HOW TO COMPETE AND HOW TO COMPETE PROFITABLY: A MODEL OF COMPETITIVE POSITIONS AND BUSINESS PERFORMANCE

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ABSTRACT

Competitive strategy still lacks a widely accepted analytical framework. Indeed, to this day, there is still no consensus on its key dimensions and types, and their relationship with performance. This paper proposes a new framework for the study of competitive strategy, which divides the topic into two questions: how to compete and how to compete profitably; related both to market and financial performance. With this aim in mind, the author develops a dynamic causal model of competitive strategies, called the performance and competitive positions model, based on three dimensions: perceived price, perceived differentiation, and costs.

INTRODUCTION

Competitive strategies have been and continue to be a topic within the field of management that has attracted enormous interest (e.g., Kim, Nam and Stimpert, 2004; Rhee and Mehra, 2006; Pecotich, Purdie, and Hattie, 2003). Indeed, since they were popularized by Porter (1980), a great deal has been written on their diverse forms and their relationship with performance, and competitive strategies are still the subject of a great deal of debate (Campbell-Hunt, 2000; Parnell, 2000).

It is widely recognized that, while corporate strategy considers the fundamental question of what line of business the firm should be in (i.e. corporate strategy problem), competitive strategy proposes solutions as to how to compete in a given business, i.e. the business strategy problem (Hofer and Schendel, 1978; White, 1986). This last question will form the pivotal theme of this article.

The question of how to compete has been dealt with in numerous studies and from a variety of perspectives (examples of which can be seen in Campbell-Hunt, 2000; Galbraith and Schendel, 1983; and Herbert and Deresky, 1987). Certain studies deal with a mixture of the corporate and business levels of strategy, as in the case of the grand strategies (see, for example, Pearce, 1982) or the strategic patterns of Miles and Snow (1978). Others have focused solely on the business level strategy, as in the case of the generic competitive strategies proposed by Porter (1980) and the strategy mission/portfolio strategies contributed by Buzzell, Gale, and Sultan (1975), and Gupta and Govindarajan (1984). This study addresses the question of how to compete from the perspective of competitive position, fundamentally represented by the theoretical framework presented by Porter (1980). This approach is the dominant paradigm in present day research (Campbell-Hunt, 2000; Ramos and Ruíz, 2004) and carries with it the advantage of not mixing the questions of where to compete and how to compete.

This article is structured into three parts. In the first part, we study the principal models of competitive positions presented in the specialized literature. The second part is dedicated to the presentation of a new integrative model. The final section includes the main conclusions and implications.

PREVIOUS COMPETITIVE POSITION MODELS

The most famous model of competitive strategies is that of Porter (1980) (Campbell-Hunt, 2000; Ramos and Ruíz, 2004). This author proposes a competitive strategies model based on two dimensions:

competitive scope and competitive advantage. The cross between these two dimensions provides four strategies, which Porter described as "pure" strategies. Figure 1 shows Porter's competitive strategies model and their predicted business performance.

Figure 1: Porter's (1980) Model

Fig. 1.a. Pure competitive strategies

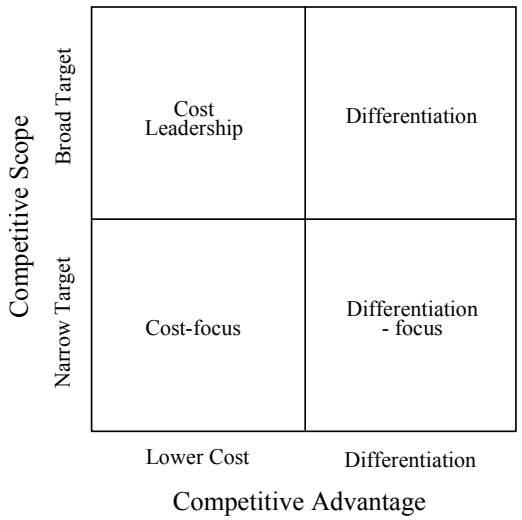
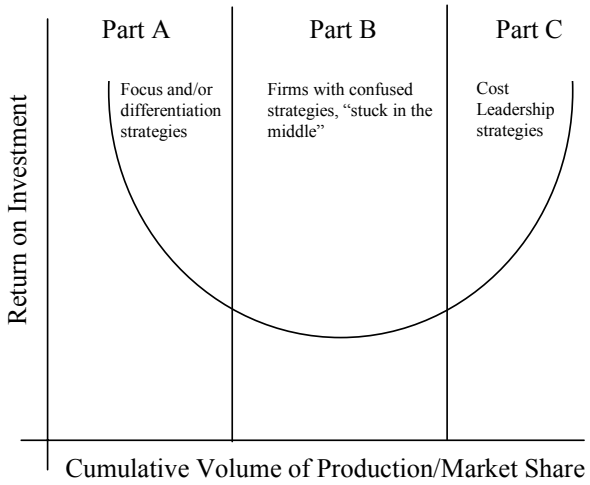


