

Association for Information Systems

AIS Electronic Library (AISeL)

ICEB 2007 Proceedings

International Conference on Electronic Business
(ICEB)

Winter 12-2-2007

Why Differentiation Strategy Fails?

Tzu-Hsin Liu

Heng-Hui Wu

Tzu-An Chen

Wei-Kuo Chen

Follow this and additional works at: <https://aisel.aisnet.org/iceb2007>

This material is brought to you by the International Conference on Electronic Business (ICEB) at AIS Electronic Library (AISeL). It has been accepted for inclusion in ICEB 2007 Proceedings by an authorized administrator of AIS Electronic Library (AISeL). For more information, please contact elibrary@aisnet.org.

*Proceedings of The Seventh International
Conference on Electronic Business, Taipei,
Taiwan, December 2-6, 2007, pp. 514-518.*

WHY DOES DIFFERENTIATION STRATEGY FAIL?

Tzu-Hsin Liu, Da-Yeh University, Taiwan, thliu@mail.dyu.edu.tw

Heng-Hui Wu, Providence University, Taiwan, hhwu@pu.edu.tw

Tzu-An Chen, Da-Yeh University, Taiwan, cleopatra_licca@hotmail.com

Wei-Kuo Chen, Da-Yeh University, Taiwan, felixpapa@hotmail.com

ABSTRACT

Differentiation strategy has been considered critical for securing a competitive advantage. However, not all firms can create competitive advantages through differentiation. In this paper, we draw on a Taiwanese hotel, restaurant, and TV program provider to show why differentiation strategy fails. On the basis of these three cases, three failed differentiation strategies are proposed and a framework for implementing a differentiation strategy is provided. Finally, we present the discussion and conclusions for the theory and practice of differentiation strategy.

Keywords: differentiation strategy, competitive advantage, service industry

INTRODUCTION

Over the two decades, scholars and practitioners have recognized that cost- and differentiation-based strategies [1], are important sources of competitive advantage. Porter's [1] generic competitive strategy has become the dominant paradigm [2]. Of particular interest is the question of how to leverage Porter's [1] generic strategies to attain superior performance. There is an ongoing debate over whether the two strategies are mutually exclusive or whether they can be combined [3]. In this paper, we argue that the differentiation strategy is more effective and practical than the cost-based strategy. The basis of the cost-based strategy is the firm's resources. In contrast to the differentiation strategy, it may be achievable even with limited resources. For instance, prior research has shown the benefits of differentiation strategy in gaining and sustaining key business relationships [4], even in a stalemate context for value creation [5].

However, although differentiation strategy has been influential in securing competitive advantages, not all firms can enjoy competitive advantages by adopting a differentiation strategy. In other words, a differentiation strategy does not guarantee a competitive advantage. Further, we have to explore into the reasons why differentiation strategy fails.

To explain this phenomenon, we draw on three service firms in Taiwan: a hotel, a restaurant, and a television program provider. We use these cases to describe three failed differentiation strategies and provide a framework for a successful one.

Understanding the mechanisms will extend the literature on differentiation strategy for creating competitive advantage.

This paper consists of five sections. First, we describe competitive strategy including cost leadership strategy and differentiation strategy and explain why differentiation strategy is critical for competitive advantage. Second, we present the data and methodology. The third section describes the three firms with failed differentiation strategies. The conclusion discusses the implications of differentiation strategy for managers and researchers.

THEORETICAL BACKGROUND

Porter [1] developed three generic strategies for creating competitive advantage. First, the cost leadership strategy emphasizes low cost relative to competitors. Second, differentiation strategy maintains a firm's need to create a unique product or service. Third, the focus strategy argues that firms should focus on a particular group of customers, geographic markets, or product lines. Karnani [6] indicated that the focus strategy involves achieving low cost or differentiation. Therefore, there are only two ways of securing competitive advantage: a cost leadership strategy and a differentiation strategy [6].

