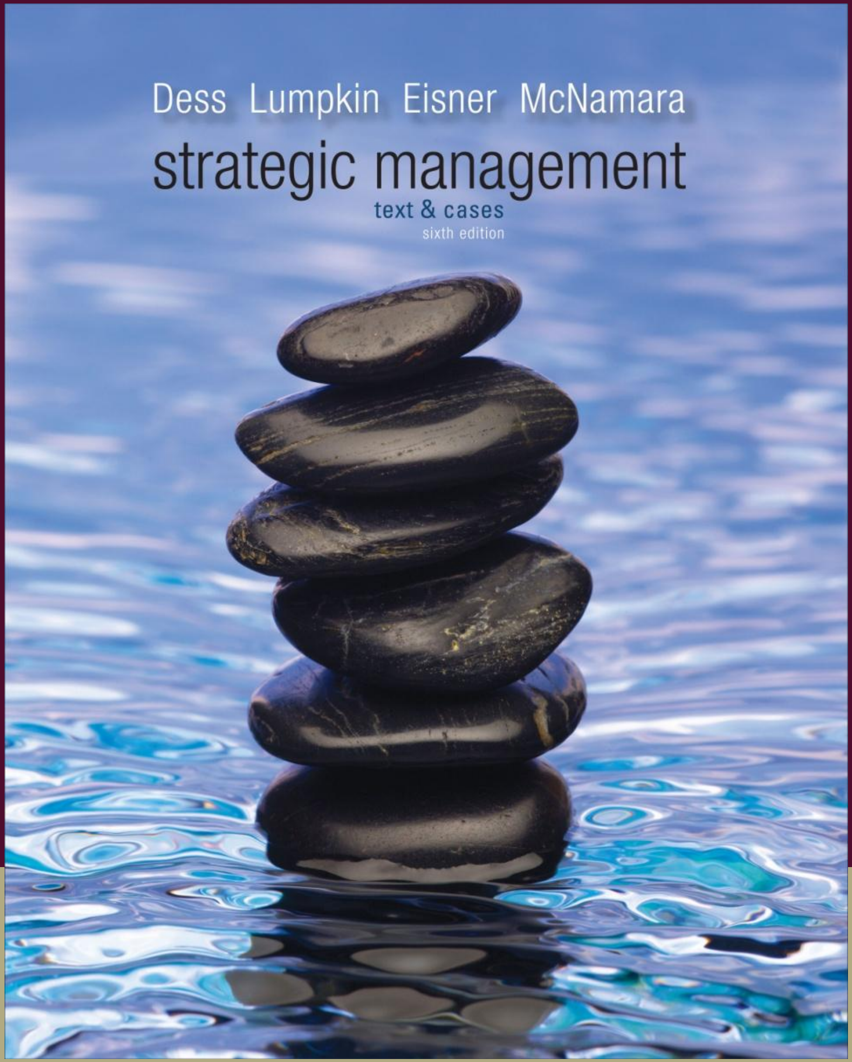
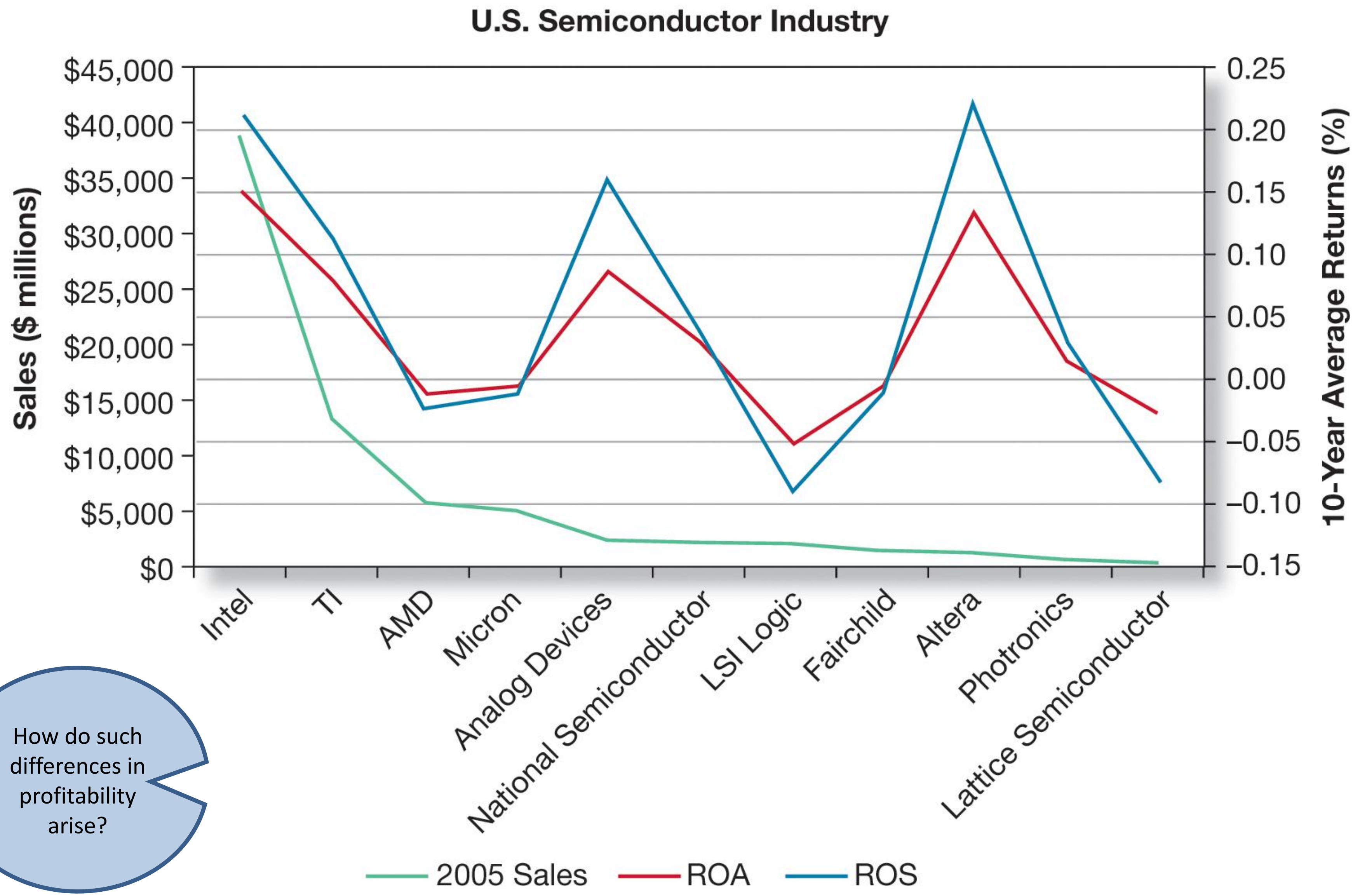


