9

Differentiation Advantage

If the three keys to selling real estate are location, location, location, then the three keys of selling consumer products are differentiation, differentiation, differentiation.

—ROBERT GOIZUETA, FORMER CHAIRMAN, COCA-COLA COMPANY

If you gave me $100 billion and said, "Take away the soft drink leadership of Coca-Cola in the world," I'd give it back to you and say, "It can't be done."

—WARREN BUFFETT, CHAIRMAN, BERKSHIRE HATHAWAY, AND COCA-COLA'S BIGGEST SHAREHOLDER

OUTLINE

Introduction and Objectives

A firm differentiates itself from its competitors "when it provides something unique that is valuable to buyers beyond simply offering a low price."[1] Differentiation advantage occurs when a firm is able to obtain from its differentiation a price premium in the market that exceeds the cost of providing the differentiation.

Every firm has opportunities for differentiating its offering to customers, although the range of differentiation opportunities depends on the characteristics of the product. An automobile or a restaurant offers greater potential for differentiation than cement, wheat, or memory chips. These latter products are called "commodities" precisely because they lack physical differentiation. Yet, even commodity products can be differentiated in ways that create customer value: "Anything can be turned into a value-added product or service for a well-defined or newly created market," claims Tom Peters.[2]

During the 1990s, desktop PCs became commodity items identified by their technical specifications more than by their brand names. Yet, Dell Computer's direct sales model allowed it to differentiate its PCs by permitting customers to design their own computer system and offering complementary services such as online customer support, three-year on-site warranty, web hosting, installation and configuration of customers' hardware and software. Gasoline and diesel fuel are also commodities, yet shell has established retail market leadership both through introducing premium fuels (V-Power) and upgrading facilities and service at its filling stations.[3] The lesson is this: differentiation is not simply about offering different product features, it is about identifying and understanding every possible interaction between the firm and its customers, and asking how the these interactions can be enhanced or changed in order to deliver additional value to the customer.

Analyzing differentiation requires looking at both the firm (the supply side) and its customers (the demand side). While supply-side analysis identifies the firm's potential to create uniqueness, the critical issue is whether such differentiation creates value for customers, and whether the value created exceeds the cost of the differentiation. Hence, in this chapter we shall be concerned especially with the demand side of the market. By understanding what customers want, how they choose, and what motivates them, we can identify opportunities for profitable differentiation.

Differentiation strategies are not about pursuing uniqueness for the sake of being different. Differentiation is about understanding customers and how our product can meet their needs. To this extent, the quest for differentiation advantage takes us to the heart of business strategy. The fundamental issues of differentiation are also the fundamental issues of business strategy: Who are our customers? How do we create value for them? And how do we do it more effectively and efficiently than anyone else?

Because differentiation is about uniqueness, establishing differentiation advantage requires creativity – it cannot be achieved simply through applying standardized frameworks and techniques. This is not to say that differentiation advantage is not amenable to systematic analysis. As we have observed, there are two requirements for creating profitable differentiation. On the supply side, the firm must be aware of the resources and capabilities through which it can create uniqueness (and do it better than competitors). On the demand side, the key is insight into customers and their needs and preferences. These two sides form the major components of our analysis of differentiation.

By the time you have completed this chapter you will be able to:

- Understand what differentiation is, recognize its different forms, and appreciate its potential for creating competitive advantage.
- Analyze the sources of differentiation in terms of customers' preferences and characteristics, and of the firm's capacity for supplying differentiation.
- Formulate strategies that create differentiation advantage by linking the firm's differentiation capability to customers' demand for differentiation.

The Nature of Differentiation and Differentiation Advantage

Let us begin by exploring what differentiation is and why it is such an important basis for competitive advantage.

Differentiation Variables

The potential for differentiating a product or service is partly determined by its physical characteristics. For products that are technically simple (a pair of socks, a brick), that satisfy uncomplicated needs (a corkscrew, a nail), or must meet rigorous technical standards (a spark plug, a thermometer), differentiation opportunities are constrained by technical and market factors. Products that are technically complex (an airplane), that satisfy complex needs (an automobile, a vacation), or that do not need to conform to particular technical standards (wine, toys) offer much greater scope for differentiation.

Beyond these constraints, the potential in any product or service for differentiation is limited only by the boundaries of the human imagination. For seemingly simple products such as shampoo, toilet paper, and bottled water, the proliferation of brands on any supermarket's shelves is testimony both to the ingenuity of firms and the complexity of customer preferences. Differentiation extends beyond the physical characteristics of the product or service to encompass everything about the product or service that influences the value customers derive from it. This means that differentiation includes every aspect of the way in which a company relates to its customers. Starbucks' ability to charge up to $4 for a cup of coffee rests not just on the characteristics of the coffee but also on the overall "Starbucks' Experience," which encompasses the retail environment, the values the company projects, and a sense of community that customers feel a part of. Differentiation is not an activity specific to particular functions such as design and marketing; it infuses all activities within the organization and is built into the identity and culture of a company.

In analyzing differentiation opportunities, we can distinguish *tangible* and *intangible* dimensions of differentiation. Tangible differentiation is concerned with the observable characteristics of a product or service that are relevant to customers' preferences and choice processes. These include size, shape, color, weight, design, material, and technology. Tangible differentiation also includes the performance of the product or service in terms of reliability, consistency, taste, speed, durability, and safety.

Tangible differentiation extends to products and services that complement the product in question. There is little that is distinctive about Dell's computers. The differentiation lies in the speed with which they are delivered, the flexibility with which customers can configure their own systems, and after-sales services including technical support, online training courses, repair service, upgrading service, and customer discussion forum – to mention but a few.

Opportunities for intangible differentiation arise because the value that customers perceive in a product or service does not depend exclusively on the tangible aspects of the offering. There are few products where customer choice is determined solely by observable product features or objective performance criteria. Social, emotional, psychological, and esthetic considerations are present in choices over all products and services. The desires for status, exclusivity, individuality, and security are powerful motivational forces in choices relating to most consumer goods. Where a product or service is meeting complex customer needs, differentiation choices involve the overall image of the firm's offering. Image differentiation is especially important for those products and services whose qualities and performance are difficult to ascertain at the time of purchase ("experience goods"). These include cosmetics, medical services, and education.

