



## Cost vs Differentiation strategies

Successful companies are defined either as having a “Cost Advantage” strategy or a “Differentiation” strategy, or even better a combination of the two.



This knowledge paper is supportive of Procurement professionals operating at Managerial level of the CIPS Global Standard



CIPS members can record one CPD hour



## Cost vs Differentiation strategies

### Definitions

Successful companies are defined either as having a “Cost Advantage” strategy or a “Differentiation” strategy, or even better a combination of the two.

A **Cost Advantage strategy** gives a lower cost profile to specific products or services than competitor companies.

A **Differentiation Advantage strategy** provides an ‘added value’ advantage over competitive offerings.

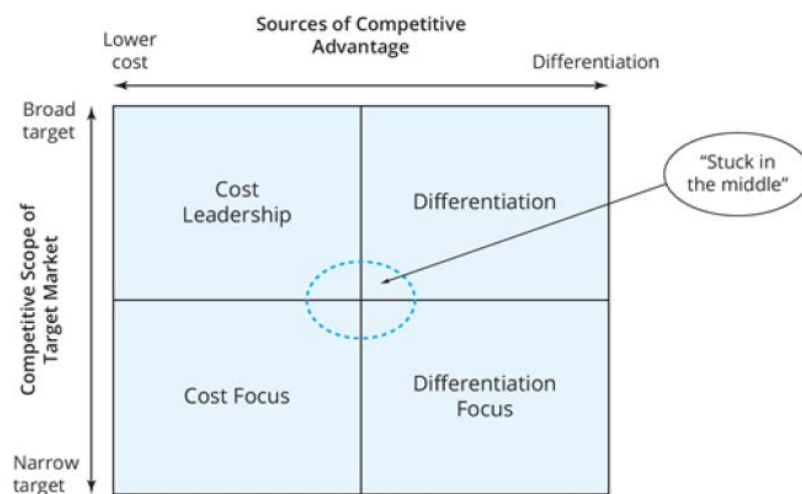
A **Competitive Advantage** in business is found firstly in the ability of an organisation to operate at a lower cost and therefore a greater profit than their competitors or to differentiate themselves positively or uniquely, in the eyes of the customer, from the competition and thereby attract a defined share of the market.

A third approach, a **Focus strategy**, involves achieving Cost or Differentiation Advantage within niche markets in ways that are not available to more broadly focused players. A Focus strategy aims to retain customers through creating an almost personal offering.

### Porter’s Model for Generic Strategies for Competitive Advantage

Michael Porter, Professor at Harvard Business School, developed a Generic Strategies model for Competitive Advantage. He describes three basic strategic options available to organisations for gaining competitive advantage. These are Cost, Differentiation and Focus Strategies.

## Porter's Generic Strategies Model



*Porter's generic strategies model (Source: Porter, M.E. (1980). Competitive Strategy: Techniques for Analysing Industries & Competitors. The Free Press, NY)*

The choice of which strategy a business should pursue underpins every other strategic decision that is made, so it is worth spending time to get it right.

Porter warns that businesses should adopt just one strategic approach and not get caught in two camps or the direction can become diluted and the execution muddled. Cost leadership requires a very detailed internal focus on processes. Differentiation on the other hand, demands an outward-facing, highly creative approach. Convergent thinkers look for 'the one' solution that drives to lower costs. Divergent thinkers look for 'many solutions' that lead to creative ways to win and retain customers.

### Cost Leadership Strategy

Cost Leadership is based on the idea of gaining efficiency, exploiting economies of scale and reducing the overall cost structure. This way the business can offer to the market products that are cheaper than its rivals and gain competitive advantage.

With this strategy, the objective is to become the **lowest-cost producer in the industry**. The strategy is usually associated with large-scale businesses offering 'standard' products with relatively **little differentiation** that are readily acceptable to the majority of customers.

Organisations that achieve Cost Leadership can benefit either from gaining market share through lowering prices (whilst maintaining profitability) or by maintaining average prices and therefore increasing profits.

A strategy of cost leadership requires close cooperation between all internal functional areas of a business. They need to show:

- High levels of productivity
- High capacity utilisation
- Use of bargaining power to negotiate the lowest prices for production inputs
- Lean production methods such as Just in Time.
- Effective use of technology in the production process
- Access to the most effective distribution channels

The greatest risk in pursuing a cost leadership strategy is that the sources of cost reduction are not unique to you and that other companies can copy your cost reduction strategies. That is why it is important to find ways of reducing cost at every opportunity.

For example, costs can be reduced by re-thinking your logistics – outsourcing to a third party provider (or now a 4<sup>th</sup> party provider). Training costs can be cut by providing in house tuition or online training. Staff costs can be reduced by hiring less expensive staff or making non-essential staff redundant. Changes to the energy type or the supplier can reduce heating and lighting costs.

The 'no frills' airline operators have opted to cut costs to a minimum in these ways and pass their savings on to customers in lower prices and thereby increase their market share. In contrast, the

luxury airlines focus their efforts providing service extras and the higher prices they can command as a result make up for their higher cost of the service.

### **Differentiation Leadership Strategy**

In contrast to the 'no frills' approach, the luxury airlines focus their efforts providing service extras such as dedicated waiting lounges and full catering services. This differentiates them in the market and the higher prices they can command as a result make up for their higher cost of the service.

In this way, companies that pursue a Differentiation strategy win market share by offering unique features that are valued by their customers. The chosen product is purchased not for itself but for what it can 'deliver' for you. These benefits may be intangible such as brand image, range of products, innovation or customer care.

Customers are also becoming more service sensitive particularly with omnichannel provision and many companies have focused on service as a means of gaining differentiation and a new competitive edge. This enhanced service offering can take many forms – flexible delivery services, after-sales services, financial packages, technical support, and easy returns service, range of choice or colours, 24-hour helplines, 24-hour opening.

To make a success of a Differentiation strategy, organisations need:

- Good research and development, continuous improvement and innovation
- The ability to deliver high-quality products or services
- Effective sales and marketing so that the market understands the benefits offered by the differentiated offerings.
- Dedication to improving customer service by providing focus groups and feedback opportunities

The risk in large organisations pursuing a differentiation strategy is the threat of copycat attacks by competitors, so product development processes need to stay agile and innovative.

### **Focus Strategy**

Focus strategies involve achieving Cost Leadership or Differentiation within niche markets in ways that are not available to more broadly focused players. It often exploits knowledge or expertise that can be used or developed to add value to the customer that isn't available to broad market competitors.

Companies that use Focus strategies concentrate on particular niche markets and by understanding the dynamics of that market and the unique needs of the customer within it, develop uniquely low cost or well-specified products. Because they serve customers in the market uniquely well they tend to build strong brand loyalty amongst their customers. This may make their particular market segment less attractive to larger competitors.

For example, Betabrand, the women's clothing start-up, releases a few limited edition designs every week for pre-order. Customers can vote on their favourites, building brand loyalty and in this way, they receive constant demand data and customer feedback. They have reduced the risk of carrying

excess inventory and eliminate waste so they can maintain optimum pricing. They have a cost advantage and a differentiation advantage in a niche market.

SUMMARY OF COMPETITIVE ADVANTAGE CHARACTERISTICS
Cost Leadership Characteristics
High Levels of Productivity
High Capacity Utilisation
Use of negotiation to reduce cost of inputs
Lean Production methods e.g. JIT or Lean
Effective use of technology
Access to most effective distribution channels
Differentiation Leadership characteristics
Developing a 'uniqueness' that cannot be easily replicated
Good research and development and innovation
Effective sales and marketing so that the market understands the benefits
Agile approach to stay ahead of copycat competitors
Strong customer engagement messages to retain loyalty
Focus characteristics
Exploits knowledge or expertise that isn't broadly available in the market
Designs uniquely low cost or well specified products
Build strong brand and customer loyalty

### Hybrid approaches to cost and differentiation

Despite Porter's warning about adopting just one strategic approach and not trying to do both, recent contemporary research has shown evidence of successful forms of 'hybrid strategy'. The research has challenged Porter's concept of mutual exclusivity of low cost and differentiation strategies and argues that a successful combination of these two strategies can lead to sustainable competitive advantage.

P Wright in *A Refinement of Porters Strategies*, argues that in the 1980s where the business environment was relatively stable there was no need for flexibility in business strategy. However, in today's highly unpredictable market conditions, flexibility is what is required to face any contingency and therefore the price/differentiation exclusivity may be too rigid to get the best from changing conditions where rapid reactions and innovation are both required.

Charles W L Hill in *Differentiation versus Low Cost or Differentiation and Low Cost: A Contingency Framework* argues that a contingency framework in which differentiation can be a means for firms to establish an overall low-cost position is possible and even desirable in some cases to sustain competitive advantage.

Porter did revise his thinking subsequently and accepted the fact that hybrid strategies could exist and be successful in certain market conditions.

Other refinements on these approaches can be found in Bowman's Strategic Clock which develops the next level of detail and splits Porters options into 8 sub-strategies.

### The Application of cost and differentiated strategies in the Supply Chain

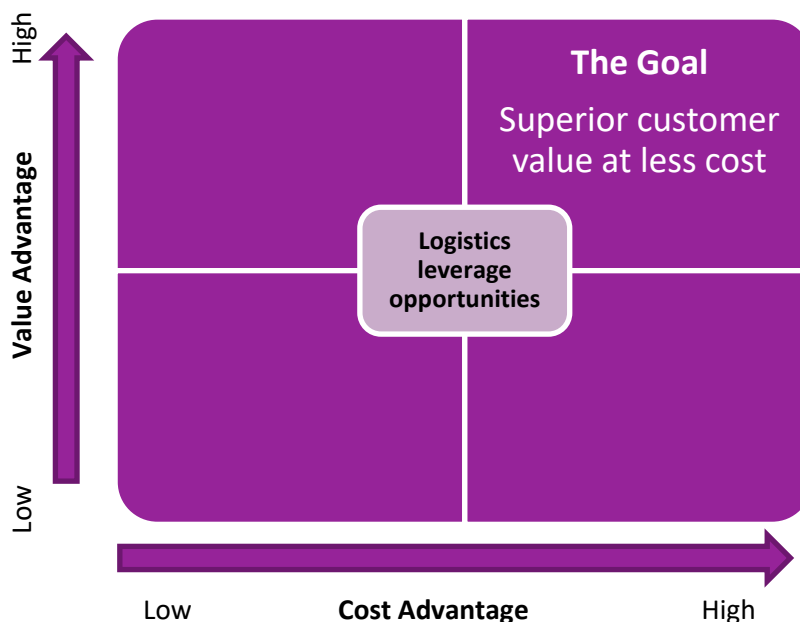
An increasingly powerful route to achieving a cost advantage comes not necessarily through volume and economies of scale but instead through logistics and supply chain management. In many industries, logistics costs represent such a significant proportion of total costs that it is possible to make major cost reductions through fundamentally re-engineering logistics processes.

In today's world, much of the cost of a product lies outside of the business, in the wider supply chain. It is increasingly through better logistics and supply chain management external to the company, that efficiency and productivity can be achieved, leading to significantly reduced cost.

In *Logistics and Supply Chain Management, 5<sup>th</sup> edition*, Professor Martin Christopher argues that "A position of enduring superiority over competitors in terms of customer preference may be achieved through better management of the logistics and supply chain."

Those companies that have been able to establish a Differential Advantage over their competitors through service excellence are typically those companies where logistics management is a high priority. Xerox, Zara and Dell are typical of such organisations. The attainment of service excellence in this broad sense can only be achieved through a closely integrated logistics strategy.

### Logistics Leverage Opportunities



Source: *Logistics and Supply Chain Management 5<sup>th</sup> edition* by Martin Christopher

with lower prices and a young customer base, the other with higher pricing and a more mature **Cost Advantage Leverage** – Improved Capacity utilisation; Inventory reduction; Closer integration with suppliers

**Value Advantage Leverage** – Tailored customer services; Reliability; Responsiveness

“The challenge of management is to identify appropriate logistics and supply chain strategies to take the organization to the top right-hand corner of the matrix. This position is extremely difficult for competitors to attack... the goal is to link the marketplace, the distribution network, the manufacturing process and the procurement activity in such a way that customers are serviced at higher levels and yet lower cost.”

### Case Studies

The three approaches below show the difference in Cost versus Differentiation strategy in the international cosmetics supply market.

Both Lush and L’Occitane have invested heavily in the instore experience across the globe as part of their differentiation strategy, one and traditional clientele. Their ethical roots and instore experience is key to their differentiation strategy and successful customer retention.

NYX began as an online supplier only. The price of cosmetic products in online cosmetic stores is always lower than the physical store. Suppliers can take advantage of the e-commerce market to gain more profitability. Online retailers have to try and re-create the same ‘brand memory’ without the physical presence of the item. Technology helps them achieve this. Smartphones and tablets are used to shop and research and brands must be aware of these and social media platforms to ensure that they stay in touch and keep up with their ‘virtual’ customers.

For some online cosmetic retailers, this is done through increasing use of QR codes and Augmented Reality tools. These can re-create the personal touch at a fraction of the cost, allowing products to be accessible but the prices kept very low. The use of online make-up sessions with demonstrations from celebrities in a ‘blogging style’ also helps generate an ‘in-person’ feel without the in-person costs of premises and staff. This produces a powerful source of competitive advantage. The online retailers have a price advantage over the high street based retailers and can exploit their resources and capabilities to achieve a higher rate of return. However, the risk is that their customer base may not remain loyal and may move to another online retailer if the prices or the ‘deal’ is better.

It is interesting to note that having established its cost advantage in the online marketplace, NYX, after being bought out, went on to establish a differentiated offering too.

### Author



*Susan has worked in corporate industry within procurement for many years, undertaking everything from expediting, through contract negotiation, to strategy development and large scale change management initiatives.*

*She is now focusing on project procurement, commercial training, coaching and technical authoring through her own business.*

*Susan is a great contributor to CIPS and has been involved with CIPS through her chairmanship of the Birmingham branch and participation in the annual Negotiation Challenge events.*

**Susan Randall (BA FCIPS Chartered)**



[LinkedIn](#)



