Todd Zenger, Crafting a Competitive Advantage Part 1

One of your goals as an entrepreneur is of course to create and build a business that has some form of competitive advantage relative to other peers that either already exist or other competitors that exist already or that may emerge as your business advances through time. I want to talk a little bit about this concept of competitive advantage and how it relates to your task as an entrepreneur. As an entrepreneur, you're of cause trying to compose value and you're going to compose that value collaboratively with a bunch of other actors. You're going to have other co-founders, you're going to have other employees that you bring in. You're going to have suppliers. You're going to have other collaborators, partners that will work with you to introduce this value to solve this problem that you have articulated and in doing so, create value and ultimately you're going to try to position yourself to capture some portion of the value that you're creating. The logic here is that it's not just enough to solve this problem that you envision will be very valuable if solved, but you actually have to do this in a way that allows you to capture that value or at least some portion of that value that you create. To this point, we've talked about the idea of theories of value and business models. As you begin to build your business and start really competing with others, one could think about that business model and this theory of value is indicating a strategy. The strategy is your core guidance that you're using to direct your efforts to then create and capture value. As we've talked about this process of finding an effective strategy that's going to create value and allow you to capture that is a very complex and difficult exercise involving lots of choices. You as an entrepreneur have all suppliers you could work with. You have all problems that you could tackle. You could have different ways you can tackle those different problems and ultimately, this is a very complex search exercise in which you are trying to discover that point B there, that very highly valuable position that you think are convinced will create value. I think the key point we want to make in this lecture is that it's not just enough to find that place of value. It's not just enough to solve a problem that introduces tremendous amounts of value, but you have to do this in a way that is unique and sustainably unique. In strategy, we think about firms that are particularly successful from an image standpoint is occupying a castle on a hill with a moat around it, or high defensive walls which are doing what their precluding competitors from coming in and imitating and doing exactly what you're doing. The essence here of strategy is that you're trying to not only identify something that's really valuable and solve that problem that you think is particularly valuable, but you're trying to solve it in a way that's going to be difficult for your competitors to imitate because it's only in making and having it be difficult for others to imitate that you're going to be in a position to actually capture sustainably that value that you're creating. To create a competitive advantage, a firm must configure itself to do something that's not just valuable, but unique in the way it creates that value and the test of your uniqueness of this venture that you're composing is essentially, if your venture were to disappear, could a competitor, a supplier, or some customer step in and replace you perfectly the more difficult and costly it is for somebody to step in and replace you, the more value that you're providing or the more unique value that you are creating. As you think about your business model and think about your strategy, it's not just enough to identify this problem that you're going to solve, but you have to think carefully about, so what's going to make me unique in the long run, in my capacity to solve that particular problem. Otherwise, all you're doing is revealing to everybody else the path to solving the problem you've tackled, which is a nice thing to do. It's a wonderful thing to do for your customers. They will still love and appreciate you. But you're unlikely to be able to capture much of the value that you created for those customers. Let me give you an example of this logic. Before the invention of the portal crane, this device that would sit above a logging yard and move around with a claw and reach down and grab logs and move them wherever they needed to be moved to. What had happened at a logging yard was that there would be a fleet of these forklifts that would move around and pick these things up and transport them with forklifts. At a typical logging yard, let's just make up some numbers here. A set of these forklifts might cost a million dollars and over the lifetime of the logging yard, you might spend another $6.5 million and just operating costs maintaining these vehicles as well as the employees to manage them. Somebody comes along and develops the portal crane and the equivalent cost over the lifetime of the logging yard for that device is $2.5 million. It requires one person sitting up at the top of that crane is moving around rather than a fleet of vehicles and the manpower required to move them, so highly efficient, great innovation introduces tremendous amounts of value, solves a great problem. We can think about this example in the following way, that this is a company through their innovative intervention here, this firm in the middle. It has customers, it's selling this product to, and it's got suppliers that it is accessing in order to access the steel and other technology that's embedded in this portal crane and the value that that portal crane inventor a company called Harnish-Vager. The value that they're creating is the difference between the willingness to pay on the part of these logging yards that would be interested in purchasing a portal crane and what we'll call supplier opportunity costs and what do we mean by that? This is essentially the walk-away prices that these input providers of technology and raw materials would require to build this portal crane. That's the total value that's created here. However, that's not the value that this innovator Harnish-Vager is actually going to capture. Instead, of cause any company is going to capture the difference between price and cost. The price they're able to charge the customer, and the prices they're able to negotiate with these suppliers. That means that there's some value that gets captured by the suppliers. These suppliers are also shrewd bargainers and they're able to extract value be above there through walkaway prices. Similarly, the customers have to be induced to switch from the forklifts to using the portal crane and you're going to have to probably give them a little bit of value in order to induce that switch. Rather than the price you're able to charge being the difference between, I think we said it was 6.5 million for the operating cost plus 1.1 million for the forklifts themselves, you might say, well, the total willingness to pay out to be 7.5. Well, you're not going to be able to charge 7.5 because you have to induce this switching and so that's the customer price. What you get to capture is again, the difference between price and cost. Now what happens when another company comes along Crane Co, looks at the technology that's in this portal crane that Harnish-Vager has invented and realizes that the patent protection is not very tight and they introduce a competitive crane. There costs are essentially identical. What happens now to the value that Harnish-Vager is going to be able to capture. Well, of course, the price comes down aggressively as these two companies Harnish-Vager and Crane Co, compete for customers. Now suppliers continue to capture value but now the customer is capturing an enormous amount of value because these two companies are competing for market share. The amount of value that they capture becomes relatively trivial. Why is that? Because now the uniqueness that either of these two companies is able to introduce or sustain is relatively meager. They're selling identical products and so most of the value that comes