Defining Competitive Advantage:
How much more value do you deliver than your competitors?

By Willie Pietersen

The future never just happened. It was created.
— Will Durant

The centerpiece of any strategy is encapsulated in an organization's Winning Proposition. If an organization can't define its Winning Proposition in a simple and compelling way, it cannot claim to have a strategy.

What does *winning* mean?

Does it mean your ability to survive? Does it mean keeping your shareholders happy? Does it mean providing benefits for your customers and stakeholders and the communities in which you live and operate? Does it mean having the largest market share?

Winning encompasses all of these things, but to take it out of the realm of slogans we need a rigorous measure that tells us unambiguously whether we are winning or not. This can be distilled to one simple test: a Winning Proposition must clearly produce a competitive advantage for your organization.

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Unfortunately, "competitive advantage" is one of those buzz phrases that has become a substitute for thought. We have all heard executives proclaiming proudly that their organizations have a competitive advantage without offering any clear explanation of what that means. The fact is that competitive advantage is very tangible and can be evaluated, so there need be no speculation about whether it exists. In fact, I would argue that it is the single most important gauge of organizational success. To clarify this assessment, we need to define exactly what we mean by competitive advantage.

The underlying idea is that in a competitive environment, everything is comparative. Absolutes have no meaning. If we hear that an Olympic athlete has run the 100-meter race in 9.8 seconds, this tells us very little (unless he or she was the only runner). But if we hear the athlete won the gold medal, this tells us everything. The same is true in business.

Now, let me pose a question. In attaining competitive advantage, which is more important: providing unique benefits for customers or achieving superior operational effectiveness?

This question is a trap. Clearly, the one without the other (at least to some degree) is not the answer. The temptation is to say both and be done with it. But while both are true, that answer is incomplete and therefore misleading. Doing both obviously is necessary, but it's not sufficient. The real answer is that competitive advantage lies in the *difference* between the two. It's the gap that says it all.

Mind the gap

If you have ever visited London, you probably have had the experience of riding on the London underground railway system. When a train pulls into a station and the doors open, a loud announcement echoes along the platform. Three short words caution passengers to watch their step as they get on and off the train, to avoid tripping in the space between the train and the platform: "MIND THE GAP!"

Competitive advantage in a business entails exactly the same injunction: Mind the gap! There are many gaps you ignore at your peril. At its most fundamental, though, competitive advantage means achieving a bigger gap than your competitors between the value your customers see in your product and the costs you incur in providing that product.

This gap is not a matter of subjective opinion. It can be objectively assessed, as Figure 1 illustrates. As this diagram shows, you achieve competitive advantage if your value/cost gap is bigger than that of your competitors. Let's briefly examine the elements involved in this simple measure. Value can be described as the numerator, and costs as the denominator.

The denominator (costs) is straightforward. Any organization can—and should—regularly benchmark its costs against those of its competitors. Published data, supported by good analysis, can be relied upon to produce a well-grounded comparison. This is not particularly difficult. It is done all the time.

But what about the numerator? How do you compare the value your organization creates against your competitors? The crucial point to understand is that there is a dynamic interaction between value, price, and volume. Value is the driver—the prime mover, if you like. Price and volume are *derivatives of value*; they have no independent existence. So to assess the amount of value you are creating, look at its outputs: price and volume. This is the ultimate gauge of the amount of value you are generating.

How do you measure whether you are producing superior customer value? Rather than just claiming it, you can assess it. When you are generating greater value than your competition, you can either charge a premium price without sacrificing volume, or you can im-

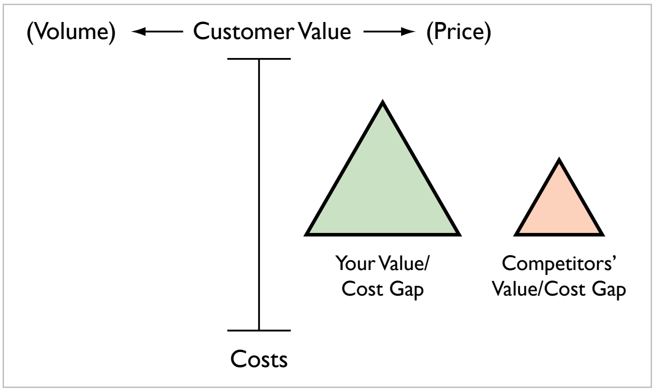

Figure 1. Achieving Competitive Advantage

prove market share at comparable prices. If you are losing on value, then both volume and price will be under pressure, and one or both will be falling. Market share does not have a life of its own; it's a child of customer value. Similarly, price does not have an independent existence; it, too, is a derivative of value. This logic is ruthless: Your customers will convey it to you very loudly in very simple terms. Customers will buy more of your offerings, or pay you a higher price for them, only if they place a higher value on them than the competing alternatives. And, of course, the reverse is also painfully true.

