Creating Value

The Core

Staking Out Your Company's Unique Competitive Position Using Michael Porter's Elements of Strategy

Excerpted from

Understanding Michael Porter:
The Essential Guide to Competition and Strategy

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CHAPTER 4

Creating Value:

The Core

STRATEGY'S FIRST TEST, HAVING a distinctive value proposition, is so intuitive that many managers think they have a strategy if they can get this far. Choosing the particular kind of value you will offer your customers is the core of competing to be unique. But recall the definition of competitive advantage: a difference in relative price or relative costs that arises because of *differences in the activities* being performed. Your value chain must be specifically tailored to deliver your value proposition. A value proposition that can be effectively delivered without a tailored value chain will not produce a sustainable competitive advantage. The tailored value chain is Porter's second test, and it is neither obvious nor intuitive.

How these two core elements of strategy are linked to each other—and how they are linked to industry structure and competitive advantage—is the subject of this chapter. Strategy means deliberately choosing a different set of activities to deliver a unique mix of value. If all rivals produce the same way, distribute the same way, service the same way, and so on, they are, in Porter's terms, competing to be the best, and not competing on strategy.

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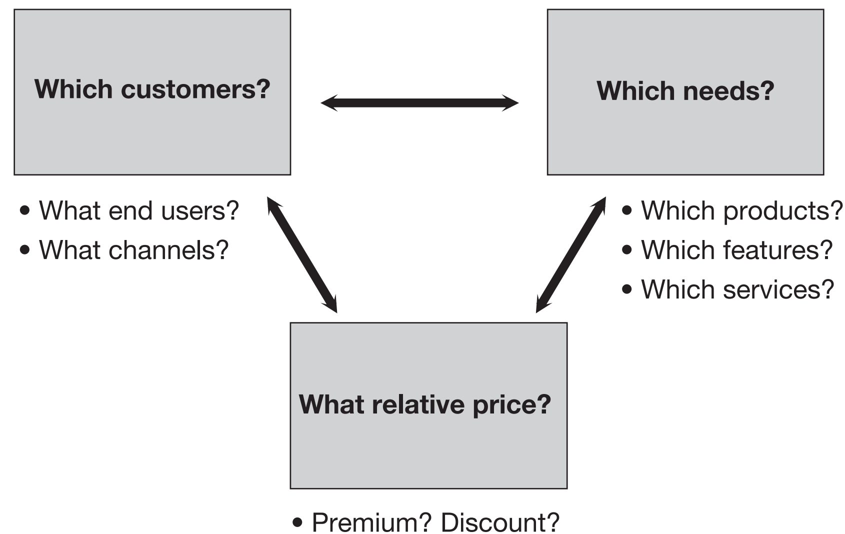
The First Test: A Distinctive Value Proposition

The value proposition is the element of strategy that looks outward at customers, at the demand side of the business. A value proposition reflects choices about the particular kind of value the company will offer, whether those choices have been made consciously or not. Porter defines the value proposition as the answer to three fundamental questions (see figure 4-1):

- Which customers are you going to serve?
- Which needs are you going to meet?
- What relative price will provide acceptable value for customers and acceptable profitability for the company?

FIGURE 4-1

The value proposition answers three questions



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> The value proposition is the element of strategy that looks outward at customers, at the demand side of the business. The value chain focuses internally on operations. Strategy is fundamentally integrative, bringing the demand and supply sides together.

This definition reflects the evolution of Porter's thinking beyond his 1996 HBR article "What Is Strategy?" There he described three sources of positioning: variety, needs, and access. Subsequent work led him to the more complete formulation discussed here, one he has elaborated over the past decade in numerous speeches and lectures.

Which Customers?

Within an industry, there are usually distinct groups of customers, or customer segments. A value proposition can be aimed specifically at serving one or more of these segments. For some value propositions, choosing the customer comes first. That choice then leads directly to the other two legs of the triangle: needs and relative price.

Customer segmentation is typically part of any good industry analysis, and choosing the customer(s) you will serve can be an important anchor in your positioning vis-à-vis the five forces. In the examples that follow, note how each reflects a different basis for segmentation: Walmart's segmentation was based on geography, Progressive's on demographics, and Edward Jones's on psychographics.

Given that Walmart is the world's largest retailer, with over $400 billion in sales, it may seem irrelevant to ask which segment Walmart

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serves. But like all large companies, Walmart started small, and it had to pick a place to begin. Choosing to serve a specific customer group gave Walmart its start. In the 1960s, when Walmart began operations, discount retailing was a new, disruptive business model. While the early players focused on big cities and metropolitan areas like New York, Sam Walton did something unique: he chose isolated rural towns with populations between 5,000 and 25,000. Walmart's "key strategy," in Walton's own words, "was to put good-sized stores into little one-horse towns which everybody else was ignoring."