Differentiation and Segmentation

Differentiation is different from segmentation. Differentiation is concerned with *how* a firm competes – the ways in which it can offer uniqueness to customers. Such uniqueness might relate to consistency (McDonald's), reliability (Federal Express), status (American Express), quality (BMW), and innovation (Sony). Segmentation is concerned with *where* a firm competes in terms of customer groups, localities, and product types.

Whereas segmentation is a feature of market structure, differentiation is a strategic choice by a firm. A segmented market is one that can be partitioned according to the characteristics of customers and their demand. Differentiation is concerned with a firm's positioning within a market (or market segment) in relation to the product, service, and image characteristics that influence customer choice.[4] By locating within a segment, a firm does not necessarily differentiate itself from its competitors within the same segment. Ameritrade, E*Trade, and T.D. Waterhouse are all located within the online segment of the brokerage industry, yet are not significantly differentiated from one another. Conversely, Toyota, McDonald's, Amazon, and Starbucks pursue differentiation, but position themselves within the mass market and span multiple segments.

Nevertheless, differentiation decisions tend to be closely linked to choices over the segments in which a firm competes. By offering uniqueness in its offerings, a firm may inevitably target certain market niches. By selecting performance, engineering, and style as the basis on which BMW competes in the automobile industry, it inevitably appeals to different market segments than does VW. To the extent that differentiation is imitated by other companies, the result can be the creation of new market segments. In the beer industry innovative differentiation to offer light beer, high-alcohol beer, microbrews, and brewpubs has resulted in the emergence of new market segments.[5]

The Sustainability of Differentiation Advantage

Although strategy analysis has traditionally emphasized cost advantage as the primary basis for competitive advantage, low cost offers a less secure basis for competitive advantage than does differentiation. The growth of international competition has revealed the fragility of seemingly well-established positions of domestic cost leadership. The cost advantages of Ford in autos, Honda in motorcycles, Indesit in domeskc appliances, and Matsushita in consumer electronics have all been overturned by the emergence of new competitors from countries with low labor costs.

In addition, cost advantage is highly vulnerable to unpredictable external forces. The rise of the euro against the US dollar during 2002 to 2006 has seriously affected the cost competitiveness of most European companies.

Cost advantage is also vulnerable to new technology and strategic innovation. US integrated iron and steel producers lost ground to the minimill producers – Nucor, Chaparral Steel, and Steel Dynamics. Discount brokers such as Quick and Reilly, Brown & Company, Olde, and Seibert were undercut by online brokers such as Ameritrade and E*Trade. Internet telephony (VoIP) offered by Skype, Vonage, and other upstarts has potentially devastating implications for conventional telecom suppliers such as AT&T and Bell South.

Hence, sustained high profitability is associated more with differentiation than cost leadership. Large companies that consistently earn a high return on equity – such as Colgate-Palmolive, Microsoft, Anheuser-Busch, Yum Brands, Kellogg's, Procter & Gamble, 3M, and Wyeth – tend to be those that have pursued differentiation through quality, branding, and innovation.

Analyzing Differentiation: The Demand Side

Successful differentiation involves matching customers' demand for differentiation with the firm's capacity to supply differentiation. Let's begin with the demand side. Analyzing customer demand enables us to determine which product characteristics have the potential to create value for customers, customers' willingness to pay for differentiation, and a company's optimal competitive positioning in terms of differentiation variables.

Analyzing demand begins with understanding why customers buy a product or service. What are the needs and requirements of a person who is purchasing a personal computer? What is motivating a company when it hires management consultants? Market research systematically explores customer preferences and customer perceptions of existing products. However, the key to successful differentiation is to understand customers. In gaining insight into customer requirements and preferences, simple, direct questions about the purpose of a product and its performance attributes can often be far more illuminating than objective market research data obtained from

STRATEGY CAPSULE 9.1

Understanding What a Product Is About

Getting back to strategy means getting back to a deep understanding of what a product is about. Some time back, for example, a Japanese home appliance company was trying to develop a coffee percolator. Should it be a General Electric-type percolator, executives wondered? Should it be the same drip-type that Philips makes? Larger? Smaller? I urged them to ask a different kind of question: Why do people drink coffee? What are they looking for when they do? If your objective is to serve the customer better, then shouldn't you understand why that customer drinks coffee in the first place? Then you would know what kind of percolator to make.

The answer came back: good taste. Then I asked the company's engineers what they were doing to help the consumer enjoy good taste in a cup of coffee. They said they were trying to design a good percolator. I asked them what influences the taste in a cup of coffee. No one knew. That became the next question we had to answer. It turns out that lots of things can affect taste – the beans, the temperature, the water. We did our homework and discovered all the things that affect taste . . .

Of all the factors, water quality, we learned, made the greatest difference. The percolator in design at the time, however, didn't take water quality into account at all . . . We discovered next the grain distribution and the time between grinding the beans and pouring in the water were crucial. As a result we began to think about the product and its necessary features in a new way. It had to have a built-in dechlorinating function. It had to have a built-in grinder. All the customer should have to do is pour in water and beans . . .

To start you have to ask the right questions and set the right kinds of strategic goals. If your only concern is that General Electric has just brought out a percolator that brews coffee in ten minutes, you will get your engineers to design one that brews it in seven minutes. And if you stick to that logic, market research will tell you that instant coffee is the way to go . . . Conventional marketing approaches won't solve the problem. If you ask people whether they want their coffee in ten minutes or seven, they will say seven, of course. But it's still the wrong question. And you end up back where you started, trying the beat the competition at its own game. If your primary focus is on the competition, you will never step back and ask what the customers' inherent needs are, and what the product really is about.

