Cost-leadership strategy essay sample

Economics

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Definition: A firm pursuing a cost-leadership strategy attempts to gain a competitive advantage primarily by reducing its economic costs below its competitors.

If cost-leadership strategies can be implemented by numerous firms in an industry, or if no firms face a cost disadvantage in imitating a cost-leadership strategy, then being a cost leader does not generate a sustained competitive advantage for a firm. The ability of a valuable cost-leadership competitive strategy to generate a sustained competitive advantage depends on that strategy being rare and costly to imitate.

Sources of cost advantage•Economies of scaleEconomies of scaleOne of the most cited sources of cost advantage for a firm is its SIZE. There is a relationship between firm size measured in terms of volume of production – and costs – measured in terms of average costs per unit of production. The optimal volume of production is reached when the average costs per unit of production is minimum.

Sources of economies of scale : volume of production and specialized machines : Accompany with a high level of production, it is able to purchase and use specialized manufacturing tools that cannot be kept in operation in small companies.

volume of production and cost of plant and equipment : A high volume of production may allow a firm to build larger manufacturing operations. Large-volume firms will be able to build lower per unit cost manufacturing operations and will have lower average costs of production.

volume of production and employees specialization : High volumes of production are also associated with high levels of employee specialization. Adam Smith first observed that cost advantages may be associated with the division of labor.

volume of production and overhead costs : A firm with high volumes of production can spread its overheads costs (accounting, control, R&D,..) over more unitsDiseconomies of scaleSources of diseconomies of scale: physical limits to efficient size : There are physical limitations to the size of some manufacturing processes.

managerial diseconomies : As a firm increases in size, it often increases in complexity, and the ability of managers to control and operate it efficiently becomes limited.

worker motivation : A third source of diseconomies of scale depends on the relationship between firm size, employee specialization and employee motivation. One of the advantages of high volumes of production is that it allows workers to specialize in smaller and more narrowly defined production tasks. However, researches suggest that these types of specialized jobs can be demotivating for employees and can affect productivity and quality. Solutions have been experienced: participation schemes, quality circles, etcdistance to markets and suppliers : A source of diseconomies of scale can be the distance between a large manufacturing facility and the place where the goods are sold, or the places where essential raw materials are purchased (large transportation costs).

•The learning curveThe learning-curve model attempts to relate the volume of production and coats over time. Economies of scale focuses on the relationship between the volume of production at a given point in time and average unit costs. The learning-curve focuses on the relationship between the cumulative volume of production and average unit costs.

•Differential Low-Cost Access to Factors of ProductionDifferential low-cost access to factors of production may create cost differences among firms producing similar products in an industry. Factors of production are any inputs used by a firm in conducting its business activities. They include labor (human resources), capital, land, raw materials, knowledge)•Technological Advantages Independant of ScaleA possible source of cost advantage – not depending on economies of scale – may be the different technologies that firms employ to manage their business. Technologies include not only technological hardware of companies but also technological software of firms (quality of relations among labor and management, an organization's culture, the quality of managerial controls). All these characteristics of a firm have an impact on a firm's economic costs.

•Policy ChoicesIn general firms that attempt to implement a cost-leadership strategy will choose to produce relatively simple standardized products that sell for relatively low prices compared to the products and prices of firms pursuing other business or corporate strategies.

When does a low-cost producer strategy work best?•When price competition among rival sellers is a dominant competitive force•When the industry's product is a standard, commodity-type item readily available from a variety

of sellers•When there are not many ways to achieve product differentiation that have value to the buyer•When most buyers use the product in the same ways and have much the same needs / requirements•When buyers incur low switching costs in changing from one seller to another and are prone to shop for the best price•When buyers are large and have significant bargaining power

The competitive strengths of a low-cost producer strategy•A low-cost leader is in the strongest position to set the floor on market price (competitive strategy principle)•A low-cost producer strategy provides attractive defenses against competitive forces : rival competitors, buyers, suppliers, potential entrants, substitutes)Cost leadership and the Five Forces ModelThreat of Entry : If an incumbent firm is a cost leader, the new entrants may have to invest heavily to reduce their costs prior to entry. Often, new entrants will enter using another business strategy (differentiation, alliance) rather than attempting to compete on costs.

Threat of Rivalry : This threat is reduced through two choices of pricing strategies. 1. The cost-leader can set its price equal to the price of higher-cost competitors. By doing this, it reduces the chance that competitors will imitate the low-cost firm. However, keeping prices equal to a competitor’s prices does sacrifice market share dans sales volume. At this competitive price, the cost-leader firm earns an above-normal profit. 2. The low-cost firm can price its goods or services below the prices of its high-cost rivals. The lower price of the low-cost firm will attract numerous customers and increase its market share and sales volume but the cost is a lower profit earned. This

strategy sends a signal to competitors that lower costs are possible. Such a signal may motivate competitors to try to reduce theirs costs.

