PORTER’S STRATEGY, VALUE CHAINS AND COMPETITIVE ADVANTAGE

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Abstract: A strategy means the plans and actions necessary to achieve the goals of an organization. Porter defines business strategy as "a broad formula for how a business is going to compete, what its goals should be, and what policies will be needed to carry out these goals." He recommends for strategy formation a the three-phase process. The “Five Forces” diagram reflect the main idea of Porter’s theory of competitive advantage, defining the rules of competition in any industry. The five forces are: industry competitors, buyers, suppliers, substitutes, potential entrants. The term “value chain” is suggesting that the chain was made up of a series of activities that added value to products the company sold.

Key words: strategy, competition, competitive advantage, value chain.

Defining a strategy

A strategy means the plans and actions necessary to achieve the goals of an organization. The manager must consider the strengths and weaknesses on their own organization and its competitors and to know the external environment threats and opportunities. The most important theory about the business strategies was elaborated by Michael Porter in his book “Competitive strategy: Techniques for Analyzing Industries and Competitors” in 1980. In this book Porter analyzed the various sources of environmental threats and opportunities and described how companies could position themselves in the marketplace.
Porter defines business strategy as "a broad formula for how a business is going to compete, what its goals should be, and what policies will be needed to carry out these goals." He recommends for strategy formation a three-phase process (figure 1):

**Phase 1: What is the company doing now?**
1. Identify current strategy
2. Identify assumptions

**Phase 2: What is happening in the environment?**
1. Identify key factors for success and failure in the industry
2. Identify capabilities and limitations of competitors
3. Identify likely government and societal changes
4. Identify company's strengths and weaknesses relative to competitors

**Phase 3: What should the company do next?**
1. Compare present strategy to environmental situation
2. Identify alternative course of action
3. Choose best alternative

*Figure 1* Porter's process for defining a company strategy.
(Source: Porter M., *Competitive Strategy.*)

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Phase 1: Determine the current position of the company. The formal strategy process begins with a definition of where the company is now - what its current strategy is - and the assumptions that the company managers currently make about the company's current position, strengths and weaknesses, competitors, and industry trends. Most large companies have a formal strategy and have already gone through this exercise several times. Indeed, most large companies have a strategy committee that constantly monitors the company's strategy.
— Phase 2: Determine what's happening in the environment. In the second phase of Porter's strategy process the team developing the strategy considers what is happening in the environment and ignores the assumptions the company makes at the moment and gathers intelligence that will allow them to formulate a current statement of environmental constraints and opportunities facing all the companies in their industry. The team examines trends in the industry the company is in, and reviews the capabilities and limitations of competitors. It also reviews likely changes in society and government policy that might affect the business. When the team has finished its current review, it reconsiders the company's strengths and weaknesses, relative to the current environmental conditions.

— Phase 3: Determine a new strategy for the company. During the third phase, the strategy team compares the company's existing strategy with the latest analysis of what's happening in the environment. The team generates a number of scenarios or alternate courses of action that the company could pursue. In effect, the company imagines a number of situations the company could find itself in a few months or years hence and works backward to imagine what policies, technologies, and organizational changes would be required, during the intermediate period, to reach each situation. Finally, the company's strategy committee, working with the company's executive committee, selects one alternative and begins to make the changes necessary to implement the company's new strategy.

Porter's model of competition

The “Five Forces” diagram (figure 2) reflect the main idea of Porter’s theory of competitive advantage, defining the rules of competition in any industry. The five forces are: industry competitors, buyers, suppliers, substitutes, potential entrants.
Figure 2: Porter’s 5 Forces - Elements of Industry Structure
(Source: M. Porter, Competitive Advantage, 1985)

The buyers want to buy the company’s products at the lowest prices. There are two situations: if the company is the only source the company will keep higher prices, or the invert situation, if there are many companies with similar prices who made the product, it will be obligated to reduce the prices.

