Bulletin

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Scarcity is in short supply

MARKET NICHES AND DISTINCTIVE CAPABILITIES

Many businesses believe that their success depends on positioning themselves in the right market. Others are convinced that their unique capabilities provide a lasting advantage. Two different schools of strategy literature emphasise these different approaches, which need to be combined in order to identify and exploit that scarce element of success: a sustainable competitive advantage. This bulletin explains why.

As any airport bookstall will demonstrate, the massive literature on business strategy offers two broad schools of thought about how firms can improve their performance.

- The first concentrates on ***positioning.*** Firms should choose markets and niches where rivalry is soft and where suppliers and customers are not too powerful.

- The second school of thought emphasises ***resources*** as the key to successful strategy. Firms should accumulate assets, skills or capabilities that will distinguish them from their rivals and which are difficult to imitate.

The positioning view is based on the theory that industry structure (that is, the number of players, the nature of the product and the associated cost structure) determines conduct (that is, the behaviour of players), which then determines profitability. The resources view is derived from a simple economic law: value (profits, in this case) is connected to scarcity.

Each of these views of strategy has many followers, most of whom have slightly different views about how strategy should be implemented, and their critics. They point out that the positioning school fails to recognise the interactions between the behaviour of different firms and the way in which these then affect both structure and profitability. Modern economic thinking recognises the links. For example, certain forms of behaviour (such as predation) can change the industry structure. Similarly, high levels of profit will attract new entrants, and these might then change industry structure.

The resources view is however also inadequate on its own. It provides no information on how to undertake day-to-day management decisions on things like pricing, advertising or customer service. Similarly, whilst it is relatively easy to understand the concept of scarcity, it is often more difficult to find the right distinctive capabilities to deploy in any particular market.

The key point is that it is a mistake to see the positioning and resources views as alternatives. They are, in fact, complementary. Successful firms will not choose between positioning themselves well or cultivating distinctive capabilities. They will understand that good positioning must be based on an understanding of one's own capabilities, and those of rivals.

In the short run, a firm has a fixed stock of resources and capabilities. These will determine its immediate competitive opportunities. Over the longer term, however, a firm can alter both its resources and capabilities, through investment and experience, and can alter its competitive position relative to its rivals. So firms need to take a dynamic view of strategy, aiming to build a long-term competitive advantage by building up the required resources and capabilities.

SUSTAINING AN ADVANTAGE

Achieving long-term, sustainable, competitive advantage depends on doing something that is both valuable and difficult to copy. Intellectual property rights, such as patents on innovations, can provide protection against imitation for many years. Similarly, ownership of certain assets, like an electricity inter-connector or an airport, can provide a sustainable advantage if it is uneconomic to build another.

Such clear examples, inevitably, tend to attract the attention of regulators. What the firm sees as successful exploitation of a competitive advantage based on scarcity, competition authorities may decide is an abuse of market power based on entry barriers. However, there are less extreme examples of assets and capabilities that are difficult to imitate, such as brands and reputation. Similarly, where economies of scale are so great that the market can only support one or two firms, their cost advantages may be sustainable.

A very different form of hard-to-replicate capability is based on the culture of the firm. Of course, not all distinctive business cultures provide a competitive advantage. Whether they do so depends in part on the markets such businesses face. A culture of honesty and care may be advantageous in markets with powerful customers. A culture which encourages free thinking is more likely to add value when innovation is important.

The idea that sustainable competitive advantage comes from doing something that few others can do is fairly obvious. It is, however, much less obvious just what constitutes a distinctive capability. In our experience, many firms have difficulty in understanding which elements of their resources really are and are not scarce.

I CAN DO THAT

The easiest way to tackle this conundrum is to follow the approach that competition economists apply to the (similar) issue of identifying entry barriers. That is, to start by breaking down the business or the value chain into a series of activities. For each activity you then ask: "why can't somebody else do that?".

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This approach is deceptively simple. But it can take some time to identify the relevant activities for analysis, since the firms in question may be complex organisations with many different activities. The key to the comparative analysis is to focus on competitors or potential entrants who are financially strong (since financial resources cannot be seen as a sustainable competitive advantage), and to be imaginative. Just because an incumbent services a market in a particular way does not mean that this is the only way it can be done.

The really contentious part is drilling down to the foundation of an advantage. The analysis cannot stop with identifying a "brand". What is this brand signalling, and to whom? Does it appear different to customers and suppliers? Why does the brand do what it does? How quickly could it change (or be copied)? Rigorous analysis may make it clear that some brands are the outcomes of other advantages, not advantages in themselves.

Similarly, some firms claim to be good at "innovation". Again, the question is: why? Are they continually out-innovating rivals or were they lucky once or twice? Do they employ a single bright scientist or is innovation the result of a wider culture? Where does this culture come from and is it secure? Have the innovations really added value, or are they taking the credit due to some other perhaps less visible (or glamorous) advantage?

