

# **Session 6**

## **Superior Value through Operations and Cost Structure**

In this session you will learn:

1. How to use technology as a competitive advantage in creating superior value
2. How to use an understanding of the theories of technology progress as the basis for assessing the competitive environment
3. How to use technological innovation to create competitive advantage
4. How to define your firm's technology strategy

# Once Chosen, Strategy Has Pervasive Effects

## *Low Cost Producer*

**Sophisticated forecasting**

**Vertical organizations**

**Routine employee skills**

**Supply/demand pricing**

**Cost oriented culture**

**Cutthroat marketplace behavior**

**Manufacturing route to top**

**One winner takes all**

## *Differentiated Producer*

**Market sensitivity**

**Flat organizations**

**Fast decisions**

**Entrepreneurial skills**

**Customer oriented culture**

**Value pricing**

**Competitive avoidance**

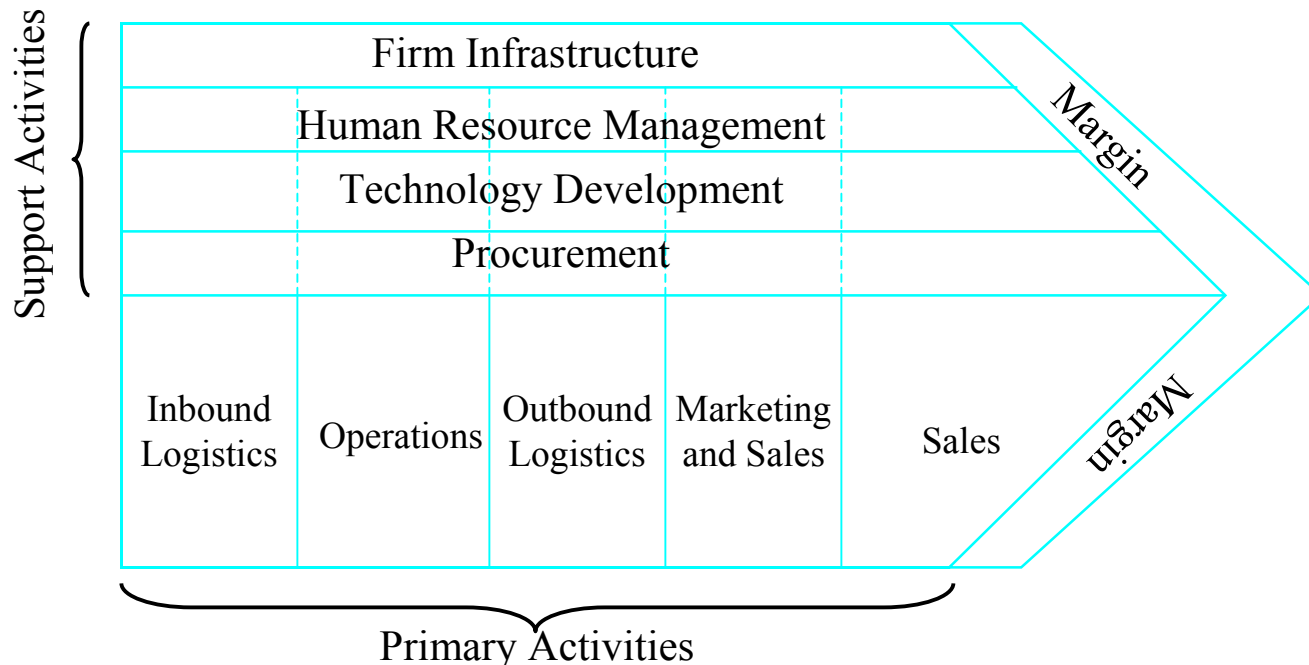
**Marketing route to top**

**Many can coexist**

# The Value Chain Allows Visualization of:

- The Operations that Create Value and
- Costs and Investments they Incur

Generic value chain activities



SOURCE: Reprinted with permission of The Free Press, a Division of Macmillan, Inc from CORPORATE STRATEGIC ANALYSIS by Marcus C. Boque III and Elwood S. Buffa. Copyright © 1986 by The Free Press.

