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The Internal Organization: Resources, Capabilities, Core Competencies, and Competitive Advantages

Studying this chapter should provide you with the strategic management knowledge needed to:

- 1** Explain why firms need to study and understand their internal organization.
- 2** Define value and discuss its importance.
- 3** Describe the differences between tangible and intangible resources.
- 4** Define capabilities and discuss their development.
- 5** Describe four criteria used to determine whether resources and capabilities are core competencies.
- 6** Explain how firms analyze their value chain for the purpose of determining where they are able to create value when using their resources, capabilities, and core competencies.
- 7** Define outsourcing and discuss reasons for its use.
- 8** Discuss the importance of identifying internal strengths and weaknesses.
- 9** Discuss the importance of avoiding core rigidities.

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ZARA: THE CAPABILITIES BEHIND THE SPANISH "FAST FASHION" RETAIL GIANT



Amancio Ortega built the world's largest fashion empire through his Zara branded products and company-owned stores.

Through his management approach, Ortega has become the third richest man in the world behind Microsoft's Bill Gates and Mexico's Carlos Slim Helú.

Headquartered in La Coruña in Spain's Galicia region, Ortega founded the Inditex Group with Zara as its flagship brand. Despite Spain's 24 percent unemployment rate and crippling debt, in 2012 Zara increased its revenue 17 percent. Also, in 2012 Zara averaged a new store opening every day, including its six thousandth store launched on London's Oxford Street. Although the influence of the economic environment (an influence from the external environment that we examined in Chapter 2) affects Zara's success, the way Zara uses its

resources and capabilities as the foundation for core competencies (defined in Chapter 1, core competencies are capabilities that serve as a potential source of competitive advantage for a firm over its rivals) demonstrates the value of understanding a firm's internal organization (this chapter's subject).

Ortega built this successful business based on two critical goals: Give customers what they want, and get it to them faster than anyone else. To do "fast fashion" as it is called, there are several critical capabilities that must be in place. The first critical capability is the ability to design quickly; the design pace at Zara has been described as "frantic". The designers create about three items of new clothing a day, and pattern makers cut one sample for each. Second are the commercial sales specialists from each region where Zara has stores. They provide input on customer tastes and buying habits which are reported through store man-

agers. Each specialist is trained to keep an eye on what people are wearing, which Ortega does personally as well since founding Zara. As such, Zara has a team approach to match quick and creative design to information coming in from the sales staff through regional specialists and sector specialists to operationalize new fashion ideas.

The supply chain is also managed much more efficiently than those of other companies. The logistics department is the essence of the company; rather than waiting for cloth to come in after designing, it already has much basic cloth and owns its own dyeing operation to maintain control and speed. Zara's objective is to deliver customized orders to every store in its empire with a 24-hour turnaround deadline for Europe, the Mideast, and much of the United States, and 48 hours for Asia and Latin America. The frequent shipments keep product inventories fresh but also scarce

since they send out very few items in each shipment. This approach compels customers to visit stores frequently in search of what they want and, because of the scarcity, creates an incentive for them to buy on the spot because it will likely not be in stock tomorrow. Accordingly, Zara's global store average of 17 visits per customer per year is considerably higher than the average of three visits per year for its competitors.

Until 2010 Zara did not have an online strategy. Unlike most retailers it has used very little advertising because it has focused on a rather cheap but fashionable approach. The fashion draws the interest of customers, and thereby created a huge following on Facebook, with approximately 10 million followers. This compares favorably to other competitors such as Gap. The rarity of the individual pieces of clothing gives customers a sense of individuality. This gives Zara a stronger potential to pursue an online strategy relative to its competitors.

Most Zara stores are owned by the parent company, and many of its suppliers, although not owned by the company, are considered long-time, relationship-oriented partners. As such, these partners identify with the company and thereby are also loyal. This approach also sets it apart and makes its strategy difficult to duplicate because all of the various facets and capabilities of the company fit together through a unified culture. As noted above, Zara also operates its own dyeing plant for cloth, giving it significant control over its products. Likewise, it sews many of these garments in its own factories, and thus maintains a high level of quality control and an ability to make quick changes. Overall, the company has a unique set of capabilities which fit together well as it manages their activities to produce "fast fashion," which creates demand from their customers and loyalty from their partner suppliers.

Sources: E. Carlyle, 2013, The year's biggest winner: Zara billionaire Amancio Ortega, *Forbes*, www.forbes.com, March 4; R. Dudley, A. Devnath, & M. Townsend, 2013, The hidden cost of fast fashion, *Bloomberg Businessweek*, February 11, 15–17; V. Walt, 2013, Meet the third-richest man in the world, *Fortune*, January 14, 74–79; 2012, Inditex, Asos post double-digit sales gains, *Women's Wear Daily*, September 20, 6; B. Borzykowski, 2012, Zara eludes the pain in Spain, *Canadian Business*, September 17, 67; K. Willems, W. Janssens, G. Swinnen, M. Brengman, S. Streukens, & N. Vancauteren, 2012, From Armani to Zara: Impression formation based on fashion store patronage, *Journal of Business Research*, (65)10: 1487–1494.

As discussed in the first two chapters, several factors in the global economy, including the rapid development of the Internet's capabilities¹ and globalization in general have made it increasingly difficult for firms to find ways to develop sustainable competitive advantages.² Increasingly, innovation appears to be a vital path to efforts to develop such advantages.³ As the Opening Case indicates, Zara's ability to produce new clothing designs quickly is definitely an advantage for them; the continual appearance of fresh designs has led to 17 visits per customer per year in its stores compared to the average of three visits per year in competitor stores.

Innovation is key at most organizations, like Zara, to maintain their competitive advantage. For example, at General Motors, efforts are underway to reduce the "drag" the firm's bureaucracy creates on innovation. According to a company official, "GM still wastes millions of dollars developing engines and vehicle variants that interest few customers." To remedy this problem, GM is making changes with the intention of having the "right people and the right engineers on the right priorities and products, not just do the most vehicles possible."⁴

People are an especially critical resource for helping organizations learn how to continuously innovate as a means of achieving successful growth.⁵ This is the case at 3M, where harnessing the innovative powers of the firm's employees is the means for rekindling growth; in 2012 3M was ranked third on Booz & Company's list of most innovative behind Apple and Google but did not spend the same proportion on R&D relative to its sales as many other companies.⁶ At 3M and other companies, people who are able to facilitate their firm's efforts to innovate are themselves a valuable resource with the potential to be a competitive advantage.⁷ A sign of the times is the fact that a global labor market now exists as firms seek talented individuals to add to their fold. As Richard Florida argues, "[W]herever talent goes, innovation, creativity, and economic growth are sure to follow."⁸

To identify and successfully use resources over time, those leading firms need to constantly think about how to manage resources for the purpose of increasing the value their

M. Stasy

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draws the interest of
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goods or services create for customers as compared to the value rivals' products create. As this chapter shows, firms achieve strategic competitiveness and earn above-average returns by acquiring, bundling, and leveraging their resources for the purpose of taking advantage of opportunities in the external environment in ways that create value for customers.⁹

Even if the firm develops and manages resources in ways that create core competencies and competitive advantages, competitors will eventually learn how to duplicate the benefits of any firm's value-creating strategy; thus all competitive advantages have a limited life.¹⁰ Because of this, the question of duplication of a competitive advantage is not if it will happen, but when. In general, a competitive advantage's sustainability is a function of three factors: (1) the rate of core competence obsolescence because of environmental changes, (2) the availability of substitutes for the core competence, and (3) the imitability of the core competence.¹¹ For all firms, the challenge is to effectively manage current core competencies while simultaneously developing new ones.¹² Only when firms are able to do this can they expect to achieve strategic competitiveness, earn above-average returns, and remain ahead of competitors (see Chapter 5).

We studied the general, industry, and competitor environments in Chapter 2. Armed with knowledge about the realities and conditions of their external environment, firms have a better understanding of marketplace opportunities and the characteristics of the competitive environment in which those opportunities exist. In this chapter, we focus on the firm itself. By analyzing its internal organization, a firm determines what it can do. Matching what a firm *can do* (a function of its resources, capabilities, and core competencies in the internal organization) with what it *might do* (a function of opportunities and threats in the external environment) is a process that yields insights the firm requires to select its strategies.

We begin this chapter by briefly describing conditions associated with analyzing the firm's internal organization. We then discuss the roles of resources and capabilities in developing core competencies, which are the sources of the firm's competitive advantages. Included in this discussion are the techniques firms use to identify and evaluate resources and capabilities and the criteria for identifying core competencies from among them. Resources by themselves typically are not competitive advantages; in fact, resources create value when the firm uses them to form capabilities, some of which become core competencies, and hopefully competitive advantages. Because of the relationship among resources, capabilities, and core competencies, we also discuss the value chain and examine four criteria firms use to determine if their capabilities are core competencies and, as such, sources of competitive advantage.¹³ The chapter closes with cautionary comments about outsourcing and the need for firms to prevent their core competencies from becoming core rigidities. The existence of core rigidities indicates that the firm is too anchored to its past, which prevents it from continuously developing new capabilities and core competencies.

3-1 Analyzing the Internal Organization

3-1a The Context of Internal Analysis

One of the conditions associated with analyzing a firm's internal organization is the reality that in today's global economy, some of the resources that were traditionally critical to firms' efforts to produce, sell, and distribute their goods or services such as labor costs, access to financial resources and raw materials, and protected or regulated markets, although still important, are now less likely to become competitive advantages.¹⁴ An important reason for this is that an increasing number of firms are using their resources to form core competencies through which they successfully implement an international strategy (discussed in Chapter 8) as a means of overcoming the advantages created by these more traditional resources.