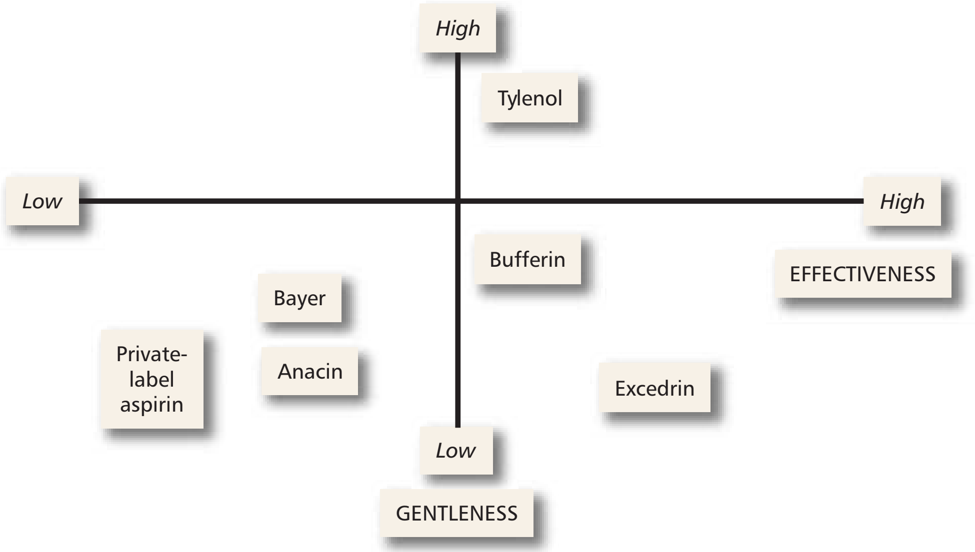
Source: Kenichi Ohmae, "Getting Back to Strategy," *Harvard Business Review* (November–December 1988): 154.

large samples of actual and potential customers. Strategy Capsule 9.1 offers a striking example of the value of simplicity and directness in probing customer requirements.

Product Attributes and Positioning

Virtually all products and services serve multiple customer needs. As a result, understanding customer needs requires the analysis of multiple attributes. Market research

FIGURE 9.1 Consumer perceptions of competing pain relievers: a multidimensional scaling mapping



has developed numerous techniques for analyzing customer preferences in relation to different product attributes. These techniques – including multidimensional scaling, conjoint analysis, and hedonic price analysis – can guide the positioning of new products, repositioning of existing products, and setting product prices.

Multidimensional Scaling Multidimensional scaling (MDS) permits customers' perceptions of competing products' similarities and dissimilarities to be represented graphically and for the dimensions to be interpreted in terms of key product attributes.[6] For example, a survey of consumer ratings of competing pain relievers resulted in the mapping shown in Figure 9.1. MDS has also been used to classify 109 single-malt Scotch whiskies according to the characteristics of their color, nose, palate, body, and finish.[7]

Conjoint Analysis Conjoint analysis is a powerful means of analyzing the strength of customer preferences for different product attributes. The technique requires, first, an identification of the underlying attributes of a product and, second, market research to rank hypothetical products that contain alternative bundles of attributes. The results can then be used to estimate the proportion of customers who would prefer a hypothetical new product to competing products already available in the market.[8] Conjoint analysis has been used to predict market shares of forthcoming new models of personal computer, to analyze windsurfer preferences, and to design new products, including Marriott's Courtyard hotel chain and nature tourism in the Amazon basin.

Hedonic Price Analysis The demand for a product may be viewed as the demand for the underlying attributes that the product provides.[9] The price at which a product can sell in the market is the aggregate of the values derived from each of these individual attributes. Hedonic price analysis observes price differences for competing products, relates these differences to the different combinations of attributes offered by each product, and calculates the implicit market price for each attribute. For example:

- For European automatic washing machines, price differences were related to differences in capacity, spin speed, energy consumption, number of programs, and reliability. For example, a machine that spins at 1000 rpm sold at about a $200 price premium to one that spins at 800 rpm.[10]
- In the case of personal computers, hedonic price analysis showed that price differences between models reflected differences in processor speed, memory, and hard drive capacity.[11]

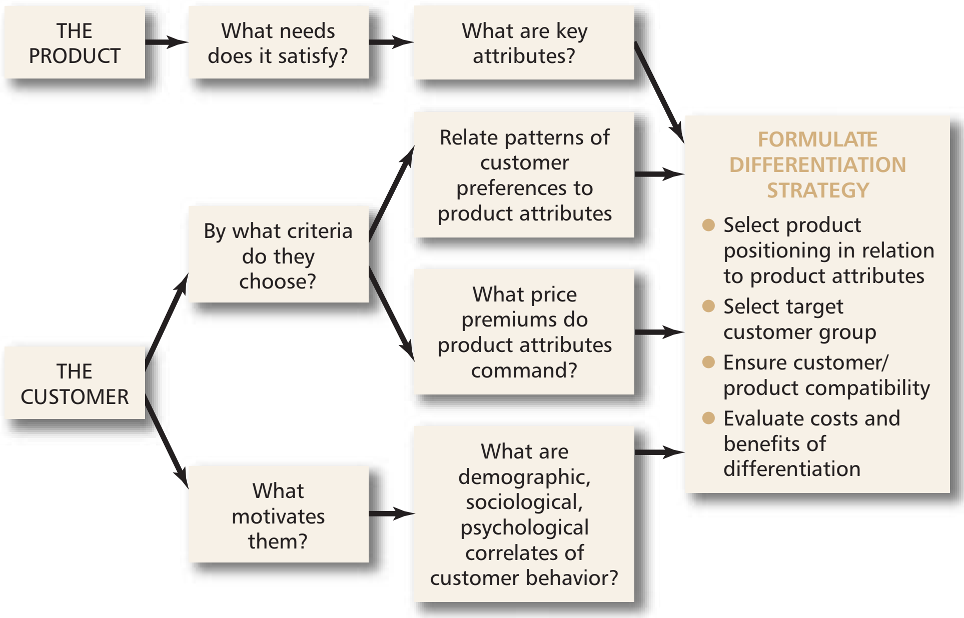
Value Curve Analysis Selecting the optimal combination of attributes depends not only on which attributes are valued by customers, but also on where competitors' offerings are positioned in relation to different attributes. Chan Kim and Renee Mauborgne argue that to position products or to create a whole new market space it is useful to position competitive offerings according to a set of basic performance characteristics that deliver value to customers. Presented graphically, they call such a mapping a *value curve*. Thus, in book retailing key value metrics include price, knowledge levels of staff, selection of books, store ambiance, store hours, and facilities such as cafés and reading areas. By viewing the positioning of independent book stores and chain bookstores along these dimensions can identify the opportunity for a new combination of attributes – such as those offered by Borders and Barnes and Noble.[12] The key to deploying the value curve in order to create differentiation advantage, they argue, is to look beyond the conventionally defined boundaries of competition and consider competitive offerings from different industries, strategic groups, and buyer segments.