# Two Key Cost Concepts to Consider

## 1. Cost Structure

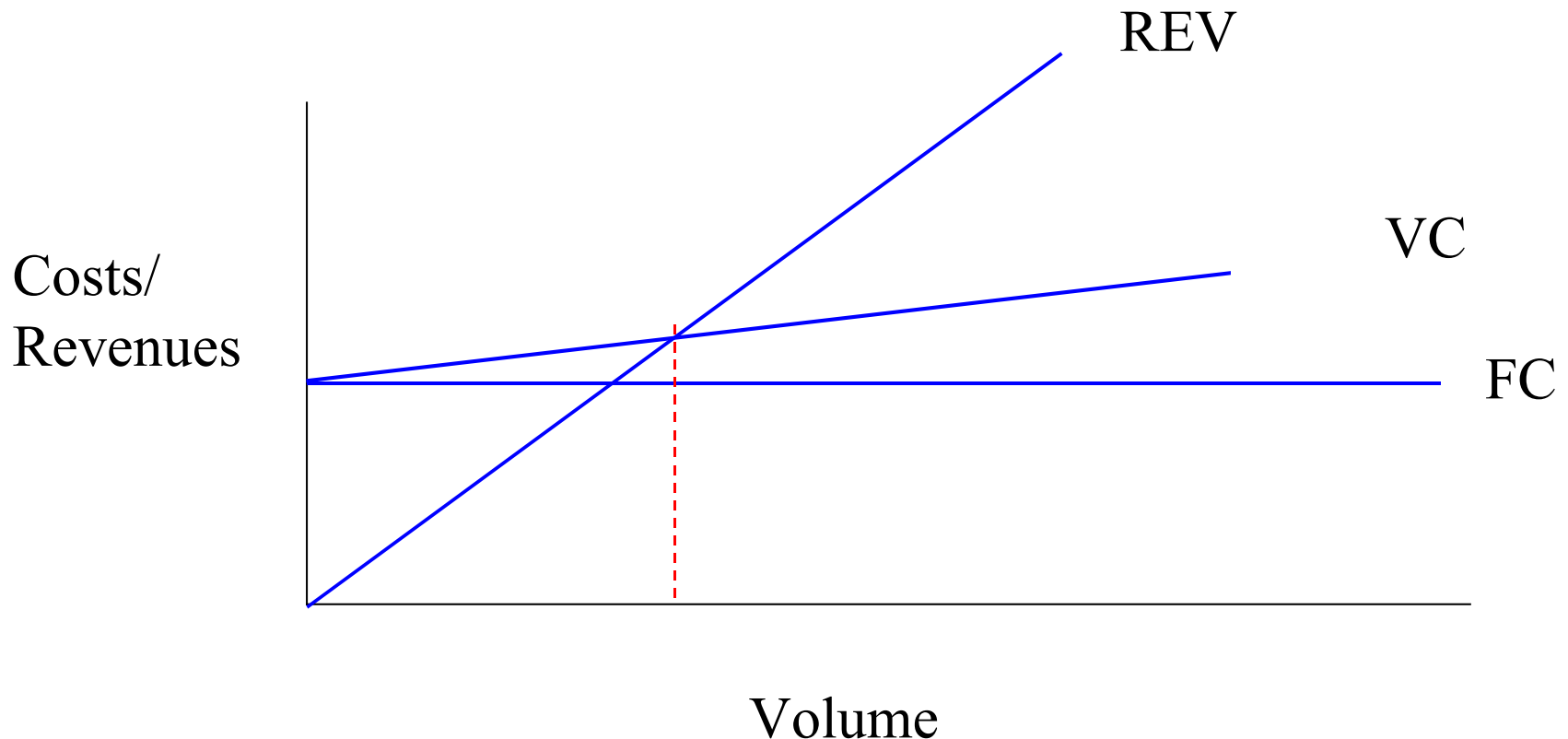
*Fixed and Variable Costs*

