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by Bruce Greenwald and Judd Kahn
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“Strategic” is the most overused word in the vocabulary of business. Frequently it’s just another way of saying, “This is important.” The reality is that there are only a few situations in which companies’ strategies affect outcomes. Such situations are, however, worth trying to create since the alternative, achieving superior efficiency, is a more demanding route to success, and a more impermanent one.

The aim of true strategy is to master a market environment by understanding and anticipating the actions of other economic agents, especially competitors. But this is possible only if they are limited in number. A firm that has privileged access to customers or suppliers or that benefits from some other competitive advantage will have few of these agents to contend with. Potential competitors without an advantage, if they have their wits about them, will choose to stay away. Thus, competitive advantages are actually barriers to entry. Indeed, the two are, for all intents and purposes, indistinguishable.

Firms operating in markets without barriers—that is, where competitive advantages do not exist or cannot be established—have no choice but to forget about strategy and run their businesses as efficiently as possible. Even so, many neglect operations and divert attention and resources to purportedly strategic moves like acquiring companies in related businesses or entering bigger markets.

In markets without barriers, competition is intense. If the incumbents have even brief success in earning more than normal returns on investments, they will find new entrants swarming in to grab a share of the profits. Sooner or later, the additional competition will push returns down to the firms’ cost of capital. The process that drives down profits also makes strategy irrelevant since there will be too many other players to take into account and their roster will always be changing. (See the sidebar “Efficiency in Place of Strategy.”)

Even for companies operating behind solid barriers to entry, life is not necessarily serene. If the incumbents are well matched, they may try to gain market share by cutting prices, im-
proving services, or making some other costly move. However, chances are good that they will succeed only in lowering their returns. Still, such competitors might recognize that the market is roomy enough not to require head-to-head confrontation at every turn. Avoiding competition that leaves every participant worse off is an especially enlightened choice, and one that deserves to be called “strategic.”

The erosion of profitability due to increased competition from new entrants isn’t confined to commodity markets, as one might expect. It occurs as well in markets for differentiated products, so long as all actual and potential competitors have equal access to customers, technology, and resources. Consider the luxury car market in the United States. When Cadillac and Lincoln were the only significant competitors, their brands commanded higher prices, relative to costs, leading to high returns on invested resources. These returns attracted other competitors to the market: First the Europeans (Jaguar, Mercedes-Benz, BMW), and then the Japanese (Acura, Lexus, Infiniti), started to sell cars in America.

The arrival of these competing products did not lower prices as it might have for a commodity like copper. Differentiation protected against that possibility. But profitability still suffered. Cadillac and Lincoln lost sales to the newcomers. As sales volumes fell, fixed costs per car sold—such as advertising, product development, special service support, market intelligence, and planning—inevitably increased, since these costs had to be covered by the revenues from the smaller number of units sold. Margins fell—same old prices, higher unit costs—so profits took the double hit of lower margins and reduced sales. If there were very low barriers to entry, entrants attracted by the reduced but still above-average return on investment would have continued to arrive until all the excess profits were eliminated.

Barriers to entry are easier to maintain in sharply circumscribed markets. Only within such confines can one or several firms hope to dominate their rivals and earn superior returns on their invested capital. When competition is global in scope, the need to circumscribe the competitive arena is even greater. That is why Jack Welch, instead of just setting revenue and growth targets, insisted that the only markets in which GE would do business were ones where it could be first or second.

The conduct of strategy, then, requires the competitive arena to be "local," either in the literal, geographic sense or in the sense of being limited to one product or a handful of related ones. The two most powerful competitive advantages, customer captivity and economies of scale—which pack an even bigger punch when combined—are more achievable and sustainable in markets that are restricted in these ways.

Indeed, it’s perilous to chase growth across borders. Because a global market’s dimensions are wider and less defined than a nation’s or a region’s, firms face a higher risk of frittering away the advantages they have secured on smaller playing fields. If a company wants to grow and still maintain superior returns, the appropriate strategy is to assemble and dominate a series of discrete but preferably contiguous markets and then expand only at their edges. As we will show, Wal-Mart’s diminishing margins over the past 15 or so years are strong evidence of the danger of proceeding otherwise.