Assessing the Internal Environment of the Firm

Chapter Three



How do such differences in profitability arise?

Resource-Based View of the Firm

Why some firms outperform others?

- Endowment of strategic resources that are valuable, rare, costly to imitate, and costly to substitute.
- Determine the resources and capabilities that are likely sources of competitive advantage (internal and external focus)
  - Three key types of resources: Tangible, Intangible, and Organizational Capabilities
  - Central theme – *competitive advantages are created and sustained through the bundling of several of these resources to unique combinations*

Resource-Based View of the Firm

- **Tangible resources** – relatively easy to identify
  - Financial – firm's cash, accounts receivables
  - Physical – company's plant, equipment, and machinery
  - Technological
  - Organizational – company's strategic planning process, employee development

Resource-Based View of the Firm

- **Intangible resources** – embedded in unique routines and practices
  - Human – experience and capability of employees, trust and collaboration
  - Innovation and creativity – technical and scientific expertise
  - Reputation – brand name, reputation with suppliers/customers
- **What do firms such as BP and Toyota do when their intangible resource – reputation was damaged due to scandals?**

Resource-Based View of the Firm

- **Organizational capabilities** – competencies/skills that a firm employs to transform inputs into outputs
- Enable a firm to take full advantage of other resources it controls
  - Examples:
    - Outstanding customer service
    - Excellent product development capabilities
    - Ability to hire, motivate, and retain human capital
    - Marketing skill
    - Cooperative relationships

QUESTION

Gillette combines several technologies to attain unparalleled success in the wet shaving industry. This is an example of their