## 2. Cost Behavior

*How costs change with Time and Volume*

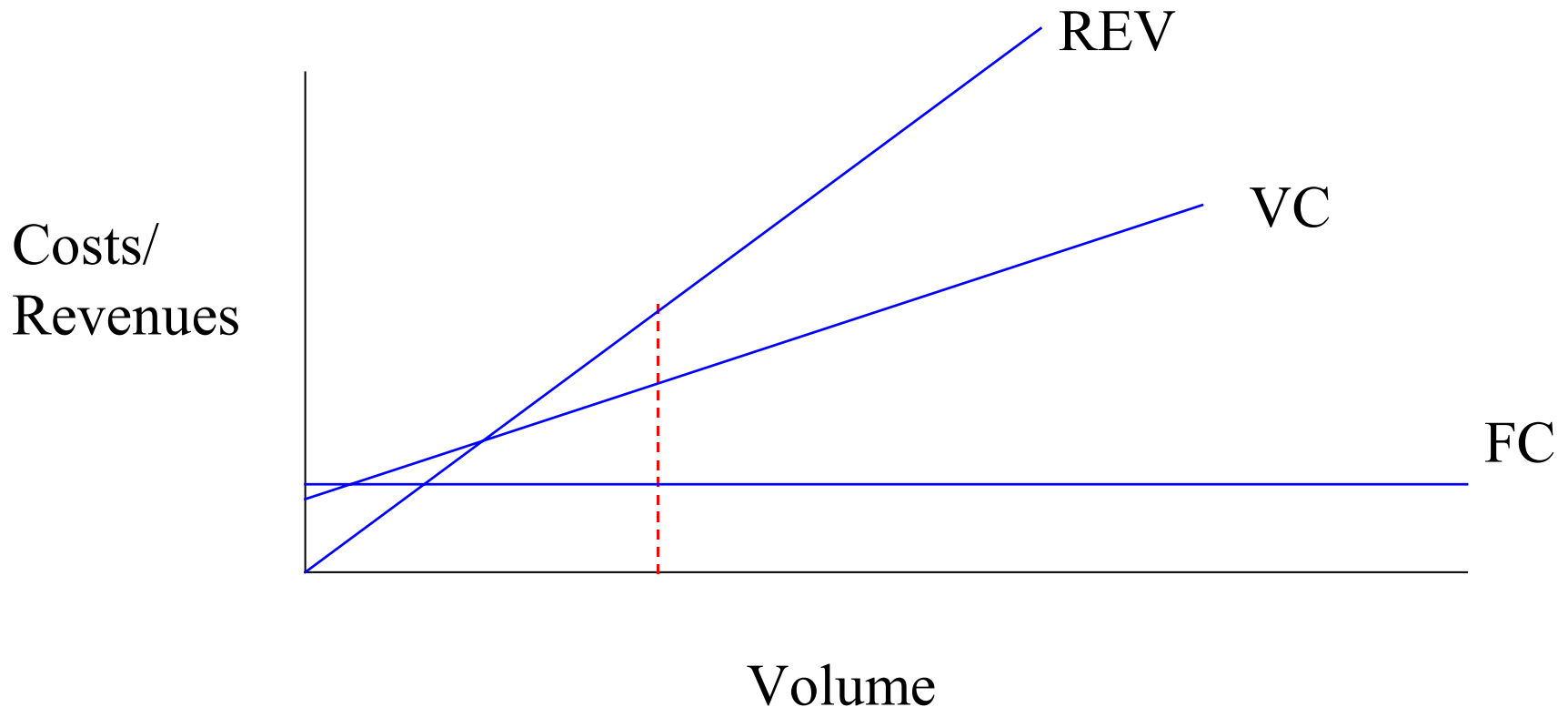
# Cost Structure Has Major Impact on Strategy and Behavior

