

## CHAPTER 2

### LITERATURE REVIEW

#### 2.1 Introduction

Strategically competitive organization in the 21<sup>st</sup> century are those that select and implement business level strategies with the purpose of solving customers' problems with the goods or services they sell and remain focused on the need to innovate continuously, even when their current offerings are selling well. Business level strategy reflects a firm's belief about where and how it has advantage over its rival. The essence of firm's business-level strategy is choosing to perform activities differently or to perform different activities than rivals (Hitt et al., 2001). Michael Porter's theory of business-level generic strategy contains two elements, first a scheme for describing firms' competitive strategies according to their market scope, focused or broad, and their source of competitive advantage, cost or differentiation (Swink & Hegarty, 1998).

#### 2.2 Business-level Generic Strategies

Led by Porter (1980, 1985), the focus shifted from strategic planning to strategic management and a broad range of concepts and frameworks evolved aimed at building and sustaining competitive advantage by anticipating and exploiting business opportunities. Porter presented three generic strategies for improving the competitive advantage of a firm: cost leadership, differentiation, and focus (Porter, 1985).

Empirical evidence suggested wide spread application of Porter's generic strategy model throughout various industries such as in the healthcare industry

(Hlavacka, Bacharova, Rusnakova & Wagner, 2001), steel and cardboard industries (Calori & Ardisson, 1988), adhesive and sealant industry (Helms, Dibrell & Wright, 1997) and crystal glass industry (Marques, Lisboa, Zimmerer & Yasin, 2000). Various activities within a business firms value chain were aligned to the generic strategies approach such as time-based differentiation (Jacome, Lisboa & Yasin 2002), vendor development (Chakraborty & Philip 1996), manufacturing (Kotha & Vdlamani, 1995; Kotha & Orne, 1989), product differentiation (Swink & Hegarty, 1998), quality differentiation (Beal & Lockamy III, 1999) and marketing (Dawes & Sharp, 1996). Even in the Malaysian context, a study by Khairuddin (2000) identified 30% of the small and medium enterprises (SMEs) in Malaysia followed the differentiation strategy while 26% adopted the cost leadership strategy.

Each of the generic strategies involves a fundamentally different route to competitive advantage, combining a choice about the type of competitive advantage sought with the scope of the strategic target in which competitive advantage is to be achieved. Each implies different skills and requirements or success, which commonly translate into differences in organisation structure and culture. Competitive advantage can be achieved through the value chain, a template that a firm uses to understand its cost position and the existing and potential sources of differentiation. The value chain is also used to identify the multiple means that might be used to facilitate the implementation of business-level strategy (Porter, 1985 pp11 –38).

The value chain, which is segmented into primary and support activities are composed of nine generic categories of activities, linked together in characteristic ways. Five of the generic categories are primary activities namely inbound logistics, operations, outbound logistics, marketing and sales and finally service. The other four categories are known as the support activities that support the primary activities such as procurement, technology development, human resource management and firm infrastructure. Firms competing in the same

industry sector are likely to have a similarly configured value chains. However, the differences that exist in the value chain of the firms will determine the potential competitive advantage (Porter, 1985 pp 38 -39).

Chakraborty and Philip (1996) explain the basic dichotomy that exists between the differentiation and cost leadership strategies is the relationship between price, cost and profits. Although, both strategies focus on profits, which are the difference between price and cost, their approaches to improve profits are different. Profits are improved in cost leadership by having the lowest cost position, while they are improved in differentiation by providing the customer with something, which he perceives to be unique, and will pay a premium price for the same.

### **2.3 Cost Leadership Strategy**

Cost leadership means that the firm achieves or seeks to achieve the status of lowest-cost producer or supplier to its market. The lowest-cost producer has the ability to price below competitors but, while this provides a cushion in times of severe price competition, to do so gives away the profit margin advantage that is available. A cost leader may accept average market prices, i.e. it can maintain price parity with its competitors and this will lead to superior profitability. Pursuit of a cost-leadership strategy may frequently require a strong focus on cost management, economies of scale and experience curve cost advantages through maintenance of volumes (Porter, 1985 pp12 – 13).