Dess and Davis [7] suggested that firms concentrate on either cost leadership strategy or differentiation strategy to avoid being "stuck in the middle" characterized by Porter. In other words, according to Porter, the two strategies are unlikely to be pursued simultaneously for a sustainable competitive advantage. Miller [8] argued that the differentiation strategy is most likely to be pursued in uncertain environments, while the cost leadership strategy is connected with stable and predictable environments.

Other research has examined firms will benefit the highest market share and profitability from the integration of the two competitive strategies. Kim, Nam, and Stimpert [9] argued that the integration of both cost leadership and differentiation strategies will outperform cost leadership or differentiation strategies. Hall [10] and Murray [11] also considered that the generic strategies are not mutually exclusive. Each strategy may be associated with a variety of strategic means [11].

Elaborating on Murray [11], we argue that a differentiation strategy can be an important way for a firm to acquire a competitive advantage regardless of whether a cost-based strategy has already been implemented or not. In other words, firms can adopt differentiation strategy to reduce competition [12]. Specifically, a differentiation strategy is an effective and profitable means of securing a competitive advantage in a stalemate situation [5]. Hill [13] viewed that differentiation strategy can be a way for firms to establish an overall low-cost position. Thus, differentiation strategy can always be a critical competitive weapon for a firm regardless of whether a cost leadership strategy exists and despite whatever competitive advantages firms have.

Yet, although firms can apply their skills and resources to meet environmental needs and create enduring competitive advantage [14], differentiation strategy is not guaranteed to succeed. Therefore, firms should need to consider how to avert

failure when pursuing differentiation strategy. In this paper, we use the examples of three service firms to show why some differentiation strategies fail. Accordingly, we propose three critical mechanisms of a differentiation strategy.

METHOD

The primary objective of this paper is to explain why differentiation strategy fails. This study is based on three Taiwan's service firms: a hotel, restaurant, and TV program provider. The three cases were chosen because they demonstrate some interesting and overlooked phenomena. The cases are thus ideal for expanding Porter's [1] competitive strategy of differentiation.

There are two main sources in this study: primary data (interviews) and secondary data (archives). The primary data are collected through focused interviews [15]. Eight 1- or 2-hour interviews were held with three general managers who are responsible for running the hotel, restaurant, and TV station. The secondary data were drawn from both internal and external documents. Internal sources consist of press releases, the company websites, and presentations. External sources include business and management periodicals, public company records, and virtual communities on websites. The data is triangulated among sources to increase the construct validity of this study [16, 17]. We stop data collection upon reaching a level of saturation [18].

For data analysis, this study adopts the iterative [17] and narrative [19] process of switching among data collection, data analysis, literature review, and theory building in order to construct a theoretical framework that explains why differentiation strategy fails. The explanation-building process enhances the internal validity of this study [20]. Finally, this study is written as a teaching case for EMBA and MBA program class discussion to gain important insight on increasing the validity of this study.

Case 1 The SML Teacher's Hotel

In the middle of Taiwan, Nantou County is characterized by its glorious landscape of lakes and mountains. Sun Moon Lake in Nantou is one of the most beautiful scenic spots in Taiwan, and attracts many tourists hoping to enjoy its climate every year. Therefore, more and more hotels have opened in the area. There are three kinds of hotel in this area.

The six-star Lalu Hotel is the first type. Its decor and facilities are brilliant and comfortable. Amenities include a spa, sauna, gym, fishing trips, bike rental, and swimming pool. In particular, the hotel overlooks Sun Moon Lake. Besides, the best service in this hotel is also delivered to its customers. The Lalu Hotel won the World Travel Award in 2006 and has become the leading spa resort in Taiwan. This type of hotel is differentiated from the others by its first-rate services.

The second type of hotel in the Sun Moon Lake area is the guesthouse. Guesthouses provide homey rooms and breakfasts prepared by the hosts. Every host creates a unique living environment. Each guesthouse has a highly personal services and decor. For example, one guesthouse is a wooden house building with naturalism. One guesthouse boasts strong coffee and superbly friendly service. One guesthouse is a Japanese garden building. In sum, these guesthouses have distinctive personalities.

