

Agenda for today

Generic Business Strategies

- What are business level strategies?
- How can firms obtain cost leadership and what are its benefits?
- What are the challenges faced in implementation?

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The Strategic Management Process

Difference between Business and Corporate Strategy

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Business Level Strategies

Generic Business Level Strategies

Cost Leadership:

- generate economic value by having lower costs than competitors

Price ↓

Example: Wal-Mart

Differentiation:

- generate economic value by offering a product that customers prefer over competitors' product

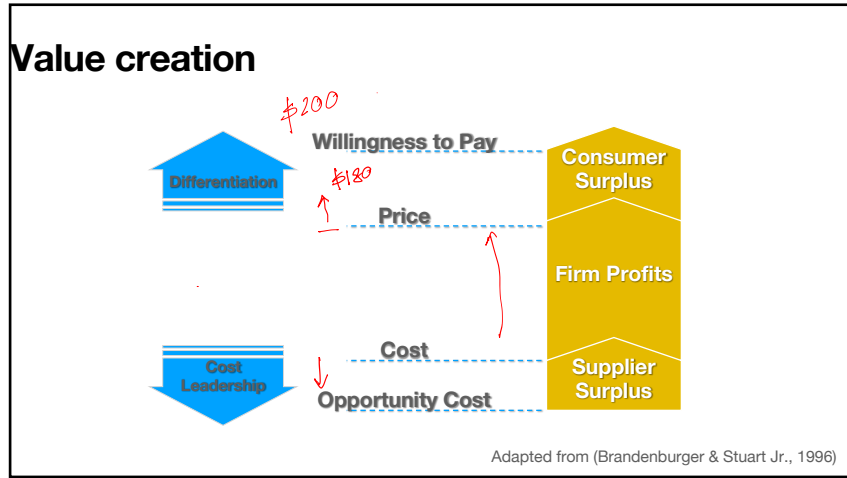
Example: Harley-Davidson

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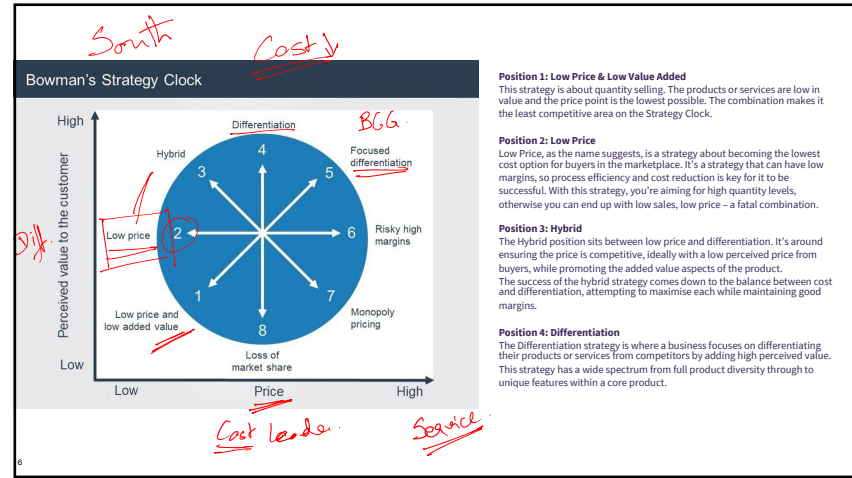
Porter's Generic Strategies