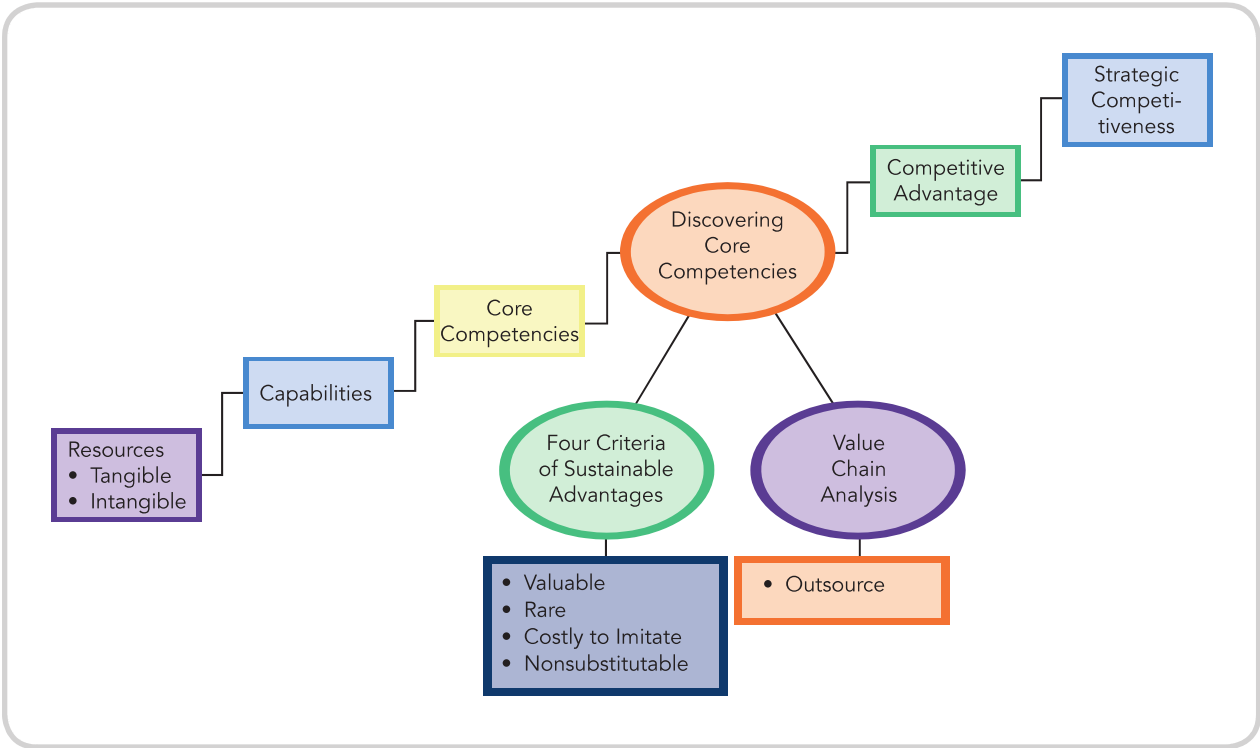
The Volkswagen Group has established “Strategy 2018” as its international strategy. The firm, which sells its products in over 150 countries, employs 550,000 people to operate more than 100 production plants around the world. By using its resources to form technological and innovation capabilities, Volkswagen intends to create superior customer service and product quality as core competencies on which it will rely to implement its international strategy.¹⁵

Increasingly, those analyzing their firm’s internal organization should use a global mind-set to do so. A **global mind-set** is the ability to analyze, understand, and manage an internal organization in ways that are not dependent on the assumptions of a single country, culture, or context.¹⁶ Because they are able to span artificial boundaries, those with a global mind-set recognize that their firms must possess resources and capabilities that allow understanding of and appropriate responses to competitive situations that are influenced by country-specific factors and unique cultures. Using a global mind-set to analyze the internal organization has the potential to significantly help the firm in its efforts to outperform rivals.¹⁷ A global mind-set was used to develop Volkswagen Group’s “Strategy 2018.”

Finally, analyzing the firm’s internal organization requires that evaluators examine the firm’s entire portfolio of resources and capabilities. This perspective suggests that individual firms possess at least some resources and capabilities that other companies do not—at least not in the same combination. Resources are the source of capabilities, some of which lead to the development of core competencies; in turn, some core competencies may lead to a competitive advantage for the firm.¹⁸ Understanding how to leverage the firm’s unique bundle of resources and capabilities is a key outcome decision makers seek when analyzing the internal organization.¹⁹ Figure 3.1 illustrates the relationships among resources, capabilities, core competencies, and competitive advantages and shows how their integrated use can lead to strategic competitiveness. As we discuss next, firms use the assets in their internal organization to create value for customers.

A **global mind-set** is the ability to analyze, understand, and manage an internal organization in ways that are not dependent on the assumptions of a single country, culture, or context.

Figure 3.1 Components of an Internal Analysis



3-1b Creating Value

Firms use their resources as the foundation for producing goods or services that will create value for customers.²⁰ **Value** is measured by a product's performance characteristics and by its attributes for which customers are willing to pay. Firms create value by innovatively bundling and leveraging their resources to form capabilities and core competencies.²¹ Firms with a competitive advantage create more value for customers than do competitors.²² Walmart uses its "every day low price" approach to doing business (an approach that is grounded in the firm's core competencies, such as information technology and distribution channels) to create value for those seeking to buy products at a low price compared to competitors' prices for those products.²³ The stronger these firms' core competencies, the greater the amount of value they're able to create for their customers.²⁴

Ultimately, creating value for customers is the source of above-average returns for a firm. What the firm intends regarding value creation affects its choice of business-level strategy (see Chapter 4) and its organizational structure (see Chapter 11).²⁵ In Chapter 4's discussion of business-level strategies, we note that value is created by a product's low cost, by its highly differentiated features, or by a combination of low cost and high differentiation, compared with competitors' offerings. A business-level strategy is effective only when it is grounded in exploiting the firm's capabilities and core competencies. Thus, the successful firm continuously examines the effectiveness of current capabilities and core competencies while thinking about the capabilities and competencies it will require for future success.²⁶

At one time, the firm's efforts to create value were largely oriented to understanding the characteristics of the industry in which it competed and, in light of those characteristics, determining how it should be positioned relative to competitors. This emphasis on industry characteristics and competitive strategy underestimated the role of the firm's resources and capabilities in developing core competencies as the source of competitive advantages. In fact, core competencies, in combination with product-market positions, are the firm's most important sources of competitive advantage.²⁷ A firm's core competencies, integrated with an understanding of the results of studying the conditions in the external environment, should drive the selection of strategies.²⁸ As Clayton Christensen noted, "Successful strategists need to cultivate a deep understanding of the processes of competition and progress and of the factors that undergird each advantage. Only thus will they be able to see when old advantages are poised to disappear and how new advantages can be built in their stead."²⁹ By emphasizing core competencies when selecting and implementing strategies, companies learn to compete primarily on the basis of firm-specific differences. However, while doing so they must be simultaneously aware of how things are changing in the external environment.³⁰

3-1c The Challenge of Analyzing the Internal Organization

The strategic decisions managers make about their firm's internal organization are non-routine,³¹ have ethical implications,³² and significantly influence the firm's ability to earn above-average returns.³³ These decisions involve choices about the resources the firm needs to collect and how to best manage them.

Making decisions involving the firm's assets—identifying, developing, deploying, and protecting resources, capabilities, and core competencies—may appear to be relatively easy. However, this task is as challenging and difficult as any other with which managers are involved; moreover, the task is increasingly internationalized.³⁴ Some believe that the pressure on managers to pursue only decisions that help the firm meet the quarterly earnings expected by market analysts makes it difficult to accurately examine the firm's internal organization.³⁵

The challenge and difficulty of making effective decisions are implied by preliminary evidence suggesting that one-half of organizational decisions fail.³⁶ Sometimes, mistakes

Value is measured by a product's performance characteristics and by its attributes for which customers are willing to pay.

are made as the firm analyzes conditions in its internal organization.³⁷ Managers might, for example, think a capability is a core competence when it is not. This may have been the case at Polaroid Corporation as decision makers continued to believe that the capabilities it used to build its instant film cameras were highly relevant at the time its competitors were developing and using the capabilities required to introduce digital cameras. In this instance, Polaroid's decision makers may have concluded that superior manufacturing was a core competence, as was the firm's ability to innovate in terms of creating value-adding features for its instant cameras. If a mistake is made when analyzing and managing a firm's resources, such as appears to have been the case some years ago at Polaroid, decision makers must have the confidence to admit it and take corrective actions.³⁸

A firm can improve by studying its mistakes; in fact, the learning generated by making and correcting mistakes can be important to efforts to create new capabilities and core competencies.³⁹ One capability that can be learned from failure is when to quit. Polaroid should have obviously changed its strategy earlier than it did, and by doing so it may have been able to avoid more serious failure. Another example is News Corp.'s acquisition of MySpace in 2006. It poured over \$580 million of investment for several years as it lost market share to FaceBook, and the acquisition was eventually sold for only \$34 million.⁴⁰

As we discuss next, three conditions—uncertainty, complexity, and intraorganizational conflict—affect managers as they analyze the internal organization and make decisions about resources (see Figure 3.2).

Managers face uncertainty because of a number of issues, including those of new proprietary technologies, rapidly changing economic and political trends, transformations in societal values, and shifts in customers' demands.⁴¹ Environmental uncertainty increases the complexity and range of issues to examine when studying the internal environment.⁴² Consider how uncertainty affects how to use resources at coal companies such as Peabody Energy Corp and Arch Coal Corp.

Peabody is the world's largest private-sector coal company. The firm's coal products fuel approximately 11 percent of all U.S. electricity generation and 2 percent of worldwide electricity. But the firm faces a great deal of uncertainty with respect to how it might best use its resources today to prepare for its future. One reason for this is that at least for some, coal is thought of as a "dirty fuel." Partly to reduce the uncertainty the firm faces because of this, Peabody is using some of its resources to build a "clean" coal-fired plant and has signed agreements to develop clean coal in China. As a proponent of strong emissions standards, Peabody's leaders argue for more use of "clean coal." Besides having to deal with increasingly advanced technological improvements such as clean coal, demand situations around the world are also creating uncertainty. China, for instance, one of the U.S.'s largest coal

Figure 3.2 Conditions Affecting Managerial Decisions about Resources, Capabilities, and Core Competencies

Conditions	Uncertainty	Uncertainty exists about the characteristics of the firm's general and industry environments and customers' needs.
	Complexity	Complexity results from the interrelationships among conditions shaping a firm.
	Intraorganizational Conflicts	Intraorganizational conflicts may exist among managers making decisions as well as among those affected by the decisions.

