Chapter 4: The Internal Organization: Resources, Capabilities, and Core Competencies

CHAPTER SUMMARY

This chapter focuses on the firm's internal organization and what it can do, showing how firms use the strategic management process to create value and earn high returns by effectively leveraging their unique core competencies to take advantage of opportunities in the external environment.

The role of firm resources, capabilities, and core competencies to provide a foundation for creating strategies and the relationship amongst these concepts in developing sustainable competitive advantage are discussed.

The value-chain concept and four criteria to evaluate core competencies are presented as tools of internal resource analysis that aid firms in establishing competitive advantages with higher performance potential.

The chapter closes with an examination of performance dimensions from stakeholder perspectives and the strategic importance of considering the broader socially-responsible role that organizations are now expected to fill within their communities.

CHAPTER OUTLINE

- Internal Analysis and Value Creation
  - Conditions Influencing Internal Analysis
  - Creating Value
- Resources, Capabilities, and Core Competencies
  - Resources
  - Capabilities
  - Core Competencies
- Building Core Competencies
  - Four Criteria of Sustainable Competitive Advantage
  - Value-Chain Analysis
  - Outsourcing
  - When Core Competencies Lose Their Value
- Firm Performance
  - Stakeholder Objectives and Value
  - Measures of Firm Performance
  - Balancing Stakeholder Performance
  - Sustainable Development
- Summary

KNOWLEDGE OBJECTIVES

1. Explain the need for firms to study and understand their internal organization.
2. Define value creation and discuss its importance.
3. Describe the differences between tangible and intangible resources.
4. Define capabilities and discuss how they are developed.
5. Describe four criteria used to determine whether resources and capabilities are core competencies.

6. Explain how value-chain analysis is used to identify and evaluate resources and capabilities.
7. Define outsourcing and discuss the reasons for its use.
8. Discuss the importance of preventing core competencies from becoming core rigidities.
9. Explain several methods to measure firm performance and how firms can use multiple measures to balance stakeholder interests and enhance value creation.

LECTURE NOTES

The Internal Organization - This opening section launches a discussion of looking at the actions that are permitted by a firm‘s unique bundle of resources, capabilities, and core competencies and what happens to a firm‘s competitive advantage over time in today‘s rapidly changing environment.

See slides 1-4. See Figure 4.1: Outcomes from External and Internal Organizational Analyses (slide 3).	1. What three factors determine the sustainability of a competitive advantage? a. The rate of core competence obsolescence caused by environmental change b. The availability of substitutes for the core competence c. The imitability of the core competence

Internal Analysis and Value Creation - This section presents the challenge of making decisions related to an organization‘s resources, capabilities, and core competencies.

Conditions Influencing Internal Analysis - This section highlights the impact that an emerging global economy has had on the sources of competitive advantage for businesses and other conditions that influence how firms make effective strategic decisions.

See slide 5.	**Key Terms** ▪ Global Mind-Set - ability to study an internal environment in ways that do not depend on the assumptions of a single country, culture, or context.
See slide 6.	2. How have global considerations and the pace of change in the environment affected strategic thinking? a. The environmental context exists beyond any one national or cultural set of boundaries. b. The tendency to resist change must be overcome by involving more and diverse individuals in the strategic

	process to prevent inertia, resistance to change, and denial of the need for adjustments to strategy. c. An organizational setting which fosters experimentation and learning is critical to promoting responsiveness to the need for change. d. Confident, bold managers with integrity, the capacity to handle an uncertain and complex decision-making environment, and the willingness to hold people accountable are required for success. e. Decision makers must define their firm's strategy in terms of a unique (exclusive) and viable competitive position beyond the operational demands of its external environment.
See Figure 4.2: Conditions Affecting Managerial Decisions about Resources, Capabilities, and Core Competencies (slide 7).	3. Managerial decisions about resources, capabilities, and core competencies are characterized by what three conditions? a. Uncertainty b. Complexity c. Intra-organizational conflict

Create Value - This section discusses the idea of exploiting core competencies and meeting global standards of competition to create superior value for customers.

See slide 8.	**Key Terms** ▪ <u>Value</u> - measured by a product's performance characteristics and by its attributes for which customers are willing to pay.

Resources, Capabilities, and Core Competencies - This section discusses the evolution of the strategic management process into a broader, comprehensive theory which identifies the importance of both adaptation and enactment in strategy formulation.

See slide 9. See Figure 4.3: Components of Internal Analysis Leading to Competitive Advantage and Value Creation (slide 10).	4. What is the relationship among resources, capabilities, and core competencies? a. Resources are the source of a firm's capabilities. b. Capabilities, in turn, are the source of a firm's core competencies. c. A firm's core competencies are the basis for its competitive advantages in the marketplace.

Resources - This section outlines and describes both tangible and intangible types of resources.