A. Tangible resources
B. Intangible resources
C. Organizational capabilities
D. Strong primary activities

Resource-Based View of the Firm

- Two Critical Assumptions of RBV:
  - Resource Heterogeneity:
    - different firms have different resources.
    - heterogeneity of resources typically occurs as a result of ‘bundling’ seemingly homogeneous resources of a firm and create uncommon resources or capabilities.
    - Result: competitive advantage!
  - Resource Immobility:
    - it may be costly for firms without certain resources to acquire or develop them
    - Although most resources seem *technically* mobile, in many cases it may not be economically viable to acquire them

Firm Resources and Sustainable Competitive Advantages

- **Four Key Attributes of Resources**
- Is the resource <u>valuable</u>?
  - Enable a firm to formulate and implement strategies that improve its efficiency or effectiveness
- Is the resource <u>rare</u>?
  - Common strategies based on similar resources give no one firm an advantage
  - Competitive advantages are gained only from uncommon resources

Firm Resources and Sustainable Competitive Advantages

- Can the resource be <u>imitated</u> easily?
  - Physical uniqueness (a beautiful resort)
  - Path dependency (first mover advantage)
  - Causal ambiguity
  - Social complexity (org. relationships & culture)

- Are <u>substitutes</u> readily available?
  - Similar resource(s)
  - Strategic substitutes

Criteria for sustainable competitive advantage and strategic implications

Is a resource or capability . . .				
Valuable	**Rare**	**Difficult to Imitate**	**Without Substitutes**	**Implications for Competitiveness**
No	No	No	No	Competitive disadvantage
Yes	No	No	No	Competitive parity
Yes	Yes	No	No	Temporary competitive advantage
Yes	Yes	Yes	Yes	Sustainable competitive advantage

Source: Adapted from Barney, J. B. 1991. Firm resources and sustained competitive advantage. *Journal of Management*, 17: 99–120.

	Putting Pfizer's Drug Patents up to the VRINE test	Answers
	Let's walk through the VRINE model as applied to Pfizer's patents for Zoloft (sertraline HCl), an antidepressant known as a selective serotonin reuptake inhibitor (SSRI). If you were studying Pfizer and the pharmaceutical industry using the VRINE model, you would probably identify a number of resources and capabilities that may be the source of competitive advantage. You would probably identify patents, R&D capabilities, and marketing as key resources and capabilities that drive the differentiator facet of its strategy.	
Value: Do Pfizer's two patents on Zoloft provide value?	In any given year, about 7 percent of the U.S. population (approximately 20 million people) will experience a depressive disorder. Approximately 16 percent of adults will experience depression at some point in their lives. Women are twice as likely as men to experience depression. Thus, it appears that having a patent for a treatment for depression would enable a pharmaceutical company to take advantage of a large market opportunity.	Yes
Rarity: Are they rare?	Pfizer's patents on Zoloft give it the exclusive right to use the chemical compound sertraline HCl to treat depression (the patents expired in June, 2006). When the patents expire, generic drug makers will be able to sell copied versions of the drug. The patents for Zoloft are definitely rare during the term of the patents, but will not be after they expire (assuming that several generic companies make the drug, its scarcity relative to demand will decline).	Yes, but not after they expire.
Inimitability?	Pfizer is certainly not the only large pharmaceutical company that desires to profit from therapies for depression. However, a patent makes direct imitation illegal until the patent expires.	
Nonsubstitutability: Is there protection against ready substitutes?	Competitors can and do attempt to find substitute compounds that have similar effects. Indeed, Zoloft itself was a Pfizer innovation in the face of Eli Lilly's patent for Prozac. Zoloft is not the only treatment for depression; other SSRIs include Prozac, Paxil, and others. The patents for Zoloft may convey temporary advantage, but Pfizer's value from them will probably erode over time as others invent substitute compounds and as the patents expire, resulting in direct imitation.	Not completely.
Exploitability: Is there evidence these are exploitable?	To satisfy this VRINE criterion, Pfizer needs to be able to move drugs from successful clinical trial to market distribution. Fortunately for Pfizer, marketing and distribution are two of its core competences. Indeed, Pfizer has more drug representatives than any other pharmaceutical company. Pfizer also has large cash reserves that can be used to bring sufficient quantities of the product quickly to market prior to the lapsing of the patents.	Yes
The verdict?	As you may have guessed by now, Pfizer's patents on Zoloft largely stand up to the VRINE framework, suggesting that patents are a resource that can generate competitive advantage. The expiration of those patents could largely diminish the VRINE advantages they provided. Note, however, that Zoloft is such a resource not just because of patents. Pfizer also possesses the complementary VRINE resources and capabilities underlying its exploitability.	Yes