If a lowest-cost competitor can maintain parity with the competition by offering an attractive set of product attributes, it obtains profit advantage. If it offers fewer differentiating attributes at a lower price, then its ability to generate above-average profits will depend on its ability to manage its cost base (Partridge &

Perren, 1985). Mintzberg as quoted by Kotha and Vadlamani (1995) argued that cost leadership based on cost minimization does not provide an advantage itself, it has to result in below average market prices to be a competitive advantage. Thus, he labels cost leadership strategy as differentiation by price.

Wheelen and Hunger (1985, p189) on the other hand highlighted the risk of cost leadership when competitors imitate the firm's product, technology changes that allow competitors to lower their cost, or when other bases for cost leadership erode for the firm. CEO of Emerson, Charles Knight, supported this view and acknowledged cost cutting was taking toll on research and development in his firm, which was required to facilitate the firm's growth. (Helms et al., 1997). Faulkner and Bowman cite that cost leadership, unless demonstrated by a lowest-price strategy, is relatively invisible and therefore cannot be used to win customers and gain competitive advantage (Partridge & Perren, 1985).

## **2.4 Cost Drivers in Achieving Cost Leadership Strategy**

Successful cost leaders usually derive their cost advantage from multiple sources within the value chain. Sustainable cost advantage stems not from one activity but from many, reconfiguring the chain frequently plays a role in creating cost advantage. The following are major cost drivers that determine the cost behaviour of value activities. The first cost driver is economies of scale that can be reflected in large buying quantity of inputs, which will tilt the bargaining power towards the firm, huge production capacity that will reduce the average total cost, and a global scale market that will result in huge customer base and have an impact on the earlier two activities.

The second cost driver is learning, which can be reflected in the firm's ability to construct efficient plants and facilities that operates at an optimum level, and

learns how to keep the cost of scarp low. The third cost driver is exploitation of cost linkages within the value chain through technology and information systems, which allows efficient coordination of activities or through computer aided design or manufacturing, creates an efficient system.

Porter (1985) also mentioned the importance of controlling interrelationships where the firm will share appropriate value activities with other business units or sister units. Sharing is a way to achieve scale, go down the learning curve faster, or load capacity outside of the boundaries of a single industry. The fifth cost driver is controlling integration, which can be achieved by linking all interested parties through information system technology. This reduces the cost of interaction.

The next cost driver is timing. The right timing in purchasing raw material or machinery is able to yield major cost savings. Another cost driver is to develop low cost production technology, facilitate automation, and design low cost product that will reduce the cost of producing one unit of product. Porter also identified location activities that will have an impact on labour rates, logistical efficiency, and supplier access. Finally the last cost driver is the firm's ability to influence on government policies that has an impact on cost of operation (Porter, 1985 pp70 –83).

Chakraborty and Philip (1996) when assessing Vendor Development Strategies identified firms that followed the cost leadership have vendors on a global geographic scope, vendors with reciprocal interdependence, structured vendor tasks, short-term vendor contracts, open tender vendor selection, controlled part development by vendors and vendors with a mass customer base.

Kotha and Orne (1989) when studying the generic manufacturing strategies found firms with strong cost leadership to have the following characteristic, 1) strong focus on cost reduction and cost control; 2) high level of process

engineering skills; 3) strong focus on the elimination of discontinuities and work in process inventories; 4) high level of production standards and finally 5) high level of machine pacing of material flow.

In another study conducted by Marques et al., (2000), in determining the effectiveness of strategic employed by dominant firms in the Portuguese crystal glass industry, the CEOs of these firms rated highly the following competitive methods for cost leadership strategy: (a) operating efficiency, (b) competitive pricing, (c) procurement of raw materials and (d) innovation in manufacturing processes. The lowly rated competitive methods for cost leadership as follows, (a) customer service, (b) innovation in marketing techniques and methods, (c) serving specific geographic markets, (d) capacity to manufacture specialty products and (e) products in high price market segments.

## **2.5 Differentiation Strategy**

Strategies based on differentiation seek to establish fundamental differences in a variety of dimensions so that buyers perceive a marked contrast between the products or services of one firm and its rivals. This strategy is more visibly customer-focused and value-orientated. Firms that successfully differentiate themselves are rewarded for their uniqueness with a premium price. The economics inherent in this generic strategy requires the premium exceed the extra cost incurred in being unique. Differentiation cannot ignore cost issues because premium prices will be nullified by inordinately high cost (Porter, 1985 p 14).

