In Chapter 3 we described how to use the tools of industry analysis to assess the profit potential and key success factors of a company's external environment. This laid the groundwork for matching a company's strategy to its external situation. In this chapter we discuss techniques for evaluating a company's internal situation, including its collection of resources and capabilities and the activities it performs along its value chain. Internal analysis enables managers to determine whether their strategy has appealing prospects for giving the company a significant competitive edge over rival firms. Combined with external analysis, it facilitates an understanding of how to reposition a firm to take advantage of new opportunities and to cope with emerging competitive threats. The analytical spotlight will be trained on six questions:

1. How well is the company's present strategy working?
2. What are the company's competitively important resources and capabilities?
3. Is the company able to take advantage of market opportunities and overcome external threats to its external well-being?
4. Are the company's prices and costs competitive with those of key rivals, and does it have an appealing customer value proposition?
5. Is the company competitively stronger or weaker than key rivals?
6. What strategic issues and problems merit front-burner managerial attention?

In probing for answers to these questions, five analytical tools—resource and capability analysis, SWOT analysis, value chain analysis, benchmarking, and competitive strength assessment—will be used. All five are valuable techniques for revealing a company's competitiveness and for helping company managers match their strategy to the company's own particular circumstances.

QUESTION 1: HOW WELL IS THE COMPANY'S PRESENT STRATEGY WORKING?

LO 1

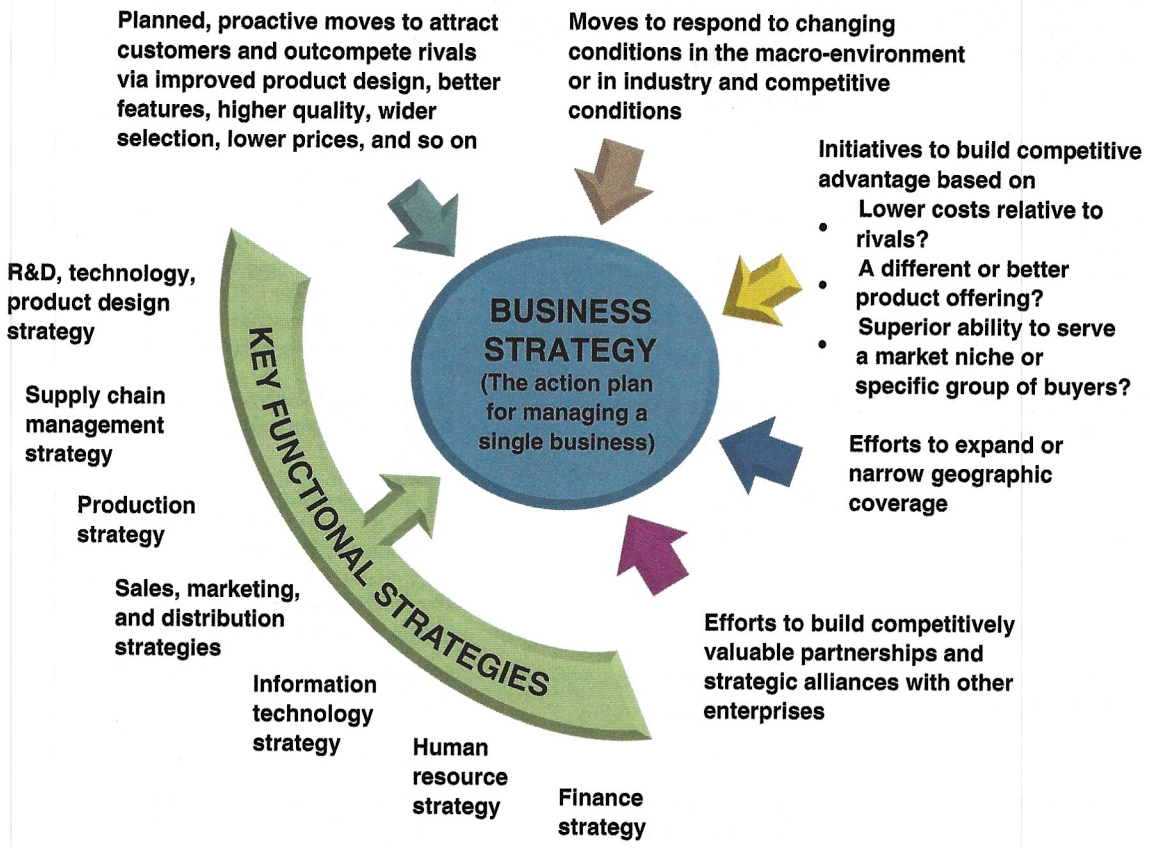
Learn how to take stock of how well a company's strategy is working.

In evaluating how well a company's present strategy is working, the best way to start is with a clear view of what the strategy entails. Figure 4.1 shows the key components of a single-business company's strategy. The first thing to examine is the company's competitive approach. What moves has the company made recently to attract customers and improve its market position—for instance, has it cut prices, improved the design of its product, added new features, stepped up advertising, entered a new geographic market (domestic or foreign), or merged with a competitor? Is it striving for a competitive advantage based on low costs or an appealingly different or better product offering? Is it concentrating on serving a broad spectrum of customers or a narrow market niche? The company's functional strategies in R&D, production, marketing, finance, human resources, information technology, and so on further characterize company strategy, as do any efforts to establish competitively valuable alliances or partnerships with other enterprises.

The two best indicators of how well a company's strategy is working are (1) whether the company is achieving its stated financial and strategic objectives and (2) whether the company is an above-average industry performer. Persistent shortfalls in meeting company performance targets and weak performance relative to rivals are reliable warning signs that the company has a weak strategy or suffers from poor strategy execution or both. Other indicators of how well a company's strategy is working include:

- Whether the firm's sales are growing faster than, slower than, or about the same pace as the market as a whole, thus resulting in a rising, eroding, or stable market share.
- Whether the company is acquiring new customers at an attractive rate as well as retaining existing customers.
- Whether the firm's profit margins are increasing or decreasing and how well its margins compare to rival firms' margins.
- Trends in the firm's net profits and return on investment and how they compare to the same trends for other companies in the industry.
- Whether the company's overall financial strength and credit rating are improving or declining.
- How shareholders view the company on the basis of trends in the company's stock price and shareholder value (relative to the stock price trends at other companies in the industry).
- Whether the firm's image and reputation with its customers are growing stronger or weaker.
- How well the company stacks up against rivals on technology, product innovation, customer service, product quality, delivery time, price, getting newly developed products to market quickly, and other relevant factors on which buyers base their choices.
- Whether key measures of operating performance (such as days of inventory, employee productivity, unit cost, defect rate, scrap rate, order-filling accuracy, delivery times, and warranty costs) are improving, remaining steady, or deteriorating.

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



The stronger a company's current overall performance, the less likely the need for radical changes in strategy. The weaker a company's financial performance and market standing, the more its current strategy must be questioned. Weak performance is almost always a sign of weak strategy, weak execution, or both.

The stronger a company's financial performance and market position, the more likely it has a well-conceived, well-executed strategy.

Evaluating how well a company's strategy is working should include quantitative as well as qualitative assessments. Table 4.1 provides a compilation of the financial ratios most commonly used to evaluate a company's financial performance and balance sheet strength.

QUESTION 2: WHAT ARE THE COMPANY'S COMPETITIVELY IMPORTANT RESOURCES AND CAPABILITIES?

Regardless of how well the strategy is working, it is important for managers to understand the underlying reasons. Clearly, this is critical if strategy changes are needed. But even when the strategy is working well, this can help managers to bolster a

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	$\frac{\text{Revenues} - \text{Cost of goods sold}}{\text{Revenues}}$	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)	$\frac{\text{Revenues} - \text{Operating expenses}}{\text{Revenues}}$ *or* $\frac{\text{Operating income}}{\text{Revenues}}$	Shows how much profit is earned on each dollar of sales, before paying interest charges and income taxes. Earnings before interest and taxes is known as *EBIT* in financial and business accounting. Higher is better, and the trend should be upward.
3. Net profit margin (or net return on sales)	$\frac{\text{Profits after taxes}}{\text{Revenues}}$	Shows after-tax profits per dollar of sales. Higher is better, and the trend should be upward.
4. Return on total assets	$\frac{\text{Profits after taxes} + \text{Interest}}{\text{Total assets}}$	A measure of the return on total 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. Return on stockholder's equity	$\frac{\text{Profits after taxes}}{\text{Total stockholders' equity}}$	Shows the return stockholders are earning on their investment in the enterprise. A return in the 12% to 15% range is "average," and the trend should be upward.
6. Return on invested capital	$\frac{\text{Profits after taxes}}{\text{Long-term debt} + \text{total equity}}$	Shows how effectively a company uses the monetary capital invested in its operations and the returns to those investments. Higher is better, and the trend should be upward.
7. Earnings per share	$\frac{\text{Profits after taxes}}{\text{Number of shares of common stock outstanding}}$	Shows the earnings for each share of common stock outstanding. The trend should be upward, and the bigger the annual percentage gains, the better.
Liquidity Ratios		
1. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Shows a firm's ability to pay current liabilities using assets that can be converted to cash in the near term. The ratio should definitely be higher than 1.0; a ratio of 2.0 or higher is better still.
2. Working capital	Current assets − Current liabilities	Shows the cash available for a firm's day-to-day operations. 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.

(Continued)

Ratio	How Calculated	What It Shows
Leverage Ratios		
1. Debt-to-assets ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	Measures the extent to which borrowed funds 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	$\frac{\text{Long-term debt}}{\text{Long-term debt} + \text{Total stockholders' equity}}$	An important measure of creditworthiness and balance sheet strength. It indicates the percentage of capital investment that has been financed by creditors and bondholders. 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. A debt-to capital ratio above 0.50 and certainly above 0.75 indicates a heavy and perhaps excessive reliance on debt, lower creditworthiness, and weak balance sheet strength.
3. Debt-to-equity ratio	$\frac{\text{Total debt}}{\text{Total stockholders' equity}}$	Should usually be less than 1.0. A high ratio (especially above 1.0) signals excessive debt, lower creditworthiness, and weaker balance sheet strength.
4. Long-term debt-to-equity ratio	$\frac{\text{Long-term debt}}{\text{Total stockholders' equity}}$	Shows the balance between debt and equity in the firm's *long-term* capital structure. A low ratio indicates greater capacity to borrow additional funds if needed.
5. Times-interest-earned (or coverage) ratio	$\frac{\text{Operating income}}{\text{Interest expenses}}$	Measures the ability to pay annual interest charges. Lenders usually insist on a minimum ratio of 2.0, but ratios above 3.0 signal better creditworthiness.
Activity Ratios		
1. Days of inventory	$\frac{\text{Inventory}}{\text{Cost of goods sold} \div 365}$	Measures inventory management efficiency. Fewer days of inventory are usually better.
2. Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$	Measures the number of inventory turns per year. Higher is better.
3. Average collection period	$\frac{\text{Accounts receivable}}{\text{Total sales} \div 365}$ *or* $\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	Indicates the average length of time the firm must wait after making a sale to receive cash payment. A shorter collection time is better.
Other Important Measures of Financial Performance		
1. Dividend yield on common stock	$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$	A measure of the return to owners received in the form of dividends.

(Continued)

Ratio	How Calculated	What It Shows
2. Price-earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings per share}}$	A P/E ratio above 20 indicates 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	$\frac{\text{Annual dividends per share}}{\text{Earnings per share}}$	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	After tax 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 is its ability to internally fund new strategic initiatives, repay debt, make new acquisitions, repurchase shares of stock, or increase dividend payments.

CORE CONCEPT

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

successful strategy and avoid harmful missteps. How well a strategy works depends a great deal on the relative strengths and weaknesses of a company's resources and capabilities. A company's resources and capabilities are its **competitive assets** and determine whether its competitive power in the marketplace will be impressively strong or disappointingly weak. Companies with minimal or only ordinary competitive assets nearly always are relegated to a trailing position in the industry.

Resource and capability analysis provides managers with a powerful tool for sizing up the company's competitive assets and determining whether they can provide the foundation necessary for competitive success in the marketplace. This is a two step process. The first step is for managers to identify the company's resources and capabilities so that they have a better idea of what they have to work with in crafting the company's competitive strategy. The second step is to examine the company's resources and capabilities more closely to ascertain which of them are the most competitively valuable and to determine whether the best of them can help the firm attain a sustainable competitive advantage over rival firms.[1] This step involves applying the *four tests of a resource's competitive power.*

LO 2

Understand why a company's resources and capabilities are central to its strategic approach and how to evaluate their potential for giving the company a competitive edge over rivals.

Identifying the Company's Resources and Capabilities

A firm's resources and capabilities are the fundamental building blocks of its competitive strategy. In crafting strategy, it is essential for managers to be able to recognize a resource or an organizational capability for what it is and to know how to take stock of the company's full complement of resources and capabilities.

To do a good job with this, managers and strategists need to start with a basic understanding of what these terms mean.

In brief, a **resource** is a productive input or competitive asset that is owned or controlled by the firm. Firms have many different types of resources at their disposal that vary not only in kind but in quality as well. Some are higher-quality than others, and some are more competitively valuable, having greater potential to give a firm a competitive advantage over its rivals. For example, a company's brand is a resource, as is an R&D team—yet some brands such as Coca-Cola and Kleenex are well known, with enduring value, while others have little more name recognition than generic products. In similar fashion, some R&D teams are far more innovative and productive than others due to the outstanding talents of the individual team members, the team's composition, and its chemistry.

