

Strategic Management CB4303

WEEK 5: BUSINESS LEVEL STRATEGY I

Haeyoung Koo
Department of Management
City University of Hong Kong

In-Class Quiz

- Please download the LockDown Browser if you have not already
- Then follow the steps below:
 1. Open LockDown Browser from the computer
 2. Log in Canvas and then navigate to the quiz
 - Access our course -> Quizzes -> In-Class Quiz #1
 3. Quiz will start at 12:10PM and end at 12:30PM
 - 15 multiple-choice questions
 - Once you make the selection for your answer, you may not go back to change them

Note on Plagiarism

- Students must observe the University's policy on academic honesty in all areas relating to the course
- Any allegation of academic dishonesty will be referred to the appropriate University Officer for action
- Proven offence will subject to the disciplinary procedures stated in the Code of Student Conduct

Recap

Traditional Frameworks

Accounting Data

- How much profit does the firm create? (traditional definition of “bottom-line”)
- Challenge: does not fully take into account intangibles

Shareholder Value

- How much value does the firm create for shareholders?
- Challenge: investor expectations

Economic Value Creation

- How much economic surplus does the firm generate?
- Challenge: firm-level aggregation

These performance dimensions generally correlate, particularly over time:

- Need to consider together
- Consider limitations of each

Towards Stakeholder Capitalism

Shift in focus

- Focus on profit maximization ->
- Focus on shareholder value maximization ->
- Corporate social responsibility ->
- Creating shared value (dual focus)

Key Issues

- “Tragedy of the commons” problem, i.e. grand challenge
- Example: climate change
- Economic inequality

“Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.”

- Larry Fink, CEO of BlackRock, Inc.

Integrative Frameworks

Balanced scorecard

- Wholistic measure of competitive advantage
- Customers
- Value creation
- Core competencies
- Shareholders

Triple Bottom Line

- Consideration for profits, people, and the planet
- Focus on economic, social, and ecological performance

Agenda for Today

- Topic: Business-level strategy
 - ✓ Define business-level strategy and describe how it determines a firm's strategic position
 - ✓ Examine the relationship between value drivers and differentiation strategy
 - ✓ Examine the relationship between cost drivers and cost-leadership strategy

Business-level Strategy

What Is Business Level Strategy?

Goal of business-level strategy:

