Cost is an essential consideration in any business strategy. Running a company in an efficient way is the bread and butter of traditional management, but in some industries, assessing your cost position against the positions of your competitors can have more explicitly strategic implications that are often best understood using concepts from game theory. Understanding a rival’s costs often amounts to understanding its supply curve—the amount of goods the organization will produce at a given price and, by extension, the price at which its managers might choose to exit the industry entirely.

In 1980 Carter Bales, P. C. Chatterjee, Donald Gogel, and Anupam Puri published a staff paper outlining a rigorous approach for determining how to achieve and sustain a cost advantage. Their paper, "Competitive cost analysis," introduced the concept of the business system and went on to show how strategists might use this deceptively simple tool to help companies become cost leaders. Later that year, in a McKinsey Quarterly article, Fred Gluck provided a broader description of how the business system concept could be used to help formulate strategy. Gluck’s article—"Strategic choice and resource allocation"—was referred to by Michael Porter in his 1985 book.

Understanding your industry’s cost structure can give you a powerful competitive advantage. And if you happen to be in a manufacturing business, it can dramatically improve your capacity and production decisions.

The microeconomics of industry supply

This article can be found on our Web site at www.mckinseyquarterly.com/strategy/miq100.asp.
Competitive Advantage, which described his concept of the value chain. For this anthology, the Firm’s strategy practice has written a new article, entitled “The business system: A new tool for strategy formulation and cost analysis,” adapted from the “Competitive cost analysis” staff paper and from Gluck’s Quarterly article.

In 1981, a year after “Competitive cost analysis” was written, Don C. Watters wrote a staff paper introducing the cost curve as a model for analyzing the strategic decisions about capacity and production that players in heavy, high-fixed-cost industries have to make. Originally developed in McKinsey’s San Francisco office by Ted Hall and others, the model presented in Watters’s paper, “The industry cost curve as a strategic tool,” is still a mainstay of McKinsey’s work in such industries.

The business system: A new tool for strategy formulation and cost analysis

Carter F. Bales, P. C. Chatterjee, Frederick W. Gluck, Donald Gogel, and Anupam Puri

One definition of strategy at the business unit level—a definition that fits many companies’ needs—is “an integrated set of actions designed to gain a sustainable advantage over competitors.” Both parts of this definition are important. In military terms, “sustainable advantage over competitors” means that you not only win the hill but also hold it. Gaining a sustainable advantage on the corporate battlefield usually requires more than simply playing the game better by the existing rules of the industry; you must change the ground rules yourself. The definition’s other key phrase—“an integrated set of actions”—is highlighted by the concept of the business system, which is proving to be a powerful framework for putting together such a set of actions to achieve a sustainable competitive advantage.

See Roberto Buaron, “New-game strategies,” on page 34 of this anthology.

This article is adapted from “Competitive cost analysis,” a McKinsey staff paper dated January 1980, and from “Strategic choice and resource allocation,” which was originally published in The McKinsey Quarterly, Winter 1980. Copyright © 1980, 2000 McKinsey & Company. All rights reserved. The authors of both articles are alumni of McKinsey’s New York office, except Anupam Puri, who is a director there.
The concept is based on a sequential chart showing the key elements of the system by which a business delivers its products or services to a market or market segment. For example, in a technology-based manufacturing company, these system elements might be technology, product design, manufacturing, marketing, distribution, and service (Exhibit 1). At each link of the business system, management can choose how to conduct the business.

The business system concept encourages managers to ask option-generating questions at each stage of the process. Such questions include the following:

- How am I performing this function? Is there a better way to do it? What are the outer limits to what I can do here?
- Will—or should—changes in the external environment affect the way I perform this function?
- How does my competitor perform this function? Is the competitor’s way better than mine? Does it cost less? Does it provide more value to customers?
- How does what I am doing at this stage fit in with what I am doing at other stages in the business system? Do I really have an integrated strategy?

A key point the business system suggests is that there are many ways to gain a strategic advantage other than through product innovation. Some of the most exciting success stories have hinged not on inventing a new product but rather on changing the conventional system for getting an existing...
Consider just one example. Hanes Corporation, which had been making women’s stockings for years, one day asked itself if there was any reason high-quality stockings shouldn’t be marketed through grocery and discount stores. There wasn’t, so Hanes did it. The company’s imaginatively packaged L’eggs line quickly built a leading market share. This example illustrates how dissecting the business system can reveal new strategic opportunities in a business you are already in. It can also help you identify expansion or diversification opportunities that permit you to build on an existing set of strengths. One leading manufacturer of dictating machines, Lanier Business Products, used its strength in marketing to sell stand-alone word processors successfully. Instead of making word processors, the company sourced them from another manufacturer. The products were not leading-edge. But Lanier used its advertising and marketing muscle to transform an intimidating high-technology machine into the secretary’s best friend. The firm called its machine “No Problem,” differentiating it from rival models, with names consisting of scientific-sounding strings of letters and numbers.

Dissecting the business system can help identify opportunities that permit your business to build on an existing set of strengths. The business system concept can also serve as a tool for evaluating acquisitions, and it proves to be much more powerful in that respect than financial criteria alone. Consider Philip Morris’s successful acquisition of Miller Beer. Until then, what separated the winners from the losers in the beer business had been manufacturing efficiencies of control and distribution. Philip Morris saw the opportunity to apply cigarette marketing techniques to beer. For example, it saturated prime-time TV with advertising and introduced new products such as Miller Lite to appeal to different market segments. By creating competitive advantage in the marketing link of the beer industry’s business system, Philip Morris changed the rules of the game.

The business system has also proved extremely powerful as a tool for developing strategies built on cost as a competitive advantage. A strong competitive cost advantage is a versatile and often decisive strategic asset. To a company seeking to create or maintain such an advantage, an accurate understanding of relative costs is the soundest possible starting point. Building a cost advantage, however, is no easy task. Many companies have tried to use shortcuts to understand their relative cost positions, but these shortcuts, including the well-known experience curve, have proved to be less than satisfactory in practice.