A **capability** is the capacity of a firm to perform some activity proficiently. Capabilities also vary in form, quality, and competitive importance, with some being more competitively valuable than others. Apple's product innovation capabilities are widely recognized as being far superior to those of its competitors; Nordstrom is known for its superior incentive management capabilities; PepsiCo is admired for its marketing and brand management capabilities.

Resource and capability analysis is a powerful tool for sizing up a company's competitive assets and determining if they can support a sustainable competitive advantage over market rivals.

CORE CONCEPT

A **resource** is a competitive asset that is owned or controlled by a company; a **capability** is the capacity of a firm to perform some activity proficiently.

Types of Company Resources A useful way to identify a company's resources is to look for them within categories, as shown in Table 4.2. Broadly speaking, resources can be divided into two main categories:

Table 4.2 Types of Company Resources

Tangible Resources
• *Physical resources:* ownership of or access rights to natural resources (such as mineral deposits); state-of-the-art manufacturing plants, equipment, and/or distribution facilities; land and real estate; the locations of stores, manufacturing plants, or distribution centers, including the overall pattern of their physical locations
• *Financial resources:* cash and cash equivalents; marketable securities; other financial assets such as the borrowing capacity of the firm (as indicated from its balance sheet and credit rating)
• *Technological assets:* patents, copyrights, and trade secrets; production technology, stock of other technologies, technological processes
• *Organizational resources:* IT and communication systems (servers, workstations, etc.); other planning, coordination, and control systems; the company's organizational design and reporting structure
Intangible Resources
• *Human assets and intellectual capital:* the experience, cumulative learning, and tacit knowledge of employees; the education, intellectual capital, and know-how of specialized teams and work groups; the knowledge of key personnel concerning important business functions (e.g., skills in keeping operating costs low, improving product quality, and providing customer service); managerial talent; the creativity and innovativeness of certain personnel
• *Brands, company image, and reputational assets:* brand names, trademarks, product image, buyer loyalty and goodwill; company image, reputation for quality, service, and reliability; reputation with suppliers and partners for fair dealing
• *Relationships:* alliances or joint ventures that provide access to technologies, specialized know-how, or geographic markets; partnerships with suppliers that reduce costs and/or enhance product quality and performance; networks of dealers or distributors; the trust established with various partners
• *Company culture and incentive system:* the norms of behavior, business principles, and ingrained beliefs within the company; the attachment of personnel to the company's ideals; the compensation system and the motivation level of company personnel

tangible and **intangible** resources. Although *human resources* make up one of the most important parts of a company's resource base, we include them in the intangible category to emphasize the role played by the skills, talents, and knowledge of a company's human resources.

Tangible resources are the most easily identified, since tangible resources are those that can be touched or quantified readily. Obviously, they include various types of *physical resources* such as manufacturing facilities and mineral resources, but they also include a company's *financial resources, technological resources,* and *organizational resources* such as the company's communication and control systems.

Intangible resources are harder to discern, but they are often among the most important of a firm's competitive assets. They include various sorts of *human assets and intellectual capital,* as well as a company's *brands, image, and reputational assets.* While intangible resources have no material existence on their own, they are often embodied in something material. Thus the skills and knowledge resources of a firm are embodied in its managers and employees; a company's brand name is embodied in the company logo or product labels. Other important kinds of intangible resources include a company's *relationships* with suppliers, buyers, or partners of various sorts, and the *company's culture and incentive system.* A more detailed listing of the various types of tangible and intangible resources is provided in Table 4.2.

Listing a company's resources category by category can prevent managers from inadvertently overlooking some company resources that might be competitively important. At times, it can be difficult to decide exactly how to categorize certain types of resources. For example, resources such as a work group's specialized expertise in developing innovative products can be considered to be technological assets or human assets or intellectual capital and knowledge assets; the work ethic and drive of a company's workforce could be included under the company's human assets or its culture and incentive system. In this regard, it is important to remember that *it is not exactly how a resource is categorized that matters but, rather, that all of the company's different types of resources are included in the inventory.* The real purpose of using categories in identifying a company's resources is to ensure that none of a company's resources go unnoticed when sizing up the company's competitive assets.

Identifying Capabilities Organizational capabilities are more complex entities than resources; indeed, they are built up through the use of resources and draw on some combination of the firm's resources as they are exercised.[2] Virtually all organizational capabilities are *knowledge-based, residing in people and in a company's intellectual capital or in organizational processes and systems, which embody tacit knowledge.* For example, General Mill's brand management capabilities draw on the knowledge of the company's brand managers, the expertise of its marketing department, and the company's relationships with retailers, since brand building is a cooperative activity requiring retailer support. The capability in video game design for which Electronic Arts is known derives from the creative talents and technological expertise of its highly talented game developers, the company's culture of creativity, and a compensation system that generously rewards talented developers for creating best-selling video games.

Because of their complexity, capabilities are harder to categorize than resources and more challenging to search for as a result. There are, however, two approaches that can make the process of uncovering and identifying a firm's capabilities more systematic. The first method takes the completed listing of a

firm's resources as its starting point. Since capabilities are built from resources and utilize resources as they are exercised, a firm's resources can provide a strong set of clues about the types of capabilities the firm is likely to have accumulated. This approach simply involves looking over the firm's resources and considering whether (and to what extent) the firm has built up any related capabilities. So, for example, a fleet of trucks, the latest RFID tracking technology, and a set of large automated distribution centers may be indicative of sophisticated capabilities in logistics and distribution. R&D teams composed of top scientists with expertise in genomics may suggest organizational capabilities in developing new gene therapies or in biotechnology more generally.

The second method of identifying a firm's capabilities takes a functional approach. Many capabilities relate to fairly specific functions; these draw on a limited set of resources and typically involve a single department or organizational unit. Capabilities in injection molding or continuous casting or metal stamping are manufacturing-related; capabilities in direct selling, promotional pricing, or database marketing all connect to the sales and marketing functions; capabilities in basic research, strategic innovation, or new product development link to a company's R&D function. This approach requires managers to survey the various functions a firm performs to find the different capabilities associated with each function.

A problem with this second method is that many of the most important capabilities of firms are inherently *cross-functional.* Cross-functional capabilities draw on a number of different kinds of resources and are generally multidisciplinary in nature—they spring from the effective collaboration among people with different expertise working in different organizational units. An example is the capability for fast-cycle, continuous product innovation that comes from teaming the efforts of groups with expertise in market research, new product R&D, design and engineering, advanced manufacturing, and market testing. Cross-functional capabilities and other complex capabilities involving numerous linked and closely integrated competitive assets are sometimes referred to as **resource bundles.** Although resource bundles are not as easily pigeonholed as other types of resources and capabilities, they can still be identified by looking for company activities that link different types of resources, functions, and departmental units. It is important not to miss identifying a company's resource bundles, since they can be the most competitively important of a firm's competitive assets. Unless it includes a company's cross-functional capabilities and resource bundles, no identification of a company's resources and capabilities can be considered complete.

CORE CONCEPT

A **resource bundle** is a linked and closely integrated set of competitive assets centered around one or more cross-functional capabilities.

Determining Whether a Company's Resources and Capabilities Are Potent Enough to Produce a Sustainable Competitive Advantage

To determine the strategic relevance and competitive power of a firm's resources and capabilities, it is necessary to go beyond merely identifying a company's resources and capabilities. The second step in resource and capability analysis is designed to ascertain which of a company's resources and capabilities are competitively valuable and to what extent they can support a company's quest for a sustainable competitive advantage over market rivals. This involves probing the *caliber* of a firm's competitive assets relative to those of its competitors.[3] When a company has competitive assets that are central to its strategy and superior

to those of rival firms, it has a competitive advantage over other firms. If this advantage proves durable despite the best efforts of competitors to overcome it, then the company is said to have a ***sustainable* competitive advantage.** While it may be difficult for a company to achieve a sustainable competitive advantage, it is an important strategic objective because it imparts a potential for attractive and long-lived profitability.

The Four Tests of a Resource's Competitive Power The competitive power of a resource or capability is measured by how many of the following four tests it can pass.[4] The first two tests determine whether a resource or capability can support a competitive advantage. The last two determine whether the competitive advantage can be sustained in the face of active competition.

CORE CONCEPT

A ***sustainable* competitive advantage** is an advantage over market rivals that persists despite efforts of the rivals to overcome it.

1. *Is the resource (or capability) competitively valuable?* To be competitively valuable, a resource or capability must be directly relevant to the company's strategy, making the company a more effective competitor, able to exploit market opportunities and ward off external threats. Unless the resource contributes to the effectiveness of the company's strategy, it cannot pass this first test. An indicator of its effectiveness is whether the resource enables the company to strengthen its business model through a better customer value proposition and/or profit formula. Companies have to guard against contending that something they do well is necessarily competitively valuable. Apple's operating system for its PCs is by most accounts a world beater (compared to Windows Vista and Windows 7), but Apple has failed miserably in converting its strength in operating system design into competitive success in the global PC market—it is an also-ran with a paltry 3 to 5 percent market share worldwide.
2. *Is the resource rare—is it something rivals lack?* Resources and capabilities that are common among firms and widely available cannot be a source of competitive advantage. All makers of branded cereals have valuable marketing capabilities and brands, since the key success factors in the ready-to-eat cereal industry demand this. They are not rare. The brand strength of Cheerios, however, is uncommon and has provided General Mills with greater market share as well as the opportunity to benefit from brand extensions like Honey Nut Cheerios. A resource or capability is considered rare if it is held by only a small number of firms in an industry or specific competitive domain. Thus, while general management capabilities are not rare in an absolute sense, they are relatively rare in some of the less developed regions of the world and in some business domains.
3. *Is the resource hard to copy?* If a resource or capability is both valuable and rare, it will be competitively superior to comparable resources of rival firms. As such, it is a source of competitive advantage for the company. The more difficult and more costly it is for competitors to imitate, the more likely that it can also provide a *sustainable* competitive advantage. Resources tend to be difficult to copy when they are unique (a fantastic real estate location, patent-protected technology, an unusually talented and motivated labor force), when they must be built over time in ways that are difficult to imitate (a well-known brand name, mastery of a complex process technology, a global network of dealers and distributors), and when they entail financial outlays or large-scale operations that few industry members can undertake. Imitation is also difficult for resources that reflect a high level of *social complexity* (company culture, interpersona

relationships among the managers or R&D teams, trust-based relations with customers or suppliers) and *causal ambiguity,* a term that signifies the hard-to-disentangle nature of the complex resources, such as a web of intricate processes enabling new drug discovery. Hard-to-copy resources and capabilities are important competitive assets, contributing to the longevity of a company's market position and offering the potential for sustained profitability.

4. *Can the resource be trumped by different types of resources and capabilities—are there good substitutes available for the resource?* Even resources and capabilities that are valuable, rare, and hard to copy can lose much of their competitive power if rivals have other types of resources and capabilities that are of equal or greater competitive power. A company may have the most technologically advanced and sophisticated plants in its industry, but any efficiency advantage it enjoys may be nullified if rivals are able to produce equally good products at lower cost by locating their plants in countries where wage rates are relatively low and a labor force with adequate skills is available.

CORE CONCEPTS

Social complexity and **causal ambiguity** are two factors that inhibit the ability of rivals to imitate a firm's most valuable resources and capabilities. Causal ambiguity makes it very hard to figure out how a complex resource contributes to competitive advantage and therefore exactly what to imitate.

The vast majority of companies are not well endowed with standout resources or capabilities, capable of passing all four tests with high marks. Most firms have a mixed bag of resources—one or two quite valuable, some good, many satisfactory to mediocre. Resources and capabilities that are valuable pass the first of the four tests. As key contributors to the efficiency and effectiveness of the strategy, they are relevant to the firm's competitiveness but are no guarantee of competitive advantage. They may offer no more than competitive parity with competing firms.

Passing both of the first two tests requires more—it requires resources and capabilities that are not only valuable but also rare. This is a much higher hurdle that can be cleared only by resources and capabilities that are *competitively superior.* Resources and capabilities that are competitively superior are the company's true strategic assets.[5] They provide the company with a competitive advantage over its competitors, if only in the short run.

To pass the last two tests, a resource must be able to maintain its competitive superiority in the face of competition. It must be resistant to imitative attempts and efforts by competitors to find equally valuable substitute resources. Assessing the availability of substitutes is the most difficult of all the tests since substitutes are harder to recognize, but the key is to look for resources or capabilities held by other firms that *can serve the same function* as the company's core resources and capabilities.[6]

Very few firms have resources and capabilities that can pass these tests, but those that do enjoy a sustainable competitive advantage with far greater profit potential. Walmart is a notable example, with capabilities in logistics and supply chain management that have surpassed those of its competitors for over 30 years. Lincoln Electric Company, less well known but no less notable in its achievements, has been the world leader in welding products for over 100 years as a result of its unique piecework incentive system for compensating production workers and the unsurpassed worker productivity and product quality that this system has fostered.

A Company's Resources and Capabilities Must Be Managed Dynamically Even companies like Walmart and Lincoln Electric cannot afford to rest on their laurels. Rivals that are initially unable to replicate a key resource may develop better and better substitutes over time. Resources and

capabilities can depreciate like other assets if they are managed with benign neglect. Disruptive environmental change can also destroy the value of key strategic assets, turning resources and capabilities "from diamonds to rust."[7] Some resources lose their clout quickly when there are rapid changes in technology, customer preferences, distribution channels, or other competitive factors.

