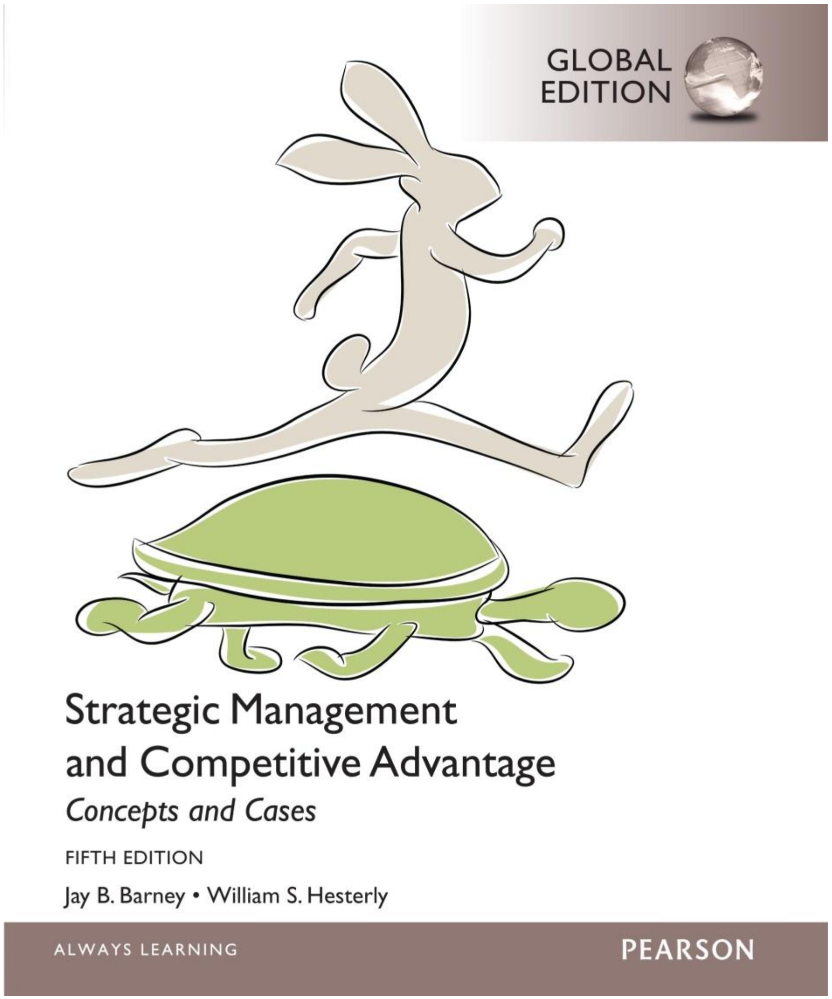


Chapter 3

Evaluating a Firm's Internal Capabilities

What Does Internal Analysis Tell Us?

Internal analysis provides a comparative look at a firm's capabilities.

- What are the firm's strengths?
- What are the firm's weaknesses?
- How do these strengths and weaknesses compare to competitors?

Why Does Internal Analysis Matter?

Internal analysis helps a firm:

- determine if its resources and capabilities are
  likely sources of competitive advantage
- establish strategies that will exploit any sources
  of competitive advantage

The Theory Behind Internal Analysis

The Resource-Based View

- developed to answer the question: Why do some firms achieve better economic performance than others?
- used to help firms achieve competitive advantage and superior economic performance
- assumes that a firm's resources and capabilities are the primary drivers of competitive advantage and economic performance

The Resource-Based View

Resources and Capabilities

Resources:

- tangible and intangible assets of a firm
  - » tangible: factories, products intangible: reputation
- used to conceive of and implement strategies

Capabilities:

- a subset of resources that enable a firm to take full advantage of other resources
  - » marketing skill, cooperative relationships

The Resource-Based View

Resources and Capabilities

Firm Assets:	Are these resources or capabilities?
Machinery	?
Collective Product Design Skill	?
Recruiting Skill	?
Engineering Skill of Individuals	?
Mineral Deposits	?

The Resource-Based View

Four Categories of Resources

- Financial (cash, retained earnings)
- Physical (plant and equipment, geographic location)
- Human (skills and abilities of individuals)
- Organizational (reporting structures, relationships)

The Resource-Based View

Two Critical Assumptions of the RBV

- Resource Heterogeneity
  - » Different firms may have different resources.
- Resource Immobility
  - » It may be costly for firms without certain resources to acquire or develop them.
  - » Some resources may not spread from firm to firm easily.

The Resource-Based View

What do these assumptions really mean?

- if one firm has resources that are valuable and other firms don't, and…
- if other firms can't imitate these resources without incurring high costs, then…
- the firm possessing the valuable resources will likely gain a sustained competitive advantage

The Resource-Based View

Resource Heterogeneity

- Heterogeneity of resources typically occurs as the result of “bundling” the resources and capabilities of a firm.
- Managers of a firm could take resources that seem homogeneous and “bundle” them to create heterogeneous combinations.
- Competitive advantage typically stems from several resources and capabilities “bundled” together.