The third type of hotel in the Sun Moon Lake area is the public hotel, such as the SML Teacher's Hotel. It opened on Teacher's Day in 1960. It is located on Sun Moon Lake. The public hotel once catered to teachers. Nowadays, it is open to everyone but teachers receive discounts. Since few people know this, most travelers assume that this is just a hotel for teachers. In addition, the hotel staff had a reputation of being unfriendly. In short, although the hotel had differentiated itself in the past by catering to teachers, the hotel ceased to differentiate itself by appealing to everyone. In contrast to the first and second types of hotel, the third type of hotel is differentiated because it is neither a six-star hotel nor a guesthouse. In other words, it plays the role of the passive recipient of ready-made differentiation. However, customers who are looking for a hotel on Sun Moon Lake will be inevitably attracted by the six-star hotels and guesthouses. Consequently, the third type of hotel is ignored. Its revenue thus did not significantly improve even after it opened to everyone.

Case 2 The CS Restaurant in Taichung

The CS Restaurant is located on a famous food street in Taichung. The restaurant was founded before two years ago and has already closed its doors. The famous food street is next to a high school so students are the majority of customers. Therefore, although there are many restaurants there, more are opening. The street is a natural place for restaurants to compete.

At the start-up stage, the CS Restaurant attempted to stand apart from its rivals. Although differentiation was the dominant strategy to this restaurant, its differentiation strategy had the wrong emphasis. The CS Restaurant believed that if it offered many kinds of differentiations in foods or services, then it would dominate the market. At first, each of the three floors of the restaurant served a different cuisine. The first floor served teppanyaki, the second floor delivered served Japanese shabu, and the third floor offered Thai cuisine. The Thai cuisine was the only one that became popular. The first and second floors could not generate enough money to cover the restaurant's high overhead (employee salaries, rent, and utilities).

In order to improve its service, the CS Restaurant paid a lot of money to install an elevator. The owner considered the service is an important differentiation strategy in the highly competitive market. However, although customers enjoyed the convenience, the costly elevator was not a necessity for young and able-bodied students who were the restaurant's main customers.

Again, considering the targeted customers as high school students, the owner of the restaurant thought of ways to create more differentiations to attract more student customers and increase revenues of the first and second floors. Finally, it considered that installing a television could be a good way to gain and keep student customers. However, there was no improvement in revenue.

The restaurant laws in Taiwan prohibit restaurants from blowing kitchen exhaust outside. Therefore, restaurants had to re-modulate their exhaust fan apparatus. The CS Restaurant tried to meet this requirement. The owner of this restaurant even re-modulated exhaust fan apparatus so that the indoor air was better than that of its rivals. However, it was a basic requirement for customers. Further, adopting a different apparatus as one more differentiation strategy can not guarantee a growth in

revenue.

In sum, although the CS restaurant indeed had created many differentiations such as combining different cuisines in one restaurant, installing an elevator, providing TV shows, and even setting up an unusual exhaust fan apparatus, it ignored the importance of value-based differentiation exploitation. In other words, it enjoyed achievement of quantity of differentiation but suffered from low revenue. Finally, the restaurant closed down.

Case 3 TV program provider - Chunghwa Telecom

Chunghwa Telecom is the largest telecommunication company in Taiwan. It launched HiNet Internet Services on April 1, 1995. HiNet is the Taiwan's largest Internet Service Provider (ISP) and was voted as "Best ISP" and "Best ADSL (Asymmetric Digital Subscriber Line)" by both the consumers and information managers, in surveys conducted by Information and Computers Institute for Information Technology for five consecutive years. The number of ADSL customers has passed four million.

