

CREATING AND SUSTAINING COMPETITIVE ADVANTAGE¹

Competitive advantage is a term often discussed, though frequently misunderstood. This short article lays out what is competitive advantage, highlights the important distinction between current versus sustainable competitive advantage, and briefly summarizes some of the most common sources of competitive advantage across different industries in the modern economy. The goal is to help readers understand their firm's current and potential competitive advantages so as to better shape investments, performance, and growth.

Competitive Advantage

A competitive advantage is something that allows a firm to capture more value than competitors for a given volume of sales, often in the form of having higher profit margins at the firm or unit economics level. Not all firms have competitive advantages. Indeed, the majority have performance either on par with or below rivals. But some firms have multiple competitive advantages, allowing them to have much greater profitability than rivals.

Core to every competitive advantage is some form of difference from rivals. At a high-level these differences generally operate by: (a) allowing a firm to charge more than rivals, (b) lowering costs compared to rivals, or (c) doing both simultaneously.

Competitive advantages can vary in their magnitude. Some competitive advantages provide big effects while others provide small effects. The magnitude of benefits provided by a competitive advantage may often vary between industries. It is therefore especially important to theorize about what drives competitive advantage in your industry and develop your strategy accordingly. While other industries can provide creative inspiration, care should be taken in appropriately selecting when a strategy that works in one industry may work in another. Likewise, different firms in the same industry often find success using different strategies.

Current versus Sustainable Competitive Advantage

As rivals begin to understand one another's competitive advantages, they often begin to imitate each other. Something that may once have been highly unique and a key competitive advantage for a firm over time often becomes common place. The activity or attribute may still be important but it may now be a source of *competitive parity*, becoming "table stakes" needed to be a viable participant in the industry.

¹ Teaching note prepared by Ben Hallen with feedback from the Strategy and Entrepreneurship faculty at the University of Washington.

The ease and speed with which rivals can imitate a firm depends on the nature of its competitive advantages. Some competitive advantages can be easily understood and copied. Others are hard to imitate they are difficult to understand (complex) or because they cannot be easily purchased on the open market.

Particularly long-lasting competitive advantages are often referred to as “inimitable” and are especially desirable, though they are not always possible in all industries. Given that many competitive advantages tend to erode over time as firms imitate one another, the following distinctions can be helpful:

- *Current competitive advantages* – differences that currently allow a firm to capture more value than competitors. May or may not be long-lasting.
- *Sustainable competitive advantages* – differences that are likely to resist attempts at imitation for at least a certain amount of time. What is meant by long-lasting, however, may vary substantially across industries.
- *Potential competitive advantages* – opportunities for a firm to build new competitive advantages through investments of capital, effort, or learning. Identifying potential competitive advantages can guide future investments and directions of growth.

Common Drivers of Competitive Advantage (Some sustainable, some not)

What follows is a short review of some of the most common competitive advantages for modern firms, organized very roughly by each advantage’s durability. Industries tend to differ in terms of which types of competitive advantages are most prevalent or most important. The importance of different competitive advantages also often changes within an industry over time.

Short Term (Unless Reinforced with Other Competitive Advantages)

Products or services with differentiated functionality – when a product or service has functionality that is important to customers and cannot be obtained from rivals or substitutes, this allows these offerings to be priced higher. So long as this does not require a proportionate increase in unit costs, this will create a competitive advantage for the moment.

- *How to create: Unique insight into customer needs + better product / service design*
- *Durability: Short to long-term - however long it takes rivals to identify the value of this functionality and develop similar offerings. This will vary with the technical complexity of the product and other barriers to imitation (e.g., other sources of competitive advantage).*
- *Example: Tesla’s early Model S and Model X offered luxury electric performance, which took rivals a few years to imitate. Rivian was one of the first to offer strong offroad capabilities in an electric vehicle.*

Medium to Long Term

Differentiated back-end processes, structures, or capabilities – Some firms have behind-the-scenes processes, structures, or capabilities allowing them to produce offerings for lower costs.

Other firms have back-end differences that allow them to produce offerings at a higher-quality, which is valuable when customers recognize this and will pay for it.

- *How to create: Devote time and effort to learning and experimentation; Learn from other firms, especially those in adjacent industries that may have adopted sooner.*
- *Durability: Medium to long-term – underlying processes are often hard to identify from the outside. But eventually employees may be hired by rivals or rivals may figure out the back-end differences on their own. This generally happens faster when competitors are large and well capitalized, and slower where competitors are smaller.*
- *Example: Toyota has long been known for its Toyota Production System (TPS) focused on commitment continuous improvement in manufacturing. This involves the physical setup of the assembly line, work practices for line workers, and specific management practices. Over time these practices have become more widely imitated.*

Learning curves – The accumulation of know-how can provide executional advantages that take time for rivals to figure out. This has long been observed in manufacturing, with costs falling and quality improving as a plant gets more experience manufacturing a particular good. Often times learning curves create product / service differentiation or differentiated back-end processes, structures, or capabilities.