The Internal Analysis Tool

The VRIO Framework

Four Important Questions:

- Value
- Rarity
- Imitability
- Organization

The VRIO Framework

If a firm has resources that are:

- valuable,
- rare,
- costly to imitate, and
- the firm is organized to exploit these resources,

then the firm can expect to enjoy a sustained competitive advantage.

The VRIO Framework

Applying the Tool

- A resource or bundle of resources is subjected to each question to determine the competitive implication of the resource.
- Each question is considered in a comparative sense (competitive environment).

Applying the VRIO Framework

The Question of Value

- In theory: Does the resource enable the firm to exploit an external opportunity or neutralize an external threat?
- The practical: Does the resource result in an increase in revenues, a decrease in costs, or some combination of the two? (Levi's reputation allows it to charge a premium for its Docker's pants)

Applying the VRIO Framework

The Question of Rarity

- If a resource is not rare, then perfect competition dynamics are likely to be observed (i.e., no competitive advantage, no above normal profits).
- A resource must be rare enough that perfect competition has not set in.
- Thus, there may be other firms that possess the resource, but still few enough that there is scarcity (several pharmaceuticals sell cholesterol-lowering drugs, but the drugs are still scarce—look at prices).

Applying the VRIO Framework

Valuable and Rare

If a firm's resources are:	The firm can expect:
Not Valuable	Competitive Disadvantage
Valuable, but Not Rare	Competitive Parity
Valuable and Rare	Competitive Advantage (at least temporarily)

Applying the VRIO Framework

The Question of Imitability

- The temporary competitive advantage of valuable and rare resources can be sustained only if competitors face a cost disadvantage in imitating the resource.
  - Intangible resources are usually more costly to imitate than tangible resources. (Harley-Davidson's styles may be easily imitated, but its reputation cannot.)

Applying the VRIO Framework

The Question of Imitability

- If there are high costs of imitation, then the firm may enjoy a period of sustained competitive advantage.
  - » A sustained competitive advantage will last only until a duplicate or substitute emerges.
    - ◆ If a firm has a competitive advantage, others will attempt to imitate it. **(Razor scooters were a big hit and others quickly imitated them.)**

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Unique Historical Conditions (Caterpillar)

- first mover advantages
- path dependence

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Causal Ambiguity (Southwest Airlines: HR)

- Causal links between resources and competitive advantage may not be understood.
- Bundles of resources fog these causal links.

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Social Complexity (WordPerfect)

- The social relationships entailed in resources may be so complex that managers cannot really manage them or replicate them.

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Patents

- Patents may be a two-edged sword.
- Offer a period of protection if the firm is able to defend its patent rights.
- Required disclosure may actually decrease the cost of imitation, and the timing.

Applying the VRIO Framework

Value, Rarity, and Imitability

If a firm's resources are:	The firm can expect:
Valuable, Rare, but not Costly to Imitate	Temporary Competitive Advantage
Valuable, Rare, and Costly to Imitate	Sustained Competitive Advantage (if Organized appropriately)

Applying the VRIO Framework

The Question of Organization

- A firm’s structure and control mechanisms must be aligned so as to give people ability and incentive to exploit the firm’s resources.
- Examples: formal and informal reporting structures; management controls, compensation policies, relationships, and so on
- These structure and control mechanisms complement other firm resources—taken together, they can help a firm achieve sustained competitive advantage.

The VRIO Framework

Valuable?	Rare?	Costly to Imitate?	Exploited by Organization?	Competitive Implications
No			No	Disadvantage
Yes	No			Parity
Yes	Yes	No		Temporary Advantage
Yes	Yes	Yes	Yes	Sustained Advantage

The VRIO Framework

Valuable?	Rare?	Costly to Imitate?	Exploited by Organization?	Competitive Implications	Economic Implications
No			No	Disadvantage	Below Normal
Yes	No			Parity	Normal
Yes	Yes	No		Temporary Advantage	Above Normal
Yes	Yes	Yes	Yes	Sustained Advantage	Above Normal

Competitive Dynamics of Resource Imitation

Competitive Dynamics:

- the strategic decisions and actions of firms in response to the strategic decisions and actions of other firms

Firm B's Possible Responses

Firm A
(strategy decisions lead to competitive advantage)

→ No Response

→ Change Tactics

→ Change Strategy

Competitive Dynamics

"No Action" Response (Rolex → Casio)

A firm may decide to take no action because:

- the other firm is serving a different market
- a response may hurt its own competitive advantage
- it does not have the resources and capabilities to mount an effective response
- it wants to reduce or manage rivalry in the market through tacit collusion

Competitive Dynamics

"Change" Responses

Tactics (Tide)

- specific *actions*
  - » tweaking product characteristics
- usually imitated so quickly that there is no advantage
- a "leap frog" move may create advantage