The Role of Social and Psychological Factors

The problem with analyzing product differentiation in terms of measurable performance attributes is that it does not delve very far into customers' underlying motivations. Very few goods or services are acquired to satisfy basic needs for survival: most buying reflects social goals and values in terms of the desire to find community with others, to establish one's own identity, and to make sense of what is happening in the world. Our discussion of goals in Chapter 2 referred to Maslow's hierarchy of needs: once basic needs for survival are satisfied, there is a progression from security needs, to belonging needs, to esteem needs, to selfactualization needs.[13] Most suppliers of branded goods recognize that their brand equities have much more to do with status and conformity than to survival or security. The disastrous introduction of "New Coke" in 1985 was the result of Coca-Cola giving precedence to tangible differentiation (taste preferences) over intangible differentiation (authenticity).[14] Harley-Davidson harbors no such illusions: it recognizes quite clearly that it is in the business of selling lifestyle, not transportation.

If the key customer needs that a product satisfies are self-identity and social affiliation, the implications for differentiation are far reaching. In particular, to understand customer demand and identify profitable differentiation opportunities requires

FIGURE 9.2 Identifying differentiation potential: the demand side



that we analyze the product and its characteristics, but also customers, their lifestyles and aspirations, and the relationship of the product to these lifestyles and aspirations. Market research that looks behind the product and explores the demographic (age, sex, race, location), socioeconomic (income, education), and psychographic (lifestyle, personality type) characteristics of potential customers may be of some value. However, effective differentiation is likely to depend on an understanding of what customers want and how they behave rather than the results of statistical market research. While the phenomenon is complex, the answer, according to Tom Peters, is simple: business people need to "get out from behind their desks to where the customers are . . . [and] construct settings so as to maximize 'naive' listening."[15]

In practice, understanding customer needs and preferences is likely to require more than listening. Typically, consumers cannot clearly articulate the motives that drive them and the emotions that different products trigger. Companies must observe their customers to understand their lives and their use of the product. The implication is that, for companies to understand their customers, they need to become involved with them. Going beyond functionality to explore the emotional and esthetic aspects of consumers' relationships with products is central to Japanese companies' approaches to marketing.[16]

Figure 9.2 summarizes the key points of this discussion by posing some basic questions that explore the potential for demand-side differentiation.

Analyzing Differentiation: The Supply Side

Demand analysis identifies customers' demands for differentiation and their willingness to pay for it, but creating differentiation advantage also depends on a firm's ability to offer differentiation. To identify the firm's potential to supply differentiation, we need to examine the activities the firm performs and the resources it has access to.

The Drivers of Uniqueness

Differentiation is concerned with the provision of uniqueness. A firm's opportunities for creating uniqueness in its offerings to customers are not located within a particular function or activity, but can arise in virtually everything that it does. Michael Porter identifies a number of drivers of uniqueness that are decision variables for the firm:

- Product features and product performance.
- Complementary services (e.g., credit, delivery, repair).
- Intensity of marketing activities (e.g., rate of advertising spending).
- Technology embodied in design and manufacture.
- The quality of purchased inputs.
- Procedures influencing the conduct of each of the activities (e.g., rigor of quality control, service procedures, frequency of sales visits to a customer).
- The skill and experience of employees.
- Location (e.g., with retail stores).
- The degree of vertical integration (which influences a firm's ability to control inputs and intermediate processes).[17]

Most offerings do not involve a single product or a single service, but are a combination of products and services. In analyzing the potential for differentiation, we can distinguish between differentiation of the product ("hardware") and ancillary services ("software"). On this basis, four transaction categories can be identified (see Figure 9.3).[18]

As markets mature, so systems comprising both hardware and software tend to "unbundle." Products become commoditized while complementary services become provided by specialized suppliers. However, as customer preferences become increasingly sophisticated and companies seek new opportunities for differentiation advantage, so hardware and software is repackaged into new systems. Service stations once offered a comprehensive array of services to motorists – gasoline, oil changes, car repair, tires, car washing, and so on. As more and more of these services have become commodities provided by specialist suppliers, so the oil companies have

FIGURE 9.3 Differentiation of merchandise (hardware) and support (software)

		SUPPORT (SOFTWARE) Differentiated	SUPPORT (SOFTWARE) Undifferentiated
MERCHANDISE (HARDWARE)	Differentiated	SYSTEM	PRODUCT
MERCHANDISE (HARDWARE)	Undifferentiated	SERVICE	COMMODITY

SOURCE: SHIV MATHUR AND ALFRED KENYON, *CREATING VALUE* (OXFORD: BUTTERWORTH-HEINEMANN, 1997).

sought differentiation through creating new bundles of retail services at their service stations.

