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UNDERSTANDING

MICHAEL
PORTER

*The Essential Guide to
Competition and Strategy*

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Competitive: Advantage

The Value Chain and Your P&L

NO TERM IS MORE closely associated with Porter than *competitive advantage*. You hear it in companies all the time, but rarely as Porter intended. Used loosely, as it most often is, it has come to mean little more than anything an organization thinks it is good at. Implicitly, it is the weapon managers count on to prevail against their rivals.

This misses the mark in important ways. For Porter, competitive advantage is not about trouncing rivals, it's about creating superior value. Moreover, the term is both concrete and specific. If you have a real competitive advantage, it means that compared with rivals, you operate at a lower cost, command a premium price, or both. These are the only ways that one company can outperform another. If strategy is to have any real meaning at all, Porter argues, it must link directly to your company's financial performance. Anything short of that is just talk.

If you have a real competitive advantage, it means that compared with rivals, you operate at a lower cost, command a premium price, or both.

In the last chapter, we saw how the five forces shape the industry's average P&L. Industry structure, then, determines the performance any company can expect just by being an "average" player in its industry. *Competitive advantage* is about superior performance. In this chapter we'll trace the roots of competitive advantage to the value chain, another key Porter framework.

Economic Fundamentals

Competitive advantage is a *relative* concept. It's about *superior* performance. What exactly does that mean? The pharmaceutical company Pharmacia & Upjohn had a seemingly impressive average return on invested capital of 19.6 percent between 1985 and 2002. During the same period, the steel manufacturer Nucor earned around 18 percent. Are these comparable returns? Should you conclude that Pharmacia & Upjohn had the superior strategy?

Not at all. Relative to the steel industry, where the average return was only 6 percent, Nucor was a stellar performer. In contrast, Pharmacia & Upjohn lagged its industry, in which the superior performers earned more than 30 percent. (For an explanation of why Porter uses return on capital, see the box "Right and Wrong Measures of Competitive Success.")

Right and Wrong Measures of Competitive Success

What is the right goal for strategy? How should you measure competitive success? Porter is sometimes criticized for not paying enough attention to people, to management's softer side. Yet he is adamant about the importance of setting the right goal, a view that couldn't be more people-centric.

As any manager knows, goals—and how performance is measured against them—have a huge impact on how people in organizations behave. Goals affect the choices managers make. Although managerial psychology has never been the central focus of Porter's work, this insight about behavior informs his thinking. Start out with the wrong goal—or with goals defined in a misleading way—and you will likely end up in the wrong place.

Performance, Porter argues, must be defined in terms that reflect the economic purpose every organization shares: to produce goods or services whose value exceeds the sum of the costs of all the inputs. In other words, organizations are supposed to use resources effectively.

The financial measure that best captures this idea is return on invested capital (ROIC). ROIC weighs the profits a company generates versus *all* the funds invested in it, operating expenses and capital. Long-term ROIC tells you how well a company is using its resources.* It is also, Porter points out, the only measure that matches the multidimensional nature of competition: creating value for customers, dealing with rivals, and using resources productively. ROIC integrates all three dimensions. Only if a company earns a good return can it satisfy customers in a sustainable way. Only if it uses resources effectively can it deal with rivals in a sustainable way.

The logic is clear and compelling. Yet when companies choose their goals—or when they accept the goals financial markets impose on them—this basic logic is often nowhere to be seen. When Porter questions why so few companies are able to maintain successful strategies, he often points to flawed goals as the culprit:

- Return on sales (ROS) is used widely, although it ignores the capital invested in the business and therefore is a poor measure of how well resources have been used.
- Growth is another widely embraced goal, along with its sister goal, market share. Like ROS, these fail to account for the capital required to compete in the industry. Too often companies pursue unprofitable growth that never leads to superior return on capital. As Porter notes wryly when he talks to managers, most companies could instantly achieve rapid growth simply by cutting their prices in half.
- Shareholder value, measured by stock price, has proven to be a spectacularly unreliable goal, yet it remains a powerful driver of executive behavior. Stock price, Porter warns, is a meaningful measure of economic value only over the long run. (For more on this, see Porter's comments in the interview at the end of this book.)

As Southwest Airline's former CEO Herb Kelleher observes, flawed goals such as these lead to bad decisions. "Market share has nothing to do with profitability," he says. "Market share says we

just want to be big; we don't care if we make money doing it. That's what misled much of the airline industry for fifteen years, after deregulation. In order to get an additional 5 percent of the market, some companies increased their costs by 25 percent. That's really incongruous if profitability is your purpose.'"