Fig. 1.b. Business performance of different strategies



At around the same time as Porter presented his ideas, Hall (1980) proposed another competitive positions model, in which the two fundamental dimensions were differentiation and cost, splitting Porter's main dimension in two, as later proposed by Hambrick (1983), and Jones and Butler (1988). Hall obtained empirical evidence to suggest that firms with lower costs, operating at reasonable prices, producing fair quality products, and more differentiated firms also with an acceptable level of prices or costs, or even with lower costs, obtained the best market and financial performance. On the other hand, firms with a lower than average differentiation achieved only mediocre performance levels and the worse their performance became, the worse their cost position. This author's model is shown in Figure 2.

Hall's research proposed the possibility that firms might have a high level of differentiation and very low costs. This possibility was refuted by Porter (1980, 1985), according to whom, firms that simultaneously pursue low costs and differentiation would end up "stuck in the middle", and would obtain a lower financial performance than the average for that industry (Figure 1.b).

What stands out in Hall's study is the reference to price as an independent part of competitive strategy, in light of the fact that in Porter's model is totally linked to both cost and differentiation (low cost = low price, and high differentiation = high price). However, in Hall's model, price is not graphically operative. Another weakness appears to be an absence of the separation of market and financial performance, as the model simultaneously foresees the failure and success of both; something which does not occur in a good deal of real-life competitive situations. This weakness was overcome by Karnani (1984), who presented a competitive strategy model for firms in mature oligopolistic markets similar to that of Hall, establishing a causal relationship between "competitive strength", market share and profitability (Figure 3).

Figure 2: Hall's (1980) Model

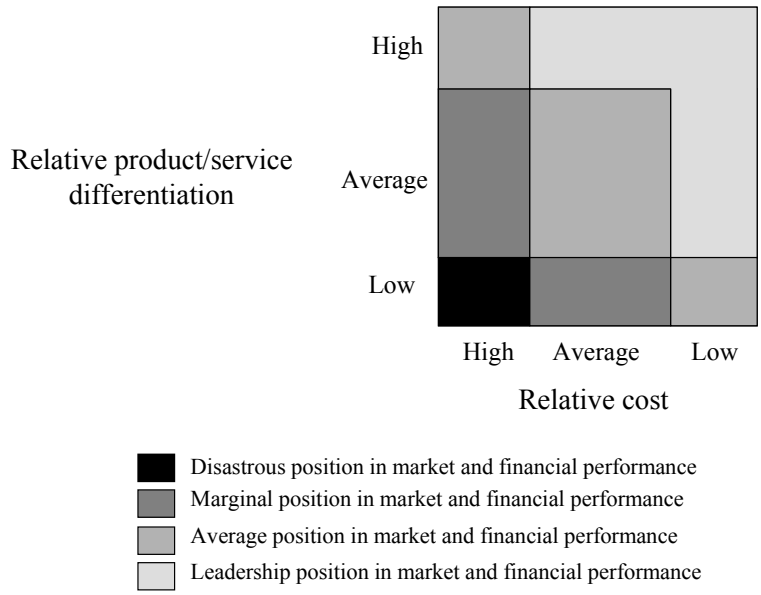
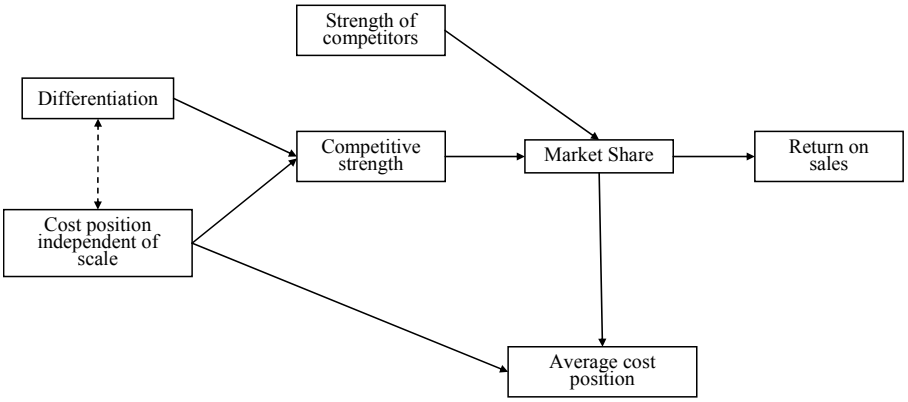