- *How to create: Accumulate experience before competitors. Accelerate by fostering a learning culture and better creating documented processes that can be taught to new hires.*
- *Durability: Moderate*
- *Examples: Figuring out how to use AI and machine learning within a particular industry*

Customer Switching Costs – Sometimes there is high friction around a customer switching from between rivals. This reduces the ease with which customers can price shop and allows firms to charge a premium. Generally, there are limits though to just how much friction this can create, reducing the premium that companies can charge for this advantage.

- *How to create: More viable for some types of offerings than others.*
- *Durability: Moderate*
- *Examples: Paper Culture and other holiday card companies make it easy to import address lists but do not allow exporting. This increases the likelihood that customers will continue to use their service every year even if their prices are a little higher.*

Economies of Scale – These are advantages that a firm has from being bigger than rivals. One particularly prominent form is being able to better spread-out certain development or activity costs across a greater volume of transactions. This is especially true where upfront development costs are substantial (software, drug development, building a large manufacturing plant, etc.).

- *How to create: Grow faster than rivals while making investments that allow revenues to increase faster than costs*
- *Durability: Medium to long-term – lasts until other rivals also scale*
- *Example: Many Software-as-a-Service companies' main competitive advantages are economies of scale. They have invested heavily in building complex software. This has upfront development costs, but limited marginal costs for each new customer / user.*

Reputation for Quality / Status – In industries where it can be hard to perfectly evaluate the quality of a good or service at the time of purchase, customers are often willing to pay a premium when a firm has a verifiable track record of past quality. Sometimes this comes in the form of referrals from past customers. Sometimes it comes from 3rd parties like ratings agencies. In other cases, even past quality can be difficult to evaluate directly, in which case affiliations with high-status others is often used as a proxy to infer quality. For instance, a law firm highlighting the status of the schools that its lawyers attended.

- *How to create: Reputation – consistently produce high-quality outputs over time and in a way that prospective customers can reference. Status – affiliate with high-quality others or institutions. Both of these can take a long-time to develop.*
- *Durability: High – though can be jeopardized if current quality drops*
- *Examples: Professional service firms often depend heavily on their reputation for quality and reliability*

Patents and other legal protections of Intellectual Property – In some industries, it is possible to legally block competitors from using a firm’s unique insights through legal protections like patents or trade secrets. Patents effectively grant a firm an exclusive monopoly to the protected knowledge for a set period of years that they can enforce by taking other firms to court. However, in some industries like software, patents have been found to provide only weak protections as they are “easy to invent around”. Enforcing patents through lawsuits can also be expensive. Trade secrets allow firms to prevent unauthorized disclosure of proprietary information, for instance restricting employees from going to a competitor and sharing key knowledge about the firm. Rivals are not restrained, though, from reverse-engineering trade secrets.

- *How to create: After having an innovation, work with lawyers to create legal protections (this can be expensive, and further capital is often required to enforce these protections through lawsuits against competitors).*
- *Durability: High, though patents limited in lifespan (typically 20 years in the US currently).*
- *Examples: Moderna holds several patents around the technology used to develop its COVID-19 vaccine.*

Network Effects – Network effects occur when the value to users of a product / service increases with the number of other users of the product / service. There are two broad types of network effects. *One-sided network effects* occur when customers directly benefit from more other customers also using the product or service. This is common in many communication networks. Examples are telephones, email, social media, etc. *Two-sided network effects* involve two different types of parties in addition to the firm. These are common with marketplaces and platforms. So for instance, the Rover dogwalking platform that connects dog owners and dog walkers.

- *How to create: Grow each side of the network faster than rivals. For two-sided network effects, this often requires building out one side before engaging the other or narrowing focus initially to improve matches and fit.*
- *Durability: High (until another rival creates a step-function jump in functionality)*
- *Examples: Many marketplaces, software platforms, social networks etc. Common in Web 2.0 Internet companies (AirBnB, Uber, Dating Apps, etc).*

A note: What about high-quality employees?

A common question is what about employees as a source of competitive advantage? Employees can provide current and sustainable competitive advantages, but there are a few important caveats. The skills of the employees need to be truly differentiated from rivals, and in a way that allows a firm to charge higher prices or have lower costs. Moreover, employees only create competitive advantages for firms to the extent that the value they add exceeds their costs in terms of salaries, benefits, and other overhead. Overall, a firm's competitive advantages often reside in its employees – but leaders also need to understand exactly how these employees are creating hard to imitate competitive advantages.

Conclusion

Firms that understand their current and potential competitive advantages can better grow, capture opportunities, and improve their competitive positions. Building this understanding often requires taking the time to think about what truly differentiates a firm from its rivals in a way that customers appreciate. But understanding is generally not enough. Leaders then need to make investments and plans that leverage and expand a firm's competitive advantages.