

STRATEGY PAPER – Generic Strategies: a substitute for thinking?

What influences your strategic decisions? Of all the things you could learn about strategy, what theories and models do you really need to know? Are they sufficient? If they worked in your last organisation, will they work now? Cliff Bowman reviews strategy prescriptions of the last 30 years and identifies their shortcomings, arguing that there can be no substitute for thought and solutions unique to individual business scenarios.

The publication of Porter's *Competitive Strategy* in 1980 launched the era of *generic strategies*. Generic strategies are prescriptions about what the *content* of a firm's strategy should be. Some offer a very limited choice of options, while others proffer a list of practices that are purported to lead to superior performance, for example Peters and Waterman's *In Search of Excellence*. Prescriptions like Porter's, are derived from theory, whereas others are deduced from identifying 'successful' firms and figuring out some common causes of success, as in, for example, Treacy and Wiersema's *Value Disciplines*, Jim Collins' *Good to Great*, and Kim and Mauborgne's *Blue Ocean Strategy*.

With the advent of generic strategies the task of the executive suddenly became much simpler. Rather than by slogging through a structured analytical process, success could be achieved by following the checklist in the latest airport book. So the search for unique strategies has been replaced by a simplistic choice between a prescribed and limited set of generic alternatives.

All of these generic strategy prescriptions are in some way *incomplete*. There are also problems with each theory that can lead to confusion. A robust business level (or 'competitive') strategy needs to address the following five questions^{1,2}:

- 1) Where should we compete?
- 2) How can we gain and sustain advantage?
- 3) What assets, capabilities, structures, systems and culture do we need to deliver the strategy?
- 4) What do we look like now?
- 5) How can we change?

This article discusses how well a selection of popular generic strategy prescriptions addresses these key questions. We begin by considering the most influential theory, Porter's generic strategies.

Porter's generic strategies

Porter's generic strategies derive from a well established theory of industry structure, firm strategy and profit performance. Porter's 'Five Forces' approach to industry analysis addresses the 'where to compete' question – some industries are structurally more attractive than others, so, given a choice, firms should locate in these industries. Selecting a particular generic strategy determines how the firm can gain and sustain advantage. Porter argues that a firm needs to adopt one of two alternative generic strategies: *cost leadership* or *differentiation*. He adds a third, a focus strategy which suggests that firms can choose to focus on a narrow rather than broad 'scope' of products and markets, but they still need to choose between cost leadership and differentiation. By adopting and successfully implementing one of these generic strategies the firm will earn superior profits, compared to rival firms. Each strategy offers protection against the competitive forces that operate in an industry to reduce the firm's profits. Failure to pursue either of these generic options leaves the firm 'stuck in the middle'.

Although Porter's thinking still dominates much of the strategy field, its apparent simplicity masks a number of problems. The most significant are that the theory: 1) confuses 'where to compete' with 'how to compete'; 2) confuses competitive strategy with corporate strategy; and 3) excludes other feasible strategy options.

Confusing where to compete with how to compete

In answering our first question 'Where should we compete?', Porter advocates that firms should choose to operate in structurally attractive industries. Indeed, a firm can 'find new industries in which to grow where it can use its generic strategy'³. But just how feasible is it for a firm to enter a new industry? If a book retailer with a chain of shops is having a tough time due to competition from Amazon, can it 'choose' to enter the actuarial consulting industry, which seems to be a better bet?

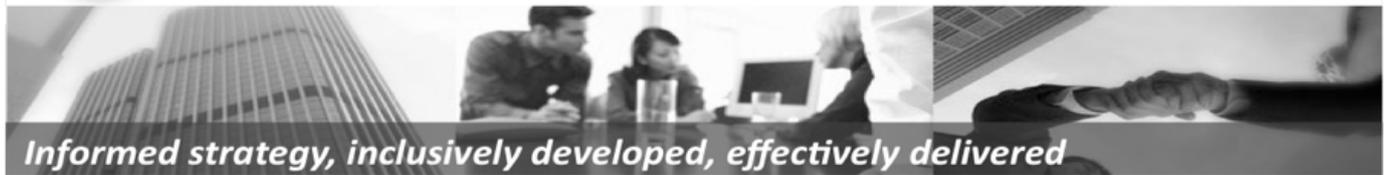
Porter uses broad definitions of industries, for example 'pharmaceuticals', 'cosmetics', 'automobiles'⁴. But because of his broad definitions, the choice between cost leadership, differentiation and focus is more about 'where to compete'