The Varieties of Competitive Advantage

A competitive advantage is something a firm can do that rivals cannot match. It either generates higher demand or leads to lower costs. “Demand” competitive advantages give firms unequalled access to customers. Also known as customer captivity, this type of advantage generally arises from customers’ habits, searching costs, or switching costs. “Cost” (or “supply”) advantages, by contrast, almost always come down to a superior technology that competitors cannot duplicate—because it is protected by a patent, for example—or a much larger scale of operation, accompanied by declining marginal costs, that competitors cannot match.

These three factors (customer captivity, proprietary technology, and economies of scale) generate most competitive advantages. The few other sources—government support or protection, for instance, and superior access to information—tend to be limited to particular industries.

Intel benefits from all three fundamental factors. Its customers, the PC manufacturers, are reluctant to switch to another supplier because of their long-established relationships.

Bruce Greenwald is the Robert Heilbrunn Professor of Asset Management and Finance and the director of the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School in New York. Judd Kahn is a principal of Hummingbird Management, also in New York. They are the authors of *Competition Demystified* (Portfolio, 2005), from which this article is adapted.
To confer sustainable competitive advantages, economies of scale must be accompanied by some degree of customer captivity.

with Intel as well as their customers’ preference, thanks in part to the “Intel Inside” campaign. Intel’s many patents and years of production experience allow the company to reach a higher yield rate—fewer defects—in chip production more quickly than its competitors. And because it can spread the fixed costs of R&D for each new generation of chips over many more units than its rivals, it enjoys major economies of scale.

Technological advantages have their limitations, though. The technologies on which they rest may rapidly become obsolete. And in cases where such technologies are highly stable, they eventually become available to all firms. Advantages based on customer captivity are similarly perishable. Aside from literally passing away, currently captive customers may move or age into new markets.

Economies of scale can make up for these sorts of losses. Coca-Cola’s infrastructures, for example, enable the company to attract more new customers, and to do so more profitably, than its smaller and less-established competitors can. Its weapons include more extensive advertising and, thanks to scale advantages in distribution, lower prices. Because of similar scale advantages, Intel can spend many times as much as Advanced Micro Devices, IBM, or Freescale (a spin-off of Motorola) on developing new microprocessors and thus achieve dominance with each new generation of its signal product. Even when a rival has temporarily moved ahead, Intel (so far, at least) has always had the time and the resources to recover.

However, economies of scale must be accompanied by some degree of customer captivity if they are to confer sustainable competitive advantages. And without such advantages, firms that have a dominant share of their market will be forced to surrender some of it to new entrants. Even trivial switching costs can enhance captivity and thus multiply the advantages of scale. For example, before the advent of the remote control, sheer inertia kept fans of a popular TV program from abandoning whatever show came next, which might have been one the network was trying to launch. Now, the most sedentary couch potatoes will not hesitate to seek something more to their liking. To their delight, their fondness for choice has brought forth a proliferation of program options; to the major networks’ detriment, it has spawned a greater number of competitors and, hence, smaller viewerships.

Sustainable dominance is more likely in markets of restricted size. It is paradoxical but true that economies of scale are subject to scale limitations themselves. First of all, economies of scale require levels of production above a certain size. Such scale is easier to attain in large markets. Past a certain point, however, economies of scale cease being commensurate with continued increases in quantity. In fact, they become subject to diminishing returns, disadvantaging a larger competitor. In a restricted market, by contrast, economies of scale are much more difficult for a new entrant to achieve because it may have to capture 20% to 25% of the market—a difficult threshold to reach when each incremental gain comes out of the incumbent’s existing share. But unless the new entrant reaches those levels, its economies will not come close to paralleling the incumbent’s.

The second reason that sustainable dominance is more likely in markets of restricted size is that many fixed costs are fixed only within the region or product market in question. Expanding into another region that cannot be served by an existing distribution infrastructure, for instance, will necessitate new investment. To take another example, economies of scale in advertising may be limited to the area in which the language of the ad is spoken.