A company requires a dynamically evolving portfolio of resources and capabilities to sustain its competitiveness and help drive improvements in its performance.

For a company's resources and capabilities to have *durable* value, they must be continually refined, updated, and sometimes augmented with altogether new kinds of expertise. Not only are rival companies endeavoring to sharpen and recalibrate their capabilities, but customer needs and expectations are also undergoing constant change. Organizational capabilities grow stale unless they are kept freshly honed and on the cutting edge.[8] A company's resources and capabilities are far more competitively potent when they are (1) in sync with changes in the company's own strategy and its efforts to achieve a resource-based competitive advantage and (2) fully supportive of company efforts to attract customers and combat competitors' newly launched offensives to win bigger sales and market shares. Management's challenge in managing the firm's resources and capabilities dynamically has two elements: attending to ongoing recalibration of existing competitive assets and casting a watchful eye for opportunities to develop totally new kinds of capabilities.

The Role of Dynamic Capabilities Companies that know the importance of recalibrating and upgrading their most valuable resources and capabilities ensure that these activities are done on a continual basis. By incorporating these activities into their routine managerial functions, they gain the experience necessary to be able to do them consistently well. At that point, their ability to freshen and renew their competitive assets becomes a capability in itself—a **dynamic capability.** A dynamic capability is the ability to modify or augment the company's existing resources and capabilities.[9] This includes the capacity to improve existing resources and capabilities incrementally, in the way that 3M continually upgrades the R&D resources driving its product innovation strategy. It also includes the capacity to add new resources and capabilities to the company's competitive asset portfolio. An example is Pfizer's acquisition capabilities, which have enabled it to replace degraded resources such as expiring patents with newly acquired capabilities in biotechnology.

CORE CONCEPT

A **dynamic capability** is the capacity of a company to modify its existing resources and capabilities or create new ones.

QUESTION 3: IS THE COMPANY ABLE TO SEIZE MARKET OPPORTUNITIES AND NULLIFY EXTERNAL THREATS?

An essential element in evaluating a company's overall situation entails examining the company's resources and competitive capabilities in terms of the degree to which they enable it to pursue its best market opportunities and defend against the external threats to its future well-being. The simplest and most easily applied tool for conducting this examination is widely known as *SWOT analysis*, so named because

it zeros in on a company's internal Strengths and Weaknesses, market Opportunities, and external Threats. Just as important, a first-rate SWOT analysis provides the basis for crafting a strategy that capitalizes on the company's resource strengths, overcomes its resource weaknesses, aims squarely at capturing the company's best opportunities, and defends against the threats to its future well-being.

LO 3

Discover how to assess the company's strengths and weaknesses in light of market opportunities and external threats.

Identifying a Company's Internal Strengths

A *strength* is something a company is good at doing or an attribute that enhances its competitiveness in the marketplace. A company's strengths depend on the quality of its resources and capabilities. Resource and capability analysis provides a way for managers to assess the quality objectively. While resources and capabilities that pass the four tests of sustainable competitive advantage are among the company's greatest strengths, other types can be counted among the company's strengths as well. A capability that is not potent enough to produce a sustainable advantage over rivals may yet enable a series of temporary advantages if used as a basis for entry into a new market or market segment. A resource bundle that fails to match those of top-tier competitors may still allow a company to compete successfully against the second tier.

SWOT analysis is a simple but powerful tool for sizing up a company's strengths and weaknesses, its market opportunities, and the external threats to its future well-being.

Assessing a Company's Competencies—What Activities Does It Perform Well? One way to appraise the degree of a company's strengths has to do with the company's competence level in performing key pieces of its business—such as supply chain management, R&D, production, distribution, sales and marketing, and customer service. Which activities does it perform especially well? And are there any activities it performs better than rivals? A company's proficiency in conducting different facets of its operations can range from a mere competence in performing an activity to a core competence to a distinctive competence.

Basing a company's strategy on its most competitively valuable resource and capability strengths gives the company its best chance for market success.

A **competence** is an internal activity an organization performs with proficiency—a capability, in other words. A **core competence** is a proficiently performed internal activity that is *central* to a company's strategy and competitiveness. Ben & Jerry's Ice Cream, a subsidiary of Unilever, has a core competence in creating unusual flavors of ice cream and marketing them with catchy names like Chunky Monkey, Chubby Hubby, Cherry Garcia, Karamel Sutra, Imagine Whirled Peace, and Phish Food. A core competence is a more competitively valuable company strength than a competence because of the activity's key role in the company's strategy and the contribution it makes to the company's market success and profitability. Often, core competencies can be leveraged to create new markets or new product demand, as the engine behind a company's growth. 3M Corporation has a core competence in product innovation—its record of introducing new products goes back several decades and new product introduction is central to 3M's strategy of growing its business.

CORE CONCEPT

A competence is an activity that a company has learned to perform with proficiency—a capability, in other words.

A **distinctive competence** is a competitively valuable activity that a company *performs better than its rivals.* A distinctive competence thus signifies greater proficiency than a core competence. Because a distinctive competence represents a level of proficiency that rivals do not have, it qualifies as a *competitively superior strength* with competitive advantage potential. This is particularly true when the distinctive competence enables

CORE CONCEPT

A **core competence** is an activity that a company performs proficiently that is also central to its strategy and competitive success.

CORE CONCEPT

A **distinctive competence** is a competitively important activity that a company performs better than its rivals—it thus represents *a competitively superior internal strength.*

a company to deliver standout value to customers (in the form of lower prices, better product performance, or superior service). For instance, Apple has a distinctive competence in product innovation, as exemplified by its iPod, iPhone, and iPad products.

The conceptual differences between a competence, a core competence, and a distinctive competence draw attention to the fact that a company's strengths and competitive assets are not all equal.[10] Some competencies merely enable market survival because most rivals have them—indeed, not having a competence or capability that rivals have can result in competitive disadvantage. If an apparel company does not have the competence to produce its apparel items very cost-efficiently, it is unlikely to survive given the intensely price-competitive nature of the apparel industry. Every Web retailer requires a basic competence in designing an appealing and user-friendly Web site. Core competencies are *competitively* more important strengths than competencies because they are central to the company's strategy. Distinctive competencies are even more competitively important. Because a distinctive competence is a competitively valuable capability that is unmatched by rivals, it can propel the company to greater market success and profitability. A distinctive competence is thus potentially the mainspring of a company's success—unless it is trumped by other, even more powerful types of competencies that rivals hold.

Identifying Company Weaknesses and Competitive Deficiencies

CORE CONCEPT

A company's **strengths** represent its competitive assets; its **weaknesses** are shortcomings that constitute competitive liabilities.

A **weakness,** or *competitive deficiency,* is something a company lacks or does poorly (in comparison to others) or a condition that puts it at a competitive disadvantage in the marketplace. A company's internal weaknesses can relate to (1) inferior or unproven skills, expertise, or intellectual capital in competitively important areas of the business; (2) deficiencies in competitively important physical, organizational, or intangible assets; or (3) missing or competitively inferior capabilities in key areas. *Company weaknesses are thus internal shortcomings that constitute competitive liabilities.* Nearly all companies have competitive liabilities of one kind or another. Whether a company's internal weaknesses make it competitively vulnerable depends on how much they matter in the marketplace and whether they are offset by the company's strengths.

Table 4.3 lists many of the things to consider in compiling a company's strengths and weaknesses. Sizing up a company's complement of strengths and deficiencies is akin to constructing a *strategic balance sheet,* where strengths represent *competitive assets* and weaknesses represent *competitive liabilities.* Obviously, the ideal condition is for the company's competitive assets to outweigh its competitive liabilities by an ample margin—a 50-50 balance is definitely not the desired condition!

Identifying a Company's Market Opportunities

Market opportunity is a big factor in shaping a company's strategy. Indeed, managers can't properly tailor strategy to the company's situation without first identifying its market opportunities and appraising the growth and profit potential each one holds. Depending on the prevailing circumstances, a company's

opportunities can be plentiful or scarce, fleeting or lasting, and can range from wildly attractive (an absolute "must" to pursue) to marginally interesting (because of the high risks or questionable profit potentials) to unsuitable (because the company's strengths are ill-suited to successfully capitalizing on the opportunities). A sampling of potential market opportunities is shown in Table 4.3.

Newly emerging and fast-changing markets sometimes present stunningly big or "golden" opportunities, but it is typically hard for managers at one company to peer into "the fog of the future" and spot them much ahead of managers at other companies.[11] But as the fog begins to clear, golden opportunities are nearly always seized rapidly—and the companies that seize them are usually those that have been actively waiting, staying alert with diligent market reconnaissance, and preparing themselves to capitalize on shifting market conditions by patiently assembling an arsenal of competitively valuable resources—talented personnel, technical know-how, strategic partnerships, and a war chest of cash to finance aggressive action when the time comes.[12] In mature markets, unusually attractive market opportunities emerge sporadically, often after long periods of relative calm—but future market conditions may be more predictable, making emerging opportunities easier for industry members to detect.

A company is well advised to pass on a particular market opportunity unless it has or can acquire the competencies needed to capture it.

In evaluating a company's market opportunities and ranking their attractiveness, managers have to guard against viewing every *industry* opportunity as a *company* opportunity. Not every company is equipped with the competencies to successfully pursue each opportunity that exists in its industry. Some companies are more capable of going after particular opportunities than others, and a few companies may be hopelessly outclassed. *The market opportunities most relevant to a company are those that match up well with the company's competitive assets, offer the best growth and profitability, and present the most potential for competitive advantage.*

Identifying the Threats to a Company's Future Profitability

Often, certain factors in a company's external environment pose *threats* to its profitability and competitive well-being. Threats can stem from the emergence of cheaper or better technologies, rivals' introduction of new or improved products, the entry of lower-cost foreign competitors into a company's market stronghold, new regulations that are more burdensome to a company than to its competitors, vulnerability to a rise in interest rates or tight credit conditions, the potential of a hostile takeover, unfavorable demographic shifts, adverse changes in foreign exchange rates, political upheaval in a foreign country where the company has facilities, and the like. A list of potential threats to a company's future profitability and market position is shown in Table 4.3.

External threats may pose no more than a moderate degree of adversity (all companies confront some threatening elements in the course of doing business), or they may be so imposing as to make a company's situation and outlook quite tenuous. On rare occasions, market shocks can give birth to a *sudden-death* threat that throws a company into an immediate crisis and a battle to survive. Many of the world's major airlines were plunged into an unprecedented financial crisis by the perfect storm of 9/11, rising prices for jet fuel, mounting competition

Table 4.3 What to Look For in Identifying a Company's Strengths, Weaknesses, Opportunities, and Threats

Potential Strengths and Competitive Assets	Potential Weaknesses and Competitive Deficiencies
• Competencies that are well matched to industry key success factors • Strong financial condition; ample financial resources to grow the business • Strong brand-name image/company reputation • Attractive customer base • Proprietary technology/superior technological skills/ important patents • Superior intellectual capital • Skills in advertising and promotion • Strong bargaining power over suppliers or buyers • Product innovation capabilities • Proven capabilities in improving production processes • Good supply chain management capabilities • Good customer service capabilities • Superior product quality • Wide geographic coverage and/or strong global distribution capability • Alliances/joint ventures that provide access to valuable technology, competencies, and/or attractive geographic markets • A product that is strongly differentiated from those of rivals • Cost advantages over rivals • Core competencies in _____ • A distinctive competence in _____ • Resources that are hard to copy and for which there are no good substitutes	• Competencies that are not well-matched to industry key success factors • In the wrong strategic group • Losing market share because _____ • Lack of attention to customer needs • Weak balance sheet, short on financial resources to grow the firm, too much debt; • Higher overall unit costs relative to those of key competitors • Weak or unproven product innovation capabilities • A product/service with ho-hum attributes or features inferior to the offerings of rivals • Too narrow a product line relative to rivals • Weak brand image or reputation • Weaker dealer network than key rivals and/or lack of adequate global distribution capability • Behind on product quality, R&D, and/or technological know-how • Lack of management depth • Inferior intellectual capital relative to rivals • Plagued with internal operating problems or obsolete facilities • Too much underutilized plant capacity • No well-developed or proven core competencies • No distinctive competencies or competitively superior resources • Resources that are readily copied or for which there are good substitutes • No clear strategic direction
Potential Market Opportunities	**Potential External Threats to a Company's Future Profitability**
• 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 know-how 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	• 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 • Vulnerability to industry driving forces • 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 • Adverse economic conditions that threaten critical suppliers or distributers • Changes in technology—particularly disruptive technology that can undermine the company's distinctive competencies • Restrictive foreign trade policies • Costly new regulatory requirements • Tight credit conditions • Rising prices on energy or other key inputs