A critical issue is whether such bundling really creates customer value. Thus, the offer of "one-stop shopping" by financial service companies through diversifying across personal banking, brokerage services, fund management, and insurance has had limited appeal to customers. The advent of internet-based electronic commerce has greatly reduced customers' transaction costs, allowing them to assemble their own bundles of goods and services at low cost. The declining fortunes of European tour operators that organize vacations comprising flights, hotel bookings, car hire, insurance, and other services is the result of the increasing consumer preference to use online information and reservations systems to create their own customized vacations.[19] The result, according to McKinsey consultants Hagel and Singer, is not just unbundling of products, but the unbundling of the corporation itself.[20]

Product Integrity

All companies face a range of differentiation opportunities. The primary issue is likely to be determining which forms of differentiation may be most successful in distinguishing the firm in the market and which are most valued by customers. However, such choices cannot be made on a piecemeal basis. Establishing a coherent and effective differentiation position requires that the firm assemble a complementary package of differentiation measures. If Beck's beer wishes to differentiate itself on the basis of the quality of its ingredients, then it must adopt production methods that are consistent with quality ingredients, and packaging, advertising, and distribution appropriate to a quality, premium-priced product.

Product integrity refers to the consistency of a firm's differentiation; it is the extent to which a product achieves:

> *total balance of numerous product characteristics, including basic functions, esthetics, semantics, reliability, and economy . . . Product integrity has both internal and external dimensions. Internal integrity refers to consistency between the function and structure of the product – e.g., the parts fit well, components match and work well together, layout achieves maximum space efficiency. External integrity is a measure of how well a product's function, structure, and semantics fit the customer's objectives, values, production system, lifestyle, use pattern, and self-identity.*[21]

In their study of product development in the auto industry, Clark and Fujimoto argue that simultaneously achieving internal and external integrity is the most complex organizational challenge facing automakers, since it requires linking close cross-functional collaboration with intimate customer contact. The organizational changes among US and European automakers, including the growing role of product managers, have attempted to imitate the success of Toyota and Honda in achieving internal–external integration.[22]

Combining internal and external product integrity is especially important to those supplying "lifestyle" products whose differentiation is based on customers' social and psychological needs. Here, the credibility of the image depends critically on the consistency of the image presented. A critical factor in such differentiation is the ability of employees and customers to identify with one another. Thus:

- Harley-Davidson's ability to develop its image of ruggedness, independence, and individuality is supported by a top management team that dons biking leathers and ride its "hogs" to owners' group rallies, and a management system that empowers shop-floor workers and fosters quality, initiative, and responsibility.
- MTV's capacity to stay at the leading edge of popular culture and embody "coolness" for new generations of young people owes much to its internal culture and human resource management, which rely heavily on the ideas and enthusiasm of its youngest employees.[23]

Maintaining integrity of differentiation is ultimately dependent on a company's ability to live the values embodied in the images with which its products are associated (see Strategy Capsule 9.2).

STRATEGY CAPSULE 9.2

Body Shop: The Role of Values in Differentiation

Anita Roddick opened her first Body Shop in Brighton, England in 1976. With the rapid expansion that followed its IPO in 1985, Body Shop became the world's leading "alternative" cosmetics and toiletries brand.

Two key strategic lessons can be drawn from Body Shop's success. First, a contrarian strategy can be highly effective in creating a new market space. Roddick contradicted most of the industry's long-established, most deeply held conventions. Rather than peddle the allure of beauty, youth, and sexual attractiveness, Body Shop rejects this "magic" – "My products can only cleanse, moisten, and protect," says Roddick. She is equally scornful of the business practices that characterize the industry. In selecting franchisees, Body Shop typically rejects those with prior business experience in favor of those with energy, enthusiasm, and commitment to Body Shop ideals.

Second, for all its apparent naivety and opposition to typical business methods, Body Shop demonstrates a comprehensive and sophisticated approach to differentiation. Roddick created a clear, distinctive identity and personality for Body Shop and its brand, reinforced and projected through its products, packaging, promoting, retail environment, and business system. For example, the products contain only natural ingredients; the packaging emphasizes simplicity and economy; the retail stores are open, unostentatious, and designed to encourage customers to interact with the products and sales personnel; the business system emphasizes commitment, open communication, loyalty, and individual accountability. Guiding all these aspects of differentiation are the Body Shop's principles and values relating to environmental and social responsibility. The result is that Body Shop is not just a supplier of skin creams and shampoo; it is engaged in creating identity with its customers through commitment to naturalness, honesty, global environmental responsibility, economic support for indigenous people through fair trade, and a rejection of business methods that involve exploiting the natural environment and the economically weak.

Differentiation that embodies ennobling principles and values can be very powerful. But it is also creates vulnerability. During the past 10 years, Body Shop has faced many allegations concerning lapses in its ethical standards including departures from "all natural" ingredients, the use of animal-tested ingredients, unfair treatment of franchisees and employees, and lack of commitment to its community support and fair trade initiatives. However, the biggest threat to Body Shop's continued success was its acquisition by L'Oreal – one of the world's biggest and most successful personal care giants – in 2006.

While many of Body Shop's most loyal customers regarded the acquisition as a sellout by Roddick to the enemy, Ms. Roddick was adamant that Body Shop's values would not just be protected, but that the merger offered Body Shop the opportunity to influence the way that L'Oreal did business. To help safeguard Body Shop's values and brand integrity, L'Oreal committed to operating Body Shop as an independent entity within the group and to appoint Ms. Roddick as adviser to L'Oreal's chairman on fair trade policies. Others were skeptical fearing that attacks on Body Shop by consumer activist groups – including Naturewatch's boycott of Body Shop and *Ethical Consumer* magazine's cutting Body Shop's ethical rating from 11 out of 20 to 2.5 – would weaken the brand, undermine morale, and lead to the disintegration of Body Shop's unique corporate culture.

Source: *Body Shop International*, Case No. 9-392-032 (Boston: Harvard Business School, 1992); "Body Shop: Shrewd Sale or Sell-out?" *Financial Times* (March 18, 2006).

Signaling and Reputation

Differentiation is only effective if it is communicated to customers. But information about the qualities and characteristics of products is not always readily available to potential customers. The economics literature distinguishes between *search goods*, whose qualities and characteristics can be ascertained by inspection, and *experience goods*, whose qualities and characteristics are only recognized after consumption. This latter class of goods includes medical services, baldness treatments, frozen TV dinners, and wine. Even after purchase, performance attributes may be slow in revealing themselves – it took me almost ten years to reach the conclusion that my dentist was incompetent and my financial adviser was a charlatan.