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export markets, is increasing its own capacity in clean coal. Although India has continually increasing demand as it builds more coal-fired generating plants, pressure is growing to reduce their plants' CO₂ emissions. Tougher environmental regulations in Europe and a sluggish economy there have crippled coal demand in that region. Likewise, cheaper natural gas is continuing to displace coal in power generation in the United States.⁴³

Also, biases about how to cope with uncertainty affect decisions made about how to manage the firm's resources and capabilities to form core competencies.⁴⁴ Additionally, intraorganizational conflict may surface when decisions are made about the core competencies a firm should develop and nurture. Conflict might surface in Peabody or Arch Coal about the degree to which resources and capabilities should be used to form new core competencies to support newer "clean technologies."

In making decisions affected by these three conditions, judgment is required. *Judgment* is the capability of making successful decisions when no obviously correct model or rule is available or when relevant data are unreliable or incomplete. In such situations, decision makers must be aware of possible cognitive biases, such as overconfidence. Individuals who are too confident in the decisions they make about how to use the firm's resources may fail to fully evaluate contingencies that could affect those decisions.⁴⁵

When exercising judgment, decision makers often take intelligent risks. In the current competitive landscape, executive judgment can become a valuable capability. One reason is that, over time, effective judgment that decision makers demonstrate allows a firm to build a strong reputation and retain the loyalty of stakeholders whose support is linked to above-average returns.⁴⁶

Finding individuals who can make the most successful decisions about using the organization's resources is challenging. Being able to do this is important because the quality of leaders' decisions regarding resources and their management affect a firm's ability to achieve strategic competitiveness. Individuals holding these key decision-making positions are called *strategic leaders*. Discussed fully in Chapter 12, for our purposes in this chapter we can think of strategic leaders as individuals with an ability to make effective decisions when examining the firm's resources, capabilities, and core competencies for the purpose of making choices about their use.

Next, we consider the relationships among a firm's resources, capabilities, and core competencies. While reading these sections, keep in mind that organizations have more resources than capabilities and more capabilities than core competencies.

3-2 Resources, Capabilities, and Core Competencies

Resources, capabilities, and core competencies are the foundation of competitive advantage. Resources are bundled to create organizational capabilities. In turn, capabilities are the source of a firm's core competencies, which are the basis of establishing competitive advantages.⁴⁷ We show these relationships in Figure 3.1. Here, we define and provide examples of these building blocks of competitive advantage.

3-2a Resources

Broad in scope, resources cover a spectrum of individual, social, and organizational phenomena. By themselves, resources do not allow firms to create value for customers as the foundation for earning above-average returns. Indeed, resources are combined to form capabilities.⁴⁸ Subway links its fresh ingredients with several other resources including the continuous training it provides to those running the firm's fast food restaurants as the

foundation for customer service as a capability; customer service is also a core competence for Subway. As its sole distribution channel, the Internet is a resource for Amazon.com. The firm uses the Internet to sell goods at prices that typically are lower than those offered by competitors selling the same goods through what are more costly brick-and-mortar storefronts. By combining other resources (such as access to a wide product inventory), Amazon has developed a reputation for excellent customer service. Amazon's capability in terms of customer service is a core competence as well in that the firm creates unique value for customers through the services it provides to them. Amazon also uses its technological core competence to offer AWS (Amazon Web Services), services through which businesses can rent computing power from Amazon at a cost of pennies per hour. In the words of the leader of this effort, "AWS makes it possible for anyone with an Internet connection and a credit card to access the same kind of world-class computing systems that Amazon uses to run its \$34 billion-a-year retail operation."⁴⁹

Some of a firm's resources (defined in Chapter 1 as inputs to the firm's production process) are tangible while others are intangible. **Tangible resources** are assets that can be observed and quantified. Production equipment, manufacturing facilities, distribution centers, and formal reporting structures are examples of tangible resources. As indicated in the Strategic Focus, Kinder Morgan's pipelines are a tangible resource. **Intangible resources** are assets that are rooted deeply in the firm's history and have accumulated over time. Because they are embedded in unique patterns of routines, intangible resources are difficult for competitors to analyze and imitate. Knowledge, trust between managers and employees, managerial capabilities, organizational routines (the unique ways people work together), scientific capabilities, the capacity for innovation, brand name, the firm's reputation for its goods or services and how it interacts with people (such as employees, customers, and suppliers), and organizational culture are intangible resources.⁵⁰ As illustrated in the Strategic Focus, the marketing routines and brand Coca-Cola uses to facilitate consumer demand for its products are examples of intangible resources.

The four primary categories of tangible resources are financial, organizational, physical, and technological (see Table 3.1). The three primary categories of intangible resources are human, innovation, and reputational (see Table 3.2).

Tangible resources are assets that can be observed and quantified.

Intangible resources include assets that are rooted deeply in the firm's history, accumulate over time, and are relatively difficult for competitors to analyze and imitate.

Tangible Resources

As tangible resources, a firm's borrowing capacity and the status of its physical facilities are visible. The value of many tangible resources can be established through financial statements, but these statements do not account for the value of all the firm's assets, because they disregard some intangible resources.⁵¹ The value of tangible resources is also constrained

Table 3.1 Tangible Resources

Financial Resources	• The firm's capacity to borrow • The firm's ability to generate funds through internal operations
Organizational Resources	• Formal reporting structures
Physical Resources	• The sophistication of a firm's plant and equipment and the attractiveness of its location • Distribution facilities • Product inventory
Technological Resources	• Availability of technology-related resources such as copyrights, patents, trademarks, and trade secrets

Sources: Adapted from J. B. Barney, 1991, Firm resources and sustained competitive advantage, *Journal of Management*, 17: 101; R. M. Grant, 1991, *Contemporary Strategy Analysis*, Cambridge: U.K.: Blackwell Business, 100-102.

Table 3.2 Intangible Resources

Human Resources	• Knowledge • Trust • Skills • Abilities to collaborate with others
Innovation Resources	• Ideas • Scientific capabilities • Capacity to innovate
Reputational Resources	• Brand name • Perceptions of product quality, durability, and reliability • Positive reputation with stakeholders such as suppliers and customers

Sources: Adapted from R. Hall, 1992, The strategic analysis of intangible resources, *Strategic Management Journal*, 13: 136-139; R. M. Grant, 1991, *Contemporary Strategy Analysis*, Cambridge: U.K.: Blackwell Business, 101-104.

Strategic Focus

SUCCESS

Emphasis on Value Creation through Tangible (Kinder Morgan) and Intangible (Coca-Cola Inc.) Resources

Some firms have valuable resources which allow them to ultimately create value as they manage these resources through their capabilities. As outlined in the chapter, tangible resources can be categorized into financial, organizational, physical, and technological, whereas intangible resources are human, innovation, and reputational.

Kinder Morgan is a company that has vast tangible resources through its system of oil and gas pipelines throughout the United States and into Canada. Richard Kinder, CEO of Kinder Morgan, manages the Kinder Morgan Corporation, which is the third largest energy firm headquartered in the United States in terms of overall valuation. In regard to specific physical tangible resources, Kinder Morgan has 75,000 miles of pipe and 180 storage terminals capable of handling 2.5 million barrels of oil and 55 billion cubic feet of gas per day. It has a number of publicly traded entities which total \$100 billion in enterprise value (equity plus debt). Kinder Morgan also has assets in Canada to facilitate transporting gas liquids to Alberta to dilute thick tar sands, which are then carried to tankers on the Pacific Coast. Much of this natural gas comes from as far south as Texas. Furthermore, additional physical assets were picked up in an acquisition of El Paso, another pipeline company, which allows natural gas to be liquefied and transported to energy-starved markets such as Japan and Korea. The liquid natural gas is a nice play because gas prices in Japan and Korea can be \$12 per thousand cubic feet, where the same gas in the United States may cost less than \$4 per thousand cubic feet, creating a nice profit potential.

Interestingly, Kinder Morgan also has financial assets, as many firms do, but some of these assets come through creative tax



Bulk terminals in Tampa, Florida are some of Kinder Morgan's above-ground tangible resources.

approaches to earnings distribution. Most pipelines in the United States have the availability of a corporate structure known as a master limited partnership (MLP). MLPs have income-producing assets which are handled by the general partner and distributed to the limited partners. As such, all profits and tax liabilities are passed on to the unit holders such that the corporations involved pay no income tax. This has created an incentive to acquire assets where a corporate tax is paid and incorporating them into the MLP framework such that corporate taxes are no longer paid, although the unit limited partners do pay taxes. Although the resources noted above create the potential for value, the capabilities to choose the right resources and pipelines to buy as well

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capabilities and the foresight needed to do this, of course, relevant to the ultimate goal. In this case, the U.S. shale drilling has led to a significant increase in gas, propane, and oil prices in the market and has created a huge opportunity for Kinder Morgan because they can charge more for each barrel of oil passing through their pipeline and storage tanks. Kinder Morgan has many assets; however, many of its competitive advantages with Coca-Cola are of the intangible type. Coca-Cola has its brand name and the ability to create a way that creates continual value for its customers. Coca-Cola has many ad agencies to help it deliver its message to its consumers. Although it is at the center of Coca-Cola's marketing strategy, Coca-Cola's team has been able to create content to support its image. It also created a "Shareable, online content" campaign, "Where in the World", which was heard of everywhere. Furthermore, its online videos of the Super Bowl featuring its polar bears, which Coca-Cola advertising dating back to 1922, have gained millions of views. This shareable, online content has helped Coca-Cola's drink earnings a 5 percent bump in 2013. Of course, a firm must be able to manage its intangible brand through distinctive marketing strategies that are by Coca-Cola.

Coca-Cola also has resources that are focused on tangible financial abilities. Coke accounts for 17 percent of juice-related volume sold in the world's top 22 markets, compared with 9 percent for PepsiCo. It has massive storage tanks in Florida insulated and full of fresh-squeezed juice chilling at 30 °F to 34 °F. Coke and Cutrale (Coca-Cola's Brazilian juice partner) buy almost one-third of the 145 million boxes of oranges grown by more than 400 Florida growers. Coca-Cola markets its juice in the United States through the Minute Maid brand, which it bought in 1960. The "secret" formula in juices is the complex algorithm of business analytics to manage the flow from the farm to the distribution center, including the large tanks of frozen juice concentrate which is the base material used in the beverage. The financial analytics to manage this process are a distinct tangible resource that Coca-Cola uses to manage the flow of these products. Again, it takes distinct capabilities to manage both the intangible, reputational resources, as well as the tangible financial analytics that manage the flow of juices in Coke's worldwide operations.