Cost Leadership & Differentiation

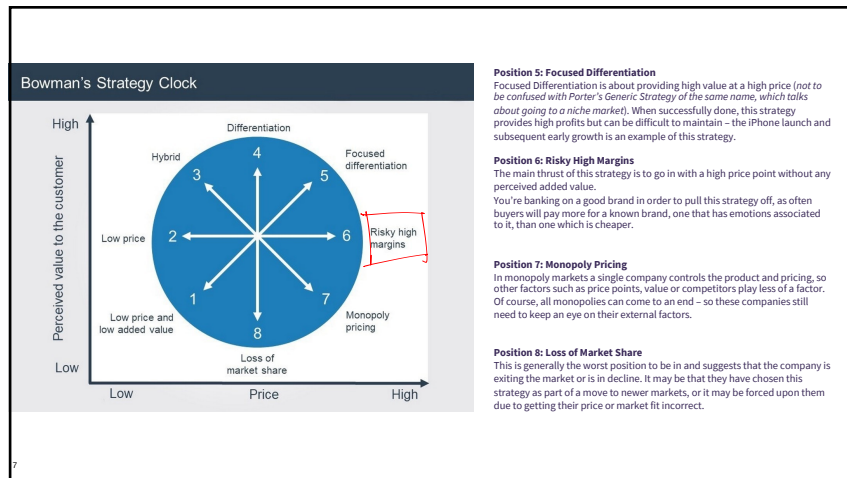
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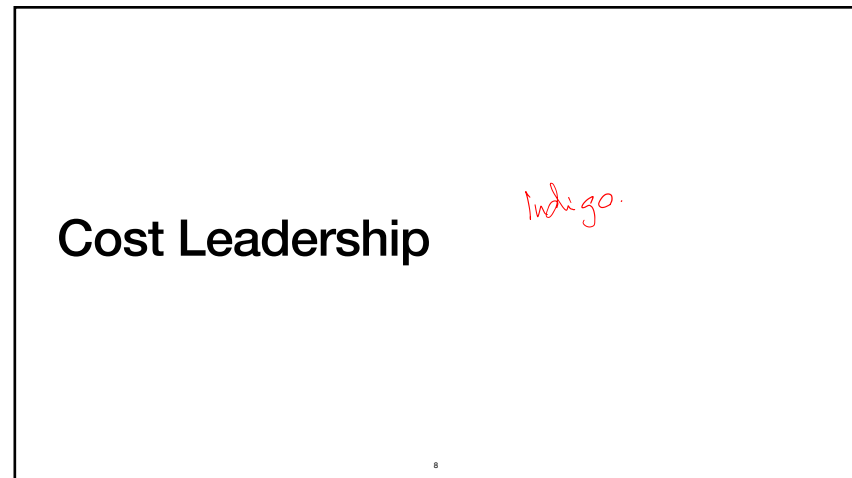
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Cost Leadership

Sources of Cost Advantage

1. Economies of Scale ↑
2. Diseconomies of Scale ↓
3. Learning Curve Economies ↑
4. Low-cost access to factors of production ↑
5. Technology independent of Scale ↑
6. Policy Choices ↑

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Sources of Cost Advantage

Economies of Scale

- Average cost per unit falls as quantity increases—until the minimum efficient scale is reached
- are a cost advantage because competitors may not be able to match the scale because of capital requirements (barrier to entry)
 - Input – output relationships not linear
 - Indivisibilities
 - Specialization
- international expansion may allow a firm to have enough sales to justify investing in additional capacity to capture economies of scale

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Sources of Cost Advantage

Economies of Scale

Indigo Spice Jet: \$100mn, \$1bn, Airbus. Mkt Rev = 100 x 100 = 10000, 0.1%. 40% mkt sh. 100 x 100 = 10000

- Economies of scale operate when:
 - activities are executed more efficiently at larger volume,
 - the cost of certain activities can be divided over large sales volume, or
 - activities have less proportional cost increases compared with the output growth
- Technology, specialization and minimum size are important factors influencing the dynamics of economies of scale

Airbus A320 Neo: training ↓, maintenance ↓

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COST ANALYSIS

Economies of Scale: The Long-Run Cost Curve for a Plant

Sources of scale economies:

- technical input/output relationships
- indivisibilities
- specialization

Minimum Efficient Plant Size: the point where most scale economies are exhausted

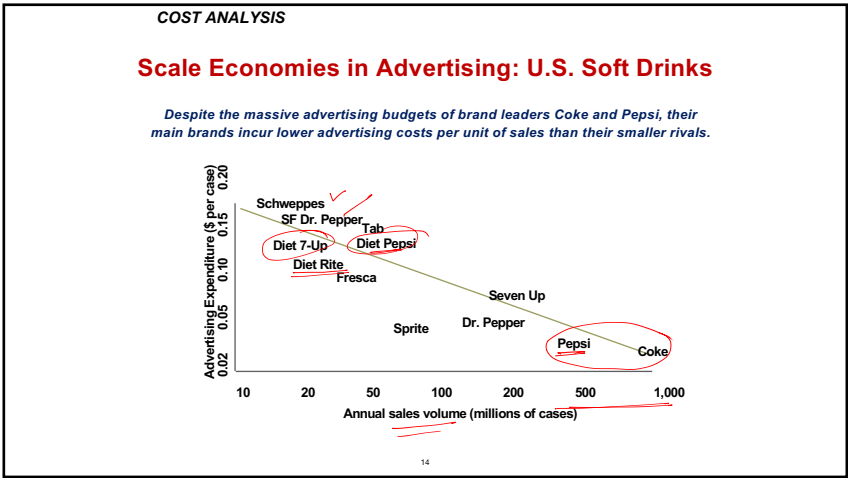
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New Product Development Projects

