Understanding Michael Porter

The Essential Guide to Competition and Strategy

Joan Magretta

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Key Concepts

- **Vying to be the best is intuitive, but it is a self-destructive approach.** Often, companies compete head-on in an industry and, over time, their differences erode and they look more and more alike. This typically descends into price wars that erode profit margins for each company and assure mutual destruction.

- **Competition is about profits, not market share.** Competitive advantage is not about beating rivals; it is about staking out a unique position that creates unique value for customers, and that value should be reflected in the profit and loss statement.

- **A distinctive value proposition is essential for strategy and requires a specifically tailored value chain to successfully implement.** The sign of a good value chain is that it deliberately makes some customers unhappy by choosing whom a company serves and whom it does not. All good value chains require such limits, and this helps to set a company apart from its rivals.

- **Trade-offs force decisions and make it difficult for competitors to imitate.** Trade-offs are hard decisions for companies to make. It often seems as if a company is leaving money on the table when it makes a trade-off, but once these decisions are made and stuck with over time, they become part of the company ethos and image and are difficult to emulate by rivals.

- **Good strategies depend on many interconnected choices.** No successful strategy is dependent on one choice. Many choices are involved in a sound, evolving strategy, and one choice may affect several others in key ways. These kinds of interconnected decisions are hard for rivals to imitate due to the many inherent complexities.

- **Good business strategy takes time and continuity.** Developing a sound business strategy does not happen overnight. It often takes years of trial and error and fine-tuning to build a unique brand value.
INTRODUCTION

In Understanding Michael Porter, Joan Magretta distills the essential principles taught by business guru Michael Porter in developing winning strategies that produce sustainable competitive advantages for businesses. The book serves as an executive summary on identifying good and bad strategies based on Porter’s key foundational principles, which are often taught in business schools but misunderstood by many managers.

COMPETITION: THE RIGHT MIND-SET

According to Porter, the key to competitive success lies in an organization’s ability to create unique value. How a business captures some of that value is determined by its strategy. Making bad choices can unleash a race to the bottom, while good choices promote healthy competition, innovation, and growth.

A good competitive strategy will result in sustainable, superior performance. However, competitive strategy is often misunderstood as a competition to be the best. Businesses competing solely to be the best often end up in competitive convergence, in which rivals begin to look alike. Companies under this winner-take-all influence tend to do damage to themselves by cutting prices to gain volume. They often descend into a price competition that is the business equivalent of mutually assured destruction.

The focus should instead be on creating superior value for chosen customers. Competing to be unique is what sets a company apart and produces the best results.

THE FIVE FORCES: COMPETING FOR PROFITS

Porter’s elementary framework, the Five Forces, helps managers visualize the competition for profits at work within an industry. Managers can use this framework to gain insights about the performances of their industries and their companies.

The five forces determining industry structure are:

1. The intensity of rivalry among existing competitors
2. The bargaining power of buyers
3. The bargaining power of suppliers
4. The threat of substitutes
5. The threat of new entrants

Identifying these forces determines an industry’s structure and serves as a critical early step to understanding how to position a company to achieve a sustained competitive advantage. The better grasp a company has on its industry structure, the better it can spot and exploit changes that can reshape that industry structure.

The more powerful a force becomes, the more pressure it will put on prices and cost. For example, the emergence of powerful retailers such as Lowe’s and Home Depot represents high-volume bargaining power for buyers and puts enormous pressure on the makers of home improvement products, as does Walmart with its suppliers. The collective strength of the forces matters as well, because it affects prices, costs, and the investments required to compete.

A good analysis of the five forces allows a company to see through the complexity of competition and enables it to optimally position itself. By doing so, it can build defenses against competitive forces or find a position in the industry where forces are weakest.

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Although industry-wide change often takes time, managers should remember that industry structure is dynamic, not static, and that any analysis is a snapshot of the industry at that given time.

**Competitive Advantage: The Value Chain and Your P&L**

Competitive advantage is often misunderstood as the weapon used to trounce opponents. However, competitive advantage is really about creating value and doing so differently from rivals. Competitive advantage is fundamentally about superior value creation.

Real competitive advantage means that, compared to rivals, a company operates at a lower cost, commands a premium price, or both. The economic relationship between relative price and relative cost is the starting point for a company to understand where its profit performance comes from.

A company should disaggregate its performance into relative prices and relative costs. For Porter, the ability to charge a relatively higher price is known as differentiation. Buyers may be willing to pay more for convenience or for luxury, for example.