In terms of the five forces, this choice of customers insulated Walmart from direct rivalry with other discounters. Although people tend to think of Walmart as a fierce competitor, Walmart started out by completely avoiding head-to-head competition. Doing so gave it many years of breathing room to develop and extend its positioning as a provider of everyday low prices.

Progressive, the Ohio-based auto insurer, also built a strategy around a customer its industry was largely avoiding. For about three decades, Progressive thrived by choosing to serve what the industry called "nonstandard" drivers, those more likely to be involved in accidents and to file insurance claims (motorcycle owners, for example, or motorists with drunk-driving records). With few alternatives, nonstandard buyers typically had little bargaining power.

Finally, if you look at the wealth management business, you'll find just about everyone chasing the same demographic segment: the high-net-worth individual. Not Edward Jones, one of the consistently most successful U.S. brokerage firms. For thirty years, it has focused on customers defined not by how much money they have, but on their attitude toward investing. Jones serves conservative investors who delegate financial decisions to a trusted advisor. In terms of the five forces, this customer segment has been less price sensitive and more loyal.

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As often happens, each of these value propositions targeted a customer group overlooked or avoided by the industry. That's not essential, however. In insurance, for example, USAA has been a stellar performer with a value proposition aimed at low-risk customers. Here's what *is* essential: finding a unique way to serve your chosen segment profitably.

Which Needs?

In many cases, choosing the need the company will serve is the primary decision that leads to the other two legs of the triangle. Here, strategy is built on a unique ability to meet a particular need or a subset of needs. Often that ability arises from the specific features of a product or service. Typically, value propositions based on needs appeal to a mix of customers who might defy traditional segmentation. Instead of belonging to a clear demographic category, the company's customers will be defined by the common need or set of needs they share at a given time.

Typically, value propositions based on needs appeal to a mix of customers who might defy traditional demographic segmentation.

Enterprise Rent-A-Car is the market leader in car rental services in North America, where it is bigger than the once-dominant players, Hertz and Avis. Enterprise has also been dramatically more profitable. It is the only major company in the industry that has enjoyed sustained superior profitability, because for decades it pursued a distinctive strategy.

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The Enterprise value proposition is based on a simple insight: renting a car meets different needs at different times. Hertz and its followers in the industry built their business around travelers, people away from home on business or on vacation. Enterprise recognized that a sizeable minority of rentals, roughly 40 to 45 percent, occur in the renter's home city. If your car is stolen, for example, or damaged in an accident, you'll need a rental. In such cases, your insurance company might cover the cost, usually with contractual limits on the price it will pay. About a third of Enterprise's revenues come from insurers. Other occasions prompt home-city rentals as well—for example, when a car has a mechanical failure or when a child is home from school on vacation. In all of these uses, home-city car renters tend to be more price sensitive than business or vacation travelers.

Enterprise crafted a unique value proposition to meet these needs: reasonably priced, convenient, home-city rentals. Compared with Hertz and Avis, Enterprise has chosen to serve a different need at a different relative price. It is not that Enterprise is the *best* car rental company. Nor is the market it serves inherently better. But starting with the specific need it serves, Enterprise has made a *different* choice about the value proposition triangle. Enterprise's customer base would confound traditional market segmentation by demographic characteristics.

Zipcar, started in Cambridge, Massachusetts, in 2000, is pursuing a different path to uniqueness in home-city car rentals. Its value proposition targets yet another kind of customer with a different kind of need (see figure 4-2). Zipsters, as the company's members are called, are often people who choose not to own a car, but who occasionally need to use one. Zipcar allows them to rent a car for time periods as short as an hour.

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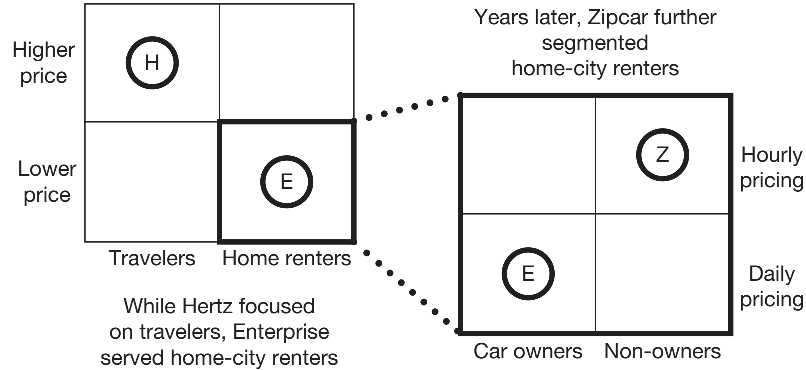
FIGURE 4-2

