

The nuts and bolts of formulating differentiation strategy.

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Differentiation strategies can help a company stand out when the firm offers the same products as others. Differentiation elements include: emphasizing product features; targeting audiences; catering service and support to customers' needs; and developing pricing which gives cost savings to customers. A variety of steps can be used to achieve strategic differentiation such as: knowing market needs and wants; identifying the viability of options and eliminating those that are not economically feasible; and knowing the costs and capabilities of competitors.

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All the functions of a company must support a differentiation strategy or it will be doomed to failure. This step-by-step, team-oriented approach to differentiation development also defines the planner's role in the multifunctional process.

Major competitive success stories always hinge on the winner's superiority along at least one of the five major dimensions of differentiation:

- * Product features that are aesthetically appealing or functionally superior.
- * Marketing channels that provide desired levels of responsiveness, convenience, variety, and information.
- * Service and support tailored to end-user and channel member sophistication and urgency of need.
- * Brand or image positioning that imbues the company's offerings with greater appeal on critical selection criteria.
- * Price, including both net purchase price and cost savings available to the customer through the use of the product or service.

Some companies have become successful by leaning heavily on one or two differentiation weapons. Let's consider, for example, a company that lacks a unique product and has to build a loyal customer base with a delivery system. Steelcase, Inc., an office furniture systems company, differentiates itself through two types of services: on-time and complete delivery, and a high level of on-site installation support. Until recently, neither Steelcase's tangible product features and design characteristics nor its prices distinguished it from competitors. (This year the firm introduced its innovative Context System [TM].) But, the ferocity with which it emphasizes the two attributes that differentiate it have made Steelcase a successful competitor.

Other firms accomplish differentiation with an array of

tactics. Fel-Pro, the world's largest supplier of gaskets to the automotive aftermarket, differentiates its gaskets (an "undifferentiable" product if ever there was one!) along five dimensions:

- * High quality (reflective of a heavy investment in materials technology, R&D, and manufacturing), and an all-inclusive product line. (Need a gasket for your 1948 Hudson? Fel-Pro makes it.)
- * Its channel partner program assures extensive distribution through a nation-wide network of auto parts outlets.
- * Fel-Pro offers the only sales and service organization in the industry specializing in gaskets.
- * Fel-Pro colors all its gaskets blue, solely to create a unified brand identity across a widely varied line of items.
- * Because its distribution system makes all its gaskets easily available, and because of its reputation for quality, Fel-Pro enables auto shops to reduce inventory requirements without having to stockpile parts to avoid the cost of a work stoppage. Fel-Pro's system yields a "net cost" reduction not easily copied by competitors.

Did the success of Fel-Pro and other differentiated companies, such as Fidelity Investments and Federal Express, spring from divine inspiration -- or was it simply a case of being in the right business at the right time? As suggested in Exhibit 1, "inspirational" differentiation is a quick, if risky, route to competitive advantage. While it's not wise to automatically assume that bypassing the analytical approach to either creating or testing differentiation ideas will inevitably cause a firm to fail, those flashes of insight that lead directly to major business successes are relatively rare. Nonetheless, suppose you are inspired but still wish to test your visions? We believe that the structured approach to identifying and testing differentiation opportunities can lead to breakthrough competitive strategies.

Differentiation and Low Cost

Some of you might ask, "What happened to low cost as a

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generic competitive strategy? Isn't it an opposite and equally attractive option, according to Michael Porter's famous theory, that there are two alternative fundamental sources of competitive advantage: low cost and differentiation?" In our view low cost is not an opposing strategy, but rather a necessary tool for sustaining a differentiated position.

