Introduction

Thanks to Michael Porter's groundbreaking work, *Competitive Strategy*, published in 1980, strategic thinking in recent years has increasingly come to recognize the importance of interactions among economic actors. By concentrating on external agents and how they behave, Porter clearly moved strategic planning in the right direction. But for many people, identifying the various factors in Porter's complex model and figuring out how they will play off one another has proven to be frustratingly difficult.

While Porter's view is that five forces - substitutes, suppliers, potential entrants, buyers and competitors within the industry - can affect the competitive environment, those forces aren't of equal importance. One of them is clearly much more significant than the others. It's so dominant that leaders seeking to develop and pursue winning strategies should begin by ignoring the others and focus only on it. That force is barriers to entry - the force that underlies Porter's "potential entrants."

If there are barriers, then it's difficult for new firms to enter the market or for existing companies to expand, which is basically the same thing. Essentially, there are only two possibilities. Either the existing firms within the market are protected by barriers to entry (or to expansion) or they aren't. No other feature of the competitive landscape has as much influence on a company's success as where it stands with regard to those barriers.

If there are no barriers to entry, then many strategic concerns can be ignored. The company doesn't have to worry about interacting with identifiable competitors or about anticipating and influencing their behavior. There are simply too many of them to deal with.

With a universe of companies seeking profitable opportunities for investment, the return in an unprotected industry will be driven down to levels where there's no "economic profit" - no return above the costs of invested capital. If demand conditions enable any firm to earn unusually high returns, other companies will notice the same opportunity and flood in. Demand is fragmented among the various companies. Costs per unit rise as fixed costs are spread over fewer units sold. Prices fall. The high profits that attracted the new entrants disappear.

Life in an unprotected market is a game played on a level field in which anyone can join. Only the very best players will survive and prosper in such markets, and even they have to be continually on their toes. Without the protection of barriers to entry, the only option a company has is to run itself as efficiently and as effectively as possible.

Operational effectiveness might be thought of as a strategy - indeed, as the only strategy appropriate in markets without barriers to entry. However, operational effectiveness, identified by Michael Porter as doing what rivals do but doing it better, is an internal matter. It's actually tactical rather than strategic.

That doesn't make it insignificant. Operational effectiveness can be the single most important factor in the success, or indeed in the survival, of any business. Still, the pursuit of operational effectiveness doesn't require consideration of all
the external interactions that are the essence of real strategy.

**Barriers to Entry**

The existence of barriers to entry means that incumbent firms are able to do what potential rivals cannot. Being able to do what rivals cannot is the definition of a competitive advantage. Thus, barriers to entry and incumbent competitive advantage are simply two ways of describing the same thing.

In an increasingly global environment, with lower trade barriers, cheaper transportation, faster flow of information and relentless competition from both established rivals and newly liberalized economies, it might appear that competitive advantages and barriers to entry will diminish. But that macro view misses on essential feature of competitive advantages - they're almost always grounded in what are essentially "local" circumstances.

Consider the history of Wal-Mart, one of the greatest economic success stories of the late 20th century. It began as a small and regionally focused discounter in an area where it had little competition. It expanded incrementally outward from this geographic base, adding new stores and distribution centers at the periphery of its existing territory. The market that it dominated and in which it first enjoyed competitive advantage wasn't discount retailing in the United States but discount retailing within a clearly circumscribed region. As it pushed the boundaries of this region outward, Wal-Mart consolidated its position in the newly entered territory before continuing its expansion.

The same process of establishing local dominance and then expanding into related territories accounts for two of the other great corporate achievements of the period, although in those cases the geography in question was product market space, not physical territory.

Microsoft began by dominating one particular segment, the operating systems for IBM-type personal computers. It faced some competitors at the start, including for a time IBM itself, but Microsoft was able to establish and secure competitive advantages and marginalize all the other players. It expanded successfully at the edges of this business, adding adjacent software products like word processing, spreadsheets and other productivity tools. Even as a much larger company, with an extensive product line, the core of Microsoft's profitability remains the operating system and the adjacent software.

Apple's experience stands in stark contrast. From the start, it took a more global approach than Microsoft. It was both a computer manufacturer and a software producer. Its Macintosh operating system anticipated the attractive features of Windows by many years. Yet its comprehensive product strategy has been at best a limited and occasional success, especially when compared to Microsoft's more focused approach.

Intel's history is closer to Microsoft's. It began life as a manufacturer of memory chips in the 1970s and was profitable for a time in that market. It also designed and produced microprocessors, one of which was selected by IBM as the heart of its new PC in 1980. Intel continued in both businesses for several years but began to lose out on the memory chip side to companies with lower costs and fewer defects. It made the decision in 1985 to abandon that business, even though memory chips were part of its corporate DNA. By concentrating on microprocessors, Intel restored and increased its profitability and has maintained its dominance of a large market ever since.