Positioning maps



Zipcar offers an interesting and complex mix of value: extreme convenience in vehicle pickup and drop-off; extreme flexibility in the rental period; clear, all-inclusive pricing that includes insurance and gas; and the intangible "cool" factor associated with this fast-growing brand. I should add that because this company is an early work-in-progress, it will undoubtedly continue to test the boundaries of its value proposition and to make adjustments to it as it learns.

What Relative Price?

For some value propositions, relative price is a primary leg of the triangle. Some value propositions target customers who are overserved (and hence overpriced) by other offerings in the industry. A company can win these customers by eliminating unnecessary costs and meeting "just enough" of their needs. At the product level, think about

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the difference between a bare-bones cell phone and a more expensive, feature-laden smartphone. Where customers are overserved, the lower relative price is often the dominant leg of the triangle.

Conversely, some value propositions target customers who are underserved (and hence underpriced) by other offerings in the industry. Customers who choose NetJets instead of flying first class on a commercial airline, for example, want an enhanced service and are willing to pay a steep premium for it. Similarly, Denmark's Bang & Olufsen (B&O) gives its customers something more than the spectacular sound quality offered by other high-end audio equipment makers. B&O's customers want products that look as good as they sound, and they are willing to pay more for beautiful design. In value propositions like B&O's, the unmet need is typically the dominant leg of the triangle, while the higher relative price supports the extra costs the company has to incur to meet it.

When Needs Are Overserved: Southwest. According to company legend, here's how Southwest Airlines was born. Back in the late 1960s, "a couple of guys said, 'Here's an idea. Why don't we start an airline that charges just a few bucks and has lots of flights every day instead of what the other guys are doing—charging a lot of bucks and having just a few flights each day?'" That, in a nutshell, is Southwest Airlines' value proposition: very low prices coupled with very convenient service.

Southwest Airlines, the most successful—and the most emulated—airline in the world, has thrived by meeting "just enough" of its customers' needs at dramatically lower prices. From its humble beginnings flying only to three cities in Texas in 1971, Southwest has grown to be one of the world's leading airlines, both in size and in profitability. It has done so with a value proposition that for three decades was radically different from other airlines.

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Southwest didn't promise to get you anywhere you wanted to go, as other airlines did. Nor did it offer the basic amenities that were once standard industry fare: meals, assigned seats, baggage transfers. Full-service airlines (perhaps a term that no longer accurately describes the legacy carriers, with their higher costs and prices) overserved the needs of a large number of travelers flying Southwest's shorter point-to-point routes.

Southwest's value proposition put it in a unique position vis-à-vis the five forces. As most know, the airline industry is brutally inhospitable.

- Suppliers, especially the labor unions but also plane makers, are powerful.
- Customers are powerful because they are price sensitive and have low switching costs.
- Rivals, dealing with high fixed costs, compete on price to fill seats.
- New entrants are a constant threat, because entry barriers are lower than you might think. You can start an airline with a couple of leased planes.
- Substitutes keep prices down. Customers can choose other forms of transportation, especially on shorter trips.

Southwest's low relative costs provided shelter from the industry's self-destructive price competition. Moreover, its value proposition gave it a truly unique positioning vis-à-vis that last force, substitution. Its low fares made flying an attractive alternative for price-sensitive travelers accustomed to driving or taking a bus. In the early years, a shareholder asked CEO Herb Kelleher if Southwest couldn't raise its prices by just a few dollars since its $15 price on the Dallas–San Antonio

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route was so much lower than Braniff's $62 fare. Kelleher said no, our real competition is ground transportation, not other airlines.

Consider Southwest's first expansion beyond its original three cities, Dallas, Houston, and San Antonio. It chose Harlingen, Texas, a town in the Rio Grande Valley probably few people have ever heard of. The year before Southwest launched its service, 123,000 passengers flew from Southwest's base cities to the Valley. Within a year after Southwest began flying to Harlingen, passenger volume jumped to 325,000.

And price isn't the whole story. Southwest was also more convenient. First, its frequent departures allowed customers to travel when they wanted. Second, its flights arrived on time and customers didn't have to wait in slow lines at the ticket counter. Third, the secondary airports that became central to Southwest's strategy were closer to downtown, cutting a traveler's total trip time. These convenience factors were a draw for business travelers.