A. High Fixed, Low Variable Costs

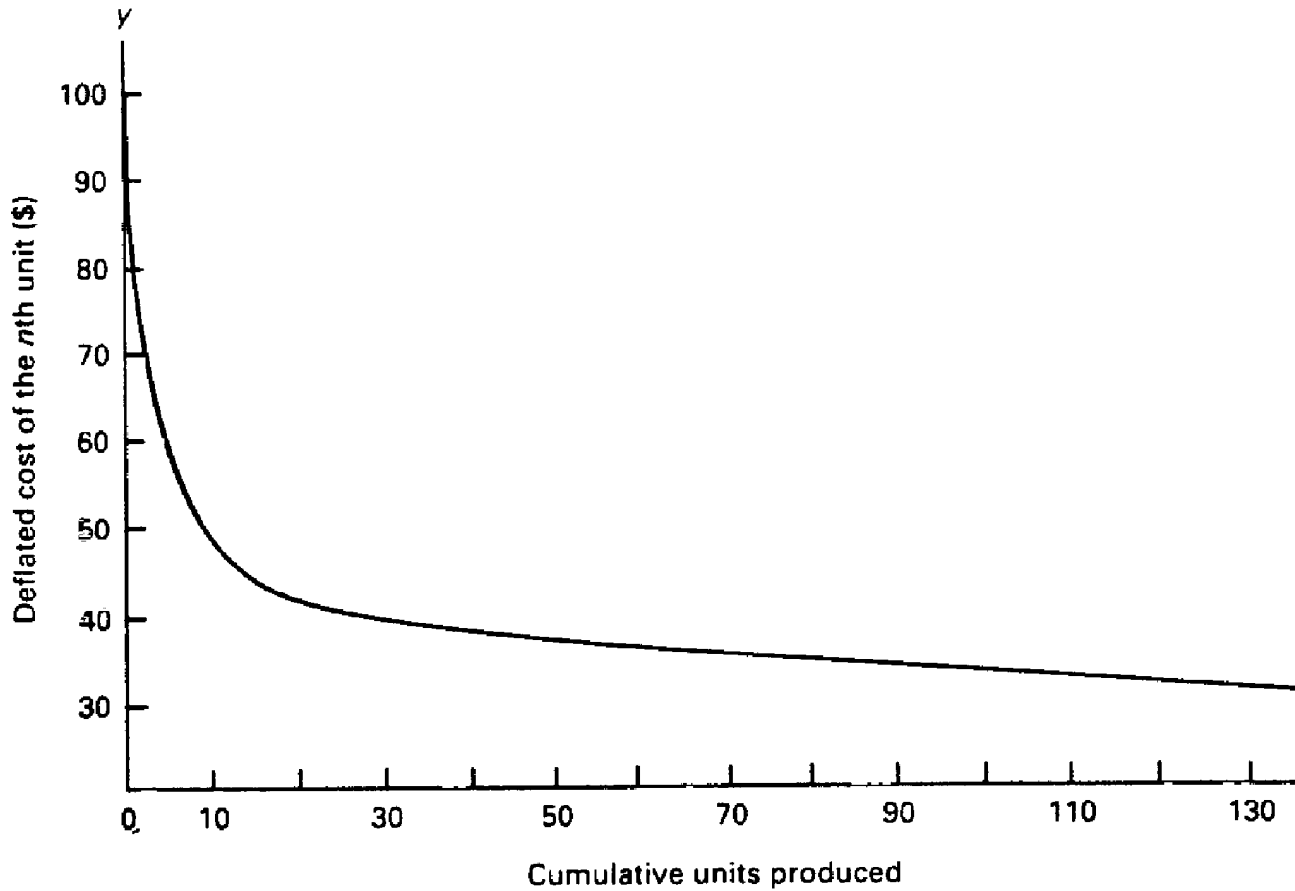


# Cost Structure Has Major Impact on Strategy and Behavior

A. Low Fixed, High Variable Costs

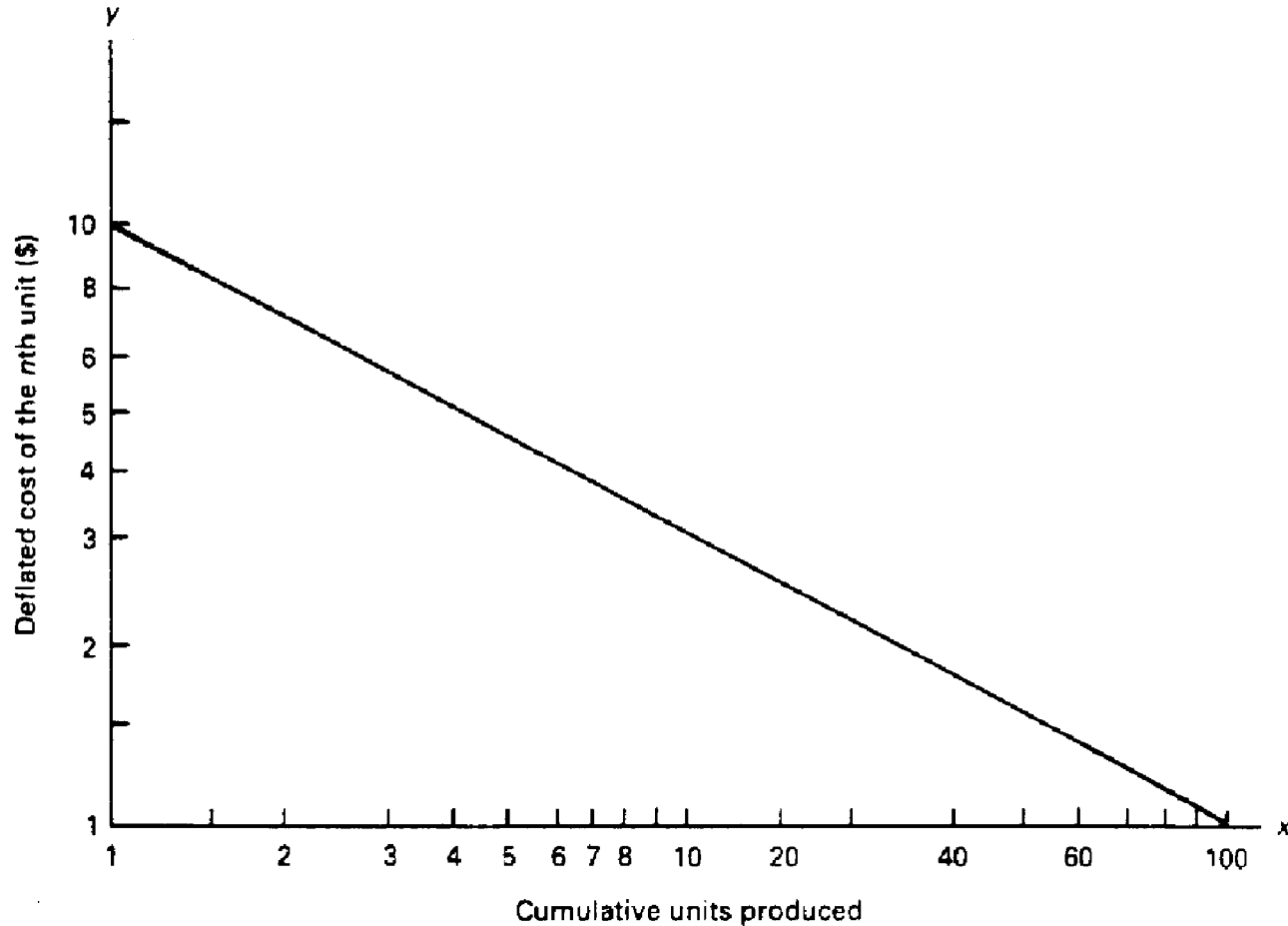


# A Typical Experience Curve



a. The 80% Experience Curve Plotted on an Arithmetic Scale

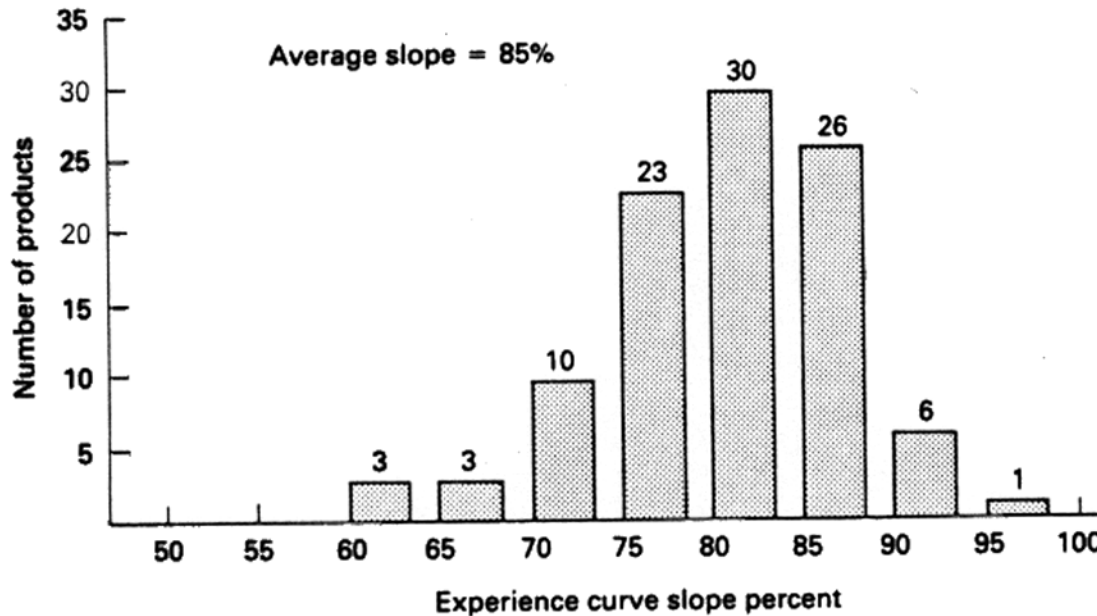
# An Experience Curve on a Log-Log Scale



b. The 80% Experience Curve Plotted on a Log-Log Scale

# Experience Curve Slope Centers on 85%

Experience curve variation by product



SOURCE: Reprinted by permission of *Harvard Business Review*. An excerpt from "Building Strategy on the Experience Curve" by Pankaj Ghemawat, March/April 1985. Copyright © 1985 by the President and Fellows of Harvard College; all rights reserved.