## 2.6 Drivers of Uniqueness

Strong differentiation such as branding can be costly and may often need to be built over time. It is also true that a successful differentiator can choose to take additional income in increased volumes, rather than increased prices. Differentiation stems from the specific activities that the firm performs and how they affect the buyer. Any value activity in a firm can be a source of differentiation (Swink & Hegarty, 1998). According to Porter (1985 p124) a firm can be differentiated based on product features and performance it wanted to offer, how the service is going to be provided, quality of inputs procured for an activity, technology employed, skill and experience of personnel. He also identified procedures governing the actions of personnel in an activity, promotion and advertisement and information employed to control an activity as drivers of uniqueness. Mintzberg typology on the other hand describes the strategies of differentiation by quality, design, support and image in addition to Porter's differentiation by price (Kotha & Vadlamani, 1995).

Swink and Hegarty (1998) in their study using the Mintzberg typology identified innovation, marketing, image differentiation, and product delivery timing as differentiation variables. According to them, the ability to innovate a valuable new manufacturing technology or to use technology in a unique way, coupled with abilities to communicate an understanding of the technology's superior or unique capabilities, makes manufacturing more supportive of innovation differentiation. They also identified marketing as a form of differentiation when it addresses ancillary product aspects such as superior product promotion, service, delivery speed and reliability, packaging, installation and maintenance.

Swink and Hegarty (1998) also pointed out that to enhance external customer satisfaction, firms seek to make their products more attractive by offering customers easy access to manufacturing information and consultation, and by making inputs into the design or sales of the product or accompanying service.



Davidow and Uttal found image differentiation produced when addressing customers' expectations via promotions or other communications (Swink & Hegarty, 1998).

Finally product delivery timing is also an important element of competition. Suppliers are increasingly asked to support just-in-time production requirements. In addition, customers buying finished goods are continually pressing for faster product delivery. Time-oriented manufacturing outcomes include product lead-time and the variance in lead times. Three components of lead time: time required to place the order, time required to develop the product and associated processes and the time required to produce and deliver the product (Swink & Hegarty, 1998).

Marques et al., (2000) rated highly the following competitive methods for differentiation: (1) new product development, (2) brand identification, (3) innovation in marketing techniques and methods, and finally (4) advertising. Rated as low are the following, (1) competitive pricing, (2) broad range of products, (3) procurement of raw materials and (4) minimum use of outside financing.

Chakraborty and Philip (1996) also identified firms that followed the differentiation strategy to have vendors on a global geographic scope, vendors with reciprocal interdependence, unstructured vendor tasks, long-term vendor contracts, direct selection of vendors, proprietary part development by vendors and single customer vendors.

Quality differentiation plays an important role in allowing small manufacturing firms to achieve sustained competitive advantage across three stages of industry evolution, introduction, growth and maturity. Competitive methods identified in quality differentiation are strict quality control, benchmarking, immediate resolution of customer problems and product improvements (Beal & Lockamy III, 1999). Fortune's annual ranking of America's most admired corporations has



always included quality of products or services and quality of management as one of the eight key attributes of reputation (Hellriegel, Jackson & Slocum, 1999 pg 725).

Kotha and Orne (1995) meanwhile identified manufacturing firms with strong differentiation strategy with the following characteristic 1) strong focus on products and services designed for premium value; 2) relatively high end product complexity; 3) high variety of final products; 4) high level of product engineering skills; and finally 5) high level of flexibility in production scheduling. Miller (1998), listed product features, after sales service, desirable image, technological innovation, reputation, manufacturing consistency and status symbol as attributes that can differentiate products.

## **2.7 Relationship between Cost Leadership and Differentiation Strategy**

According to Porter (1985) the notion underlying the concept of generic strategies is that if a firm is to attain a competitive advantage, it must make a choice about the type of competitive advantage it seeks to attain and the scope within which it will attain it. Porter argued achieving cost leadership and differentiation is usually inconsistent because differentiation is usually costly and leads to premium prices. Conversely, cost leadership often requires a firm to forgo some differentiation by standardising its product, reducing marketing overhead, and the like to achieve low cost. Porter (1985) also noted when a firm is facing with capable competitors who are also striving for cost leadership, the firm will ultimately reach a point where further cost reduction requires a sacrifice in differentiation. It is at this point that the generic strategies become inconsistent and a firm must make a choice.