Sources: 2013, Super Bowl: Classic vs. fresh, *Fast Company*, February, 22; J. Kirby, 2013, Creative that cracks the code, *Harvard Business Review*, (91)3: 86–89; Z. R. Mider, 2013, It pays to own a pipeline, *Bloomberg Businessweek*, January 28, 26–28; D. Stanford, 2013, Coke has a secret formula for orange juice, too, *Bloomberg Businessweek*, February 4, 19–21; N. Zmuda, 2013, Behind the scenes of Coca-Cola's Super Bowl in 2013 ad plans, *Advertising Age*, February 4, 24; C. Helman, 2012, Richard Kinder's energy kingdom, *Forbes*, December 10, 76–84; T. Shufelt, 2012, Why Kinder is winning the pipeline race, *Canadian Business*, October 1, 21; T. Stynes & A. Sider, 2012, Kinder Morgan sells assets as part of El Paso deal, *Wall Street Journal*, August 21, B3.

because they are hard to leverage—it is difficult to derive additional business or value from a tangible resource. For example, an airplane is a tangible resource, but “You can’t use the same airplane on five different routes at the same time. You can’t put the same crew on five different routes at the same time. And the same goes for the financial investment you’ve made in the airplane.”⁵²

Although production assets are tangible, many of the processes necessary to use these assets are intangible. Thus, the learning and potential proprietary processes associated with a tangible resource, such as manufacturing facilities, can have unique intangible attributes, such as quality control processes, unique manufacturing processes, and technologies that develop over time.⁵³

Intangible Resources

Compared to tangible resources, intangible resources are a superior source of capabilities and subsequently, core competencies.⁵⁴ In fact, in the global economy, “the success of a corporation lies more in its intellectual and systems capabilities than in its physical assets. [Moreover], the capacity to manage human intellect—and to convert it into useful products and services—is fast becoming the critical executive skill of the age.”⁵⁵

Because intangible resources are less visible and more difficult for competitors to understand, purchase, imitate, or substitute for, firms prefer to rely on them rather than on tangible

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resources as the foundation for their capabilities. In fact, the more unobservable (i.e., intangible) a resource is, the more valuable that resource is to create capabilities.⁵⁶ Another benefit of intangible resources is that, unlike most tangible resources, their use can be leveraged. For instance, sharing knowledge among employees does not diminish its value for any one person. To the contrary, two people sharing their individualized knowledge sets often can be leveraged to create additional knowledge that, although new to each individual, contributes potentially to performance improvements for the firm.

Reputational resources (see Table 3.2) are important sources of a firm's capabilities and core competencies. Indeed, some argue that a positive reputation can even be a source of competitive advantage.⁵⁷ Earned through the firm's actions as well as its words, a value-creating reputation is a product of years of superior marketplace competence as perceived by stakeholders.⁵⁸ A reputation indicates the level of awareness a firm has been able to develop among stakeholders and the degree to which they hold the firm in high esteem.⁵⁹

A well-known and highly valued brand name is a specific reputational resource.⁶⁰ A continuing commitment to innovation and aggressive advertising facilitates firms' efforts to take advantage of the reputation associated with their brands.⁶¹ Harley-Davidson has a reputation for producing and servicing high-quality motorcycles with unique designs. Because of the desirability of its reputation, the company also produces a wide range of accessory items that it sells on the basis of its reputation for offering unique products with high quality. Sunglasses, jewelry, belts, wallets, shirts, slacks, belts, and hats are just a few of the large variety of accessories customers can purchase from a Harley-Davidson dealer or from its online store.⁶² However, reputation is also being facilitated more quickly now through social media. As one analyst wrote, "your brand is nothing more than the sum of conversations being had about it. That is why social media is so powerful."⁶³ One study showed that Hokey Pokey, a popular "super premium" ice cream retailer with a dozen outlets in India, improved its brand equity "by using social media platforms to connect with its target consumers and create an engaging brand experience."⁶⁴ As noted in the Strategic Focus, Coca-Cola is using social media effectively to build its reputational resources.

3-2b Capabilities

The firm combines individual tangible and intangible resources to create capabilities. In turn, capabilities are used to complete the organizational tasks required to produce, distribute, and service the goods or services the firm provides to customers for the purpose of creating value for them.⁶⁵ As a foundation for building core competencies and hopefully competitive advantages, capabilities are often based on developing, carrying, and exchanging information and knowledge through the firm's human capital.⁶⁶ Hence, the value of human capital in developing and using capabilities and, ultimately, core competencies cannot be overstated.⁶⁷ At IBM, for example, human capital is critical to forming and using the firm's capabilities for long-term customer relationships and deep scientific and research skills, and the breadth of the firm's technical skills in hardware, software, and services.⁶⁸

As illustrated in Table 3.3, capabilities are often developed in specific functional areas (such as manufacturing, R&D, and marketing) or in a part of a functional area



Developing capabilities in specific functional areas can give companies a competitive edge. The effective use of social media to direct advertising to specific market segments has given some firms an advantage over their rivals.

(e.g., advertising). Table 3.3 shows a grouping of organizational functions and the capabilities that some companies are thought to possess in terms of all or parts of those functions.

3-2c Core Competencies

Defined in Chapter 1, core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals. Core competencies distinguish a company competitively and reflect its personality. Core competencies emerge over time through an organizational process of accumulating and learning how to deploy different resources and capabilities.⁶⁹ As the capacity to take action, core competencies are “crown jewels of a company,” the activities the company performs especially well compared to competitors and through which the firm adds unique value to the goods or services it sells to customers.⁷⁰

Innovation is thought to be a core competence at Apple. As a capability, R&D activities are the source of this core competence. More specifically, the way Apple has combined some of its tangible (e.g., financial resources and research laboratories) and intangible (e.g., scientists and engineers and organizational routines) resources to complete research and development tasks creates a capability in R&D. By emphasizing its R&D capability, Apple is able to innovate in ways that create unique value for customers in the form of the products it sells, suggesting that innovation is a core competence for Apple.

Excellent customer service in its retail stores is another of Apple’s core competencies. In this instance, unique and contemporary store designs (a tangible resource) are combined with knowledgeable and skilled employees (an intangible resource) to provide superior service to customers. A number of carefully developed training and development procedures are capabilities on which Apple’s core competence of excellent customer service is based. The procedures that are capabilities include “... intensive control of how employees interact

Table 3.3 Example of Firms’ Capabilities

Functional Areas	Capabilities	Examples of Firms
Distribution	Effective use of logistics management techniques	Walmart
Human Resources	Motivating, empowering, and retaining employees	Microsoft
Management Information Systems	Effective and efficient control of inventories through point-of-purchase data collection methods	Walmart
Marketing	- Effective promotion of brand-name products - Effective customer service - Innovative merchandising	- Procter & Gamble - Ralph Lauren Corp. - McKinsey & Co. - Nordstrom Inc. - Crate & Barrel
Management	Ability to envision the future of clothing	- Hugo Boss - Zara
Manufacturing	- Design and production skills yielding reliable products - Product and design quality - Miniaturization of components and products	- Komatsu - Witt Gas Technology - Sony
Research & Development	- Innovative technology - Development of sophisticated elevator control solutions - Rapid transformation of technology into new products and processes - Digital technology	- Caterpillar - Otis Elevator Co. - Chaparral Steel - Thomson Consumer Electronics

Strategic Focus

TECHNOLOGY

Samsung Bests Apple in Smartphone Sales by Its Imitation Capability

Samsung is a large, diversified business group located in South Korea and accounts for 17 percent of South Korea's gross domestic product (GDP). The overall business group employs 370,000 people in more than 80 countries. Samsung's largest separate business is Samsung Electronics, which has grown to over \$141 billion in sales in 2012. In particular, it has had strong strategic success in smartphones; in 2012 it overtook Apple, with 29 percent market share versus Apple's 22 percent. It realized a 7 percent gain in smartphone market share relative to other competitors compared to its position in 2011. Samsung got into the electronics business like other Korean conglomerates such as LG and Hyundai by starting small, making components for other firms in the industry.

Getting into the semiconductor industry requires a semiconductor fab (i.e., a silicon wafer fabrication plant) which costs \$2 to \$3 billion. Once you have the infrastructure in place, you can begin selling semiconductor components to other companies. The knowledge that comes from developing key components allows strong insight into how the industry works. "Indeed, part of Samsung's secret sauce is that it controls and manufactures many of the building blocks of its phones." The firm leverages this foothold to develop an advantage that other companies have little chance of matching. In 2012, Samsung Electronics devoted \$21.5 billion to capital expenditures, more than twice the investment spent by Apple.

To get into smartphones, Samsung built upon an existing innovation, the iPhone. Over time, it built a more advanced product that sold better than the iPhone. Samsung has pursued a "copycat" strategy by innovating where it has an advantage and imitating every place else. The proof of the imitation strategy is found in a recent court ruling that went against Samsung in a case where Apple claimed patent infringement. Although Samsung has copied some design aspects of the iPhone, it has been in high technology screens for quite a long time, having been a maker of televisions and other LED screen technology applications. Product improvements in the smartphone came through Samsung's core competence, "producing big, beautiful screens." Furthermore, Samsung has cultivated an ability to quickly understand the functions and imitate—and where possible given its strengths, improve on—competitors' products. Because it has the ability to manufacture products quickly as a contract manufacturer, it has the skill to produce incremental product improvements quickly.

Interestingly, Samsung has risen with this strategic approach, which is focused on manufacturing its own components as well as other competitors' components, while others have failed in the smartphone market. Motorola split up its handset business and sold part of it to Google. Nokia's longstanding number one



Samsung has pursued a competitive strategy based on both innovation and imitation.

position in cell phones was eroded. Not only was it blindsided by smartphones earlier, but it was overtaken by Samsung on cell phones. Sony Ericsson's partnership dissolved, and Palm disappeared into Hewlett-Packard. BlackBerry is on the edge of failure as well. Samsung Electronics strives for manufacturing efficiency and excellence and stellar new product development across a range of product lines. It also has established a new institute in Silicon Valley to develop its own software, one area where it is behind. Samsung's Galaxy line of smartphones uses the Android operating system created by Google.

Although Samsung produces key components for other producers, including Apple, it suggests that it has a walled-off business where one side does not talk to the other to know what the other is doing. However, because they manufacture components for many other firms, "they can see three years ahead," one analyst commented. Of course, there are upstart Chinese firms that might become the next Samsung, just as Samsung has displaced Sony in consumer electronics. As such, Samsung's chairman, D. J. Lee, continues to suggest that, "We are in danger. We are in jeopardy." However, this perpetual crisis mentality has helped them to maintain their lead.

