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.

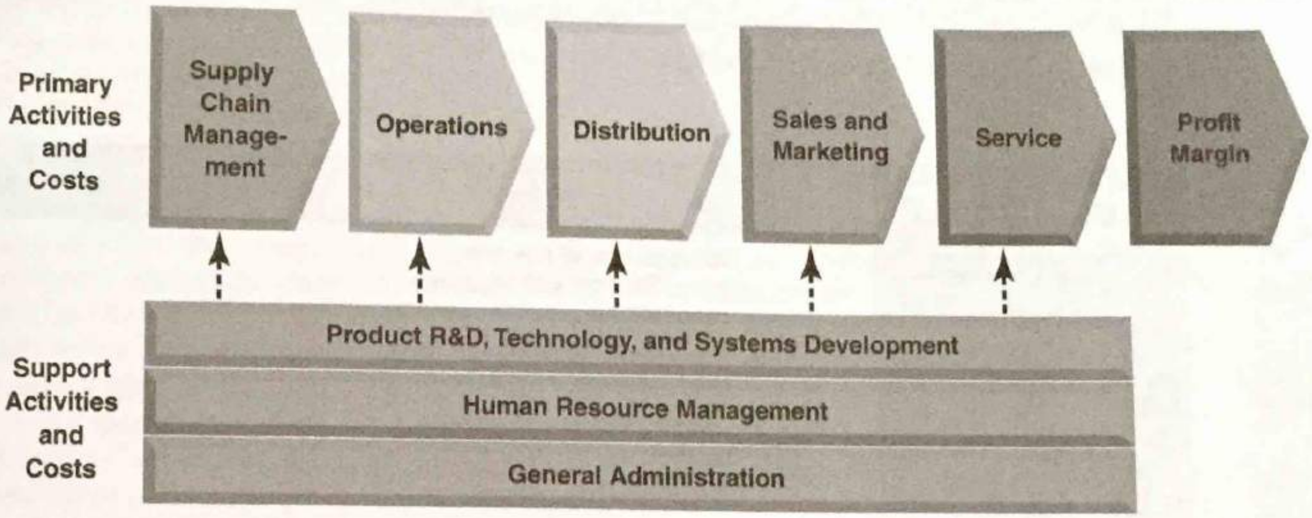
Illustration Capsule 4.1 shows representative costs for various activities performed by Just Coffee, a cooperative producer and roaster of fair-trade organic coffee.

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	$2.30
2. Import fees, storage costs, and freight charges	.73
3. Labor cost of roasting and bagging	.89
4. Cost of labels and bag	.45
5. Average overhead costs	3.03
6. Total company costs	$7.40
7. Average retail markup over company costs (company operating profit)	2.59
8. Average price to consumer at retail	$9.99

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

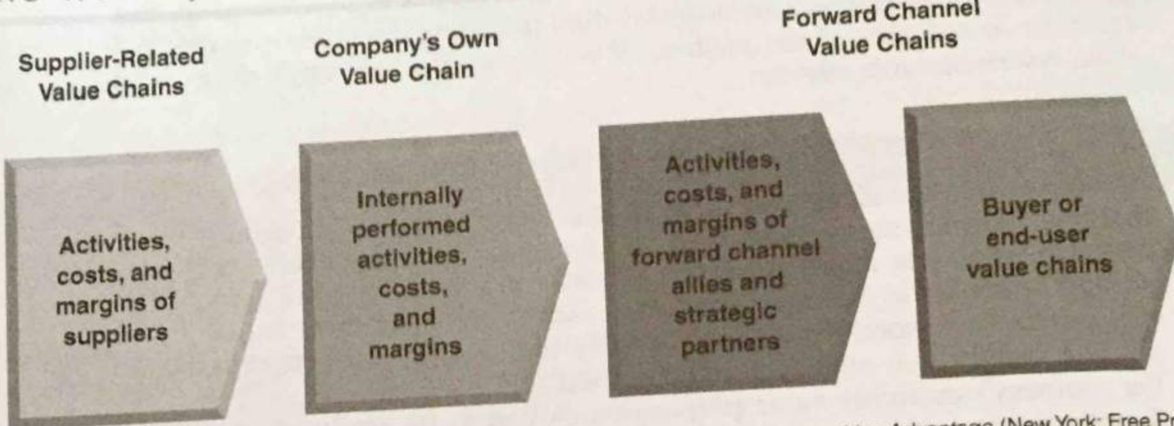
A company's value chain is embedded in a larger system of activities that includes the value chains of its suppliers and the value chains of whatever wholesale distributors and retailers it utilizes in getting its product or service to end users. This *value chain system* has implications that extend 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]

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.

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 benchmarking partner's name with the data obtained or practices observed requires the prior permission of the benchmarking partner.
- Honor the wishes of benchmarking partners regarding how the information that is provided will be handled and used.
- In benchmarking with competitors, establish specific ground rules up front. For example, "We don't want to talk about things that will give either of us a competitive advantage, but rather we want to see where we both can mutually improve or gain benefit."
- Check with legal counsel if any information-gathering procedure is in doubt. If uncomfortable, do not proceed. Alternatively, negotiate and sign a specific nondisclosure agreement that will satisfy the attorneys representing each partner.
- Do not ask competitors for sensitive data or cause benchmarking partners to feel they must provide data to continue the process.
- Use an ethical third party to assemble and "blind" competitive data, with inputs from legal counsel in direct competitor sharing. (Note: When cost is closely linked to price, sharing cost data can be considered to be the same as sharing price data.)
- Any information obtained from a benchmarking partner should be treated as internal, privileged communications. If "confidential" or proprietary material is to be exchanged, then a specific agreement should be executed to specify the content of the material that needs to be protected, the duration of the period of protection, the conditions for permitting access to the material, and the specific handling requirements 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.