Take SAP, the giant business software company, which has achieved high market shares in its chosen segments. SAP offers integrated solutions designed to improve efficiencies across its customers' entire supply chains, an enormously valuable benefit in today's world of global supply chains. SAP's destiny depends on its continuing ability to deliver superior results on this promise. If it begins to falter on delivering superior value, it would see the consequences either in falling market shares or lower prices versus competitors.

The signals would be unmistakable. Granted, the value comparison is not as precise as the cost comparison. But absolute precision is not the objective here. This is a diagnostic measure, which will tell you unarguably whether you are winning or losing on value.

Stretching the elastic band

How can you improve your competitive advantage? Think of an elastic band stretched between value and costs (see Figure 2). The wider you can stretch this elastic band, the greater your competitive advantage and the larger the amount of profit being generated. Many businesses are tempted to compete on efficiency alone, and constantly stress operational effectiveness as a cure-all. In many ways, this is an easy way out. If you want to reduce costs, competitors can't stop you. But when you compete on costs, you are really competing only against yourself. Winning on value is much tougher. You have to outcompete your rivals.

Competing on costs is a requirement for staying in the game. Creating superior value is a necessity for winning the game. The key, of course, is to pull both upward and downward on the elastic band. Knowing where and how to stretch the band are strategic decisions that ultimately decide the difference between you and your competitors.

Take a look at the airline industry. Many of the big carriers fly the same type of aircraft to the same destinations in similar time slots with comparable safety records. With all this sameness, there is no basis for creating competitive advantage, right? Wrong. Airlines such as Virgin Atlantic and Singapore Airlines are able systematically to charge a price premium over their competition. Why? Simply because they concentrate on understanding the most important needs of their customers and on delivering a better all-round experience, consistently. We know they are creating greater value, because their customers are paying them more. We can't argue with the facts.

Cemex, the international cement company based in Mexico (which recently ran into difficulties for financial engineering, not operating reasons), achieved competitive advantage by pulling the elastic upward. Its costs per ton are similar to its largest global competitor, Holcim, but its price per ton is much higher.[1] Cemex provides higher value through a superb just-in-time system for cement deliveries that keeps construction projects humming along without delays, a major economic benefit. Cemex's customers agree, and are willing to pay a higher price.

There is, in the final analysis, no such thing as a commodity. Many people might consider cement or an airline trip to be a commodity, but these examples prove otherwise. To be sure, you can try to compete on price, but price cuts can be quickly neutralized, and the net effect is to transfer profits to customers. What companies like Cemex, Virgin Atlantic, and Singapore Airlines demonstrate is that when you consider the total customer experience, not just the underlying product, you can always find ways of generating superior value. To call your product or service a commodity is to abandon the pursuit of value, and hence the pursuit of competitive advantage.

A second point is that it is *perceived* value that counts. A brand

Figure 2. The Elastic Band between Value and Costs

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Consider the following example: In the mid-1980s, Hitachi and General Electric jointly owned a factory in England that made identical TV sets. The only difference was the brand names on those sets.

Through superior image building, which created greater trust in the minds of customers, the Hitachi units sold for $75 more than the GE sets, and sold twice as many![2] That's what prompted GE to get out of the TV set business. It would never be able to match Hitachi's profitability because it had lost the game on the perception of value.

When you think about it, you can never win by competing on price alone. The customer won't let you. In the customer's mind, you are competing on the relationship between price and value. This is true whether you acknowledge it or not. As Warren Buffet has pointed out, value is what customers get, and price is what they pay in return.[3] The two are inextricably connected.

GM's race to the bottom

Cautionary tales teach us as well. One of the most instructive examples I know is the sad story of General Motors' inexorable death march—a cautionary tale with few equals in the scale of its value destruction. This was not a sudden, unexpected event; it was a saga that played out over about 40 years. The causes of the misery were not hidden. They were starkly visible. And yet GM seemed strangely incapable of addressing the reality that was slowly killing it.

In its prime, GM boasted more than 50 percent of the U.S. auto market.[4] It seemed unassailable. Its array of brands, as its advertisements proclaimed, matched "every purse and purpose," albeit concentrating on the larger vehicles Americans preferred. Its profits were monumental. But since the first oil shock in the late 1960s, that market share has steadily declined and incredibly, now sits at under 20 percent. As a result of this catastrophic market-share slump, GM experienced a financial collapse and eventually had to be rescued by the government. What led to this tragic downfall of an American industrial icon?