from this brilliant solution that Harnish-Vager created disappears because of the inability of Harnish-Vager to prevent a competitor Crane Co from replicating the technology. One way to articulate this idea comes from this quote from a couple of my colleagues at Harvard Business School who say, a firm creates value when it is unique in some valuable way. It's Harnish-Vager without Crane Co being able to replicate what they're doing, then they're unique in a valuable way. When the network of suppliers, customers and complementors, that is the people that are enabling them to create this new product are more productive with Harnish-Vager than without it, and it's not easily replaced. It isn't easy for somebody else Crane Co in this case to step in and essentially compose the exact same product. You're looking for a similar thing if you think about your new venture. What is it that's going to prevent imitators from simply looking at what you've done, recognize that you've scoped out a great problem that you have articulated a beautiful means to solve that problem and they recognize that they can do exactly what you've done, perhaps with better resources than you have. You need to think carefully about what it is that's going to enable you to not only solve your problem, create this value, but in the end, prevent others from imitating exactly what you're doing. One way to think about this is that firms that successfully create and capture value either are pursuing a cost strategy that they found creative clever ways to lower costs and lower them relative to their peers that they're competing against or that they've found a way to comparatively increase differentiation by which I mean, they found clever ways to be able to increase the price they're able to, or the customer's willingness to pay and the price they're able to charge their customers, again, relative to their peers that are competing in the same markets. Well, it's certainly the case that all firms need to focus on both their ability to charge market or above market types of prices and the efficiency with which they're able to do it. That is their cost. Firms typically have a primary strategy which is either to compete on the basis of differentiation or other basis of cost. They're seeking to enjoy competitive advantage, uniqueness relative to their competitors, either on the basis of cost or the basis of differentiation. One of the reasons that there are trade-offs here, that it's tough to do and think about being superb on both dimensions, is that there are some trade-offs that are associated with choosing to focus on cost versus differentiation. If you're focused on cost advantage, you're going to be focusing on things like scale and speed of learning and process design and control. You're going to try to build resources and capabilities that focus on cost control. You're going to be more likely to use quantitative incentives. You're going to be very focused on shrewdly negotiating with your suppliers. If on the other hand, you're focused on differentiation, you're going to be emphasizing things like branding and service and quality and reliability features of your product. You're going to be building out capabilities and resources that are much more focused on marketing and product design. You're going to be much more focused on qualitative incentives, how can we delight this customer? What does this customer care about? These things tend to be measured in a more qualitative way as opposed to quantitative measures that might be focused on cost. You're going to be focused on creativity as opposed to shrewd negotiation. The sense is that these two organizations that you would build are really different in culture, measurement focus, emphasis resources across these two different approaches. Let's think a little bit about this trade-off between cost and differentiation. Think about an industry average competitor in this space that you are trying to play in as a new entrepreneur and an industry average enjoy some profit margin. This difference between, in this case the industry average price and the industry average cost. If you're playing a differentiation game, the game then is about finding clever ways to increase the customer's willingness to pay the price, thereby, you're able to extract from the customer. Arguably this is actually a relatively easy thing. In any kind of space that you're thinking about entering there's a long list of features and enhancements and refinements that you could add to the product or service that the customer would actually be willing to pay for. What makes this difficult and requires strategic thought and thinking is that there are trade-offs involved here. The trade-off is that all of those efforts to increase willingness to pay involve some additional cost. The trick to an effective differentiation strategy is to be able to elevate that price and willingness to pay on the part of customer without dramatically increasing the costs. It's about driving this wedge creatively through your differentiation strategy. On the other hand, you might decide to pursue a cost advantage strategy. Here again, what's easy is finding ways to lower costs. There are always things that you've cut back. You can cut back on service and features and quality. Lots of ways that one could actually lower cost, but the trick is being able to lower costs in a way that doesn't dramatically reduce the customer's willingness to pay. How do you maximize this wedge between price and cost in a clever strategic way? Of course, what you would ideally like to be is a competitor that has a dual advantage with an ability to charge higher prices and lower cost. That's, I think in most instances, very difficult to do. There's a third dimension I want to focus on here for a minute, which is in addition to thinking about, are you trying to compete primarily on the basis of differentiation? Are you trying to compete on the basis of cost? You also face and I suspect for many of you, this is going to be of primary importance. There is also an ability to focus where one is playing. One can focus on a particular type of customer. One can focus on a particular distribution channel. One can focus geographically. One can focus on a limited range or a single type of product in a particular space. There are lots and lots of opportunities to focus. There's an interesting strategic interaction between choosing to focus and one's capacity to enjoy cost or differentiation advantage. This interaction gets captured, I think nicely in a diagram that you may have seen before, which is this depiction of generic strategies that one can pursue in an industry. One can either be, as we've talked about, a cost leader or one can be a differentiation leader. But at the same time, one can think about the scope in which you're playing in this industry. Either competing broadly across lots of different channels with lots of different products, with lots of different customer types or you could be competing very narrowly, perhaps on a specific channel, a particular customer type, a particular product. This then leads to different types of strategies. There are broad cost leaders, broad differentiation leaders, but then lots and lots of different focused variance of that. Firms that are cost leaders, but only as it relates to a particular customer type or a particular channel, or one can be differentiated and enjoy a price advantage, but only as it relates to a particular product or a particular customer, or a particular channel. As you think about the problem that you're trying to solve and the venture you're trying to compose and the business model you are trying to put together, think about what type of strategy you think you're playing. Is it cost differentiation? In all probability, at some focused version of those. To summarize, effective entrepreneurs have thought deeply about the source of competitive advantage that they're building, whether it be cost advantage or differentiation. In most instances, I think most of you as entrepreneurs are thinking about focus strategies. You need to therefore think carefully about what is this dimension of focus that's going to allow you to enjoy B cost or differentiation advantage.