Porter's solution to this problem requires some courage: the only way to know if you are achieving the ultimate goal of creating economic value is to be brutally honest about the true profits you've earned and all the capital you've committed to the business. Strategy, then, must start not only with the right goal, but also with a commitment to measure performance accurately and honestly. That's a tall order, not because it's technically challenging, but because the overwhelming tendency in organizations is to make results look as good as you possibly can.

The same logic applies to nonprofits. Even though they operate in a world without market prices, and therefore without literal profits, the measure of performance should be the same: Does this organization use resources effectively? Measuring performance in the social sector is an equally tall order, one that is not undertaken as often or as rigorously as it should be.

** Note that the time horizon for evaluating ROIC will vary depending on the investment cycle that characterizes the industry. In the aluminum industry, for example, where it can take eight years to bring a new smelter on-line, the appropriate time horizon is probably a decade. In contrast, three to five years is more appropriate for many service businesses. In a business with little capital, other measures of effective resource use may be required. For example, a consulting firm might measure returns per partner.*

In gauging competitive advantage, then, returns must be measured relative to other companies within the same industry, rivals who face a similar competitive environment or a similar configuration of the five forces. Performance is meaningfully measured only on a *business-by-business* basis because this is where competitive forces operate and competitive advantage is won or lost. Just to keep our terminology straight, for Porter *strategy* always means "competitive strategy" within a business. The business unit, and not the company overall, is the core level of strategy. *Corporate strategy* refers to the business logic of a multiple-business company. The distinction matters. Porter's research shows that overall corporate return in a diversified corporation is best understood as the sum of the returns of each of its businesses. While the corporate parent can contribute to performance (or, as has been known to happen, detract from it), the dominant influences on profitability are industry specific.

If you have a competitive advantage, then, your profitability will be sustainably higher than the industry average (see [figure 3-1](#)). You will be able to command a higher *relative* price or to operate at a lower *relative* cost, or both. Conversely, if a company is less profitable than its rivals, by definition it has lower relative prices or higher relative costs, or both. This basic economic relationship between relative price and relative cost is the starting point for understanding how companies create competitive advantage.

FIGURE 3.1

The right analytics: Why are some companies more profitable than others?

A company's performance has two sources:

**INDUSTRY
STRUCTURE****RELATIVE
POSITION**

	INDUSTRY STRUCTURE	RELATIVE POSITION
Porter's framework	Five forces	Value chain
The analysis focuses on	Drivers of industry profitability	Differences in activities
The analysis explains	Industry average price and cost	Relative price and cost

If a company has a **COMPETITIVE ADVANTAGE**, it can sustain higher relative prices and/or lower relative costs than its rivals in an industry.

From here Porter takes us through a thought process that's a lot like peeling an onion. First, disaggregate the overall profitability number into its two components, price and cost. This is done because the underlying causal factors, the drivers of price and cost, are so different, and the implications for action are different as well.

Relative Price

A company can sustain a premium price only if it offers something that is both unique and valuable to its customers. Apple's hot, must-have gadgets have commanded premium prices. Ditto for the high-speed Madrid-to-Barcelona train and the trucks Paccar creates for owner-operators. Create more buyer value and you raise what economists call *willingness to pay* (WTP), the mechanism that makes it possible for a company to charge a higher price *relative to rival offerings*.

For many years, U.S. automakers could sell basic passenger cars only by offering substantial rebates or other financial incentives relative to companies such as Honda and Toyota. In 2010, a wave of new products from Ford was beginning to end that long-standing relative price disadvantage. The new Ford Fusion was a top pick of auto critics at *Motor Trend* and *Consumer Reports*, winning praise for quality and reliability. Car buyers seemed to agree. Of the record \$1.7 billion Ford earned in the third quarter of 2010, Ford attributed \$400 million to higher prices.

In industrial markets, value to the customer (which Porter calls *buyer value*) can usually be quantified and described in economic terms. A manufacturer might pay more for a piece of machinery because, compared with lower-priced alternatives, it will produce offsetting labor costs that exceed the higher price.

With consumers, buyer value may also have an "economic" component. For example, a consumer will pay more for prewashed salad in order to save time. But rarely do consumers actually figure out what they are paying for convenience, in the way a business customer would. (I once calculated, for example, that consumers were effectively paying well over \$100 an hour for the unskilled labor involved in grating cheese.)

A consumer's WTP is more likely to have an emotional or intangible dimension, whether it is the trust engendered by an established brand or the status associated with owning the latest electronic gadget. Automakers are betting that consumers will pay a price premium for hybrid cars that well exceeds their potential savings from lower fuel costs. Clearly, noneconomic factors are at work in this calculation.