When a market gets too big, diseconomies of coordination can prevail over economies of scale. In expanding markets, globalization has undermined profitability by undercutting existing economies-of-scale advantages. The story is told most clearly in manufacturing. When the automobile industry was fragmented into national segments, each had room for only a small number of highly profitable participants—such as GM, Ford, and Chrysler, in the United States, and Renault, Citroën, and Peugeot, in France. With globalization, these segments increasingly coalesced into a single international market capable of supporting a large number of competitors. A viable share of this global market—that is, one offering absolute scale advantages—was much easier to attain than a viable share of a local market, which would have required gaining a substantial market share. As a consequence, entry and competition accelerated, to the marked detriment of automobile manufacturers’ competi-
Efficiency in Place of Strategy

Companies can vary enormously in their operating efficiencies, and these differences can be sustained for many years. But operating efficiencies are not a competitive advantage because they can be, and usually are, adopted by other companies. Also, competitive advantages are related to characteristics of the external environment in which a firm operates—primarily, its competitors—and not to its internal practices.

Take bar code scanning in the retail industry. The first firms to install scanning equipment had a big advantage over their slower competitors. They knew on a daily and ultimately instantaneous basis what they had sold and thereby gained better control of inventory and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and ordering processes. But since the bar code systems were not proprietary and operating with superior efficiency is the only method of competing available to a company that is separated from the conditions in which strategy can make a difference.

Wal-Mart and the Retail Industry

Wal-Mart offers the most powerful demonstration of the importance of dominating a local market. The retailer began in the south-central region of the United States, expanding steadily at the periphery of its territory. But it did not stop there. It is now the largest retailer in the country—indeed, in the world.

Although we attribute Wal-Mart’s historical performance primarily to a strategy of local dominance, there are competing explanations for the retailer’s success. Some observers have argued that Wal-Mart owes its superior returns to its enormous size and, as a consequence, its purchasing power. Alternatively, Wal-Mart is held up as a model of operating efficiency, which, critics charge, sometimes comes at the expense of its labor force.

But enormous size alone does not deliver a competitive advantage. If the purchasing power that comes with size were responsible for the company’s success, then Wal-Mart’s profitability should have increased as the company grew. Yet its operating margins (earnings before interest and taxes) have not increased since hitting their high watermark in the mid-1980s. In the years around 1985, Wal-Mart had operating margins of 7% to 8% of sales. Recent margins in its U.S. discount stores division have been about the same. But with Sam’s Club (Wal-Mart’s warehouse centers) and foreign operations included, overall margins drop below 5%. Also, in the early 1980s, Wal-Mart was no more than one-third the size of Kmart and should have suffered from a purchasing-power disadvantage. Yet Wal-Mart’s margins at the time were substantially higher than Kmart’s were. As Wal-Mart has grown, however, its profit margins have suffered in comparison with those of more geographically concentrated competitors, such as Target.

The purchasing-power explanation also defies economic logic. At least 90% of Wal-Mart’s sales are made up of nationally branded products that are sold through a wide range of competing outlets. The producers of these brands, by their own testimony, are reluctant to favor one retailer over others and risk antagonizing a majority of their distributors. As a result, they offer discounts to Wal-Mart only to the extent that Wal-Mart’s more efficient distribution systems lower their own costs. Looked at closely, purchasing power does not seem to be chiefly responsible for the Wal-Mart success story.

Are superior operating efficiencies, then, the key factor? Certainly, Wal-Mart enjoys some advantages of efficiency—for instance, lower labor costs than those of Kmart. But as with purchasing power, economics and the broad historical record suggest otherwise. Greater operating efficiency should lead to greater profitability. If Wal-Mart has a special talent for efficient operation, then that strength should be apparent in all the company’s divisions. Yet Sam’s Club appears to be no more profitable than the other two major warehouse chains, Costco and BJ’s Wholesale Club. The fact that Sam’s Club is the least geographically concentrated of the three competitors appears to have offset any advantages derived from Wal-Mart’s efficiency. Even though competitors over the years have copied many
of Wal-Mart’s cutting-edge techniques, such as outsourcing to China and requiring leading suppliers to put RFID tags on their goods, the deterioration in the company’s margins can be blamed on its inability to replicate the same local economies-of-scale advantages in the new regions it has entered. (The 2002 McKinsey study “Retail: The Wal-Mart Effect” illustrates this point in greater detail.)

Wal-Mart’s experience overseas tends to confirm the limited impact of the retailer’s operating advantages. Because the operations and technologies of Wal-Mart’s foreign competitors are less advanced than those of competitors in the United States, the company should be able to parlay this competitive edge into operating margins abroad at least as high as those of its domestic operations. In fact, overseas returns for Wal-Mart, whether on sales or on invested capital, are less than half its domestic margins. Especially in countries like Germany, where Wal-Mart faces entrenched competitors with dominant local-market shares, Wal-Mart’s earnings performance has been markedly substandard. Our point is that while Wal-Mart’s operations may be more efficient than those of its competitors, that advantage loses its power in a foreign market dominated by a domestic company.