In 2005, Chunghwa Telecom entered the market of providing TV programs based on a digital set-top-box, Multimedia on Demand (MOD). MOD is installed on the basis of ADSL platform. The TV program service enables customers to freely choose their favorite TV contents any time. It also provides an interactive function such as fast forward and rewind. The differentiation the TV program provider created enables customers to watch what they want when they want. The unique differentiation is totally different from the cable TV provider because the cable TV subscribers can only watch TV programs that are broadcast at specific times.

Yet, the TV program provider with MOD still has a very low market share. Although the target customer number is one million for the TV program provider with MOD, the number of customer with MOD was 6,307 in 2005, 22,926 in 2006, and 43,974 in 2007. The growth is far below its market goal. Besides, it only provides 28 basic TV channels. In contrast, its rivals, the cable TV program providers (the five major cable TV providers in Taiwan), deliver more than one hundred TV channels and have more than four million customers in Taiwan. If customers switch to MOD, the opportunity cost is the loss of the programs broadcast by cable TV providers.

Although the TV program provider has a distinctive differentiation, multimedia on demand, its complicated pricing strategy increases switching cost of customers from cable TV program providers. The cost of subscribing to cable TV is between NT\$500~600 per month. Subscribing to MOD includes an installation fee of NT\$800 and a basic monthly fee of NT\$150 for only 28 channels. If customers need more program channels such as finance or entertainment, they must pay more fees of about NT\$200. In addition, customers also need to pay NT\$80 for every video program they selected. Moreover, customers must enter a password to watch a video that costs more than NT\$100. Customers are also restricted to watch a program in 24 hours and 72 hours with different fees.

In addition, the video programs provided by the TV program provider with MOD are often the older movies. In contrast, customers of the cable TV program providers do not need to have extra charge for older movies or any other programs. Even a DVD/VCD video rental company as Blockbuster providing the older movies only costs an average of NT\$60 per movie. If a customer rents three DVD movies, he or she just pays NT\$140.

In sum, the cable TV program providers have clear pricing strategies and a wealth of TV programs. However, the high uncertainty and complexity of payment for basic and extra TV programs increases switching cost of customers. In other words, if customers of the TV program provider with MOD want to enjoy the same number of TV programs, they have to pay much higher fees than customers of the cable TV program providers. Even they only choose only a few of TV programs; they cannot clearly tell if the payment is going to be higher or lower than the fee for watching the cable TV programs. Indeed, the innovative value-based differentiation of the TV program provider with MOD is unable to create outstanding growth and revenue in that customers cannot understand how high the switching cost will be. Therefore, the TV program provider with MOD needs to simplify its differentiation content (e.g. pricing strategy), and externalize its value-based differentiation to change customers' opinion.

DISCUSSION AND CONCLUSIONS

Understanding the effects of differentiation strategy on competitive advantage is very important to both the theory and practice of management. Much discussion has examined how differentiation strategy leads to superior performance (e.g. [4, 21]). However, little research has been undertaken into the explanations about why differentiation strategy fails. In this paper, we propose three failures of differentiation strategies in Table 1. We suggest three levels of pursuing successful differentiation strategy in Figure 1. On the basis of these, this study extends Porter's (1980) differentiation competitive strategy. That is, we suggest that a successful differentiation strategy process involves (1) creating differentiation; (2) exploiting value-based differentiation; and (3) simplifying and externalizing value-based differentiation.

Table 1 Three failed differentiation strategies

Firms	The role for differentiation activity	The shouldn't-have enjoyment in differentiation	The lack of differentiation activity
Type 1	The passive recipient of ready-made differentiation released from rivals	Enjoying surplus value of rivals' differentiations	Lack of differentiation creation
Type 2	The actor greedy for more differentiation exploitation	Enjoying achievement of quantity of differentiation	Lack of value-based differentiation exploitation
Type 3	The active deliverer of innovative	Enjoying achievement of consumer value-based differentiation	Lack of effective simplification and externalization of differentiation

