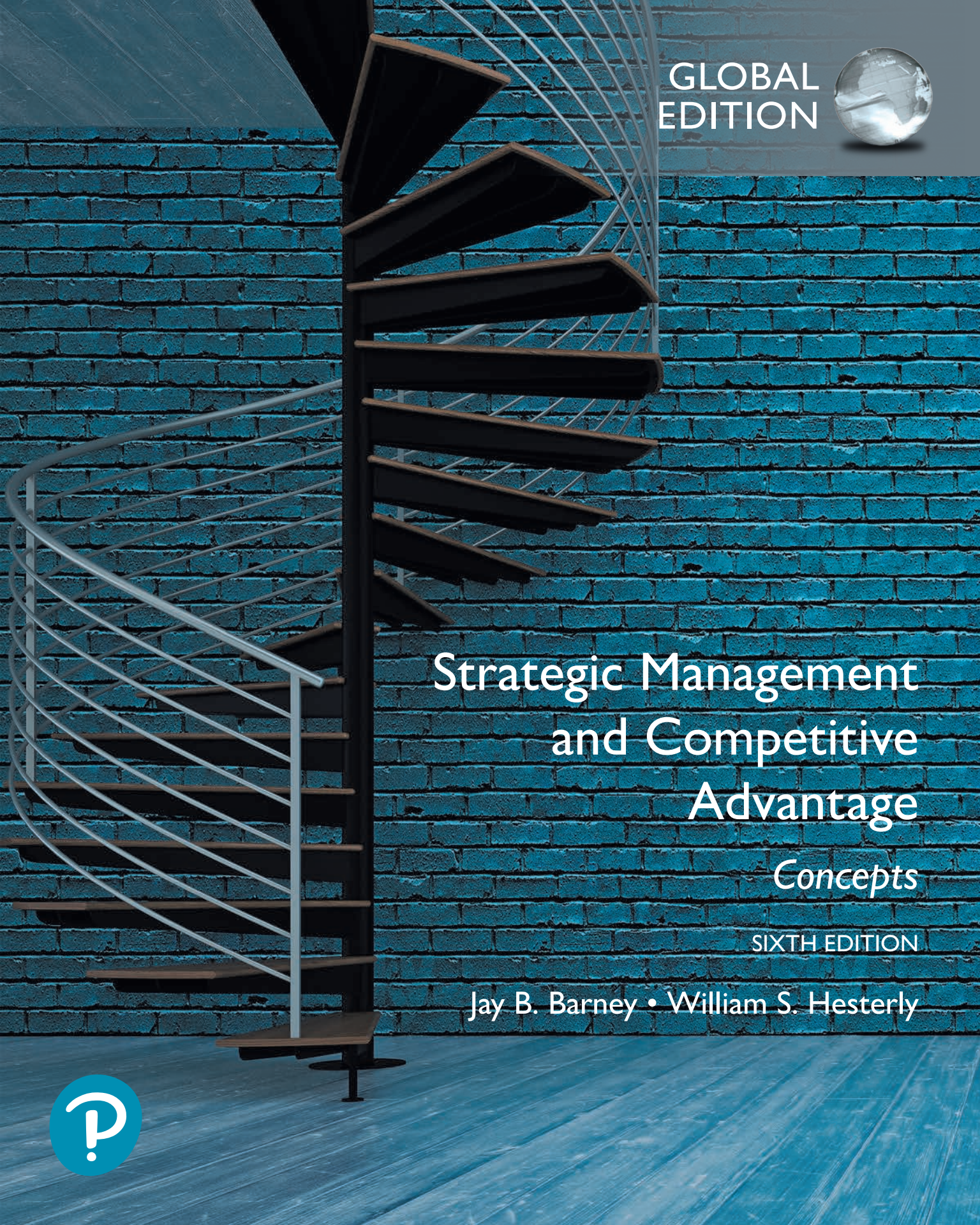
GLOBAL
EDITION
Strategic Management
and Competitive
Advantage
Concepts
SIXTH EDITION
Jay B. Barney • William S. Hesterly

"VALUE. RARITY. IMITABILITY. ORGANIZATION."

What Is It?

This book is not just a list of concepts, models, and theories. It is the first undergraduate textbook to introduce a **theory-based, multi-chapter organizing framework** to add additional structure to the field of strategic management.