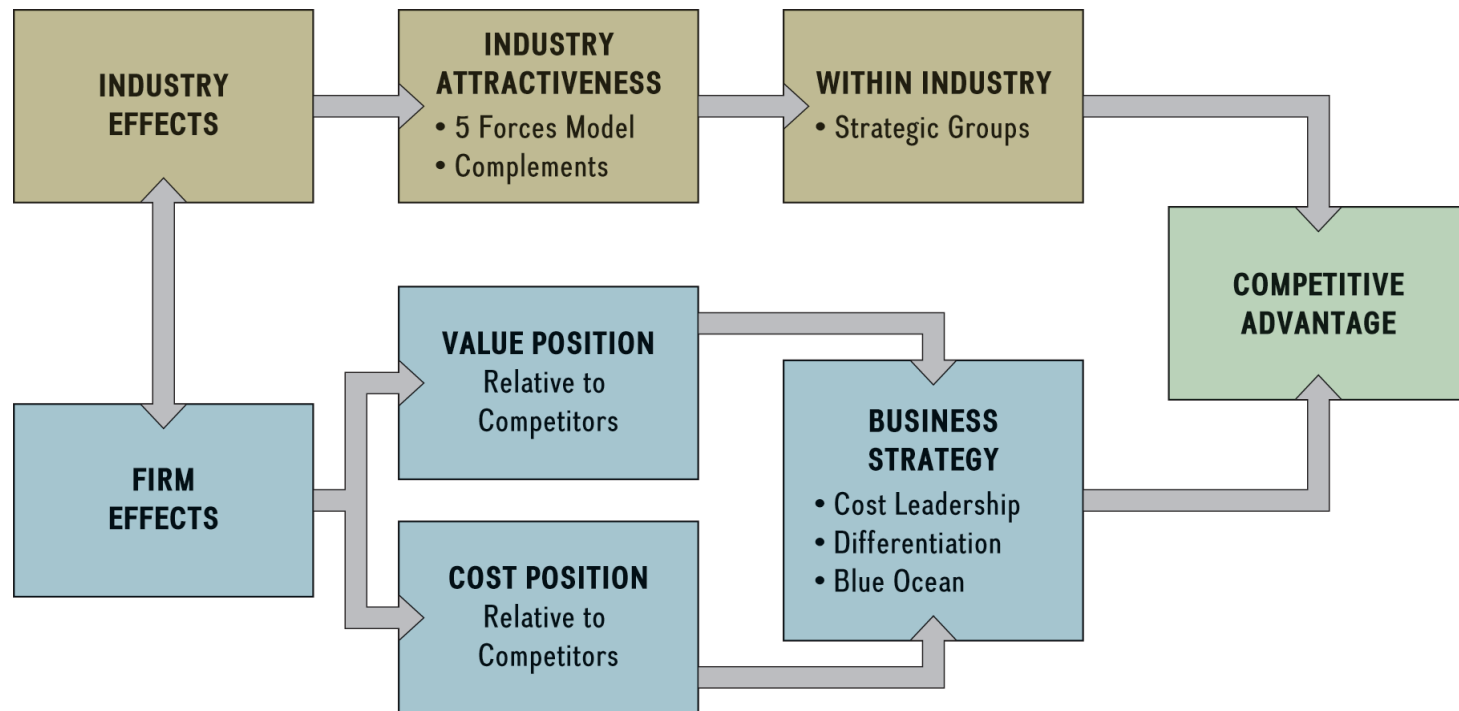
- To achieve competitive advantage in a single product market

“How should we compete?”

- **Who:** which customer segments?
- **What:** customer needs will we satisfy?
- **Why:** do we want to satisfy them?
- **How:** will we satisfy our customers' needs?

Industry and Firm Effects Jointly Determine Competitive Advantage

Exhibit 6.1



Strategic Position and Trade-off

Strategic Position

- A strategic profile based on value creation and cost in a specific product market
- A valuable and unique position which:
 - Meets customer needs
 - Maximizes product value
 - Lowest possible product cost

Strategic Trade-off

- Choices between a cost OR value position
- Tension between value creation and pressure to keep cost in check
- Purpose to maximize the firm's:
 - Economic value creation
 - Profit margin

Generic Business Strategies

Can be used by any organization independent of industry

- Manufacturing or service
- Large or small
- For-profit or non-profit
- Public or private

Differentiation and cost leadership require distinct strategic positions

Differentiation:

- Seeks to create higher value vs. competitors
- Offers unique features
- Charges higher prices

Cost Leadership:

- Seeks to create similar value vs. competitors
- Charges lower prices

Focused Business Strategies

Pursuing differentiation vs. cost leadership in narrower competitive scope

Focused **Differentiation**:

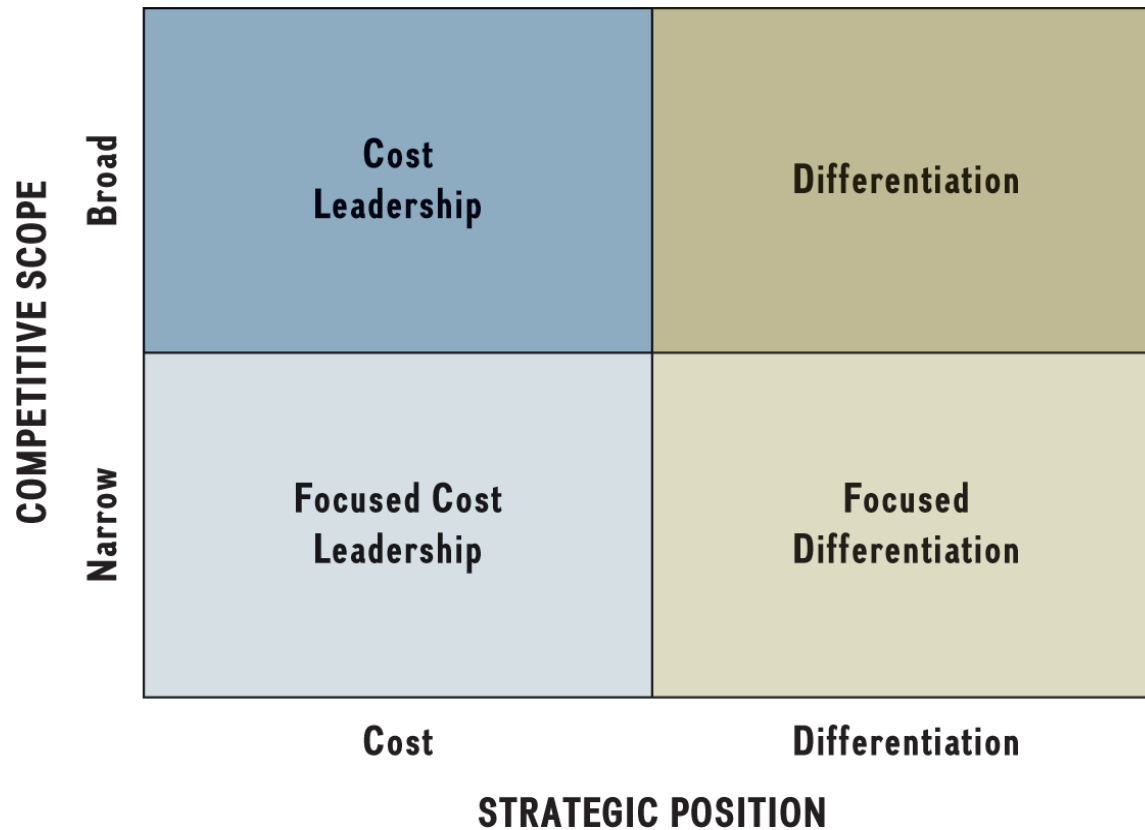
- Example of Mont Blanc
 - Exquisite pens at several hundred dollars

Focused **Cost Leadership**:

- Example of BIC: disposable pens at low cost

Strategic Position and Competitive Scope

Exhibit 6.2



Source: Based on M.E. Porter (1980), *Competitive Strategy. Techniques for Analyzing Industries and Competitors* (New York: Free Press).

Differentiation Strategy

Goal

- The goal is to use unique features that increase value so that consumers pay a higher price

What Drives Additional Value?

- Product features
 - Increase the perceived value of the product or service offering
- Customer service
- Complements
 - Add value to a product or service when they are consumed in tandem
- Effective marketing

