**Todd Zenger, MBC Online, Crafting a Competitive Advantage Part 2**

To this point, we've talked about cost and differentiation strategies and focused versions of those strategies, and I want to talk in a little bit more detail about what's required to build a cost leadership strategy or a differentiation strategy, and how we think about focused versions of those strategies. If you're pursuing a cost leadership strategy, the game is about delivering unacceptable product or service, but really finding clever ways to do that at the lowest possible cost. Here you're trying to think about what is it that drives cost in this particular space that you're competing in, so figure out what those cost drivers are, and then in clever ways, manage those cost drivers such that you enjoy a cost advantage, and ultimately try to open a significant sustainable cost gap over your competitors. Recognizing, as we've talked about this idea that it's not just about lowering cost because you have to be able to maintain some parody or proximity in satisfying the buyer's needs. Otherwise, the buyer's willingness to pay for your product is going to dramatically drop, so there's this trade-off game that you're having to play strategically. Cost leadership is about making these trade-offs with differentiation. Emphasizing cost while trying to keep prices at something near the industry average. If you're pursuing a differentiation strategy, here the game is about selecting one or more needs that the buyer might, particularly value, and in your case, you might have found and identified some particular unique problem that you think the buyer has, and you are going to cleverly solve that problem. In doing so, be able to charge a higher price for your product or service relative to your competitors. Here, the game might involve selectively adding costs if necessary to meet those needs, and if you're successful at it, you're able to extract premium prices from that customer based on the differentiation that you're offering. Again, differentiation means that you enjoy above-average profitability. That is, you enjoy a competitive advantage if you're able to maintain cost parody or at least proximity to competitors. It's not just about finding clever ways to solve the customer's problems in ways that your competitors can't. It's being able to do that without dramatically elevating the costs that you're having to incur to solve those problems. Now, focus strategies, you're exploiting the same fundamental types of competitive advantage, either cost or differentiation, but you are selectively targeting a narrow set of customers that have some particular unusual need. It could be you've found a unique problem that a particular channel has, and you've discovered ways in which by solving that channel's problem, you're able to lower costs or delight those customers in a way that they're willing to pay a premium price to you. Or it could be that by focusing geographically, you're able to deliver higher value or you're enjoying a cost advantage. Or by focusing on a narrow product rather than competing broadly across all products in that segment by focusing on a single one, you're able to uniquely solve a problem, and charge premium prices or uniquely solve a problem and do it at a lower cost. Again, by focusing, you're able to enjoy a uniqueness to your cost of differentiation advantage. Focus by that logic is desirable. Where the activities required to serve some customers or some channel or some geography are different from the activities required to service the broad set of customers. That is, you're able to therefore come in and cherry-pick. We're going to pick off this particular customer type or this particular channel and give them something that there competitors can't do. Because we're going to uniquely configure our business model to addressing that particular customer's problem, and in doing so, either secure a unique cost advantage or a unique differentiation advantage as you evaluate your strategy, I'd encourage you to think about four steps to this process. But again, the evaluation of your strategy here is about thinking about ways you can create sustainable competitive advantage. First step, and we'll talk about each of these in a little bit more detail is the catalog and really understand the critical activities that are required in the value chain that you're composing your business model. What are the activities that need to be in this chain in order to compose the value that we're trying to introduce? Secondly, to identify and really think deeply about what is it that gives a one company in a cost advantage relative to their competitors in performing that specific activity that's in your value chain. Third is to think deeply about the drivers of your customers' willingness to pay. What are they willing to pay you a premium price for? Then finally, to pull this together and make choices and decisions that will either generate cost advantage or will help you generate a differentiation advantage. Another way to think about this as a way to pressure test, your existing business model. Is my business model going to give me cost advantage or differentiation advantage? A way to think through the choices that you've made in your business model. Are they consistent with this logic? Thus, will they in a sustainable way grant us cost or differentiation advantage? Step 1 is to define the key activities in your value chain. Describe your approach to performing each. Hopefully, at this point, you've already thought deeply about what your business model is, and in doing so, you've articulated the critical activities that need to be performed. One tool that you could use to describe your activities as a generic type of value chain here, and think about how you're performing inbound logistics and operations and outbound logistics, and what's your approach to marketing and sales and a variety of support activities as well. Here's a filled-out version of that generic value chain for Walmart. They have a unique approach to their inbound logistics, and these are descriptive phrases that describe their approach to operations. They've got a lot of private-label product. They obviously are known for having big stores in small towns. They tried to have pricing that's relatively flexible across those stores, giving latitude to store managers. Again, we will walk through all of these, but this is an example of how one might go about filling out and thinking about how you perform or will perform activities in order to build out your business model. Step 2 is then to think about cost advantage, so having identified the critical activities\ that are required to build your product or deliver your service, and you're thinking our game is ultimately about being lower cost or it's about differentiation you still need to think about cost. What are the key drivers of cost advantage in each of these activities that need to be performed? Then what strategies or choices could we make that would lead to our firm possessing a cost advantage relative to our competitors in solving these problems that we've laid out in this business model? Are we going to enjoy cost advantage in these particular activities? Terms of cost drivers for any given activity, it could be that you need to be particularly big in order to be low cost. It could be learning. It could be that you need to be efficient in your utilization of capacity. It could be the relationships with particular suppliers give you a cost advantage. It could be that you have some unique technology that's going to give you a cost advantage. It could be your level of vertical integration. It could be your location or a variety of other factors but think about in each of these activities what grants cost advantage, and think about the choices that you're going to make that will either elevate or diminish those costs. One quick example that you don't need to necessarily fill out this entire diagram. But here we focus in on the critical technologies