"VRIO" is a mechanism that integrates two existing theoretical frameworks: the positioning perspective and the resource-based view. It is the primary tool for accomplishing internal analysis. It stands for four questions one must ask about a resource or capability to determine its competitive potential:

1. **The Question of Value:** Does a resource enable a firm to exploit an environmental opportunity, and/or neutralize an environmental threat?
2. **The Question of Rarity:** Is a resource currently controlled by only a small number of competing firms?
3. **The Question of Imitability:** Do firms without a resource face a cost disadvantage in obtaining or developing it?
4. **The Question of Organization:** Are a firm's other policies and procedures organized to support the exploitation of its valuable, rare, and costly-to-imitate resources?

What's the Benefit of the VRIO Framework?

The VRIO framework is the organizational foundation of the text. **It creates a decision-making framework for students** to use in analyzing case and business situations.

Students tend to view concepts, models, and theories (in all of their coursework) as fragmented and disconnected. Strategy is no exception. This view encourages rote memorization, not real understanding. VRIO, by serving as a consistent framework, connects ideas together. This encourages real understanding, not memorization.

This understanding enables students to better analyze business cases and situations—the goal of the course.

Within each chapter, the VRIO framework makes it possible to discuss the formulation and implementation of a strategy simultaneously.

Because the VRIO framework provides a simple integrative structure, we are actually able to address issues in this book that are largely ignored elsewhere—including discussions of vertical integration, outsourcing, real options logic, and mergers and acquisitions, to name just a few.

PART

2 BUSINESS-LEVEL STRATEGIES

CHAPTER

4 Cost Leadership

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

4.1 Define business level strategies.

4.2 Define cost leadership as a business level strategy and identify six reasons firms can differ in their costs.

4.3 Describe how cost leadership can create economic value for a firm.

4.4 Identify the bases of cost leadership that are more likely to be rare and costly to imitate and those that area less likely to be rare and costly to imitate.

4.5 Explain how firms use a functional organizational structure, formal and informal management controls, and compensation policies to implement cost leadership strategies.

Brathwait: A Transparent Watchmaker

Brathwait is a new entrant into the minimalist watch segment, but it has a significant competitive advantage—the low price of its watches. Brathwait's mission is to bring transparency into the field of watchmaking by informing their customers about the total breakdown of the production costs and the amount of profit they make per item. According to Henrik Torp, the founder and CEO, Brathwait minimizes the watches' costs to give the customer an excellent watch at a much lower price in comparison to traditional brands, which charge exceptionally high prices. Industry insiders believe that Brathwait is poised to make a big splash in the minimalist segment of the global wristwatch market, and it's all down to their transparent marketing strategy.

The unlikely inspiration for a brand of exquisitely designed minimalist watches came from a book called *The English Gentleman*, authored by Richard Brathwait in 1631. His codes of etiquette were a huge influence on the way people were expected to behave in society. The watch brand is named after him not only to acknowledge his legacy but also to reflect the values of the modern gentleman and gentlewoman who follows the heritage of those codes of etiquette—and, of course, wears Brathwait watches.

The watch industry is going through the second phase of disruptive innovation due to the arrival of smartwatches. The traditional watchmaking industry has entertained

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a gloomy outlook for the last two years, but the industry experienced a similar disruptive phase during the 1970s with the advent of Japanese quartz movement technology—a quartz watch is powered by an electronic oscillator synchronized by a quartz crystal. The more recent disruptions in the industry have not stopped Brathwait's entry into a market dominated by Swiss manufacturers. In addition, recent performance data shows a rebound of traditional watches in the market. The Swiss watch industry has reported CHF 5.0 billion in exports in the second quarter of 2017, compared to CHF 4.8 billion in 2016.

Manufacturing watches only costs a fraction of the total cost; a substantial proportion of it is spent on exclusive promotions and advertising. A Swiss quartz movement with extra-long battery life can cost as little as $10, and Chinese-made quartz movements are even cheaper at $3. However, due to celebrity endorsements and other branding activities, the final price of an average Swiss watch can be fifty times the original cost or even higher.

Brathwait keeps costs low by manufacturing its watches in China, excluding intermediaries (like retailers and stockists) and using an advertisement strategy that focuses on social media. The components are sourced from Italy (leather straps), Switzerland (quartz movement), and Japan (automatic movement). Their cost breakdown, available on its Web site, shows a total cost of $92.35 for the Classic Swiss model.

To gain market share at the higher end of Swiss-made watches, Brathwait launched a few limited editions of automatic watches powered by the Sellita Sw260-1 high beat movement; the higher number of jewels in Sellita reduces the friction in automatic winding, increasing reliability. The strategy for the limited-edition Brathwait watches is to offer the elegance of the Swiss watches at an affordable price.

