Chapter 3

The Internal Environment: Resources, Capabilities, and Core Competencies

Competitive Advantage

- Firms achieve strategic competitiveness and earn above-average returns when their core competencies are effectively
  - Acquired
  - Bundled
  - Leveraged

- Over time, the benefits of any value-creating strategy can be duplicated by competitors
Competitive Advantage (cont’d)

- Sustainability of a competitive advantage is a function of
  - The rate of core competence obsolescence due to environmental changes
  - The availability of substitutes for the core competence
  - The difficulty competitors have in duplicating or imitating the core competence

Outcomes from External and Internal Environmental Analyses

By studying the external environment, firms identify:
- what they *might* choose to do

By studying the internal environment, firms determine:
- what they *can* do

Examine unique resources, capabilities, and competencies (sustainable competitive advantage)

Components of Internal Analysis

- Resources: Tangible, Intangible
  - Core Competencies
  - Capabilities
  - Discovering Core Competencies
  - Competitive Advantage
  - Value Chain Analysis
    - Valuable
    - Rare
    - Costly to Imitate
    - Nonsubstitutable
    - Outsource

Figure 3.1
Figure 3.2
Creating Value

- By exploiting their core competencies or competitive advantages, firms create value
- Value is measured by
  - A product’s performance characteristics
  - The product’s attributes for which customers are willing to pay
- Firms create value by innovatively bundling and leveraging their resources and capabilities

Conditions Affecting Managerial Decisions about Resources, Capabilities and Core Competencies

Resources, Capabilities and Core Competencies

- Resources
  - Are the source of a firm’s capabilities
  - Are broad in scope
  - Cover a spectrum of individual, social and organizational phenomena
  - Alone, do not yield a competitive advantage
  - Are a firm’s assets, including people and the value of its brand name
  - Represent inputs into a firm’s production process, such as:
    - Capital equipment
    - Skills of employees
    - Brand names
    - Financial resources
    - Talented managers
Tangible Resources

Financial Resources
- The firm’s borrowing capacity
- The firm’s ability to generate internal funds

Organizational Resources
- The firm’s formal reporting structure and its formal planning, controlling, and coordinating systems

Physical Resources
- Sophistication and location of a firm’s plant and equipment
- Access to raw materials

Technological Resources
- Stock of technology, such as patents, trade-marks, copyrights, and trade secrets


Intangible Resources

Human Resources
- Knowledge
- Trust
- Managerial capabilities
- Organizational routines

Innovation Resources
- Ideas
- Scientific capabilities
- Capacity to innovate

Reputational Resources
- Reputation with customers
- Brand name
- Perceptions of product quality, durability, and reliability
- Reputation with suppliers
- For efficient, effective, supportive, and mutually beneficial interactions and relationships


Resources, Capabilities and Core Competencies

- Capabilities
  - Are the firm’s capacity to deploy resources that have been purposely integrated to achieve a desired end state
  - Emerge over time through complex interactions among tangible and intangible resources
  - Often are based on developing, carrying and exchanging information and knowledge through the firm’s human capital
Resources, Capabilities and Core Competencies

**Capabilities**

- The foundation of many capabilities lies in:
  - The unique skills and knowledge of a firm's employees
  - The functional expertise of those employees
- Capabilities are often developed in specific functional areas or as part of a functional area

**Examples of Firms' Capabilities**

<table>
<thead>
<tr>
<th>Functional Area</th>
<th>Capabilities</th>
<th>Examples of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution</td>
<td>Effective use of logistics management techniques</td>
<td>Wal-Mart</td>
</tr>
<tr>
<td>Human resources</td>
<td>Motivating, empowering, and retaining employees</td>
<td>Microsoft Corp.</td>
</tr>
<tr>
<td>Information</td>
<td>Effective and efficient control of information through point-of-purchase data collection methods</td>
<td>Wal-Martin</td>
</tr>
<tr>
<td>Marketing</td>
<td>Effective promotion of brand-name products</td>
<td>Gillette Co.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Polo Ralph Lauren</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Coach</td>
</tr>
<tr>
<td></td>
<td></td>
<td>McKinsey &amp; Co.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Nordstrom Inc.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Selectron</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Corporation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Norrell Corporation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Crate &amp; Barrel</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Gap Inc.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>PepsiCo</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Komatsu</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Gap Inc.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sony</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Caterpillar</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Otis Elevator Co.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Chaparral Steel</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Thomson Consumer</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Electronics</td>
</tr>
</tbody>
</table>