Substantial, regionally determined fixed costs for advertising, distribution, and store supervision provide the locally dominant competitors with operating cost advantages that most likely overwhelm any differences in efficiency that companies like Wal-Mart obtain by applying widely available retailing technologies. In its discount store operations within the United States, where Wal-Mart is the one that benefits from local economies of scale, the company is an almost irresistibly powerful competitor. Overseas and even in the U.S. warehouse store category, where others enjoy these advantages, Wal-Mart is merely ordinary. Sam Walton’s genius was to recognize these facts first by establishing dominance in a core region and then by attacking weaker competitors at the margins of that territory, where his core advantages could be extended with relative ease.

What is true for Wal-Mart appears to be equally true for other areas of retailing, including banking. In Jim Collins’s list of “good to great” retail companies, Kroger, Wells Fargo, and Walgreens all had strong positions in local or regional markets. The one retail company that made Collins’s list without being in such a position—Circuit City—has fallen on very hard times indeed. Moreover, a systematic analysis of particular sectors shows a close connection between local or regional market

Supermarket Profitability and Local Market Share

Despite an increasingly global retail market, thinking locally paid off for certain grocery chains in the fiscal year ending in 2002. The most profitable were the ones that dominated their local markets. (Here, profitability is defined as pretax return on invested capital.)

share and profitability (see the exhibit “Supermarket Profitability and Local Market Share”). And retailer-manufacturers like Benetton that were the evangelists of a new wave of global retailing have since largely retreated to their core markets.

**Pharmaceuticals and R&D**

Pharmaceutical firms have been dramatic producers of shareholder value throughout the past 20 years of globalization. As this record unfolded, the industry’s structure changed to reflect the logic of specializing in particular areas of research and the drugs that emerge from them and to encompass a global network of local distribution systems.

What has happened is that basic research has migrated out of large pharmaceutical companies and into smaller, more narrowly focused firms that specialize in research. Roughly half of the licensed new drugs that big firms seek to bring to market are licensed from these smaller research companies, and this portion seems to be increasing.

With the expansion of global markets, such companies can achieve scale advantages formerly the exclusive property of large companies, given the size and expense of the infrastructure required for major research. The result is that large companies themselves—having lost their scale advantages—must now focus on particular product areas.

Another new development for big drug companies is cross-border mergers—as we saw with Britain’s Beecham and the U.S. company SmithKline (before the merger with the UK’s Glaxo Wellcome), for instance, and with Sweden’s Pharmacia and the U.S. firm Upjohn (before their acquisition by Pfizer). Cross-border mergers and concentration on particular diseases (such as Amgen’s focus on arthritis—not the company’s only specialization) both represent responses to the increasingly local imperatives of global competition.

Globalization has eroded competitive advantages among the established drug companies just as it did in the automobile industry. Fortunately, the benefits of specialization by research area have allowed small drug firms to seek, though not always find, competitive advantages and operational efficiency within particular product market niches. By acquiring licenses from these focused companies, the major pharma firms are simply adapting to the new strategic mandates that the advent of global markets has brought about.

In contrast to the development of new drugs, their marketing remains an essentially local operation. Selling new drugs through U.S. doctors, hospitals, and pharmacies has always involved U.S.-based clinical trials, sales teams, and distribution systems. Marketing is also targeted to medical specialties. For a U.S. firm to carry out all these functions in Germany, for instance, it would have to have an elaborate infrastructure there; similar infrastructures would be needed in all the other significant national markets. Each of these organizations would have a large fixed-cost component as well. The patients reached by such marketing efforts happen to be consistent in their purchases, which translates into substantial customer captivity. As a result, each national drug-marketing organization enjoys competitive advantages in both its geographic and its specialty markets.

The efficient marketing of drugs, therefore, requires a full range of national marketing organizations. Comprehensive global networks of locally dominant entities can be formed by several means, including licensing, joint ventures, and cross-border mergers. The recent wave of transnational mergers is easily explained by the presence of competitive advantages based on local economies of scale.

