Best **practice** ≠ Best **strategy**

Philipp M. Nattermann

Benchmarking is an important way to improve operational efficiency, but it is not a tool for strategic decision making. When competitors all try to play exactly the same game, declining margins are bound to follow.

"As a group, lemmings may have a rotten image, but no individual lemming has ever received bad press."

—Warren Buffett

Best practice. It may be the most readily recognized and widely used of all business management tools. And why shouldn't it be? To executives, modeling a company's performance on its best-in-class competitor is an ambitious but attainable aspiration. To investors, the strategy is a guarantee of the soundness of any company that embraces it. And to consultants, it is the tide that lifts every client's boat.

So why is it killing your margins? Everyone who follows business has seen the fat margins of growing young companies attract scores of new entrants, which eventually crowd the field and drive those very margins down. Why would top executives convert this regrettable fact of business life into a creed, especially when doing so simply hastens the endgame for everyone—first mover and Johnny-come-lately alike?

They act as they do because they don't understand that benchmarking is simply an operational tool. Instead, they all want to occupy the point on the strategic landscape that their most successful competitor has staked out.[1] Soon other competitors can be seen herding, lemminglike, around

[1] *See* Eric D. Beinhocker, "On the origin of strategies," *The McKinsey Quarterly*, 1999 Number 4, pp. 38–45.

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that best-practice company's product, pricing, and channel strategies. Products and services become increasingly commoditized, and margins tumble as more and more incumbent companies compete for smaller and smaller segments of customers and industry resources.

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Alarmingly, strategic herding appears to be in vogue in some of the most dynamic industries of the new information economy. A close look at the behavior of wireless telecommunications service providers in Germany indicates that strategic convergence by itself accounted for a 50 percent decline in margins from 1993 to 1998. Strategic herding also appears to be rampant in the manufacture of computers and consumer electronics goods and in the Internet strategies of many companies.

The herding instinct

Best-practice benchmarking—the measurement and implementation of the most successful operational standard or strategy available in an industry—can be one of the most effective tools for increasing a corporation's efficiency, productivity, and, ultimately, earnings. To see the benefits such benchmarking can yield, you need look no further than the US automobile industry, which transformed itself during the 1980s by adopting Japanese manufacturing techniques. More recently, Ericsson and Motorola copied the Finnish cell phone maker Nokia's use of the same phone chassis across different technologies to achieve economies of scale in design and production.

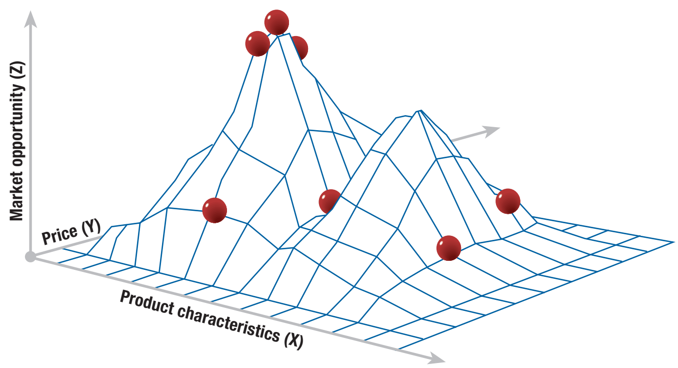
Broadly speaking, strategic decision making occurs along three dimensions: product characteristics, price, and market opportunity. When a company enters a new market, management's choices are restricted to the first two dimensions; the third element, market opportunity, consists of consumer preferences and income, which are beyond a company's ability to influence directly.[2]

Management's overriding goal is to position a company and its products where the market opportunity is highest. The more consumers who are located in a specific region of the strategic landscape, or the higher their

[2] Strategic differentiation is more than simple product differentiation. In the early 1990s, Apple's computers were more distinctive than Dell's, but Dell became the more successful company because its approach to channel management was more innovative and it was continually reinventing its strategy. In addition, few customers wanted to purchase computers, however well designed or distinctive, that had a shrinking software base.

EXHIBIT 1

You are here: Mapping the strategic terrain



disposable incomes, the higher this particular peak will rise (Exhibit 1). Especially in newer industries, the task of finding market opportunities is complicated by a lack of information about the willingness of consumers to spend, the exact distribution of their preferences, and other characteristics of the strategic landscape. Management really knows only its own company's location and earnings, and those of its competitors insofar as they make this information public. Even then, the information doesn't fill out the entire landscape.

The payoff a company receives for occupying any part of the landscape depend on the height of the point it occupies and on the number of companies operating nearby. A single firm operating at a particular peak receives all of the local market value. If a number of companies operate within a region, the market value or resources must be shared. The more companies that are located in a single region, the lower the payoff for each.