Figure 3: Karnani's (1984) Model



White (1986) proposed a similar model to that of Hall (1980), but with the advantage of illustrating both of Porter's pure strategies and the two types of stuck in the middle, where one is a winning situation and the other a losing position, in terms of profitability. In a similar vein to Porter, White assumed that differentiation entailed high prices. In fact, in his empirical study, he used price as a proxy for differentiation. Figure 4 shows his model and the results of his empirical study.

Figure 4: White's (1986) Model

Cost position	Differentiation position: Low	Differentiation position: High
Low	**Pure cost** ROI=28.6% Sales growth=3.9%	**Cost and differentiation** ROI=30.2% Sales growth=5.9%
High	**No competitive advantage** ROI=4.9% Sales growth=5.9%	**Pure differentiation** ROI=22.1% Sales growth=10.9%

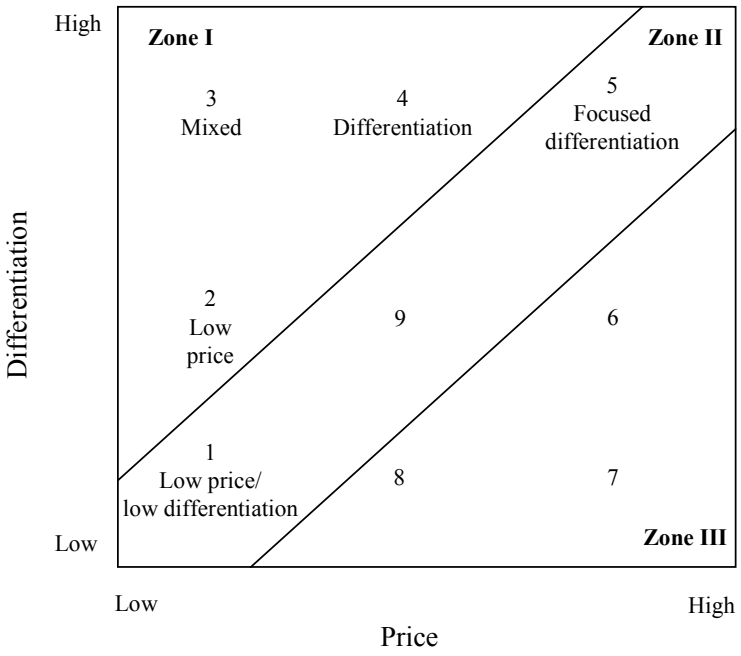
Hill (1988) did not produce a competitive strategies model, but rather studied the effects of differentiation on market and financial performance, analyzing in more detail the competitive strategy that White called "cost and differentiation", known to others as a "mixed strategy" (e.g. Miller and Dess, 1993). According to Hill (1988: 402-403), "investment expenditure aimed at differentiating a product has *two* effects upon demand. The first is to create brand loyalty, decreasing the price elasticity of demand for the firm's product. The second is to broaden the appeal of a product, enabling the firm to capture more of the market at a given price and to increase the volume sold. […] The immediate effect of differentiation will be to increase unit costs. However, if costs fall with increasing volume, the long-term effect may be to reduce unit costs. Three sources of declining cost can be identified: learning effects, economies of scale, and economies of scope".

