Cost Advantage

Idea In Short

Cost advantage is one of two core competitive strategies identified by Michael Porter. It focuses on lowering production and operational costs to either undercut competitors on price or improve profit margins without sacrificing market position.

In the book Competitive Advantage, there are several chapters on using value chain analysis1. Michael Porter argues that there are only two types of competitive advantage:

- Differentiation
- cost leadership

As its name might imply, cost leadership allows a competitive edge by manipulating production costs. It does this in two important ways:

1. **Charging lower prices to increase market share.** This is done by casting the company as a low-cost alternative, which increases both sales and the company's profile
2. **Reducing costs to increase profits.** With fewer expenses on the books, organizations can move money into other avenues, like salaries or product research

How companies go about implementing the Cost Leadership strategy2 often depends on the specifics of their given industry3. Many business ventures will have access to capital for investing in technology and infrastructure. These kinds of adjustments and innovations help businesses bring down costs. It also helps to minimize the standard operating expenses. As an extension of that, proper logistics are crucial. Companies must be able to effectively manage the flow of products between the point of creation and respective storefronts. One real-world business who has championed Cost Leadership is Wal-Mart. The conglomerate has built its model partly on low prices, continually promising to beat those of its competitors. Executives are able to do that because Wal-Mart has an especially efficient supply chain, often sourcing products from less expensive foreign markets. To gain cost

advantage a firm has to go through 5 analysis steps:

1. **Identify the firm's primary and support activities** All the activities that are undertaken to produce goods or services have to be clearly identified and separated from each other. This requires an adequate knowledge of company's operations because value chain activities are not organized in the same way as the company itself. The managers who identify value chain activities have to look into how work is done to deliver customer value
2. **Establish the relative importance of each activity in the total cost of the product** The total costs of producing a product or service must be broken down and assigned to each activity. Activity based costing is used to calculate costs for each process. Activities that are the major sources of cost or done inefficiently (when benchmarked against competitors) must be addressed first
3. **Identify cost drivers for each activity**. Only by understanding what factors drive the costs, managers can focus on improving them. Costs for labor-intensive activities will be driven by work hours, work speed, wage rate, etc. Different activities will have different cost drivers
4. **Identify links between activities**. Reduction of costs in one activity may lead to further cost reductions in subsequent activities. For example, fewer components in the product design may lead to less faulty parts and lower service costs. Therefore identifying the links between activities will lead to better understanding how cost improvements would affect he whole value chain. Sometimes, cost reductions in one activity lead to higher costs for other activities
5. **Identify opportunities for reducing costs**. When the company knows its inefficient activities and cost drivers, it can plan on how to improve them. Too high wage rates can be dealt with by increasing production speed, outsourcing jobs to low wage countries or installing more automated processes.

Personally, I am not a huge fan of the cost leadership because there is always someone in the market who can come along with a product or service that is a little bit cheaper. For a cost leadership strategy to work, you require a significant cost differential that competitors recognize. Else, you are caught in a commodity trap selling an undifferentiated product at lower and lower prices.

Summary

Cost leadership works best when a firm maintains a meaningful cost gap over rivals. Without a significant differential, the strategy risks commoditization, where products become indistinguishable and margins erode through continuous price competition.