The outline of the story carries a familiar ring. As GM grew to prominence, it became bloated, bureaucratic, inward-looking, and complacent. Product quality slipped further year by year, causing long-lasting damage to the image of its brands. It became a sitting duck for a customer-focused competitor.

Enter Toyota, which had a perfect opportunity to make its move when oil prices spiked again in 1980. Essentially, Toyota pursued a three-pronged attack on a vulnerable GM. It:

• Introduced highly reliable, fuel-efficient cars, which consistently outperformed GM brands on product quality.
• Instituted the lowest manufacturing costs in the industry, based on the awesome Toyota Production System.
• Developed superior brand appeal, based on the total customer experience, exemplified by its Lexus brand.

While Toyota was the most successful, other Japanese competitors, such as Honda, followed a similar strategy, as GM's market share drained away bit by painful bit.

What was GM's reaction to this meltdown? Astonishingly, senior management repeatedly blamed the company's woes on its so-called heritage costs. During the good years it had agreed to generous worker benefits, such as pension and healthcare payments for retirees. These obligations eventually came to represent a cost penalty of about $2,500 per car, versus Toyota.

There is something I have never been able to understand about this explanation. Presumably, these heritage costs were fixed, rather than variable, costs. Therefore, as GM's market share continued to fall, the "heritage" cost penalty per car would inevitably rise, making this a largely self-inflicted wound. Let's assume that roughly half of the cost penalty ($1,250) was due solely to GM's market share collapse.

This would mean that the $1,250 was actually a *value* deficit, not a cost deficit.

Another telling statistic is the estimate by James Womack, who heads up the Lean Enterprise Institute, that GM typically sold its cars, after discounts and cash rebates, at $2,000 less than the comparable Japanese models.[5] The statistic is revealing because it explains how GM's value deficit translates directly into dollars.

Now let's tally this up. If we add the $1,250 per-car value deficit arising from the market share loss to the cash discount gap of $2,000 per car, that puts GM's total value deficit at a jaw-dropping $3,250 behind Toyota on every car it sold.

It is not my purpose to take cheap shots at a company in dire circumstances. What I am interested in is the lessons we can learn from its difficulties. To begin with, it is pretty clear that GM's fundamental problem was only in part due to its cost disparity, important though that was. Its fatal "illness" was that it was losing out badly on value. How do we know that? Let's go back to our equation to assess competitive advantage. GM's problem lay in its crumbling numerator. Both its market share and auto prices suffered serious declines versus Toyota and Honda. The Japanese car makers cleaned GM's clock at the value game. Toyota and Honda stretched the elastic band both at the top and the bottom to a much greater degree than GM was able to (see Figure 3).

With this persistent deficit on value, GM's fate was sealed. In recent years the company tried mightily to save its way to success, but this seldom works. Each time it experienced a negative step-change in volume, it moved to cut its costs to match the lower volume. By the time it had reached the lower cost level, volume had dropped even further, so it embarked on yet another round of cost cuts, in an endless chain reaction. With costs chasing volume downward, this amounted to a race to the bottom.

It's understandable that GM—and other organizations in similar situations—turn to cost-cutting as a strategy for salvation. Costs can be controlled internally; competitors cannot stop you. But lower costs represent a limited advantage. The competitor that beats you on value is the more serious long-term threat. Strategy is a bet on the future. Once you start to lose the value game, it's very difficult to scramble back, and your options for the future are severely limited.

To be fair, GM recently did make up impressive ground on quality. However, in products with a long purchase cycle, brand image is very "sticky," and in the end, product improvements came too late to save the company.

The key lesson here is that if you have a value problem, then that is what you must acknowledge and fix—and fast. You can't cure a value problem through cost reductions. It's like having liver disease and treating your lungs instead, and then expecting a cure. The only salvation for GM would have been an early diagnosis of the value issue and an urgent set of measures to turn around its brands. Failure to treat the right disease is what ultimately led to bankruptcy.

Value leadership through a winning proposition

This brings me to a pet peeve. Over and over again, I hear organizations seeking to define their "value proposition." This always concerns me. Pursuing value is obviously the right thing to do, but this is plainly not a competitive statement. It ignores the most important question of all: How much value? In a competitive marketplace, absolutes have no meaning. It's the margin of difference—the gap—that counts. All value is relative, and customers have choices. Competitive advantage comes from providing greater value than your competitors for your chosen customers. The task, in other words, is *value leadership*.