**About the Author**

Joan Magretta is a senior institute associate at the Institute for Strategy and Competitiveness. Her work with Professor Porter began in the early 1990s when she was the strategy editor at the *Harvard Business Review*. Prior to joining *HBR*, Dr. Magretta was a partner at the management consulting firm of Bain & Co. Her recent book, *What Management Is*, reflects her career-long interest in the intersection between strategy and general management. Before getting her MBA at Harvard Business School in 1983, Magretta was a university professor in the humanities. She is a Phi Beta Kappa graduate of the University of Wisconsin, with an MA from Columbia and a PhD in English from the University of Michigan.

A company can sustain premium prices only if it offers something that is both unique and valuable to its customers. By creating more of this buyer value, a company can raise what economists call willingness to pay, the mechanism that makes it possible for a company to charge a higher price relative to rival offerings.

Relative cost advantages normally involve many parts of a company, enabling successful cost leaders to multiply their cost advantages. It is often revealing to disaggregate the cost advantage (or disadvantage) into operating costs (income statement) and utilization of capital (balance sheet).

The most common error is that competitive success comes from being the best. However, only by being unique can an organization achieve sustained, superior performance.

Cost advantages should not be confused with what Porter terms operational effectiveness (OE), or a company’s ability to perform similar activities better than its rivals. Simply improving OE does not provide a robust competitive advantage because “best practice” advantages spread rapidly, causing absolute improvement in OE across an industry while providing relative improvement for no one.

A better way for a company to set itself apart is by focusing on its own value chain, which is the sequence of activities performed to design, produce, sell, deliver, and support a company’s products or services in a unique way. The way these activities are performed affects the cost or price. The value chain focuses on the specific activities that generate costs and create value for buyers.

Key steps involved in value chain analysis are:

1. **Lay out the industry value chain.** This is the prevailing business model and dominant approaches within an industry.

2. **Compare the company’s value chain to the industry.** If these are largely the same, the company is in a competition to be the best, not unique.

3. **Zero in on price drivers, those activities that have a high current or potential impact on differentiation.** Buyer value can come from product design, inputs used
The first test of a strategy is whether your value proposition is different from your rivals. If you are trying to serve the same customers and meet the same needs and sell at the same relative price, then by Porter’s definition, you don’t have a strategy.

Creating Value: The Core

Having a unique value proposition is the first test of a good strategy. A value chain tailored to serving that unique value proposition is the second test, and the two work hand-in-hand.

Porter defines the value proposition as the answer to three fundamental questions:

1. Whom will a company serve?
2. What needs are going to be met?
3. What relative price will provide acceptable value for customers and acceptable profits for the company?

Customer segmentation is typically part of any good industry analysis, and choosing the customers a company will serve is vital to an organization’s positioning. Then, a company must find a unique way to serve this segment profitably.

When customers are overserved, a lower relative price is often a dominant factor. In addressing an overserved market, Southwest Airlines’ low relative cost provided it shelter from the airline industry’s self-destructive price competition. Its value proposition has given it a truly unique position. Conversely, some value propositions target customers who are underserved (and hence underpriced), such as those willing to pay a steep price for service or convenience.

The second test of strategy is a tailored value chain. A distinctive value proposition, Porter explains, will translate into a meaningful strategy only if the set of activities to deliver it is different from the activities performed by rivals. This distinctive, or tailored, value chain is vital to establishing a competitive advantage.

Such a tailored value chain is possible only if there are limits, and only if a company is not trying to be all things to all people. Determining limits can lead to painful decisions for a company, but these decisions make it possible to develop a value chain that is different than those of rivals.

Creating a robust strategy with a distinctive value proposition and a tailored value chain often requires discovering new positions. By definition, strategy is about creating something unique and making a set of choices that nobody else has made. Southwest Airlines staked out a valuable strategic position based on its unique set of activities that excluded seat assignments and baggage transfers, for instance.

Trade-Offs: The Linchpin

Managers tend to believe that more is better, and that making trade-offs is a sign of weakness. However, strategy requires choice, and trade-offs become vital economic linchpins by differentiating companies and making it difficult for rivals to copy them.

Some incredibly successful companies that have made brave choices to serve different market segments or offer different value propositions than their rivals include Southwest Airlines, IKEA, Enterprise Rent-A-Car, Walmart, BMW, and Apple. These companies have all found sustained success due to their unique market positions.