An example may help make this point. Sam's Warehouse Clubs -- which offer customers (including large numbers of commercial enterprises) the advantages of one-stop access to popular consumer goods in a wide range of categories at rock-bottom prices -- must be a low-cost provider or it will be vulnerable to competition. Similarly, take an elegant department store like Neiman-Marcus. If it wishes to build a truly sustainable advantage, it must be the low-cost provider of advice, service, selection, and image benefits. Obviously, Neiman-Marcus' prices and costs, measured in almost any way, will exceed those of Sam's. However, the key driver of success for both companies is to establish a position as the low-cost provider of a set of benefits highly valued by a targeted portion of the market. In such a case, low cost and differentiation cease to be opposites. Instead, they become joint requirements for strategic success.

As market preferences and needs become more fragmented, and once-dominant firms fail to offer goods or services that yield high value to target segments at the lowest cost, more and more specialized niche providers begin picking off portions of the marketplace. For example, office supplies used to be distributed almost entirely through full-service wholesalers, who in turn sold through a network of local stationery stores to a variety of buyers, including small businesses. Over time, alternatives emerged, each of which offered different sets of benefits at lower prices with lower costs. Today, small businesses buy office supplies through everything from warehouse clubs and office products wholesalers, to telemarketers and mail-order houses. Consequently, the volume of traditional, full-service channels continues to shrink under attack from better differentiated, lower cost competitors. As a corollary lesson, when providing benefits, keep in mind that more is not necessarily better. Successful companies understand the needs and preferences of portions of their markets well enough to continue to provide the optimal levels of highly valued benefits, efficiently, and at low cost by dropping benefits of lesser value.

Differentiation requires a firm to harness all of its productive capabilities and aim them at defined (and often quite separate) sets of customer needs, while carefully managing costs and eliminating activities that do not directly contribute added value for customers. For example, at Fel-Pro (the blue gasket company),

manufacturing, research, marketing, engineering, logistics, and even employee relations have all contributed to creating the benefits that its customers value. Fel-Pro's multifunction system is typical of all successful support and differentiation strategies -- the process of development and execution depends upon the best contributions of all functions within the organization.

A Comprehensive Approach

There are several approaches a company can take in developing effective, differentiated strategies. It can focus on costs, on industry structure, on market preferences, or internal capabilities. In our experience, the approach that is most likely to succeed (see Exhibit 2), is a comprehensive one that:

- * Starts with market segment preferences and needs, and identifies the key functional activities required to meet those needs. Classic examples of companies that have taken this approach are SAS, Toys "R" Us, American Hospital Supply, and BMW.
- * Thoroughly assesses the economic viability of various options, to preclude pursuit of options that are appealing to the marketplace but financially doomed. (People Express failed, not because management didn't segment the market effectively, but because it lost sight of economic constraints.)
- * Considers both competitors' capabilities and costs and the way that competitive offerings are perceived by segments of the market in terms of providing value-added benefits. (The "Big Three" American auto manufacturers not only consistently underestimated the market appeal of Japanese products, but also the degree of cost advantage that results from the Japanese approach to management.)
- * Objectively assesses both the firm's ability to implement the required activities, as well as organizational and cultural roadblocks in the path to success. Companies such as Marriott, Honda, Steelcase, Worthington Steel, Nordstrom, and Fel-Pro have cultures that comprehensively support their differentiation strategy.

Best-laid Plans

There are many case histories of companies that have addressed one or two of these elements in formulating strategy, only to run afoul of the others. But even thorough, well-designed efforts (including, for example, research-based market needs analysis; company, customer, supplier, and competitor value-chain analyses; perceptual mapping of competitive offerings, and competitor response role playing) can fail if they do not

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adequately take into account organizational and political constraints and the conflicting management objectives and priorities that exist in all large and most small organizations.

If differentiation strategy is to succeed, companies must follow an "ICI Rule." This acronym stands for:

- * Involving all internal functions and important constituencies.
- * Comprehensive addressing of customer needs, competitor strengths, economics, and a firm's ability to implement.
- * Integrating every element in the whole process.

How to Do It

One of the most useful approaches is to address each of the elements in Exhibit 3 in a three-stage process:

Phase I: Knowledge-building, or the idea-generation

step of the process shown in Exhibit 1.

