

## Generic Strategy: Cost Leadership

### Key Points:

- The cost leadership strategy focuses a firm on the single objective of becoming the cost leader in a particular industry. As such, each industry has only one cost leader.
- To achieve the cost leading position, a firm's overall policies, goals, activities, investments and focus need to be singularly oriented on gaining and maintaining the low cost position.
- Cost leaders risk losing their low cost positions to competitors with better technology, to changes in market tastes, or to increases in input costs that reduce the value of cost advantage relative to the value provided by differentiators.

### Main Thoughts:

Firms can achieve better than average returns in their industries by achieving the low-cost position. To accomplish this, the entire firm's focus must be on the single objective of cost leadership. Throughout the entire value chain, emphasis is concentrated on driving costs down below the point of the next most efficient competitor (i.e. the second lowest cost competitor). This concentration on driving down costs does not have to be accomplished within every value chain activity; however, it must be done in total.

Cost leadership strategy is effective because it mitigates many, if not all, of the challenges faced in industry competition. Customers generally cannot find prices that are lower than those provided by cost leader. Similarly, low-cost leaders are better able to cope with price increases from suppliers because of their abilities to absorb cost increases better than competitors are. A low-cost position also serves as a deterrent to firms wishing to enter the industry.

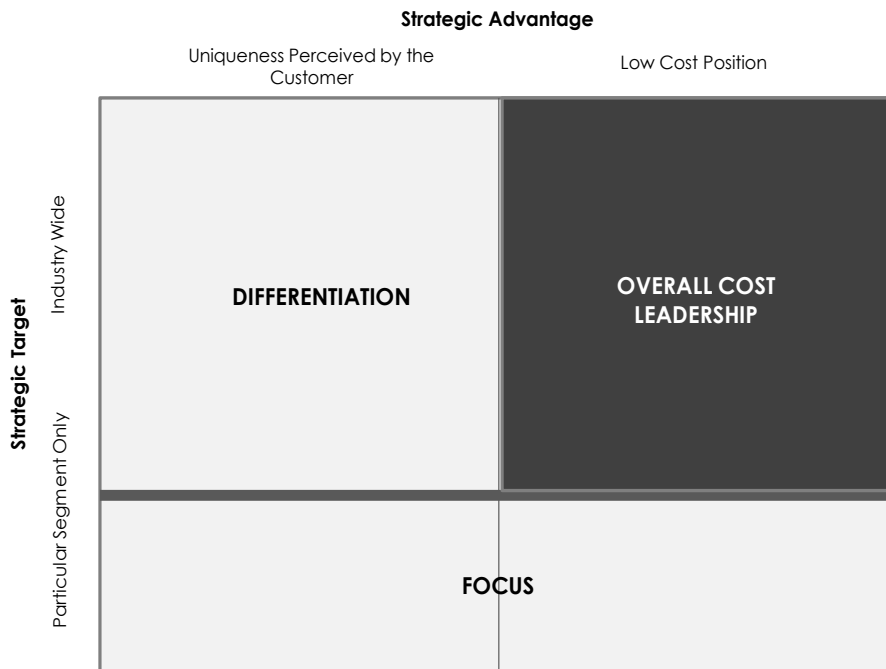
Gaining a broad cost leadership position can often require high market share and scale in operations. Access to low-cost inputs may also be necessary. Some firms have achieved cost leadership by dramatically redesigning product or services in the face of complacent industry competitors. IKEA, the Swedish furniture company, accomplished cost leadership by redesigning its products away from high-end, craftsman-oriented pieces to low-priced, modular items. The following table highlights common requirements of a cost leadership strategy:

<u>Skills &amp; Resources</u>	<u>Organizational Requirements</u>
Capital Investment	Cost Control
Process Improvement	Structured Organization
Close Supervision	Appropriate Technology
Easy to Produce/Deliver Products and Services	Incentives Related to Low-Cost Production

**Figure 1: Low Cost Strategy Requirement (Adapted From Porter, Michael, Competitive Strategy, 1980, Free Press)**

Maintaining the low-cost position requires a constant focus on complexity avoidance, equipment and facility modernization, and changes in customer tastes. Further, low-cost leaders must be mindful of firms whose investment, experience and willingness to cut prices to gain share positions them as the potential cost-leaders. Lastly, low-cost leaders must be sure that the benefit to customers from their low prices is significant enough to offset any meaning perceptual difference from differentiators.

**Figure 2: Generic Strategy Matrix (From Porter, Michael, Competitive Strategy, 1980, Free Press)**



**As an Example:**

Perhaps the best-known low-cost leader today is Wal-Mart. According to case data published by Harvard Business School, Wal-Mart maintains a 0.3% to 3.0% cost differential in all value chain activities over direct retail competitors<sup>1</sup>. The only exception is in the area of information technology where their costs exceed those of competitors by 0.2%. Wal-Mart is willing to accept this excess, because it is their information technology superiority that enables them to operate so efficiently and effectively in almost all other aspects of their business<sup>1</sup>.

**Figure 3: Cost Differences between Wal-Mart and Direct Competitors (Adapted From...)**

**Editorial**

Cost-leadership is not new as a strategy. Firms have been competing on costs—or at least attempting to do so—since the inception of commercial business. Having low prices and competing on costs, although related, are not the same concept.

In a true cost leadership strategy, a firm works to achieve the low-cost position in its industry. The key here is that there is only one low-cost leader. While other organization may be pursuing a low-cost strategy, they are not the cost leader and thus are susceptible to the ill effects of competition that the low-cost form is better able to withstand. For instance, if raw material input costs increase for all manufacturers in an industry, all competitors will be hurt, but the low-cost leader will be hurt the least. The input cost increases can cause shakeout of the least fit competitors especially those who are not competing effectively using one of the strategies highlighted in Figure 2. A key takeaway for the leadership of the firms pursuing a cost leadership strategy is commitment. It will be difficult, if not impossible, to capture and defend the low-cost position without a total commitment to the strategy. Attempts to blend cost leadership with differentiation, in the broader market at least, typically lead to adding costs for features or services for which target customers are not willing to pay. The effects of blending cost leadership with differentiation are both position and profit erosions.

**For More Information See:**References:

Bradley, Stephen, P., Ghemawat, Pankaj, Wal-Mart Stores, Inc., Case Study 9-794-024, Harvard Business School Publishing, 2002.

Articles:

n/a

Text

Porter, Michael, E., Competitive Strategy: Techniques for Analyzing Industries and Competitors, Free Press, 1980.