Tracking the herd

This herding instinct first manifests itself in the corporate search for profit peaks. To improve earnings, laggard companies typically benchmark their performance against the best practitioners and migrate closer to them. The laggards do so by mimicking competitors' product offerings, matching advertising and spending targets, using the same sales channels, and offering the same services. The migration continues as long as one of the companies earns higher returns than any of the rest.

Unfortunately, clustering around the strategy of the most successful company actually destroys value: the profits the industry leader earns are soon divided among the group of companies converging around its space. Companies that had been earning profits on lower peaks leave them to join the herd. Once forsaken, those sources of profit lie fallow unless other companies, seeing opportunity, occupy them. The combination of profits lost through the abandonment of smaller peaks and static overall earnings at the herding point forces industry earnings downward.

A strategic-differentiation index (SDI) can document the herding phenomenon and gauge the ensuing decline in industry margins (*see* sidebar, "Measuring strategic differentiation"). German wireless telecommunications is a prime example of a relatively new industry that has destroyed value by herding. Two companies—Deutsche Telekom's D1 and Mannesmann's D2—joined the incumbent operator, C-Tel, in the market in mid-1992. Between then and the end of 1998, operators reduced the industry's degree of strategic differentiation by 83 percent. Herding effectively eliminated differences among the individual carriers' product offerings, tariffs, and customer segments. One of the alarming effects of this loss of differentiation has been a decline in industry margins by roughly 50 percent from mid-1993 to year-end 1998 (Exhibit 2).

D1 and D2, the carriers that entered the business in mid-1992, quickly gained market shares that together exceeded 70 percent of the total wireless industry. The carriers very closely matched each other's pricing schemes,

Measuring strategic differentiation

The first step in determining the degree of strategic differentiation among competing companies is to measure their products' "characteristics" numerically. These include not only each product's inherent physical attributes (in the case of an automobile, for example, its horsepower, weight, and size) but also the commercial environment in which it is marketed, including the customer segments the company has targeted, the channels it employs, its advertising, and the locations of its activities.

Generating a two-dimensional plot that relates product characteristics to price is the next step. The strength of customer preferences for each product characteristic is estimated, and these estimates are used to calculate a price/product-characteristics index for all companies in the comparison. The higher the value of the index, the greater the number of desirable product characteristics the company offers at a given price. (In the case of two cars with identical product characteristics, the one with a lower price would have a higher index.)

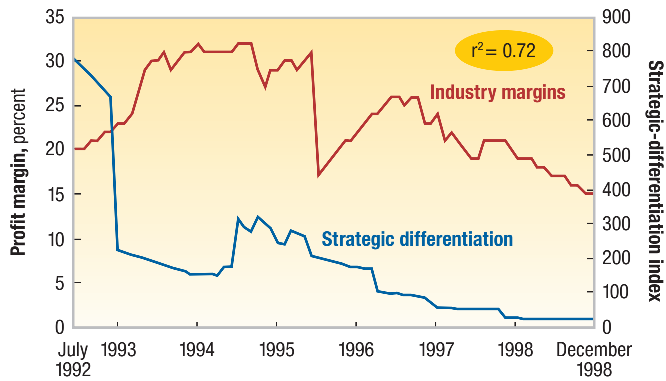
The price/product-characteristics index of each company describes its position vis-à-vis its competitors in the strategic landscape. The variance among the companies' individual indexes, denoting the degree of strategic differentiation across the industry, generates the strategic-differentiation index (SDI).

A company with a high individual index has succeeded in differentiating itself clearly from competitors. But the value of the industry's SDI at any given time is of little interest; it is change over the long term, or simply over the course of an industry cycle, that establishes whether herding has taken place. A sharp decline in the SDI demonstrates that managers are engaged in strategic herding.

with per minute and fixed monthly prices never differing by more than 3 percent. Both relied heavily on third-party sales outlets in 1993 and 1994 and used very similar advertising methods, channels, and pitches. Both targeted the small but affluent market of business users by advertising high fixed charges and lower charges per minute.