**Core Competencies**

- Resources and capabilities that serve as a source of a firm's competitive advantage:
  - Distinguish a company competitively and reflect its personality
  - Emerge over time through an organizational process of accumulating and learning how to deploy different resources and capabilities
Resources, Capabilities and Core Competencies

- **Core Competencies**
  - Activities that a firm performs especially well compared to competitors
  - Activities through which the firm adds unique value to its goods or services over a long period of time

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

Outcomes from Combinations of the Criteria for Sustainable Competitive Advantage

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Competitive disadvantage</td>
<td>Below-average returns</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes/no</td>
<td>Competitive parity</td>
<td>Average returns</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes/no</td>
<td>Temporary competitive advantage</td>
<td>Above-average returns to average returns</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Sustainable competitive advantage</td>
<td>Above-average returns</td>
</tr>
</tbody>
</table>

Table 3.4

Table 3.5
Value Chain Analysis

- Allows the firm to understand the parts of its operations that create value and those that do not
- A template that firms use to:
  - Understand their cost position
  - Identify multiple means that might be used to facilitate implementation of a chosen business-level strategy

Value Chain Analysis (cont'd)

- Primary activities involved with:
  - A product's physical creation
  - A product's sale and distribution to buyers
  - The product's service after the sale
- Support activities
  - Provide the support necessary for the primary activities to take place

The Value Chain
Outsourcing

- The purchase of a value-creating activity from an external supplier
  - Few organizations possess the resources and capabilities required to achieve competitive superiority in all primary and support activities
- By forming and emphasizing fewer capabilities
  - A firm can concentrate on those areas in which it can create value
  - Specialty suppliers can perform outsourced capabilities more efficiently

Outsourcing Decisions

A firm may outsource all or only part of one or more primary and/or support activities.

Outsourced activity

Strategic Rationales for Outsourcing

- Improve business focus
  - Lets a company focus on broader business issues by having outside experts handle various operational details
- Provide access to world-class capabilities
  - The specialized resources of outsourcing providers makes world-class capabilities available to firms in a wide range of applications
Strategic Rationales for Outsourcing (cont’d)

- **Accelerate business re-engineering benefits**
  - Achieves re-engineering benefits more quickly by having outsiders—who have already achieved world-class standards—take over process

- **Sharing risks**
  - Reduces investment requirements and makes firm more flexible, dynamic and better able to adapt to changing opportunities

- **Frees resources for other purposes**
  - Redirects efforts from non-core activities toward those that serve customers more effectively

Outsourcing Issues

- **Greatest value**
  - Outsource only to firms possessing a core competence in terms of performing the primary or supporting the outsourced activity

- **Evaluating resources and capabilities**
  - Do not outsource activities in which the firm itself can create and capture value

- **Environmental threats and ongoing tasks**
  - Do not outsource primary and support activities that are used to neutralize environmental threats or to complete necessary ongoing organizational tasks

Outsourcing Issues (cont’d)

- **Nonstrategic team of resources**
  - Do not outsource capabilities that are critical to the firm’s success, even though the capabilities are not actual sources of competitive advantage

- **Firm’s knowledge base**
  - Do not outsource activities that stimulate the development of new capabilities and competencies
Cautions and Reminders

- Never take for granted that core competencies will continue to provide a source of competitive advantage
- All core competencies have the potential to become core rigidities
- Core rigidities are former core competencies that now generate inertia and stifle innovation
- Determining what the firm can do through continuous and effective analyses of its internal environment increases the likelihood of long-term competitive success
- Determining what the firm can do through continuous and effective analyses of its internal environment increase the likelihood of long-term competitive success

SWOT Analysis

Based on assumption an effective strategy derives from a sound “fit” between a firm’s internal resources and its external situation

Opportunities
A major favorable situation in a firm’s environment

Weaknesses
A limitation or deficiency in one or more resources or competencies relative to competitors

Strengths
A resource advantage relative to competitors and the needs of markets firm serves

Threats
A major unfavorable situation in a firm’s environment

Numerous environmental opportunities

Critical internal weaknesses

Cell 3: Supports a turnaround-oriented strategy

Cell 1: Supports an aggressive strategy

Cell 4: Supports a defensive strategy

Substantial internal strengths

Cell 2: Supports a diversification strategy

Major environmental threats