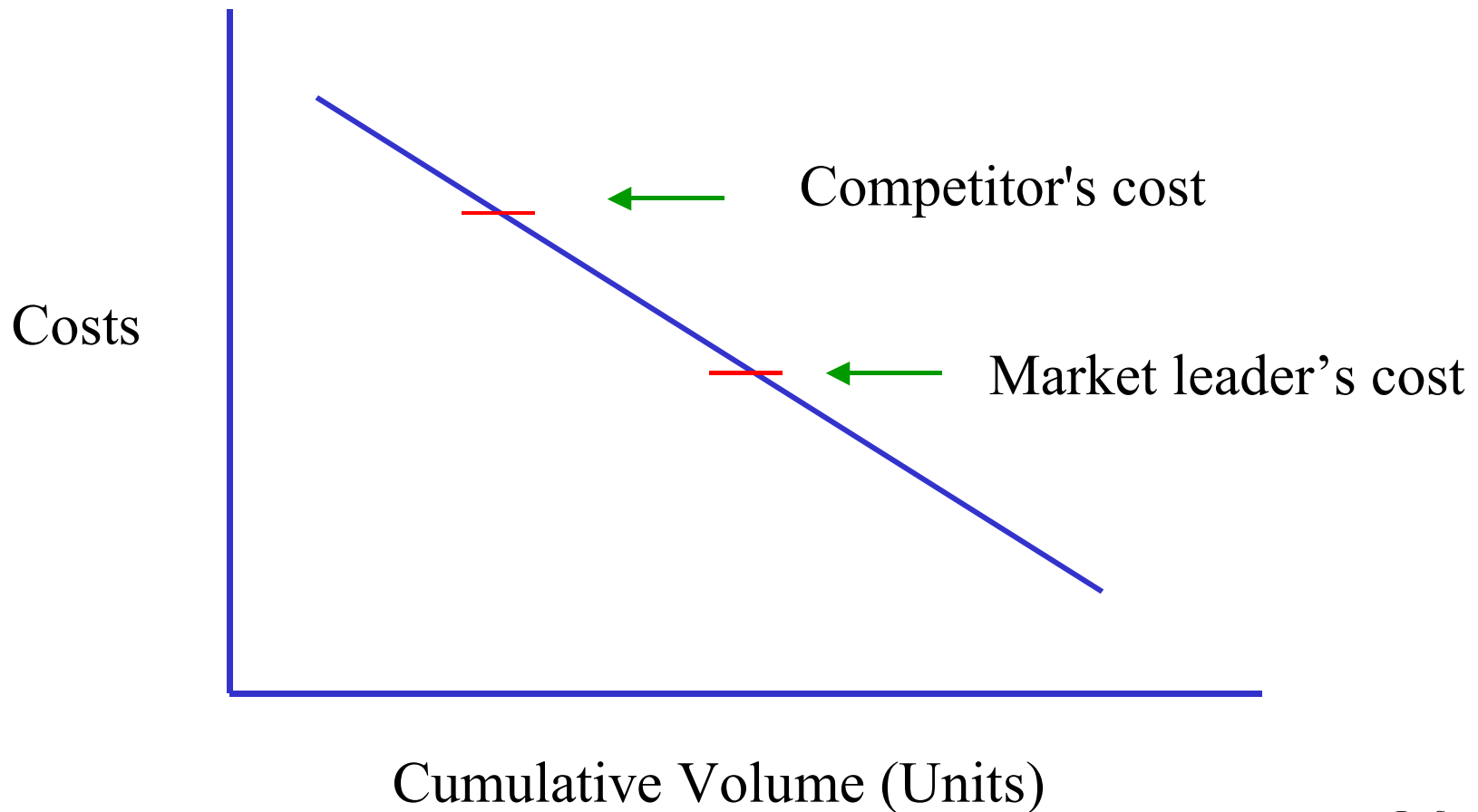
# There Are Three Causal Drivers of the Experience Effect

- **Technology**
  - **Bench** → **Pilot** → **Batch** → **Continuous**
  - **Personal Selling** → **Mass Media**
- **Scale Economies**
  - **Plant Size and Vessels**
  - **R&D, Administration, Advertising**
- **Learning**
  - **Product**
  - **Process**
  - **Marketing Efficiency**

