STRATEGY Core Concepts and Analytical Approaches

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CHAPTER 4 Evaluating a Company's Resources and Ability to Compete Successfully

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"Before executives can chart a new strategy, they must reach a common understanding of the company's current position."

— W. Chan Kim and Rene Mauborgne

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Only firms who are able to continually build new strategic assets faster and cheaper than their competitors will earn superior returns over the long term.

— C. C. Markides and P. J. Williamson

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"Organizations succeed in a competitive marketplace over the long run because they can do certain things their customers value better than can their competitors."

— Robert Hayes, Gary Pisano, and David Upton

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Learning Objectives

1. Learn how to determine whether a firm's strategy is working well and to evaluate a firm's resource strengths, competencies, competitive capabilities, and resource weaknesses.
2. Understand the meaning and significance of company and industry value chains.
3. Gain proficiency in using four analytical tools to evaluate a firm's ability to compete successfully: SWOT analysis, value chain analysis, benchmarking, and competitive strength assessment.
4. Learn what to look for in identifying the strategic issues company managers must address.

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Chapter 4 Roadmap

- Evaluating a Firm's Resources and Ability to Compete Successfully: The Five Questions to Answer
  - ***Question 1:*** How Well Is the Firm's Present Strategy Working?
  - ***Question 2:*** Are the Firm's Resources and Capabilities Attractive and Well-matched to Its Market Opportunities and External Threats?
  - ***Question 3:*** Are the Firm's Prices and Costs Competitive?
  - ***Question 4:*** Is the Firm Competitively Stronger or Weaker than Key Rivals?
  - ***Question 5:*** What Strategic Issues and Problems Merit Front-burner Managerial Attention?

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Evaluating a Firm's Ability to Compete Successfully

- The analytical spotlight in evaluating a firm's resources and ability to compete successfully is trained on five questions:
  1. How well is the company's present strategy working?
  2. Does the company have attractively strong resource capabilities and how well do they match its market opportunities and the external threats to its future well-being?
  3. Are the company's prices and costs competitive with those of key rivals, and does it have an appealing customer value proposition?
  4. Is the company competitively stronger or weaker than key rivals?
  5. What strategic issues merit front-burner managerial attention?

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Question 1: How Well Is the Firm's Present Strategy Working?

- Begin by understanding what its strategy is:
  - Identify the firm's competitive approach
    - Lower-costs relative to rivals?
    - A different or better product/service?
    - Superior ability to serve a particular market niche or group of buyers?
  - Determine its competitive scope
    - Broad or narrow geographic market coverage?
    - Wide or narrow product line?
  - Examine recent strategic moves
  - Identify functional strategies

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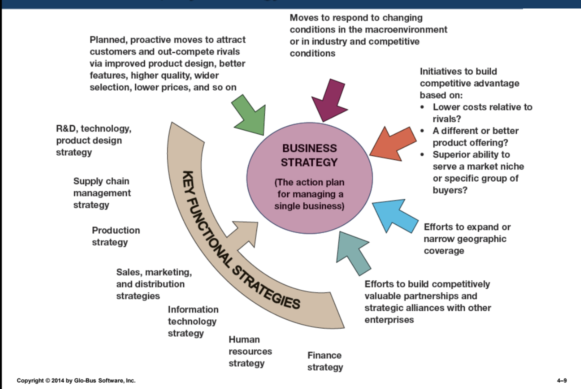
FIGURE 4.1 Identifying the Components of a Single-Business Company's Strategy



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Key Indicators of How Well a Company's Strategy Is Working

- Best indicators:
  - Whether the firm is meeting or beating its financial and strategic performance targets
  - Whether the firm is an above-average industry performer
  - Whether the firm is gaining customers and outcompeting one or more of its close rivals

Persistent shortfalls in meeting performance targets and weak performance relative to rivals are warning signs that the firm has a weak strategy or suffers from poor strategy execution or both.

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Other Good Indicators of How Well a Company's Strategy Is Working

- Whether the firm's sales are growing faster, slower, or at about the same pace as the market as a whole, thus resulting in a rising, eroding, or stable market share.
- Whether the firm is acquiring new customers at an attractive rate, as well as retaining existing customers.
- Whether the firm's image and reputation with its customers is growing stronger or weaker.
- How well the firm stacks up against rivals on product innovation, customer service, product quality, delivery time, price, getting newly developed products to market quickly, and other relevant factors affecting buyers' choice of brands.
- Whether the firm's profit margins are increasing or decreasing and how well its margins compare to the profit margins of rival firms.
- Trends in the firm's net profits and return on investment and how these compare to the same trends for rival companies.
- Whether the firm's overall financial strength and credit rating are improving or growing weaker.

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Evaluating a Company's Financial Performance

- Accurate diagnosis of a company's financial performance and financial statements ***requires some number-crunching.***
- The financial ratios in Table 4.1 provide guidance and direction in what numbers need to be calculated and how to interpret them.

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TABLE 4.1 Key Financial Ratios: How to Calculate Them and What They Mean

Ratio	How Calculated	What It Shows
Profitability Ratios		
1. Gross profit margin	(Sales revenues – Cost of goods sold) / Sales revenues	Shows the percentage of revenues available to cover operating expenses and yield a profit. Higher is better and the trend should be upward.
2. Operating profit margin (or return on sales)	(Sales revenues – Operating expenses) / Sales revenues or Operating income / Sales revenues	Shows the profitability of current operations without regard to interest charges and income taxes. Higher is better and the trend should be upward.
3. Net profit margin (or net return on sales)	Profits after taxes / Sales revenues	Shows after-tax profits per dollar of sales. Higher is better and the trend should be upward.
4. Total return on assets	(Profits after taxes + Interest) / Total assets	A measure of the return on total monetary investment in the enterprise. Interest is added to after-tax profits to form the numerator since total assets are financed by creditors as well as by stockholders. Higher is better and the trend should be upward.
5. Net return on total assets (ROA)	Profits after taxes / Total assets	A measure of the return earned by stockholders on the firm's total assets. Higher is better, and the trend should be upward.
6. Return on stockholder's equity (ROE)	Profits after taxes / Total stockholders' equity	Shows the return stockholders are earning on their capital investment in the enterprise. A return in the 12–15% range is "average," and the trend should be upward.
7. Return on invested capital (ROIC)—sometimes referred to as return on capital employed (ROCE)	Profits after taxes / (Long-term debt + Total stockholders' equity)	A measure of the return shareholders are earning on the long-term monetary capital invested in the enterprise. A higher return reflects greater bottom-line effectiveness in the use of long-term capital, and the trend should be upward.
8. Earnings per share (EPS)	Profits after taxes / Number of shares of common stock outstanding	Shows the earnings for each share of common stock outstanding. The trend should be upward, and the bigger the annual percentage gains, the better.