Phase II: Strategy formulation, in which strategic

options identified in the first phase are tested
and a direction is chosen.

Phase III: Implementation, in which all functional

participants in the process execute their roles
in the strategy.

A detailed schematic of the approach is shown in Exhibit 4. The circular structure of the approach reflects the need to integrate the requirements for success (segment need satisfaction; economic viability; competitive uniqueness; and ability to implement) at each phase of the process.

Phase I: Knowledge-building. The overall approach begins with one of its most important steps: structuring the collaborative process. Since it is likely that all functions will need to be involved in implementing the results of any far-reaching differentiation strategy, broad involvement in the collaborative process should be emphasized at an early stage. This ensures that the best information will be found and used, and that blockages and constraints to change (and there will be many) will be quickly identified and openly addressed. So, although planners or strategists may lead the analytical effort, the process must

be "owned" by all internal constituencies. This task is made easier by setting up a representative task force or team. Two important criteria for selecting participants are:

- * Pick individuals experienced enough to have a broad view, but junior enough to help with information retrieval and analysis.
- * Top functional management should be represented either by delegating authority to team members, or through the formation of a steering group that meets at key decision points.

Once the team has been formed, analysis should begin with an assessment of market segment needs and expectations. The market segments should be identifiable, reachable, substantial groups of customers who seek similar sets of benefits. It is critically important at this stage to move beyond traditional demographic definitions of segments (such as big versus small, customers versus noncustomers, Pennsylvania versus Ohio) and to search for groups with similar needs. How? Preferably through market research that asks customers to assess trade-offs against potential benefits. This can yield, for example, a market segment that values service elements over product features; and, within that segment, a subset that values rapid repairs instead of frequent personal sales calls.

Any research questionnaire that attempted to cover user needs for products, service, selling channels, price, and supplier image in any level of detail would be too long. A way around this limitation is to work with brief initial surveys that pinpoint major areas of unmet needs in the market. Later, another focused survey can identify appropriate buyer clusters. Once clusters of users with different preferences have been identified, the analysis should characterize each cluster along demographic and behavioral dimensions, such as company size and suppliers used most frequently.

While you're gathering this information from the market, you should also ask a number of other questions to determine:

- * The ideal level or quantity of each benefit desired by each respondent.
- * Product features that are appealing or functional to customers or intermediaries.
- * The performance of existing offerings (both yours and your competitors') in providing each benefit. One of the important aims of the search is to identify big groups of customers seeking high levels of specific benefits, who find that current offerings don't meet their needs.

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While this analysis is being conducted, another part of the team should be looking at Company and Industry Economics and Competitor Positions, using value chain analysis and industry structure analysis. The main issue is to understand the actual costs of major value chain activities, and to benchmark your company against its competitors. With these analyses in hand, the potential for scale economies will then become clear. Look for clues that indicate which segments of the market may have unmet needs that the company might serve by altering its value chain strategy, for example, through consolidation.

The final step in the competitor position assessment process looks back at the market research to see how customers rate competitors in providing desired benefits.

Phase II: Strategy Formulation. As in the knowledge-building phase, strategy formulation should be an iterative process in which an option's economics are tested and potential competitive responses are considered. Specific steps are shown in Exhibit 4:

* **Gap and Option Identification.** The team evaluates market research and the results of external interviews with an eye to both the company's current offerings and those being sought by customers. This process identifies gaps, and develops a range of the possible approaches to closing them.

* **Option Economic Assessment,** which should look at both costs and benefits to end-users, channel members, and manufacturers. At this point, several options will collapse under their own weight, as costs will clearly overwhelm potential benefits.

* **Option Competitive Assessment.** Put bluntly, this is when the team has to decide whether its firm is actually capable of implementing an option, or whether its competitors -- by virtue of economic resources, functional capabilities, or cultural resolve -- are likely to gain the upper hand. Key questions to ask are: How will major competitors respond? Who has greater leverage with end-users and channels? What are the major functional strengths required to win? What barriers to imitation can be built? Should the firm focus on options not easily copied, such as channel restructuring, rather than such easy-to-emulate changes as price structure?