Suppliers want to sell their products for a higher price. If the suppliers are the only source of a needed product or if there is lots of demand for a relatively rare product, then suppliers will tend to have more power and will increase their prices. If the suppliers products is widely available, or available more cheaply from someone else, the company (buyer) will try to force the supplier's price down.

Companies in every industry also need to watch to see that no products or services become available that might function as substitutes for the products or services the company sells. At a minimum, a substitute product can drive down the company's prices and even can product bankruptcy.

Finally, there is the threat that new companies will enter an industry and the competition will increase, driving up the
cost of products and lowering each company's profit margins.

Potter describes competition says that most companies follow one of three generic strategies: cost leadership, differentiation, and niche specialization.

The cost leadership is the company that can offer the product at the cheapest price. In most industries, price can be driven down by economies of scale, by the control of suppliers and channels, and by experience that allows a company to do things more efficiently. In most industries, large companies dominate the manufacture of products in huge volume and sell them more cheaply than their smaller rivals.

If a company can't sell its products for the cheapest price, an alternative is to offer better or more desirable products. Customers are often willing to pay a premium for a better product, and this allows companies specialize in producing a better product to compete with those selling a cheaper but less desirable product.

Niche specialist’s focus on specific buyers, specific segments of the market, or buyers in particular geographical markets and often only offer a subset of the products typically sold in the industry. They represent an extreme version of differentiation, and they can charge a premium for their products, since the products have special features beneficial to the consumers in the niche.

Porter’s Theory of Competitive Advantage

The term value refers to value that a customer perceives and is willing to pay for. The idea of the value chain is that each activity in the chain or sequence adds some value to the final product. It's assumed that if you asked the customer about each of the steps, the customer would agree that the step added something to the value of the product. A value proposition describes, in general terms, a product or service that the customer is willing to pay for.
There are some activities or steps that don't add value, directly, but facilitate adding value. These are often called value-enabling activities. Thus acquiring the parts that will later be used to assemble a product is a value-enabling activity. The key reason to focus on value, however, is, ultimately, to identify activities that are non-value-adding activities. These are activities that have been incorporated into a process, for one reason or another, that no longer add any value to the final product. Non-value-adding activities should be eliminated.

Many individual subprocesses must be combined to create a complete value chain. Every process, subprocess, or activity that contributes to the cost of producing a given line of products must be combined. Once all the costs are combined and subtracted from the gross income from the sale of the products, one derives the profit margin associated with the product line. Porter discriminates between primary processes or activities, and includes inbound logistics, operations, outbound logistics, marketing and sales, and service. He also includes support processes or activities, including procurement, technology development, human resource management, and firm infrastructure, which includes finance and senior management activities.

The term “value chain” is suggesting that the chain was made up of a series of activities that added value to products the company sold. Some activities would take raw materials and turn them into an assembled mechanism that sold for considerably more than the raw materials cost. That additional value would indicate the value added by the manufacturing process. One goal of many process redesign efforts is to eliminate or minimize the number of non-value-adding activities in a given process.

In his book, Porter has defined the competitive advantage and shows how value chains were the key to maintaining competitive advantage. He considered that a strategy depends
on defining a company position that the company can use to maintain a competitive advantage. A position simply describes the goals of the company and how it explains those goals to its customers.

A competitive advantage occurs when your company can make more profits selling its product or service than its competitors can. The managers have to establish a long-term competitive advantage. This provides the best possible return, over an extended period, for the effort involved in creating a process and bringing a product or service to market. A company with a competitive advantage is not the largest company in its industry, but is the one that is selling a desirable product and is producing great profits. There are two variables that determine a company's profitability: the industry structure, that imposes broad constraints on what a company can offer and charge and a competitive advantage that results from a strategy and a well-implemented value chain that lets a company outperform the average competitor in an industry over a sustained period of time.

In conclusion, in Porter's books, companies that create and sustain competitive advantage do it because they have the discipline to choose a strategic position and then remain concentrated on it. They gradually refine their business processes and the fit of their activities so that their efficiencies are very hard for competitors to follow.

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