Thus, the structure of the modern large pharmaceutical organization looks like a giant tree trunk connecting sets of roots and branches. The drug research and development, or “root,” end is increasingly handled by firms specializing in particular sciences and products, and the distribution end is handled by strong local organizations, either of the now merged pharma company or of its affiliates. Perhaps this trunk, through which specialized producers pass their creations to equally specialized distributors, should replace “drug pipeline” as the industry’s defining metaphor.

**Consumer Nondurables: Coke and Pepsi**

Producers of consumer nondurables constitute another group of companies whose prosperity has withstood the challenges of globalization. Companies such as Coca-Cola, Colgate-Palmolive, Nestlé, PepsiCo, and Procter & Gamble, all of which were market value leaders 20 years ago, have continued to produce high returns. The
products they sell have well-established global identities. However, their relative competitive positions vary dramatically across national markets. Local economies of scale in advertising and distribution are an important competitive advantage for all these companies, especially when combined with habit-based customer captivity. The geographic advantages these multinational corporations possess have allowed them to do a good job of defending themselves against one another (although no domestic company has stepped forward to challenge them).

Local strategic factors have always been an essential aspect of competition among these well-established companies. But when Pepsi announced that it would challenge Coca-Cola’s global dominance, with the goal of more than doubling its sales outside the United States, it made the mistake of ignoring the local nature of the markets in which it presumed to compete. Coca-Cola responded with a focused attack in the one market—Venezuela—where Pepsi was the leader. Pepsi’s position there depended on its local bottler and distributor, which enabled Pepsi to realize economies of scale in advertising, sales, support, and distribution. In 1996 Coca-Cola made the bottling and distribution company an offer it could not refuse, displacing Pepsi as its cola source and wiping out Pepsi’s strongest presence outside the United States.

Coke and Pepsi may be quintessential global brands, but their competitive advantages, as Pepsi found out the hard way, must be defended one local market at a time.

**Telecommunications and Media**

In no other industry has the chasm between broad global ambition and local success been as great as in telecommunications and media. The Internet, with its global reach and ubiquitous presence, has been the protagonist in the narrative of increasing global interconnectedness. Satellites and other new distribution technologies, coupled with the digitization of virtually everything, have been widely expected to usher in a new era of universal integrated content. Yet the companies in this industry that have achieved high returns on capital and created value for their shareholders have traditionally been—and still are—those dominating local markets. Nothing seems to have changed in this ostensibly new era.

In telecommunications, would-be global heavyweights WorldCom and Global Crossing had bouts with Chapter 11 bankruptcy protection. Traditional long-distance competitors like Sprint and Qwest have had negative returns on invested capital, little if any revenue growth, and awful stock performance. Some have been absorbed by local telephone companies, and others, namely Qwest, have survived only by buying a regional Bell. Even AT&T, once the dominant long-distance and international communications firm, saw its performance deteriorate steadily before being acquired this year by SBC (formerly Southwestern Bell, one of the regional companies created in the breakup of AT&T in 1984). In the United States, the telecommunications companies at the head of the pack after two decades of upheaval are former local Bell operating companies—Verizon, SBC, Qwest, and BellSouth.

The situation in Europe and Asia is similar to that in the United States. The leading (as measured by profitability and market value) telecommunications firms providing landline services, such as NTT in Japan, France Télécom, Deutsche Telekom, and Telefónica in Spain, all have strong local franchises.

The same pattern holds for wireless communications. The profitable operators in the United States are Verizon and Cingular. Verizon’s strength is in the Northeast; its base consists largely of the former wireless subsidiaries of NYNEX and Bell Atlantic. Before Cingular acquired AT&T Wireless, Cingular’s customers came mostly from the wireless operations of BellSouth and SBC—again, regionally based organizations. The more nationally oriented providers, AT&T (whose acquisition by SBC awaits regulatory approval) and Sprint, have fared poorly. The only successful national competitor has been Nextel, which has specialized in business communications and offers a walkie-talkie service with its phones. In Europe, the only company with strong positions in more than its host country is Vodafone, which has a major share in the United Kingdom and some other markets. Otherwise, the field is populated by national champions.