Source: M. Chafkin, 2013, Samsung: For elevating imitation to an art form, *Fast Company*, March, 108; S. Grobart, 2013, Think colossal: How Samsung became the world's no. 1 smartphone maker – and its plans to stay on top, *Bloomberg Businessweek*, April 1–April 7, 58–64; R. Hof, 2013, Report: Samsung gains in grab for Google's mobile ad revenues, *Forbes*, www.forbes.com, April 3; Y. Kim, F. Bellman, & S. Grundberg, 2013, Samsung covets low-end of smartphone market, too, *Wall Street Journal*, March 22, B5; M. Lev-Ram, 2013, Samsung's road to mobile domination, *Fortune*, February 4, 98–102; J. Osawa, M. Lee, & D. Wakabayashi, 2013, Samsung in talks to invest in Sharp, in deal that could lead to purchase of LCD panels, *Wall Street Journal*, March 6, B3; O. Shenkar, 2010, *Copycats: How Smart Companies Use Imitation to Gain a Strategic Edge*, Cambridge: Harvard Business School Press.

with customers, scripted training for on-site tech support and consideration of every store detail down to the pre-loaded photos and music on demo devices.”⁷¹

Interestingly, even though Apple has excellent innovation capabilities, Samsung has overtaken Apple in smartphone sales, as illustrated in the Strategic Focus. It has done so largely through imitating Apple’s products and by adding additional features such as larger screens, one of Samsung Electronics’ core competencies. Samsung also has core competencies in manufacturing its own components and components for other competitors, which give it insight into future innovations and allow it to produce new products quickly. It also seems to retain these capabilities by continually maintaining a crisis mentality.⁷²



Learn about Samsung,
a competitor of Apple.
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3-3 Building Core Competencies

Two tools help firms identify their core competencies. The first consists of four specific criteria of sustainable competitive advantage that can be used to determine which capabilities are core competencies. Because the capabilities shown in Table 3.3 have satisfied these four criteria, they are core competencies. The second tool is the value chain analysis. Firms use this tool to select the value-creating competencies that should be maintained, upgraded, or developed and those that should be outsourced.

3-3a The Four Criteria of Sustainable Competitive Advantage

Capabilities that are valuable, rare, costly to imitate, and nonsubstitutable are core competencies (see Table 3.4). In turn, core competencies can lead to competitive advantages for the firm over its rivals. Capabilities failing to satisfy the four criteria are not core competencies, meaning that although every core competence is a capability, not every capability is a core competence. In slightly different words, for a capability to be a core competence, it must be valuable and unique from a customer’s point of view. For a core competence to be a potential source of competitive advantage, it must be inimitable and nonsubstitutable by competitors.⁷³

A sustainable competitive advantage exists only when competitors cannot duplicate the benefits of a firm’s strategy or when they lack the resources to attempt imitation. For some period of time, the firm may have a core competence by using capabilities that are valuable and rare, but imitable. For example, some firms are trying to develop a core competence and potentially a competitive advantage by out-greening their competitors. (Interestingly, developing a “green” core competence can contribute to the firm’s efforts to earn above-average returns while benefitting the broader society.) Since 2005, Walmart has used its

Table 3.4 The Four Criteria of Sustainable Competitive Advantage

Valuable Capabilities	• Help a firm neutralize threats or exploit opportunities
Rare Capabilities	• Are not possessed by many others
Costly-to-Imitate Capabilities	• Historical: A unique and a valuable organizational culture or brand name • Ambiguous cause: The causes and uses of a competence are unclear • Social complexity: Interpersonal relationships, trust, and friendship among managers, suppliers, and customers
Nonsubstitutable Capabilities	• No strategic equivalent

resources in ways that have allowed it to reduce its stores' carbon footprint by more than 10 percent and the carbon footprint of its trucking fleet by several times this percentage. It is also influencing its supply chain vendors to foster this same goal. For example, it has aligned with Patagonia, an outdoor apparel firm with a strong record in sustainability, "to launch the Sustainable Apparel Coalition, whose members now produce more than 30% of all clothing sold globally. The goal is to develop the tools to measure, monitor, and reduce the impact the apparel industry has on the environment."⁷⁴

The length of time a firm can expect to create value by using its core competencies is a function of how quickly competitors can successfully imitate a good, service, or process. Value-creating core competencies may last for a relatively long period of time only when all four of the criteria we discuss next are satisfied. Thus, either Walmart or Patagonia would know that it has a core competence and possibly a competitive advantage in terms of green practices if the way the firm uses its resources to complete these practices satisfies the four criteria.

Valuable

Valuable capabilities allow the firm to exploit opportunities or neutralize threats in its external environment. By effectively using capabilities to exploit opportunities or neutralize threats, a firm creates value for customers.⁷⁵ For example, Groupon created the "daily deal" marketing space and reached \$1 billion in revenue faster than any other company in history. However, many imitators appeared very quickly and often with lower fixed costs, which allowed them to survive in the space even though they were not the first mover. Groupon may succeed but shorter development cycles, especially for such online firms, makes it harder for successful startups to create enduring competitive advantage. "In other words, they are increasingly vulnerable to the same capital-market pressures that plague big companies—but before they've developed lasting corporate assets."⁷⁶

Rare

Rare capabilities are capabilities that few, if any, competitors possess. A key question to be answered when evaluating this criterion is, "How many rival firms possess these valuable capabilities?" Capabilities possessed by many rivals are unlikely to become core competencies for any of the involved firms. Instead, valuable but common (i.e., not rare) capabilities are sources of competitive parity.⁷⁷ Competitive advantage results only when firms develop and exploit valuable capabilities that become core competencies and that differ from those shared with competitors. The central problem for Groupon is that its capabilities to produce the "daily deal" reached competitive parity quickly. Similarly, Walmart has developed capabilities to foster their sustainability/green initiatives which are valuable, but Target, another big-box retailer, may duplicate them and as such they may not be rare.

Costly to Imitate

Costly-to-imitate capabilities are capabilities that other firms cannot easily develop. Capabilities that are costly to imitate are created because of one reason or a combination of three reasons (see Table 3.4). First, a firm sometimes is able to develop capabilities because of *unique historical conditions*. As firms evolve, they often acquire or develop capabilities that are unique to them.⁷⁸

A firm with a unique and valuable *organizational culture* that emerged in the early stages of the company's history "may have an imperfectly imitable advantage over firms founded in another historical period;"⁷⁹ one in which less valuable or less competitively useful values and beliefs strongly influenced the development of the firm's culture. Briefly discussed in Chapter 1, organizational culture is a set of values that are shared by members in the organization. We explain this in greater detail in Chapter 12. An organizational culture is a source of advantage when employees are held together tightly by their belief in it and the leaders

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Costly-to-imitate capabilities are capabilities that other firms cannot easily develop.



ZUMA Press, Inc./Alamy

Even though it has well over 100 stores and 18,000 employees, CarMax has developed a small-company culture that is difficult for competitors to imitate.

who helped to create it.⁸⁰ With its emphasis on cleanliness, consistency, and service and the training that reinforces the value of these characteristics, McDonald's culture is thought by some to be a core competence and a competitive advantage. The same appears to be the case for CarMax, one of *Fortune* magazine's 100 Best Companies to Work For. CEO Tom Folliard visited 70 stores in 2012 and hosted grand openings, employee town hall meetings, and steak cookouts. CarMax epitomizes "the small-company culture" even as it "has grown to 119 stores and 18,000 employees."⁸¹ Folliard states that "I've always believed the saying, 'if you take care of your associates, they'll take care of your customers, and the rest will take care of itself'."⁸²

A second condition of being costly to imitate occurs when the link between the firm's core competencies and its competitive advantage is *causally ambiguous*.⁸³ In these instances, competitors can't clearly understand how a firm uses its capabilities that are core competencies as the foundation for competitive advantage. As a result, firms are uncertain about the capabilities they should develop to

duplicate the benefits of a competitor's value-creating strategy. For years, firms tried to imitate Southwest Airlines' low-cost strategy but most have been unable to do so, primarily because they can't duplicate this firm's unique culture.

Social complexity is the third reason that capabilities can be costly to imitate. Social complexity means that at least some, and frequently many, of the firm's capabilities are the product of complex social phenomena. Interpersonal relationships, trust, friendships among managers and between managers and employees, and a firm's reputation with suppliers and customers are examples of socially complex capabilities. Southwest Airlines is careful to hire people who fit with its culture. This complex interrelationship between the culture and human capital adds value in ways that other airlines cannot, such as jokes on flights by the flight attendants or the cooperation between gate personnel and pilots.

Nonsubstitutable

Nonsubstitutable capabilities are capabilities that do not have strategic equivalents. This final criterion "is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable. Two valuable firm resources (or two bundles of firm resources) are strategically equivalent when they each can be separately exploited to implement the same strategies."⁸⁴ In general, the strategic value of capabilities increases as they become more difficult to substitute. The more intangible and hence invisible capabilities are, the more difficult it is for firms to find substitutes and the greater the challenge is to competitors trying to imitate a firm's value-creating strategy. Firm-specific knowledge and trust-based working relationships between managers and nonmanagerial personnel, such as existed for years at Southwest Airlines, are examples of capabilities that are difficult to identify and for which finding a substitute is challenging. However, causal ambiguity may make it difficult for the firm to learn as well and may stifle progress, because the firm may not know how to improve processes that are not easily codified and thus are ambiguous.⁸⁵

In summary, only using valuable, rare, costly-to-imitate, and nonsubstitutable capabilities has the potential for the firm to create sustainable competitive advantages. Table 3.5 shows the competitive consequences and performance implications resulting from combinations of the four criteria of sustainability. The analysis suggested by the table helps managers determine the strategic value of a firm's capabilities. The firm should not emphasize

Nonsubstitutable capabilities are capabilities that do not have strategic equivalents.