Cost Analysis

Product	Lead company	Estimated development cost	Launch date
F-35 Lightning II joint strike fighter	Lockheed Martin	\$240 billion	2012
B-2 Spirit "stealth bomber"	Northrup Grumman	\$23 billion	December 1993
A380 "super-jumbo"	Airbus Industrie	\$19 billion	October 2007
787 Dreamliner	Boeing	\$16-18 billion	3rd Quarter 2010
Windows Vista	Microsoft	\$7 billion	January 2007
PlayStation 3	Sony	\$7 billion	November 2006
Iridium satellite communication system	Motorola/Iridium Satellite LLC	\$6 billion	July 1999
Ford Contour/Mondeo	Ford Motor Company	\$6 billion	October 1992

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Sources of Cost Advantage

Diseconomies of Scale

Capital. Company A → Company B
Airbus → 500 planes

- Diseconomies of scale occur when the increase in the volume of an activity creates complexity in its management and coordination costs
 - are an advantage for those who do not have diseconomies of scale
 - occur when firms become too large and bureaucratic
 - are a risk of international expansion
 - Lease back model. Asset ↓ Insurance ↓ Interest ↓ Depreciation ↓
 - HQ destinations. Vigag. Delhi 7:00 am 1:00 pm 9:00 pm.

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Sources of Cost Advantage

Learning Curve Economies

- The costs of activities may decline over time as the activity is performed more efficiently due to learning process.
- Learning improves how processes are performed.
- Learning can occur due to the volume of activity, level of investment, or simply time

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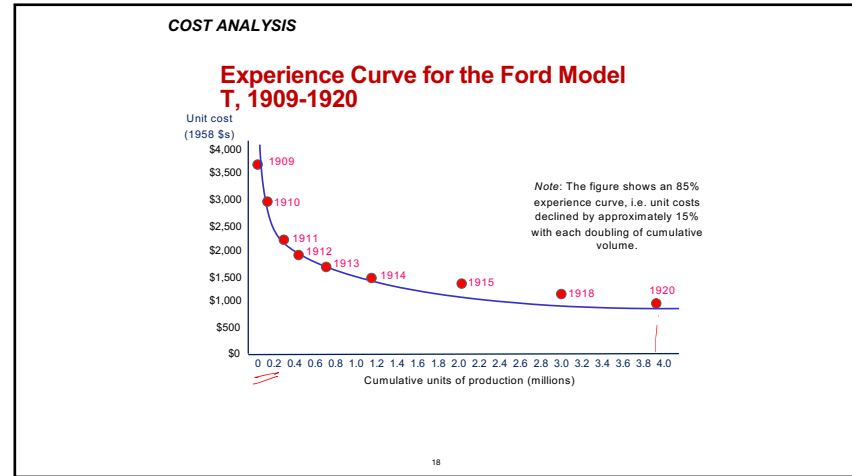
Sources of Cost Advantage

Learning Curve Economies

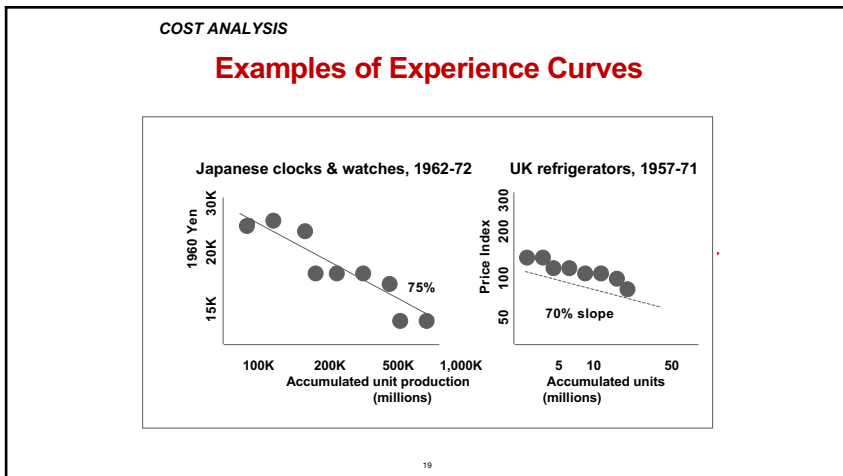
- A firm gets more efficient at a process with experience *factory*
- The more complicated/technical the process, the greater the experience advantage. *Airplane → Air.*
- International expansion may propel a firm down the experience curve because of higher volumes.