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TABLE 4.1 Key Financial Ratios: How to Calculate Them and What They Mean

Ratio	How Calculated	What It Shows
Liquidity Ratios		
1. Current ratio	Current assets / Current liabilities	Shows a firm's ability to pay current liabilities using assets that can be converted to cash in the near term. Ratio should definitely be higher than 1.0; ratios of 2 or higher are better still.
2. Working capital	Current assets – Current liabilities	Bigger amounts are better because the company has more internal funds available to (1) pay its current liabilities on a timely basis and (2) finance inventory expansion, additional accounts receivable, and a larger base of operations without resorting to borrowing or raising more equity capital.
Leverage Ratios		
1. Total debt-to-assets ratio	Total debt / Total assets	Measures the extent to which borrowed funds (both short-term loans and long-term debt) have been used to finance the firm's operations. A low fraction or ratio is better—a high fraction indicates overuse of debt and greater risk of bankruptcy.
2. Long-term debt-to-capital ratio	Long-term debt / (Long-term debt + Total stockholders' equity)	An important measure of creditworthiness and balance sheet strength. It indicates the percentage of capital investment in the enterprise that has been financed by both long-term lenders and stockholders. A ratio below 0.25 is usually preferable since monies invested by stockholders account for 75% or more of the company's total capital. The lower the ratio, the greater the capacity to borrow additional funds. Debt-to-capital ratios above 0.50 and certainly above 0.75 indicate a heavy and perhaps excessive reliance on long-term borrowing, lower creditworthiness, and weak balance sheet strength.

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TABLE 4.1 Key Financial Ratios: How to Calculate Them and What They Mean

Ratio	How Calculated	What It Shows
3. Debt-to-equity ratio	Total debt / Total stockholders' equity	Shows the balance between debt (funds borrowed both short term and long term) and the amount that stockholders have invested in the enterprise. The further the ratio is below 1.0, the greater the firm's ability to borrow additional funds. Ratios above 1.0 and definitely above 2.0 put creditors at greater risk, signal weaker balance sheet strength, and often result in lower credit ratings.
4. Long-term debt-to-equity ratio	Long-term debt / Total stockholders' equity	Shows the balance between long-term debt and stockholders' equity in the firm's *long-term* capital structure. Low ratios indicate greater capacity to borrow additional funds if needed.
5. Times-interest-earned (or coverage) ratio	Operating income / Interest expenses	Measures the ability to pay annual interest charges. Lenders usually insist on a minimum ratio of 2.0, but ratios progressively above 3.0 signal progressively better creditworthiness.
Activity Ratios		
1. Days of inventory	Inventory / (Cost of goods sold ÷ 365)	Measures inventory management efficiency. Fewer days of inventory are usually better.
2. Inventory turnover	Cost of goods sold / Inventory	Measures the number of inventory turns per year. Higher is better.
3. Average collection period	Accounts receivable / (Total sales ÷ 365) or Accounts receivable / Average daily sales	Indicates the average length of time the firm must wait after making a sale to receive cash payment. A shorter collection time is better.

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TABLE 4.1 Key Financial Ratios: How to Calculate Them and What They Mean

Ratio	How Calculated	What It Shows
Other Important Measures of Financial Performance		
1. Dividend yield on common stock	Annual dividends per share / Current market price per share	A measure of the return that shareholders receive in the form of dividends. A "typical" dividend yield is 2–3%. The dividend yield for fast-growth companies is often below 1% (maybe even 0); the dividend yield for slow-growth companies can run 4–5%.
2. Price-earnings ratio	Current market price per share / Earnings per share	P-E ratios above 20 indicate strong investor confidence in a firm's outlook and earnings growth; firms whose future earnings are at risk or likely to grow slowly typically have ratios below 12.
3. Dividend payout ratio	Annual dividends per share / Earnings per share	Indicates the percentage of after-tax profits paid out as dividends.
4. Internal cash flow	After-tax profits + Depreciation	A quick and rough estimate of the cash a company's business is generating after payment of operating expenses, interest, and taxes. Such amounts can be used for dividend payments or funding capital expenditures.
5. Free cash flow	Aftertax profits + Depreciation – Capital expenditures – Dividends	A quick and rough estimate of the cash a company's business is generating after payment of operating expenses, interest, taxes, dividends, and desirable reinvestments in the business. The larger a company's free cash flow, the greater its ability to internally fund new strategic initiatives, repay debt, make new acquisitions, repurchase shares of stock, or increase dividend payments.

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Question 2: Are the Firm's Resources and Capabilities Attractive and Well-matched to Its Market Opportunities and External Threats?

- **SWOT Analysis**
  - Is a powerful analytic tool for evaluating a whether a firm's overall situation is fundamentally healthy or unhealthy.
  - Focuses on the firm's resource **Strengths** and **Weaknesses**, market **Opportunities**, and external **Threats**.
  - Aids managers in crafting a strategy that:
    - Capitalizes on the firm's resource strengths
    - Aims squarely at capturing its best market opportunities
    - Defends against external threats to the firm's future well-being and business prospects

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Identifying Company Resource Strengths

- A ***resource strength*** is a unique asset, something a firm does well or an attribute that enhances its competitiveness:
  - A skill, specialized expertise, or competitively important capability
  - Valuable physical assets
  - Valuable human assets and intellectual capital
  - Valuable organizational assets
  - Valuable intangible assets
  - An achievement or attribute that puts the firm in a position of market advantage
  - Competitively valuable alliances or cooperative ventures

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Core Concept

A company's resource strengths represent its *competitive assets* and are big determinants of its competitiveness and ability to succeed in the marketplace.