Resources of Manchester United

- Manchester United is one of the world's most popular sports franchises, and its revenue has soared on the strength of licensing deals. The team's shoddy on-field performance might not matter much as more big-name companies are chasing the sport's growing fan base.
- Fresh off its worst season in more than two decades, Manchester United is in talks with Nike and some of the biggest names in sports apparel for a contract that could top $600 million.
- Profit tripled last year, revenues up by 26%.
- What are some of Man. U's critical resources?

Questions

1. According to text, how well did Manchester United play in 2013-14? How has this affected the profitability of the club? What does this tell you about the nature of the "game"? In fact, what kind of game is Manchester United playing?
2. Based on the article, what is the most precious resource of Manchester United? How is Manchester United trying to leverage this resource? How does Manchester United try to add value to this resource, besides -- or instead of -- just winning some soccer games?
3. How many of you are fans of Manchester United? Why does this team have a special brand? What does it take for a sports team to build up a global brand outside the local community?

Biggest kit deals in Europe

After 13 years with Nike, on July 2014, Man U reached a deal with Adidas for £750m.

TEAM	MAKER	PER YEAR	YEARS	TOTAL
Manchester United	Adidas	£70m	10 years	£750m
Real Madrid	Adidas	£31m	8 years	£248m
Chelsea	Adidas	£30m	10 years	£300m
Arsenal	Puma	£30m	5 years	£170m
Barcelona	Nike	£27m	10 years	£270m
Liverpool	Warrior	£25m	6 years	£150m
Manchester City	Nike	£12m	6 years	£72m

Value-Chain Analysis

- **Value-chain analysis**
  - a strategic analysis of an organization that uses value creating activities.
  - View the organization as a sequential process of value-creating activities
- Value is the amount that buyers are willing to pay for what a firm provides them
- A firm is profitable when the value of its products or services exceeds the total costs involved in creating them
- Creating value for buyers that exceeds the costs of production (i.e., margin) is a key driver of a firm’s competitive position.