The same is true in a small but growing corner of the food business. Why are consumers increasingly willing to pay price premiums of three or four hundred percent for what has long been a basic commodity, a carton of eggs? There are a variety of explanations, all of them related to a growing awareness of how eggs are produced on factory farms. For the health-conscious customer, the added value is food safety. For the farm-to-table enthusiast, it's better taste. For the animal ethicist, it's the humane treatment of the hens that lay the eggs.

The ability to command a higher price is the essence of *differentiation*, a term Porter uses in this somewhat idiosyncratic way. Most people hear the word and immediately think "different," but they might apply that difference to cost as well as to price. For example, "Ryanair's low costs differentiate it from other airlines." Marketers have their own definition of differentiation: it's the process of establishing in customers' minds how one product differs from others. Two brands of yogurt may sell for the same price, but you're told that Brand A has "50 percent fewer calories."

Porter is after something different. He is focused on tracking down the root causes of superior profitability. He is also trying to encourage more precise and rigorous thinking by underscoring the distinction between price effects and cost effects. For Porter, then, *differentiation* refers to the ability to charge a higher relative price. My advice here: Don't get hung up on the language, as long as you don't get sloppy about the underlying distinction. Remind yourself that the goal of strategy is superior

profitability and that one of its two possible components is relative price—that is, you are able to charge more than your rivals charge.

Relative Cost

The second component of superior profitability is relative cost—that is, you manage somehow to produce at lower cost than your rivals. To do so, you have to find more efficient ways to create, produce, deliver, sell, and support your product or service. Your cost advantage might come from lower operating costs or from using capital more efficiently (including working capital), or both.

Dell Inc.'s low relative costs up through the early 2000s came from both sources. Vertically integrated rivals, such as Hewlett-Packard, designed and manufactured their own components, built computers to inventory, and then sold them through resellers. Dell sold direct, building computers to customer orders using outsourced components and a tightly managed supply chain. These competing approaches had very different cost and investment profiles. Dell's model required little capital since the company did not design or make components, nor did it carry much inventory. In the late 1990s, Dell had a substantial advantage in days of inventory carried. Because component costs were then dropping so fast, buying components weeks later, as Dell effectively did, translated into lower relative costs per PC. And Dell's customers actually paid for their PCs *before* Dell had to pay its suppliers. Most companies have to finance the working capital they need to run their business. Dell's strategy resulted in *negative* working capital, which further enhanced Dell's cost advantage.

Sustainable cost advantages normally involve many parts of the company, not just one function or technology. Successful cost leaders multiply their cost advantages. They are not just “low-cost producers”—a commonly used phrase that implies that cost advantages come only from the production area. Typically, the culture of low cost permeates the entire company, as it does with companies as diverse as Vanguard (financial services), IKEA (home furnishings), Teva (generic drugs), Walmart (discount retailing), and Nucor (steel manufacture). Not only has Nucor historically achieved cost advantages in production, for example, but for years it ran a multibillion-dollar company out of a corporate headquarters about the size of a dentist's office. The “executive dining room” was the deli across the street.

The big idea here is this: strategy choices aim to shift relative price or relative cost in a company's favor. Ultimately, of course, it's the spread between the two that matters: any strategy must result in a favorable relationship between relative price and relative cost. A distinct strategy will produce its own unique structure. One strategy might, for example, result in 20 percent higher costs but 35 percent higher price. Companies such as Apple or BMW lean in that direction. Another strategy might lead to 10 percent lower costs and 5 percent lower price. Companies such as IKEA and Southwest have chosen this kind of structure. Where the net result of the configuration is positive, the strategy has, by definition, created competitive advantage. For Porter, thinking in such precise, quantifiable terms is essential because it ensures that strategy is economically grounded and fact based.

Strategy choices aim to shift relative price or relative cost in a company's favor.

The same big idea applies to nonprofits as well. Remember, competitive advantage is fundamentally about superior value creation, about using resources effectively. Strategy choices for nonprofits aim to shift relative value or relative cost in society's favor. In other words, a good

strategy would enable a nonprofit to produce more value for society (the analogue of higher price) for every dollar spent, or to produce as much value using fewer resources (the equivalent of lower cost). To apply Porter's ideas in a nonprofit setting, keep in mind that the nonprofit's goal is to meet a specific social objective with the greatest efficiency. On this score, for-profit managers have it easier. Market prices give them a clear yardstick against which to measure the value they create. Nonprofit managers face the same task, creating value, but without the clarity of that yardstick.

The Value Chain

We now have a concise, concrete definition of competitive advantage: superior performance resulting from sustainably higher prices, lower costs, or both. But we have to peel one final layer of the onion to arrive at what I'll call the managerially relevant sources of competitive advantage—the things that managers can control. Ultimately, all cost or price differences between rivals arise from the hundreds of *activities* that companies perform as they compete.