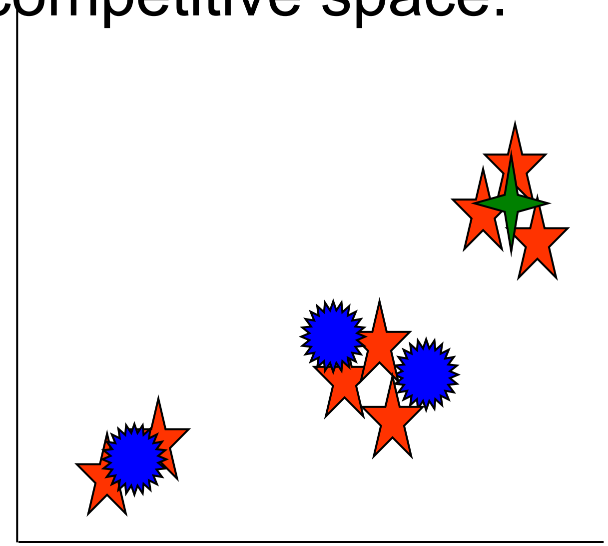
Strategy (Monsanto)

- a fundamental change in a firm's theory
- may be necessary if current strategy becomes obsolete
- a mimetic change may achieve parity, but not advantage

Competitive Dynamics

Imitation will seldom lead to competitive advantage

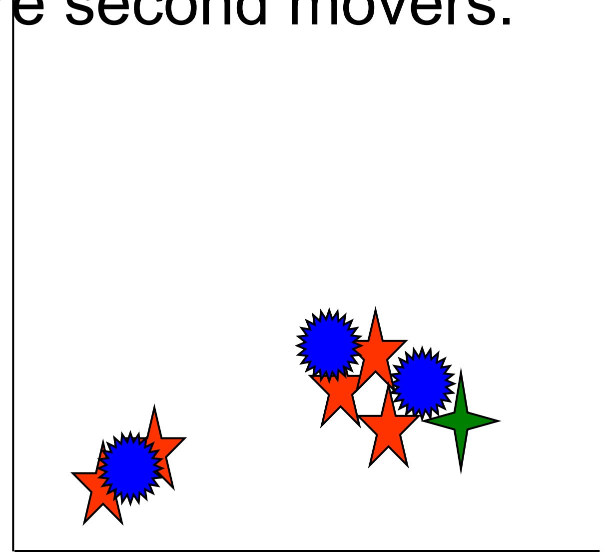
- Firms should use resources and capabilities to fill unique competitive space.



Competitive Dynamics

Similar strategies *may* lead to competitive advantage.

- Some firms can achieve competitive advantage even if they are second movers.



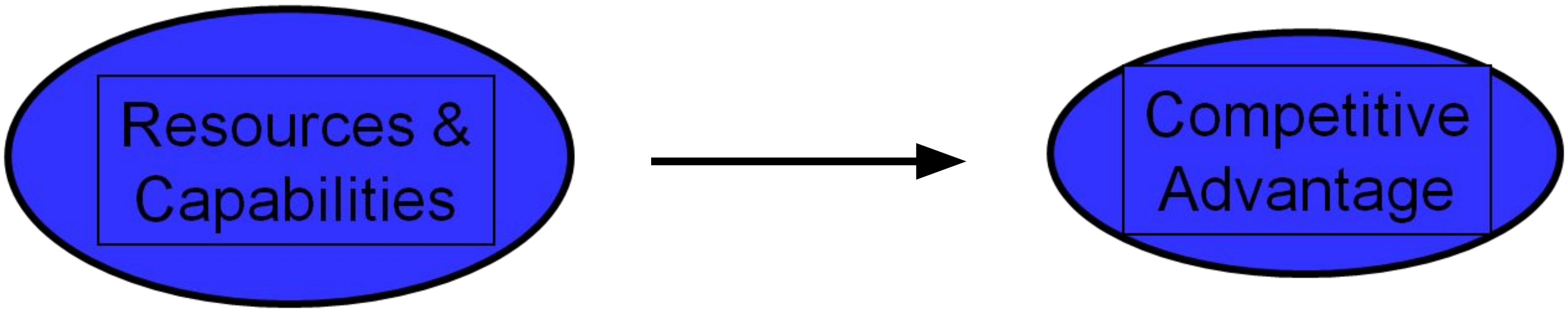
» higher quality/ lower cost offering may lead to advantage

Internal Analysis

Assumes:

- Determinates of economic performance are firm-level characteristics (resources and capabilities).
  - Firms may be different (heterogeneity).
  - Differences may be enduring (immobility).
- Competitive advantage stems from resources and capabilities that meet the VRIO criteria.

The Resource-Based View



- Valuable
- Rare
- Costly to Imitate
- Organized to Exploit

CA will be sustained if:

- other firms' costs of imitation are greater than benefit of imitation
- the firm is organized to exploit advantages

Internal Analysis

Tells us:

- what the firm *should* do, given the relative strengths and weaknesses of resources and capabilities

Managers' Job:

- bundle resources and capabilities to achieve competitive advantage

VRIO Framework Helps Managers Recognize Sources of Competitive Advantage