The Value Chain

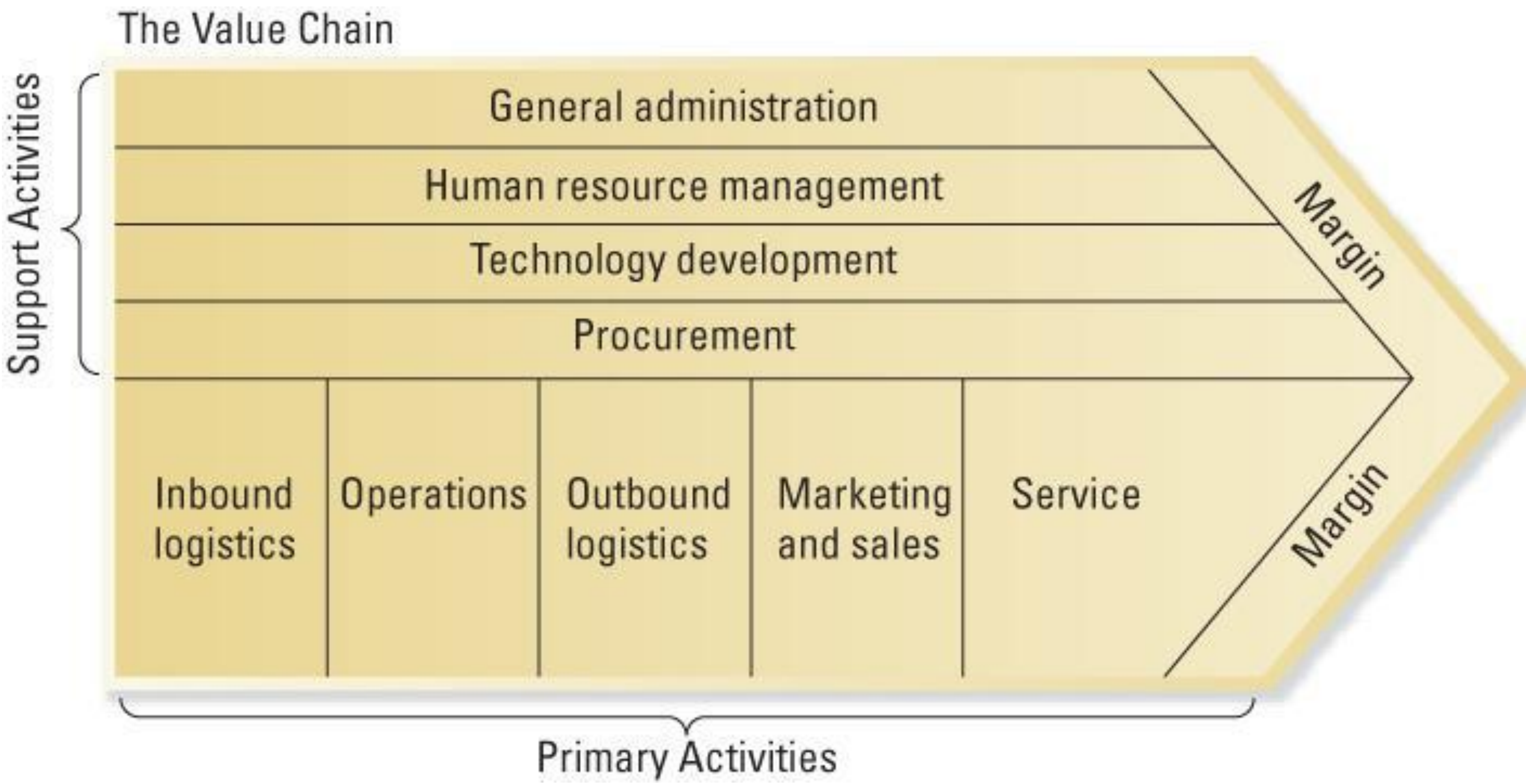


Exhibit 3.1

Value-Chain Analysis

- **Primary activities**
  - contribute to the physical creation of the product or service, its sale and transfer to the buyer, and its service after the sale.
    - inbound logistics
    - operations
    - outbound logistics
    - marketing and sales
    - service

Value-Chain Analysis

Support activities

- activities of the value chain that either add value by themselves or add value through important relationships with both primary activities and other support activities
  - procurement
  - technology development
  - human resource management
  - general administration

QUESTION

In assessing its primary activities, an airline would examine:

A. Employee training programs

B. Baggage handling

C. Criteria for lease versus purchase decisions

D. The effectiveness of its lobbying activities

Primary Activity: Inbound Logistics

- Associated with receiving, storing and distributing inputs to the product
  - Location of distribution facilities
  - Material and inventory control systems
  - Systems to reduce time to send “returns” to suppliers
  - Warehouse layout and designs

Toyota’s use of JIT system

Wal-mart’s Electronic Data Interchange system

Primary Activity: Operations

- Associated with transforming inputs into the final product form
  - Efficient plant operations
  - Incorporation of appropriate process technology
  - Quality production control systems
  - Efficient plant layout and workflow design

How Does Automation Affect Cost Structure?

Harley-Davidson

Then and Now

Primary Activity: Outbound Logistics

- Associated with collecting, storing, and distributing the product or service to buyers
  - Effective shipping processes to provide quick delivery and minimize damages
  - Shipping of goods in large lot sizes to minimize transportation costs.
  - Efficient finished goods warehousing processes

Ex: Cambell Soup's e-network continuous replenishment program

Primary Activity: Marketing and Sales

- Associated with purchases of products and services by end users and the inducements used to get them to make purchases
  - Innovative approaches to promotion and advertising
  - Proper identification of customer segments and needs
  - Selection of most appropriate distribution channels
  - Effective pricing strategies

Q: Internet advertising vs. traditional ads?