Southwest didn't figure out every element of its value proposition on Day One. Companies rarely do. It learned by doing. Here's a classic example of how that happens in practice. In 1971, one of the planes in Houston needed to go to Dallas for routine maintenance over the weekend. Then-CEO Lamar Muse didn't want to fly the plane empty, figuring that some revenue was better than none. He offered seats on the Friday-night flight for $10, half off the standard $20 fare on that route. The flight sold out, providing some extra cash for the struggling start-up.

Even better than the cash was the game-changing insight about Southwest's customers. Some were clearly more price sensitive, and less time sensitive, than others. Muse acted immediately. He raised the peak fare to $26 and dropped the off-peak fare to $13. Multiple-tier pricing is now standard industry practice, but at the time, it was a major innovation. It allowed Southwest to further segment its customers and to fill its planes. Lower off-peak fares appeal to leisure

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travelers who are more price sensitive and have greater flexibility about when they travel than do business passengers.

Thus Southwest's value proposition cut across traditional customer segments, appealing, on given occasions, to a variety of customers: business travelers, families, and students. Instead of meeting all of the needs of a target customer all of the time, Southwest meets one type of need that many customers have at least some of the time. Southwest created a distinct kind of value that, for many decades, distinguished it from other airlines.

Although Southwest has been widely imitated, it would be a mistake to say that Southwest has found the "best" value proposition for the industry. It is only "best" at meeting a particular kind of need at a particular relative price.

When Needs Are Underserved: Aravind Eye Hospital. India's Aravind Eye Hospital was founded in 1976 by an idealistic retired army surgeon, Govindappa Venkataswamy, known as Dr. V. Dr. V. didn't need a detailed market segmentation map to identify a large population with a dramatically underserved need. Millions of Indians suffer from preventable blindness because they can't afford cataract surgery. Starting with just eleven beds and three doctors, Aravind has become the world's largest provider of eye care in the world, performing about 300,000 surgeries a year, at least two-thirds of them for free.

Aravind has an extraordinary value proposition. Correction: it has *two* value propositions. One is aimed at affluent customers who want the best eye care money can buy. These customers want to be seen by state-of-the-art doctors in state-of-the-art facilities, and they are willing to pay the going market rate for such advanced medical care. That's one value proposition.

The second is for those who can't afford to pay and who would otherwise become blind. Aravind offers them sight, and the

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independence that goes with it. The medical care is identical to that provided to the paying patients—same doctors, same operating rooms. The hotel function (room and board) is vastly stripped down. But the price is stripped down even further, all the way to zero.

Aravind has thrived by meeting vitally important needs for two distinct customer segments, at different price points. What's most remarkable is that Aravind is financially self-sustaining—it depends neither on government money nor on charitable donations, although its success has increasingly attracted the latter. Instead it has a strategy that has proven to be sustainable for over three decades.

The first test of a strategy is whether your value proposition is different from your rivals. If you are trying to serve the same customers *and* meet the same needs *and* sell at the same relative price, then by Porter's definition, you don't have a strategy.

In most businesses, there are many different possible configurations of the value proposition triangle. Some companies serve virtually all customers in the market but only meet a specific need or cluster of needs. Other companies serve a more focused customer base but aim to meet more of those customers' needs. Some companies deliver higher value at a premium price. Others, enabled by their efficiency, offer a low relative price.

The first test of a strategy is whether your value proposition is different from your rivals. If you are trying to serve the same customers *and* meet the same needs *and* sell at the same relative price, then by Porter's definition, you don't have a strategy. You're competing to be the best.

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The Second Test: A Tailored Value Chain

If you're trying to describe a strategy, the value proposition is a natural place to begin. It's intuitive to think of strategy in terms of the mix of benefits aimed at meeting customers' needs. But the second test of strategy is often overlooked because it is not intuitive at all. A distinctive value proposition, Porter explains, will not translate into a meaningful strategy unless the best set of activities to deliver it is different from the activities performed by rivals. His logic is simple and compelling: "If that were not the case, every competitor could meet those same needs, and there would be nothing unique or valuable about the positioning."

Insight into customers' needs is important, but it's not enough. The essence of strategy and competitive advantage lies in the *activities*, in choosing to *perform activities differently* or to *perform different activities* from those of rivals. Each of the companies we've just described has done just that, tailoring their value chains to their value propositions.

Walmart, Progressive, and Edward Jones

Let's return to the trio of companies whose value propositions were built around serving a distinct customer. We'll begin our look at tailored value chains by simply highlighting the major activity choices that reflect each company's chosen segment, and how those choices are different from those made by rivals who are serving different customers.