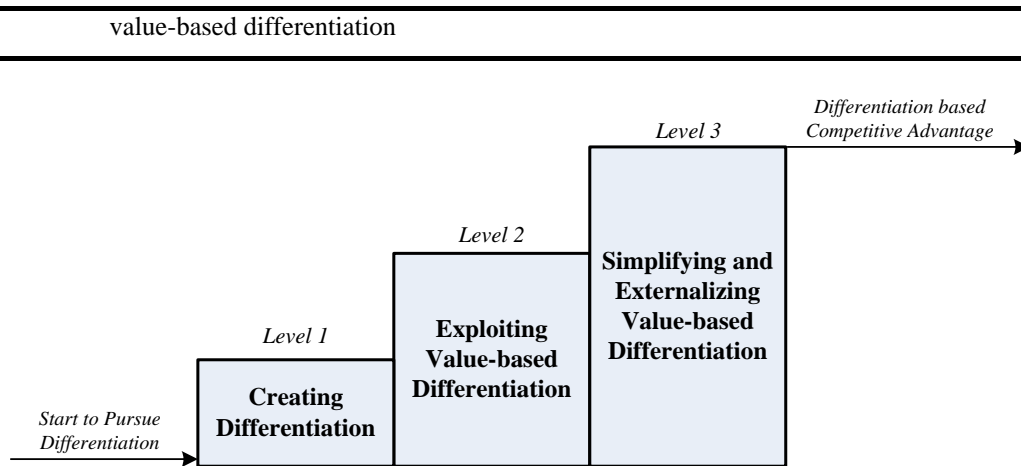


Figure 1 The three-level differentiation strategy

We propose three suggestions based on the three cases in this paper. First, creating differentiation establishes a competitive advantage. More importantly, a firm should be more than a passive receiver of ready-made differentiation. In other words, if competitors of a firm all have unique or evident differentiation in an industry, then the focal firm without actively creating differentiation will receive the remained differentiation from its competitors. Accordingly, the focal firm receives the surplus value of its rivals' differentiations. However, even though the differentiation has been shaped, the focal firm cannot secure a high competitive advantage in that consumers do not see the differentiation. In contrast, consumers would be easily attracted by the remarkable differentiations of other rivals. The firms with the failed differentiation strategies usually do not have a competitive advantage.

Second, exploiting value-based differentiation is the second level to establish a competitive advantage for firms. Some firms tend to struggle for more differentiation. In other words, they believe more differentiation means more satisfied customers. Accordingly, they think that quantity of differentiation such as creating value and gaining competitive advantage can be fulfilled. However, quality of differentiation is more important than quantity of differentiation. Firms must clearly realize what customers care about differentiation. If firms provide many differentiations that customers do not value, the differentiation strategy is likely to fail. Therefore, it is more important for firms to emphasize customer value-based differentiation. Firms like the failed restaurant often lack a competitive advantage.

Simplifying and externalizing value-based differentiation is the third level to establish competitive advantage. Indeed, some firms create innovative value-based differentiations. However, they still cannot secure substantial competitive advantages. This is because they only manage to achieve innovative differentiation without simplifying and externalizing differentiation. In other words, consumers cannot understand how the innovative value-based differentiation functions, such as the complicated pricing strategy of TV station. The complicated differentiation will be recognized as a high switching cost to consumers, so they will resist the differentiation. Indeed, it is imperative for firms to simplify and externalize the innovative value-based differentiation. Otherwise, the firms that have failed to adopt a differentiation strategy would be likely to have only a small competitive advantage.

This paper develops three mechanisms of a differentiation strategy. Future research could explore what other possible failed differentiation mechanisms in the process of implementing differentiation strategy in the service industries. Future research could also use a longitudinal study to explore how firms eliminate the possible failed mechanisms during the process of implementing differentiation strategy. Additionally, this study focuses on the implementation of differentiation strategy, while future studies may concentrate on the planning of differentiation strategy. Relying on the investigation of the planning process of differentiation strategy, firms may be able to avoid some failed differentiation strategies. On the basis of these findings, the differentiation strategy adopted in the service industry could be more complete. Furthermore, the service firms would benefit from more sophisticated differentiation strategies.