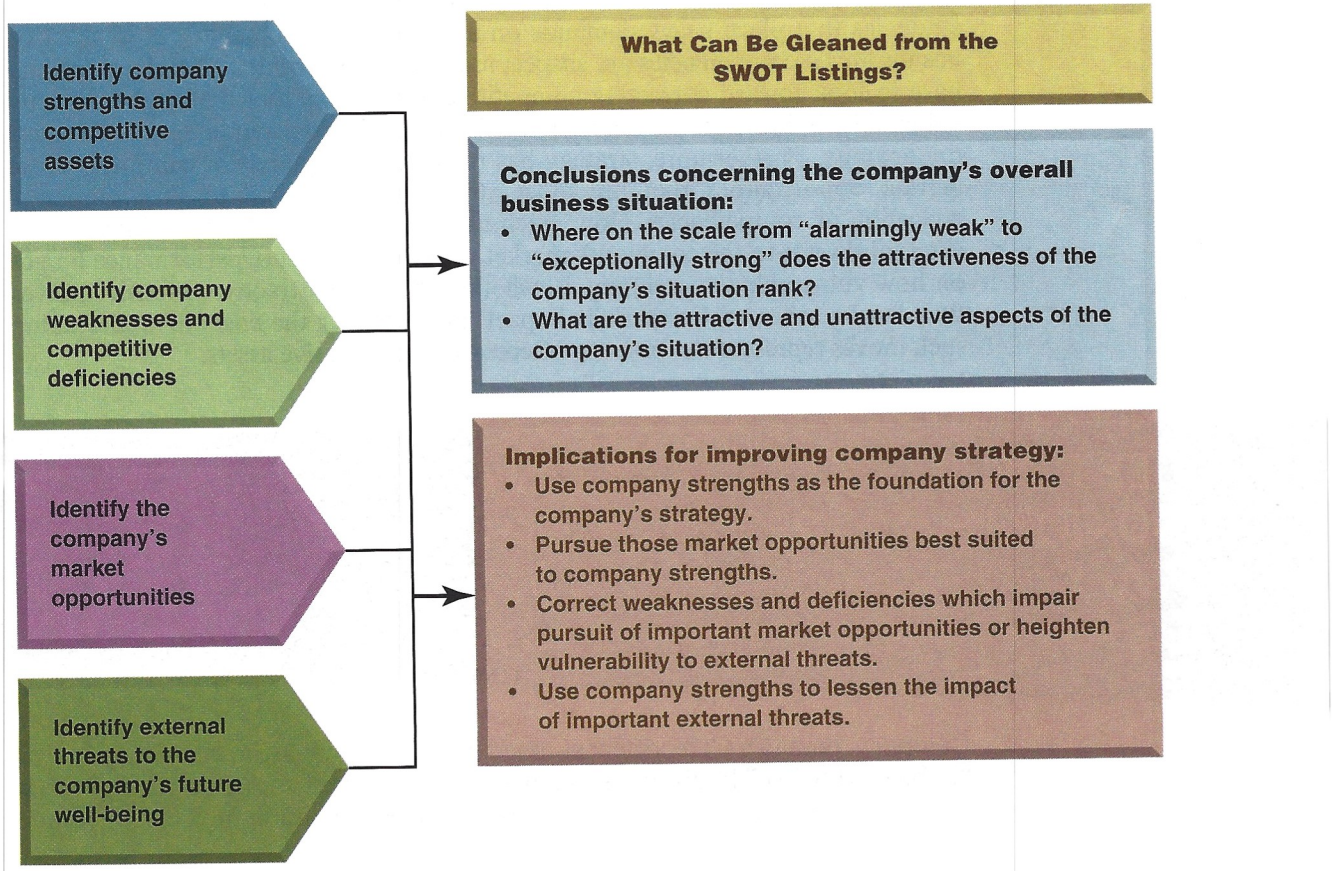
from low-fare carriers, shifting traveler preferences for low fares as opposed to lots of in-flight amenities, and higher labor costs. Similarly, the global economic crisis that began with the mortgage lenders, banks, and insurance companies has produced shock waves from which few industries have been insulated, causing even strong performers like General Electric to falter. While not all crises can be anticipated, it is management's job to identify the threats to the company's future prospects and to evaluate what strategic actions can be taken to neutralize or lessen their impact.

What Do the SWOT Listings Reveal?

SWOT analysis involves more than making four lists. The two most important parts of SWOT analysis are *drawing conclusions* from the SWOT listings about the company's overall situation and *translating these conclusions into strategic actions* to better match the company's strategy to its internal strengths and market opportunities, to correct important weaknesses, and to defend against external threats. Figure 4.2 shows the steps involved in gleaning insights from SWOT analysis.

Simply making lists of a company's strengths, weaknesses, opportunities, and threats is not enough; the payoff from SWOT analysis comes from the conclusions about a company's situation and the implications for strategy improvement that flow from the four lists.

Figure 4.2 The Steps Involved in SWOT Analysis: Identify the Four Components of SWOT, Draw Conclusions, Translate Implications into Strategic Actions



Just what story the SWOT listings tell about the company's overall situation is often revealed in the answers to the following set of questions:

- What aspects of the company's situation are particularly attractive?
- What aspects are of the most concern?
- All things considered, where on a scale of 1 to 10 (where 1 is alarmingly weak and 10 is exceptionally strong) do the company's overall situation and future prospects rank?
- Are the company's internal strengths and competitive assets powerful enough to enable it to compete successfully?
- Are the company's weaknesses and competitive deficiencies mostly inconsequential and readily correctable, or could one or more prove fatal if not remedied soon?
- Do the company's strengths and competitive assets outweigh its weaknesses and competitive liabilities by an attractive margin?
- Does the company have attractive market opportunities that are well suited to its internal strengths? Does the company lack the competitive assets to pursue any of the most attractive opportunities?
- Are the threats alarming, or are they something the company appears able to deal with and defend against?

The final piece of SWOT analysis is to translate the diagnosis of the company's situation into actions for improving the company's strategy and business prospects. *A company's internal strengths should always serve as the basis of its strategy—placing heavy reliance on a company's best competitive assets is the soundest route to attracting customers and competing successfully against rivals.*[13] As a rule, strategies that place heavy demands on areas where the company is weakest or has unproven competencies are suspect and should be avoided. Plainly, managers have to look toward correcting competitive weaknesses that make the company vulnerable, hold down profitability, or disqualify it from pursuing an attractive opportunity. Furthermore, strategy has to be aimed squarely at capturing those market opportunities that are most attractive and suited to the company's collection of competencies. How much attention to devote to defending against external threats to the company's market position and future performance hinges on how vulnerable the company is, whether there are attractive defensive moves that can be taken to lessen their impact, and whether the costs of undertaking such moves represent the best use of company competitive assets.

QUESTION 4: ARE THE COMPANY'S PRICES AND COSTS COMPETITIVE WITH THOSE OF KEY RIVALS, AND DOES IT HAVE AN APPEALING CUSTOMER VALUE PROPOSITION?

Company managers are often stunned when a competitor cuts its price to "unbelievably low" levels or when a new market entrant comes on strong with a very low price. The competitor may not, however, be "dumping" (an economic

term for selling at prices that are below cost), buying its way into the market with a super-low price, or waging a desperate move to gain sales—it may simply have substantially lower costs. One of the most telling signs of whether a company's business position is strong or precarious is whether its prices and costs can remain competitive with industry rivals. For a company to retain its market share, its costs must be *in line* with those of close rivals selling similar quality products.

LO 4

Grasp how a company's value chain activities can affect the company's cost structure, degree of differentiation, and competitive advantage.

While less common, new entrants can also storm the market with a product that ratchets the quality level up so high that customers will abandon competing sellers even if they have to pay more for the new product. With its vastly greater storage capacity and lightweight, cool design, Apple's iPod left other makers of portable digital music players in the dust when it was first introduced. By introducing new models with even more attractive features, Apple has continued its worldwide dominance of this market. Apple's new iPad appears to be doing the same in the market for e-readers and tablet PCs.

The higher a company's costs are above those of close rivals, the more competitively vulnerable it becomes.

Regardless of where on the quality spectrum a company competes, it must also remain competitive in terms of its customer value proposition in order to stay in the game. Tiffany's value proposition, for example, remains attractive to customers who want customer service, the assurance of quality, and a high-status brand despite the availability of cut-rate diamond jewelry online. Target's customer value proposition has withstood the Walmart low-price juggernaut by attention to product design, image, and attractive store layouts in addition to efficiency.

The value provided to the customer depends on how well a customer's needs are met for the price paid. How well customer needs are met depends on the perceived quality of a product or service as well as other, more tangible attributes. The greater the amount of customer value that the company can offer profitably compared to its rivals, the less vulnerable it will be to competitive attack. For managers, the key is to keep close track of how *cost effectively* the company can deliver value to customers relative to its competitors. If they can deliver the same amount of value with lower expenditures (or more value at the same cost), they will maintain a competitive edge.

The greater the amount of customer value that a company can offer profitably relative to close rivals, the less competitively vulnerable it becomes.

Two analytical tools are particularly useful in determining whether a company's prices, costs, and customer value proposition are competitive: value chain analysis and benchmarking.

The Concept of a Company Value Chain

Every company's business consists of a collection of activities undertaken in the course of designing, producing, marketing, delivering, and supporting its product or service. All the various activities that a company performs internally combine to form a **value chain**—so called because the underlying intent of a company's activities is to do things that ultimately *create value for buyers.*

CORE CONCEPT

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

As shown in Figure 4.3, a company's value chain consists of two broad categories of activities: the *primary activities* that are foremost in creating value for customers and the requisite *support activities* that facilitate and enhance the performance of the primary activities.[14] The exact nature of the primary and secondary activities that make up a company's value chain

vary according to the specifics of a company's business; hence, the listing of the primary and support activities in Figure 4.3 is illustrative rather than definitive. For example, the primary value-creating activities for a manufacturer of bakery goods, such as Pepperidge Farm, include supply chain management, baking and packaging operations, distribution, and sales and marketing but are unlikely to include service. Its support activities include quality control as well as product R&D, human resource management, and administration. For a department store retailer, such as Macy's, customer service is included among its primary activities, along with merchandise selection and buying, store layout and product display, and advertising; its support activities include site selection, hiring and training, and store maintenance, plus the usual assortment of administrative activities. For a hotel chain like Marriot, the primary activities and costs are in site selection and construction, reservations, operation of its hotel properties, and marketing; principal support activities include accounting, hiring and training hotel staff, supply chain management, and general administration.

With its focus on value-creating activities, the value chain is an ideal tool for examining how a company delivers on its customer value proposition. It permits a deep look at the company's cost structure and ability to offer low prices. It reveals the emphasis that a company places on activities that enhance differentiation and support higher prices, such as service and marketing. Note that there is also a profit margin component to the value chain; this is because profits are necessary to compensate the company's owners/shareholders and investors, who bear risks and provide capital. Tracking the profit margin along with the value-creating activities is critical because unless an enterprise succeeds in delivering customer value profitably (with a sufficient return on invested capital), it can't survive for long. This is the essence of a sound business model.

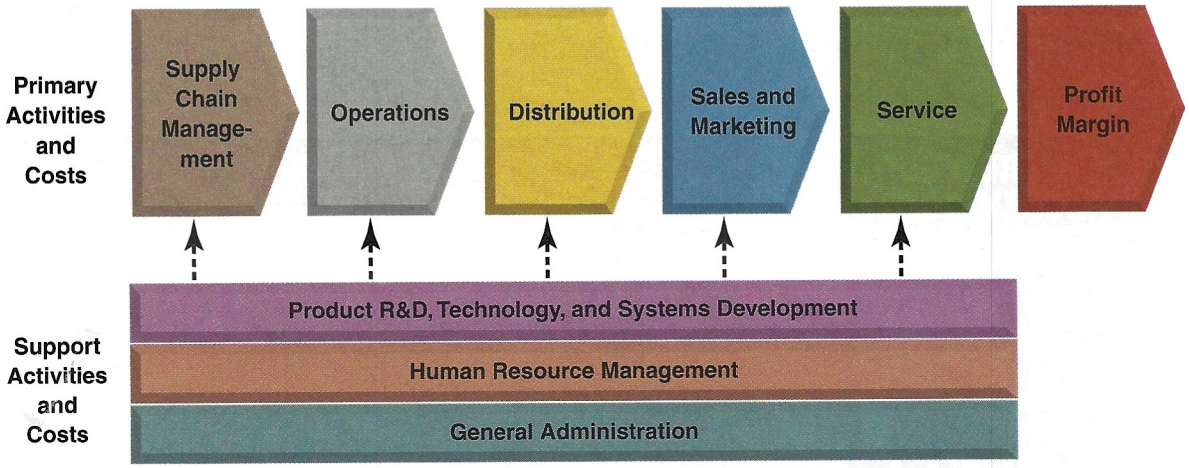
Illustration Capsule 4.1 shows representative costs for various activities performed by Just Coffee, a cooperative producer and roaster of fair-trade organic coffee.

Comparing the Value Chains of Rival Companies The primary purpose of value chain analysis is to facilitate a comparison, activity-by-activity, of how effectively and efficiently a company delivers value to its customers, relative to its competitors. Segregating the company's operations into different types of primary and secondary activities is the first step in this comparison. The next is to do the same for the company's most significant competitors.

Even rivals in the same industry may differ significantly in terms of the activities they perform. For instance, the "operations" component of the value chain for a manufacturer that makes all of its own parts and components and assembles them into a finished product differs from the "operations" of a rival producer that buys the needed parts and components from outside suppliers and only performs assembly operations. How each activity is performed may affect a company's relative cost position as well as its capacity for differentiation. Thus, even a simple comparison of how the activities of rivals' value chains differ can be revealing of competitive differences.

A Company's Primary and Secondary Activities Identify the Major Components of Its Internal Cost Structure Each activity in the value chain gives rise to costs and ties up assets. For a company to remain competitive, it is critical for it to perform its activities cost-effectively,

Figure 4.3 A Representative Company Value Chain



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 form (production, 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 installation, spare parts delivery, maintenance and repair, technical assistance, buyer inquiries, and complaints.