Brathwait's story is an intriguing for its dual proposition of breaking the secrecy of watchmaking and offering watch-lovers high-quality timepieces at an affordable price. However, it should be said that the company is still a new entrant, and it may face numerous entry barriers and growth pains in the future.[1]

The Brathwait watch company has been able to grow in an industry traditionally dominated by Swiss watch manufacturers such as Swatch and Tissot. Brathwait's success so far is attributed to its stylish wristwatches that are considerably less expensive than its more established rivals. Brathwait is a classic example of a low-cost strategy.

Objective 4.1 Define business level strategies.

What is Business-Level Strategy?

Part 1 of this book introduced the basic tools required to conduct a strategic analysis: tools for analyzing external threats and opportunities (in Chapter 2) and tools for analyzing internal strengths and weaknesses (in Chapter 3). Once these two analyses have been completed, it is possible to begin making strategic choices. As explained in Chapter 1, strategic choices fall into two large categories: business strategies and corporate strategies. **Business-level strategies** are actions firms take to gain competitive advantages in a single market or industry. **Corporate-level strategies** are actions firms take to gain competitive advantages by operating in multiple markets or industries simultaneously.

The business-level strategies discussed in this book are cost leadership (this chapter), product differentiation (Chapter 5), flexibility (Chapter 6), and collusion (Chapter 7). The importance of these business-level strategies is so widely recognized that they are often called **generic business strategies**.

Objective 4.2 Define cost leadership as a business level strategy and identify six reasons firms can differ in their costs.

What is Cost Leadership?

A firm that chooses a **cost leadership business strategy** focuses on gaining advantages by reducing its costs to below those of all its competitors. This does not mean that this firm abandons other business or corporate strategies. Indeed, a single-minded focus on *just* reducing costs can lead a firm to make low-cost products that no one wants to buy. Recall that Warby Parker focuses on keeping its costs (and prices) low, but that it does not abandon the effort to sell stylish eyeglasses to consumers. That said, a firm pursuing a cost leadership strategy focuses much of its effort on keeping its costs low.

Numerous firms besides Warby Parker have pursued cost leadership strategies. Ryanair follows this strategy in the airline industry, Timex and Casio in the watch industry, and BIC in the disposable pen and razor market. All these firms advertise their products. However, these advertisements tend to emphasize reliability and low prices—the kinds of product attributes that are usually emphasized by firms pursuing cost leadership strategies.

In automobiles, Fiat has implemented a cost leadership strategy with its emphasis on low-priced cars for basic transportation. Like Ryanair, Timex, Casio, and BIC, Fiat spends a significant amount of money advertising its products, but its advertisements tend to emphasize its sporty, sexy styling and low price. Fiat has positioned its cars as fun and inexpensive, not a high-performance sports car or a luxurious status symbol. Fiat's ability to sell these fun and inexpensive automobiles depends on its design choices (keep it simple) and its low manufacturing costs.[2]

Sources of Cost Advantages

An individual firm may have a cost advantage over its competitors for several reasons. Cost advantages are possible even when competing firms produce similar products. Some of the most important of these sources of cost advantage are listed in Table 4.1 and discussed in this section.

1. Size differences and economies of scale
2. Size differences and diseconomies of scale
3. Experience differences and learning-curve economies
4. Differential low-cost access to productive inputs
5. Technological advantages independent of scale
6. Policy choices

TABLE 4.1 Important Sources of Cost Advantages for Firms

Size Differences and Economies of Scale

One of the most widely cited sources of cost advantages for a firm is its size. When there are significant economies of scale in manufacturing, marketing, distribution, service, or other functions of a business, larger firms (up to some point) can have a cost advantage over smaller firms.

The concept of economies of scale was first defined in Chapter 2. **Economies of scale** are said to exist when the increase in firm size (measured in terms of volume of production) is associated with lower costs (measured in terms of average costs per unit of production), as depicted in Figure 4.1. As the volume of production in a firm increases, the average cost per unit decreases until some optimal volume of production (point X) is reached, after which the average costs per unit of production begins to rise because of **diseconomies of scale** (a concept discussed in more detail later in this chapter).

If the relationship between volume of production and average costs per unit of production depicted in Figure 4.1 holds, and if a firm in an industry has the largest volume of production (but not greater than the optimal level, X), then that firm will have a cost advantage in that industry. Increasing the volume of production can reduce a firm's costs for several reasons. Some of the most important of these reasons are summarized in Table 4.2 and discussed in the following text.