In media, broadly defined, actual experience has been even more strikingly at odds with prevailing strategic wisdom, which in the last ten to 20 years has proclaimed that successful media companies would be those that
integrate content and distribution, are global in reach, and embrace and master new technologies. The premier companies pursuing these strategies have been four U.S.-based media giants: Time Warner, Viacom, Disney, and News Corporation (which was originally based in Australia). One European company that followed this path, Vivendi Universal, imploded spectacularly, and another, Bertelsmann, has pulled back from America. But the American companies have also stumbled. In the past ten years, they have all been able to grow revenue, but their top-line growth has not translated into substantial value creation. None of the leading global media companies has equaled the performance of the S&P 500 over the past 14 years; their average has been lower by almost 5% per year.

This performance history is in sharp contrast to that of the old-fashioned, locally based newspaper companies in the United States. These companies have not grown their revenues as fast as the big media firms, which is understandable, given the dated nature of their products. However, their shareholders' returns have generally exceeded those of the broad market indexes. Their strategies, focused on dominating their local markets, have yielded far greater returns than those of the big media companies. (See the exhibit “More Isn't Always More.”)

The economics underlying these experiences in both the telecommunications and the media industries should by now be familiar. Landline telecommunications, cellular phone systems, and local newspapers all involve significant fixed costs within each regional market, which are a requirement for economies of scale. These economies have created barriers to entry, protecting the incumbents. Potential entrants would have to seize sufficient local market share to become viable competitors, and the incumbents’ existing degree of customer captivity has made this difficult to achieve. By contrast, global markets for long-distance telecommunications, film production, recorded music, and books are so large that they will support many entrants, each with a relatively limited market share. As a result, these industries lack effective barriers to entry, must cope with intense and uncontrollable competition, and suffer from disappointing profitability and shareholder returns.

**Information Technology**

The history of distributed personal computing illustrates the importance of concentrating on narrowly defined product markets in establishing competitive advantages. In the early 1980s, at the dawn of the PC era, a number of large, well-financed companies were in command of the technologies that are now at the core of modern information processing. Apple and IBM, early leaders in the market, demonstrated their abilities as developers of software, hardware, and microchips. Digital Equipment was a leader in time-share computing, the precursor to modern distributed-computing networks, and in Ethernet connectivity technology. Xerox, with its Palo Alto Research Center, was a pioneer in software technology, and the company enjoyed a strong marketing presence at the office level, where much PC equipment was purchased. AT&T was a leader in digital communications, systems software (the UNIX system was AT&T’s creation), semiconductor technology, and fiber optics. Motorola had well-developed capabilities in chips and communications. Hewlett-Packard was strong in a wide area of individual computing technologies and incubated many of the leading technologists in Silicon Valley. Yet, with the exceptions of HP in the specialized market of printers and IBM in enterprise applications software, none of these giant companies is a significant player in today’s information technology world.

Instead, competitive advantages and the value creation they spawned have been in the hands of companies that took a far more local approach to product development. Microsoft began by focusing narrowly and obsessively on the PC operating system, designing its early word-processing, spreadsheet, and browser software to protect and extend that franchise. Intel concentrated solely on chips and, after the mid-1980s, microprocessors. Cisco specialized in routers and other intracompany network systems, incorporating both hardware and software. Dell initially devoted itself entirely to personal computers sold directly to customers, bypassing established and, it proved, less efficient channels. Even IBM and HP have been successful in “local” rather than general markets. Firms with strategies like Apple’s, designed to dominate the PC market as a whole, have not succeeded. In the new industry of personal-computing networks, successful
companies have confined themselves to local product markets.

Two factors account for this outcome. First, economies of scale apply within particular segments, not to the information technology market as a whole. Network effects, through which customers receive greater value as more users acquire the same products or technology, are specific to individual segments. Those accruing to users of operating systems, for example, don’t spill over to users of communications software. These effects have contributed significantly to the leading positions of Microsoft and Cisco in their respective markets. Large fixed development costs are characteristic of both software code and microprocessor design and production. By adding features and capabilities to successive generations of their basic products, Microsoft, Intel, and Cisco have managed to distribute those costs across a greater number of unit sales. Since all three companies enjoy powerful customer captivity and a dominant market share, they can in turn afford to spend much more on the fixed costs necessary to produce the next generation of technology, yet they will still have lower costs per customer than their rivals, an advantage that helps them maintain their dominance. Apple’s recent decision to switch to Intel microprocessors underscores the power of this advantage.