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 Resources 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 and regulatory affairs, safety and security, management information systems, forming strategic alliances and collaborating with strategic partners, and other "overhead" functions.

Source: Based on the discussion in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), pp. 37–43.

ILLUSTRATION CAPSULE 4.1

The Value Chain for Just Coffee, a Producer of Fair-Trade Organic Coffee

Value Chain Activities and Costs in Producing, Roasting, and Selling a Pound of Fair-Trade Organic Coffee	
1. Average cost of procuring the coffee from coffee-grower cooperatives	$2.:
2. Import fees, storage costs, and freight charges	.
3. Labor cost of roasting and bagging	.!
4. Cost of labels and bag	.
5. Average overhead costs	3.(
6. Total company costs	$7.4
7. Average retail markup over company costs (company operating profit)	2.5
8. Average price to consumer at retail	$9.9

Source: Developed by the authors with help from Jonathan D. Keith from information on Just Coffee's Web site, www.justcoffee.coop/the_coffee_dollar_breakdown (accessed June 16, 2010).

regardless of which it chooses to emphasize. Once the major value chain activities are identified, the next step is to evaluate the company's cost competitiveness using what accountants call *activity-based costing* to determine the costs of performing each value chain activity (and assets required, including working capital).[15] The degree to which a company's costs should be disaggregated into specific activities depends on how valuable it is to develop cost data for narrowly defined activities as opposed to broadly defined activities. Generally speaking, cost estimates are needed at least for each broad category of primary and secondary activities, but finer classifications may be needed if a company discovers that it has a cost disadvantage vis-à-vis rivals and wants to pin down the exact source or activity causing the disadvantage. Quite often, there are links between activities such that the manner in which one activity is done can affect the costs of performing other activities. For instance, how an automobile is designed has a huge impact on the number of different parts and components, their respective manufacturing costs, and the expense of assembling the various parts and components into a finished product.

The combined costs of all the various activities in a company's value chain define the company's internal cost structure. Further, the cost of each activity contributes to whether the company's overall cost position relative to rivals is favorable or unfavorable. But a company's own internal costs are insufficient to

assess whether its costs are competitive with those of rivals. Cost and price differences among competing companies can have their origins in activities performed by suppliers or by distribution allies involved in getting the product to the final customer or end user of the product, in which case the company's entire value chain system becomes relevant.

The Value Chain System for an Entire Industry

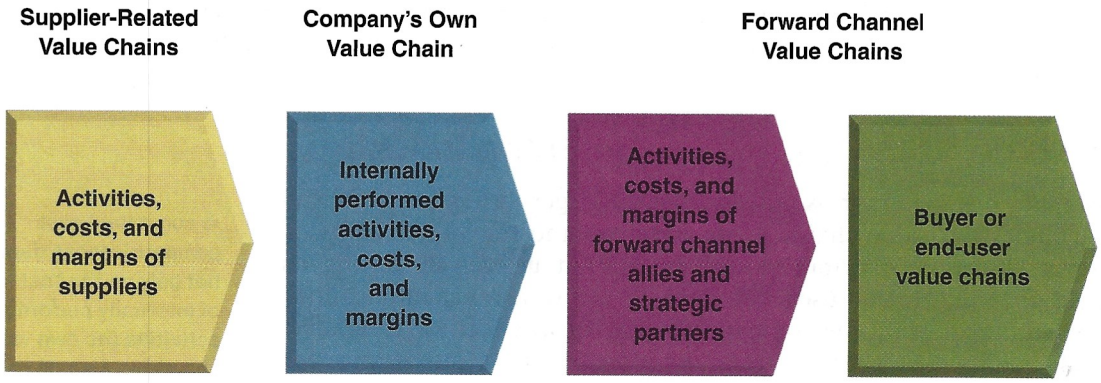
A company's cost competitiveness depends not only on the costs of internally performed activities (its own value chain) but also on costs in the value chains of its suppliers and distribution channel allies.

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. This *value chain system* has implications that extend far beyond the company's costs. It can affect attributes like product quality that enhance differentiation and have importance for the company's customer value proposition as well as its profitability.[16] Suppliers' value chains are relevant because suppliers perform activities and incur costs in creating and delivering the purchased inputs utilized in a company's own value-creating activities. The costs, performance features, and quality of these inputs influence a company's own costs and product differentiation capabilities. Anything a company can do to help its suppliers' drive down the costs of their value chain activities or improve the quality and performance of the items being supplied can enhance its own competitiveness—a powerful reason for working collaboratively with suppliers in managing supply chain activities.[17]

Similarly, the value chains of a company's distribution channel partners are relevant because (1) the costs and margins of a company's distributors and retail dealers are part of the price the ultimate consumer pays and (2) the activities that distribution allies perform affect sales volumes and customer satisfaction. For these reasons, companies normally work closely with their distribution allies (who are their direct customers) to perform value chain activities in mutually beneficial ways. For instance, motor vehicle manufacturers have a competitive interest in working closely with their automobile dealers to promote higher sales volumes and better customer satisfaction with dealers' repair and maintenance services. Producers of bathroom fixtures are heavily dependent on the sales and promotional activities of their distributors and building supply retailers and on whether distributors/retailers operate cost-effectively enough to be able to sell at prices that lead to attractive sales volumes.

As a consequence, *accurately assessing a company's competitiveness entails scrutinizing the nature and costs of value chain activities throughout the entire value chain system for delivering its products or services to end-use customers.* A typical industry value chain system that incorporates the value chains of suppliers and forward channel allies (if any) is shown in Figure 4.4. As was the case with company value chains, the specific activities constituting industry value chains also vary significantly. The primary value chain system activities in the pulp and paper industry (timber farming, logging, pulp mills, and papermaking) differ from the primary value chain system activities in the home appliance industry (parts and components manufacture, assembly, wholesale distribution, retail sales). The value chain system in the soft-drink industry (syrup manufacture, bottling and can filling, wholesale distribution, advertising, and retail merchandising) differs from that in the computer software industry (programming, disk loading, marketing, distribution).

Figure 4.4 Representative Value Chain System for an Entire Industry



Source: Based in part on the single-industry value chain displayed in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), p. 35.

Benchmarking: A Tool for Assessing Whether the Costs and Effectiveness of a Company's Value Chain Activities Are in Line

Once a company has developed good estimates for the costs and effectiveness of each of the major activities in its own value chain and has sufficient data relating to the value chain activities of suppliers and distribution allies, then it is ready to explore how it compares on these dimensions with key rivals. This is where benchmarking comes in. **Benchmarking** entails comparing how different companies perform various value chain activities—how inventories are managed, how products are assembled, how fast the company can get new products to market, how customer orders are filled and shipped—and then making cross-company comparisons of the costs and effectiveness of these activities.[18] The objectives of benchmarking are to identify the best practices in performing an activity, to learn how other companies have actually achieved lower costs or better results in performing benchmarked activities, and to take action to improve a company's competitiveness whenever benchmarking reveals that its costs and results of performing an activity are not on a par with what other companies have achieved.

CORE CONCEPT

Benchmarking is a potent tool for improving a company's own internal activities that is based on learning how other companies perform them and borrowing their "best practices."

Xerox became one of the first companies to use benchmarking in 1979 when Japanese manufacturers began selling midsize copiers in the United States for $9,600 each—less than Xerox's production costs.[19] Xerox management suspected its Japanese competitors were dumping, but it sent a team of line managers to Japan, including the head of manufacturing, to study competitors' business processes and costs. With the aid of Xerox's joint venture partner in Japan, Fuji-Xerox, which knew the competitors well, the team found that Xerox's costs were excessive due to gross inefficiencies in the company's manufacturing processes and business practices. The findings triggered a major internal effort at Xerox to become cost-competitive and prompted Xerox to begin benchmarking 67 of its key work processes against companies identified as employing the best

practices. Xerox quickly decided not to restrict its benchmarking efforts to its office equipment rivals but to extend them to any company regarded as "world class" in performing *any activity* relevant to Xerox's business. Other companies quickly picked up on Xerox's approach. Toyota managers got their idea for just-in-time inventory deliveries by studying how U.S. supermarkets replenished their shelves. Southwest Airlines reduced the turnaround time of its aircraft at each scheduled stop by studying pit crews on the auto racing circuit. Over 80 percent of Fortune 500 companies reportedly use benchmarking for comparing themselves against rivals on cost and other competitively important measures.

The tough part of benchmarking is not whether to do it but rather how to gain access to information about other companies' practices and costs. Sometimes benchmarking can be accomplished by collecting information from published reports, trade groups, and industry research firms or by talking to knowledgeable industry analysts, customers, and suppliers. Sometimes field trips to the facilities of competing or noncompeting companies can be arranged to observe how things are done, ask questions, compare practices and processes, and perhaps exchange data on productivity, staffing levels, time requirements, and other cost components—but the problem here is that such companies, even if they agree to host facilities tours and answer questions, are unlikely to share competitively sensitive cost information. Furthermore, comparing one company's costs to another's costs may not involve comparing apples to apples if the two companies employ different cost accounting principles to calculate the costs of particular activities.

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

However, a third and fairly reliable source of benchmarking information has emerged. The explosive interest of companies in benchmarking costs and best practices has prompted numerous consulting firms and business organizations (e.g., Accenture, A.T. Kearney, Benchnet—The Benchmarking Exchange, Best Practices LLC, and the Strategic Planning Institute's Council on Benchmarking and Best Practices, LLC) to gather benchmarking data, distribute information about best practices, and provide comparative cost data without identifying the names of particular companies. Having an independent group gather the information and report it in a manner that disguises the names of individual companies protects competitively sensitive data and lessens the potential for unethical behavior on the part of company personnel in gathering their own data about competitors. Illustration Capsule 4.2 presents a widely recommended code of conduct for engaging in benchmarking.

Strategic Options for Remedying a Disadvantage in Costs or Effectiveness

Examining the costs of a company's own value chain activities and comparing them to rivals' indicates who has how much of a cost advantage or disadvantage and which cost components are responsible. Similarly, much can be learned by comparisons at the activity level of how effectively a company delivers on its value proposition relative to its competitors and which elements in its value chain system are responsible. Such information is vital in strategic actions to eliminate a cost disadvantage, deliver more customer value, enhance differentiation, and improve profitability. Such information can also help a company to recognize and reinforce activities in which it has a comparative advantage and to find

ILLUSTRATION CAPSULE 4.2

Benchmarking and Ethical Conduct

Because discussions between benchmarking partners can involve competitively sensitive data, conceivably raising questions about possible restraint of trade or improper business conduct, many benchmarking organizations urge all individuals and organizations involved in benchmarking to abide by a code of conduct grounded in ethical business behavior. One of the most widely used codes of conduct is the one developed by APQC (formerly the American Productivity and Quality Center) and advocated by the Qualserve Benchmarking Clearinghouse; it is based on the following principles and guidelines:

- Avoid discussions or actions that could lead to or imply an interest in restraint of trade, market and/or customer allocation schemes, price fixing, dealing arrangements, bid rigging, or bribery. Don't discuss costs with competitors if costs are an element of pricing.
- Refrain from the acquisition of trade secrets from another by any means that could be interpreted as improper, including the breach of any duty to maintain secrecy. Do not disclose or use any trade secret that may have been obtained through improper means or that was disclosed by another in violation of duty to maintain its secrecy or limit its use.
- Be willing to provide to your benchmarking partner the same type and level of information that you request from that partner.
- Communicate fully and early in the relationship to clarify expectations, avoid misunderstanding, and establish mutual interest in the benchmarking exchange.
- Be honest and complete with the information submitted.
- The use or communication of a benchmarki partner's name with the data obtained or pra tices observed requires the prior permission the benchmarking partner.
- Honor the wishes of benchmarking partne regarding how the information that is provid will be handled and used.
- In benchmarking with competitors, establi specific ground rules up front. For example, "\ don't want to talk about things that will g either of us a competitive advantage, but ratl we want to see where we both can mutua improve or gain benefit."
- Check with legal counsel if any informatic gathering procedure is in doubt. If uncomfortab do not proceed. Alternatively, negotiate and si a specific nondisclosure agreement that v satisfy the attorneys representing each partne
- Do not ask competitors for sensitive data cause benchmarking partners to feel they mu provide data to continue the process.
- Use an ethical third party to assemble a "blind" competitive data, with inputs from leg counsel in direct competitor sharing. (Not When cost is closely linked to price, sharii cost data can be considered to be the same a sharing price data.)
- Any information obtained from a benchmarkir partner should be treated as internal, privilege communications. If "confidential" or propr etary material is to be exchanged, then a spe cific agreement should be executed to specif the content of the material that needs to b protected, the duration of the period of protec tion, the conditions for permitting access to th material, and the specific handling requirement necessary for that material.

Sources: APQC, www.apqc.org; Qualserve Benchmarking Clearinghouse, www.awwa.org (accessed October 8, 2010).

new avenues for enhancing its competitiveness through lower costs, greater differentiation, or a more attractive customer value proposition. There are three main areas in a company's total value chain system where company managers can try to improve its efficiency and effectiveness: (1) a company's own activity segments, (2) suppliers' part of the overall value chain, and (3) the distribution channel portion of the chain.