¹ Hambrick, D. and Fredrickson, J. (2001) Are you sure you have a strategy? *Academy of Management Executive*, 15, 48-59

² Bowman, C. (1998) *Strategy in Practice*, Prentice Hall Europe

³ Porter, M.E. (1985) *Competitive Strategy*, The Free Press, New York

⁴ Ibid



than it is about ‘how to gain and sustain advantage’. The cost leader strategy requires the firm to produce a ‘standard, no frills product’ at a competitive price. This product offer is presumably targeted at a market segment that values a keenly priced standard product. The differentiation strategy has the firm offering a superior product targeted at a less price sensitive segment. So firms choosing a ‘cost leader’ strategy are, in effect, choosing which segment to target, i.e. the price sensitive segment. Similarly, choosing a differentiation strategy is opting not to serve the price sensitive segment.

The problem then is who is the ‘industry average firm’ we are comparing these successfully implemented strategies against? The provider of the standard, ‘no-frills’ product is clearly not competing with the firm offering superior products to relatively price insensitive customers. Similarly, as Porter explains, there may be several different segments of customers who are prepared to pay for different enhanced product features, or additional services. So in the ‘auto industry’ is Hyundai competing with Ferrari? Moreover, is Ferrari even competing with Rolls Royce? Are firms serving one of these segments actually competing with firms serving another segment? If they aren’t competing, it makes no sense to compare their performance.

The most appropriate definition of a group of rival firms would be the customer’s definition. After all, it’s the customer who determines the set of products considered to be close substitutes.

Confusing corporate strategy with competitive strategy

Cost leaders and differentiators seek competitive advantage in a ‘broad range of industry segments’, and ‘may even operate in related industries’. Porter argues that these firms should employ either one or the other generic strategy across the range of markets served. But firms that compete across many market segments are best categorised as *corporations*, so the broad scope strategy is not a *business* level strategy at all; it is a *corporate* level strategy.

But why should a corporation adopt the same strategy across all its business units? Take LG, the South Korean corporation, whose businesses range from oil and gas to consumer electronics. Would the same generic strategy be effective across these different markets?

Let’s assume that a corporation managed certain activities from the centre very efficiently. These activities could range from support functions, like human resources, legal, public relations, treasury etc, to core activities like R&D, manufacturing, procurement and marketing. The cosmetics giant L’Oreal would be a good example here. The strategic business units compete in different product and geographic markets, but focus on less price sensitive segments, and thus pursue Porter’s premium-pricing differentiation strategy in each segment. But because of the efficient delivery of these centrally managed activities, the SBUs also have a cost advantage. So is this corporation pursuing a cost leader strategy or a differentiation

strategy? Or is it a strange hybrid, or is it ‘stuck in the middle’? Does it matter?

Successful firms need to be differentiated and low cost. They need to deliver customer value as efficiently as they possibly can, i.e. they need to be *simultaneously effective and efficient*. To focus on just one of these aims is a mistake.

Why either cost leadership or differentiation?

The two strategies can be explained using a simple equation:

$$\text{Profits} = \text{Quantity} \times (\text{Price} - \text{Cost})$$

The *cost leadership* strategy enables the firm to have the lowest unit costs (C) in the industry, and assuming average prices (P) and quantities sold (Q), this would deliver above average profits.

The *differentiation strategy* enables the firm to *premium price*, so, using the same logic, the higher average prices coupled with average unit costs (C) and average quantities sold (Q) would again deliver above average profits. And, because of the margin advantage (P – C) the firm enjoys from either strategy, it is better placed than rival firms to cope with powerful buyers who try to push output prices down, or powerful suppliers trying to force input prices up. So far, so straightforward. This is, more or less, Porter’s central thesis.

However, we have finessed a few problems with the argument by assuming that each alternative generic strategy alters just one variable, i.e. either price increases, or unit cost falls, and leaves the other variables the same. Porter explains that assuming average price and cost variables is a central part of his theory: cost leaders need to be as ‘differentiated’ as the average firm so that they can price ‘at or near’ the average. Differentiators need to have ‘cost parity or proximity’ relative to their competitors.