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Classifying How Well a Company Performs Particular Activities

- A company's skill or proficiency in performing different facets of its operations can range from one of minimal ability to perform an activity (perhaps having just struggled to do it the first time) to the other extreme of being able to perform an activity better than any other company in the industry. A firm can have of four levels of proficiency in performing an activity:
  - **Level 1 (lowest level)**: When a firm has only performed an activity a few times and has yet to prove it can perform the activity consistently well and/or at acceptable cost.
  - **Level 2:** A company's proficiency rises to the level of a proven **competence** ***once it learns to perform the activity consistently well and at acceptable cost.***
  - **Level 3:** A competence takes on a higher level of importance and becomes a **core competence** when a company can ***proficiently perform an activity that is central to its strategy and competitiveness.***
  - **Level 4 (highest level):** A core competence rises to an even higher level of importance and becomes a ***distinctive competence*** when a company gains the proficiency to ***perform a competitively important activity better than its rivals.***

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Core Concept: Competence

A firm has a **competence** in performing an activity when, over time, it gains the experience and know-how to perform an activity *consistently well and at acceptable cost.*

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Where Are a Firm's Competencies Located?

- Some competencies spring from proficiency in a single discipline or function and may be performed in a single department or organizational unit.
- However, many (maybe most?) competencies, core competencies, distinctive competencies, and competitive capabilities are inherently multi-disciplinary or cross-functional and are the product of effective collaboration among people with different expertise in different organizational units.
- Examples of Core or Distinctive Competencies:
  - The ability to speed new/next-generation products to market
  - Skills/expertise in producing a high-quality product at a low cost
  - The capability to fill customer orders accurately and swiftly.

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Core Concept: Core Competence

A **core competence** is an activity that a firm performs not only consistently well and at acceptable cost, but that is also *central to its strategy and competitiveness*.

A core competence is a more important resource strength than a competence because it adds power to a firm's strategy and has a bigger positive impact on its competitive strength and profitability.

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Core Concept: Distinctive Competence

A company possesses a ***distinctive competence*** when it has demonstrated ability to perform a competitively important activity **better than its rivals.**

A distinctive competence is a competitively superior resource strength because it represents a level of proficiency that rivals do not have. Consequently, a distinctive competence can be a basis for sustainable competitive advantage.

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Why a Distinctive Competence Matters

- A *distinctive competence* adds real power to a firm's strategy and provides a pathway to competitive advantage when:
  - It relates to an activity important to market success
  - Rival companies do not have offsetting competencies
  - It is costly and time-consuming for rivals to imitate the competence

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Building a Firm's Competence or Capability

- A firm's proficiency in performing an activity can progress from *minimal ability* to perform the activity to *a true competence* to a *core competence* to a *distinctive competence*.
  - The competence-building process begins first with deliberate efforts to develop the ability to perform an activity, however imperfectly or inefficiently.
  - To the extent that experience builds and the firm gains proficiency to perform the activity *consistently well* and *at an acceptable cost*, its ability evolves into a proven **competence** (or capability).
  - If a firm achieves competence in performing an activity that is an important component of its strategy and that positively affects its ability to compete against rivals, then it is said to have a **core competence** in performing that activity.
  - Should a company gain the proficiency to perform a competitively valuable activity better than any of its rivals, then it is said to have a **distinctive competence** in performing that activity.

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Ways to Test the Competitive Power of a Resource Strength or Capability

- The four tests of the competitive power of a resource strength or capability:
  1. Does the resource strength or capability have competitive value?
  2. Do many or most rivals have much the same resources or capabilities?
  3. Is the resource or capability hard to copy?
  4. Can the resource strength be trumped by the different resource strengths and competitive capabilities of rivals?

Core Concept	The degree of success a firm enjoys in the marketplace hinges on the competitive power of its resources—the set of competencies, capabilities, and competitive assets at its command.

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Determining Whether a Firm Has a Competitively Attractive Collection of Resources

- It is important to identify which skills and proficiencies are *competencies*, which represent *core competencies*, and which represent *distinctive competencies*
  - Both core competencies and distinctive competencies are valuable and act to enhance a firm's competitiveness
  - Competencies merely enable market survival because most rivals also possess them
  - Not having an important competence or competitive capability that rivals have can result in competitive disadvantage

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Dynamic Capabilities

- Why is it important for the firm to keep competencies updated and on the cutting-edge?
  - To effectively respond to ongoing changes in customer needs and expectations
  - To protect its long-term competitiveness against the strategic maneuvering of rivals to win bigger sales and market shares
  - To help improve its performance over the long-term

Important Point	A firm requires a dynamically evolving portfolio of competencies and capabilities in order to sustain its competitiveness and help drive improvements in its performance.

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The Challenges in Developing Dynamic Capabilities

Management's challenge in developing *dynamic capabilities has two elements:*

1. Attending to ongoing recalibration of existing competencies and capabilities
2. Casting a watchful eye for opportunities to develop totally new capabilities for delivering better customer value and/or outcompeting rivals

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The Importance of Tying Strategy to Competitively Powerful Resource Strengths

- A company's strategy should seek to leverage and capitalize on its most competitively powerful resource strengths and capabilities. **WHY?**

  Because using its most potent resource strengths and capabilities to power strategic initiatives to deliver value to customers and win business away from rivals gives a company its best chances for competitive success and better performance.

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The Importance of Tying Strategy to Competitively Powerful Resource Strengths (cont.)

- Deploying the company's resources and capabilities to maximum advantage is a no-risk proposition: There's nothing to lose and much to gain
  - Should the company's resource strengths and capabilities turn out to be competitively stronger than those of some or many rivals, its business performance is certain to improve
  - And, in the best-case outcome, effectively deploying competitively valuable resources and capabilities that are hard for rivals to copy or trump usually puts achieving a sustainable competitive advantage within reach

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Tying Strategy to Competitively Powerful Resource Strengths

- Why base a firm's strategy on its competitively powerful resource strengths and capabilities?
  - Anchoring its strategy in those strengths gives the firm its best chances for competitive success
    - A firm's resource strengths are central in delivering value to customers and winning business away from rivals
    - It is difficult for rivals to outcompete a firm with powerful resources and capabilities that are hard to copy and hard to overcome
    - A strategy grounded in competitively superior resource strengths helps the firm achieve a sustainable competitive advantage

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TABLE 4.2 What to Look for in Identifying Resource Strengths

- A powerful strategy
- Core competencies in _______
- A distinctive competence in _______
- A product that is strongly differentiated from those of rivals
- Competencies and capabilities that are well matched to industry key success factors
- A strong financial condition; ample financial resources to grow the business
- Strong brand name image/company reputation
- An attractive customer base
- Proprietary technology / superior technological skills / important patents
- Superior intellectual capital relative to key rivals
- Cost advantages over rivals
- Skills in advertising and promotion
- Product innovation capabilities
- Proven capabilities in improving production processes
- Good supply chain management capabilities
- Good customer service capabilities
- Better product quality relative to rivals
- Wide geographic coverage and/or strong global distribution capability
- Alliances / joint ventures with other firms that provide access to valuable technology, competencies, and/or attractive geographic markets

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Identifying Resource Weaknesses and Competitive Deficiencies

- A ***resource weakness***, or competitive deficiency, is something a firm lacks, does poorly, or that puts it at a disadvantage in the marketplace
- Resource weaknesses relate to:
  - Inferior or unproven skills, capabilities, expertise, or intellectual capital in important areas of the business
  - Deficiencies in competitively important physical, organizational, or intangible assets
  - Missing or competitively weak capabilities in key areas

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Core Concept

A firm's resource weaknesses are shortcomings that constitute competitive liabilities.