EXHIBIT **2**

Herding destroys value in German wireless



r^2 = the proportion or percentage of variance explained by a regression

When a third digital carrier, E-Plus, entered the market in mid-1994, it attempted to differentiate itself with a pricing package directed at relatively low-volume private users, including students, families, and senior citizens. To turn these people into customers, E-Plus offered them a low fixed fee and higher per minute charges. In addition, its charges for calls that both originated and terminated within its network were lower than charges for those that did not. Within three months, all of the other networks had imitated E-Plus's customer-targeting and pricing strategy, effectively destroying that company's bold attempt to increase differentiation in the industry.[3]

An analysis of the impact of such crowding indicates that a 10 percent decline in the wireless industry's SDI resulted in an 11.2 percent decline in margins. The entry of E-Plus into the market in mid-1994 reduced margins by some 19 percent. Between 1992 and 1998, however, the SDI tumbled 83 percent, pulling margins down 50 percent from their peak. In short, it was the low degree of strategic differentiation engineered by the incumbent operators, not the entry of new companies into the market, that was primarily responsible for the lost earnings, which amounted to more than $780 million in 1998 alone.

As strategic differentiation and margins decline, companies frantically attempt to distinguish themselves from competitors, typically with higher ad spending. In the case of the German telecom operators, between 1992 and year-end 1998 a 10 percent decline in the differentiation index was followed by a 13.5 percent overall increase in average advertising expenditures. The 83 percent decline in the SDI from mid-1992 to the end of

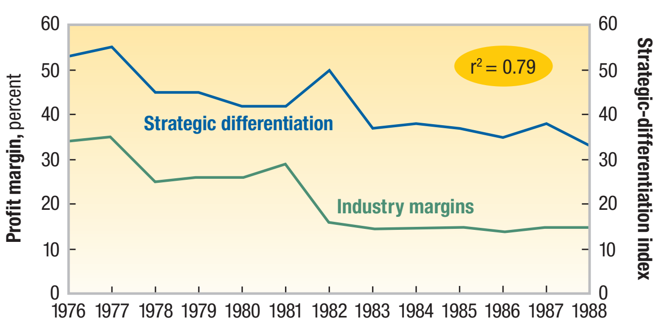
[3]For a more complete treatment of the German wireless market, *see* Philipp M. Nattermann, "The German cellular market: A case of involuntary competition?" *Info*, Volume 1, Number 4, August 1999.

1998 was accompanied by a $21 million average annual increase in ad spending, which by the end of that period was 58 percent higher than it had been at the beginning. All of that excess represents earnings lost to the industry as a result of herding.

Strategic herding has destroyed margins in the US personal-computer industry, too. In a 1998 study by the Federal Reserve Bank of Boston, Joanna Stavins, a senior research economist, examined the degree of strategic differentiation and its effect on the margins of the 13 companies that accounted for 98 percent of the market from 1976 to 1988. During that period, the PC industry's SDI declined by more than 37 percent as firms clustered around the now dominant IBM-clone PC model. As a result of this decline, margins fell during the same period by 56 percent (Exhibit 3), representing $2.95 billion in destroyed margins by 1988. Stavins also showed that increased clustering eroded "brand" effects, which derive from a company's innate distinguishing characteristics. Brand effects, including such intangibles as reputation and market image, explain that portion of margins that is not attributable to observable product differences.

EXHIBIT 3

Follow the leader: Strategic herding in the PC industry



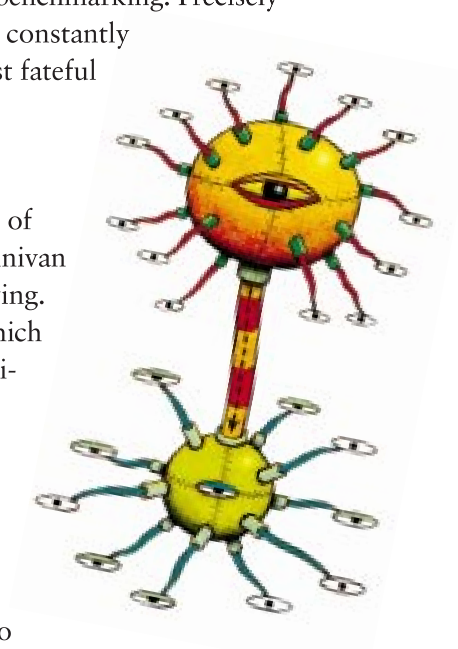
r^2 = the proportion or percentage of variance explained by a regression

Intense strategic herding also harms the margins and returns on equity of original-equipment manufacturers (OEMs) of consumer electronics products, such as Philips, Sony, Toshiba, and Zenith (which recently filed for Chapter 11). The OEMs' television-manufacturing activities are acute cases of industry herding around a product's physical characteristics. TVs from every manufacturer not only come with the same screen sizes but are also, excluding minor differences, identical inside. Even innovative technological features, such as Sony's Trinitron picture tube, are typically copied within six months to a year. Brand strength, the only discernible difference among manufacturers, requires huge advertising expenditures to sustain. Partly as a result of the lack of marginal strategic differentiation among the consumer electronics OEMs, the market capitalization of the industry's top five players increased by only 8 percent between 1994 and 1998. During that time the S&P 500 rose by 168 percent.