But if there are economies of scale, to become the cost leader in an industry a firm needs to sell more than its rivals. If it offers the same product at the same price, where are these additional sales coming from? So the firm would need to offer equivalent products at lower prices. Then all three variables on the right-hand side of our equation would be different to the average firm. In order to guarantee superior profits the quantities sold would need to more than offset the impact of the reduced margin resulting from the price cut. So, the situation is not as straightforward as it might first have appeared.

Arguably the firm could achieve superior sales volumes by improving the perceived value of its products, rather than by introducing a price cut. This could be done, but would appear to be a differentiation strategy without premium pricing, not a cost leadership strategy. This strategy of product enhancement with competitive prices is excluded from Porter’s strategy



Informed strategy, inclusively developed, effectively delivered

options. But it could clearly lead to lower costs if there are significant volume related benefits to offset the costs of differentiating.

Moreover, a successful differentiator could exploit scale and experience effects to become the low cost producer. Lexus is a good example. Crucially, Lexus is the *lowest cost producer of luxury saloon cars*, not 'cars' generally. It could be argued that firms need to be simultaneously differentiated and low cost. Evidence shows that this is possible, and at some point, even in the luxury saloon car market, you will be competing on price, so low relative costs are a necessity.

A firm may be able to compete with premium priced, differentiated products across a wide range of sub-segments, effectively a multi-niche strategy. If the bases of differentiation are essentially around marketing and branding, but the firm's production processes are centralised and scale efficient, then there is no conflict between being simultaneously differentiated and low cost. For example, the VW Audi Group offers a wide range of cars serving multiple segments in a differentiated way, but has common platforms for the major cost items (engines and transmissions).

Porter's generic strategy theory is actually a segmentation strategy, which divides a market into two segments. There are 'average' producers selling average products, at average prices and average costs to, presumably, customers who are quite happy with what they are being offered, otherwise why would they continue to buy? But amongst these average firms there is one supplier who has lower costs. This fact is not discernable to the customers, however, as the products and prices they can perceive remain at the 'average'. The other segment is prepared to pay premium prices for added product benefits. There may be several sub-divisions here where different customers value different additional features, so the less price-sensitive segment could be fragmented into many smaller 'niches'. In the next section we see how Treacy and Wiersema extend this segmentation idea.

Treacy and Wiersema's Value Disciplines

Whereas Porter's generic strategies can be traced back to an underpinning economic theory (industrial organisation economics), Treacy and Wiersema took an empirical approach. However, there are clear parallels between the theories. Following in the tradition of previous consultants, notably Peters and Waterman, Treacy and Wiersema went into the field to spot high performing firms, initially in the USA, then across Europe.

The basis of their theory is the identification of market segments. They explain that in any sector there are three generic segments. One segment values a standard product at a keen price. To serve these customers a firm must adopt the value discipline of 'operational excellence'. The second segment demands the very latest innovations and product features, and may be prepared to pay a price premium to get them. These are best served with a 'product leader' strategy.

And the third generic segment values a bespoke product or service, tailored to meet their particular needs. These should be served with a 'customer intimacy' strategy.

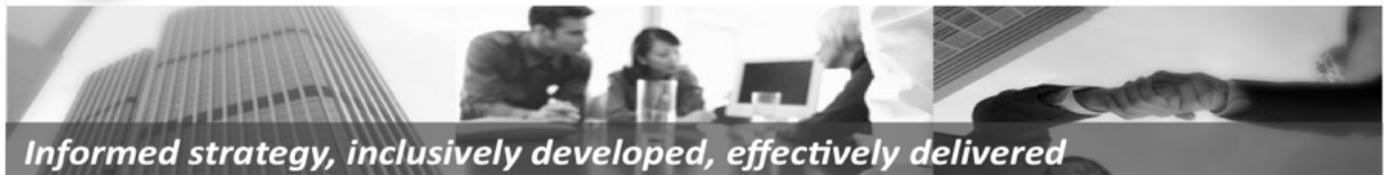
Interestingly, Treacy and Wiersema, like Porter, are combining the two questions we introduced earlier: *where* to compete, i.e. the generic market segment, which determines *how you compete*, i.e. the appropriate value discipline. They are careful to point out that theirs is a theory of business-level strategy not corporate strategy, so they recognise that within a corporate structure business units could be pursuing different value disciplines. They also emphasise that firms cannot ignore the other non-chosen disciplines; they have to be averagely good at these, but need to excel in one discipline.