Hill's study is important because he established a sequence that had previously not included competitive strategy models. This sequence consisted of the following causal chain: If ↑ differentiation and maintaining price → ↑ demand & ↓ price elasticity → ↓ unit cost → ↑ profit margin.

An important step forward in the modeling of competitive strategy as a competitive posture or position came about with the proposal of Mathur (1988). According to this author, when a firm makes decisions concerning competitive strategy, it should be understood that the first "judges" they will encounter are their buyers, and, consequently, it is only what buyers perceive that will serve as a means of answering, in the first instance, the question of how to compete. Moving away from the previous dominant proposals, which incorporated costs as a fundamental dimension in their models (i.e. Hall, 1980, and Porter, 1980), Mathur (1988) said that competitive strategy is basically the strategy which determines the firm's perceived position in terms of price and differentiation (the firm's outputs).

This interpretation of competitive strategy was later illustrated by Bowman (1992), which he presented as his strategy clock or map of competitive position built upon the two dimensions proposed by Mathur: price and differentiation (Figure 5). In the strategy clock, once the firm has identified the industry average perceived price and the industry average degree of perceived differentiation, it can place itself within a simple model of competitive strategies, where those companies creating more demand are situated in Zone I (positions 2, 3, and 4) and those at the opposite end of the scale are found in Zone III (positions 6 to 8). This model provoked great interest because it reduced the question of how to compete to six possible competitive positions (1 to 5, and 9). However, Bowman's model did not allow for the connection of competitive positions to profitability.

Figure 5: Bowman's (1992) Model



Most of the models proposed by other authors not expressly discussed in the previous paragraphs are variations on those presented herein. In general, they all function using two or three dimensions, and usually establish direct relations with business performance, normally measured through sales growth and returns. For example, Miller and Dess (1993) use a model with three dimensions (relative cost, relative differentiation and relative focus) that produce seven competitive strategies, assessed with the ROI, cash flow on investment, sales growth, and market share gained. Campbell-Hunt (2000) presents a similar model to that of White (1986). However, it also considers the dimension of focus, which leads to the proposal of seven types of competitive strategies, assessed according to financial return and growth. Spanos and Lioukas (2001) present a framework in which competitive strategy is defined by firm differentiation and by costs. In this model, competitive strategy, the forces of industry (barriers to entry, power over buyers…), and firm assets, jointly and directly determine both market and financial performance (market share, absolute sales volume, increase in market share and sales, ROE, ROS and net profits).

PERFORMANCE AND COMPETITIVE POSITIONS MODEL

This section deals with the proposal of a new competitive positions model based on three dimensions (price, differentiation and cost) and two types of business performance (market and financial performance). The model builds on studies by Hall (1980), Karnani (1984), Hill (1988), Mathur (1994), and Bowman (1992). Its main contribution is that of joining related conceptual frameworks that have hitherto been treated separately, in an integrated theoretical and graphical framework.

The work of Bowman (1992) and especially that of Mathur (1994) are used in the model to define the "external" competitive position (ECP). The contributions of Karnani (1984) and Hill (1988) are used to lend weight to the sequence "ECP → market performance → cost → profits", and the latter study provides the basis for the model's graphic development. The study by Hall (1980) has allowed for the consideration of three dimensions (price, cost and differentiation) rather than two (cost and differentiation) in defining competitive strategy.

Therefore, the proposed model:

1. Separates Mathur's (1988) ECP from Porter's competitive strategy (1980), by not mixing ECP with costs.
2. Differentiates between two types of business performance: market and financial performance, following the ideas of Karnani (1984) and Hill (1988), and thus moves away from studies that analyze these aspects without establishing a causal relationship between them (e.g. Miles and Dess, 1993; White, 1986)
3. Works with costs as a consequence of the ECP and as one of the causes of financial performance (Hall, 1980; Hill, 1988).

We will look at these questions in more detail in the following sections.

Business Performance

The business strategy problem is how to compete in the long run (Hofer and Schendel, 1978). Several authors have stressed the importance of price, differentiation, and cost, in business performance (e.g. Bowman, 1992; Hall, 1980; Maital, 1994), but few have distinguished the sequential relationship between the market and financial performance (e.g. Hill, 1988; Karnani, 1984). In our opinion, if a competitive strategies model is to be truly explanatory, it should divide the *business strategy problem* into two levels: how to compete and how to compete profitably; as it is one thing is to be successful in a market and quite another to make money from the position occupied by the firm.