Important Point — **The degree to which a firm's resource weaknesses make it competitively vulnerable depends on how much they matter in the marketplace and the extent to which they can be offset by the firm's resource strengths.**

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TABLE 4.2 What to Look for in Identifying a Firm's Weaknesses

- No clear strategic direction
- Resources that are not well matched to an industry's key success factors
- No well-developed or proven core competencies
- A weak balance sheet; burdened with too much debt
- Higher overall unit costs relative to key competitors
- Weak or unproven product innovation capabilities
- A product/service with ho-hum attributes or features inferior to those of rivals
- Too narrow a product line relative to rivals
- Weak brand image or reputation
- Weaker dealer network than key rivals and/or inadequate global distribution capability
- Behind on product quality, R&D, and/or technological know-how
- In the wrong strategic group
- Losing market share because…
- Lack of management depth
- Inferior intellectual capital relative to rivals
- Subpar profitability because…
- Plagued with internal operating problems or obsolete facilities
- Short on financial resources to grow the business and pursue promising initiatives
- Too much underutilized plant capacity

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Market Opportunities

- Managers tailoring the firm's strategy to its situation must first identify and appraise its market growth opportunities and the profit potential each one holds.
- A firm's market opportunities can be:
  - Plentiful or scarce, fleeting or lasting
  - Very attractive (an absolute "must" to pursue)
  - Marginally interesting (because of the high risks or large capital requirements or unappealing revenue growth and profit potentials)
  - Unsuitable (because the firm's resource strengths and capabilities are ill-suited to capturing particular opportunities)

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Identifying a Firm's Market Opportunities

- The market opportunities most relevant to a firm are those that:
  - Match up well with the firm's financial and organizational resource capabilities
  - Offer the best prospects for growth and profitability
  - Present the most potential for competitive advantage

Rule — **A firm should pass on a particular market opportunity unless it has or can acquire the resources and capabilities to capture it.**

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TABLE 4.2 What to Look for in Identifying Market Opportunities

- Openings to win market share from rivals
- Sharply rising buyer demand for the industry's product
- Serving additional customer groups or market segments
- Expanding into new geographic markets
- Expanding the company's product line to meet a broader range of customer needs
- Utilizing existing company skills or technological knowhow to enter new product lines or new businesses
- Online sales via the Internet
- Integrating forward or backward
- Falling trade barriers in attractive foreign markets
- Acquiring rival firms or companies with attractive technological expertise or capabilities
- Entering into alliances or joint ventures to expand the firm's market coverage or boost its competitive capability
- Openings to exploit emerging new technologies

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Identifying External Threats to a Firm's Future Profitability

- Factors in a firm's external environment can pose ***threats*** to its profitability and competitive well-being
- ***External threats vary in importance***
  - Some pose only a moderate degree of adversity (most all companies confront some threatening outside elements in the course of conducting their business)
  - Some may be formidable enough to make a firm's situation and outlook quite tenuous
  - On rare occasions, a market shock can give birth to *a sudden-death threat* that throws a firm into an immediate crisis and battle to survive

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TABLE 4.2 What to Look for in Identifying External Threats

- Increasing intensity of competition among industry rivals—may squeeze profit margins
- Slowdowns in market growth
- Likely entry of potent new competitors
- Loss of sales to substitute products
- Growing bargaining power of customers or suppliers
- A shift in buyer needs and tastes away from the industry's product
- Adverse demographic changes that threaten to curtail demand for the industry's product
- Vulnerability to unfavorable industry driving forces
- Restrictive trade policies on the part of foreign governments
- Costly new regulatory requirements
- Tight credit conditions
- Rising prices for energy or other key inputs

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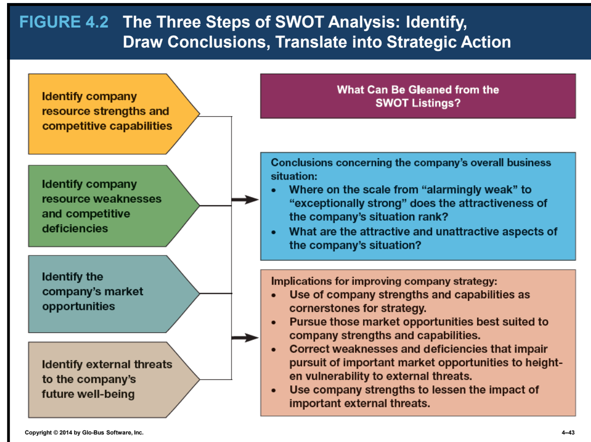

Step 2 of SWOT Analysis: Drawing Conclusions from the Four Lists

- What are the attractive aspects of the firm's situation?
- What aspects are of the most concern?
- Could one or more of the firm's weaknesses and competitive deficiencies prove fatal if not remedied, or are they either inconsequential or correctable?
- Do the firm's resource strengths and competitive capabilities outweigh its resource weaknesses and competitive deficiencies by a little or a lot (or not at all)?
- Does the firm have attractive market opportunities that are well suited to its resource strengths and competitive capabilities?
- Does the firm lack certain resources and/or capabilities to pursue any of the most attractive opportunities?
- Are any of the external threats of major concern, or are they something the firm appears able to withstand and/or defend against?
- Considering the four lists, where on a scale of 1 to 10 (where 1 is alarmingly weak and 10 is exceptionally strong) should the firm's position and overall situation be ranked?