or choices that give the company Gallo Wines a cost advantage relative to its competitors, and one is clearly its scale, and its scale allows it to do national advertising, and national advertising is cheaper than the local advertising. They also, because they do so much purchasing of grapes, they have a capability in, and scale advantage in purchasing that gives them cost advantage, and they also have a blending technology that allows them to deliver a consistent product. Buying the diverse set of grapes nonetheless, a consistent product. That's cost advantage. If you're thinking about differentiation, this is Step 3 here the task is by activity, so you perform lots of potentially different activities as you provide after-sale service to this customer. As you interact and then actually sell the product as you deliver the product, whatever those activities might be. By activity, identify opportunities for value creation. One test it might be really helpful here is to think not just about your customer in some monolithic sense but to actually identify the value chain of that customer. What are the things that your customer does across its entire value chain? Then think about ways in which you can connect your value chain to their value chain. What are the features, attributes, and services that this customer is going to be willing to pay a premium for? Unlike cost advantage, where you're really competing along one dimension, which is cost. When we're talking about differentiation, there are a host of dimensions along which you could compete and be better than your competitors. It could be quality and reliability, could be consistency, speed, durability. Each of these can be associated with a unique problem that you are trying to solve. It could be about safety accessories, availability, long list of dimensions along which one could differentiate ones product or service, so you think about a company like Stouffer's Frozen Foods. While you don't think about differentiation and frozen foods, they are differentiated relative to other brands able to charge higher prices. They have recognized that one of the biggest differentiators in frozen foods is if you can develop better sauce than your competitors. The challenge you face here is that the peas are frozen, the vegetables are frozen, the meat is frozen. How do we make this palatable and differentiated well. If we can develop a superior sauce that bleeds into the vegetables, we can make everything taste superior to our competitors. They, relative to their peers, have heavily invested in sauce technology, they've developed innovative menus, but they've thought very strategically about what it is that the customer is going to care most about, and they have placed particular strategic emphasis on those areas. In thinking about differentiation if you're selling to consumers, the exercise is somewhat more straightforward in that you just need to think carefully about what that consumer cares about, what are the problems that they have, presumably if you're selling to consumers, you've already targeted and thought carefully about what that problem is. If your game is differentiation, you've thought carefully about what problem you could solve that the customer is willing to pay a premium for. If you're selling business to business, as I mentioned earlier, you want to think about the entire value chain of your customer and how can you configure your value chain to feed in and fuel value into your customer's value chain. Ultimately, the game here, as we've talked about, it's about competitive advantage, you're trying to think about these dimensions of differentiation or cost that either give you a comparative cost advantage or that allow you to increase comparative differentiation. Step 4 is to think carefully about how you then are composing your business model. I encourage you to think about three critical questions. One is is this set of choices that you're making going to deliver something that is unique and difficult to imitate? Is it going to deliver a position of value that is sustainable? Are these choices complimentary with one another in enabling you to secure that defensible, difficult to imitate position in this space that you're trying to compete in? Ultimately, you are trying to compose this set of activities in a way that's going to deliver competitive advantage. You think about a company like Walmart has composed a set of very unique activity choices relative to its competitors that give it cost advantage in a particular geographic location. Their business model has orchestrated this set of activities in a way that delivers it a cost advantage. Or Southwest Airlines also cost advantage play here as orchestrated an unusual set of activity choices with no meals, no seat assignments, no baggage transfers, limited passenger amenities, frequent turnarounds. They've orchestrated a set of activities that grant them a cost advantage relative to their competitors. They've done this in many ways by identifying unique problems to solve relative to their competitors. Ultimately, these bundles of activity choices, this business model you are putting together as either trying to target differentiation advantage or it's trying to target a low cost advantage, and again, just to remind you, is because I think most of your businesses are going to be focused businesses, as you think about your focus and think about whether it's going to give you competitive advantage relative to your big competitors that might be competing in your space, you're likely to secure an advantage if the activities that are required to serve as this particular customer and this particular customer's problem that you've articulated are different than the activities that are required to service the broad set of customers that your bigger competitors are focused on. Focus here is about increasing comparative differentiation or lowering comparative cost through this exercise of focus. If you think about a couple of examples of successful focus companies, Enterprise Rent- A-Car for many years was extremely different than its competitors. They were focused on off airport, suburban locations. Their typical customer was somebody who needed a temporary car for car repairs, body shop work. They were located proximate to these customers. They, as a consequence of this, were able to use their vehicles for a longer period of time, longer lease than you might require if they were primarily at the airport, they did very little advertising because the advertising came through these repair facilities. It was a relationship sale as opposed to an advertising based sale. As a consequence of this, they were extraordinarily successful relative to their peers. In fact, the adage in the industry that there were two types of rental car companies, those that lose money and there was an enterprise. In fact, they were so successful that they actually ended up purchasing a couple of other competitors. Of course, now you see them on airport all the time, but often through the brands that they purchased as opposed to through the enterprise or national brand. Key takeaways here. Your business model should generate sustainable unique value that thereby delivers competitive advantage. If it's valuable and sustainably unique, you will possess competitive advantage relative to your peers. You need to understand whether you're fundamentally pursuing cost or differentiation advantage. You need to ensure that the activities that you choose, the business model that you compose, is really focused on that advantage that you seek. Again, understand that uniqueness, and really it's about sustainable uniqueness, is the central driver of your capacity to create and capture value. It's incumbent on you to think about what it is that's going to prevent others from seeing the problem that you brilliantly reveal and stepping in and solving it just as effectively or even more effectively than you're solving what's going to make you difficult to imitate going forward.