Dynamic pricing model. supply chain. demand. £ 5000 £ 15000 £ 4715 £ 5235 Faster Turnaround of Planes.

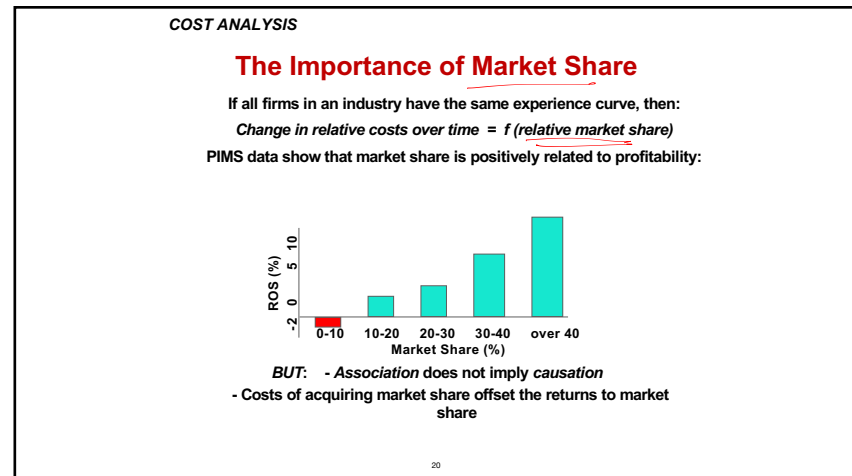
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Sources of Cost Advantage

Low-cost access to factors of production

- Input costs
 - Location advantages
 - Ownership of low-cost inputs
 - Bargaining power supplier cooperation
- Managerial and organizational efficiency
 - Organizational slack

Handwritten notes:
 ↳ Land (Gates, Airbus)
 ↳ Labor (India)
 ↳ Capital (Patent capital)
 HDD
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Sources of Cost Advantage

Low-cost access to factors of production

- may result from:
 - history—being in the right place at the right time *Airbus*
 - being first into a market—esp. foreign markets *Gates*
 - natural endowment—owning a mineral deposit
 - locking up a source—buying all of its output *SOO*

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Sources of Cost Advantage

Technology Independent of Scale

- may allow small firms to become cost competitive
 - Process technology and process design (business process reengineering)
 - Product design
 - Capacity utilization
- advantage typically accrues to the “owner” of the technology—may or may not be the ones who actually use the technology
- size of the advantage depends both on how valuable and protectable the technology is

Handwritten notes:
 ATF ↑
 A320 Neo fuel efficient.
 Shark fin

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Sources of Cost Advantage

Technology Independent of Scale

- Production
 - Mechanization and automation
 - Efficient utilization of material
 - Increased precision
- Product design and product line
 - Design for automation
 - Design to economise on material
 - Cost of product line complexity

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Sources of Cost Advantage

Technology Independent of Scale

- If the competitive advantage arises from strongly linked activities (internally and externally), then their costs depend on the performance of other activities.
 - Therefore, it is necessary to undergo a systemic evaluation of the drivers by considering all other activities connected.
- When linkages are external, external actors may be integrated into the company (vertical integration) as a way of controlling costs for the activity

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Sources of Cost Advantage

Policy Choices

- Firms get to choose how they will serve the market.
- We'll offer level of quality that is inexpensive to produce.
- Firms can make policy choices that give people incentives to reduce cost at every opportunity.
- Firms ability to reduce "organizational slack" or x-inefficiency