The model proposed by Bowman (1992) is suitable for representing the "external" competitive position (ECP), which explains market performance and corresponds to the matter of how to compete, but it is inappropriate if the objective is to discover whether a competitive position will be profitable (i.e., it does not answer the question of how to compete profitably), as it does not explicitly consider cost position.

Financial performance is more complex than market performance, as it depends on the firm's level of sales (which is a measure of market performance) and internal efficiency (i.e. costs). A firm may be obtaining excellent market performance, for example, in terms of revenue, and still be losing money, because costs are greater than income from sales (Figure 6, cell II). If this situation is prolonged, the firm will not normally survive in the long term if drastic measures are not taken. However, the situation may be temporary if the firm manages to reduce its unit costs thanks to learning effects, economies of scale, and economies of scope, moving from cell II to cell I (see, the study by Hill, 1988, for a detailed analysis of the effect of differentiation upon demand, cost, and profits).

Figure 6: Market and Financial Performance

Market performance	Financial Performance: High	Financial Performance: Low
High	I	II
Low	III	IV

Some firms enjoy a certain degree of monopoly in their area of influence which cannot be put down to differentiation. This degree of monopoly is due, among other things, to a high level of switching costs for buyers (see Porter, 1980), which means that, despite the fact that the firm is offering an inferior price/value compared to its competitors, buyers continue to purchase its products or services (consider,

e.g., a local shop that offers more expensive and less quality goods and then ask the question, how can they continue to sell?). Firms that enjoy a certain degree of monopoly can sell at expensive prices and spend little money on differentiation, which produces mediocre results in market performance, but gives a high financial performance (cell III). Obviously, the appearance of a new competitor or the removal of the power of monopoly may induce the move from cell III to cell IV.

Cell III also represents the case of firms that are withdrawing investment. Such organizations have decided to abandon the business to all intents and purposes and are simply reaping as much benefit as the business permits. In the short term, they will remain in cell III, but little by little they will begin to move into cell IV.

Cell IV represents the case of firms that fail in their ECP and in solving the problem of efficiency, which leads them firstly to poor sales, and subsequently to scarce profit and even debts. This is normally the case of firms with neither a clear competitive advantage (be it in differentiation or in cost) nor a clear competitive strategy.

In short, financial performance is a consequence of market performance and of internal efficiency (costs); and market performance is a consequence of the ECP, which, in turn, is a result of prices and differentiation.

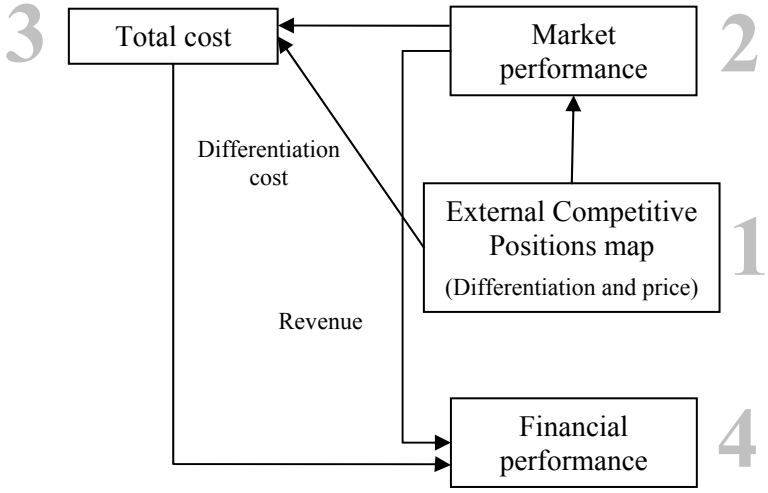
The Performance and Competitive Positions Model

The *performance and competitive positions model* (PCPM) is based upon that logic. Its synthetic graphical representation (Figure 7) shows the *sequence of causality* deduced from the theory in such a way that competitive strategy is defined on two levels (Hill, 1988; Mathur, 1988): price and differentiation on the first level (part 1 of Figure 7) and cost, shown on the second level (part 3). These are linked to performance at two different moments in time (Hill, 1988; Karnani, 1984): before and after the intervention of costs (parts 2 and 4). The reasoning behind this is simple. The effect of ECP is to bring about a "response" to the market. The demand generated by each firm, thanks to their ECP, implies a particular scale of production, which allows them to obtain, together with the cost of differentiation, the total cost for the firm. Lastly, costs are subtracted from sales, thus obtaining financial performance.