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Step 3 of SWOT Analysis: Taking Actions to Improve Strategy

- A firm's resource strengths and competitive capabilities must always serve as the cornerstones of its strategy
  - Reliance on a firm's best competitive assets is critical to attracting customers and competing successfully against rivals
- Managers must correct competitive weaknesses that
  - Make the firm vulnerable
  - Hold down profitability
  - Disqualify the firm from pursuing a particularly attractive market opportunity

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Step 3 of SWOT Analysis: Taking Actions to Improve Strategy (cont'd)

- Managers should aim the firm's strategy at capturing market opportunities that are both attractive and suited to the firm's collection of strengths and capabilities
- Attention to defending against external threats and fostering future performance hinges on:
  - How vulnerable the firm is to the threats
  - Whether there are attractive defensive moves that can be taken to lessen the impact of particular threats
  - Whether the costs of undertaking such moves represent the best use of company resources

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Question 3: Are the Firm's Prices and Costs Competitive and Does It Have an Appealing Customer Value Proposition?

- Signs of the strength of a firm's business position:
  - Whether its prices are justified by the value it delivers to customers
  - Whether its prices and costs are competitive with industry rivals
- Two analytical tools useful in determining whether a firm's customer value proposition, prices, and costs are competitive:
  - Value chain analysis
  - Benchmarking

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What Does the Term "Value Chain" Mean?

- A company's ***value chain***
  - Concerns the functions, tasks, and activities that a firm performs internally to create value for customers
  - Consists of two broad categories of activities
    - ***Primary activities*** that are foremost in the firm's scheme for creating and delivering value to customers
    - ***Support activities*** that facilitate and enhance the performance of primary activities.
- A firm has no sound business justification for performing an activity that does not result in greater value for customers

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Core Concept

A company's ***value chain*** identifies the primary activities it performs that create customer value and the related support activities.

The "outputs" of an organization's value chain activities are the value delivered to customers and the resulting revenues it collects.

The "inputs" are all of the resources required to conduct the various value chain activities; use of these resources creates costs.

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FIGURE 4.3 A Representative Company Value Chain

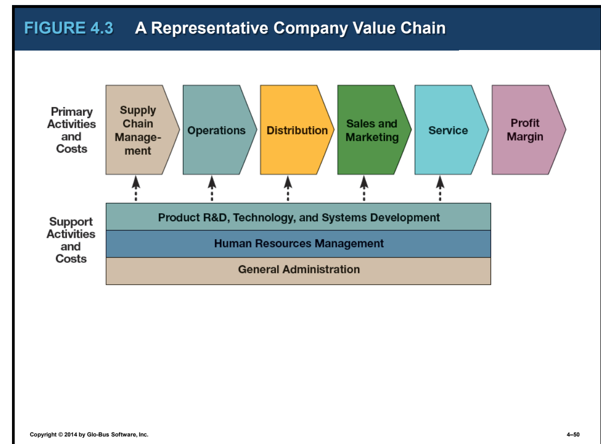

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FIGURE 4.3 Illustrative Primary Activities

- **Supply Chain Management**—Activities, costs, and assets associated with purchasing fuel, energy, raw materials, parts and components, merchandise, and consumable items from vendors; receiving, storing and disseminating inputs from suppliers; inspection; and inventory management.
- **Operations**—Activities, costs, and assets associated with converting inputs into final product from (producing, assembly, packaging, equipment maintenance, facilities, operations, quality assurance, environmental protection).
- **Distribution**—Activities, costs, and assets dealing with physically distributing the product to buyers (finished goods warehousing, order processing, order picking and packing, shipping, delivery vehicle operations, establishing and maintaining a network of dealers and distributors).
- **Sales and Marketing**—Activities, costs, and assets related to sales force efforts, advertising and promotion, market research and planning, and dealer/distributor support.
- **Service**—Activities, costs, and assets associated with providing assistance to buyers, such as installations, spare parts delivery, maintenance and repair, technical assistance, buyer inquiries, and complaints.

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FIGURE 4.3 Illustrative Support Activities

- **Product R&D, Technology, and Systems Development—**Activities, costs, and assets relating to product R&D, process R&D, process design improvement, equipment design, computer software development, telecommunications systems, computer-assisted design and engineering, database capabilities, and development of computerized support systems.
- **Human Resource Management**—Activities, costs, and assets associated with the recruitment, hiring, training, development, and compensation of all types of personnel; labor relations activities; and development of knowledge-based skills and core competencies.
- **General Administration**—Activities, costs, and assets relating to general management, accounting and finance, legal regulatory affairs, safety and security, management information systems, forming strategic alliances and collaborating with strategic partners, and other overhead functions.

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Example: Value Chain Activities for a Bakery Goods Maker

- **Primary Activities**
  - Supply chain management
  - Recipe development and testing
  - Mixing and baking
  - Packaging
  - Sales and marketing
  - Distribution
- **Support Activities**
  - Quality control
  - Human resource management
  - Administration

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Example: Value Chain Activities for a Department Store Retailer

- **Primary Activities**
  - Merchandise selection and purchasing
  - Store layout and product display
  - Advertising
  - Customer service
- **Support Activities**
  - Site selection
  - Hiring and training
  - Store maintenance
  - Administrative activities

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Rivals' Value Chains Are Often Different

- Several factors cause the value chains of rival firms to be different:
  - Different strategies
  - Different operating practices
  - Different technologies
  - Different degrees of vertical integration
  - Some firms perform certain activities internally while others outsource them

Differences in the value chains of competing firms complicate assessment of their relative cost positions.

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Which Company's Value Chain Is Best?

- Differences in the value chains of competing firms raise two important questions:
  1. Whose value chain delivers the best customer value relative to the prices being charged?

     When a competitor's value chain approach delivers greater value to customers relative to its prices, it gains competitive advantage even if its costs are equivalent to (or higher than) its close rivals.
  2. Which firm has the lowest cost value chain?

     When close competitors deliver much the same value, charge comparable prices, and have very similar value chains, then competitive advantage accrues to the firm with the most cost-efficient value chain operations.

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Core Concept

The greater the value a firm can profitably deliver to its customers relative to the value delivered by close rivals, the less competitively vulnerable it becomes.

The higher a firm's costs relative to those of rivals delivering comparable customer value at a comparable price, the more competitively vulnerable it becomes.