Table 3.5 Outcomes from Combinations of the Criteria for Sustainable Competitive Advantage

Is the Capability Valuable?	Is the Capability Rare?	Is the Capability Costly to Imitate?	Is the Capability Nonsubstitutable?	Competitive Consequences	Performance Implications
No	No	No	No	• Competitive disadvantage	• Below-average returns
Yes	No	No	Yes/no	• Competitive parity	• Average returns
Yes	Yes	No	Yes/no	• Temporary competitive advantage	• Average returns to above-average returns
Yes	Yes	Yes	Yes/no	• Sustainable competitive advantage	• Above-average returns

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capabilities that fit the criteria described in the first row in the table (i.e., resources and capabilities that are neither valuable nor rare and that are imitable and for which strategic substitutes exist). Capabilities yielding competitive parity and either temporary or sustainable competitive advantage, however, will be supported. Some competitors such as Coca-Cola and PepsiCo and Boeing and Airbus may have capabilities that result in competitive parity. In such cases, the firms will nurture these capabilities while simultaneously trying to develop capabilities that can yield either a temporary or sustainable competitive advantage.

3-3b Value Chain Analysis

Value chain analysis allows the firm to understand the parts of its operations that create value and those that do not.⁸⁶ Understanding these issues is important because the firm earns above-average returns only when the value it creates is greater than the costs incurred to create that value.⁸⁷

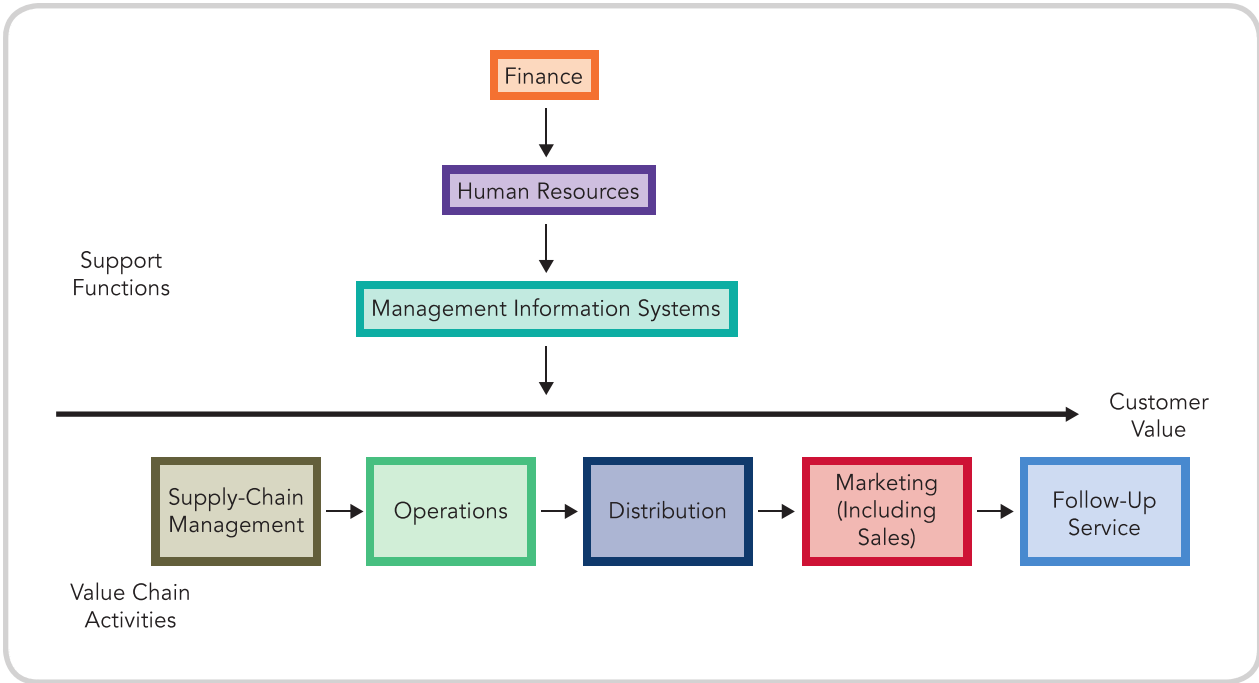
The value chain is a template that firms use to analyze their cost position and to identify the multiple means that can be used to facilitate implementation of a chosen strategy.⁸⁸ Today's competitive landscape demands that firms examine their value chains in a global rather than a domestic-only context.⁸⁹ In particular, activities associated with supply chains should be studied within a global context.⁹⁰

We show a model of the value chain in Figure 3.3. As depicted in the model, a firm's value chain is segmented into value chain activities and support functions. **Value chain activities** are activities or tasks the firm completes in order to produce products and then sell, distribute, and service those products in ways that create value for customers. **Support functions** include the activities or tasks the firm completes in order to support the work being done to produce, sell, distribute, and service the products the firm is producing. A firm can develop a capability and/or a core competence in any of the value chain activities and in any of the support functions. When it does so, it has established an ability to create value for customers. In fact, as shown in Figure 3.3, customers are the ones firms seek to serve when using value chain analysis to identify their capabilities and core competencies. When using their unique core competencies to create unique value for customers that competitors cannot duplicate, firms have established one or more competitive advantages. This appears to be the case for Samsung as it relies on several core competencies, described earlier in a Strategic Focus, to quickly produce high-quality electronic products that are sold at lower prices than those of their competitors to customers throughout the world.

Value chain activities are activities or tasks the firm completes in order to produce products and then sell, distribute, and service those products in ways that create value for customers.

Support functions include the activities or tasks the firm completes in order to support the work being done to produce, sell, distribute, and service the products the firm is producing.

Figure 3.3 A Model of the Value Chain



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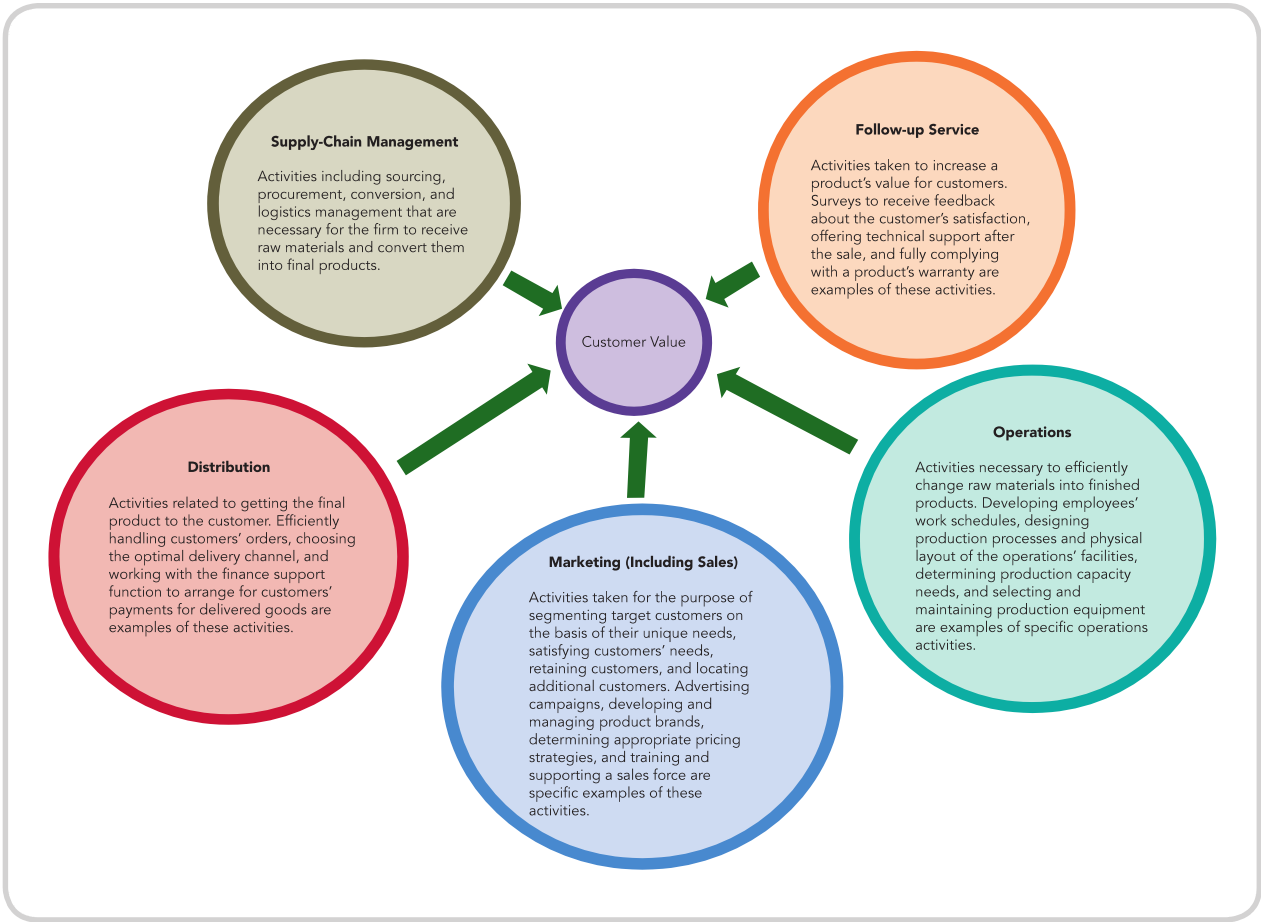
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The activities associated with each part of the value chain are shown in Figure 3.4, while the activities that are part of the tasks firms complete when dealing with support functions appear in Figure 3.5. All items in both figures should be evaluated relative to competitors' capabilities and core competencies. To become a core competence and a source of competitive advantage, a capability must allow the firm (1) to perform an activity in a manner that provides value superior to that provided by competitors, or (2) to perform a value-creating activity that competitors cannot perform. Only under these conditions does a firm create value for customers and have opportunities to capture that value.

Creating value for customers by completing activities that are part of the value chain often requires building effective alliances with suppliers (and sometimes others to which the firm outsources activities, as discussed in the next section) and developing strong positive relationships with customers. When firms have such strong positive relationships with suppliers and customers, they are said to have "social capital."⁹¹ The relationships themselves have value because they produce knowledge transfer and access to resources that a firm may not hold internally.⁹² To build social capital whereby resources such as knowledge are transferred across organizations requires trust between the parties. The partners must trust each other in order to allow their resources to be used in such a way that both parties will benefit over time and neither party will take advantage of the other.⁹³ Trust and social capital usually evolve over time with repeated interactions, but firms can also establish special means to jointly manage alliances that promote greater trust with the outcome of enhanced benefits for both partners.⁹⁴

Evaluating a firm's capability to execute its value chain activities and support functions is challenging. Earlier in the chapter, we noted that identifying and assessing the value of a firm's resources and capabilities requires judgment. Judgment is equally necessary when using value chain analysis because no obviously correct model or rule is universally available to help in the process.