IKEA, for instance, made different choices from others in the furniture industry in offering affordable furnishings. The company made trade-offs when they chose to focus on materials over design, leading to a narrow style range. In addition, IKEA decided to use self-service in stores to keep prices down, outsourc-
ing delivery to customers, and using flat-packs so consumers could transport their purchased furniture easily. Trade-offs make effective strategy possible by creating the need for choice. By their nature, tradeoffs make strategies sustainable because they are not easy to match or neutralize. The copycat would pay an economic penalty to do so. The most common form of competitive imitation is straddling, which occurs when a company tries to match the benefits of a successful position while at the same time maintaining its existing position. This often results in failure.

A repositioner, by contrast, effectively chooses to run the same race as a rival who has a giant head start. Lowe’s, for example, copied Home Depot’s large store format, but rather than appeal to Home Depot’s core audience of contractors and do-it-yourself males, Lowe’s decided to appeal to women, who make many of the home improvement decisions. Lowe’s emphasized products such as home fashion, lawn and garden, decorating items, and consumer appliances.

It is just as important to decide which needs a company will not serve, and which products, features, or services it will not offer—and then stick to those decisions. The many trade-offs essential to Southwest’s strategy included no assigned seats, no first class, no meals, no planes other than 737s, and no baggage transfers.

The essence of strategy is choosing what not to do, and a strategy should be linked directly to a profit and loss statement. Any competitive advantage should be reflected in this statement.

**Fit: The Amplifier**

Good strategies do not rely on one good thing or on making one good choice, nor do they result from a series of independent choices. Good strategies depend on the interconnections that result from making interdependent choices. Good “fit” is the result of these interdependent choices. Fit aligns the various functions and activities needed to compete in business.

Fit also amplifies the competitive advantage of a strategy by lowering costs or raising customer value (and price). It makes a sound strategy more sustainable by raising barriers to imitation. There are three types of fit:

1. **Consistent.** Each activity is aligned with the company’s value proposition.
2. **Complementary.** Real synergy results when the value of each activity is raised.
3. **Substitution.** Here, performing one activity makes it possible to eliminate another activity. For example, IKEA’s full-room displays and product hang-tags are substitutes for on-floor salespeople, and this substitution works to optimize the company’s value chain.

Once managers see strategy as a system of interconnected choices, they can grasp how quickly these choices compound to make a good strategy sustainable. Strategy raises the cost of imitation because the activities are so interconnected they are difficult for rivals to copy. Companies with strong fit are typically superior in both strategy and execution, and thus they are less likely to attract imitators in the first place.

**Executives often resist making trade-offs for fear they will lose customers. The irony is that unless they make trade-offs and deliberately choose not to serve all customers and needs, then they are unlikely to do a good job of serving any customers and needs.**

**Continuity: The Enabler**

If a value proposition and a tailored value chain form the foundation of a sound strategy, trade-offs act as linchpins to create sustainable cost and price differences, and fit amplifies and enhances those differences, continuity becomes the enabler. Without continuity, organizations are unlikely to develop competitive advantages at all.

Developing continuity in a company’s strategy and realizing the competitive advantages that result takes time. Magretta writes that, “Strategy isn’t a stir-fry; it’s a stew.” It takes time for the flavors and textures to seep in and develop. Over time, all a company’s constituents—internal and external—come to a deeper understanding of what a company can offer them, and a raft of activities become better tailored to the strategy and better aligned with each other.
Moreover, continuity reinforces a company’s identity in several ways:

- It builds a company’s brand, its reputation, and its customer relationships.
- It helps suppliers and other outside parties to contribute to a company’s competitive advantage.
- It fosters improvements in individual activities and allows an organization to build unique capabilities and skills tailored to its strategy.
- It increases the odds that people throughout the organization will understand the company’s strategy and how they can contribute to it.

This integrated approach often emerges through a process of trial and error, as a company tests its positioning and learns how to best deliver it.

Continuity in a strategy should not be confused with remaining static. An effective strategy is dynamic and should constantly assimilate “best practices” that fit into its game plan and the trade-offs that are required. Such continuity can actually improve an organization’s ability to adapt to changes in the environment and to innovate.

Successful companies rarely have to reinvent themselves because they are constantly reinventing their methods. They keep getting better at what they do, and they keep searching for ways to create more value and increase their profits. By contrast, frequent shifts in strategy are likely to be a drag on performance and on profits.

Magretta cites numerous case studies and anecdotes about how companies, such as Walmart, Apple, The Home Depot, IKEA, and Honda, have achieved sustained competitive advantages by differentiating themselves from other companies and gearing their value chains toward their goals. There is also an insightful Q&A with Michael Porter, and a glossary of key concepts.

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