There are similarities between Porter's theory and Treacy and Wiersema's. 'Operational excellence' is very similar to Porter's low cost strategy, but at least with Treacy and Wiersema we are clear that the strategy is targeted at a particular type of segment. 'Product leadership' is a strategy of differentiation through innovation, and 'customer intimacy' is a strategy of differentiation through bespoke service. And the requirement to be 'averagely good' in the non-chosen value disciplines is analogous to Porter's requirement for *cost parity* and *price parity*.

But why would we expect every market to have three segments? And what evidence is there that there aren't other segments as well as these three? The problem with the theory is that as a segmentation strategy it gives little guidance about how to gain sustained advantage in serving the chosen segment.

For instance, assume we are a firm of house-builders, and we have chosen to serve the price sensitive 'first-time buyer' market. So we select the appropriate strategy, which we think is 'operational excellence'. Now, there are only two ways in which we can assume that the segment-determined choice of value discipline will lead to superior profitability. First, we could hope that our competitors are not clever enough to adopt the appropriate discipline and choose instead an inappropriate one, i.e. they are offering a 'product leader' strategy which fails to meet the price points demanded by these first time buyers. Our second hope is that our rival firms are less capable of successfully implementing the appropriate value discipline so that even if they 'read' the market in the same way, they might not be as skilled at implementing 'operational excellence' as we are. So the key here is the *quality of implementation*, not the choice of generic strategy.

In summary, Treacy and Wiersema have a particular and linked set of answers to the 'where to compete' and 'how to gain advantage' questions. The value disciplines also prescribe to some extent the kind of organisation and capabilities that each discipline would require. So we have answers to three of our five questions.



Kim and Mauborgne's Blue Ocean Strategy

Like Porter and Treacy and Wiersema, Blue Ocean strategy also works back from a market context. In Porter's case the industry definitions are too broad. In Treacy and Wiersema's theory there is an attempt at segmentation to *determine* the choice of strategy. In Blue Ocean strategy the trick is not to compete, achieved by identifying a market demand that has not yet been met. Blue Oceans are characterised by an absence of competition: "In Blue Oceans, competition is irrelevant"⁵. However, where Porter takes too broad a definition of an industry, Kim and Mauborgne take an overly narrow definition of competition.

There are problems with this theory. The first is that Kim and Mauborgne's examples of Blue Ocean thinking have been selected *retrospectively*, for example Cirque du Soleil and [yellow tail] wines. There is no suggestion that the firms used the methodology Kim and Mauborgne prescribe to successfully identify these 'Blue Oceans'.

The second problem is that they are able to choose from those strategies that were actually successful, with the benefit of 20:20 hindsight. For every Cirque du Soleil there are hundreds of failed innovations that either never reached the market or did reach the market but the fledgling businesses did not survive.

Third, there is the issue of industry definition raised earlier. Again starting from a customer perspective, customers enter a market to satisfy their perceived *needs*. The alternatives a customer considers to meet their needs might include a range of similar products, or some very different products.

For example, consider the watch industry. From a product perspective all watch producers would be included in the industry definition. But is a £20 digital watch considered by any customer as a feasible alternative to a £5,000 Rolex? If we consider the needs that the customer is wishing to satisfy we could end up with a quite different solution set.

If I want to give an expensive gift I might consider the watch, and compare the Rolex on some criteria (for example, brand cachet, appearance) with other premium Swiss watches (say Tag Heuer). But I might also include other products in the set of alternative ways of meeting my gift-giving needs, for example, a weekend break in an expensive health spa, or a handbag. So when we consider the notion of a competition-free 'Blue Ocean', these spaces only exist theoretically, where a limited, *product-driven definition of competition* is used. From a needs perspective Cirque du Soleil are competing head on with movies, theatres, restaurants or a night in with a DVD! Cirque du Soleil may not compete in the circus market, but in many respects they are little different from other novelty theatre productions, like *Riverdance*. Similarly, [yellow tail] wines don't compete with traditional wine makers, but they

certainly compete with the makers of beer and pre-mixed cocktails. So Blue Oceans only exist if we take a narrow, product-driven definition of a market.

Fourth, we have the problem of the methodology itself. Kim and Mauborgne advocate a systematic process of questioning the value dimensions in any particular market, by asking whether a 'factor' could be *reduced, eliminated, raised or created*. This might provoke some novel thinking, but the key problem is connecting these ideas to a market need that can be economically exploited.

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⁵ Kim, W. Chan and Mauborgne, R. (2005) Blue Ocean Strategy, Harvard Business School Press