First, Walmart. While other discounters chose to put stores in large metropolitan areas, Walmart invested in small-town locations, where the nearest city was probably a four-hour drive away. Walton knew this terrain well. He rightly bet that if his stores could match or beat those city prices, "people would shop at home." Moreover, many of Walmart's markets were too small to support more than one large

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retailer. This was a powerful barrier to entry. By being first, Walton was able to preempt competitors and discourage them from entering Walmart's territory, allowing the company time to hone the enduring sources of its competitive advantage: its ability to provide everyday low prices in markets all across the country and beyond.

Progressive's target customer posed a special challenge. How do you turn a bad driver into a profitable customer? Progressive needed a different value chain from the industry's standard one. First, Progressive tackled risk assessment in a different way, building a massive database with more granular indicators that better predicted the probability of accidents. It used this data to spot the good risks in pools that looked like bad drivers to other insurers. For example, among drivers cited for drinking, those with children were least likely to reoffend; among motorcyclists, Harley owners aged forty-plus were likely to ride their bikes less often. Progressive used information like this to set prices so that even the worst customers could be profitable. Progressive's competitive advantage, then, started with relative price (for comparable risks).

Second, since accidents were likely, Progressive focused on minimizing their cost once they occurred. The faster claims were settled, for example, the more money Progressive could save. (Less time meant fewer lawsuits.) Progressive's value chain accomplished this in a number of ways. Most dramatically, an adjuster equipped with a company van and a laptop could go directly to the accident scene and issue a check on the spot. This was not common practice in the industry. Progressive's competitive advantage, then, also had a component of lower relative cost.

Like Progressive, Edward Jones also tailored its value chain to its chosen customer segment, conservative individual investors who wanted a trusted advisor to make financial decisions for them. Trust is built through personal, face-to-face relationships. To that end,

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Jones invests in conveniently located offices, and lots of them—in small towns, suburbs, and strip malls. Each office has just one financial advisor, a model unique in the industry. Jones prefers to hire from outside the industry, looking for advisors with both community and entrepreneurial spirit. It spends heavily on training new hires in its conservative product line (mostly blue-chip investments) and its buy-and-hold philosophy.

Jones pays a price for these activities tailored to its chosen customer. It foregoes revenue from more frequent trading or more exotic investments with higher margins. Its training and its occupancy costs are high relative to other brokerage firms. But these activities create value for Jones's chosen customers, who are willing to pay a large premium ($100 per trade versus $8 for low-priced brokers) for Jones's trusted personal touch.

Aravind's Value Chain

The original inspiration for Aravind came from, of all places, McDonald's. Dr. V. wanted to produce cataract surgeries as efficiently and as consistently as McDonald's produced hamburgers. He designed a system that does just that.

Essentially, while a surgeon is operating on one patient, the next patient is already prepped on a table behind him. When one operation ends, the surgeon simply turns around and starts the next one. Not a minute of the skilled surgeon's valuable time is lost. Everyone in the operating room, including the surgeon, is trained to follow a standardized procedure. Every step in the process is carefully integrated to produce an efficient whole.

The results speak for themselves: Aravind, in 2009–2010, performed about 5 percent of all eye surgeries in India, employing only 1 percent of the nation's ophthalmic manpower. The achievement

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mirrors that of Henry Ford's assembly line for the Model T, which made Ford workers five times more productive than the auto industry average. Aravind has made cataract surgery affordable by applying the core design elements that Ford used to make cars affordable for the masses: standardization of activities, specialization of labor and equipment, and a high-volume production line that never stops.

The operating model drives Aravind's ability to create value, but it's not the whole story. After all, what good is being a low-cost producer in a market where even low cost is too expensive? Dr. V.'s solution: charge paying customers market rates. Because Aravind's costs are so much lower than other providers, each paying customer subsidizes free care for two. That, very roughly speaking, is the arithmetic of Aravind's competitive advantage.

Aravind's value chain choices support its ability to attract paying customers, who are housed in a separate wing or building that offers every modern comfort. The real draw, however, is the quality of the medical care. Aravind is professionally state of the art. It has developed a premier teaching and research institute, with affiliations with leading eye centers around the world. Its doctors are world class.

Those of you who understand the challenges faced by hospital administrators are now probably shaking your heads. How do you get surgeons to agree to be treated like assembly line workers? A five forces analysis of this industry would tell you that surgeons have all the leverage to demand shorter hours, higher pay, and more autonomy. Yet Aravind is able to do something that continues to elude health-care delivery in the United States. Aravind tracks costs, time, and results—even postsurgical outcomes—all of which can be traced back to specific doctors and the data used to help them improve their performance.