From the models examined in the previous section, the most similar to ours is that of Karnani (1984) (Figure 3), however, they differ in one vital aspect. Karnani follows the Academy tradition (Hall, 1980; White, 1986) by calculating "competitive strength" from the cost position and from differentiation. Mathur (1988) proposes that this is a flawed conception, as buyers do not "see" costs, merely prices. Our model calculates the "competitive strength" (called *external competitive position*) based on prices and differentiation, which is a radical difference in basic perspective compared to Karnani's model.

Figure 8 shows the *analytical version* of the PCPM. To illustrate how the model works, the graph shows only one firm (A) and two different moments in time (0 and 1). Firm A holds an external competitive position (ECP) at moment 0 (represented by A_0 in part 1 of Figure 8) which creates *demand* q_0 (part 2). This demand implies a scale of production that generates *unit costs* of uc_0 (part 3), which, when transferred to *financial performance* (part 4), result in zero *profit per unit* (UP = 0), in accordance with the equation UP = P – UC.

Figure 7: Performance and Competitive Positions Model (PCPM)



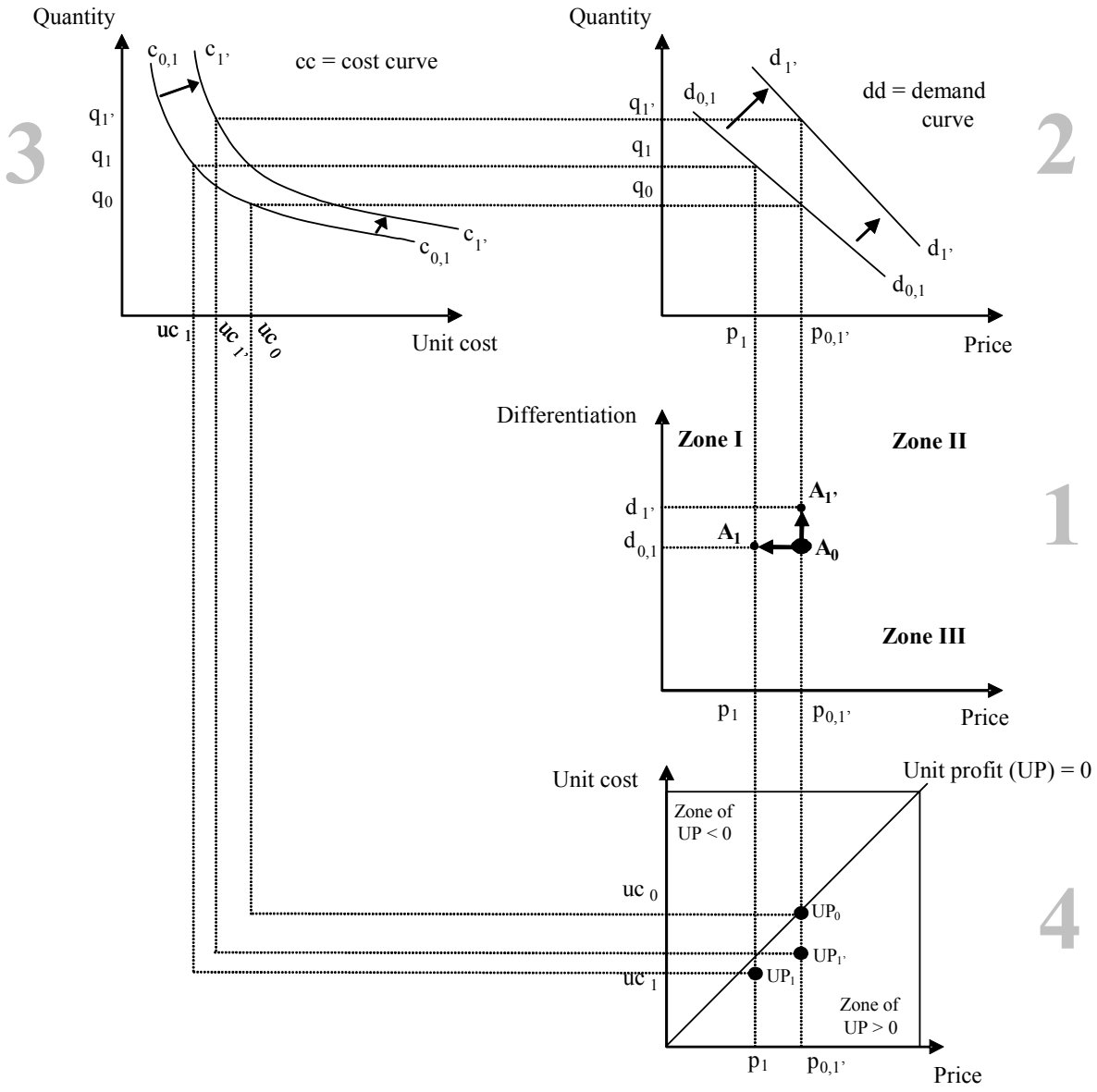
The graph also represents two competitive movements. In particular, it shows what would happen if A lowered its prices without changing the differentiation, going from A_0 to A_1, and what would happen if A raised its differentiation (for example, improving product quality) without changing the price, moving from A_0 to $A_{1'}$. Assuming that the other variables remain constant (especially the ECP of the firm's competitors), it can be observed that A's *competitive maneuvers* bring about an improvement, not only in *market performance* ($q_0 < q_1 < q_{1'}$), but also in *financial performance* ($UP_0 < UP_1 < UP_{1'}$). It can therefore be concluded that the new ECPs respond favorably to the two key questions related to competitive strategy: how to compete and how to compete profitably, although option 1' ($A_{1'}$) shows better market and financial performance.