Figure 3.4 Creating Value through Value Chain Activities



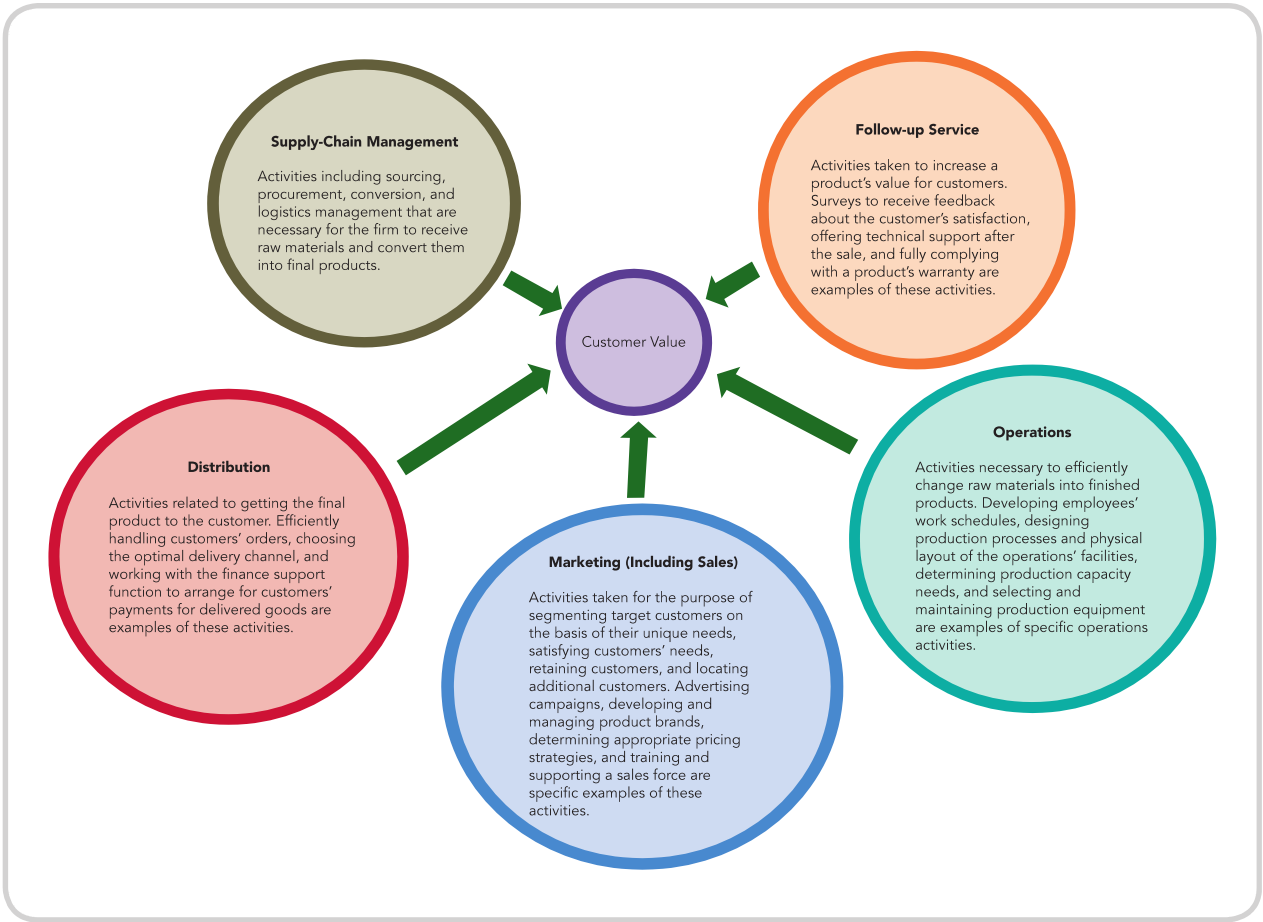
What should a firm do about value chain activities and support functions in which its resources and capabilities are not a source of core competence? Outsourcing is one solution to consider.

3-4 Outsourcing

Concerned with how components, finished goods, or services will be obtained, **outsourcing** is the purchase of a value-creating activity or a support function activity from an external supplier. Not-for-profit agencies as well as for-profit organizations actively engage in outsourcing. Firms engaging in effective outsourcing increase their flexibility, mitigate risks, and reduce their capital investments.⁹⁵ In multiple global industries, the trend toward outsourcing continues at a rapid pace.⁹⁶ Moreover, in some industries virtually all firms seek the value that can be captured through effective outsourcing. As with other strategic management process decisions, careful analysis is required before the firm decides to outsource.⁹⁷ And if outsourcing is to be used, firms must recognize that only activities where they cannot create value or where they are at a substantial disadvantage compared to competitors should be outsourced.⁹⁸

outsourcing is the purchase of a value-creating activity or a support function activity from an external supplier.

Figure 3.4 Creating Value through Value Chain Activities



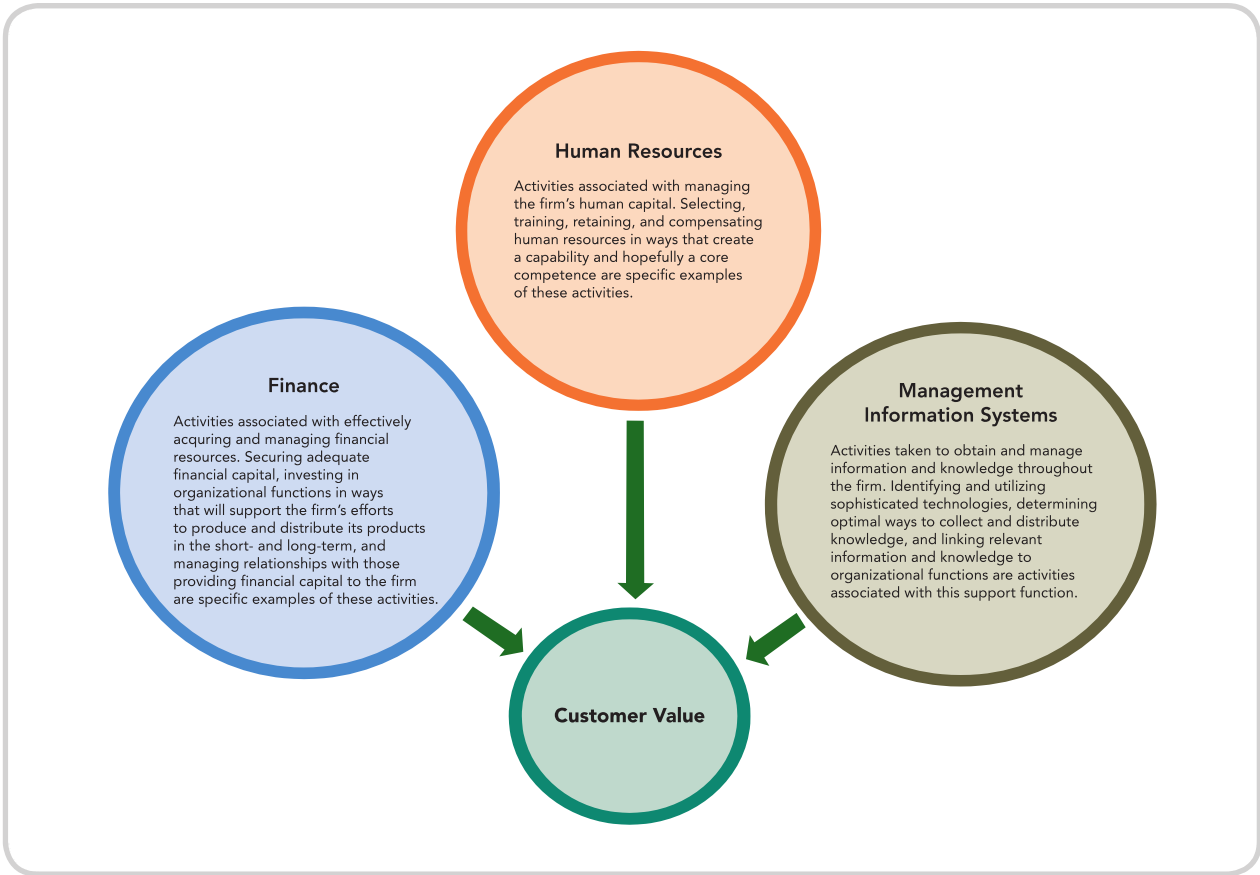
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Figure 3.5 Creating Value through Support Functions



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Outsourcing can be effective because few, if any, organizations possess the resources and capabilities required to achieve competitive superiority in all value chain activities and support functions. For example, research suggests that few companies can afford to develop internally all the technologies that might lead to competitive advantage.⁹⁹ By nurturing a smaller number of capabilities, a firm increases the probability of developing core competencies and achieving a competitive advantage because it does not become overextended. In addition, by outsourcing activities in which it lacks competence, the firm can fully concentrate on those areas in which it can create value. Many times firms establish cooperative relationships with outsourcing partners as illustrated in Chapter 9 on cooperative strategy.

The consequences of outsourcing cause additional concerns.¹⁰⁰ For the most part, these concerns revolve around the potential loss in firms' innovative ability and the loss of jobs within companies that decide to outsource some of their work activities to others. Thus, innovation and technological uncertainty are two important issues to consider when making outsourcing decisions. However, firms can also learn from outsource suppliers how to increase their own innovation capabilities.¹⁰¹ Companies must be aware of these issues and be prepared to fully consider the concerns about opportunities from outsourcing suggested by different stakeholders (e.g., employees). The opportunities and concerns may be especially significant when firms outsource activities or functions to a foreign supply source (often referred to as offshoring).¹⁰² Bangalore and Belfast are hotspots for technology

M. Stasy

outsourcing, competing with major operations in other nations such as China. Yet many firms, including Apple and General Electric, are moving activities back to the United States or keeping them home instead of moving them to a foreign location.¹⁰³ This is due in part to increasing wages in countries like China, but also because of abundant energy with low natural gas prices in the United States.

3-5 Competencies, Strengths, Weaknesses, and Strategic Decisions



David Silverman/Getty Images

This Belfast outsourcing center provides support for a U.S.-based telecom firm. Outsourcing can help firms lower costs and focus on those areas in which they can create value.