We need to slow down here for a minute because this is really important and because this language is not intuitive for most managers. Since I'm going to be referring to *activities* and *activity systems* a lot, let's be clear about the definition. *Activities* are discrete economic functions or processes, such as managing a supply chain, operating a sales force, developing products, or delivering them to the customer. An activity is usually a mix of people, technology, fixed assets, sometimes working capital, and various types of information.

Managers tend to think in terms of functional areas such as marketing or logistics because that is how their own expertise or organizational affiliation is defined. That's too broad for strategy. To understand competitive advantage, it is critical to zoom in on activities, which are narrower than traditional functions. Alternatively, managers think in terms of skills, strengths, or competences (what the company is good at), but that's too abstract and often too broad as well. To think clearly about actions you can take as a manager to impact prices and costs, you need to get down to the activity level where “what the company is good at” gets embodied in specific activities the company performs.

The sequence of activities your company performs to design, produce, sell, deliver, and support its products is called the *value chain*. In turn, your value chain is part of a larger *value system*.

The sequence of activities your company performs to design, produce, sell, deliver, and support its products is called the *value chain*. In turn, your value chain is part of a larger *value system*: the larger set of activities involved in creating value for the end user, regardless of who performs those activities. An automaker, for example, has to equip a car with tires. This involves a number of *upstream* choices: Do you make the tires yourself or buy them from a supplier? If you make them yourself, do you buy raw materials from a supplier or do you produce them yourself? Henry Ford famously chose to operate his own rubber plantation in Brazil in the late 1920s, a decision that did not turn out too well. Ultimately, choices like this, about how vertically integrated you want to be, are choices every company makes about “where to sit” in the value system.

There are also activity choices to be made looking *downstream* in the value system. In the 1920s, when cars were still rich men's toys, General Motors and other automakers started their own consumer finance divisions to help customers buy cars on credit. Henry Ford, a man of strong convictions, believed that credit was immoral. He refused to follow GM's lead. By 1930, 75 percent of cars and trucks were bought “on time,” and Ford's once dominant market share had plummeted. In thinking about your value chain, then, it's important to see how your activities have points of connection with those of your suppliers, channels, and customers. The way *they* perform activities

affects *your* cost or *your* price, and vice versa.

The value chain is another Porter framework that managers refer to all the time. Most, I believe, know what a value chain is—the metaphor of a series of linked activities is intuitive. But many miss the “so what.” Why does it matter? The answer: The value chain is a powerful tool for disaggregating a company into its strategically relevant activities in order to focus on the sources of competitive advantage, that is, the specific activities that result in higher prices or lower costs (or, if your organization is a nonprofit, the activities that result in higher value for those you serve or lower costs in serving them).

Key Steps in Value Chain Analysis

The best way to appreciate this tool is actually to use it. Here's how.

1. Start by laying out the industry value chain. Every established industry has one or more dominant approaches. These reflect the scope and sequence of activities that most of the companies in that industry perform, and this is as true for nonprofits as for any business. The industry's value chain is effectively its prevailing business model, the way it creates value (see [figure 3-2](#)). It is where most companies in the industry have chosen "to sit" in relation to the larger value system.

FIGURE 3-2

The value chain: Configuring activities to create customer value



- How far upstream or downstream do the industry's activities extend?
- What are the key value-creating activities at each step in the chain?
- Compare the value chains of rivals in an industry to understand differences in prices and costs

How far upstream do the industry's activities extend? Does the industry do basic research? Does it design and develop its products? Does it manufacture? What key inputs does it rely on? Where do they come from? How does the typical player in the industry market, sell, distribute, deliver? Is financing or after-sales service a part of the value the industry creates for customers?

Depending on the industry, some categories will be more or less important in competitive advantage. The key here is to lay out the major value-creating activities *specific to your industry*. If there are competing business models, lay out the value chain for each one. Then look for differences among rivals.

2. Next, compare your value chain to the industry's. You can use a template like the one used in the example in this section. The goal is to capture every major step in the value-creating process. For illustrative purposes, I've chosen an example from the nonprofit world, which has the advantage of simplicity. In chapter 4 we'll examine several more complex business value chains. The framework applies equally well in both worlds.