REFERENCE

- [1] Porter, M. (1980) *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, New York: Free Press.
- [2] Campbell-Hunt, C. (2000) "What have we learned about generic competitive strategy? A meta-analysis", *Strategic Management Journal*, Vol. 21, No. 2, pp. 127-154.
- [3] Jones, G.R. and Butler, J.E. (1988). "Costs, revenue, and business-level strategy", *Academy of Management Review*, Vol. 13, No. 2, pp. 202-213.
- [4] Ulaga, W. and Eggert, A. (2006) "Value-based differentiation in business relationships: Gaining and sustaining key supplier status", *Journal of Marketing*, Vol. 70, pp. 119-136.
- [5] Calori R. and Ardisson, J.M. (1988) "Differentiation strategies in 'stalemate industries'", *Strategic Management Journal*, Vol. 9, pp. 255-269.
- [6] Karnani, A. (1984) "Generic competitive strategies – An analytical approach", *Strategic Management Journal*, Vol. 5, pp. 367-380.
- [7] Dess, G.G. and Davis, P.S. (1984) "Porter's (1980) generic strategies as determinants of strategic group membership and

- organizational performance”, *Academy of Management Journal*, Vol. 27, No. 3, pp. 467-488.
- [8] Miller, D. (1988) “Relating Porter’s business strategies to environment and structure: Analysis and performance implications”, *Academy of Management Journal*, Vol. 31, No. 2, pp. 280-308.
- [9] Kim, E., Nam, D., and Stimpert, J.L. (2004) “The applicability of Porter’s generic strategies in the digital age: Assumptions, conjectures, and suggestions”, *Journal of Management*, Vol. 30, No. 5, pp. 596-589.
- [10] Hall, W.K. (1980) “Survival strategies in a hostile environment”, *Harvard Business Review*, Vol. 58, No. 5, pp. 75-85.
- [11] Murray, A.I. (1988) “A contingency view of Porter’s “generic strategies””, *Academy of Management Review*, Vol. 13, No. 3, pp. 390-400.
- [12] Deephouse, D.L. (1999) “To be different, or to be the same? It’s a question (and theory) of strategic balance”, *Strategic Management Journal*, Vol. 20, No. 2, pp. 147-166.
- [13] Hill, C.W.L. (1988) “Differentiation versus low cost or differentiation and low cost: A contingency framework” , *Academy of Management Review*, Vol. 13, No. 3, pp. 401-412.
- [14] Chrisman, J.J., Hofer, C.W., and Boulton, W. (1988) “Toward a system for classifying business strategies”, *Academy of Management Review*, Vol. 13, No. 3, pp.413-428.
- [15] Merton, R.K. & Kendall, P.L. (1946) “The focused interview”, *American Journal of Sociology*, Vol. 51, pp. 541-557.
- [16] Eisenhardt, K.M. (1989) “Building theories from case study research”, *Academy of Management Review*, Vol. 14, No. 4, pp. 532-550.
- [17] Patton, M.Q. (1987). *How to Use Qualitative Methods in Evaluation*, Sage, Newbury Park, CA.: Sage.
- [18] Glaser, B.G. & Strauss, A.L. (1967) *The Discovery of Grounded Theory: Strategies for Qualitative Research*, Aldine, Chicago: Aldine.
- [19] Pentland, B. T. (1999) “Building process with narrative: From description to explanation”, *Academy of Management Review*, Vol. 24, No. 4, pp. 711-724.
- [20] Yin, R.K. (1994) *Case Study Research: Design and Methods*, 2nd ed., Sage, London, UK: Sage. 1994.
- [21] Montemayor, E.E. (1996) “Congruence between pay policy and competitive strategy in high-performing firms”, *Journal of Management*, Vol. 22, No. 6, pp. 889-908.