There is a glib answer for how Dr. V. was able to find doctors willing to accept these conditions. His original hires were family members. They simply couldn't say no. There is a more serious answer as well. Dr. V. has built an organization that offers two powerful nonmonetary

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rewards. One is its commitment to professional development and excellence. Consider, for example, the extensive training it provides and its professional affiliations. The second is an appeal to selfless service and compassion. This is an organization on a mission. And that mission, as intangible as it sounds, contributes to Aravind's competitive advantage in tangible ways. Aravind's values allow it to recruit and retain the talent it needs and to configure its activities in an extraordinary way—a way that is perfectly tailored to its value proposition.

Aravind provides quality eye care at a price everyone can afford. That's its value proposition. Its tailored value chain turns that promise into a strategy.

Southwest's Tailored Activities

Comparing high-minded Aravind to fun-loving Southwest Airlines may feel like a stretch, but strategically speaking they have a lot in common, and a lot to teach about strategy. Both have produced sustained superior performance in the face of difficult industry conditions.

Like Aravind, Southwest has cultivated a service culture that makes its strategy work. The company spent most of its early years fighting legal battles that threatened its very survival. The existing carriers in Texas did not want a low-priced competitor to enter the market. They used every legal and political weapon money could buy to prevent Southwest from flying. This intensified the sense of mission at Southwest, creating a distinctive "warrior" culture dedicated to freeing travelers from the grips of a customer-unfriendly industry. Southwest's employees, like Aravind's, go the extra mile. Though unionized, they have never adopted the adversarial, zero-sum attitude toward the company that has plagued other airlines. This contributes to competitive advantage, raising customer satisfaction and lowering relative costs. Both Southwest and Aravind, for example, benefit from low turnover.

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Before Southwest's success shook up the airline industry, most carriers pursued a common way of competing, imitating each other's hub-and-spoke systems, pricing structures, frequent flyer programs, and union agreements. Southwest chose not to pursue these industry "best practices"—some of them valid ways of competing that meet other needs on other types of routes. Instead, Southwest has created a tailored configuration of activities to deliver its unique outcome.

The traditional full-service airline is designed to get passengers from almost any point A to any point B. To reach a large number of destinations and serve passengers with connecting flights, full-service airlines employ a hub-and-spoke system centered on major airports. To attract passengers who desire more comfort or services, they offer first class or business class. To accommodate passengers who must change planes, they coordinate schedules and check and transfer baggage. Because some passengers will be traveling for many hours, full-service airlines traditionally served meals.

Southwest, in contrast, tailored all its activities to deliver frequent service on its particular type of route at the lowest cost. From the start, it didn't offer meals, assigned seats, interline baggage checking, or premium classes of service, all of which contributed to the faster gate turnaround times we saw in chapter 3. This enables Southwest to keep planes flying longer hours and to provide frequent departures with fewer aircraft. Gate and ground crews are leaner, more flexible, and more productive than its rivals. A standardized fleet of aircraft boosts the efficiency of maintenance. As Web-based travel sites became a popular distribution channel, most airlines rushed to sign up (a bad decision for industry structure, since it pushes customers to buy on price alone). Not Southwest. Its passengers buy tickets directly on the Southwest Web site, bypassing other channels and allowing Southwest to avoid sales commissions.

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These are just some of the cost drivers underpinning Southwest's competitive advantage, allowing it to serve more passengers per employee, to get more daily departures per gate, and to get more hours of use per plane. Southwest staked out a unique and valuable strategic position based on a tailored set of activities. On the routes served by Southwest, a full-service airline could never be as convenient or as low cost.

A strategic positioning, especially when it has a high degree of focus, is sometimes seen as carving out a "niche." The implication of that word is that the market opportunity is small. Although this may sometimes be the case, even focused competitors can be very large. In the case of Southwest, what initially looked like a narrow niche has revolutionized the airline industry. Both Southwest and our next example, Enterprise Rent-A-Car, have become industry leaders.

Car Rental Value Chains

Enterprise's unique value proposition—rentals for car owners in their home city—is only part of the story of its success. The choices it has made in configuring its value chain explain its competitive advantage. Enterprise was able to serve customers who wanted lower costs because those needs could be met with a different, lower-cost configuration of activities. Enterprise's strategic insight was that its particular value proposition would *require* a completely different value chain from a Hertz or an Avis.