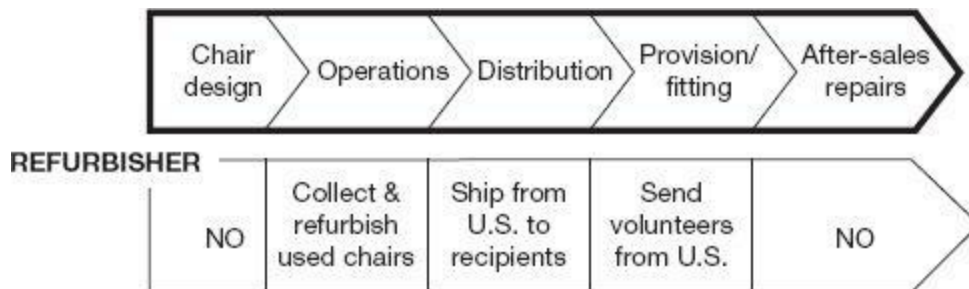
Consider that a number of U.S.-based nonprofits provide wheelchairs to people with disabilities

in developing countries. One strategy, which I'll call the "refurbisher," consists of three major activities and looks something like this ([figure 3-3](#)):

- **Product sourcing.** Used chairs donated by hospitals, individuals, and manufacturers are collected and then refurbished.
- **Distribution/delivery.** Wheelchairs are shipped to recipients overseas; an in-country charity or nongovernmental organization distributes the chairs to end users.
- **Custom fitting.** Professionals (typically volunteers) follow the chairs overseas to custom-fit each chair. This service, called *provision*, is important because an ill-fitting wheelchair can create its own health issues.

FIGURE 3-3

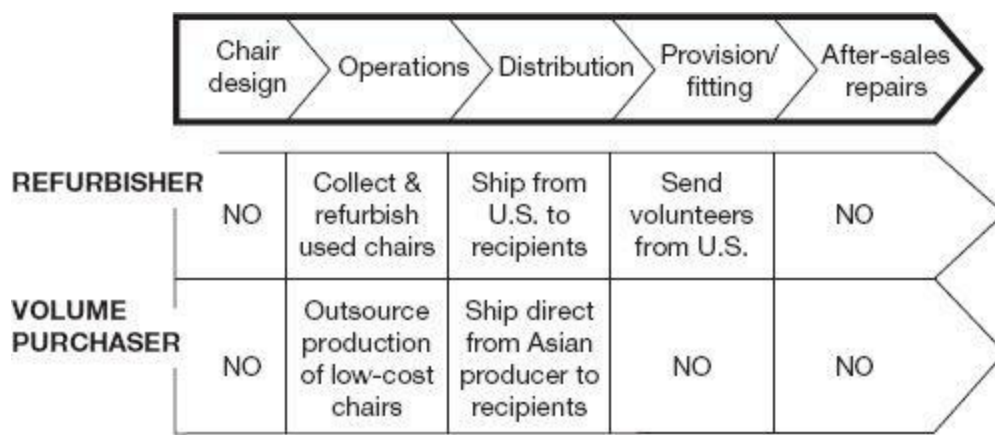
Donated wheelchairs: A value chain example



An even simpler strategy, which I'll call the "volume purchaser," consists of just two primary activities: fundraising and buying huge volumes of the most basic, standardized chairs from the lowest-cost producers in China. These are distributed without provision or other user services. Here, the value created is as stripped down as the value chain ([figure 3-4](#)): no design, no provision, no repairs.

FIGURE 3-4

Donated wheelchairs: Two competing value chains



Whirlwind Wheelchair International (WWI) takes a different approach, starting with a different way of thinking about the value it wants to create. When founder Ralf Hotchkiss was a college student in 1966, a motorcycle accident left him paralyzed. The first time he took his wheelchair out on the street, he hit a crack in the sidewalk and the chair broke. Hotchkiss, an engineer and a bicycle maker, has spent the last forty years redesigning wheelchairs, not only for his own use but also and especially for people in developing countries where the physical conditions are particularly challenging. His most famous design is called the Rough Rider. Consider Whirlwind’s value chain activities ([figure 3-5](#)):

- **Product sourcing.** Rather than accept donations of what Hotchkiss calls “hospital chairs,” good only for maneuvering indoors, he starts further upstream in order to create true “mobility” chairs. A team of designers based at San Francisco State University works with wheelchair users, designing chairs to fit their lives and withstand local conditions. Adding user-originated design to the value chain creates a higher-value product.
- **Manufacturing.** Whirlwind works with a handful of regional manufacturers outside the United States, partners large enough to achieve efficient scale and sophisticated enough to meet Whirlwind’s quality standards.
- **Distribution.** Where feasible, chairs are shipped to the end-use countries flat packed. This cuts shipping costs in half and allows for some local value-added at the final destination. Centers operated by local partners perform final assembly and provision, and they carry spare parts so the wheelchairs can be serviced over time. This extends their useful life and solves a big problem of the refurbisher approach: donated hospital chairs from the United States are next to impossible to repair if parts are needed.