Volume of Production and Specialized Machines When a firm has high levels of production, it is often able to purchase and use specialized manufacturing tools that cannot be kept in operation in small firms. Manufacturing managers at BIC

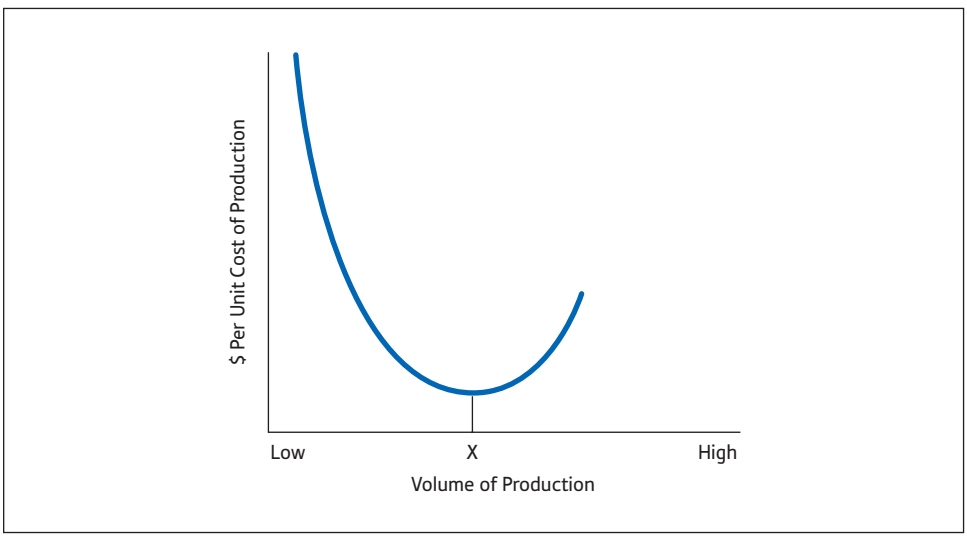

Figure 4.1 Economies of Scale

TABLE 4.2 Why Higher Volumes of Production in a Firm Can Lead to Lower Costs

With higher production volume . . .
1. Firms can use specialized machines
2. Firms can build larger plants
3. Firms can increase employee specialization
4. Firms can spread overhead costs across more units produced
. . . which can lower per-unit production costs.

Corporation, for example, have emphasized this important advantage of high volumes of production. A former director of manufacturing at BIC once observed:

> *We are in the automation business. Because of our large volume, one tenth of 1 cent in savings turns out to be enormous. . . . One advantage of the high-volume business is that you can get the best equipment and amortize it entirely over a short period of time (4 to 5 months). I'm always looking for new equipment. If I see a cost-savings machine, I can buy it. I'm not constrained by money.*[3]

Only firms with BIC's level of production in the pen industry can reduce their costs in this manner.

Volume of Production and the Cost of Plant and Equipment High volumes of production may also enable a firm to build larger manufacturing operations. In some industries, the cost of building these manufacturing operations per unit of production is lower than the cost of building smaller manufacturing operations per unit of production. Thus, large-volume firms, other factors being equal, will be able to build lower-per-unit-cost manufacturing operations and will have lower average costs of production.

The link between volume of production and the cost of building manufacturing operations is particularly important in industries characterized by **process manufacturing**—chemical, oil refining, paper and pulp manufacturing, and so forth. Because of the physical geometry of process manufacturing facilities, the costs of constructing a processing plant with increased capacity can be expected to rise as the two-thirds power of a plant's capacity. This is because the area of the surface of some three-dimensional containers (such as spheres and cylinders) increases at a slower rate than the volume of these containers. Thus, larger containers hold greater volumes and require less material per unit volume for the outside skins of these containers. Up to some point, increases in capacity come at a less-than-proportionate rise in the cost of building this capacity.[4]

For example, it might cost a firm \$100 to build a plant with a capacity of 1,000 units, for a per-unit average cost of \$0.01. But, if the "two-thirds rule" applies, it might cost a firm \$465 to build a plant with a capacity of 10,000 units ($465 = 10{,}000^{2/3}$), for a per-unit average cost of \$0.0046. The difference between \$0.01 per unit and \$0.0046 per unit represents a cost advantage for a large firm.

Volume of Production and Employee Specialization High volumes of production are also associated with high levels of employee specialization. As workers specialize in accomplishing a narrow task, they can become more and more efficient at this task, thereby reducing their firm's costs. This reasoning applies both in specialized manufacturing tasks (such as the highly specialized manufacturing functions in an assembly line) and in specialized management functions (such as the highly specialized managerial functions of accounting, finance, and sales).