This is where the words we use really matter. If something is crucially important, we should make it explicit, not hint at it indirectly. The problem is that companies so often allow the competition for superior value to be implicit, so that it happens by default. They need to make it explicit, and the way to do that is through a clear Winning Proposition.

An organization's Winning Proposition encapsulates measurable competitive advantage and defines how an organization will win the competition for value creation. It does that by answering these questions:

- What unique benefits will we offer our customers that will provide a compelling reason for them to choose us over our competitors?
- How will we translate this exceptional customer value into superior financial returns for our enterprise?

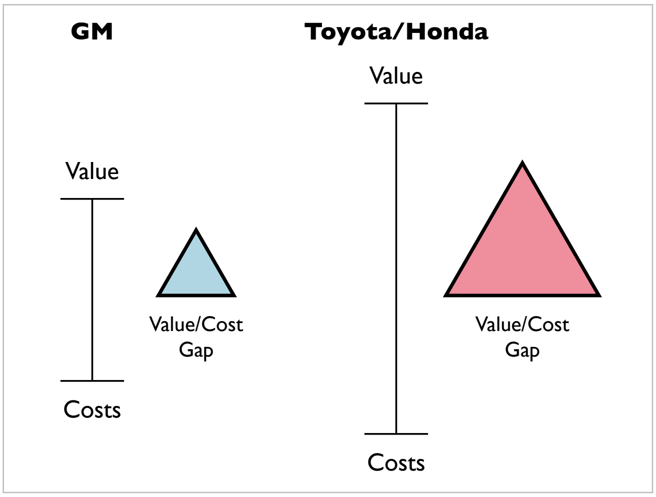

Figure 3. Toyota/Honda's Value/Cost Advantage versus GM's

Strategy is a bet on the future. Once you start to lose the value game, it's very difficult to scramble back, and your options for the future are severely limited.

These two questions force you to define how to capture both superior customer value and superior economic value, and how to convert the one into the other.

The first question is a reminder that we must adopt an outside-in view of the world. An inside-out view will lead you to think you are selling products or services. But if you take an outside-in perspective, it becomes clear that customers are not buying products or services; they are actually buying benefits.

For example, when customers buy Windex, the window cleaner, the benefit they are seeking is not the product itself. They are seeking streak-free, clean windows. When they buy a lawn fertilizer, they want to create a beautiful lawn that will enhance their homes and be the envy of their neighbors. If these products fail to deliver on the benefits, the underlying businesses will fail. Many businesses make the mistake of defining themselves purely by the products they make—"We're in the fertilizer business." What they find hard to do is define the competitive benefits those products provide. Defining those benefits with clarity not only makes them more competitive, it clarifies to everyone inside the organization what they need to concentrate on, each and every day.

The second question is actually a zinger. If you don't have to generate superior profits, the first question becomes dead easy. You could just load your products with lavish benefits and sell them at half price! Customers would love that. Balancing the first and second questions is what makes business success so hard to achieve.

Note that this second question challenges a business to aim at *superior* financial returns. Why not just *satisfactory* returns? There are a few compelling reasons for this:

• Investors, just like customers, have choices. Superior returns enable you to raise capital more readily and at a cheaper cost than competitors.

• Competitors with higher gross margins can outspend you on R&D, advertising, and human development, to fuel their growth at your expense.

• Consistently superior financial results eventually raise the price/earnings ratio on your stock. A strong stock price can be used by you as currency for acquisitions. Conversely, a weak stock price can make you an easy acquisition target.

What's your winning proposition?

The GM debacle underscores the need for every business to have a clear Winning Proposition that will define its competitive advantage and galvanize the energies of its people behind the right things. In order to lead an organization effectively, that Winning Proposition has to live in the hearts and minds of all the employees who are expected to act on it. Many executives seem to have difficulty nailing down a clear Winning Proposition, and too often will fudge this critical component of their strategy with some vague rambling statement that doesn't do the job. That's tantamount to an army marching into battle without a clear definition of how it will win, with the general saying, "Just go out there and fight. Execution is everything."

That clearly is a cop-out for effective leadership.

The essential starting point for a Winning Proposition is to capture the simple essence of the benefits your organization will provide.

Here are some examples:

Google: "We organize the world's information and make it universally accessible and useful."

Lego: "We offer products whose unique design helps children learn systematic, creative problem solving—a crucial twenty-first-century skill."

Institute for the Future: (a nonprofit research organization, of which I was once the chairman): "We are sense makers about alternative futures, to help organizations make better decisions in the present."

Hallmark Cards, Inc.: "We help people connect with one another and give voice to their feelings."

The key attribute of all these statements is that they focus on the superior benefits customers will receive, not just the internal actions these organizations will take. They offer a compelling reason why customers should choose to do business with them.