In the terminology of game theory (see Chapter 4), the market for experience goods corresponds to a classic "prisoners' dilemma." A firm can offer a high-quality or a low-quality product. The customer can pay either a high or a low price. If quality cannot be detected, then equilibrium is established, with the customer offering a low price and the supplier offering a low-quality product, even though both would be better off with a high-quality product sold at a high price (see Figure 9.4).

The resolution of this dilemma is for producers to find some credible means of signaling quality to the customer. The most effective signals are those that change the payoffs in the prisoners' dilemma. Thus, an extended warranty is effective because providing such a warranty would be more expensive for a low-quality than a high-quality producer. Brand names, warranties, expensive packaging, money-back guarantees, sponsorship of sports and cultural events, and a carefully designed retail environment in which the product is sold are all signals of quality. Their effectiveness

FIGURE 9.4 The problem of quality in experience goods: a "prisoners' dilemma"

Consumer's strategies		Producer's strategies: *High quality*	Producer's strategies: *Low quality*
	High price	7 (consumer), 7 (producer)	−5 (consumer), 10 (producer)
	Low price	10 (consumer), −5 (producer)	3 (consumer), 3 (producer)

Note: In each cell, the lower-left number is the payoff to the consumer and the upper-right number the payoff to the producer.

stems from the fact that they represent significant investments by the manufacturer that will be devalued if the product proves unsatisfactory to customers.

The need for signaling variables to complement performance variables in differentiation depends on the ease with which performance can be assessed by the potential buyer. The more difficult it is to ascertain performance prior to purchase, the more important signaling is.

- A perfume can be sampled prior to purchase and its fragrance assessed, but its ability to augment the identity of the wearer and attract attention remains uncertain. Hence, the key role of branding, packaging, advertising, and lavish promotional events in establishing an identity for the perfume in terms of the implied personality, lifestyle, and aspirations of the user.
- In financial services, the customer cannot easily assess the honesty, financial security, or competence of a broker, fund manager, or insurance company. Hence, financial service companies accord emphasis to symbols of security, stability, and competence – large, well-located head offices; conservative and tasteful office decor; smartly dressed, well-groomed employees; and stress on size and continuity over time.

Strategies for reputation building have been subjected to extensive theoretical analysis.[24] Some of the propositions that arise from this research include the following:

- Quality signaling is primarily important for products whose quality can only be ascertained after purchase ("experience goods").
- Expenditure on advertising is an effective means of signaling superior quality, since suppliers of low-quality products will not expect repeat buying and hence it is not profitable for them to spend money on advertising.
- A combination of premium pricing and advertising is likely to be superior in signaling quality than either price or advertising alone.
- The higher the sunk costs required for entry into a market and the greater the total investment of the firm, the greater the incentives for the firm not to cheat customers through providing low quality at high prices.

Brands

Brand names and the advertising that supports them are especially important as signals of quality and consistency – because a brand is a valuable asset, it acts as a disincentive to provide poor quality. For many consumer goods (and some producer goods) companies, their brand is their most important asset.

Brands fulfill multiple roles. Most importantly, a brand provides a guarantee by the producer to the consumer of the quality of the product. It does so in several ways. At its most basic, a brand identifies the producer of a product. This ensures that the producer is legally and morally accountable for the products supplied to market. Further, the brand represents an investment that provides an incentive to maintain quality and customer satisfaction. Hence, the brand represents a guarantee to the customer that reduces uncertainty and search costs. The more difficult it is to discern quality on inspection, and the greater the cost to the customer of purchasing a defective product, the greater the value of a brand. Thus, a well-known brand name is likely to be more important to us when we purchase mountaineering equipment than when we buy a pair of socks.

The traditional role of the brand as a guarantor of reliability is particularly significant in e-commerce. Internet transactions are characterized by the anonymity of buyers and sellers and lack of government regulation. As a result, well-established players in e-commerce – Amazon, Microsoft, eBay, and Yahoo! – can use their brand to reduce consumers' perceived risk.

By contrast, the value conferred by leading consumer brands such as Coca-Cola, Harley-Davidson, Mercedes-Benz, Gucci, Virgin, and American Express is less a guarantee of reliability and more an embodiment of identity and lifestyle. For these brands, advertising and promotion have long been the primary means of influencing and reinforcing customer perceptions. Increasingly, consumer goods companies are seeking new approaches to brand development that focus less on product characteristics and more on "brand experience," "tribal identity," "shared values," and "emotional dialogue."

The Costs of Differentiation

Differentiation adds cost. The direct costs of differentiation include higher quality inputs, better-trained employees, higher advertising, and better after-sales service. The indirect costs of differentiation arise through the interaction of differentiation variables with cost variables. If differentiation narrows a firm's segment scope, it also limits the potential for exploiting scale economies. If differentiation requires continual product redesign, it hampers the exploitation of learning economies.

One means of reconciling differentiation with cost efficiency is to postpone differentiation to later stages of the firm's value chain. Economies of scale and the cost advantages of standardization are frequently greatest in the manufacturing of basic components. Modular design with common components permits scale economies while maintaining considerable product variety. All the major automakers have reduced the number of platforms and engine types and increased the commonality of components across their model ranges, while offering customers a greater variety of colors, trim, and accessory options.