Differentiation Strategy Example

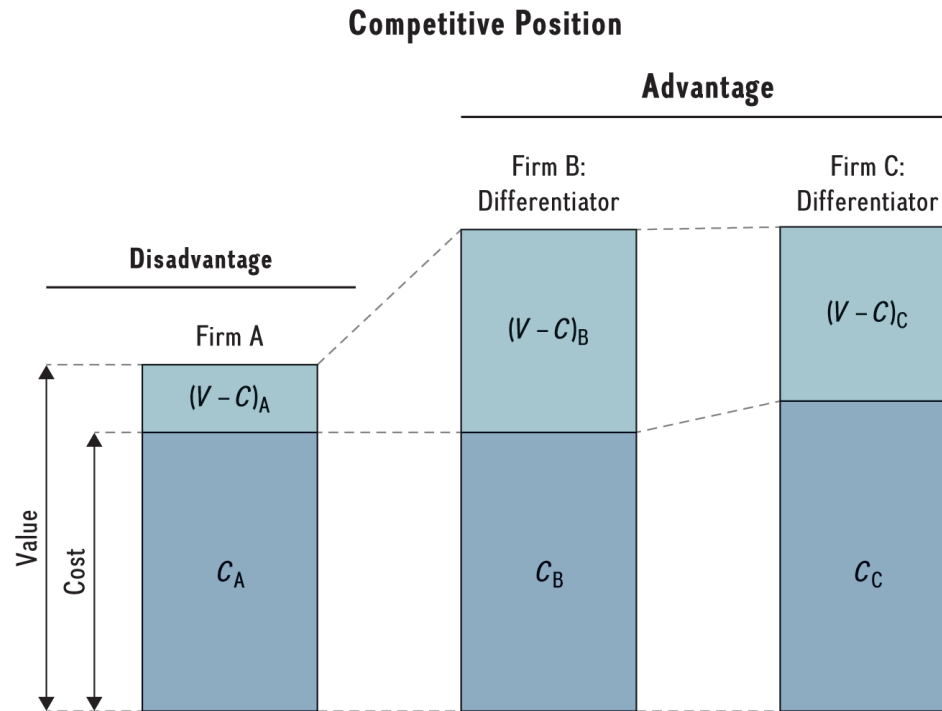


Example

- Bottled-water industry
- Shift from soft drinks to healthier choices
- Allows for differentiation strategy
- Split into two broad segments depending on the sales price
- Fiji Water (1Lx12bottles): 265HKD
- COOL Water (1.5Lx12bottles): 60HKD

Differentiation Strategy

Exhibit 6.3



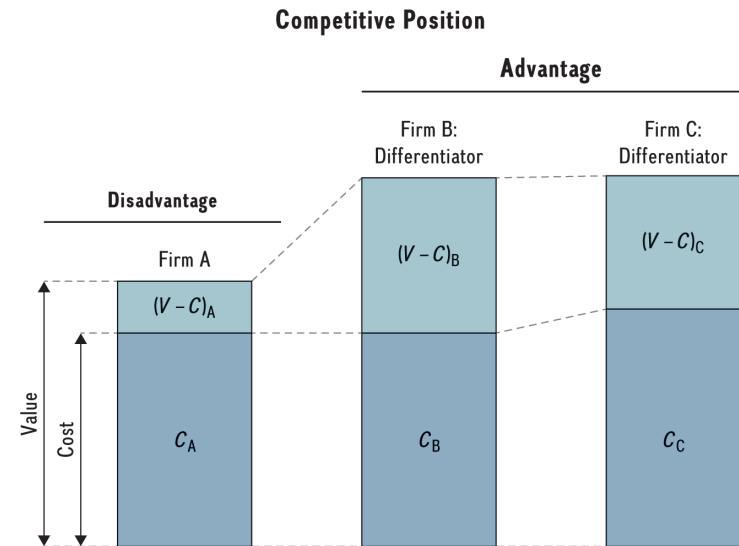
Firm B and Firm C represent two efforts at differentiation

- Either Firm B or C achieves a competitive advantage over Firm A

Differentiation Strategy (Cont'd)

Firm A vs. Firm C

- Even if a firm fails to achieve cost parity it can still gain a competitive advantage
- Higher value creation often requires higher costs
 - Higher-quality raw materials
 - Research and development
 - Employee training to provide superior customer service
- Economic value creation can still exceed that of its competitors
 - $(V - C)_C > (V - C)_A$
 - Allows company to charge a premium price



Differentiation Strategies: Summary

Focused on adding value:

- Unique features
- Customer service
- Effective marketing

Can increase costs, for example, if innovative R&D activities are needed

Customers willing to pay a price premium

Cost Leadership Strategy

Goal

- Reduce cost below competitors
- Offer adequate value
- Reduce prices for customers
- Optimize the value chain for low cost

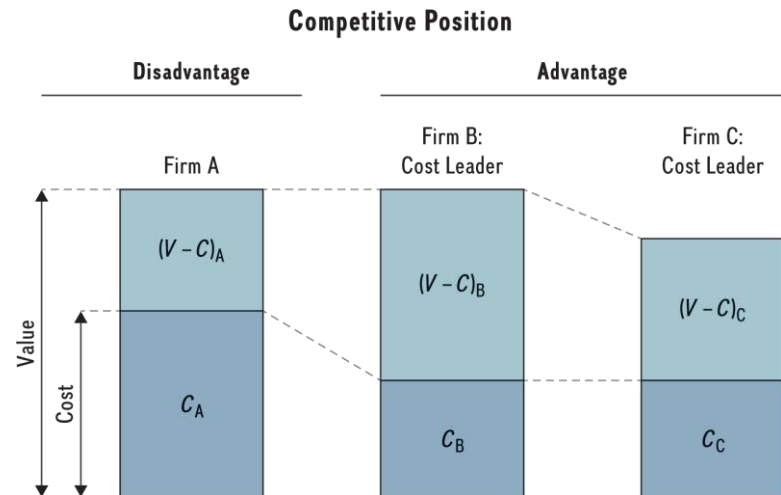
Example

- Volkswagen and Hyundai offer some models that compete directly with one another
- Hyundai cars tend to be produced at lower cost, while providing a similar value proposition

Cost-Leadership Strategy

Firm A vs. Firm B&C

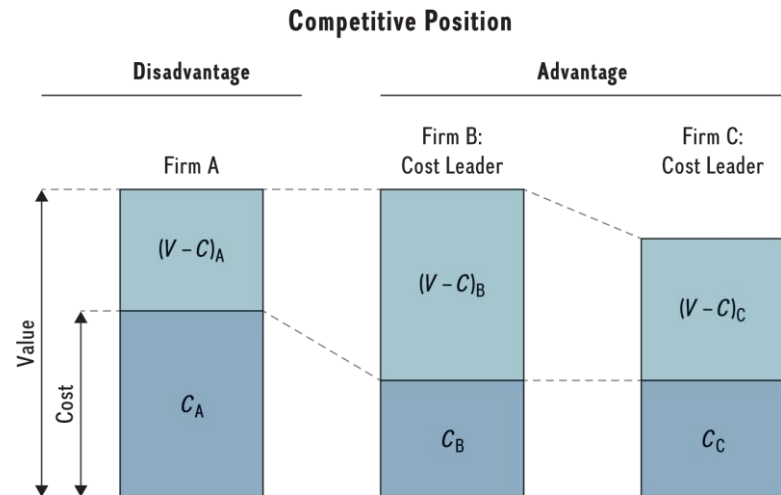
- Firms that can keep their cost low while offering acceptable value are able to gain a competitive advantage
- Two types of cost-leadership strategies
 - Charge similar prices to its competitors and benefit from a greater profit margin per unit
 - Charge lower prices than its competition and gain higher profits from higher volume
 - Both variations of a cost-leadership strategy can result in competitive advantage



Cost-Leadership Strategy (Cont'd)

Firm A vs. Firm C

- Although the product from Firm C has a lower perceived value, Firm C maintains the same reduced product cost as Firm B
- Firm C still generates higher economic value than Firm A
 - Allows company to gain greater volume



Drivers That Keep Costs Low

Cost of input factors:

- Raw materials, capital, labor, and IT services

Economies of scale:

- Decreases in cost per unit as output increases

Learning-curve effects:

- Less time to produce output with experience

Experience-curve effects:

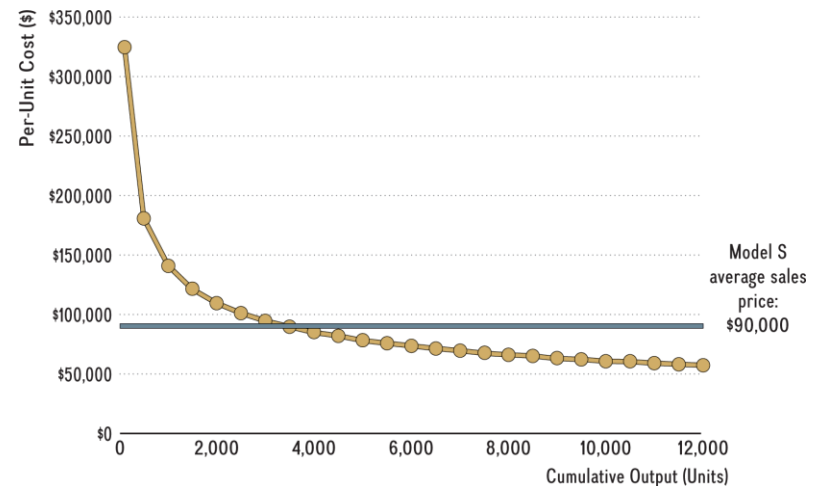
- Improvements to technology and production processes

Economies of Scale and Learning Curve

Economies of Scale

- Spreads fixed costs over a larger output
- Moves down the learning curve
- Tesla was able to drive down the unit cost for each car as production volume ramped up
- Demand for Tesla's Model S sedan allowed it to employ cutting-edge robotics
- High upfront R&D spend required \$140,000 per unit to produce 1,000 units
- Unit cost fell to about \$57,000 when reaching 12,000 units

Exhibit 6.6: Tesla's Learning Curve Producing the Model S



Economies of Scale, Minimum Efficient Scale, and Diseconomies of Scale

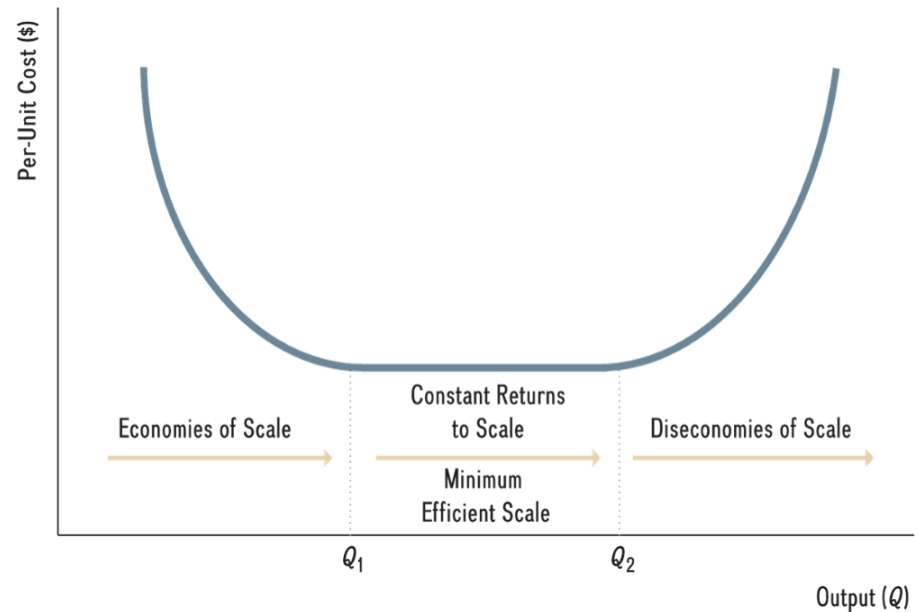
Minimum Efficient Scale

- Q1-Q2: Constant returns to scale achieved (regardless of units)
- Further economies of scale cannot be achieved

Diseconomies of Scale

- Firms too big
- Complexity of managing and coordinating the production process raises the cost
- Overly bureaucratic, with too many layers of hierarchy
- Inflexible and slow in decision making

Exhibit 6.5



Cost Leadership Strategies: Summary

Focus on:

- Offering lower costs than competitors
- Maintaining acceptable quality

Appeals to the bargain-conscious buyer:

- Attracts increased sales

Can be profitable over a long period of time

Economies of Scale And Scope

Economies of **Scale**:

- Decreases in cost per unit
- Achieved as output increases

Economies of **Scope**:

- Savings that come from producing a variety of products at less cost
- Shares the same resources or technology

Group Project Details

Choice of firm

- Your team's choice
- Submit your initial choice of firm by the end of TODAY

Content

- Analysis and evaluation of the industry and their current firm strategy using frameworks learned in class
- What are some external and internal challenges that the company is facing? Pick one or two main strategic issues to discuss
- Develop strategic recommendations for the firm

Group Project Discussion

- Industry selection suggestions
 - Choose an industry with enough public data
 - Your analysis needs to be backed up by current data on industry environment
- Company selection tips
 - Public firms will have more data available
 - Smaller start-up firms may not have enough data

Group Project Proposal

Week 7 (October 19th): 3 to 4-minute presentation per team

Prepare slides for a 4-minute presentation (maximum 4 slides total)

- Slide 1: Company description (location, product types, service offerings)
- Slide 2: Industry description
- Slide 3-4: Reason for choosing to study this company and industry
- *These slides may be reused for your main group project presentation*

No need to present your analyses or framework

Introductory presentation to present your topic of interest

1-minute Q&A / comments per team

Designate one or two speaker(s) for the proposal

Be prepared to access your team's presentation online

In-Class Discussion

Nespresso



Offers a range of coffees, espresso capsule machines, and services

- Over 80 different types of coffees
- Coffee systems: capsule coffee machines

In-Class Discussion Activity: Nespresso

Questions:

1. Does Nespresso have a sustainable competitive advantage?
2. What strategy is Nespresso currently pursuing? What are some considerations for the future?

Discussion Format:

- Group into your team
- Discussion timeline
 - Group discussion and preparation among your team (25 mins)
 - Debate as a whole class (10 mins)
 - Debrief (5 min)

Nespresso

- Strong brand 
 - First-mover advantage in the capsule market
 - Enabled a strong brand identity and up-market image
 - BUT this may be vulnerable to competition from firms who position their product at a lower price point (Tassimo, Keurig)
- Intellectual property and product development capabilities 
 - Also a first-mover advantage
 - Proprietary product designs (capsules, machines)
 - Novel method of coffee extraction, initially protected by patents
 - Skills and know-how of manufacturing a coffee machine that allows for coffee extraction at a high-speed ensuring high-quality taste
 - BUT competitors have been able to “invent around” some of the patents (Keurig, Illy)
- Nestle as a parent company 
 - Long-standing partnerships with equipment manufacturers and appliance retailers
 - Manufacturing production scale
 - Coffee sourcing network of 122,000 farmers in 15 countries
 - Significant investments in innovation, design, and research

Nespresso: Current Strategy

- Current strategy: focused differentiation
 - Higher-income households target
 - Differentiation through upscale image, high-quality coffee, and unique features (“Barista-style coffee at the touch of a button”)
 - Café experience in store to taste diverse products with different machines
 - Diverse range of products
 - Capsule types (Vertuo, original), coffee types, different machines targeting different sub-segments
 - Challenge of substitutes: consumption of coffee in other ways (popularity of hand-drip specialty coffee stores, for instance)

Nespresso: Considerations

- Innovation
 - New product collaboration with other coffee brands
 - Licensing technology to third parties
- Expansion
 - B2B – upscale hotels, restaurants and corporates represent a lucrative market (airlines, private jets)
 - International expansion into countries with emerging coffee culture
- Integration, collaboration, and cross-innovation with other Nestle brands: Starbucks capsules for Nespresso, potential Blue Bottle branding?
- Potential cannibalization: Starbucks coffee at home, Nescafe dolce gusto machines, Blue Bottle Coffee

Group Project Preparation

- Discuss potential company for the group project