# **Key Observations About the Experience Curve**

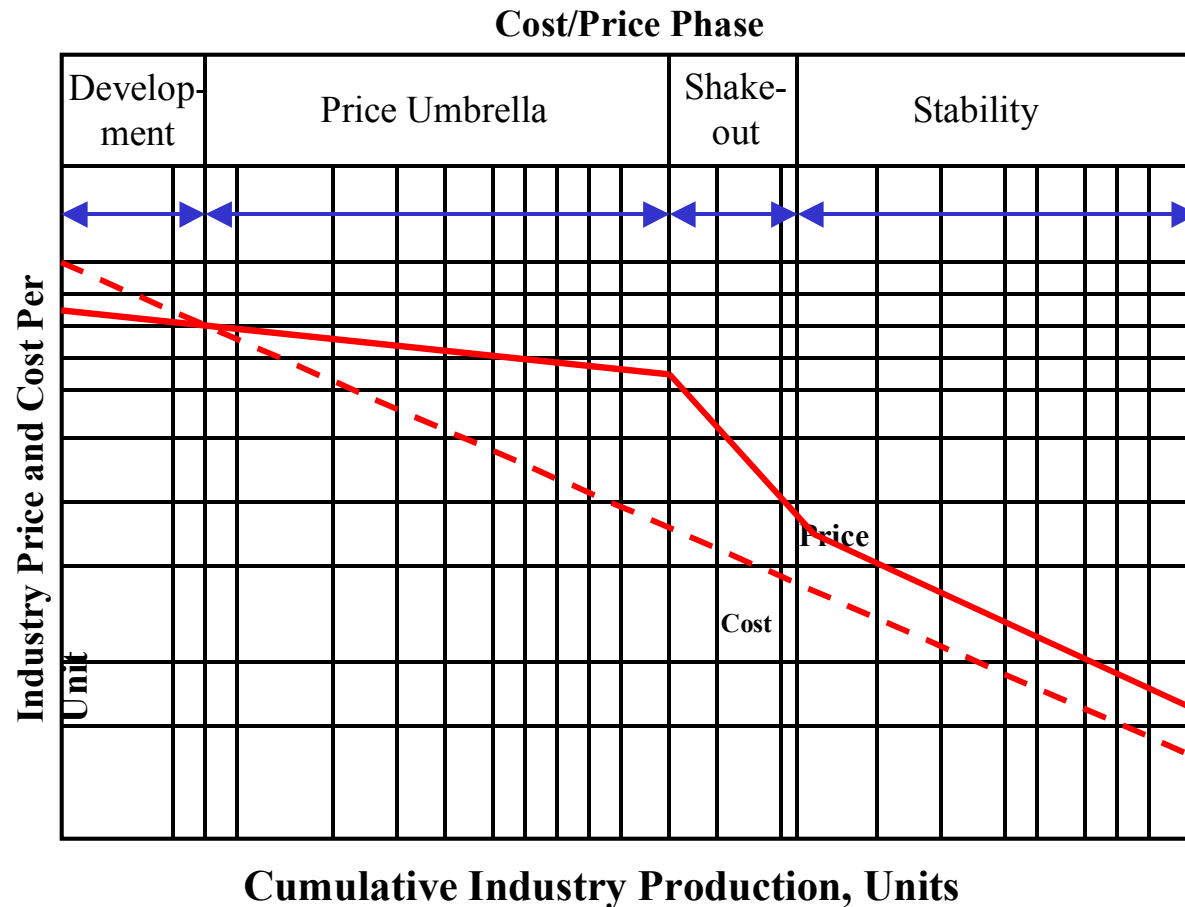
- **Largest absolute costs savings are realized in the early stages of the life cycle**
- **Cumulative production is most easily doubled in the early stages**
- **Cost reduction are not automatic (volume is not a causal variable)**
- **Differences among competitors narrow over time**