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A Firm's Primary and Support Activities Identify the Major Components of Its Internal Cost Structure

- Combined costs of primary and secondary value chain activities comprise a firm's internal cost structure
- The cost of each activity contributes to whether firm's overall cost position relative to rivals is favorable or unfavorable
- Activity-based accounting cost estimates are needed for each broad category of primary and secondary activities in a firm's value chain
  - Accurate cost assessments for specific activities within each category are required to identify the source or activity causing the cost disadvantage vis-à-vis rivals

*Knowledge of a firm's own **internal costs** is insufficient to assess whether its product offering and customer value proposition are competitive with those of rivals.*

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Value Chain System for an Entire Industry

- A company's value chain is embedded in a larger system of activities that includes the value chains of its suppliers and the value chains of whatever wholesale distributors and retailers it utilizes in getting its product or service to end users
  - Supplier value chains are relevant because suppliers perform activities and incur costs in creating and delivering the purchased inputs for a firm's own value-creating activities
  - The value chains of distribution channel partners are relevant because the costs and margins of distributors and retail dealers represent "value added" and are part of the price the ultimate consumer pays for the company's good or service

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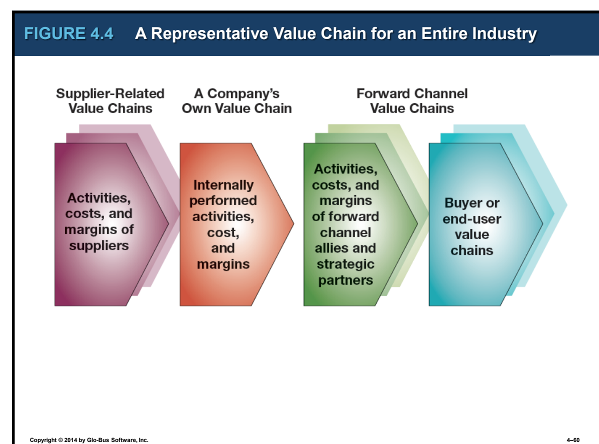
FIGURE 4.4 A Representative Value Chain for an Entire Industry



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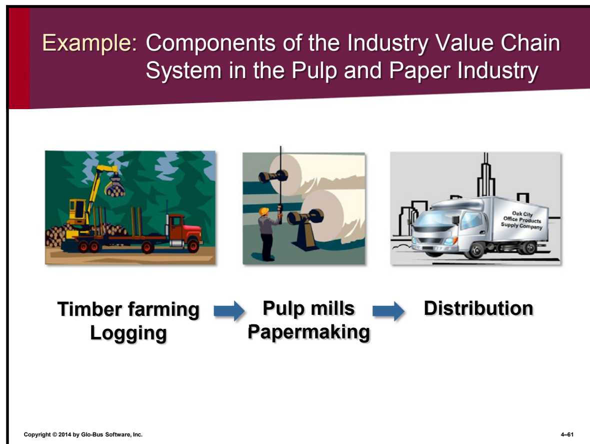

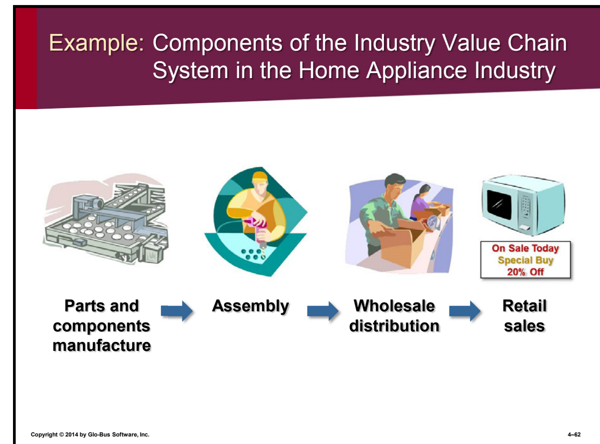

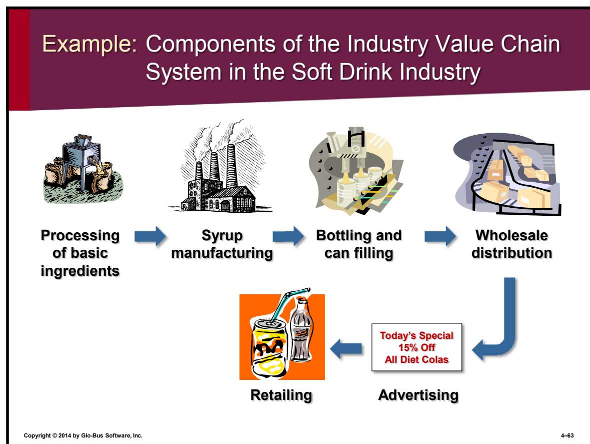

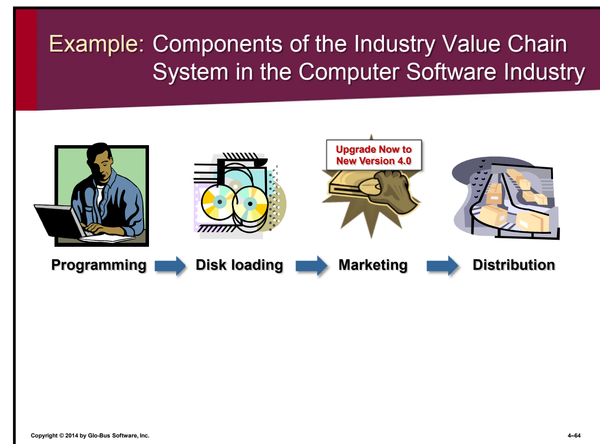

Why the Values Chains of Suppliers and Distribution Allies Matter

Whether a company's costs are competitive with the costs of close rivals is a function of

Whether the costs and profit margins embedded in its own value chain system (its own value chain plus the value chains of its suppliers and distribution allies)

are **lower than OR roughly equal to OR higher than**

the costs and profit margins embedded in the value chain systems of its close rivals (their respective value chains plus the respective value chains of their suppliers and distribution allies)

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How to Determine a Firm's Cost Competitiveness

- **STEP 1:** Determine the costs of activities across the firm's own entire value chain system:
  - The costs of activities comprising a firm's own value chain **PLUS**
  - The costs of activities comprising the value chains of its suppliers **PLUS**
  - The costs of activities comprising the value chains of its distribution allies
- **STEP 2:** Compare the ***sum*** of the costs of the firm's own value chain system to the ***sum*** of the costs of the value chain systems of close rivals (including their own value chains and the value chains of their suppliers and distribution allies) to determine if the overall costs of a firm's value chain system is ***higher*** or ***lower*** or ***roughly equal to*** the overall costs comprising the value chain systems of key rivals.

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Benchmarking: A Tool for Assessing Whether a Firm's Value Chain Costs Are in Line

- Benchmarking entails
  - Comparing how well different firms perform key value chain activities:
    - How inventories are managed
    - How products are assembled
    - How fast it takes to get new products to market
    - How customer orders are filled and shipped
  - Making cross-company comparisons of the costs of these activities

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Core Concept

Benchmarking is a potent tool for learning which firms are best at performing particular activities and then using their techniques ("best practices") to improve the cost and effectiveness of a firm's own internal activities.