Improving the Efficiency and Effectiveness of Internally Performed Value Chain Activities Managers can pursue any of several strategic approaches to reduce the costs of internally performed value chain activities and improve a company's cost competitiveness:[20]

1. Implement the use of best practices throughout the company, particularly for high-cost activities.
2. Redesign the product and/or some of its components to eliminate high-cost components or facilitate speedier and more economical manufacture or assembly—computer chip makers regularly design around the patents held by others to avoid paying royalties; automakers have substituted lower-cost plastic and rubber for metal at many exterior body locations.
3. Relocate high-cost activities (such as manufacturing) to geographic areas like Southeast Asia or Latin America or eastern Europe where they can be performed more cheaply.
4. See if certain internally performed activities can be outsourced from vendors or performed by contractors more cheaply than they can be done in-house.
5. Shift to lower-cost technologies and/or invest in productivity-enhancing, cost-saving technological improvements (robotics, flexible manufacturing techniques, state-of-the-art information systems).
6. Stop performing activities that add little or no customer value. Examples include seldom-used customer services, employee training programs that are of marginal value, and maintaining large raw-material or finished-goods inventories.

How successfully a company competes depends on more than low costs. It also depends on how effectively it delivers value to the customer and on its ability to differentiate itself from rivals. To improve the effectiveness of its customer value proposition and enhance differentiation, there are several approaches a manager can take:[21]

1. Implement the use of best practices for quality throughout the company, particularly for high-value activities (those that are important for creating value for the customer).
2. Adopt best practices and technologies that spur innovation, improve design, and enhance creativity.
3. Implement the use of best practices in providing customer service.
4. Reallocate resources to devote more to activities that will have the biggest impact on the value delivered to the customer and that address buyers' most important purchase criteria.
5. For intermediate buyers (distributors or retailers, for example), gain an understanding of how the activities the company performs impact the buyer's value chain. Improve the effectiveness of company activities that have the greatest impact on the efficiency or effectiveness of the buyer's value chain.
6. Adopt best practices for signaling the value of the product and for enhancing customer perceptions.

Improving the Efficiency and Effectiveness of Supplier-Related Value Chain Activities Improving the efficiency and effectiveness of the value chain activities of suppliers can also address a company's competitive weaknesses with respect to costs and differentiation. On the cost side, a company can gain savings in suppliers' part of the overall value chain by

pressuring suppliers for lower prices, switching to lower-priced substitute inputs, and collaborating closely with suppliers to identify mutual cost-saving opportunities.[22] For example, just-in-time deliveries from suppliers can lower a company's inventory and internal logistics costs and may also allow suppliers to economize on their warehousing, shipping, and production scheduling costs—a win-win outcome for both. In a few instances, companies may find that it is cheaper to integrate backward into the business of high-cost suppliers and make the item in-house instead of buying it from outsiders.

Similarly, a company can enhance its differentiation by working with or through its suppliers to do so. Some methods include selecting and retaining suppliers who meet higher-quality standards, coordinating with suppliers to enhance design or other features desired by customers, providing incentives to encourage suppliers to meet higher-quality standards, and assisting suppliers in their efforts to improve. Fewer defects in parts from suppliers not only improve quality and enhance differentiation throughout the value chain system but can lower costs as well since there is less waste and disruption to the production processes.

Improving the Efficiency and Effectiveness of Distribution-Related Value Chain Activities Taking actions aimed at improvements with respect to the forward or downstream portion of the value chain system can also help to remedy a company's competitive disadvantage with respect to either costs or differentiation. Any of three means can be used to achieve better cost competitiveness in the forward portion of the industry value chain: (1) Pressure distributors, dealers, and other forward channel allies to reduce their costs and markups so as to make the final price to buyers more competitive with the prices of rivals; (2) collaborate with forward channel allies to identify win-win opportunities to reduce costs—a chocolate manufacturer, for example, learned that by shipping its bulk chocolate in liquid form in tank cars instead of as 10-pound molded bars, it could not only save its candy-bar manufacturing customers the costs associated with unpacking and melting but also eliminate its own costs of molding bars and packing them; and (3) change to a more economical distribution strategy, including switching to cheaper distribution channels (perhaps direct sales via the Internet) or perhaps integrating forward into company-owned retail outlets.

The means to enhance differentiation through activities at the forward end of the value chain system include (1) engaging in cooperative advertising and promotions with forward allies (dealers, distributors, retailers, etc.), (2) creating exclusive arrangements with downstream sellers or other mechanisms that increase their incentives to enhance delivered customer value, and (3) creating and enforcing standards for downstream activities and assisting in training channel partners in business practices. Harley-Davidson, for example, enhances the shopping experience and perceptions of buyers by selling through retailers that sell Harley-Davidson motorcycles exclusively and meet Harley-Davidson standards.

Translating Proficient Performance of Value Chain Activities into Competitive Advantage

Value chain analysis and benchmarking are not only useful for identifying and remedying competitive disadvantages; they can also be used to uncover and strengthen competitive advantages. A company's value-creating activities can offer a competitive advantage in one of two ways: (1) They can contribute to

greater efficiency and lower costs relative to competitors, or (2) they can provide a basis for differentiation, so customers are willing to pay relatively more for the company's goods and services. A company that does a *first-rate job* of managing its value chain activities *relative to competitors* stands a good chance of profiting from its competitive advantage.

Achieving a cost-based competitive advantage requires determined management efforts to be cost-efficient in performing value chain activities. Such efforts have to be ongoing and persistent, and they have to involve each and every value chain activity. The goal must be continuous cost reduction, not a one-time or on-again–off-again effort. Companies whose managers are truly committed to low-cost performance of value chain activities and succeed in engaging company personnel to discover innovative ways to drive costs out of the business have a real chance of gaining a durable low-cost edge over rivals. It is not as easy as it seems to imitate a company's low-cost practices. Companies like Dollar General, Nucor Steel, Irish airline Ryanair, Greyhound Lines, and French discount retailer Carrefour have been highly successful in managing their values chains in a low-cost manner.

Ongoing and persistent efforts are also required for a competitive advantage based on differentiation. Superior reputations and brands are built up slowly over time, through continuous investment and activities that deliver consistent, reinforcing messages. Differentiation based on quality requires vigilant management of activities for quality assurance throughout the value chain. While the basis for differentiation (e.g., status, design, innovation, customer service, reliability, image) may vary widely among companies pursuing a differentiation advantage, companies that succeed do so on the basis of a commitment to coordinated value chain activities aimed purposefully at this objective. Examples include Grey Goose Vodka (status), IKEA (design), FedEx (reliability), 3M (innovation), Body Shop (image), and Nordstrom (customer service).

How Activities Relate to Resources and Capabilities There is a close relationship between the value-creating activities that a company performs and its resources and capabilities. An organizational capability or competence implies a *capacity* for action; in contrast, a value-creating activity *is* the action. With respect to resources and capabilities, activities are "where the rubber hits the road." When companies engage in a value-creating activity, they do so by drawing on specific company resources and capabilities that underlie and enable the activity. For example, brand-building activities depend on human resources, such as experienced brand managers (including their knowledge and expertise in this arena), as well as organizational capabilities in advertising and marketing. Cost-cutting activities may derive from organizational capabilities in inventory management, for example, and resources such as inventory tracking systems.

Because of this correspondence between activities and supporting resources and capabilities, value chain analysis can complement resource and capability analysis as tools for assessing a company's competitive advantage. Resources and capabilities that are *both valuable and rare* provide a company with *what it takes* for competitive advantage. For a company with competitive assets of this sort, the potential is there. When these assets are deployed in the form of a value-creating activity, that potential is realized due to their competitive superiority. Resource analysis is one tool for identifying competitively superior resources and capabilities. But their value and the competitive superiority of that value

can only be assessed objectively *after* they are deployed. Value chain analysis and benchmarking provide the type of data needed to make that objective assessment.

There is also a dynamic relationship between a company's activities and its resources and capabilities. Value-creating activities are more than just the embodiment of a resource's or capability's potential. They also contribute to the formation and development of capabilities. The road to competitive advantage begins with management efforts to build organizational expertise in performing certain competitively important value chain activities. With consistent practice and continuous investment of company resources, these activities rise to the level of a reliable organizational capability or a competence. To the extent that top management makes the growing capability a cornerstone of the company's strategy, this capability becomes a core competence for the company. Later, with further organizational learning and gains in proficiency, the core competence may evolve into a distinctive competence, giving the company superiority over rivals in performing an important value chain activity. Such superiority, if it gives the company significant competitive clout in the marketplace, can produce an attractive competitive edge over rivals. Whether the resulting competitive advantage is on the cost side or on the differentiation side (or both) will depend on the company's choice of which types of competence-building activities to engage in over this time period, as shown in Figure 4.5.

Performing value chain activities in ways that give a company the capabilities to either outmatch rivals on differentiation or beat them on costs will help the company to secure a competitive advantage.

QUESTION 5: IS THE COMPANY COMPETITIVELY STRONGER OR WEAKER THAN KEY RIVALS?

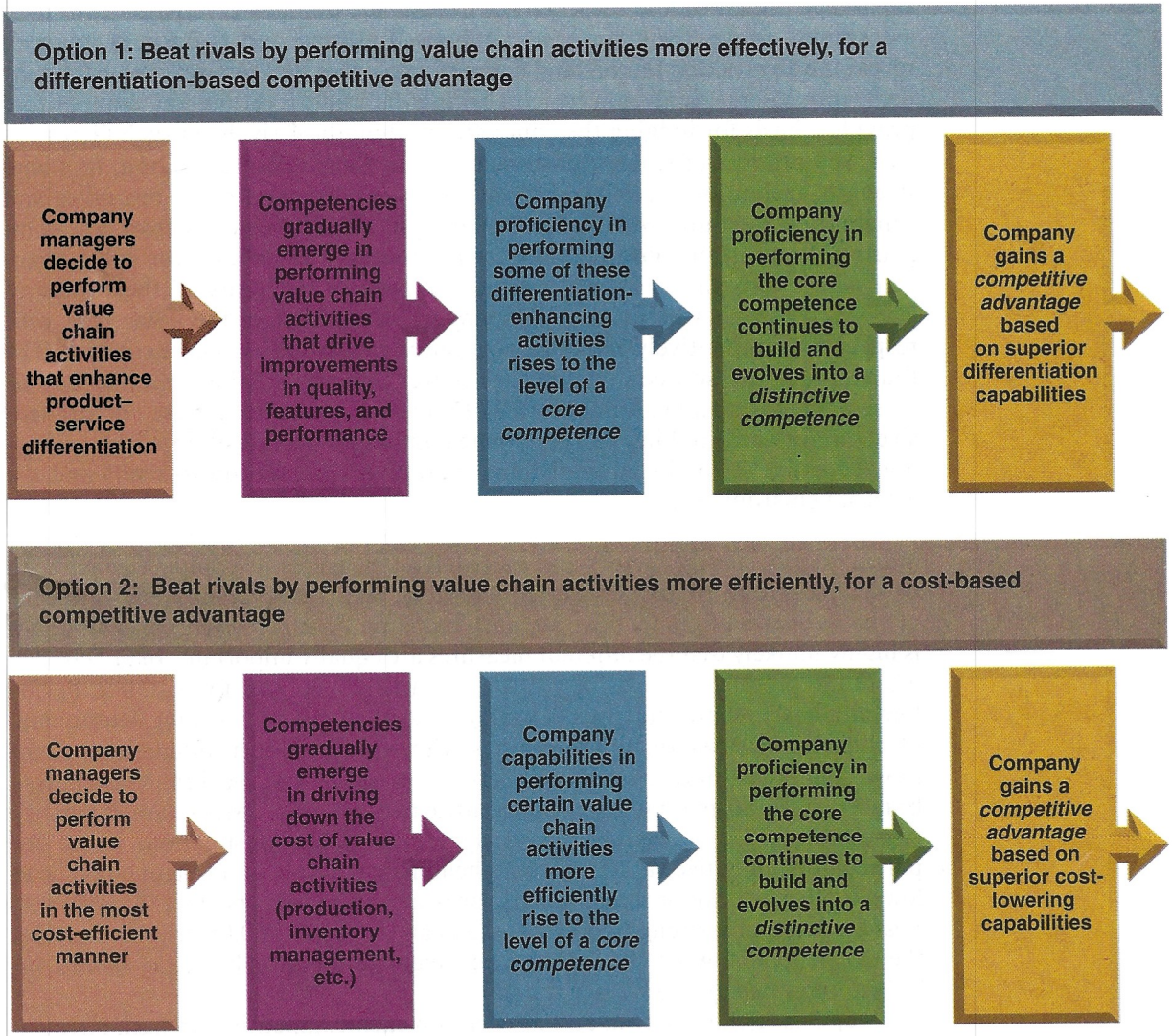
LO 5

Understand how a comprehensive evaluation of a company's competitive situation can assist managers in making critical decisions about their next strategic moves.

Resource and capability analysis together with value chain analysis and benchmarking will reveal whether a company has a competitive advantage over rivals on the basis of *individual* resources, capabilities, and activities. These tools can also be used to assess the competitive advantage attributable to a *bundle* of resources and capabilities. Resource bundles can sometimes pass the four tests of a resource's competitive power even when the individual components of the resource bundle cannot. For example, although Callaway Golf Company's engineering capabilities and market research capabilities are matched relatively well by rivals Cobra Golf and Ping Golf, the company's bundling of resources used in its product development process (including cross-functional development systems, technological capabilities, knowledge of consumer preferences, and a collaborative organizational culture) gives it a competitive advantage that has allowed it to remain the largest seller of golf equipment for more than a decade.