New manufacturing technology and the internet have redefined traditional tradeoffs between efficiency and variety. Flexible manufacturing systems and just-in-time scheduling have increased the versatility of many plants, made model changeovers less costly, and made the goal of an "economic order quantity of one" increasingly realistic. More and more automobile, motorcycle, and domestic appliance plants are producing multiple models on a single assembly line.[25] Internet communication allows consumers to design their own products and quickly communicate their requirements to manufacturers. Pioneers of mass-customization include Capital One, which offers a unique package of credit facilities and interest rate charges to its credit card customers,[26] and Adidas, whose *mi adidas* program offers individually customized sports shoes through foot scanners installed in its retail stores.[27]

Bringing It All Together: The Value Chain in Differentiation Analysis

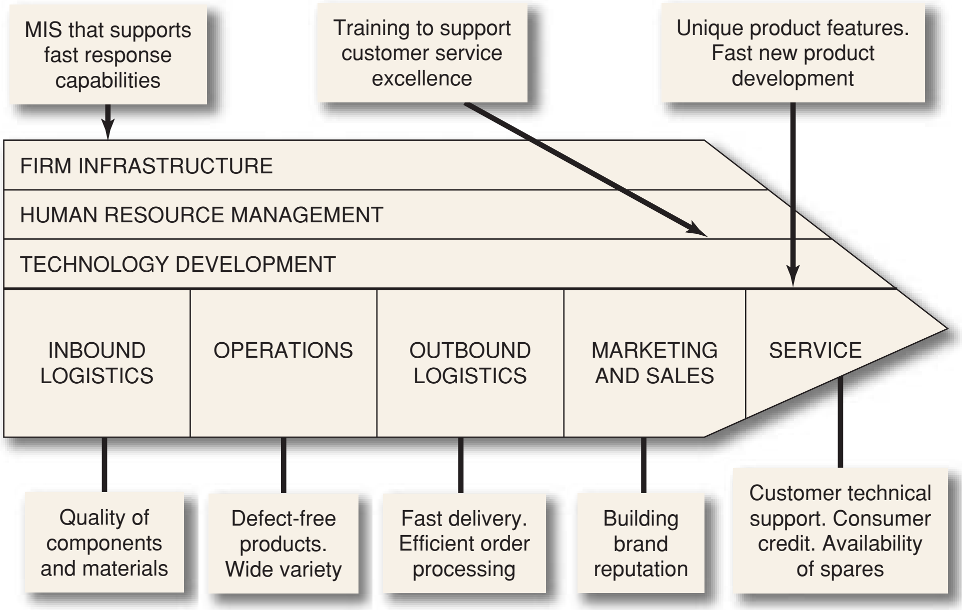
There is little point in identifying the product attributes that customers value most if the firm is incapable of supplying those attributes. Similarly, there is little purpose in identifying a firm's ability to supply certain elements of uniqueness if these are not valued by customers. The key to successful differentiation is matching the firm's capacity for creating differentiation to the attributes that customers value most. For this purpose, the value chain provides a particularly useful framework. Let's begin with the case of a producer good, i.e., one that is supplied by one firm to another.

Value Chain Analysis of Producer Goods

Using the value chain to identify opportunities for differentiation advantage involves four principal stages:

1. *Construct a value chain for the firm and the customer*. It may be useful to consider not just the immediate customer, but also firms further downstream in the value chain. If the firm supplies different types of customers – for example, a steel company may supply steel strip to automobile manufacturers and white goods producers – draw separate value chains for each of the main categories of customer.
2. *Identify the drivers of uniqueness in each activity*. Assess the firm's potential for differentiating its product by examining each activity in the firm's value chain and identifying the variables and actions through which the firm can achieve uniqueness in relation to competitors' offerings. Figure 9.5 identifies sources of differentiation within Porter's generic value chain.
3. *Select the most promising differentiation variables for the firm*. Among the numerous drivers of uniqueness that we can identify within the firm, which one should be selected as the primary basis for the firm's differentiation strategy? On the supply side, there are three important considerations.
   - First, we must establish where the firm has greater potential for differentiating from, or can differentiate at lower cost than, rivals. This requires some analysis of the firm's internal strengths in terms of resources and capabilities.

FIGURE 9.5 Using the value chain to identify differentiation potential on the supply side



- Second, to identify the most promising aspects of differentiation, we also need to identify linkages among activities, since some differentiation variables may involve interaction among several activities. Thus, product reliability is likely to be the outcome of several linked activities: monitoring purchases of inputs from suppliers, the skill and motivation of production workers, and quality control and product testing.
- Third, the ease with which different types of uniqueness can be sustained must be considered. The more differentiation is based on resources specific to the firm or skills that involve the complex coordination of a large number of individuals, the more difficult it will be for a competitor to imitate the particular source of differentiation. Thus, offering business-class passengers wider seats and more legroom is an easily imitated source of differentiation. Achieving high levels of punctuality represents a more sustainable source of differentiation.

4 *Locate linkages between the value chain of the firm and that of the buyer.* The objective of differentiation is to yield a price premium for the firm. This requires that the firm's differentiation creates value for the customer. Creating value for customers requires either that the firm lowers customers' costs, or that customers' own product differentiation is facilitated. Thus, by reorganizing its product distribution around quick response technologies, Procter & Gamble has radically reduced distribution time and increased delivery reliability. This permits retailers to reduce costs of inventory while simultaneously increasing their reliability to shoppers through lowering the risk of stockouts. To identify the means by which a firm can create value for its customers it must locate the linkages between differentiation of its own

activities and cost reduction and differentiation within the customer's activities. Analysis of these linkages can also evaluate the potential profitability of differentiation. The value differentiation created for the customer represents the maximum price premium the customer will pay. If the provision of just-in-time delivery by a component supplier costs an additional $1,000 a month but saves an automobile company $6,000 a month in reduced inventory, warehousing, and handling costs, then it should be possible for the component manufacturer to obtain a price premium that easily exceeds the costs of the differentiation.

Strategy Capsule 9.3 demonstrates the use of value chain analysis in identifying differentiation opportunities available to a manufacturer of metal containers.

STRATEGY CAPSULE 9.3

Analyzing Differentiation Opportunities for a Manufacturer of Metal Containers

The metal container industry is a highly competitive, low-growth, low-profit industry. Cans lack much potential for differentiation and buyers (especially beverage and food canning companies) are very powerful. Clearly, cost efficiency is essential, but are there also opportunities for differentiation advantage? A value chain analysis can help a metal can manufacturer identify profitable opportunities for differentiation.

