to assess the quality of the model, suggest how it may be used and apply it to relevant cases.

Strategic option generation forms an important part of the rational planning process. This process involves:

- deciding the general direction of the organisation and the level of performance it must reach to satisfy stakeholders;
- identifying the main threats and opportunities in its operating environment, in particular the factors affecting financial performance, and forecasts or scenarios for how these may develop;
- an assessment of its strengths and weaknesses in relation to threats and opportunities;
- an understanding of the contribution to earnings from its products and customer groups and how these may change.

Porter’s three strategic approaches to gaining competitive advantage are:

- overall cost leadership – low cost relative to competitors;
- differentiation – creating something that is perceived in the industry as unique;
- focus – serving a narrow strategic target more effectively than rivals who are competing more broadly. This can be split into “cost focus” and “differentiation focus”.

Executing each strategy successfully involves different resources, strengths, organisational arrangements and managerial style. It is rare for all three to suit any one firm so managers should focus on just one strategy or risk dilution of their competitive advantage. This is, according to Porter, the only way that firms can outperform rivals and deliver satisfactory shareholder returns.

Porter’s strategic prescriptions stem from analysis of the impact of five competitive forces on a firm’s profits. The forces Porter refers to include:

- the threat of new entrants into an industry or market served by a specific company;
- the bargaining power of suppliers;
- the bargaining power of the consumer;
- the threat of substitute products/services;
- the intensity of rivalry among existing firms.

He argues that a firm must adopt a strategy that combats these forces better than the strategy developed by its rivals if it is to deliver superior shareholder value.

If the firm is successful in this, its improved profitability will come from a combination of two things – each year it will enjoy a higher margin than its rivals operating in the same market and, as the product lifecycle unfolds and prices start to fall during the mature stage, it will survive longer than its rivals. Combining the two means better long-term profitability and this, in turn, equates to superior shareholder value – in other words, higher present value of future financial returns than rival firms.

Let’s look at Porter’s three strategies. Achieving the industry’s lowest delivered cost to customer provides several competitive advantages. It reduces the impact of competition by allowing the firm to increase profit margins at the prevailing level of industry prices – it can also become the price leader because no other firm can undercut it.

It also reduces the impact of buyer and supplier power by giving the firm a “cushion” of profits against cost increases and price cuts – buyer and supplier power could instead drive rivals from the industry. Differentiation is a perceived value for the buyer with several competitive advantages:

![Fig 1: Porter’s model – Three Generic Strategies model (adapted from Porter 1980, 1995)](image)

![Fig 2: A model of a rational strategy process](image)
• premium prices can be charged for the product to give better margins in the short run, while in the long run exempting the firm from the price wars at mature stage;  
• a barrier to competition;  
• buyer power from retailers and manufacturers may be reduced if the differentiation of the product makes it an essential element in attracting their customers;  
• the cushion of better profits reduces the impact of buyer and supplier power.

Porter argues that a firm must choose between differentiation and being a cost leader. Failure to do so will leave the firm stuck in the middle, unable to access high-volume customers who demand low costs, or having to reduce its margins to attract them, leaving it vulnerable in the long run. It cannot attract high-margin customers because it is associated with cheaper offerings.

It will have a confused corporate culture that tries to combine excellence with parsimony. Its management style and control systems will become contradictory – for example, a cost leader focuses on cost accounting controls, whereas a differentiationist will have more interest in controlling innovation and brands. This will affect the relative power and influence of factions in the management teams.

To pursue cost leadership or differentiation successfully a firm must be better than all its rivals. But few businesses have sufficient resources to implement this, so Porter recommends that these companies follow focus or niche strategies. Focus strategies recommend that these companies follow cost leadership in a particular area, leaving it vulnerable in the long run. It cannot attract high-margin customers because it is associated with cheaper offerings.

As an alternative to the business strategies of Porter, let’s look at the choice of development strategies as described by G Johnson and K Scholes (Exploring Corporate Strategy (4th edn), Prentice-Hall 1997) and how two organisations, Virgin Group and the Disney Corporation, have applied concepts such as “alternative directions” and “basis of choice” to their business plans.

“Basis of choice”, sometimes called the choice of competitive strategy, decides the business methods used to win customers and beat rivals. Virgin Group allows business units to set their own course within a framework consistent with maintaining the corporation’s image of customer friendliness, fair dealing and relative informality. Disney Corporation maintains a strong central control over its business operations to ensure that brands and characters are used consistently and that the “magic kingdom” remains reassuring to children and parents at all times.

“Alternative directions” deals with the future of the product and customer portfolio of the business. It also involves issues such as international growth. Virgin remains primarily focused on UK markets and its business has developed by adding extra products. Although it has extended its Megastores concept outside the UK and its airlines attract bookings from non-UK residents, the bulk of its investment has been in the UK. For example, its rail services, cinemas, financial services, mobile phones and soft drinks are unique to this country.

Disney has a more global outlook and has significant investments in many countries. It has developed its business from film production by extending its range of products to include toys, shops, holidays, television programming and multimedia publishing. Its market segment has remained fundamentally the same – children and parents – but its geographical scope has widened. However it has expanded into feature films (Touchstone Pictures) and film and video distribution services (Buena Vista).