## **2.8 Integrated Cost Leadership-Differentiation Strategy (“Stuck In the Middle”)**

Firms that adopts both strategies in their value chain is known as “stuck in the middle” approach (Porter, 1985) or following the integrated cost leadership - differentiation strategy (Hitt et al., 2001 pp 172 - 173). According to Porter (1985), these firms posses no competitive advantage and usually a recipe for below-average performance. These firms will compete at a disadvantage because the cost leader, differentiators or focusers will be better positioned to compete in any segment. A firm that is “stuck in the middle” will earn attractive profits only if the structure of its industry is highly favourable, or the firm is fortunate enough to have competitors that are also stuck in the middle.

Miller (1998) however argued that past managers were often advised to concentrate on a single competitive advantage, rather than run the risk of having strategic positions, which were “stuck in the middle” being “neither fish nor fowl”. This thinking seems especially plausible, considering the clear importance the data show for having some form of competitive advantage and the inconclusive differences among the benefits of either individual advantage. However, as Table 1 shows, in every industrial sector, the highest performance levels are those seen by firms holding both type of competitive advantage simultaneously. Firms in the integrated cost leadership - differentiation strategy category enjoy returns on investment ranging from the mid-to high 30s in percentage terms when the average ROI for all business units in the database near 22 percent, such performance must be considered outstanding.

Table 1: Competitive Advantage Increases Profitability

Industry Sector	Differentiation Advantage	Average ROI			
		Low	Low	High	High
		Low	High	Low	High
<b>MANUFACTURING</b>					
Consumer Products:					
Durable goods		14.2	20.2	21.0	38.7
Nondurable goods		9.7	27.0	15.0	33.2
Industrial products:					
Capital goods		8.1	19.7	28.5	35.2
Raw or semi finished goods		2.9	28.8	15.1	34.9
Components for finished goods		10.5	22.8	29.0	38.8
Supplies of consumable		14.1	33.3	31.0	38.4
<b>SERVICES</b>		10.0	22.8	26.8	31.5
<b>OVERALL</b>		9.5	26.2	22.0	34.7

Source: Based on data gathered from Miller's analysis of the PIMS database (Miller, 1998)

A firm that is capable of successfully using an integrated cost leadership - differentiation strategy should be in a better position to adapt quickly to environment changes, learn new skills and technologies more quickly, and effectively leverage its core competencies across business units and product lines. A growing body of evidence supports the relationship between the implementation of an integrated strategy and above-average returns. An integrated strategy allows firms to gain competitive advantage by offering two types of value to customers: some differentiated features but fewer than those provided by the product-differentiated firm and relatively low cost but not as low as the products of the cost leader (Hitt et al., 2001 pp 172 - 175).

In most recent comprehensive studies, it was discovered that businesses, which combined multiple forms of competitive advantage outperformed businesses that were only identified with a single form. Kim and Lim, acknowledged that the highest-performing companies in the Korean electronic industry were those that combined both the differentiation and cost leadership strategies, suggesting the viability of the integrated strategy in different nations (Hitt et al, 2001 p172). Marques et al., (2000), when studying the Portuguese crystal glass industry

found positive results in firms adopting the integrated strategy. Hlavacka et al., (2001), when examining the performance implication in Slovak hospitals found integrated strategy was associated with superior performance. Calori and Ardison (1998) identified differentiation strategy with strong cost controls to be profitable in stalemate industries.

Helms et al., (1997), found firms that simultaneously compete with both strategies surpassed the firms that only compete with the low cost strategy in cost containment efforts, since they have lower manufacturing expenses, lower relative direct costs and higher capacity utilization. They also noted firms that simultaneously compete with both strategies seem to surpassed the firms that only compete with the differentiation strategy, since they have been able to charge significantly higher prices. This explanation derived from the benefits that were drawn from the firms' emphasis on quality, product or service innovations, and systems innovations as well as its emphasis on process innovations and cost controls.