By analyzing the internal organization, firms are able to identify their strengths and weaknesses in resources, capabilities, and core competencies. For example, if a firm has weak capabilities or does not have core competencies in areas required to achieve a competitive advantage, it must acquire those resources and build the capabilities and competencies needed. Alternatively, the firm could decide to outsource a function or activity where it is weak in order to improve its ability to use its remaining resources to create value.¹⁰⁴

In considering the results of examining the firm's internal organization, managers should understand that having a significant quantity of resources is not the same as having the "right" resources. The "right" resources are those with the potential to be formed into core competencies as the foundation for creating value for customers and developing competitive advantages as a result of doing so. Interestingly, decision makers sometimes become more focused and productive when seeking to find the right resources when the firm's total set of resources is constrained.¹⁰⁵

Tools such as outsourcing help the firm focus on its core competencies as the source of its competitive advantages. However, evidence shows that the value-creating ability of core competencies should never be taken for granted. Moreover, the ability of a core competence to be a permanent competitive advantage can't be assumed. The reason for these cautions is that all core competencies have the potential to become *core rigidities*.¹⁰⁶ Typically, events occurring in the firm's external environment create conditions through which core competencies can become core rigidities, generate inertia, and stifle innovation. "Often the flip side, the dark side, of core capabilities is revealed due to external events when new competitors figure out a better way to serve the firm's customers, when new technologies emerge, or when political or social events shift the ground underneath."¹⁰⁷

Historically, Borders Group Inc. relied on its large storefronts that were conveniently located for customers to visit and browse through books and magazines in a pleasant atmosphere as sources of its competitive success. Over the past decade or so, though, digital technologies (part of the firm's external environment) rapidly changed customers' shopping patterns for reading materials. Amazon.com's use of the Internet significantly changed the competitive landscape for Borders and similar competitors such as Barnes & Noble. It is possible that Borders' core competencies of store locations and a desirable physical environment for customers became core rigidities for this firm, eventually leading to its filing of bankruptcy in early 2011 and subsequent liquidation.¹⁰⁸ Managers studying the firm's

internal organization are responsible for making certain that core competencies do not become core rigidities.

After studying its external environment to determine what it might choose to do (as explained in Chapter 2) and its internal organization to understand what it can do (as explained in this chapter), the firm has the information required to select a business-level strategy that it will use to compete against rivals. We describe different business-level strategies in the next chapter.

SUMMARY

- In the current competitive landscape, the most effective organizations recognize that strategic competitiveness and above-average returns result only when core competencies (identified by studying the firm's internal organization) are matched with opportunities (determined by studying the firm's external environment).
- No competitive advantage lasts forever. Over time, rivals use their own unique resources, capabilities, and core competencies to form different value-creating propositions that duplicate the focal firm's ability to create value for customers. Because competitive advantages are not permanently sustainable, firms must exploit their current advantages while simultaneously using their resources and capabilities to form new advantages that can lead to future competitive success.
- Effectively managing core competencies requires careful analysis of the firm's resources (inputs to the production process) and capabilities (resources that have been purposely integrated to achieve a specific task or set of tasks). The knowledge the firm's human capital possesses is among the most significant of an organization's capabilities and ultimately provides the base for most competitive advantages. The firm must create an organizational culture that allows people to integrate their individual knowledge with that held by others so that, collectively, the firm has a significant amount of value-creating organizational knowledge.
- Capabilities are a more likely source of core competence and subsequently of competitive advantages than are individual resources. How a firm nurtures and supports its capabilities so they can become core competencies is less visible to rivals, making efforts to understand and imitate the focal firm's capabilities difficult.
- Only when a capability is valuable, rare, costly to imitate, and nonsubstitutable is it a core competence and a source of competitive advantage. Over time, core competencies must be supported, but they cannot be allowed to become core rigidities. Core competencies are a source of competitive advantage only when they allow the firm to create value by exploiting opportunities in its external environment. When this is no longer possible, the company shifts its attention to forming other capabilities that satisfy the four criteria of a sustainable competitive advantage.
- Value chain analysis is used to identify and evaluate the competitive potential of resources and capabilities. By studying their skills relative to those associated with value chain activities and support functions, firms can understand their cost structure and identify the activities through which they can create value.
- When the firm cannot create value in either a value chain activity or a support function, outsourcing is considered. Used commonly in the global economy, outsourcing is the purchase of a value-creating activity from an external supplier. The firm should outsource only to companies possessing a competitive advantage in terms of the particular primary or support activity under consideration. In addition, the firm must continuously verify that it is not outsourcing activities from which it could create value.

REVIEW QUESTIONS

1. Why is it important for a firm to study and understand its internal organization?
2. What is value? Why is it critical for the firm to create value? How does it do so?
3. What are the differences between tangible and intangible resources? Why is it important for decision makers to understand these differences? Are tangible resources more valuable for creating capabilities than are intangible resources, or is the reverse true? Why?

4. What are capabilities? How do firms create capabilities?
5. What four criteria must capabilities satisfy for them to become core competencies? Why is it important for firms to use these criteria to evaluate their capabilities' value-creating potential?
6. What is value chain analysis? What does the firm gain by successfully using this tool?
7. What is outsourcing? Why do firms outsource? Will outsourcing's importance grow in the future? If so, why?
8. How do firms identify internal strengths and weaknesses? Why is it vital that managers have a clear understanding of their firm's strengths and weaknesses?
9. What are core rigidities? What does it mean to say that each core competence could become a core rigidity?

EXPERIENTIAL EXERCISES

EXERCISE 1: WHAT MAKES A GREAT OUTSOURCING FIRM?

The focus of this chapter is on understanding how firm resources and capabilities serve as the cornerstone for competencies and, ultimately, a competitive advantage. However, when firms cannot create value in either a value chain or support activity, outsourcing becomes a potential strategy. According to the International Association of Outsourcing Professionals (IAOP) (<http://www.iaop.org/>) at their latest longitudinal survey the results suggested some interesting trends:

1. Outsourcing service providers are taking increased steps to diversify their services as offerings are becoming more globally commoditized.
2. Firms are offering more low-end and high-end services in search of improving margins.
3. There is a resurgent trend toward nearshoring, where service providers are relocating around the globe to be closer to their clients.
4. This is changing dramatically both the scale and scope of operations for outsourcing firms.

The IAOP annually announces its Global Outsourcing 100, which represents the world's best outsourcing service providers. The evaluation process mirrors that employed by many top customers and considers four key criteria: (1) size and growth in revenue, employees, centers, and countries served; (2) customer experience as demonstrated through the value being created at the company's top customers; (3) depth and breadth of competencies as demonstrated through industry recognition, relevant certifications, and investment in the development of people, processes, and technologies; and (4) management capabilities as reflected in the experience and accomplishments of the organization's top leaders and investment in management systems that ensure outsourcing success.

With a team, pick one of the Top 100 Global best outsourcing firms to analyze from the list on the IAOP Web site at (<http://www.iaop.org/>). Prepare a brief presentation formed around the contents of the chapter that addresses at a minimum the following questions:

- Why was this company chosen to be in the top 100? What has been the company's history as regards outsourcing as a source of revenue?
- How does the firm describe, or imply, its value proposition?

- What unique competitive advantage does the firm exhibit?
- Do you consider this to be a sustainable competitive advantage? Utilize the four criteria of sustainable competitive advantage as your guide.

EXERCISE 2: WHAT IS YOUR CORE COMPETENCY?

In this chapter, the concepts of resources, capabilities, and core competencies were introduced as the foundation for establishing a competitive advantage. Resources (tangible and intangible) alone do not create value for customers but are bundled to create organizational capabilities, which are the basis for a firm's core competencies.

According to Prahalad and Hamel (Harvard Business Review, May-June 1990) there are four guidelines to identifying core competencies:

1. They support the delivery and production of a variety of services and products (thereby giving access to a variety of markets).
2. They always make a significant contribution to perceptions of services and products (i.e., they impact something that your client cares about).
3. They are often difficult for competition to imitate (because they are generally developed with a significant investment of time and resources).
4. They tend to be relatively stable over time.

However, while we normally think of core competency as a concept to be applied to existing organizations, it can equally be effective in application to one personally. If done well the result can be a strategic advantage as you enter the hiring process in that you will be able to define your core competency on your resume and at interviews.

Some interesting research in this area is being done at the University of Victoria Co-Operative Education Program and Career Services. Their work highlights some areas that are the key to developing personal core competencies, as follows:

- Personal management
- Communication
- Managing information
- Research and analysis

ide you through
coopandcareer/

studentsalumni/resources/competencykit/core.php. However numerous other avenues can provide you with a criteria map or create your own that best describes you.

This is an individual assignment. You are to create a personal core competency profile that assesses your individual assets (both tangible and intangible) as well as how those have or are developing into specific capabilities. Lastly identify 3-5 core competencies you currently possess. Your analysis will be due in a written report to your professor.

ORGANIZATIONAL CULTURE CREATES STRATEGIC COMPETITIVENESS

Zappos.com, an online shoe retailer, has been listed in *Fortune* magazine's 100 best companies to work for over the past two years because employees feel empowered and respected. Recognized as a thriving company due to its unique organizational culture, from its untimed and unscripted call centers to "bald and blue" days, Zappos gives its employees the opportunity to shine in the workplace. Tony Shay, CEO, believes that Zappos is making the world a better place by allowing employees to be happy and to look at their job as a place to be for life. By receiving job security and benefits on par with competitors, Zappos employees remain dedicated to promoting branding opportunities with every customer. As a result, Amazon.com willingly purchased Zappos for \$1.2 billion, and with both companies sharing such a strong passion for customer service, Zappos was excited to begin growing together. In 2010, Zappos experienced so much growth that it restructured the company into ten separate companies. The goal is to position Zappos as the online service leader.

Be prepared to discuss the following concepts and questions in class:

Concepts

- Value
- Resources, capabilities, and core competencies
- Sustainable competitive advantage
- Value chain
- Outsourcing

Questions

1. How is Zappos' organizational culture creating value?
2. What resources and resulting capabilities and core competencies do you see within the Zappos organization that gives it strategic competitiveness?
3. Will Zappos' competitive advantage be sustainable?
4. What value chain activities performed by Zappos help to create value for its customers?
5. Why do you think Zappos is not outsourcing its call centers?

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