FIGURE 3-5

Donated wheelchairs: Three competing value chains



	Chair design	Operations	Distribution	Provision/fitting	After-sales repairs
REFURBISHER	NO	Collect & refurbish used chairs	Ship from U.S. to recipients	Send volunteers from U.S.	NO
VOLUME PURCHASER	NO	Outsource production of low-cost chairs	Ship direct from Asian producer to recipients	NO	NO
WHIRLWIND	YES	Partners produce WWI's designs	Regional producers ship to country partners	Local partners do provision & assembly (P&A)	YES P&A centers handle parts & service

Whirlwind's configuration of activities produces a different kind of value with a different cost profile. Looking at competing value chains side by side highlights those differences. If your value chain looks like everyone else's, then you are engaged in competition to be the best.

3. Zero in on price drivers, those activities that have a high current or potential impact on differentiation. Do you or could you create superior value for your customers by performing activities in a distinctive way or by performing activities that competitors don't perform? Can you create that value without incurring commensurate costs? Buyer value can arise throughout the value chain. It can come from product design, for example, as it does for Whirlwind Wheelchair. It can come from choices in the inputs used or the production process itself, both of which are key to the success of In-N-Out Burger, a chain of over 230 hamburger restaurants that uses only the freshest ingredients and prepares its limited menu on-site. It can be created by the selling experience, as any visitor to an Apple Store will tell you. Or, it can arise from after-sales support activities. Every Apple Store, for example, has a Genius Bar where customers can go for free help with technical questions. Whirlwind's spare parts policy is another example. Whether the customer is a company or a household, examining how your activities are part of the whole value system is the key to understanding buyer value.

4. Zero in on cost drivers, paying special attention to activities that represent a large or growing percentage of costs. Your relative cost position (RCP) is built up from the cumulative cost of performing all the activities in the value chain. Are there actual or potential differences between your cost structure and those of your rivals? The challenge here is to get as accurate a picture as you can of the full costs associated with each activity, including not only direct operating and asset costs but also the overhead costs that are generated because you perform this activity.*

To get a handle on this, you can ask yourself what specific overhead costs could be cut if you stopped performing this activity.

For each activity, a cost advantage or disadvantage depends on cost drivers, or a series of influences on relative cost. The real "so what" of relative cost analysis comes when you dig deep enough into the numbers to uncover the actions you can take to improve them. A full-blown example would fill its own chapter. The brief one provided here will give you a sense of what I mean.

Southwest Airlines has long enjoyed a cost advantage, as measured in its low relative cost per available seat mile. To understand why, you would list all of Southwest's activities, assign costs to them, and then compare the results with those of other carriers. Let's follow the trail on just one activity: gate turnarounds. Southwest does it faster, and as a result it gets more out of its assets—its costs per plane and per employee are lower than those of rivals.

Seeing that gate turnarounds are a significant cost driver, you would then dive a level deeper, to the many specific subactivities involved in gate turnarounds. Here you'd be looking for ways to lower your costs without sacrificing customer value. This is how you drive an even greater wedge between your performance and that of your rivals. When a plane lands, for example, the lavatories have to be drained. To do this, a piece of equipment is hooked up to a service panel. The problem, Southwest discovered, was that this interfered with the ground crew's other servicing activities. The solution: Southwest got its supplier, Boeing, to reposition the service panel in the new 737-300.

As the Southwest example shows, ferreting out cost drivers can be like detective work. It demands both creativity and rigorous analysis. The easier path is simply to accept the industry's conventional wisdom. Most auto companies in the 1990s, for example, accepted on faith that scale was *the* decisive cost driver, that if you didn't sell at least four million cars a year, your costs would kill you. A frenzy of consolidation, much of it subsequently undone, followed.

Of course, scale matters in the auto industry. But a deeper understanding of the cost drivers is critical. Honda, for example, is a relatively small car company. This might lead you to conclude that Honda would have a cost disadvantage. But Honda is the world's largest producer of motorcycles, and overall it is a huge producer of engines. Since engines account for 10 percent of the cost of a car and Honda can share the cost of engine development across its product lines, this scope advantage offsets its overall lack of scale. Moreover, Honda's focus on engine development is an element of differentiation that supports its pricing.

Do You Really Have a Competitive Advantage? First You Quantify, and Then You Disaggregate

1. How does the long-term profitability in each of your businesses stack up against other companies in the economy? In the United States, from 1992 to 2006, the average company earned about 14.9 percent return on equity (earnings before interest and taxes divided by average invested capital less excess cash), although this varied somewhat over the business cycle. Are the returns for your business better or worse? If better, something is working in your favor. If worse, then something is wrong. In either case, dig deeper into the underlying causes.
2. Now compare your performance to the average return in your industry, and do so over the last five to ten years. Profitability can fluctuate in the short run as a result of a number of factors as transient as the weather. Choose a longer time horizon, ideally one that matches the investment cycle of your industry. This will tell you whether or not you have a competitive advantage.