Resource analysis and value chain/benchmarking analysis of the company's resources, capabilities, and activities (both as individual entities and as bundles) are necessary for determining whether the company is competitively stronger or weaker than key rivals. But they are not sufficient for gaining a complete picture

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



of a company's competitive situation. A more comprehensive assessment needs to be made of the company's *overall* competitive strengths and weaknesses since a competitive advantage along one part of its value chain can be overwhelmed by competitive disadvantages along other parts of the chain. In making an overall assessment of a company's competitiveness, the answers to two questions are of particular interest: First, how does the company rank relative to competitors on each of the important factors that determine market success? Second, all things considered, does the company have a *net* competitive advantage or disadvantage versus major competitors?

An easy-to-use method for answering these two questions involves developing quantitative strength ratings for the company and its key competitors on each industry key success factor and each competitively pivotal resource and capability. Much of the information needed for doing a competitive strength assessment comes from previous analyses. Industry and five-forces analyses reveal the key success factors and competitive forces that separate industry winners from losers. Analyzing benchmarking data and scouting key competitors provide a basis for judging the competitive strength of rivals on such factors as cost, key product attributes, customer service, image and reputation, financial strength, technological skills, distribution capability, and other resources and capabilities. Resource and capability analysis reveals which factors are competitively important, given the external situation. Together with value chain analysis, it also shines a light on the competitive strengths of the company. That is, it reveals whether the company or its rivals have the advantage with respect to competitively important resources, capabilities, and activities. The four tests of a resource's competitive power indicate, further, whether any of these advantages are sustainable. SWOT analysis provides a more comprehensive and forward-looking picture of the company's overall situation by surveying the entire set of its strengths and weaknesses in relation to rivals and the external environment.

Step 1 in doing a competitive strength assessment is to make a list of the industry's key success factors and most telling measures of competitive strength or weakness (6 to 10 measures usually suffice). Step 2 is to assign weights to each of the measures of competitive strength based on their perceived importance—it is highly unlikely that the different measures are equally important. In an industry where the products/services of rivals are virtually identical, for instance, having low unit costs relative to rivals is nearly always the most important determinant of competitive strength. In an industry with strong product differentiation, the most significant measures of competitive strength may be brand awareness, brand image and reputation, product attractiveness, and distribution capability. A weight could be as high as 0.75 (maybe even higher) in situations where one particular competitive variable is overwhelmingly decisive, or a weight could be as low as 0.20 when two or three strength measures are more important than the rest. Lesser competitive strength indicators can carry weights of 0.05 or 0.10. Whether the differences between the importance weights are big or little, *the sum of the weights must add up to 1.*

Step 3 is to rate the firm and its rivals on each competitive strength measure. Numerical rating scales (e.g., from 1 to 10) are best to use, although ratings of stronger (+), weaker (–), and about equal (=) may be appropriate when information is scanty and assigning numerical scores conveys false precision. Step 4 is to multiply each strength rating by its importance weight to obtain weighted strength scores (a strength rating of 4 times a weight of 0.20 gives a weighted strength score of 0.80). Step 5 is to sum the weighted scores on each measure to get overall weighted competitive strength ratings for each company. Step 6 is to use the overall strength ratings to draw conclusions about the size and extent of the company's net competitive advantage or disadvantage and to take specific note of areas of strength and weakness.

Table 4.4 provides an example of competitive strength assessment in which a hypothetical company (ABC Company) competes against two rivals. In the

Table 4.4 A Representative Weighted Competitive Strength Assessment

		Competitive Strength Assessment (Rating scale: 1 = very weak; 10 = very strong)					
		ABC Co.		Rival 1		Rival 2	
Key Success Factor/Strength Measure	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**						
Overall weighted competitive strength rating			**5.95**		**7.70**		**2.10**

example, relative cost is the most telling measure of competitive strength, and the other strength measures are of lesser importance. The company with the highest rating on a given measure has an implied competitive edge on that measure, with the size of its edge reflected in the difference between its weighted rating and rivals' weighted ratings. For instance, Rival 1's 3.00 weighted strength rating on relative cost signals a considerable cost advantage versus ABC Company (with a 1.50 weighted score on relative cost) and an even bigger cost advantage against Rival 2 (with a weighted score of 0.30). The measure-by-measure ratings reveal the competitive areas where a company is strongest and weakest, and against whom.

High weighted competitive strength ratings signal a strong competitive position and possession of competitive advantage; low ratings signal a weak position and competitive disadvantage.

The overall competitive strength scores indicate how all the different strength measures add up—whether the company is at a net overall competitive advantage or disadvantage against each rival. The higher a company's *overall weighted strength rating,* the stronger its *overall competitiveness* versus rivals. The bigger the difference between a company's overall weighted rating and the scores of *lower-rated* rivals, the greater is its implied *net competitive advantage.* Thus, Rival 1's overall weighted score of 7.70 indicates a greater net competitive advantage over Rival 2 (with a score of 2.10) than over ABC Company (with a score of 5.95). Conversely, the bigger the difference between a company's overall rating and the scores of *higher-rated* rivals, the greater its implied *net competitive disadvantage.* Rival 2's score of 2.10 gives it a smaller net competitive disadvantage against ABC Company (with an overall score of 5.95) than against Rival 1 (with an overall score of 7.70).

Strategic Implications of Competitive Strength Assessments

Competitive strength assessments provide useful conclusions about a company's competitive situation. The ratings show how a company compares against rivals, factor by factor (or capability by capability), thus revealing where it is strongest and weakest, and against whom. Moreover, the overall competitive strength score indicates how all the different factors add up—whether the company is at a net competitive advantage or disadvantage against each rival. The firm with the largest overall competitive strength rating enjoys the strongest competitive position, with the size of its net competitive advantage reflected by how much its score exceeds the scores of rivals.

In addition, the strength ratings provide guidelines for designing wise offensive and defensive strategies. For example, if ABC Co. wants to go on the offensive to win additional sales and market share, such an offensive probably needs to be aimed directly at winning customers away from Rival 2 (which has a lower overall strength score) rather than Rival 1 (which has a higher overall strength score). Moreover, while ABC has high ratings for technological skills (a 10 rating), dealer network/distribution capability (a 9 rating), new product innovation capability (a 9 rating), quality/product performance (an 8 rating), and reputation/image (an 8 rating), these strength measures have low importance weights—meaning that ABC has strengths in areas that don't translate into much competitive clout in the marketplace. Even so, it outclasses Rival 2 in all five areas, plus it enjoys substantially lower costs than Rival 2 (ABC has a 5 rating on relative cost position versus a 1 rating for Rival 2)—and relative cost position carries the highest importance weight of all the strength measures. ABC also has greater competitive strength than Rival 3 as concerns customer service capabilities (which carries the second-highest importance weight). Hence, because ABC's strengths are in the very areas where Rival 2 is weak, ABC is in a good position to attack Rival 2—it may well be able to persuade a number of Rival 2's customers to switch their purchases over to ABC's product.

A company's competitive strength scores pinpoint its strengths and weaknesses against rivals and point directly to the kinds of offensive/defensive actions it can use to exploit its competitive strengths and reduce its competitive vulnerabilities.

But ABC should be cautious about cutting price aggressively to win customers away from Rival 2, because Rival 1 could interpret that as an attack by ABC to win away Rival 1's customers as well. And Rival 1 is in far and away the best position to compete on the basis of low price, given its high rating on relative cost in an industry where low costs are competitively important (relative cost carries an importance weight of 0.30). Rival 1's very strong relative cost position vis-à-vis both ABC and Rival 2 arms it with the ability to use its lower-cost advantage to thwart any price cutting on ABC's part; clearly ABC is vulnerable to any retaliatory price cuts by Rival 1—Rival 1 can easily defeat both ABC and Rival 2 in a price-based battle for sales and market share. If ABC wants to defend against its vulnerability to potential price cutting by Rival 1, then it needs to aim a portion of its strategy at lowering its costs.

The point here is that a competitively astute company should utilize the strength scores in deciding what strategic moves to make—what strengths to exploit in winning business away from rivals, which rivals to attack, and which competitive weaknesses to try to correct. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

QUESTION 6: WHAT STRATEGIC ISSUES AND PROBLEMS MERIT FRONT-BURNER MANAGERIAL ATTENTION?

Zeroing in on the strategic issues a company faces and compiling a "worry list" of problems and roadblocks creates a strategic agenda of problems that merit prompt managerial attention.

The final and most important analytical step is to zero in on exactly what strategic issues company managers need to address—and resolve—for the company to be more financially and competitively successful in the years ahead. This step involves drawing on the results of both industry analysis and the evaluations of the company's own competitiveness. The task here is to get a clear fix on exactly what strategic and competitive challenges confront the company, which of the company's competitive shortcomings need fixing, what obstacles stand in the way of improving the company's competitive position in the marketplace, and what specific problems merit front-burner attention by company managers.

The "worry list" of issues and problems that have to be wrestled with can include such things as:

- *How* to stave off market challenges from new foreign competitors.
- *How* to combat the price discounting of rivals.
- *How* to reduce the company's high costs and pave the way for price reductions.
- *How* to sustain the company's present rate of growth in light of slowing buyer demand.
- *Whether* to expand the company's product line.
- *Whether* to correct the company's competitive deficiencies by acquiring a rival company with the missing strengths.
- *Whether* to expand into foreign markets rapidly or cautiously.
- *Whether* to reposition the company and move to a different strategic group.
- *What to do* about growing buyer interest in substitute products.
- *What to do* to combat the aging demographics of the company's customer base.

Actually deciding on a strategy and what specific actions to take is what comes *after* developing the list of strategic issues and problems that merit front-burner management attention.

The worry list thus always centers on such concerns as "how to … ," "what to do about … ," and "whether to… ." The purpose of the worry list is to identify the specific issues/problems that management needs to address, not to figure out what specific actions to take. Deciding what to do—which strategic actions to take and which strategic moves to take—comes later (when it is time to craft the strategy and choose among the various strategic alternatives).

A good strategy must contain ways to deal with all the strategic issues and obstacles that stand in the way of the company's financial and competitive success in the years ahead.

If the items on the worry list are relatively minor—which suggests that the company's strategy is mostly on track and reasonably well matched to the company's overall situation, company managers seldom need to go much beyond fine-tuning the present strategy. If, however, the issues and problems confronting the company are serious and indicate the present strategy is not well suited for the road ahead, the task of crafting a better strategy has got to go to the top of management's action agenda.

KEY POINTS

There are six key questions to consider in evaluating a company's ability to compete successfully against market rivals:

1. *How well is the present strategy working?* This involves evaluating the strategy from a qualitative standpoint (completeness, internal consistency, rationale, and suitability to the situation) and also from a quantitative standpoint (the strategic and financial results the strategy is producing). The stronger a company's current overall performance, the less likely the need for radical strategy changes. The weaker a company's performance and/or the faster the changes in its external situation (which can be gleaned from industry and competitive forces analysis), the more its current strategy must be questioned.
2. *Do the company's resources and capabilities have sufficient competitive power to give it a sustainable advantage over competitors?* The answer to this question comes from conducting the four tests of a resource's competitive power. If a company has resources and capabilities that are competitively valuable and rare, the firm will have a competitive advantage over market rivals. If its resources and capabilities are also hard to copy, with no good substitutes, then the firm may be able to sustain this advantage even in the face of active efforts by rivals to overcome it.
3. *Is the company able to seize market opportunities and overcome external threats to its future well-being?* The answer to this question comes from performing a SWOT analysis. The two most important parts of SWOT analysis are (1) drawing conclusions about what story the compilation of strengths, weaknesses, opportunities, and threats tells about the company's overall situation and (2) acting on the conclusions to better match the company's strategy to its internal strengths and market opportunities, to correct the important internal weaknesses, and to defend against external threats. A company's strengths and competitive assets are strategically relevant because they are the most logical and appealing building blocks for strategy; internal weaknesses are important because they may represent vulnerabilities that need correction. External opportunities and threats come into play because a good strategy necessarily aims at capturing a company's most attractive opportunities and at defending against threats to its well-being.
4. *Are the company's prices, costs, and value proposition competitive?* One telling sign of whether a company's situation is strong or precarious is whether its prices and costs are competitive with those of industry rivals. Another sign is how it compares with rivals in terms of differentiation—how effectively it delivers on its customer value proposition. Value chain analysis and benchmarking are essential tools in determining whether the company is performing particular functions and activities efficiently and effectively, learning whether its costs are in line with competitors, whether it is differentiating in ways that really enhance customer value, and deciding which internal activities and business processes need to be scrutinized for improvement. They complement resource and capability analysis by providing data at the level of individual activities that provides more objective evidence of whether individual resources and capabilities, or bundles of resources and linked activity sets, are competitively superior.

5. *On an overall basis, is the company competitively stronger or weaker than key rivals?* The key appraisals here involve how the company matches up against key rivals on industry key success factors and other chief determinants of competitive success and whether and why the company has a *net* competitive advantage or disadvantage. Quantitative competitive strength assessments, using the method presented in Table 4.4, indicate where a company is competitively strong and weak and provide insight into the company's ability to defend or enhance its market position. As a rule, a company's competitive strategy should be built around its competitive strengths and should aim at shoring up areas where it is competitively vulnerable. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.
6. *What strategic issues and problems merit front-burner managerial attention?* This analytical step zeros in on the strategic issues and problems that stand in the way of the company's success. It involves using the results of industry analysis as well as resource and value chain analysis of the company's competitive situation to identify a "worry list" of issues to be resolved for the company to be financially and competitively successful in the years ahead. The worry list always centers on such concerns as "how to … ," "what to do about … ," and "whether to … "—the purpose of the worry list is to identify the specific issues/problems that management needs to address. Actually deciding on a strategy and what specific actions to take is what comes after the list of strategic issues and problems that merit front-burner management attention is developed.