Other car rental companies chose high-rent locations convenient to travelers, for example, airports, train stations, or hotels. Not Enterprise. It chose small offices, often simple storefronts, spread all over a metropolitan area, a practice that began when founder Jack Taylor started his tiny auto leasing business in St. Louis in 1957. But as the

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Can You Be Differentiated and Low Cost at the Same Time?

Early in his career, Porter identified a set of generic strategies—focus, differentiation, and cost leadership—that quickly became one of the most widely used tools for thinking about key strategic choices. Each of the three reflects the most basic level of consistency that every effective strategy must have. *Focus* refers to the breadth or narrowness of the customers and needs a company serves. *Differentiation* allows a company to command a premium price. *Cost leadership* allows it to compete by offering a low relative price. These broad characterizations of strategy types capture the fundamental dimensions of strategic choice relevant in any industry.

At the same time, Porter described a common strategic mistake, which came to be known as getting stuck in the middle. This happens when a company tries to be all things to all customers and is outflanked by cost leaders on one side, who meet “just enough” of their customers’ needs, and by differentiators on the other side, who do a better job of satisfying customers who “want more” (of some particular attribute they value).

company grew and its strategy emerged, so did the strategic logic. Nothing could be more inconvenient for a home-city renter than to have to go to the airport to pick up a car.

What began as an accident of early company history became a matter of strategic choice. For its chosen customer, Enterprise’s neighborhood locations, now within fifteen miles of 90 percent of the U.S. population, are more convenient. The rent was also lower, allowing Enterprise to charge lower prices than rivals. Only in 1995, more than thirty-five years after the company was founded, did Enterprise

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Does this mean that a company can't be both differentiated and low cost at the same time? Not at all, although this is another persistent misconception. Porter's earliest work (circa 1980) is sometimes cited as evidence to the contrary. But Porter went on in the 1990s to refine his work on the link between the value proposition and the value chain, work that should have put that misunderstanding to rest. "When you get down to the specific needs that are served by specific products," he explains, "you see that the possible choices/combinations are far more complex. Generic strategies identified one dominant theme of a strategy, such as relative cost. But effective strategies integrate multiple themes in a unique way. Customers' needs are rarely uni-dimensional and therefore a strategy to meet those needs won't be uni-dimensional either. When a company makes choices about which customers and needs it will serve, and when it tailors its value chain to those choices, it is possible to be differentiated and low cost and focused at the same time, as Enterprise is. Or, like Southwest, you can be more convenient and lower cost—without getting stuck in the middle."

open its first airport location. In the car rental business, it is easy to see that the optimal configuration of offices is very different for travelers than for home-city renters.

In fact, positive-sum competition is possible precisely because there are a variety of ways to configure most activities. Zipcar is able to do away with offices entirely. Zipsters are paid members whose information is on file, eliminating all the usual paperwork of a rental transaction. Technology makes customer service staff unnecessary because Zipsters make reservations online. Zipcars are parked in des-

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ignated spots spread throughout a metro area. Special access Zipcards with embedded wireless chips allow members to open the specific car they've reserved only at the specified rental time. Transponders on the windshield record hours of usage and mileage, which are directly communicated to a central computer via a wireless link. Zipcar makes renting a car as easy as withdrawing cash from an ATM.

Other parts of the value chain are tailored as well. Every car rental company has to configure its fleet of vehicles. Because vacation and business travelers often want special car models—SUVs or convertibles, for example—Hertz and Avis include these "hot" vehicles in their fleets. Enterprise's home-city renters are satisfied with lower-cost, more basic models. They are also less concerned with the age of a car, enabling Enterprise to keep its cars longer than the traveler-oriented companies. Zipcar is building its brand with a fleet of "cool" cars like the environmentally friendly Honda Insight and the BMW Mini.

For Zipcar, the cars themselves, displaying the company's hip logo, are like rolling billboards that announce the company's brand to the neighborhood. Zipcar also attracts new customers through a raft of partnerships with schools and companies. In keeping with its value proposition, Enterprise tends to market to insurance companies and car dealerships, another important way in which its costs are kept low. In contrast, Hertz uses expensive consumer advertising to attract its business and leisure travelers.

When a company focuses on delivering a different kind of value to a different set of customers—for Porter, the essence of strategic positioning—the list of value chain differences can be extensive (see figure 4-3).