Primary Activity: Service

- Associated with providing service to enhance or maintain the value of the product
  - Quick response to customer needs and emergencies
  - Quality of service personnel and ongoing training
  - Warranty and guarantee policies

Support Activity: Procurement

- Function of purchasing inputs used in the firm's value chain
  - Procurement of raw material inputs
  - Development of collaborative "win-win" relationships with suppliers
  - Analysis and selection of alternate sources of inputs to minimize dependence on one supplier

Support Activity: Human Resource Management

- Activities involved in the recruiting, hiring, training, development, and compensation of all types of personnel
  - Effective recruiting, development, and retention mechanisms for employees
  - Quality relations with trade unions
  - Reward and incentive programs to motivate all employees
- *Q: Should employee performance metrics be eliminated? Why? Why not?*

Support Activity: Technology Development

- Related to a wide range of activities and those embodied in processes and equipment and the product itself
  - Effective R&D activities for process and product initiatives
  - Positive collaborative relationships between R&D and other departments
  - Excellent professional qualifications of personnel

Support Activity: General Administration

- Typically supports the entire value chain and not individual activities
  - Ability of top management to anticipate and act on key environmental trends and events
  - Excellent relationships with diverse stakeholder groups
  - Effective use of information technology to integrate value-creating activities

Value Chain – Internet Startup Example

Firm Infrastructure	Financing, legal support, accounting				
	Recruiting, training, incentive system, employee feedback				
Technology Development	Inventory system	Site software	Pick & pack procedures	Site look & feel Customer research	Return procedures
	CDs Shipping	Computers Telecom lines	Shipping services	Media	
	Inbound shipment of top titles Warehousing	Server operations Billing Collections	Picking and shipment of top titles from warehouse Shipment of other titles from third-party distributors	Pricing Promotions Advertising Product information and reviews Affiliations with other websites	Returned items Customer feedback
	Inbound Logistics	Operations	Outbound Logistics	Marketing & Sales	After-Sales Service

Primary Activities

Value Chains in Service Industries

Retail: Primary Value-Chain Activities

Engineering Services: Primary Value-Chain Activities

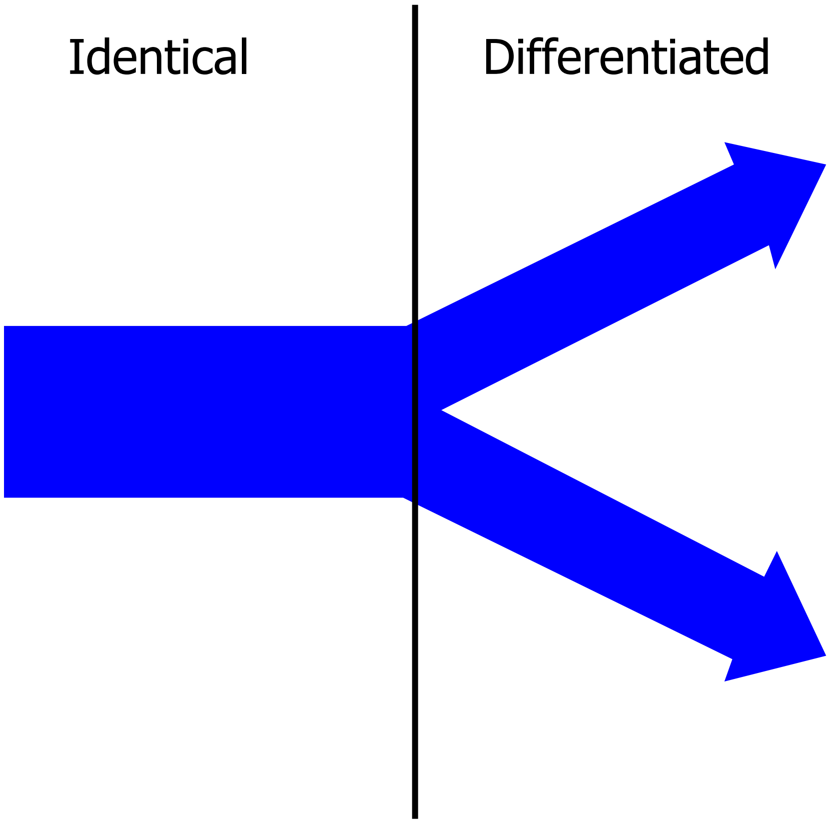
Exhibit 3.4

Value Chain and Competitive Advantage

1. Activities that can create value for the firm should not be outsourced.
2. Those activities that represent key sources of learning for the firm should not be outsourced.

Value Chain and Competitive Advantage

Identical | Differentiated

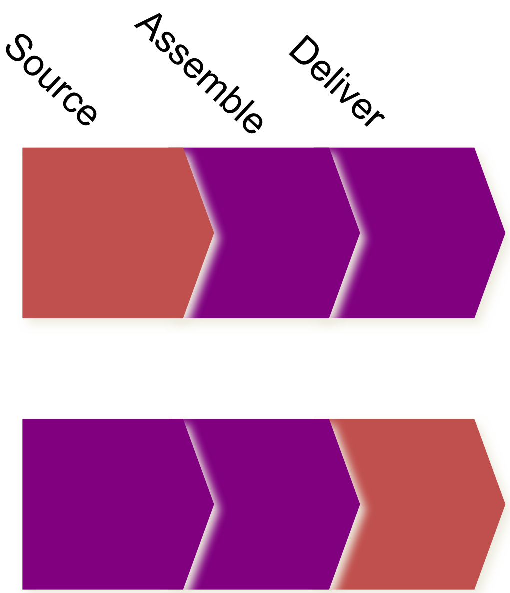


Find a better way to perform the same activities → Shorter-term advantage (competitors catch up)

Find a different way to perform activities → Longer-lasting advantage

Innovation and Integration of Value Chain

Area of innovation



IKEA — Transferred assembly and delivery to the consumer

Dell — Choose an entirely direct distribution model (rather than through retailers) and outsourced component manufacturing

Key Takeaways

- Internal strategic analysis aims to **integrate the firm's specific strengths** to maximize advantage
- To create competitive advantage, competencies need to be **valuable, rare, and difficult to imitate**
- Be careful though, these core competencies can become core rigidities!
- Another model of competitive advantage is to structure the activities in its value-chain either better or differently that its competitors
- Competitive advantage through value-chain activities only comes about if the firm can either deliver greater value than rivals or comparable value at a lower cost

Evaluating Firm Performance

- **Financial ratio analysis**
  - Balance sheet
  - Income statement
  - Historical comparison
  - Comparison with industry norms
  - Comparison with key competitors
- **Stakeholder perspective**
  - Employees
  - Customers
  - Owners

Financial Ratio Analysis

- **Five types of financial ratios**
  - Short-term solvency or liquidity
  - Long-term solvency measures
  - Asset management (or turnover)
  - Profitability
  - Market value
- Historical comparisons
- Comparison with industry norms
- Comparison with key competitors

I. Short-term solvency, or liquidity, ratios

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

$$\text{Cash ratio} = \frac{\text{Cash}}{\text{Current liabilities}}$$

II. Long-term solvency, or financial leverage, ratios

$$\text{Total debt ratio} = \frac{\text{Total assets} - \text{Total equity}}{\text{Total assets}}$$

Debt-equity ratio = Total debt/Total equity

Equity multiplier = Total assets/Total equity

$$\text{Times interest earned ratio} = \frac{\text{EBIT}}{\text{Interest}}$$

$$\text{Cash coverage ratio} = \frac{\text{EBIT} + \text{Depreciation}}{\text{Interest}}$$

III. Asset utilization, or turnover, ratios

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}}$$

$$\text{Days' sales in inventory} = \frac{\text{365 days}}{\text{Inventory turnover}}$$

$$\text{Receivables turnover} = \frac{\text{Sales}}{\text{Accounts receivable}}$$

$$\text{Days' sales in receivables} = \frac{\text{365 days}}{\text{Receivables turnover}}$$

$$\text{Total asset turnover} = \frac{\text{Sales}}{\text{Total assets}}$$

$$\text{Capital intensity} = \frac{\text{Total assets}}{\text{Sales}}$$

IV. Profitability ratios

$$\text{Profit margin} = \frac{\text{Net income}}{\text{Sales}}$$

$$\text{Return on assets (ROA)} = \frac{\text{Net income}}{\text{Total assets}}$$

$$\text{Return on equity (ROE)} = \frac{\text{Net income}}{\text{Total equity}}$$

$$\text{ROE} = \frac{\text{Net income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$$

V. Market value ratios

$$\text{Price-earnings ratio} = \frac{\text{Price per share}}{\text{Earnings per share}}$$

$$\text{Market-to-book ratio} = \frac{\text{Market value per share}}{\text{Book value per share}}$$