See slides 11-13.	**Key Terms** ▪ <u>Tangible Resources</u> - assets that can be observed and quantified ▪ <u>Intangible Resources</u> - assets that typically are rooted deeply in the firm's history and have accumulated over time ▪ <u>Reputation</u> - level of awareness a firm has been able to develop among stakeholders ▪ <u>Social Capital</u> - relationships with other organizations that contribute to the creation of value ▪ <u>Strategic Value of Resources</u> - degree to which resources can contribute to the development of capabilities, core competencies, and ultimately, competitive advantage
See Table 4.1: Tangible Resources (slide 14). See Table 4.2: Intangible Resources (slide 15). See slide 16. See Additional Notes below.	5. Describe four types of tangible resources/assets. a. Financial assets b. Organizational c. Physical d. Technological 6. Describe three types of intangible resources/assets. a. Human b. Innovative c. Reputational 7. Why is the value of intangible resources increasing relative to the value of tangible resources? a. Intangible resources are less visible, making it difficult for competitors to analyze, understand, imitate, purchase, or substitute for them. b. A competitive advantage based on an intangible resource is therefore more sustainable. c. Unlike tangible assets, intangible resources can be leveraged within a network of users to benefit each user.
	Additional Discussion Notes for Tangible vs. Intangible Resources - These notes include additional materials that cover the differences between tangible and intangible resources, using Coca-Cola® as an example to illustrate the concepts. **Tangible vs. Intangible Resources** Resources are what a firm has to work with—its assets—including its people and the value of its brand name. *Tangible* resources are in essence those things that you can put your hands on such as property, plant and equipment, personnel, raw materials, and so on. One highly illustrative example of tangible resources and how the strategic utilization/manipulation of them can have a great impact on a firm's profits are diamonds. Cartier owns or controls over 95% of the

	world's diamond mines. If the entire supply of diamonds were to be released onto the world market, the gems would devalue to 10% of the current market price or less. Cartier controls the amount, timing, quality, grade (size), and destination point of virtually every batch of diamonds that is released onto the world market. In doing so, Cartier is able to control the market price of the gems and therefore is able to manipulate profits. While the concept of tangible resources is easy to imagine, the idea of intangibles can be elusive. If tangibles are that which we can put our hands on, intangibles are everything else. Some examples are: goodwill, reputation, and brand value. For example, the late Robert Goizeuta, former CEO of Coca-Cola, once explained intangibles and their value in this way. Goizeuta said "if everything tangible that Coke owns were to be destroyed in some bizarre accident, if a fire were to burn down each and every factory, office building and bottling plant right down to a total loss of every desk, chair, and pencil, the intangible resources that Coke owns would be those things that the company still possesses; namely, brand value, the secret recipe, its distribution channels, and business relationships that it has developed over the years." These would allow Coke to go to a bank and borrow billions of uncollateralized dollars to rebuild its infrastructure. The textbook suggests that intangible resources can be categorized: ▪ *Human Resources:* knowledge, trust, managerial capabilities, organizational routines ▪ *Innovation Resources:* ideas, scientific capabilities, capacity to innovate, intellectual property ▪ *Reputational Resources:* reputation with customers , brand name, reputation with suppliers, perceived product quality, durability, and reliability Similar to the Coca-Cola example, the Harley-Davidson brand name has such cachet that it adorns a limited-edition Barbie doll, a popular restaurant in New York City, and a line of L'Oreal cologne. Moreover, Harley-Davidson MotorClothes annually generates over $100 million in revenue for the firm and offers a broad range of clothing items, from black leather jackets to fashions for tots. In sum, because reputation is difficult to imitate and substitute, it can garner competitive advantage.

Capabilities - This section highlights that the foundation of many capabilities lies in the skills and knowledge of a firm's employees and their functional expertise. The value of human capital in developing and collectively using capabilities is emphasized.	
See slide 17.	**Key Terms** ▪ <u>Capabilities</u> **-** firm's capacity to deploy resources that have been purposely integrated to achieve a desired end state

See Table 4.3: Examples of Firm's Capabilities (slide 18).	8. Discuss some capabilities that can be found in an organization's functional areas. a. Answers will vary across functional areas.

Core Competencies - This section discusses how core competencies distinguish a company competitively and reflect its personality.	
See slide 19.	**Key Terms** ▪ Core Competencies - resources and capabilities that serve as a source of competitive advantage for a firm over its rivals
See slides 20-21.	9. Describe some features of core competencies. a. Core competencies emerge within a firm over time. b. Core competencies are the capacity of an organization to take action. c. Core competencies are the activities that a firm performs well relative to its competitors, adding unique value for its customers. d. Core competencies do not represent all of a firm's resources and capabilities, only those with strategic value. e. Supporting and nurturing more than four core competencies may prevent a firm from developing the focus needed to fully exploit its competencies in the marketplace.