Limits Are Essential

Choices in the value proposition that limit what a company will do are essential to strategy because they create the opportunity to tailor

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FIGURE 4-3

Each value proposition is best delivered by a tailored value chain

	Hertz	Enterprise	Zipcar
Value proposition			
Customer/need	Travelers away from home; rent by the day	Replacement cars at home; rent by the day	Cars for non-owners at home; rent by the hour
Pricing	Premium: expense accounts or vacation travel	Economy: insurance or self-pay	Varies by usage: subscription plus hourly fee
Value chain choices			
Office locations	Airports, hotels, train stations ($$$)	Throughout metro area, strip malls ($)	None (¢)
Fleet choices	Full range of late models	"Sensible" cars, older fleet	"Cool" cars
Marketing	Consumer advertising ($$$)	Market through body shops, insurers ($)	Word of mouth, partnerships with schools (¢)

activities in a way that best delivers that kind of value. Tailoring is possible only if there are limits, only if you are not trying to be all things to all people. In other words, limits make it possible to develop a value chain that is different from that of rivals who have chosen to offer a different kind of value.

> Choices in the value proposition that limit what a company will do are essential to strategy because they create the opportunity to tailor activities in a way that best delivers that kind of value.

This is a crucially important test that should be applied to any strategy. If the same value chain can deliver different value propositions

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Discovering New Positions: Where to Begin

"Strategic competition," Porter writes, "can be thought of as the process of perceiving new positions that woo customers from established positions or draw new customers into the market." In describing a strategy *after the fact*, the value proposition is the logical place to begin, as I have done in this chapter. But how do companies, in practice, actually find new positions? Looking for new ways to segment customers or to serve unmet needs is one starting point. But the value chain—the unique set of activities your company performs—is an equally valid starting point. This, in fact, is essentially what companies do when they identify their "strengths."

Consider Grace Manufacturing, a small, family-owned company based in Arkansas. Grace is not a household name, but its leading product, the Microplane, is renowned among cooks as the tool of choice for grating hard cheeses and zesting citrus. The Microplane, followed by tens of line extensions, created a new segment in the housewares industry.

How Grace discovered its position is an interesting story. The company was a contract manufacturer of steel printer bands, a product approaching obsolescence as printer technology advanced. Facing the imminent demise of its core product, Grace's principal asset was a proprietary masking and etching process that produced

equally well, then those value propositions have no strategic relevance. Only a value proposition that requires a tailored value chain to deliver it can serve as the basis for a robust strategy. This is the first line of defense against rivals.

Strategy, then, defines a way of competing, reflected in a set of activities that delivers unique value in a particular set of uses or for a

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bands with razor-sharp edges. Chris Grace, now the company's CEO, recalled working in the family business while he was in high school: "'Back then, if you worked in the plant, it wasn't a question of whether you were going to cut your finger, but when. We realized we were good at making sharp things. And so we thought, what can we make that's sharp?'" They settled on tools for serious woodworkers.

The Microplane brand rasp was designed to be mounted on a hacksaw frame. But somehow word got out that it made an extraordinary kitchen tool. Richard Grace, the company's founder, was initially disappointed when he heard how his product was being used. But today, the company makes a whole line of sharp products for the kitchen, from pizza cutters to chocolate graters. Moreover, leveraging its proprietary know-how in producing sharp things, Grace has added products for orthopedists that grind bone or prepare hip sockets for implants. *Proprietary* is a key word in this story. Grace Manufacturing didn't just have a strength in making sharp things. Most essential for strategy, it had a *unique* strength.

Discovering new positions is a creative act. What triggers the initial insight often varies from one person, and one organization, to the next. No cookbook or expert system can reliably churn out winning strategies. By definition, strategy is about creating something unique, making a set of choices that nobody else has made.

particular set of customers, or both. In most industries, there can be many strategically relevant value propositions. This simply reflects the great diversity in customers and needs, and the fact that different activity configurations are often required to meet those needs most effectively. Even when an industry produces something that looks like a homogenous product, Porter points to many opportunities up

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and down the value chain for differentiation—in delivery, in disposal, in certification and testing, and in financing, to name just a few dimensions.

While not every single activity need be unique, robust strategies always involve a significant degree of tailoring. To establish a competitive advantage, a company must deliver its *distinctive value* through a *distinctive value chain*. It must perform different activities than rivals or perform similar activities in different ways.

Thus the value proposition and the value chain—the two core dimensions of strategic choice—are inextricably linked. The value proposition focuses externally on the customer. The value chain focuses internally on operations. Strategy is fundamentally integrative, bringing the demand and supply sides together.

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Chapter Notes and Sources

Chapter 4. Creating Value: The Core

The Porter quotes and concepts in this chapter, as well as his analysis of Southwest Airlines, come from “What Is Strategy?” reprinted in *On Competition* (2008). The graphic depicting the value proposition is Porter’s, derived from unpublished presentation materials.

Details of Southwest’s early pricing and its expansion come from *Nuts!*, cited earlier.

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