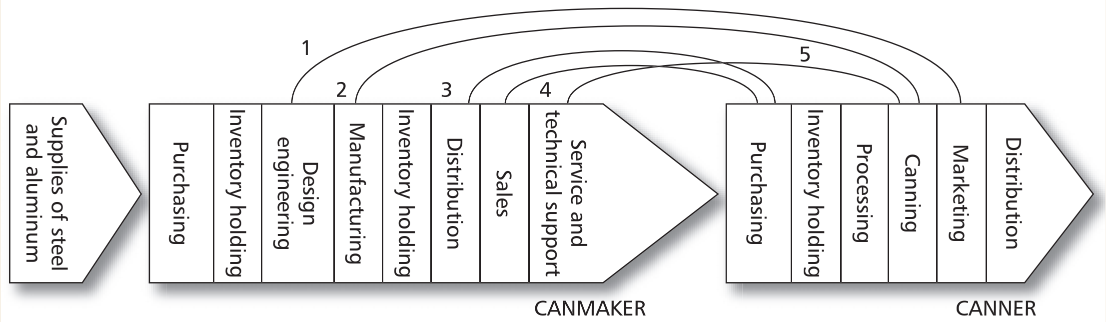
STAGE 1. Construct value chain for firm and customers. The principal activities of the can manufacturer and its customers are shown in the diagram below.

STAGE 2. Identify the drivers of uniqueness. For each of the canmaking activities it is possible to suggest several possible differentiation variables. Examples are shown on the diagram.

STAGE 3. Select key variables. To select the most promising differentiation variables, the company's internal strengths must be considered. If the firm has strong technical capabilities, then it might design and manufacture products to meet difficult technical and design specifications, and provide sophisticated technical services to customers. If its logistics capabilities are strong it might offer fast and reliable delivery, possibly extended to electronic data interchange with customers.

STAGE 4. Identify linkages. To determine differentiation likely to create value for the customer, identify linkages between the canmaker's potential for differentiation and the potential for reducing cost or enhancing differentiation within the customer's value chain. The diagram identifies five such linkages:

Identifying differentiation opportunities through linking the value chains of the firm and its customers: can manufacture



1. Distinctive can design can assist canners' marketing activities.
2. High manufacturing tolerances can avoid breakdowns in customer's canning lines.
3. Frequent, reliable delivery can permit canner to adopt just-in-time can supply.
4. Efficient order processing system can reduce customers' ordering costs.
5. Competent technical support can increase canner's efficiency of plant utilization.

Value Chain Analysis of Consumer Goods

Value chain analysis of differentiation opportunities can also be applied to consumer goods. Few consumer goods are consumed directly; in most cases consumers are involved in a chain of activities involving the acquisition and purchase of the product. Hence, even when the customer is a consumer, it is still feasible to draw a value chain showing the activities that the consumer engages in when purchasing and consuming a product.

In the case of consumer durables, customers are involved in a long chain of activities from search, purchase, financing, acquiring accessories, operation, service and repair, and eventual disposal. Complex consumer value chains offer many potential linkages with the manufacturer's value chain, with considerable opportunity for innovative differentiation. Japanese producers of automobiles, consumer electronics, and domestic appliances have a long tradition of observing their customers' behavior in selecting and utilizing products, then using the information of customer usage and selection processes in planning product design and marketing. Harley-Davidson has been particularly effective at achieving differentiation advantage through careful examination of the activities that customers undertake in selecting, purchasing, using, and maintaining their motorcycles. Harley creates value for its customers through providing test ride facilities at its dealerships, financing, driving instruction, insurance, service and repair facilities, owners' club activities, and various sponsored events for Harley riders. Even nondurables involve the consumer in a chain of activities. Consider a frozen TV dinner: it must be purchased, taken home, removed from the package, heated, and served before it is consumed. After eating, the consumer must clean any used dishes, cutlery, or other utensils. A value chain analysis by a frozen foods producer would identify ways in which the product could be formulated, packaged, and distributed to assist the consumer in performing this chain of activities.

Summary

The attraction of differentiation over low cost as a basis for competitive advantage is its potential for sustainability. It is less vulnerable to being overturned by changes in the external environment, and it is more difficult to replicate.

The potential for differentiation in any business is vast. It may involve physical differentiation of the product, it may be through complementary services, it may be intangible. Differentiation extends beyond technology, design, and marketing to include all aspects of a firm's interactions with its customers.

The essence of differentiation advantage is to increase the perceived value of the offering to the customer either more effectively or at lower cost than do competitors. This requires that the firm match the requirements and preferences of customers with its own capacity for creating uniqueness.

The value chain provides a useful framework for analyzing differentiation advantage. By analyzing how value is created for customers and by systematically appraising the scope of each of the firm's activities for achieving differentiation, the value chain permits matching demand-side and supply-side sources of differentiation.

Successful differentiation requires a combination of astute analysis and creative imagination. The two are not antithetical. A systematic framework for the analysis of differentiation can act as a stimulus to creative ideas.

Self-Study Questions

1 What examples of differentiated consumer products and service offerings can you think of that are differentiated but also succeed in attracting customers across multiple market segments? What advice would you offer companies that are attempting to differentiate their consumer offerings while maintaining a broad market appeal?

2 During 2004–7, Sony has struggling to challenge the Apple iPod's dominance of the market for portable MP3 music players. Using the framework outlined in Figure 9.2, suggest opportunities for how Apple might differentiate its MP3 Walkman to increase its customer appeal?

3 What advice would you offer L'Oreal for how it should maintain (or possibly adjust) Body Shop's differentiation and overall competitive positioning (see Strategy Capsule 9.2)?

4 During 2006, Dell Computer faced shrinking margins and a declining share price as the computer market became increasingly commoditized and price competitive. Use the value chain framework outlined in Strategy Capsule 9.3 to identify potential linkages between Dell's value chain and that of the customer in order to spot new differentiation opportunities for Dell.

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