## **2.9 Possible Approaches towards an Integrated Cost Leadership-Differentiation Strategy**

Partridge and Perren (1985) suggested that, rather than there being three discrete positions, there is actually a continuum of cost/price/ profit positions with successful firms achieving sufficient differentiation sufficient cost leadership effectively to guarantee superior profits. Miller, arguing along similar lines, suggested that an integrated strategy, combining some aspects of differentiation with cost-effectiveness, has advantages. It avoids, he claims, the risk of overspecialisation while allowing the firm to benefit from multiple abilities and the synergies between them. Successful differentiators can increase market share and achieve cost advantage from economies of scale and experience curve effects (Partridge & Perren, 1985).

Helms et al., (1997), proposed low cost strategy and differentiation strategy may be simultaneously and profitably employed in a firm. According to them, the adoption of the differentiation strategy would entail promoting higher product quality. This would probably involve bearing higher costs across a number of the functional areas in order to support the differentiation strategy. And quality products would presumably channel greater market demand towards the firm. Greater market demand allows the firm the possibility of also adopting the low cost strategy through the attainment of higher market shares and cumulative volume of production. Viewed in this context, the acceptance of differentiation strategy would mainly consist of bearing higher costs in a number of functional areas in order to support differentiation. The adoption of the low cost strategy would primarily consist of achieving lower per unit cost of production through the attainment of economies of scale.

Hitt et al., (2001, pp173-175), listed three approaches to organisational work that can increase the strategic flexibility, which is associated with the integrated strategy use namely flexible manufacturing systems, information networks across firms and total quality management systems. According to Ibid, the first approach is through the Flexible Manufacturing System (FMS), which increases the integrated flexibility of human, physical and information resources that are to create differentiated products at low costs. The goal of an FMS is to eliminate the low-cost-versus-product-variety trade-off that is inherent in traditional manufacturing technologies. Krajewski and Ritzman, the flexibility provided by an FMS allows a plant to change quickly and easily from making one product to making another one thus allowing firms to produce a large variety of products at a low cost (Hitt et al., 2001 pp173-174).

The second approach as suggested by Callahan and Nemec is through new information networks linking manufactures with their suppliers, distributors, and customers and this can be considered as another technological development that will increase a firm's strategic flexibility and responsiveness. The utilization of

Enterprise Resource Planning (ERP) software system, through which financial and operational data are moved rapidly from one department to another will allow the firms to differentiate their products more sharply while driving costs lower. The new generation of software may facilitate even more the implementation of the integrated cost leadership - differentiation strategy (Hitt et al., 2001 pp174).

The third approach is through Total Quality Management, which integrates every aspect of the differentiation and cost leadership strategies. Enhanced quality focuses customers' attention on improvements in the performance of products and on the utility and reliability of features. An emphasis on quality in production techniques lowers manufacturing and service cost through savings in reworking, scrap and warranty expenses (Hitt et al., 2001 pp175).

## **2.10 Viability of Applying Integrated Cost Leadership-Differentiation Strategy in an Industry**

Whether the integrated cost leadership - differentiation strategy necessarily so disastrous is debatable. All products must possess core attributes, which will be offered by all competitors in a given market and without which they would not be saleable in that market. Even in commodity markets, firms will attempt to differentiate, primarily through intangible attributes such as customer service or branding. Most firms will try to lift their product offering above the lowest common denominator. They will do this with varying degrees of success and with varying cost bases, none of them holding the least cost position. There is no essential need to distinguish between lowest-cost and differentiation positions but both 'better and cheaper', as the Japanese have proven (Patridge and Perren, 1985). As Miller (1998), Helms et al., (1997) and Hitt et al., (2001) found the cost leadership - differentiation strategy is a viable option to be considered by the industry to achieve above average returns. Therefore, the study will try to prove

whether this approach is taken by any of the food multinational corporations in Malaysia in order to remain competitive and generate above average returns as empirical evidence suggested for the healthcare industry (Hlavacka et al., 2001), adhesive and sealant industries (Helms et al., 1997) and stalemate industries (Calori & Ardisson, 1998).