*Business: ↑
leg space: ↑
seab. ↓
extra baggage ✓
food → hot ✓*

*Maintenance: ↑
"power by hour" Airbus. Inventory. Ramp. weight ↓*

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Sources of Cost Advantage

Policy Choices

- **Capacity Utilization**
 - If an activity has fixed costs, the utilization of the activity will have an important impact on the production costs per unit.
 - The configuration of the activity (internal factor), as well as demand fluctuations (external factors), determine the utilization of the capacity.
- Certain **strategic choices** can impact on the costs of the activities such as product configurations and variety, service, customer segments, technology, location, human resources policies, and process efficiencies

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Sources of Cost Advantage

Policy Choices

- **Timing** implies enjoying low costs when the assets for the activity are acquired in favorable conditions, e.g. business cycles, or generate more demand for an activity, e.g. being the first mover in a market
- **Economies of Scope**
 - Multi-business companies have activities shared between business units.
 - This type of activities provides the possibility of increasing its output (or utilization) by sharing it among multiple business.
 - Sharing an activity implies obtaining economies of scale and learning

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Implementation Issues

Cost Leadership

Generic strategy	Key strategy elements	Resource and organizational requirements
Cost leadership	<ul style="list-style-type: none"> • Scale-efficient plants • Design for manufacture • Control of overheads and R&D • Process innovation • Outsourcing/offshoring • Avoiding marginal customers 	<ul style="list-style-type: none"> • Access to capital • Process engineering skills • Frequent reports • Tight cost control • Specialization of jobs and functions • Incentives linked to quantitative targets

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Rare

- The rareness of a source of cost advantage depends heavily on the **industry life cycle**

Generally...	Emerging	Mature
Economies of Scale	Not Rare	Rare
Diseconomies of Scale	Rare	Rare
Learning Curve Economies	Rare	Not Rare
Differential Input Access	Rare	Rare
Technology	Rare	Not Rare
Policy Choices	Rare	Rare

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Imitability

LOW COST CONDITIONS	HIGH COST CONDITIONS
<ul style="list-style-type: none"> • Unbalanced Industry Capacity and Demand • Non-Proprietary Technology • Highly Observable Technology • Transactional Exchange 	<ul style="list-style-type: none"> • Balanced Industry Capacity and Demand • Path Dependence (Historical Uniqueness) • Protected Technology • Highly Unobservable Technology (Causal Ambiguity) • Relational Exchange (Social Complexity)
(A cost advantage can be easily imitated)	(A cost advantage cannot be easily imitated)

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Organization

Finance Mktg Manf.

- **Functional Structure** (U-Form: Unitary)
 - specialization within functions facilitates cost reduction
 - ensure best cost reduction practices are shared among divisions
 - allow and encourage decision-making by those who are in the best positions to do so—those close to decisions
 - ensure that functions are coordinating efforts in pursuit of a common strategy
- **Organizational Controls and Cost Leadership**
 - Management controls and compensation policies can be focused on cost reduction.
 - supply contracts that stipulate cost reductions over time
 - Tight credit policies
 - austere travel policies (e.g., no first class)
 - bonuses tied to cost reduction targets

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Implementation Issues

Sustaining Cost Leadership

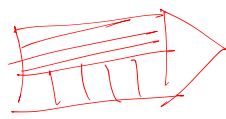
- Obscuring Superior Performance
- Deterrence and Preemption
- Causal Ambiguity and Uncertain Imitability

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Implementation Issues

Catching up with Cost Leaders

- Strategic Cost Analysis
 - Check value added at each step of the value chain.
 - Identify shifts in key cost components for your firm and competitors
 - Assess future cost increases



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Benefits of cost leadership

- Enjoy higher than average profits
- Engage in price war ✓
- Eliminate rivals ✓
- Defend market share ✓
- Increase market share 50%
- Build barriers to the entry of newcomers to the market *Tata*
- Weaken the threat of substitutes *Railways*
- Enter new markets *Dubai Singapore*

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Risks of cost leadership

- Vulnerability to even lower cost operators
- As technology improves, a competitor may be able to leapfrog the production capabilities, thus eliminating the competitive advantage
- It could lead to a damaging price wars
- There might be difficulty in sustaining cost leadership in the long run
- A firm following a focus strategy might be able to achieve even lower cost within their segment

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Summary

Porters Generic Strategies

- **Cost Leadership**
 1. Economies of Scale
 2. Diseconomies of Scale ↓
 3. Learning Curve Economies
 4. Low-cost access to factors of production
 5. Technology independent of Scale
 6. Policy Choices

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