Suppose company A earns a 15 percent return against a national benchmark of 13 percent and an industry benchmark of 10 percent. The analysis of industry structure will explain why the industry overall is 3 points below the national average. But A's superior performance—it exceeds its industry by 5 points—indicates that it has a competitive advantage. So in this case, A does not have a strategy problem. On the other hand, it does have to deal with a challenging industry structure. The distinction between these two sources of profitability is crucial because the factors that affect industry structure and those that determine relative position are very different. Until a company understands where its profit performance comes from, it will be ill equipped to deal with it strategically.

3. Next, keep digging to understand why the business is performing better or worse than the industry average. Disaggregate your relative performance into its two components: relative price and relative cost. Relative price and cost are essential for understanding strategy and performance.

In the example under discussion, company A achieved a 5 percent higher return than the average competitor. Its realized price (adjusting for concessions and discounts) was 8 percent higher than the industry average. To command that premium, company A had to spend more: in this case, its relative cost was 3 percentage points higher. That explains A's 5 percent higher return.

4. Dig further. On the price side, it may be possible to trace the overall price premium (or discount) to differences in particular product lines, in customers or geographic areas, or in list price versus discounts off list. On the cost side, it is often revealing to disaggregate the cost advantage (or disadvantage) into that part due to operating cost (income statement) and that part due to the utilization of capital (balance sheet).

These basic economic relationships underlie company performance and strategy. Strategy is about

trying to shape these underlying determinants of profitability.

Strategic Implications: Porter's Brave New World

It is no exaggeration to say that the value chain, first laid out in depth by Porter in *Competitive Advantage* (1985), has changed the way managers see the world. Consider the enormous consequences of value chain thinking.

The first is that you begin to see each activity not just as a *cost*, but as a step that has to add some increment of value to the finished product or service. Over time, this perspective has revolutionized the way organizations define their business. Thirty-five years ago, for example, the brokerage business, with its hefty commissions, was how stocks were traded. One size fit all, or at least it fit those wealthy enough to afford it. Everyone took for granted that the business was what the business was.

You begin to see each activity not just as a *cost*, but as a step that has to add some increment of value to the finished product or service.

But what happens when you start thinking about that business as a collection of value-creating activities? You see that behind that broker was a fully integrated set of activities that ranged all the way from doing research and analysis of securities to executing trades to sending out monthly statements. The costs of all those activities were buried in the price of the commission. Charles Schwab created the company that bears his name—and a new category known as *discount brokerage*—around a different value chain. Not all customers want advice, so why should they have to pay for it? Take away all the activities needed to give advice, focus instead on executing trades, and you can create a different kind of value: low-cost trades that make stock ownership accessible to a wider customer base. Matching the *value chain*—the activities performed inside the company—to the customer's definition of value was a new way of thinking just twenty-five years ago. Today it has become conventional wisdom.

A second major consequence of value chain thinking is that it forces you to look beyond the boundaries of your own organization and its activities and to see that you are part of a larger value system involving other players. For example, if you want to build a fast food business around consistent, perfect French fries, as McDonald's did, you can't make excuses to customers because the potato farmer you buy from lacks proper storage facilities. Customer don't care who's at fault. They care only about the quality of their fries. So, McDonald's has to perform specific activities to make sure that, one way or another, all the potato growers from whom it buys can meet its standards.

And everyone in the value system had better understand the role they play in the larger process of value creation, even when they are removed by one or two steps from the ultimate end user. Most wine drinkers know how unpleasant it can be to uncork a nice bottle of wine, pour it for a guest, and then discover that it's corky—that is, the taste has been ruined by a problem known as cork taint. By the 1990s, the problem reached a tipping point for wine makers and sellers. They wanted cork makers to fix it. You don't want a cheap, commodity-like component to ruin the value of an expensive product.

Cork, most of which comes from trees in Portugal and other Mediterranean countries, has enjoyed a near monopoly on wine closures not just for decades, but for centuries. No surprise, then, that the

cork makers were slow to respond. Their skill lay in harvesting cork from the outer bark of cork oaks without damaging the trees. They were hand workers—basically farmers, not chemists.

This created an opportunity for plastics makers such as Nomacorc to step into the breach. Nomacorc's value chain made it relatively easy for it to undertake research into the chemistry of wine taint, and to solve the problem. While the traditional cork makers were stuck in an older mind-set (“we're in the cork business”), the plastics makers could see how to become part of a larger value-creating process. By 2009, Nomacorc's automated North Carolina factory was churning out close to 160 million plastic stoppers a month, and synthetic corks had captured 20 percent of the market.