“Alternative methods” considers how a firm gains access to the products and markets it wants to develop into. Virgin has used most methods of growth in its history. Its original record retailing business was developed using its own capital to acquire shop leases and to develop its own recordings. Similarly, Virgin Atlantic Airlines and Virgin Megastores were set up using its own resources. In contrast, its cinema chain was an acquisition from MGM and it purchased the rail franchises from the government. Virgin also operates joint development partnerships. Its mobile phones, drinks, financial services, railway operations and some of its holidays, for example, are provided by other organisations, with Virgin providing the brand, quality systems and marketing.

Disney has, historically, preferred internal development. It owns or has a substantial shareholding in its theme parks, studios and television operations. It has developed its business from film production by extending its range of products to include toys, shops, holidays, television programming and multimedia publishing. Its market segment has remained fundamentally the same – children and parents – but its geographical scope has widened. However it has expanded into feature films (Touchstone Pictures) and film and video distribution services (Buena Vista).

The resource-based view is another alternative to Porter’s model. This puts competitive advantage inside the firm by concentrating on identifying core competencies – the things at which it excels and that cannot easily be copied by rivals. Managers look at industries where they can apply these competencies to gain competitive advantage or, better still, for industries where they can find new applications for these competencies.

Alternative methods: Disney Corporation v Virgin Group

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Porter’s model is still being used and discussed 20 years after its publication. However, like all models in strategy, it has its limitations and distortions, which can be better resolved with the implementation of alternative concepts.

Nevertheless, Porter’s theory demands further analysis within the confines of an example industry. For example, when applying Porter’s model to the car industry, it defines “industry” to mean cars, and ignores trucks and motorcycles. From the customer differentiation perspective this makes sense. But some car firms also make trucks and motorcycles. Does Mercedes-Benz’s truck manufacturing and shared R&D give it cost advantages in addition to its advantages as a differentiated car company?

Porter argues that competitive advantage derives from a firm’s position in an industry. If we cannot decide what level of industry to consider, it is hard to see how we can use his theory.

This criticism also calls into question the value of his five forces model. A car company conducting an environmental analysis,
for example, needs to decide what industry it is in to apply that model. 

Then there is the lack of definition for the strategic unit. The model is designed to help decide competitive strategy, but it is not clear whether this means the corporation as a whole or one particular business unit.

In Fig 4, Porter's model is applied to the car industry with Seat, Audi and Skoda each appearing in separate quadrant, yet all are part of the Volkswagen-Audi Group (VAG). This raises a number of awkward questions about Porter's diagram:

- Does each division outline a matrix appropriate to the industry it is in? In this case, Seat would see itself as a differentiator in the economy-car industry.

- Can a corporation follow different competitive strategies in different business units? If not, then VAG is doomed.

This brings us to another dilemma, as Porter specifies that more than one competitive strategy dilutes a firm's competitive advantage. And if Porter's theory is used at corporate level, it implies that the whole group must follow a single competitive strategy even if this is meaningless at the level of individual products and markets.

Differentiation in trucks, for example, is about reliability, economy, load capacity and manoeuvrability. For executive cars and grand tourers, styling and comfort are paramount. And how can the low costs of supply chain management and assembly at a truck assembly plant in Spain be transferred to executive car production in Germany?

Conversely, if the model is used at a business unit level (as seems inevitable), it overlooks the competitive advantages of being part of a larger group.

The model also suffers from a lack of empirical evidence. It purports to be more than a system of classification – it predicts that particular strategies will lead to better profitability and that being stuck in the middle will harm profits. But the evidence of real firms is unconvincing and muddled by the problems of definition.

And what’s wrong with the middle ground? Porter seems to suggest that markets can be successfully exploited only at the extremes of low-cost or premium provision, and that the volume market is always a low-cost one. But in most markets the consumer is drawn to the middle in search of acceptable quality and affordability. 

Porter uses the product lifecycle to defend his position and observes that, as the mature stage progresses, the margins of firms in the middle are squeezed, even if customers do not split into two extreme segments.

This exposes him to further criticisms. Industry lifecycles and profits tend to be driven by technological changes, not competitive ones. None of his strategies offsets technological obsolescence – all firms accept that products mature, and sustain their profits by launching new products. 

Many managers struggle to understand how Porter's abstract prescriptions apply to their sector. He bases his differentiation strategy, for example, on customers’ perception of the firm's market position. This encourages managers to equate it with hype, not competence. There is a danger that managers could replace sound, resource-based strategy with shallow, easily imitated promotion.

Equally, managers may wrongly perceive rivals' strategies as “smoke and dust” and not see the underlying resources. Porter counters this by discussing the need to use the value chain to develop competitive advantage.

His basis for cost leadership is flawed. Cost leadership is not a competitive strategy since customers do not buy a product because of a firm's cost structure. They look at benefits and prices. A cost leadership strategy must involve price-cutting to attract the mass market. If a firm needs to gain mass to get economies of scale, it is not initially a low-cost player. So Porter is advising firms to risk sparking a price war without first having the low-cost structure to survive it.

His model also does not consider how a firm might use its competitive advantages in new industries. It looks only at how it may develop existing business.

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Further reading: