



Creating Competitive Advantage

**Developing a Roadmap for
Sustainable Performance**

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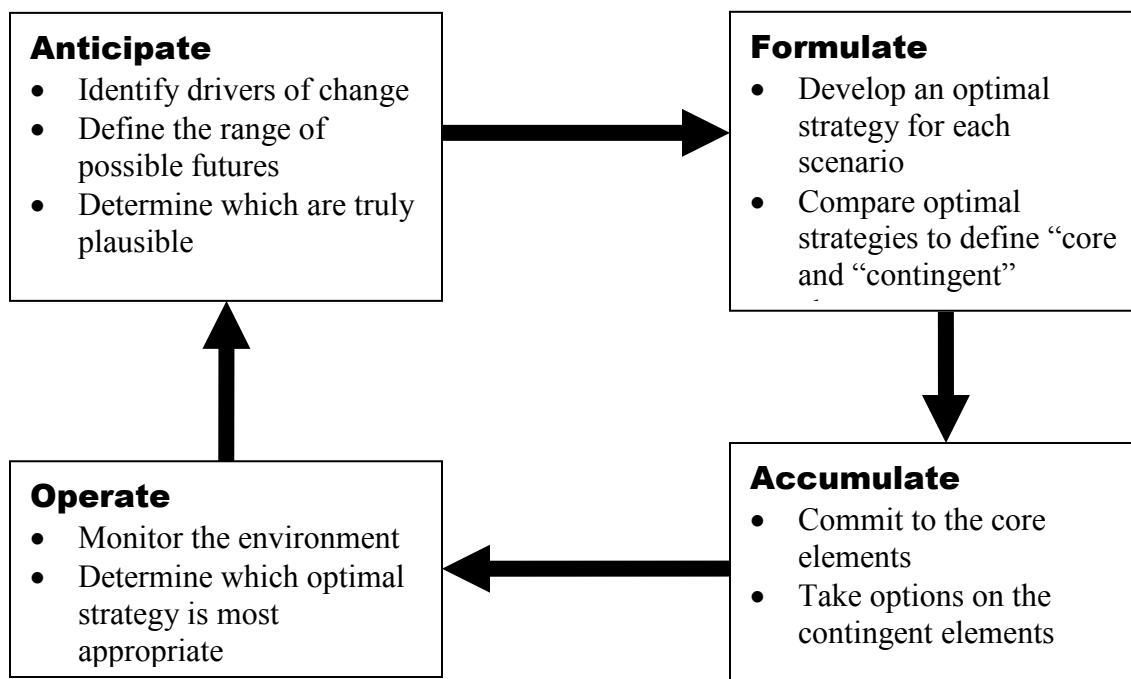
Strategic Flexibility Model

from *The Strategy Paradox*

Strategic Flexibility Model - four phases:

- **Anticipate:** Build scenarios of the future
- **Formulate:** Create optimal strategy for each of those futures
- **Accumulate:** Determine what strategic options are required
- **Operate:** Manage the portfolio of options.

We can define “Flexibility” as “change within existing constraints.” Strategic uncertainty demands strategic flexibility. Strategic Flexibility consists of four inter-related components:



Anticipate: How to build the scenarios and be sure that you have accounted for all the relevant uncertainties.

Formulate: How to create optimal strategies and identify the core and contingent elements.

Accumulate: How to create real options and ensure they remain valuable.

Operate: How to “exercise” or “abandon” the real options you have created and how to value them

Core Elements: Elements common to many of the optimal strategies.

Contingent Elements: Elements common to only a few optimal strategies or unique to one optimal strategy.

By committing to the core elements and taking options on the contingent ones, the senior executives can create the ability to implement the most appropriate strategy regardless of which anticipated future ultimately materializes.

Strategic Flexibility

An organization creates strategic flexibility when it defines scenarios as “specific and full blooded descriptions of different futures.” Creating scenarios is a five-step process:

Step #1: Ask the right question. Don’t ask “yes” or “no” sorts of questions like: “Should we build a plant in China?” Instead, ask questions such as:

- What are the underlying business models that will make sense?
- What will the balance of power be between the different stakeholders? How might this affect the viability of different ways of creating and capturing value?
- Do we have an opportunity to create valuable exposure to a new and compelling strategic opportunity?
- Should we broaden our company’s strategic scope to be able to include this new strategic opportunity?
- What time horizon is appropriate to take a set of scenarios into account?
NOTE: The time horizon considered should be far enough out to capture strategic uncertainty and certainly beyond the horizon of traditional strategic plans, which tend to be too rooted in today’s circumstances.

Step #2: Identify the dimensions of uncertainty. Often companies do this “bottoms up” by clustering individual variables into dimensions. Alternately, the organization can do it top down by decomposing overall strategic uncertainty into specific dimensions. A dimension of uncertainty tends to be beyond our control, e.g. macro-economy, technology or regulations.

Step #3: Determine the limits of uncertainty. Examples: How far might technology advance? How radically different could the sociopolitical landscape be? How robust or depressed might the overall level of economic activity be? At

this stage, do NOT look for consensus but, instead, look for divergent opinions. The possibility space lies between “entirely feasible” and ludicrous.”

Step #4: Determine the Final Scenario Set. A scenario lies at the intersection of the extreme values of the dimensions of uncertainty. It is possible to identify all such intersections using a “truth table.”

Step #5: Determine the relative possibilities. This should be a contentious process. If a consensus emerges around ONE possible future when at first one existed, management will have created the problem of unjustified confidence about what lies ahead.

The result is that senior leadership will create strategic flexibility by assembling a portfolio of real options on assets and capabilities that allow the operating divisions to change their strategies in ways they could not if left to their own devices. Management must now decide to invest in core elements or take options on contingent elements, depicted in the Strategic Flexibility Matrix as follows:

Managing the Options Portfolio

Once the organization has taken options on various future scenarios, there are three choices to manage the portfolio: Preserve the option, exercise the option, or abandon the option.

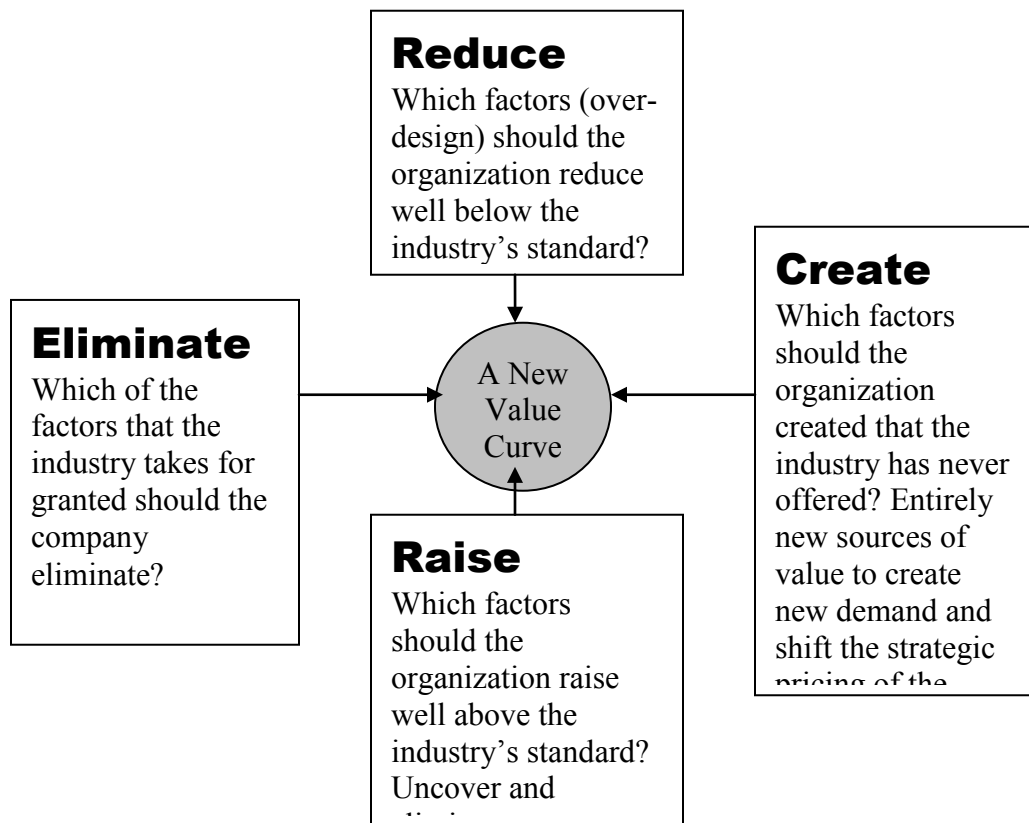
- **Preserve:** A financial option is valid for the period specified in the option contract, and the holder of the financial option need do nothing to maintain its validity during that time. Holding the right kinds of strategic options creates value indirectly by mitigating strategic risk.
- **Exercise:** This involves integrating the target company or some subset of its resources and capabilities with all or part of the original company’s operations in a manner that allows the original company to pursue a new strategy. In other words, exercising the option allows the organization to change its strategy in a way that it otherwise could not.
- **Abandon:** People usually view walking away from an option as a “failure.” This attitude creates a psychological barrier to abandoning options by exacerbating the impact of the “sunk cost effect,” i.e. the propensity of manager to continue to invest if they already have made an investment. Ironically, in the context of strategic options, if the initial

investment requires a commitment to subsequent investments, then the option is not an option at all.

Four Actions Framework

From *Blue Ocean Strategy*

The Four Actions Framework, four key questions to challenge an industry's strategic logic and business model:



The Eliminate-Reduce-Raise-Create-Grid pushes companies to ask all four questions in the four actions framework also forcing them to ACT on all four to create a new value curve.

An effective blue ocean strategy has three complementary qualities:

- **Focus:** the company does not diffuse its efforts across all key factors of competition
- **Divergence:** The value curve is different than the competitors not because of benchmarking competitors but by looking across alternatives
- **Compelling Tagline:** A quick, simple statement that adequately explains the value to customers

Strategy Formulation Principles

From *Blue Ocean Strategy*

Formulation Principle #1: Reconstruct Market Boundaries

The challenge here is to identify commercially compelling blue ocean opportunities out of all possibilities that exist. The more companies in an industry share the same “conventional” wisdom about how they compete, the greater the competitive convergence among them. Instead, blue ocean managers look across boundaries, across alternative industries, across strategic groups, across buyer groups, across complementary product and service offerings and across the functional emotional orientation of an industry and across time. There are six basic approaches to remaking market boundaries, known as the **Six Paths Framework**:

Path 1: Look across alternative industries

Path 2: Look across strategic groups within the industry

Path 3: Look across the chain of buyers

Path 4: Look across complementary product and service offerings

Path 5: Look across functional or emotional appeal to buyers

Path 6: Look across time

Path 1: Look across alternative industries. What are the alternative industries to your industry? Why do customers trade across them? EXAMPLE: The software, the CPA and the pencil are largely substitutes for each other when it comes to preparing financial statements. They have very different forms but serve the same function: Helping people manage their financial affairs. Think in terms of how your customers make trade-offs across alternative industries. By focusing on the key factors that lead buyers to trade across alternative industries and eliminating or reducing everything else, you can create blue ocean market space.

Path 2: Look across strategic groups within industries. What are the strategic groups in your industry? Why do customers trade up for the higher group and why do they trade down for the lower one? Strategic groups are a “group of companies within an industry that pursue a similar strategy.” Industry analysts generally rank strategic groups in a rough hierarchical order built on price or performance. Most companies focus on improving their

competitive position within a strategic group, e.g. luxury car strategic group or economy car strategic group.

Example Curves, the women's fitness company, built on the decisive advantages of two strategic groups in the U.S. fitness industry: traditional health clubs and home exercise programs. They eliminated or reduced everything else. Toyota's Lexus brand carved out a new blue ocean by offering the quality of the high end Mercedes, BMW and Jaguar at a price closer to the lower end Cadillac and Lincoln.

Path 3: Look Across the Chain of Buyers. What is the chain of buyers in your industry? Which buyer group does your industry typically focus on? If you shifted the buyer group of your industry, how could you unlock new value? The "chain of buyers" consists of three inter-related parties:

- **Purchasers:** Those who pay for the product or service but may not actually USE the product or service, e.g. wholesalers or distributors
- **Users:** Those who actually are the end recipient and user of the product or service
- **Influencers:** Those who help influence the decisions of purchasers or users, e.g. doctors influencing their patients to use certain types of medication manufactured by the pharmaceutical companies.

Challenging an industry's conventional wisdom about which buyer group to target can lead to the discovery of new blue ocean. EXAMPLE: Novo Nordisk, the Danish insulin producer, began to focus directly on the user of insulin vs. the influencer, i.e. the Doctors. As a result, they invented the NovoPen, the first user-friendly insulin delivery solution, designed to remove the hassle and embarrassment of administering insulin. This transformed the company from being an insulin producer to a diabetes care company.

Path 4: Look Across Complementary Product and Service Offerings. What is the context in which your product or service is used? What happens before, during, and after the purchase? Can you identify the pain points? How can you eliminate these pain points through a complementary product or service offering?

Example: NABI, a Hungarian bus company. Most municipalities purchase buses for their public transportation system strictly based on

lowest price, i.e. the initial purchase price. By doing so, over time, the designs were outdated, there were late delivery times, low quality and, in many cases, higher total cost of ownership after considering repairs and maintenance cost. NABI looked beyond initial cost and realized that most municipalities kept busses running at least 12 years. Therefore, they needed a longer-term view. They decided to manufacture their buses out of fiberglass, thus differentiating their busses in four ways: (1) Fiberglass substantially cuts the cost of preventative maintenance because it is corrosion free. (2) Body repairs were faster, cheaper and easier. (3) The busses lighter weight (30-35% lighter than steel) saved on fuel consumption and emissions making the bus environmentally more friendly. (4) The lighter bus weight allowed NABI to use lower powered engines, fewer axles resulting in lower manufacturing costs and more space inside the bus.

Path 5: Look Across Functional or Emotional Appeal to Buyers. Does your industry compete on functionality or emotional appeal? If you compete on emotional appeal, what elements can you strip out to make it functional? If you compete on functionality, what elements can you add to make it emotional?

Example: Starbucks turned the coffee industry on its head by shifting its focus from commodity coffee sales to the emotional atmosphere in which customers enjoy their coffee. Conversely, some relationship businesses such as insurance, banking and investing have gone to a more functional approach. Direct Line Group, a U.K. insurance company, has done away with traditional brokers. It determined that customers would not need the handholding and emotional comfort that brokers traditionally provide if the company did a better job of paying claims rapidly and eliminating complicated paperwork.

Path 6: Look Across Time. What trends have a high probability of affecting your industry, are irreversible, and are evolving in a clear trajectory? How will these trends affect your industry? Given this, how can you open up unprecedented customer utility?

EXAMPLE: Apple observed the flood of illegal music file sharing beginning in the late 1990's AND the trend toward digital music. Apple capitalized on this decisive trend with a clear trajectory by launching the iTunes online music store in 2003. iTunes offers legal, easy to use and flexible a la carte song downloads. By allowing people to buy individual

songs and strategically pricing them far more reasonably, iTunes broke a key customer annoyance factor, i.e. the need to purchase an entire CD when all they wanted were one or two songs.

From Head-to-Head Competition to Blue Ocean Creation

	Head-to-Head Competition	Blue Ocean Strategy
Industry	Focus on rivals within the industry	Look across alternative industries
Strategic Group	Focus on competitive position within the strategic group	Look across strategic groups within the industry
Buyer Group	Focus on better serving the buyer group	Redefine the industry buyer group
Scope of Product or Service Offering	Focus on maximizing the value of product and service offerings within the bounds of the industry	Look across to complementary product and service offerings
Functional – Emotional Orientation	Focus on improving price performance within the functional-emotional orientation of the industry	Rethink the functional-emotional orientation of its industry
Time	Focus on adapting to external trends as they occur	Participate in shaping external trends over time

Formulation Principle #2: Focus on the Big Picture, Not the Numbers

So once you understand the six paths to create a blue ocean strategy, how to align your strategic planning process to focus on the big picture and apply these ideas? Research indicates that most company’s current strategic planning processes keep them wedded to red oceans. The process tends to drive companies to compete within existing market space. The Planning Team spends most of its time filling in boxes and running numbers instead of thinking outside the box and developing a clear picture of how to break from the competition. Therefore, few strategic plans lead to the creation of blue oceans or specific actions. Drawing a strategic canvas for your business accomplishes three things:

1. It shows the strategic profile of an industry by depicting very clearly the factors (and possible future factors) that affect competition among industry players

2. It shows the strategic profile of current and potential competitors, identifying which factors they invest in strategically
3. It shows the company's strategic profile (value curve) depicting how it invests in the factors of competition and how it might invest in them in the future.

Formulation Principle #3: Reach Beyond Existing Demand

Where is your attention: On capturing a greater share of existing customer OR on converting non-customers of the industry into new demand? Do you seek out key commonalities in what buyer's value or do you strive to embrace customer differences through finer customization and segmentation? How do you maximize the size of the blue ocean you are creating? Answer: Challenge two conventional strategy practices:

- **Focus on existing customers.** Most companies try to grow by retaining and expanding existing customers. This practice often leads to finer market segmentation and greater tailoring of offerings to better meet customer preferences
- **Drive for finer segmentation to accommodate buyer differences.** The more intense the competition, usually the greater the offering customization. The risk is that you create too small target markets.

To grow the size of the blue ocean, take the opposite course. Do not concentrate on existing customers but look to non-customers. Instead of focusing on customer differences, build on powerful commonalities in what buyer's value. To reach beyond existing demand, think non-customers before customer; commonalities before differences; desegmentation before pursuing finer segmentation.

Formulation Principle #4: Get the Strategic Sequence Right

The next challenge is to build a robust business model to ensure profits from the blue ocean idea. The sequence of blue ocean strategy is as follows:

- **Buyer Utility:** Is there exceptional buyer utility in the new business idea? Is there a compelling reason for the mass of people to buy it?

- **Price:** Is the proposed price easily accessible to the mass of buyers?
- **Cost:** Can the company attain the cost target to profit at the strategic price?
- **Adoption:** What are the adoption hurdles to actualize the business idea and are you addressing those up front? Examples of adoption hurdles may be resistance on the part of retailers or partners.

If the answer to all the above questions is “yes,” then you have a commercially viable blue ocean idea. In addition, use answers to above questions to compare your new product idea against incumbent offerings to see where you have advantage and disadvantages.

Exercise #1: Is it Time to Change (Modify) Your Strategy?

Do any of the following “warning signs” relate to your organization? What specific examples can you think of in these areas pertinent to your organization?

- **When you begin to see low-end customer segments, deemed as unattractive and not profitable, disappear.** This may indicate a shift in technology, which allows new competitors to enter the market place and take these customers and make money on them. Example: Charles Schwab erased years of market dominance by Merrill Lynch in a short time by opening on line trading.
- **When you see sudden changes in customer defection rates.** Customer satisfaction surveys are useful BUT number of defections reflects actual consumer behaviors and stand as the true indicator of customer satisfaction.
- **When there is erosion of micro-segments.** An under-served micro-segment of a customer base may disappear if a new competitor offers a superior and targeted model. Example: CNN taking viewership away from CBS News.
- **When traditional business boundaries disappear.** Example: Xerox market for reproduction continues to erode as digital imagery technology continues to expand.
- **Competitive Changes:** Is a new competitor beginning to gain surprisingly rapid market share in a marginal segment of your business that you once controlled? Example: Walmart gaining huge market shares in commodity grocery item sales, previously controlled by traditional grocery stores.
- **Value Chain Changes:** Are specialists now unbundling and controlling steps in the value chain you once considered core? Examples: In the high tech world, specialists in India are unbundling software development from the rest of a company’s business and offering it cheaper. McDonald’s introduced centralized call centers in Arizona to take orders delivered locally at each store.

- **Customer / Market Changes:** Are there fast growing customer segments that you might once have been able to serve but now cannot without adding a new capability? Example: Manufacturers of “Walkman” CD players now losing market share to customers who want music to be delivered by MP3 players or iPods.
- **Other Changes:** Other changes affecting your industry not specifically addressed in above points. Please be specific.

Exercise #2: Scenario Planning

If you determine that your core strategy needs to change, then your company may need scenario planning. Some examples of “What if” scenarios as follows:

1. **What if your risk profile shifts dramatically?** Act now to spread that potential risk or buy it down (e.g. through insurance).
2. **What if demand suddenly falls off?** Could you quickly find allies who could help you consolidate the industry and save jobs?
3. **What if global events disrupt your supply chain?** What special things could you do to either find alternate suppliers or speed up distribution and delivery to offset the disruption (e.g. airfreight vs. ground delivery)?
4. **What if prices drop precipitously?** In difficult times, the low cost producer sets the price thereby controlling the level of competitors’ profit margins. Constantly scrutinize your purchasing costs and cycle times relative to competitors to detect inefficient processes and then fix them.
5. **What if a global recession hits?** Never in recent history have economies been so closely in step with each other. This increases the odds of a synchronized global recession. Do you have the cash reserves to help consolidate your industry and save jobs? Have you evaluated which competitors you should acquire based on your core business? Have you identified where you can cut costs without cutting the heart of your business?
6. **Conclusion - Most importantly, protect your core assets.** Do not take your core business for granted. Reinforcing the core assets helps recession proof your company. Over the course of a business cycle, the profitability of weak businesses or companies (as measured by margins or return on capital) can be two to three times less than that of strong businesses in the same industry. How will you protect your core assets?

Exercise #3: How to Re-Define Your Business¹

1. List all possible definitions of the business (for example, BMW is in the car business, the prestige car business, the transportation business, the ego business, the business of satisfying the transport needs of yuppies, the driving business, the engineering business, the up-market global car business, and so on). Make the list as long as possible.

2. Evaluate each definition according to a series of criteria. If we define our business as X, who are the customers and what do they need? Who are our competitors? Can we satisfy these customer needs in a unique or better way relative to our competitors? Is our definition of the market attractive? (i.e., growing in the future, protected by barriers, and so on) What will be the key success factors in this business? Can we deliver? How do our competitors behave and what does that imply about how they have defined the business? Does this definition allow us to satisfy our personal objectives for this company? Use the same questions to evaluate every possible definition. The goal is to identify the definition that gives your company maximum leverage relative to competitors.

3. Choose one definition. This is a crucial step. Making a choice implies certain follow-up decisions, for example, that the company will invest in certain products or certain country subsidiaries and not in others. It also implies that certain managers will lose out in the next budget round and others will win. Because of the serious implications that this decision entails, most companies fail to choose a definition.

4. Ask these questions: If our competitor redefined the business, what strategy would it be following? How can we prepare for it?

¹ Markides, Constantinos, "*Strategic Innovation*," Sloan Management Review, Spring 1997.

Exercise #3: How to Re-Define Your Business

Definitions of Your Business	Who are the Customers?	What are the Customer Needs?	Who are the competitors?	Can We be Unique or Better? How?

Exercise #3: How to Re-Define Your Business

Definitions of Your Business	Is the Market Attractive?	What are the Key Success Factors?	Can we Deliver on these success factors?	Does this definition satisfy our personal objectives for our business?

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