Other factors reinforce the herding reflex. For one thing, it dovetails nicely with the short-term orientation of many current investors, who are more likely than investors in the past to sell stock in companies that don't meet their earnings expectations. That tendency pressures companies to match the short-term results of their most successful direct competitors, even if long-term opportunities are sacrificed in the process. Indeed, many executives don't regret this; by embracing the industry leader's product, performance, and financial goals, they can blame performance setbacks on the fate of the industry as a whole. Finally, equity analysts by and large evaluate a corporation's results against those of its industry peer group and not against the absolute earnings levels of all industries.

Bucking the urge to converge

Understandably, in specific cases executives have trouble distinguishing the operational and strategic uses of best-practice benchmarking. Precisely because the slope is so slippery, executives should constantly ask themselves whether they have taken those first fateful steps toward destroying value.



Many companies *have* resisted the temptation to extend the best-practice technique into the realm of strategy. Chrysler, for example, introduced the minivan in 1984, when the station wagon segment was dying. Another such company was The Home Depot, which entered the do-it-yourself home improvement business in 1979, just as the baby boomers started becoming home owners; the company enjoyed growth rates of 20 percent a year, well surpassing the 5 percent rate for the overall building-supply industry.

Or consider Southwest Airlines, which managed to grow at a rate seven times the industry average in an era of overcapacity and flat demand. Southwest broke ranks with the other airlines by targeting a customer segment that, while price conscious, cares more than other price-sensitive customers about the quality of the flight experience.

Whatever industry these companies competed in, they all actively looked for "white spots"—that is, unexplored areas on the strategic landscape. White spots can take the form of new product niches, value-added services, and sales channels, as well as unexploited price points. Venturing into these uncharted regions obviously entails risk, but companies that do so increase the number of features from which to draw value and obtain first-mover advantages. Because such gains are bound to expire quickly, however, managers must continually reinvent niche products or services.

The number of white spots is almost unlimited, with opportunities ranging across all strategic dimensions. Small and midsize enterprises in Germany, choosing to exploit geographic opportunity, entered Eastern European markets after the fall of the iron curtain and succeeded because larger players initially hesitated. The Body Shop also prospered by exploiting white spots: founded in the United Kingdom in 1976 in a single storefront, it had grown so much by 1995 that it was operating more than 600 shops in 38 countries. Unlike the dominant players in the cosmetics industry, The Body Shop refused to allocate 30 percent of its revenue to advertising, conducted no elaborate promotions, and sold its products in simple plastic bottles. Madison Avenue viewed that approach with great skepticism, citing the maxim that successful cosmetics companies create hopes rather than sell products. Yet Body Shop founder Anita Roddick stuck to her guns and saw turnover soar more than 23-fold from 1984 to 1991 while pretax profits grew more than 19-fold.

The difficulties The Body Shop encountered in the mid-1990s, particularly in the United States, illustrate the pitfalls of failing to maintain strategic differentiation. Attracted by the high returns the company earned, a large number of competitors, including Bath & Body Works, Garden Botanika, and H_2O+ entered the market. (Bath & Body Works increased its sales from $112 million in 1993 to more than $1 billion in 1999.) The Body Shop's failure to reinvent its concept to ensure ongoing strategic differentiation led to a steady decline in the number of its US franchises, hurting revenues and earnings. Between 1996 and 1998, more than 20 franchises, some with more than one location, withdrew, complaining of the company's failure to outwit an ever-growing number of imitators by developing new products, formats, and packaging.

Another company that broke with the herd, Sweden's IKEA, balances quality and price in the furniture it offers through more than 130 stores in 26 countries. Contrary to the industry norm of outsourcing as much as possible, IKEA acquires stock in its more than 2,300 suppliers so that it can enforce its quality standards. Control of product design allows the company to specify construction methods. Careful attention to detail, construction, and packaging has helped it keep costs low. Thanks to this unorthodox but very well-executed strategy, the number of IKEA stores has grown 12-fold, its staff 15-fold, and its revenue 40-fold over the past 20 years, even as the industry grew by no more than 2 to 4 percent a year.

Best practice doesn't always equal best strategy. Best-practice benchmarking, rightly viewed as one of the most important tools for improving operational efficiency, can be a double-edged sword. Managers must guard against transforming what is a purely process-related technique into the overriding goal of strategic decision making. When industry competitors begin to herd around a single strategy, declining margins are bound to follow.