By repeatedly asking why somebody else can't do what you do, to achieve the same results, you will come to realise that lots of firms can do lots of what you do. This, however, is not a problem if:

- you have at least some capabilities that are difficult to replicate at your level of cost; and/or,
- it is possible to replicate each of your individual activities, but difficult to replicate them all together (that is, there may be co-ordination advantages).

Having gone through this process, which is the central part of any strategic audit, you will be left with a very short list. In our experience, no firm has more than three or four distinctive capabilities. You may, of course, be left with an empty page. Then, if you are earning profits, you should be preparing for challenge from new entrants.

Assume, however, that the page is not empty. The next question is what you should be doing to extract the maximum value from your list of valuable and scarce capabilities. The answer leads us to the value of good positioning.

TAKE YOUR PLACES

In most markets, firms behave differently from each other. They may offer different price-quality mixes, distribute their product in different ways, market or brand differently, or offer different portfolios of products. Getting these decisions right depends on positioning yourself both to fit the needs of the market and to complement the capabilities of your firm.

Fitting the market does not necessarily mean offering the most popular product, or imitating the market leader. It does mean understanding customer demands: providing value for money offers to price-sensitive market segments, direct distribution to time-starved customers, or realising that sophisticated customers are less likely to be interested in brands.

Selecting positioning strategies that complement the distinctive capabilities of the firm is, however, also important. Whatever customers want, a firm with a high cost base cannot compete for long on low prices. Reputable brands cannot be created overnight, whatever the marketing department may wish.

Successful firms also understand that the game changes. Any good positioning strategy is likely to be imitated. Thinking about this in advance, modelling competitor reactions and your own responses to these, is a good discipline. When it is based on an understanding of your own distinctive capabilities, and those of your competitors, it is a far easier discipline to apply.

THE CORE AND THE FRINGE

One way to illustrate the difference between positioning and sustainable competitive advantage is to consider the what changes might threaten the "core" group of firms in an industry – those few large firms that tend to hold their leading positions against a number of smaller ("fringe") players. Examples of this structure can be found in banking, pharmaceuticals, food retailing, oil and many consumer goods industries.

Good positioning strategies can enable firms to improve their short-term performance, often out-performing their closest rivals. A well-targeted price or advertising campaign could add a couple of percentage points to market share without sacrificing much from the bottom line. However, such strategies rarely catapult a fringe firm into the core. To move from fringe to core requires the possession of the right distinctive capabilities. These do not necessarily have to be the same capabilities as those possessed by the existing core firms, but whatever they are, they have to be capable of being exploited in a way that fits the needs of the market.

Firms that acquire or develop new distinctive capabilities, or apply them to a new market, will often do so in conjunction with a complementary positioning strategy. This is partly why it is sometimes tempting to ascribe the success to positioning, especially in new or rapidly changing markets. However, this would be a mistake – good football players have fancy boots, but buying fancy boots won't make you a great player.

The difference between decisions flowing from distinctive capabilities and those related to positioning is based on time. The life of positioning advantages differs between industries with short and long investment cycles, but in general may be only one to three years. Sustainable competitive advantages may endure for more than a decade. But these are few in number – as evidenced by the fact that so few companies sustain above average levels of financial performance over so long a period. Scarcity, in short, is in pretty scarce supply.

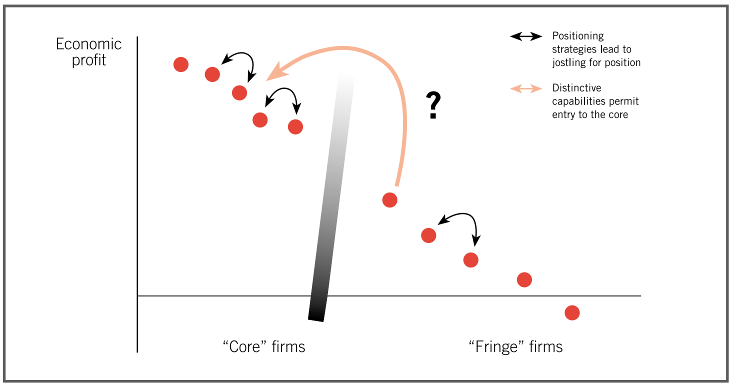

Figure: Positioning rarely moves firms from the fringe to the core.

BRINGING IT TOGETHER

Thinking about distinctive capabilities and positioning in this way clarifies the fundamentals of strategy. It is, in short, based on:

- establishing and protecting distinctive capabilities;
- selecting positioning strategies which both complement and exploit those capabilities.

A big advantage of viewing strategy in this way is that it becomes immediately obvious why positioning, in itself, cannot be a source of sustainable competitive advantage. Firms that appear successful because of the niche they serve (such as some retailers), or the distribution channels they use (such as many Internet businesses) or their price-quality strategy (such as some of the low-cost airlines) cannot sustain these advantages unless they can prevent others from copying their positioning strategies.

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