For a company like Dell in PC manufacturing, a commodity business that is not evolving much, development costs are far less significant, meaning that economies of scale are also less important. Customer captivity is also considerably weaker in the interchangeable world of PC hardware. Although Dell has tried to induce habit formation and boost switching costs among its institutional customers through ordering systems that are tightly integrated with production, evidence suggests that its customers are far less attached to its products than Microsoft’s, Intel’s, and Cisco’s users are to theirs.

For Dell, the primary benefit of its narrow product focus—until recently, only PCs—appears to have been simplicity and clarity,

More Isn’t Always More

A common strategy among U.S. media giants has been to expand, both in geographic reach and in products offered. The big four have delivered revenue growth over the past decade—but, as their low shareholder returns show, they haven’t managed to generate value. They could take a lesson from U.S. newspaper companies, whose shareholder returns have, in general, beaten market indexes. The key to the newsies’ success? Domination of local markets.

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Source: Value Line. Both tables list shareholder returns for 1991 through 2004 but include revenue growth only for the past ten years. The reason for using a later starting point to track revenues is to ensure that revenue growth rates were not built into the share prices at the start; high rates of revenue growth might have lowered subsequent investment returns by raising the initial share prices.
which have allowed Dell to concentrate on operational efficiency. Compaq, the most challenging competitor in Dell’s early years, seemed to have similar success after it refocused itself in 1991 to produce generic PCs as efficiently as possible. But Compaq lost this clarity of vision. It acquired first Tandem and then Digital, and its performance deteriorated. Clarity and simplicity—especially in markets without barriers to entry, where operational efficiency is everything—are two of the greatest benefits that a local focus imparts.

**Keeping It “Local”**

For all the talk of the convergence of global consumer demand, separate local environments are still characterized, in both obvious and subtle ways, by different tastes, different government rules, different business practices, and different cultural norms. (The single most glaring exception may be in luxury goods, where brands like Prada and Louis Vuitton have outlets throughout the developed world. These products have global appeal for the special category of cosmopolitan, high-income consumers.) And as our comparison of vertically integrated media and newspaper companies makes clear, the decision to concentrate in a narrow set of products or services has its own benefits. Coping with either regional differences or an unwieldy range of offerings puts heavy demands on any company’s management.

The more local a company’s strategies are, the better the execution tends to be. Localism facilitates decentralization—and since the days of Alfred Sloan, decentralized management has consistently served as a superior structure for concentrating management attention. Decentralization matters for both product space and physical territory. GE has always been noted for its stock of management talent, but the efficiency with which it deploys that talent is equally important. This efficiency can be attributed to a decentralized organizational structure: The company’s many activities are organized into independently focused divisions with clearly formulated, local strategic objectives, such as the need to be first or second in the relevant industry segment.

Another powerful illustration of the virtues of concentration is the performance of Microsoft, whose remarkable success is built primarily upon two related types of software, versus that of Apple, which has never stopped striving to excel in software, hardware, and media products but has enjoyed only intermittent successes mixed with frequent disappointments. Apple’s current profitability is attributable to the iPod, not the personal computer.

Strategies that are local in the nongeographic sense improve companies’ competitive strength by facilitating cooperation across product boundaries. If, like Apple, Intel had decided to produce computers and software as well as CPUs, it would clearly have had much more difficulty forging its partnership with Microsoft, a relationship that has contributed so heavily to Intel’s dominance of its own industry. Intel’s skill at designing and producing microprocessors and Microsoft’s at writing software constitute a joint enterprise of exponential efficacy.

With the globalization of manufacturing has come an increase in competition, along with a decline in profitability. Companies and countries that ignore this reality and try to compete in global markets for manufacturing face stagnation and poor performance, not to mention the challenge of going up against billions of capable, low-wage Chinese and Indian workers. The countries that have tried to follow this path—most notably Japan, Germany, and France—are suffering the consequences of low economic growth and underemployment.

At the same time that manufactured goods (even as they increase in variety, quality, and functionality) represent a shrinking portion of people’s consumption budgets, especially in the developed world, services of all kinds, including necessities like medical care and desirables like entertainment, represent a growing one. Because services are more often than not provided locally, their ever-increasing fraction of countries’ gross domestic products could create the conditions for a renaissance in another local pursuit: the making of corporate strategy.

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