What's *not* a winning proposition?

Here's a statement that far too many organizations produce when I ask them for their Winning Propositions:

"We are the best in our industry at operational effectiveness." My answer is, that's good, but it's not enough. You can be as efficient as you like, but if you don't have customers, you're broke. You must describe both your numerator (customer value) and your denominator (costs).

Another common response to my question: "Our efforts are all directed at creating superior shareholder value."

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Unfortunately, this statement is not useful. Shareholder value is an outcome (like the bottom line), not a strategy. It's like a coach telling a football team that they need to end the game with the highest score. We can assume they know that already. The question is how. Without creating superior value for customers, I doubt there is a business in the world that can generate superior shareholder value. Leaders need to define how an organization will generate that customer value. Shareholder value will surely ensue—provided, of course, it does that efficiently.

A Winning Proposition is, in short, the centerpiece of strategy. If an organization can't define its Winning Proposition in a simple and compelling way, it can't claim to have a strategy. The acid test of whether an organization has a Winning Proposition is whether the resulting actions achieve competitive advantage.

The moment of truth

Most of these lessons are encapsulated in the following story. About seven years ago, a very large global company was scouring the world to find a business school to run a series of leadership programs for its top 400 executives. Columbia Business School (where I am a faculty member) ended up on the short list and I was asked by our Executive Education dean to lead our effort to win this business. This was going to be a very big deal indeed for the school. And, of course, it was a very important decision for this company.

The contest boiled down to two schools, and I was asked to fly to this company's headquarters for a final "showdown" meeting.

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There I was met by an extremely serious-looking committee, all dressed in dark business suits. The mood was somber. While the committee members were very courteous, nobody actually smiled. All eyes were scrutinizing me, and I felt a mild tension-sweat trickling down my back.

After a brief exchange of pleasantries, the chairman of the committee (let's call him Sam) asked me if I had brought a PowerPoint presentation. I eagerly said yes, and was about to leap up and get the show going. But Sam stopped me. "Before you show us your presentation" he said, "I have a question for you." I thought he was going to ask me something personal, such as where I lived or whether I owned a dog. But it was a business question: "Why should we choose to do business with Columbia?"

Oh, boy. Here was a real moment of truth. But I had gotten lucky. It so happened I had rehearsed my summation over and over, summarizing, simplifying, clarifying the essence. Now, instead of doing this at the end, I had to do it at the beginning. So I gave the two-minute speech.

My Winning Proposition was encapsulated in three points:

- This would not be a standard set of MBA lectures. The program would be highly customized to *your* needs, based on a deep analysis of the issues in *your* industry and how you achieve competitive advantage.
- We have an obligation to bring the very best ideas in the world, regardless of their origin.
- Our philosophy is that no matter how brilliant an idea may be it has absolutely no value until it is translated into action. Not only will we bring you the best ideas but we will always combine them with powerful and practical tools that enable you to act on them and measure their results.

Last, I promised that as the faculty director of the program, I would be personally responsible for these outcomes.

Nobody smiled. Sam then asked me to give my PowerPoint presentation.

At the end of the meeting, we all shook hands, and off I went back to New York.

On the way to the airport, I called the dean, who asked how things had gone. I said, "I have no idea. Nobody smiled." The next day, the call came through: Columbia had been selected!

Nevertheless, Sam's question stuck in my mind: "Why should we choose Columbia?" He had put me on the spot, and rightly so. He knew that this was the most important question for any business to answer for the customers it wishes to serve. In my language, Sam was asking, "What is your Winning Proposition?"

Over the years of running executive programs for this company, I came to know Sam on a personal level. He had risen to the very top rungs of his organization. One day as we were chatting, I referred back to that meeting and that question he had asked. He also remembered it clearly. I asked him to tell me what would have happened if I had given him an unconvincing answer to his question. His reply summed it up beautifully and spoke on behalf of all customers everywhere: "I would have allowed you to continue with your PowerPoint presentation, but I wouldn't have listened to a word you were saying."

About the author

Willie Pietersen is a Professor of the Practice of Management at Columbia Business School in New York. He specializes in strategy and the leadership of change, and his methods and ideas, especially Strategic Learning, are widely applied within Columbia's executive education programs, and also in numerous corporations.

Prior to joining Columbia Business School he served as the CEO of multibillion-dollar businesses such as Lever Foods, Seagram USA, Tropicana and Sterling Winthrop's Consumer Health Group.

Pietersen's latest book is *Strategic Learning: How to be Smarter than Your Competition and Turn Key Insights into Competitive Advantage.*

His web site is www.williepietersen.com.

Notes

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