Competitive advantages that lead to market dominance, either by a single company or a small number of essentially equivalent firms, are much more likely to be found when the arena is local - bounded either geographically or in product space - than when it is large and scattered. That's because the sources of competitive advantage tend to be local and specific, not general and diffuse.

Paradoxically, in an increasingly global world, the key strategic imperative in market selection is to think locally. Dominance at the local level may be easier to accomplish than might be expected. If the global economy follows the path of the more developed national economies, service industries will become increasingly important, and the distinguishing feature of most services is that they're consumed locally. The chances of becoming the next Wal-Mart or Microsoft are infinitesimal, but the focused company that understands its markets and particular strengths can flourish.

**Which Competitive Advantage**

Strategic analysis begins with two key questions. In the market in which the firm currently competes or plans to enter, do any competitive advantages actually exist? And if they do, what kinds of advantages are they?

The analysis is eased as there are only three kinds of genuine competitive advantage:

- **Supply.** These are strictly cost advantages that allow a company to produce and deliver its products or services more cheaply than its competitors. Sometimes the lower costs stem from privileged access to crucial inputs, like aluminum ore or easily recoverable oil deposits. More often, cost advantages are due to proprietary technology that's protected by patents or by experience - know-how - or some combination of the
Demand. Some companies have access to market demand that their competitors cannot match. This access isn't simply a matter of product differentiation or branding, since competitors may be equally able to differentiate or brand their products. These demand advantages arise because of customer captivity that's based on habit, the costs of switching, or the difficulties and expense of searching for a substitute provider.

Economies of scale. If costs per unit decline as volume increases because fixed costs make up a large share of total costs, then even with the same technology, an incumbent firm operating at a large scale will enjoy lower costs than its competitors.

Beyond those three basic sources of competitive advantage, government protection - or, in financial markets, superior access to information - may also be competitive advantages, but these factors tend to apply to relatively few and specific situations.

The economic forces behind all three primary sources of competitive advantage are most likely to be present in markets that are local, either geographically or in product space. Cola drinkers are very loyal to their favorite cola, but Pepsi loyalists have no particular attachment to Frito-Lay salty snacks, despite Pepsi's ownership of the snack company, nor did Coke drinkers prefer movies from Columbia when that was owned by Coca-Cola. Nebraska Furniture Mart, the store Warren Buffet bought for Berkshire Hathaway one afternoon, is a dominant player in Omaha and its hinterland, more powerful there than Ethan Allen or other large national furniture retailers.

Most companies that manage to grow and still have a high level of profitability do it in one of three ways. They replicate their local advantages in multiple markets, like Coca-Cola. They continue to focus within their product space as the space itself becomes larger, like Intel. Or, like Wal-Mart and Microsoft, they gradually expand their activities outward from the edges of their dominant market positions.

The natural starting point for any strategic analysis is a market-by-market assessment of the existence and sources of competitive advantage. When there are no competitive advantages present, then genuine strategic issues are of little concern. The key is operational effectiveness - efficiency, efficiency and efficiency. That's the first priority, and the last.

But when competitive advantage is possible, the next step is to identify the nature of the competitive advantages and then to figure out how to manage them.

By definition, in any market in which companies enjoy a competitive advantage, there will always be a short list of legitimate competitors. At the extreme, companies such as Microsoft in the world of PC operating systems or IBM in its golden days will find themselves alone or surrounded by dwarfs. Strategic analysis for such a dominant firm consists almost exclusively of understanding and managing competitive advantages. The company doesn't have to confront the complexities of explicit mutual interaction among competitors.

In the remaining strategic situations, several companies enjoy roughly equivalent competitive advantages within a single market setting. The soft-drink market in the United States is an example. Nationally, Coke and Pepsi are two elephants, with the other players considerably smaller, although in particular geographic markets, regional favorites such as Dr. Pepper may be legitimate competitors.

Strategy formulation is most intense and demanding in such situations. The companies face the big challenge of figuring out how to manage their competitors.

To develop an effective strategy, a company not only needs to know what its competitors are doing; it must also be able to anticipate those competitors' reactions to any move the company makes. This is the true essence of strategic planning. It embraces all the things a company does in which a competitor's direct relations are critical to its performance - pricing policies, new product lines, geographical expansions and capacity additions. Companies need to consider using approaches such as game theory, simulation and co-operative analysis to deal with the dynamics of their strategic situation.

Conclusion
Michael Porter's classic approach sacrifices clarity for completeness. Attending to five forces at one time isn't easy, especially if none of them has any claim to priority. Porter's approach can be simplified by concentrating first on the one force that dominates all the others: barriers to entry. Then you turn to the other forces, starting with industry competitors and direct competitive interactions where they apply, and next include suppliers and customers in a bargaining context.
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