Threat of Substitutes : Cost-leader firm has the ability to keep its products or services attractive relative to substitutes.

Threat of Suppliers : Suppliers can become a Threat to a firm by charging higher prices for the goods or services they supply or by reducing the quality of those goods or services. However, when a supplier sells to a cost leader, that firm has greater flexibility in absorbing higher-cost suppliers than does a high-cost firm. Higher supply costs may destroy any above-normal profits for high-cost firms but still allow a cost-leader firm to earn an above-normal profit.

Threat of Buyers: Cost leadership can also reduce the threat of buyers. Powerful buyers are a threat to firms when they insist on low prices or higher quality and service from their suppliers. Lower prices threaten firm revenues. Higher quality can increase a firm's costs. Cost leaders can have their revenues reduced by buyer threats and still earn normal or above-normal profits. These firms can also absorb the greater costs of increased quality or service and may still have a cost advantage over their competition.

Competitive advantage through cost leadershipCost leadership is valuable if:•Buyers do not value differentiation very much•Buyers are price-sensitive•Competitors will not immediately match lower prices (do game theoretic analysis)Competitive advantage through cost leadership is sustainable if:•there are no changes in consumer tastes, technology and exogenous prices/costs•the activities taken to achieve low costs are rare and

costly to imitateRareness of Sources of Cost Advantage: Likely-to-be-rare sources of cost advantage: Learning-curve economies of scale, Differential low-cost access to factors of production, Technological softwareLess-likely-to-be-rare sources of cost advantage: Economies of scale, Diseconomies of scale, Technological hardware, Policy choicesImitability of sources of cost advantages: Even when a particular source of cost advantage is rare, it must be costly to imitate in order to be a source of sustained competitive advantage. Duplication and substitution are the forms of imitation.

Low-cost duplication possible: Economies of scale, Diseconomies of scaleMay be costly to duplicate: Learning-curve economies, Technological hardware, Policy choicesUsually costly to duplicate: Differential low-cost access to factors of production, Technological softwareOrganizing for sustained cost advantageA firm that has a cost advantage that is rare and costly to imitate has significant potential for earning above-normal returns.

Organizational attributes for firms implementing cost leadership strategies :•Firms generally have few layers in their reporting structure. Corporate staffs in these firms are kept small. These firms do not vertically integrate into a wide range of business functions. Mote operating decisions are delegate to unit (or plants) managers who have fully profit-and-loss responsibilities for their operations.

•Sustained capital investment and access to capital.

•Process engineering skills.

•Product designed for ease in manufacturing.

•Tight cost control systems: frequent and detailed control reports and close supervision of labor, raw material, inventory, distribution, and other cots.

•Reward for cost reduction and incentives based on meeting strict quantitative targets and increasing or maintaining quality.

•A cost leadership philosophy.

Cost control toolsoFull costing methodoDirect Costing Method (Uniform System of Accounts for Hospitality Industry)oActivity Based Costing (ABC): costs per activity. This creates an entirely new approach to costing. This also leads to activity management.

Risks of cost leadership•Technological change that nullifies past investment or learning•Low cost learning by industry newcomers•Inability to see required product or market change•Inflation in costsDifferentiation Strategy DefinedYour differentiation strategy is an integrated set of action designed to produce or deliver goods or services that customers perceive as being different in ways that are important to them. It call for you to sell nonstandardized products to customers with unique needs.

Why Differentiate? The concept of being unique or different is far more important today than it was ten years ago. The key to successful marketing and competing is differentiation.

Hyper competition is a key feature of the new economy. What used to be national markets with local companies competing for business has become a global market with everyone competing for everyone’s business everywhere. With the enormous competition markets today are driven by choice – your

targeted customers have too many choices, all of which can be fulfilled instantly. Choosing among multiple options is always based on differences, implicit or explicit, so you ought to differentiate in order to give the customer a reason to chose your product or service. Thus, “ differentiation is one of the most important strategic and tactical activities in which companies must constantly engage. It is not discretionary”.

Strategy – Differentiation FocusIn the differentiation focus strategy, a business aims to differentiate within just one or a small number of target market segments. The special customer needs of the segment mean that there are opportunities to provide products that are clearly different from competitors who may be targeting a broader group of customers. The important issue for any business adopting this strategy is to ensure that customers really do have different needs and wants – in other words that there is a valid basis for differentiation – and that existing competitor products are not meeting those needs and wants.

Examples of Differentiation Focus: any successful niche retailers; (e. g. The Perfume Shop); or specialist holiday operator (e. g. Carrier)Strategy – Cost FocusHere a business seeks a lower-cost advantage in just on or a small number of market segments. The product will be basic – perhaps a similar product to the higher-priced and featured market leader, but acceptable to sufficient consumers. Such products are often called “ me-too’s”.

Examples of Cost Focus: Many smaller retailers featuring own-label or discounted label products