This interdependence of value chains has enormous implications. Managing *across* boundaries, whether these are between the company and its customers or the company and its suppliers or business partners, can be as important for strategy as managing within one's own company. Using Porter's value chain construct was like looking through a microscope for the first time. Suddenly managers could see a whole world of relationships that had previously been invisible to them.

The value chain was a major breakthrough for analyzing both a company's relative cost and value. The value chain focuses managers on the specific activities that generate cost and create value for buyers. Although managers often talk about how their organization's skills or capabilities create value, activities are where the rubber meets the road. Nomacorc clearly had what most managers would call a “core competence” in chemistry. But its competitive success in the wine market resulted from decisions to deploy those capabilities in activities that enhanced the design and manufacture of wine stoppers.

Can You Execute Your Way to Competitive Advantage?

We now have a complete definition of competitive advantage: a difference in relative price or relative costs that arises because of *differences in the activities* being performed (see [figure 3-6](#)). Wherever a company has achieved competitive advantage, there *must be* differences in activities. But those differences can take two distinct forms. A company can be better at performing *the same configuration* of activities, or it can choose *a different configuration* of activities. By now, of course, you recognize that the first approach is competition to be the best. And by now, we are in a better position to understand why this approach is unlikely to produce a competitive advantage.

FIGURE 3.6

Competitive advantage arises from the activities in a company's value chain

ACTIVITIES	Perform SAME activities as rivals, execute better	Perform DIFFERENT activities from rivals
VALUE CREATED	Meet same needs at lower cost	Meet different needs and/or same needs at lower cost
ADVANTAGE	Cost advantage, but hard to sustain	Sustainably higher prices and/or lower costs
COMPETITION	Be the BEST, compete on EXECUTION	Be UNIQUE, compete on STRATEGY

Porter uses the phrase *operational effectiveness* (OE) to refer to a company's ability to perform similar activities better than rivals. Most managers use the term "best practice" or "execution." Whichever term you prefer, we are talking about a multitude of practices that allow a company to get more out of the resources it uses. The important thing is not to confuse OE with strategy.

First, let's recognize that differences in OE are pervasive. Some companies are better than others at reducing service errors, or keeping their shelves stocked, or retaining employees, or eliminating waste. Differences like these can be an important source of profitability differences among competitors.

But simply improving operational effectiveness does not provide a robust competitive advantage because rarely are "best practice" advantages sustainable. Once a company establishes a new best practice, its rivals tend to copy it quickly. This treadmill of imitation is sometimes called

hypercompetition. Best practices spread rapidly, aided by the business media and by consultants who have created an industry around benchmarking and quality/continuous improvement programs. The most generic solutions, those that apply in multiple company and industry settings, diffuse the fastest. (Name an industry that has yet to be visited by some version of Total Quality Management.)

Programs like these are compelling. Managers are rewarded for the tangible improvements they achieve when they implement the latest best practice inside their companies. That makes it all too easy to lose sight of the bigger picture of what's happening *outside* their companies. Competing on best practices effectively raises the bar for everyone. While there is absolute improvement in OE, there is relative improvement for no one. The inevitable diffusion of best practices means that everyone has to run faster just to stay in place.

No company can afford sloppy execution. Inefficiency can overwhelm even the most distinctive and potentially valuable strategies. But betting that you can achieve competitive advantage—a *sustainable* difference in price or cost—by performing *the same activities* as your rivals is a bet you will probably lose. No one has been better at OE competition than the Japanese, but, as Porter's work documents in great detail, OE competition has led even the best of them to chronically poor profitability.

Competitive rivalry, at its core, is a process working against the ability of a company to maintain differences in relative price and relative cost. Competition to be the best is the great leveler. It accelerates that process. In the next four chapters, we will see how strategy, built around a unique configuration of activities, works to achieve and sustain competitive advantage. Strategy is the antidote to competitive rivalry.

The Economic Fundamentals of Competitive Advantage

- Popular metrics such as shareholder value, return on sales, growth, and market share are misleading for strategy. The goal of strategy is to earn superior returns on the resources you deploy, and that is best measured by return on invested capital.
 - Competitive advantage is not about beating rivals; it's about creating superior value and about driving a wider wedge than rivals between buyer value and cost.
 - Competitive advantage means you will be able to sustain higher relative prices or lower relative costs, or both, than your rivals in an industry. If you have a competitive advantage, it will show up on your P&L.
 - For nonprofits, competitive advantage means you will produce more value for society for every dollar spent (the analogue of higher price), or you will produce the same value using fewer resources (the equivalent of lower cost).
 - Differences in relative prices and relative costs can ultimately be traced to the activities that companies perform.
 - A company's value chain is the collection of all its value-creating and cost-generating activities. The activities, and the overall value chain in which activities are embedded, are the basic units of competitive advantage.
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