The model is extremely useful in a graphic sense, despite the inherent complexities involved in calculating demand and cost curves. However, by adapting the curves with intuition and foresight, many competitive movements can be simulated, such as the competitive movements of the firm's more relevant market rivals, as well as their possible attacks or counterattacks on the firm's ECP.

Limitations and Contextual Application

The use of the PCPM is directly proportional to the firm's capacity to estimate, albeit intuitively, the demand and cost curves of its main competitors and, above all, its own. The model is not highly operative in sectors where there are large quantities of market segments with very different definitions of differentiation. Neither is it useful in markets where, for economic or political reasons (geographical distance, administrative concessions…) competition is developed in the form of a pseudomonopoly; nor does it function well if the buyers, for whatever reason, are not willing to change supplier (for example due to high switching costs). However, the model works well in situations where competition is fairly open, buyers abound and are reasonably homogeneous in their appreciation of suppliers' performance, besides having a sound awareness of what is offered by several suppliers without incurring large switching costs. As a result of all these reasons, it is important to assess whether the industry for analysis allows the application of the model, although whenever there is a certain rivalry between two firms, some useful elements can be found via its application and the tools presented herein.

Figure 8: Analytical Version of the PCPM



Note
In t = 1', displacement of the demand curve towards the right occurs because, for all price levels, buyers demand the product in greater quantity, due to improvement in differentiation. At the same time, as differentiation decreases the elasticity of demand, a modification in the slope of the curve also takes place. In t = 1', the cost curve is displaced towards the right because, for all levels of scale, costs increase as a consequence of the expense incurred by the firm in improving value.

According to Chrisman, Hofer, and Boulton (1988: 415), "only scope, segment differentiation, and types of competitive weapons are needed to describe an organization's competitive business substrategy". The PCPM does not include segment differentiation nor scope. Some authors have stated that the scope dimension is secondary to the quest for and use of competitive advantages (e.g., Karnani, 1984), and according to Wright (1987), in the case of smaller firms with lesser access to resources, scope is not a strategy of dimension, as all firms of this kind are focused (i.e. they concentrate on a narrow scope). On the other hand, according to Murray (1988), a necessary condition for segment differentiation in order to be viable is market heterogeneity, which makes our model a particularly useful tool in the case of smaller

firms and homogeneous markets, whilst having scarce value for highly segmented markets from the customers' point of view

The PCPM parts from a causal relation which has already been documented in the relevant literature (Hill, 1988). In this relation, costs are a consequence of the ECP and market performance, and in turn, are the cause of financial performance. Obviously, costs are not only a function of production costs and costs due to differentiation, which, to a large extent, limits the scope of the model in sectors where cost formation is less dependent on these two causes.