* **Constraint Assessment.** This is the part of the process when you lay all your cards on the table in order to expose all the constraints -- internal and external -- that would hinder or preclude the execution of certain options. After all, companies (as well as channels and markets) are social and political systems as well as economic units. And many brilliant strategies have been immobilized by

organizational friction, conflicting priorities, and cultural incompatibility. So the challenge is to trade off the ideal differentiation strategy against the possible. This iterative process (see Exhibit 4) raises several crucial issues: What unmet needs can be filled by what actions? Can the firm afford it? Can we do it better than our competitors and sustain it? And finally, can we actually pull it off? The product developed after such a process is likely to be a potent and sustainable source of competitive advantage.

Phase III: Implementation. With the differentiation strategy process formulated, each function will need to specify the activities it must perform in order to deliver the targeted benefits. Plans for linkages across functions must also be developed. Transition plans describing how each function must change or expand in order to execute the required activities (see Exhibit 5) will need to mesh with the final functional strategies. This ensures that a coherent face will be presented to the market during the transition.

Finally, each function needs to sketch out the configuration it plans to take and the outputs it will create once the new strategy is fully in place. The time lags inherent in functional change (capital investment in manufacturing; hiring and training in R&D; channel restructuring; and external image change in marketing) often necessitate a staged approach. Therefore, these intermediate stages must be fully described in terms of the resources, organizational structures, and management systems required to carry them out.

The Role of the Strategist/Planner

This integrated system bears little resemblance to planning processes conducted in annual cycles because these are primarily oriented toward capital budgeting and financial projection. What, then, is the role of the strategist, consultant, or planner in differentiation planning? If functional managers are the advocates for their groups, and general managers are advocates for the strategy, then planners must be the advocates for the entire process. In short, the planner provides the glue that unifies the process, the thorn that pricks the team's conscience, the motive force that keeps the team moving along, and the skills needed to conduct critical analyses. The planner can (and often must) serve as the "mirror" in which other participants take a hard look at organizational and business constraints. And, as the impartial facilitator, the planner carefully weighs ideal solutions against organizational realities. By invoking the ICI Rule (Involving; Comprehensive; and Integrated), the planner, strategist, or consultant plays a crucial role in the differentiation process.

Hard Work, But Worth It

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Why don't more companies and business units use this integrated approach, given its advantages? There are several reasons:

- * There is an internal resistance to allowing strategies to be fundamentally market driven. Despite the lip service paid to the critical importance of customers and to maintaining a market focus, many companies continue to be driven by technology, sales, or quarterly performance. Such dominant interests generate little enthusiasm or appetite for the rigors and patience required to understand market needs and requirements.

- * A comprehensive approach that combines market, economic, competitive, and internal analyses is difficult, time consuming, and expensive.

- * It is often difficult to build the required level of functional cooperation. The trench warfare of Sales vs. Marketing, Manufacturing vs. Systems, Finance vs. R&D, and Domestic vs. International often details the process of strategy analysis.

- * Teams bog down during the give and take of trading off ideal solutions against constraints; or they ignore constraints altogether and develop strategies that cannot be implemented by their companies. Many teams will become dominated either by naysayers or wishful thinkers.

- * Or, sadly, no resilient advocate for the ongoing process appears, so efforts start up and then quickly wind down. To succeed, every differentiation project needs a champion with energy, commitment, and clout.

The payoffs for effective differentiation, and the penalties for not differentiating, are clear. In 1980, Purolator Courier was bigger than Federal Express. The situation is now reversed. In 1982, Dreyfus had more assets under management than Fidelity. Not now. Managements that grasp the opportunity to create advantage through differentiation can create tomorrow's success stories.
[Exhibit 1 to 5 Omitted]

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