Solid analysis of the company's competitive situation vis-à-vis its key rivals, like good industry analysis, is a valuable precondition for good strategy making. A competently done evaluation of a company's resources, capabilities, and competitive strengths exposes strong and weak points in the present strategy and how attractive or unattractive the company's competitive position is and why. Managers need such understanding to craft a strategy that is well suited to the company's competitive circumstances.

ASSURANCE OF LEARNING EXERCISES

LO 2, LO 3, LO 4

1. Review the information in Illustration Capsule 4.1 concerning the average costs of producing and selling fair-trade coffee. Then answer the following questions:
   a. Companies that do not sell fair-trade coffee can buy coffee direct from small farmers for as little as $0.75 per pound. By paying substandard wages, they can also reduce their labor costs of roasting and bagging coffee to $0.70 per pound and reduce their overhead by 20 percent. If they sell their coffee at the same average price as Just Coffee, what would their profit margin be and how would this compare to Just Coffee's?

b. How can Just Coffee respond to this type of competitive threat? Does it have any valuable competitive assets that can help it respond, or will it need to acquire new ones. Would your answer change the company's value chain in any way?

LO 1

2. Using the information in Table 4.1 and the financial statement information for Avon Products below, calculate the following ratios for Avon for both 2008 and 2009:

a. Gross profit margin
b. Operating profit margin
c. Net profit margin.
d. Times interest earned coverage
e. Return on shareholders' equity
f. Return on assets
g. Debt-to-equity ratio
h. Days of inventory
i. Inventory turnover ratio
j. Average collection period

Based on these ratios, did Avon's financial performance improve, weaken, or remain about the same from 2008 to 2009?

Consolidated Statements of Income for Avon Products, Inc., 2008–2009 (in millions, except per-share data)

	Years ended December 31	
	2009	2008
Net sales	$10,284.7	$10,588.9
Other revenue	98.1	101.2
Total revenue	10,382.8	10,690.1
Costs, expenses, and other:		
Cost of sales	3,888.3	3,949.1
Selling, general and administrative expenses	5,476.3	5,401.7
Operating profit	1,018.2	1,339.3
Interest expense	104.8	100.4
Interest income	(20.2)	(37.1)
Other expense, net	7.1	37.7
Total other expenses	91.7	101.0
Income before taxes	926.5	1,238.3
Income taxes	298.3	362.7
Net income	628.2	875.6

(Continued)

	Years ended December 31	
	2009	2008
Net income attributable to noncontrolling interests	(2.4)	(.3)
Net income attributable to Avon	$ 625.8	$ 875.3
Earnings per share:		
Basic	$ 1.45	$ 2.04
Diluted	$ 1.45	$ 2.03

Consolidated Balance Sheets for Avon Products, Inc., 2008–2009 (in millions, except per-share data)

	As of Dec. 31, 2009	As of Dec. 31, 2008
Assets		
Cash and cash equivalents	$ 1,311.6	$ 1,104.7
Accounts receivable (less allowances of $165.5 and $127.9)	779.7	687.8
Inventories	1,067.5	1,007.9
Prepaid expenses and other	1,030.5	756.5
Total current assets	4,189.3	3,556.9
Property, plant, and equipment, at cost		
Land	144.3	85.3
Buildings and improvements	1,048.1	1,008.1
Equipment	1,506.9	1,346.5
Total property, plant, and equipment, at cost	2,699.3	2,439.9
Less accumulated depreciation	(1,169.7)	(1,096.0)
Net property, plant, and equipment	1,529.6	1,343.9
Other assets	1,113.8	1,173.2
Total assets	$ 6,832.7	$ 6,074.0
Liabilities and Shareholders' Equity		
Debt maturing within 1 year	$ 138.1	$1,031.4
Accounts payable	754.7	724.3
Accrued compensation	291.0	234.4
Other accrued liabilities	697.1	581.9
Sales and taxes other than income	259.2	212.2
Income taxes	134.7	128.0
Total current liabilities	2,274.8	2,912.2
Long-term debt	2,307.8	1,456.2
Employee benefit plans	588.9	665.4
Long-term income taxes	173.8	168.9
Other liabilities	174.8	159.0
Total liabilities	$ 5,520.1	$ 5,361.7
Commitments and contingencies		

(Continued)

Shareholders' equity		
Common stock, par value $.25—authorized 1,500 shares; issued 740.9 and 739.4 shares	$ 186.1	$ 185.6
Additional paid-in capital	1,941.0	1,874.1
Retained earnings	4,383.9	4,118.9
Accumulated other comprehensive loss	(692.6)	(965.9)
Treasury stock, at cost (313.4 and 313.1 shares)	(4,545.8)	(4,537.8)
Total Avon shareholders' equity	1,272.6	674.9
Noncontrolling interest	40.0	37.4
Total shareholders' equity	$ 1,312.6	$ 712.3
Total liabilities and shareholders' equity	$ 6,832.7	$ 6,074.0

Source: Avon Products, Inc., 2009 10-K.

EXERCISES FOR SIMULATION PARTICIPANTS

LO 1

1. Using the formulas in Table 4.1 and the data in your company's latest financial statements, calculate the following measures of financial performance for your company:
   - **a.** Operating profit margin
   - **b.** Return on total assets
   - **c.** Current ratio
   - **d.** Working capital
   - **e.** Long-term debt-to-capital ratio
   - **f.** Price-earnings ratio

LO 1

2. On the basis of your company's latest financial statements and all the other available data regarding your company's performance that appear in the Industry Report, list the three measures of financial performance on which your company did "best" and the three measures on which your company's financial performance was "worst."

LO 1, LO 2, LO 3, LO 4, LO 5

3. What hard evidence can you cite that indicates your company's strategy is working fairly well (or perhaps not working so well, if your company's performance is lagging that of rival companies)?

LO 3

4. What internal strengths and weaknesses does your company have? What external market opportunities for growth and increased profitability exist for

your company? What external threats to your company's future well-being and profitability do you and your co-managers see? What does the preceding SWOT analysis indicate about your company's present situation and future prospects—where on the scale from "exceptionally strong" to "alarmingly weak" does the attractiveness of your company's situation rank?

LO 2, LO 3

5. Does your company have any core competencies? If so, what are they?

LO 4

6. What are the key elements of your company's value chain? Refer to Figure 4.3 in developing your answer.

LO 5

7. Using the methodology presented in Table 4.4, do a weighted competitive strength assessment for your company and two other companies that you and your co-managers consider to be very close competitors.

ENDNOTES

[1] In recent years, considerable research has been devoted to the role a company's resources and competitive capabilities play in determining its competitiveness, shaping its strategy, and impacting its profitability. Following the trailblazing article by Birger Wernerfelt, "A Resource-Based View of the Firm," *Strategic Management Journal* 5, no. 5 (September–October 1984), pp. 171–80, the findings and conclusions have merged into what is now referred to as the resource-based view of the firm. Other very important contributions include Jay Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17, no. 1 (1991), pp. 99–120; Margaret A. Peteraf, "The Cornerstones of Competitive Advantage: A Resource-Based View," *Strategic Management Journal* 14, no. 3 (March 1993), pp. 179–91; Birger Wernerfelt, "The Resource-Based View of the Firm: Ten Years After," *Strategic Management Journal* 16, no. 3 (March 1995), pp. 171–74. A full-blown overview of the resource-based view of the firm, in its most current form, is presented in Jay B. Barney and Delwyn N. Clark, *Resource-Based Theory: Creating and Sustaining Competitive Advantage* (New York: Oxford University Press, 2007).

[2] A more detailed explanation of the relationship between resources and capabilities can be found in R. Amit and P. Schoemaker, "Strategic Assets and Organizational Rent," *Strategic Management Journal* 14 (1993), pp. 33–46.

[3] See, for example, Jay B. Barney, "Looking Inside for Competitive Advantage," *Academy of Management Executive* 9, no. 4 (November 1995), pp. 49–61; Christopher A. Bartlett and Sumantra Ghoshal, "Building Competitive Advantage through People," *MIT Sloan Management Review* 43, no. 2 (Winter 2002), pp. 34–41; Danny Miller, Russell Eisenstat,and Nathaniel Foote, "Strategy from the Inside Out: Building Capability-Creating Organizations," *California Management Review* 44, no. 3 (Spring 2002), pp. 37–54.

[4] See Barney , "Firm Resources and Sustained Competitive Advantage," pp. 105–9; M. Peteraf and J. Barney, "Unraveling the Resource-Based Tangle," *Managerial and Decision Economics* 24, no. 4 (June–July 2003), pp. 309–23.

[5] See Amit and Schoemaker, Strategic Assets and Organizational Rent, for more on the power of strategic assets to improve a company's profitability.

[6] For a discussion of how to recognize powerful substitute resources, see Margaret A. Peteraf and Mark E. Bergen, "Scanning Dynamic Competitive Landscapes: A Market-Based and Resource-Based Framework," *Strategic Management Journal* 24 (2003), pp. 1027–42.

[7] See C. Montgomery, "Of Diamonds and Rust: A New Look at Resources," in C. Montgomery (ed.), *Resource-Based and Evolutionary Theories of the Firm* (Boston: Kluwer Academic, 1995), pp. 251–68.

[8] For a good discussion of what happens when a company's capabilities grow stale and obsolete, see D. Leonard-Barton, "Core Capabilities and Core Rigidities: A Paradox in Managing New Product Development," *Strategic Management Journal* 13 (Summer 1992), pp. 111–25; Montgomery, "Of Diamonds and Rust."

[9] The concept of dynamic capabilities was introduced by D. Teece, G. Pisano, and A. Shuen, "Dynamic Capabilities and Strategic Management," *Strategic Management Journal* 18, no. 7 (1997), pp. 509–33. Other important contributors to the concept include K. Eisenhardt and J. Martin, "Dynamic Capabilities: What Are They?" *Strategic Management Journal* 21, nos. 10–11 (2000), pp. 1105–21; M. Zollo and S. Winter, "Deliberate Learning and the Evolution of Dynamic Capabilities," *Organization Science* 13 (2002), pp. 339–51; C. Helfat et al., *Dynamic Capabilities: Understanding Strategic Change in Organizations* (Malden, MA: Blackwell, 2007).

[10] For a more extensive discussion of how to identify and evaluate the competitive power of a company's capabilities, see David W. Birchall and George Tovstiga, "The Strategic Potential of a Firm's Knowledge Portfolio," *Journal of General Management* 25, no. 1 (Autumn 1999), pp. 1–16; Nick Bontis, Nicola C. Dragonetti, Kristine Jacobsen, and Goran Roos, "The Knowledge Toolbox: A Review of the Tools Available to Measure and Manage Intangible Resources," *European Management Journal* 17, no. 4 (August 1999), pp. 391–401. Also see David Teece, "Capturing Value from Knowledge Assets: The New Economy, Markets for Know-How, and Intangible Assets," *California Management Review* 40, no. 3 (Spring 1998), pp. 55–79.

[11] Donald Sull, "Strategy as Active Waiting," *Harvard Business Review* 83, no. 9 (September 2005), pp. 121–22.

[12] Ibid., pp. 124–26.

[13] See M. Peteraf, "The Cornerstones of Competitive Advantage: A Resource-Based View," *Strategic Management Journal,* March 1993, pp. 179–91.

[14] The value chain concept was developed and articulated by Michael Porter in his 1985

best-seller, *Competitive Advantage* (New York: Free Press).

[15] For discussions of the accounting challenges in calculating the costs of value chain activities, see John K. Shank and Vijay Govindarajan, *Strategic Cost Management* (New York: Free Press, 1993), especially chaps. 2–6, 10, and 11; Robin Cooper and Robert S. Kaplan, "Measure Costs Right: Make the Right Decisions," *Harvard Business Review* 66, no. 5 (September–October 1988), pp. 96–103; Joseph A. Ness and Thomas G. Cucuzza, "Tapping the Full Potential of ABC," *Harvard Business Review* 73, no. 4 (July–August 1995), pp. 130–38.

[16] Porter, *Competitive Advantage,* p. 34.

[17] The strategic importance of effective supply chain management is discussed in Hau L. Lee, "The Triple-A Supply Chain," *Harvard Business Review* 82, no. 10 (October 2004), pp. 102–12.

[18] For more details, see Gregory H. Watson, *Strategic Benchmarking: How to Rate Your Company's Performance Against the World's Best* (New York: Wiley, 1993); Robert C. Camp, *Benchmarking: The Search for Industry Best Practices That Lead to Superior Performance* (Milwaukee: ASQC Quality Press, 1989); Dawn Iacobucci and Christie Nordhielm, "Creative Benchmarking," *Harvard Business Review* 78 no. 6 (November–December 2000), pp. 24–25.

[19] Jeremy Main, "How to Steal the Best Ideas Around," *Fortune,* October 19, 1992, pp. 102–3.

[20] Some of these options are discussed in more detail in Porter, *Competitive Advantage,* chap. 3.

[21] Porter discusses options such as these in *Competitive Advantage,* chap. 4.

[22] An example of how Whirlpool Corporation transformed its supply chain from a competitive liability to a competitive asset is discussed in Reuben E. Stone, "Leading a Supply Chain Turnaround," *Harvard Business Review* 82, no. 10 (October 2004), pp. 114–21.