IMPLICATIONS AND CONCLUSIONS

Despite the enormous quantity of empirical and theoretical contributions that have appeared in the last 25 years, competitive strategy still lacks an analytical framework which is greeted with wholehearted acceptance on the part of both managers and academics. Basic topics such as the dimensions which define strategy or the different theoretical types of strategy and their foreseeable performance are still open to debate (Campbell-Hunt, 2000; Parnell, 2000).

For this study, two questions define the concept of competitive strategy: how to compete and how to compete profitably. The first question points to competitive position and the firm's success in the market, a facet which is ultimately judged by the buyer, while the second is a question of returns. They are both necessary and are interrelated, whilst being different in nature. The interpretation of this problem has led us to propose a framework which is divided into two levels, each one related to a different type of performance.

The problem of how to compete can be resolved using the two dimensions that are really seen by buyers: prices and differentiation. The result of this competitive position should be assessed only by measurements of market performance. On the other hand, resolving the question of how to compete profitably leads us to introduce a third essential dimension: cost. In this way, price, differentiation, market performance and cost can at last be related by measurements of financial performance. Seen from this perspective, having market success and earning money are consequences of different causes, although they are related.

To formalize this theory, this research has proposed a causal model called the PCPM (performance and competitive positions model). The PCPM proposes a new framework for managers and academics for the conception and empirical study of competitive strategy. The model recommends that:

1. Costs should not be used in the definition of a firm's competitive position (a good deal of the controversy in academic circles is due to its inclusion). Costs are obviously extremely important as businesses depend on them and they represent a condition for long-term viability, but they do not play a part in defining the firm's competitive position.
2. Market and financial performance are treated separately and sequentially (a large amount of academic controversy arises from the absence of this separation and sequencing). Particularly in the case of managers, the model suggests they would do well to consider whether they are searching for a competitive advantage that will benefit both types of performance or only one, in detriment to the other. For example, a business with a certain amount of monopoly on the market due to geographical location might be interested in maintaining a weak external competitive position (ECP), placed in Zone III of Figure 5. Thus, its competitive position would provide poor market performance, but perhaps high financial performance if the firm were capable of maintaining high prices. Alternatively, a business with high costs could opt for "market quota buying", making its ECP very attractive (Zone I of Figure 5) through an increase, for example, of product quality. If the firm managed to notably raise economies of scale due to a rise in sales, what started as an improvement in market performance

could, after a certain amount of losses, turn into profit. These examples show the desirability of separating the two types of performance, both in terms of academic research and in the practice of management.

3. ECP should be considered subjective and relative. It is subjective because it depends on the perceptions of buyers and it is relative because it is dependent on the ECPs of others (e.g. if a firm lowers its price, and its competitors do the same but on a bigger scale, the effect for the firm will be to have increased the price). Therefore, whenever competitive strategy is analyzed from the perspective of the PCPM, the manager or researcher would benefit from bearing in mind that the measurements obtained for price and differentiation should preferably be obtained from the buyer in a relative way. Suitable questions to ask might be of the type, does firm x have a price way under, under, similar to, over or way over that of its competitors? or Is the quality of products made by firm x far below, below, similar to, higher or much higher than that of its competitors?

The model presented herein is not without its limitations. Despite the step it implies towards synthesis and integration, there is still a long way to go. Future research should attempt to overcome these limits (by introducing market segmentation, allowing the analysis of pseudomonopolies, etc.). Moreover, an attempt should be made to extend the model to diversified firms with multiple ECPs. It would also be interesting to develop a theory of time lags between causes and effects, making theoretical propositions and later empirical contrasts of market response times and financial performance in the face of variations in the ECP.

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BIOGRAPHY

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