# The Experience Curve Explains Market Share Races

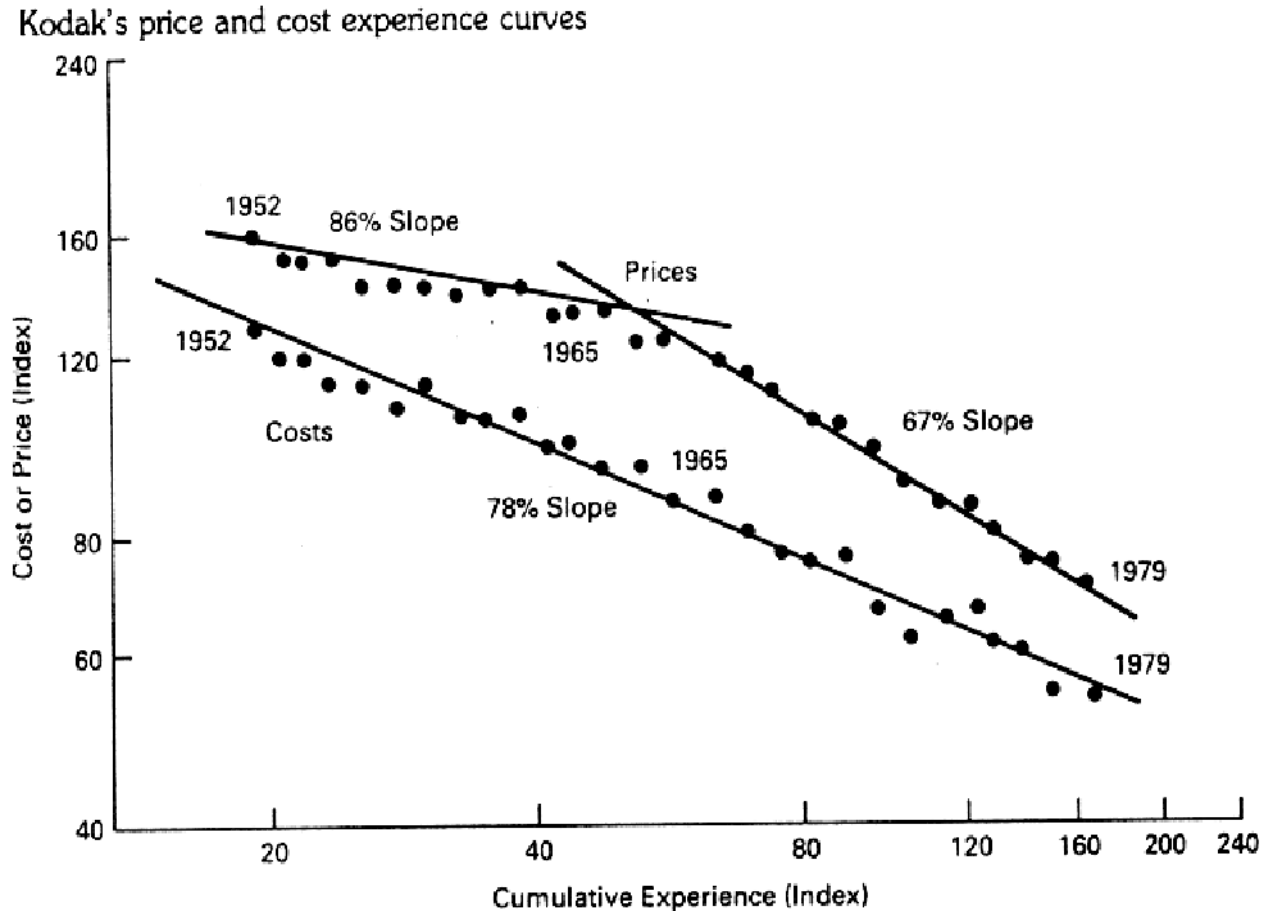


# Price-Cost Relationships in Many Markets Follow a Similar Pattern

Price/cost relationship



# Did Kodak Invite Competition?



SOURCE: Marcus C. Bogue III and Elwood Buffa, *Corporate Strategic Analysis* (New York: Free Press, 1986), p. 28.

# **Dominant Firm Has Tough Choices to Make**

- **Hold Umbrella**
- **Preemptive Pricing**
- **Preemptive Capacity**

# Followers Face Even Harder Choices

- **Settle for Second Best**
- **Push for Dominance**
- **Focus or Niche**

# The Core Messages

- **Cost competitiveness is always is always an issue**
- **Volume growth and experience provides opportunities for cost improvement**
- **The early stages offer greatest potential to achieve large cost differences**
- **Low cost competitor will ultimately use its advantage to gain strategic advantages**
- **Low cost competitors are vulnerable to shifts in technology and consumer tastes**

# **You Will Lose Share Unless You Take the Actions Your Competitors Will Force in the Long Run**

- **Prices that reflects cost plus risk-adjusted rate of return**
- **Sufficient capacity to deliver enough quantity to meet market needs**
- **Continued improvement in product performance, quality, and variety**