Course type: PG
Course: MBA
Title of Attachment: Differentiation Strategies
Name of teacher: Nalin Kishore, Visiting teacher, MBA

DIFFERENTIATION STRATEGIES

Another strategic approach to building competitive advantage is that of pursuing differentiation strategies. Differentiation strategies are based on providing buyers with something that is different or unique, that makes the company's product or service distinct from that of its rivals. The key assumption behind a differentiation strategy is that customers are willing to pay a higher price for a product that is distinct (or at least perceived as such) in some important way. Superior value is created because the product is of higher quality, is technically superior in some way, comes with superior service, or has a special appeal in some perceived way. In effect differentiation builds competitive advantage by making customers more loyal-and less price-sensitive-to a given firm's product. Additionally, consumers are less likely to search for other alternative products once they are satisfied.

Differentiation may be achieved in a number of ways. The product may incorporate a more innovative design, may be produced using advanced materials or quality processes, or may be sold and serviced in some special way. Often, customers will pay a higher price if the product or service offers a distinctive or special value or "feel" to it. Differentiation strategies offer high profitability when the price premium exceeds the costs of distinguishing the product or service. Examples of companies that have successfully pursued differentiation strategies include Prince in tennis rackets, Callaway in golf clubs, Mercedes and BMW in automobiles, Coors in beer, Beretta in guns, Brooks Brothers and Paul Stuart in classic-cut clothing, Dinners Club/Carte Blanche in credit cards, Bose in stereo speakers, American express in travel services,

J.P Morgan Chase in investment banking, Krups in coffee makers and small kitchen appliances, and Benetton in sweaters and lightfashions.

Building a differentiation-Based Advantage

Firms practicing differentiation seek to design and produce highly distinctive or unique product or service attributes that create high value for their customers. Within the firm, differentiation-based sources of competitive advantage in value-adding activities can be built through a number of methods.

An important strategic consideration managers must recognize is that differentiation does not mean the firm can neglect its cost structure. While low unit cost is less important than distinctive product features to firms practicing differentiation, the firm's total cost structure is still important. In other worlds, the costs of pursuing differentiation cannot be so high that they completely erode the price premium the firm can charge. Firms pursuing differentiation must still control expenses to balance somewhat higher costs with a distinctive edge in key activities. The cost structure of a firm or business pursuing a differentiation strategy still needs to be carefully managed, although attaining low-unit costs is not the overriding priority. A firm selecting differentiation must therefore aim at achieving cost parity or, at the very least, cost proximity relative to competitors by keeping costs low in areas not related to differentiation and by not spending too much to achieve differentiation. Thus, the cost structure of a firm practicing differentiation cannot be that far above the industry average. Also, differentiation is not an end in itself; companies must continue to search for new ways to improve the distinctiveness or uniqueness of their products/services.

7-Eleven has practiced differentiation to avoid direct competition with large supermarket chains by offering consumers greater convenience in the form of nearby location, shorter shopping time, and quicker checkout. It achieves these benefits by designing a business system within the value chain that is different from that of supermarket chains in several key respects: smaller stores, more store locations, and narrower product line. Its approach onvolved higher cost than that of supermarket chains, so 7-Eleven must ordinarily charge higher prices to achieve profitability.

However, customers are generally willing to pay a premium in exchange for the greater convenience 7-Eleven provides.

Starbucks Coffee has grown at an annual rate exceeding 30 percent over the past decade as it rolls out its distinctive and specialized blends of coffee throughout United States. Once a Seattle-based coffee-bean retailer that pioneered the concept of uniquely blended coffees, Starbucks has grown to almost 1,800 outlets throughout the country and is currently opening up a new location almost every day. For the unique flavour of Starbucks' premium coffees and ice coffee drinks, the company can charge upward of $3 per servings. To remain ahead of other competitors such as Dunkin' Donuts and even smaller specialized coffee chains, starbucks has begun to roll out an increasing number of different types of beverages that capture and retain its premium image. The Starbucks concept and image have become so popular that it is now serving new types of cold, fruit flavored drinks like Tiazzi to expand beyond coffee line. More recently, it has begun to sell many of its ice coffee drink mixes through grocery store chains and other retailers.

In almost all differentiation strategies, attention to **product quality and service** represent the dominant routes for firms to build competitive advantage. For example, firms may improve a product's quality or performance characteristics to make it more distinctive in the customer's eyes, as Lexus does with its sleek line of automobiles or Tiffany & Company does with its broad line of jewellery and gift items. The product or service can also embody a **distinctive design of offering** that is hard to copy, thus conveying an image of unique quality; as with Krups coffee and espresso makers or with American Express in travel services and charge cards. **After-sales service, convenience, and quality** are important means to achieve differentiation for numerous firms, such as for IBM in computer and electronic commerce technology or Hewlert-Packard in desktop printers and digital imaging technologies.

Technologically advanced products offer a natural route to pursue differentiation; new features convey a sense of quality that enables firms to distinguish themselves from competitors, as Sony did with great success in its Walkmans, Discmans,

Trinitron television sets, and now Playstation 1 and 2 video game systems. However, these same technologies also require the firm to remain on the cutting edge of innovation and quality, and accelerate new product development to stay in touch with customer's needs and market trends.

It is not unusual for firms practicing differentiation **to invest in production processes that use specially designed equipment that makes it hard for rivals to imitate the product's quality.** Olympus Optical fine camera lenses are one example. Olympus's skills in fine optics and lens grinding make it difficult for other competitors to rapidly imitate its fine quality of cameras, microscopes, and other laboratory instruments that command premium prices throughout the world.

Any potential source of **increased buyer value** represents an opportunity to pursue a differentiation strategy. Buyer value can be increased or made more distinctive through several approaches, including
(1) lowering the buyer's cost of using the product,
(2) increasing buyer satisfaction with the product, and
(3) modifying the buyer's perception of value.
Of course, these three approaches to increasing buyer value are not mutually exclusive; a distinctive product or service that lowers buyer's direct costs can certainly increase their level of satisfaction as well. Nevertheless, increasing buyer value on any dimension usually means a need to reconfigure or to improve other activities within the firm's value chain.

Advantages of Differentiation

1. A big advantage behind the differentiation strategy is that it allows firms to insulate themselves partially from competitive rivalry in the industry. When firms produce highly sought-after, distinctive products, they do not have to engage in destructive price wars with their competitors. In effect, successful pursuit of high differentiation along some key product attribute or buyer need may allow a firm to carve its own strategic group within the industry. This has been particularly the case in the food preparations industry, where large

manufacturers try to avoid direct price-base competition with one another through frequent product differentiation and new product introductions.

2. A major advantage behind differentiation is that customers of differentiated products are less sensitive to prices. In practical this attitude means that firms may be able to pass along price increases to their customers. Although the price of Lexus automobiles have risen steadily over the past several years, demand for these cars also continues to rise, as does buyer loyalty. The high degree of customer satisfaction with Lexus cars has translated over to the sport utility vehicle segment, where vehicles command a far higher price and profit. Buyer loyalty means that successful firms may see a substantial increase in repeat purchases for the firm’s products.
3. Another advantage is that strategies based on high quality may, up to a point, actually increase the potential market share that a firm can gain. One landmark study noted, in fact, that competitive strategies based on high product quality actually increased market share resulted in significantly increased profitability. Product quality often leads to higher reputation and demand that translate into higher marketshare.
4. Finally, differentiation creates substantial loyalty barriers that firms contemplating entry must overcome. Highly distinctive or unique products make it difficult for new entrants to compete with the reputation and skills that existing firms already possess. Nordstrom’s ability to woo and retain customers in the cut-throat fashion and clothing retailing industry enabled the leading-edge store chain to anticipate its customer’s needs and to offer them special promotions before they become available to the general buying public. Nordstrom’s focus on superior customer service has, until recently, allowed the firm to sell top-of-the line brands that offer a much higher margin than brands targeted to the middle market.

Disadvantages of Differentiation

1. A big disadvantage associated with differentiation is that other firms may attempt

to “out differentiate” firms that already have distinctive products by providing a similar or better product. Thus, differentiation strategies, while effective in generating customer loyalty and higher prices, do not completely seal off the market form other entrants. Consider the market for steak sauces in the food industry. Once a competitor develops a particular flavour of steak sauce, its rivals can easily meet that challenge with their own offerings. In fact, excessive product proliferation can even hurt a firm’s attempt to dedifferentiate, since customers may become confused with the wide variety of offerings. For example, H.J. Heinz’s recent moves to offer ketchup with different coolers may have backfired, as some buyers are turned off by the prospect of putting purple or green ketchup on their French fries. The attempt to out-differentiate another rival’s moves occurs frequently in the radio broadcasting industry. Frequently, a station will adopt a format that emphasizes a particular theme; oldies, light rock, rock form the 1970s, pop, easy listening, country, or Top 40. However, the initial gains that any given station makes are difficult to sustain, because competing stations can dilute this message with their own variation of a theme. Most recently, some radio stations are attempting to reach a previously underserved market segment, such as the growing Hispanic or African American audience. Companies such as Radio One are buying stations in different parts of the country that have a strong African American presence. Radio one hopes that its distinctive music offerings and programs will enable it to capture a disproportionate share of advertising dollars of product that target the African American market. Thus, unless differentiation is based on the possession of some truly proprietary technology, expertise, skill, service, patent, or specialized asset, a firm runs the risk of being outmanoeuvred by an even shrewder competitor.

2. Another disadvantage of differentiation is the difficulty in sustaining a price premium as a product becomes more familiar to the market. As a product becomes more mature, customers become smarter about what they want, what genuine value is, and what they are willing to pay. Price premiums become difficult to justify as customers gain more knowledge about the product. The comparatively high cost structure of a firm practicing differentiation could become

a real weakness when lower-cost product imitations or substitutes hit the market. Consider, for example, the recent travails that beset Callaway Golf. Despite the enormous popularity of its Big Bertha golf club design that made swinging and higher ball easier, Callaway golf was unable to sustain a huge market share position in the golf equipment business because other competitors eventually followed with similar, but somewhat different, designs or variations on the same theme. Even existing golf equipment providers, such as Wilson innovated their own sets of large-head golf clubs that eroded Callaway's once-distinctive identity in the marketplace. Callaway's differentiation strategy yielded fewer benefits as new entrants seized the initiative away from the innovator and started producing similar clubs at lowercost.

3. Differentiation also leaves a firm vulnerable to the eventual “commoditization" of its product/service offering or value concept when new competitors enter the market or when customers become more knowledgeable about what is available. Over time, firms that are unable to sustain their initial differentiation-based lead with future product or service innovations will find themselves at a significant, if not dangerous, cost disadvantage when large numbers of customers eventually gravitate to those firms that can produce a similar product or service at lower cost.
4. Finally firms also face risks of overdoing differentiation that may overtax or overextend the firm's resources. For example Nissan Motor of Japan during the past decade became so obsessed with finding new ways to differentiate its cars that it produced more than thirty types of steering wheels for its line of cars and a broad line of engine, all of which eventually confused customers and made manufacturing costly. Nissan recently announced a sharp reduction in the number of steering wheel sizes, optional accessories, and other features in its cars to lower its operating cost. In 2000, Nissan reduced the number of core automobile platforms to seven in order to reduce the high cost of overlap and design. Excessive differentiation can seriously erode the competitive advantage and profitability of firms as rising operating costs eat into price premiums that customers are willing to pay.