Benchmarking the costs of a firm's activities against rivals provides hard evidence of whether a firm is cost-competitive.

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How Benchmarking Works

- Identify the ***best practices*** in performing particular activities
- Learn how other firms have achieved lower costs or better results in performing benchmarked activities
- Take actions to improve cost competitiveness whenever benchmarking indicates that its own costs and results of performing an activity are nor on a par with what other companies (either competitors or non-competitors) have achieved

The tough part of benchmarking is gaining access to information about other firms' practices and costs.

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Tip for Simulation Company Co-Managers

- Carefully review the benchmarking data provided in the Industry Report after each decision round.
  - There are almost 2 pages of data showing how your company's costs in the prior year compared against the industry's low, high, and average values for a big variety of the cost components in your company's value chain.
- If your company's costs are deemed "too high" in one or more areas, consider undertaking actions to reduce these costs.
- If you have already taken actions to be more cost efficient, check (1) whether your company's cost-cutting efforts have been ***more/less*** *successful than the cost-cutting actions likely undertaken by rivals* and (2) whether your company has a cost advantage or disadvantage.

Failure to monitor the benchmarking data is perilous because it means you really have no idea whether your company's costs are competitive with those of rivals or not.

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Strategic Options for Creating a Cost Advantage or Remedying a Cost Disadvantage

- Areas in which to create a cost advantage or remedy a cost disadvantage are:
  - The value chain activities a company performs internally
  - Suppliers' part of the company's value chain system
  - The distribution-related portion of the company's value chain system

The Value Chain System for a Company

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Ways to Lower the Costs of Internally Performed Value Chain Activities

- Implement the use of best practices throughout firm
- Redesign the product to eliminate costs or enable faster and more economical manufacture or assembly
- Relocate high-cost activities to lower-cost locations
- Outsource high-cost activities to outside vendors/suppliers who can perform these activities cheaper
- Shift to lower-cost technologies and/or invest in productivity-enhancing, cost-saving technological improvements
- Cease performing any activities that add little or no customer value

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Ways to Lower the Costs of Supplier-Related Value Chain Activities

- Pressure suppliers for lower prices
- Switch to lower-priced substitute inputs
- Collaborate closely with suppliers to identify mutual cost-saving opportunities
  - Just-in-time supplier deliveries can lower both the firm's and the supplier's inventory and internal logistics costs
- Integrate backward into the businesses of suppliers responsible for cost disadvantages and make the items in-house instead of buying them from outside suppliers

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Ways to Lower the Costs of Distribution-Related Value Chain Activities

- Pressure dealers, distributors and channel allies to reduce costs to make final prices to buyers more competitive with the prices of rivals
- Collaborate with forward channel allies to identify win-win opportunities to reduce costs
- Change to a lower-cost distribution strategy or switch to cheaper distribution channels
- Integrate forward by opening company-owned retail outlets

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Translating Proficient Performance of Value Chain Activities into Competitive Advantage

- Doing a first rate job of managing value chain activities can often translate into competitive advantage.
- Competitive advantage can be achieved by out-managing rivals in either of two ways:
  1. By performing value chain activities more efficiently and cost effectively, thereby gaining a low-cost advantage over rivals
  2. By performing certain value chain activities in ways that drive value-creating improvements in quality, features, performance, and other aspects, thereby gaining a differentiation-based competitive advantage keyed to what customers perceive as a superior product offering

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FIGURE 4.5 Translating Company Performance of Value Chain Activities into Competitive Advantage

Option 1: Beat rivals by performing value chain activities more cheaply, thus achieving a cost-based competitive advantage

Company managers decide to perform value chain activities in ways that drive improvements in quality, features, performance, and other differentiation-enhancing aspects → Competencies and capabilities gradually emerge in performing many differentiation-enhancing value chain activities → Company proficiency in performing some of these differentiation-enhancing value chain activities rises to the level of a *core competence* → Company proficiency in performing differentiation-enhancing value chain activities continues to build and evolves into a *distinctive competence* → Company gains a *competitive advantage* based on superior cost-lowering capabilities

Rule It is substantially harder for rivals to achieve "best in industry" proficiency in performing a key value chain activity than it is for them to clone the features and attributes of a hot-selling product or service.

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FIGURE 4.5 Translating Company Performance of Value Chain Activities into Competitive Advantage

Option 2: Beat rivals by performing certain differentiation-enhancing value chain activities more proficiently, thus creating a differentiation-based competitive advantage keyed to delivering what customers perceive as a superior product offering.

Company managers decide to perform value chain activities in the most cost-efficient manner—every value chain activity is examined for possible cost savings → Competencies and capabilities gradually emerge in performing certain differentiation-enhancing value chain activities → Company proficiency in cost-efficient performance of value chain activities rises to the level of a *core competence* → Company proficiency in cost-efficient performance of value chain activities continues to build and evolves into a *distinctive competence* → Company gains a *competitive advantage* based on superior differentiation capabilities

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Question 4: Is the Firm Competitively Stronger or Weaker than Its Key Rivals?

- Whether a firm is competitively stronger or weaker than key rivals hinges on:
  - The firm's rank relative to competitors on each important factor that determines market success
  - The firm's net competitive advantage or disadvantage versus major competitors

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How to Do a Competitive Strength Assessment

Step 1: Make a list of 6 to 10 of the industry's key success factors and its most relevant measures of competitive strength/weakness

Step 2: Assign weights to each of the measures of competitive strength based on their perceived importance (the sum of the weights must equal 1.0)

Step 3: Rate the firm and its key rivals on each strength measure using rating scale of 1 to 10 (1 = very weak; 5 = average; 10 = very strong)

Step 4: Multiply each strength rating by its importance weight to obtain weighted strength scores

Step 5: Sum the weighted strength scores to get an overall measure of competitive strength for each rival

Step 6: Use the overall strength scores to draw conclusions about the firm's net competitive advantage or disadvantage vis-à-vis each of its rivals

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TABLE 4.3 A Representative Weighted Competitive Strength Assessment

		Competitive Strength Assessments [Rating scale: 1 = Very weak; 10 = Very strong]					
		ABC Co.		Rival 1		Rival 2	
Key Success Factors and Strength Measures	Importance Weight	Strength Rating	Weighted Score	Strength Rating	Weighted Score	Strength Rating	Weighted Score
Quality/product performance	0.10	8	0.80	5	0.50	1	0.10
Reputation/image	0.10	8	0.80	7	0.70	1	0.10
Manufacturing capability	0.10	2	0.20	10	1.00	5	0.50
Technological skills	0.05	10	0.50	1	0.05	3	0.15
Dealer network/distribution capability	0.05	9	0.45	4	0.20	5	0.25
New product innovation capability	0.05	9	0.45	4	0.20	5	0.25
Financial resources	0.10	5	0.50	10	1.00	3	0.30
Relative cost position	0.30	5	1.50	10	3.00	1	0.30
Customer service capabilities	0.15	5	0.75	7	1.05	1	0.15
Sum of importance weights	**1.00**						
Weighted overall strength rating			**5.95**		**7.70**		**2.10**

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Interpreting the Competitive Strength Scores

- The higher a firm's overall weighted strength score, the stronger its overall competitiveness versus rivals
- The lower a firm's score, the weaker is its ability to compete successfully
- The sizes of the differences between a firm's score and those of its rivals are indicative of the size of its net competitive advantage or disadvantage versus its rivals
  - The bigger the difference between a firm's overall weighted rating and the ratings of *lower-rated* rivals, the greater is its implied *net competitive advantage* over these rivals
  - The bigger the difference between a firm's overall rating and the overall ratings of *higher-rated* rivals, the greater its implied *net competitive disadvantage* vis-à-vis these rivals

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Strategic Implications of Competitive Strength Scores

- A firm's competitive strength scores pinpoint where it is competitively stronger and weaker vis-à-vis rivals
- When a firm has high competitive strength scores in areas where one or more rivals have low scores, it should *consider offensive moves that pit its competitive strengths directly against rivals' competitive weaknesses*
- When a firm has low scores on strength measures where one or more rivals have high scores, it should *consider defensive moves to curtail its vulnerability to rivals' offensive attacks*

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Questions for Simulation Company Co-Managers

- **Are you regularly monitoring your firm's competitive strengths and weaknesses vis-à-vis rival firms in each geographic region (see the bottom section on each page of the Competitive Intelligence Report)?**
- **In crafting your firm's strategy and making decision entries each year, are you trying to capitalize on your firm's competitive strengths and to correct your firm's competitive weaknesses?**
- **Have you used the menus at the top of each page of the Competitive Intelligence Reports to view the data for the competitive strengths and weaknesses of rival industry firms?**
- ***Might this information be of value in crafting your firm's strategy in the upcoming year?***

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Question 5: What Strategic Issues and Problems Merit Front-Burner Managerial Attention?

- Involves compiling a "worry list" based on:
  - Assessment of the external environment (answers to the six analytical questions posed in Chapter 3)
  - Evaluations of the firm's resources and ability to compete successfully (answers to questions 1-4 in this chapter)
  - Such concerns as
    - "How to…?"
    - "Whether to…?"
    - "What should be done about …?"

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Identifying the Strategic Issues: Some Examples

- ***How to*** stave off market challenges from new foreign competitors?
- ***How to*** combat price discounting of rivals?
- ***How to*** reduce the firm's high costs?
- ***How to*** sustain the firm's growth in light of slowing buyer demand?
- ***Whether to*** expand the firm's product line?
- ***Whether to*** acquire a rival firm?
- ***Whether to*** expand into foreign markets rapidly or cautiously?
- ***What to do about*** aging demographics of the firm's customer base?

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Why Compile a "Worry List"?

- The role of the "worry list" is to pinpoint
  - The strategic and competitive challenges confronting the firm
  - Competitive shortcomings that must be addressed
  - Obstacles to improving the firm's competitive position and financial performance
  - Other issues/problems that management must address
- The purpose is **NOT** to list what specific actions to take
  - Deciding which strategic actions to take and which strategic moves to make comes later.
    - A worry list with minor problems/issues suggests the firm's strategy is on track and fine-tuning it will be adequate
    - A worry list with major problems/issues signals the need for immediate major strategy revisions and action plans

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Items on the Worry List Represent an Agenda for Management Action

- Why create a strategic agenda?
  - Compiling a "worry list" of problems and roadblocks draws managerial attention to the strategic issues a firm faces
- What comes after developing the list of strategic issues and problems?
  - Actually deciding upon a strategy, including what specific actions to take to address each and every item on the "worry list"

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The Lessons of Chapters 3 and 4

Lesson 1: An analysis of the firm's external situation must always come **before** crafting a company's strategy

- Managers are unprepared to craft a strategy that is well-matched to the macro-environment, competitive forces, industry driving forces, industry key success factors, and the likely actions of rivals unless they first have done careful and thorough analysis of the firm's external situation and have strong understanding of all the strategically relevant external factors.

Analysis is the critical starting point for crafting a strategy capable of producing good business results.

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The Lessons of Chapters 3 and 4

Lesson 2: An analysis of the firm's internal situation must always come ***before*** crafting a company's strategy.

- A competently done evaluation of a company's resources, competencies, and competitive strengths and weaknesses exposes strong and weak points in the present strategy and how attractive or unattractive the company's competitive position is and why.

Absent such knowledge, company managers are unlikely to craft a strategy that is well suited to the company's competitive capabilities and best market opportunities.

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The Lessons of Chapters 3 and 4

- **Lesson 3**: Accurate diagnosis of the firm's external and internal circumstances and an accurate list of front-burner issues that the strategy needs to address and resolve arms managers with the knowledge they need to craft a sound strategy that is tightly matched to the firm's overall situation and thus passes "the goodness of test" for a winning strategy.

Beware — **Mangers are flying blind and operating by the seat-of-their-pants if they leap into the task of tailoring a strategy that should tightly fit a firm's situation without first having an accurate understanding of what all of the strategically relevant facets of that situation are and what issues and problems the strategy needs to address.**

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Questions for Company Co-Managers

- After each decision round, do you take into account your company's competitive strengths and weaknesses (listed on each page of the Competitive Intelligence Report) in crafting a strategy for each geographic region for the upcoming decision round?
- Before proceeding to enter decisions for each upcoming decision round, do your regularly make a list of the strategic issues and problems your company needs to address and make sure that you enter decisions intended to resolve each and every one of these issues/problems?
- If not, then is the failure to craft a strategy matched to your company's internal situation and to dealing with "worry list" likely to be a reason why your company's performance is not as good as it could be?

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