Building Core Competencies - This section develops two tools for identifying and building core competencies that will create and sustain competitive advantages. (See slide 22.)

Four Criteria of Sustainable Competitive Advantage - This section outlines and discusses each of the four criteria that qualify capabilities as core competencies and ultimately establish competitive advantages for firms.	
See slides 23-24.	**Key Terms** ▪ Valuable Capabilities - allow the firm to exploit opportunities or neutralize threats in its external environment ▪ Rare Capabilities - possessed by few, if any, current or potential competitors

	▪ Costly to Imitate Capabilities - cost for other firms to develop is prohibitive, cannot easily be developed by other firms ▪ Non-substitutable Capabilities - do not have strategic equivalents.
See Table 4.4: Four Criteria for Determining Core Competencies (slide 25). See Figure 4.4: Core Competencies as a Strategic Capability (slide 26). See slide 27. See Table 4.5: Outcomes from Combinations of the Criteria for Sustainable Competitive Advantage (slide 28). See Additional Notes Below.	10. Name and discuss the four criteria for determining core competencies. a. Capabilities are valuable. b. Capabilities are rare. c. Capabilities are costly to imitate. d. Capabilities cannot be substituted. 11. Distinguish between strategic capabilities and non-strategic capabilities. a. Strategic capabilities meet the four criteria of sustainable competitive advantage and have strategic relevance. 12. In what three ways are costly-to-imitate capabilities created? a. Capabilities were developed because of unique historical conditions. b. Capabilities have a causally ambiguous link to competitive advantage. c. Capabilities are socially complex, or are the product of complex social phenomenon. 13. Table 4.5 in the text shows the competitive consequences and performance implications resulting from combinations of the four criteria of sustainability. Discuss how this analysis helps managers determine the strategic value of the firm's capabilities. a. Capabilities that fall into the first row of the table should not be emphasized. b. Capabilities yielding competitive parity and either temporary or sustainable competitive advantage should be supported.
	Additional Discussion Notes for Discovering Core Competencies - These notes include additional materials that cover the criteria to determine core competencies, using Cartier and Starbucks as an examples to illustrate the process. **Core Competencies** A firm's core competencies are those things it does that give it a competitive advantage over another firm. They are generally valuable, rare, costly to imitate, and nonsubstitutable. They may or may not be unique to the firm. They may simply be an industry practice that a firm does better, or a set of industry practices the firm does in a specific

combination or sequence that allows the firm to be more efficient than its competitors.

Using the Cartier example, to be able to manipulate the supply of gems in the market, Cartier must be very efficient and competent at predicting the demand for its gems. If they were not very skilled at this, there would be fluctuations in the supply and demand curve and, therefore, market price that would leave an opportunity for arbitrage. The value of this arbitrage represents lost profits for Cartier. It was this ability to predict demand that allowed Cartier to see higher profits than its competitors in the 1800s, eventually eroding the market share and profitability of these competitors. Cartier subsequently acquired these firms to create the monopoly it now holds on the world's diamond market.

As noted in the textbook, an important question is "How many core competencies are required for the firm to have a sustained competitive advantage?" While responses to this question vary, McKinsey & Co. recommends that its clients identify no more than three or four competencies. Recent actions by Starbucks demonstrate this point.

Growing rapidly, Starbucks decided that it could use the Internet as a distribution channel to achieve additional growth. However, the firm quickly realized that it lacked the capabilities required to successfully distribute its products through this channel—and that its unique coffee, not the delivery of that product, is its competitive advantage. In part, this recognition forced Starbucks to renew its emphasis on existing capabilities to create more value through its supply chain. To do so, the firm trimmed the number of its milk suppliers from 65 to fewer than 25 and negotiated long-term contracts with coffee-bean growers. The firm also decided to place automated espresso machines in its busy units. These machines reduced Starbucks' cost while providing improved service to its customers, who can now move through the line much faster. Using its supply chain and service capabilities in these ways allows Starbucks to strengthen its competitive advantages of coffee and the unique venue in which on-site customers experience it.

When capabilities are valuable, rare, costly to imitate, and nonsubstitutable, they are effectively called core competencies. Alternatively, every core competence is a capability, but not every capability is a core competence. Operationally, one could argue that for a capability to be a core competence, it must be valuable and nonsubstitutable from a customer's point of view, but unique and inimitable from a competitor's point of view.

As discussed in the textbook, an important key to success occurs when the link between the firm's capabilities and its competitive advantage is causally ambiguous, where rivals can't tell how a firm uses its capabilities as the foundation for competitive advantage. Gordon Forward, CEO of Chaparral Steel, allows rivals to tour his firm's facilities and see almost everything. In Chaparral Steel's causally ambiguous operations, workers use the concept of *mentalfacturing*, by which manufacturing steel is done by using their minds instead of their hands.

<table>
<tr><td colspan="2">Value-Chain Analysis - This section introduces an internal analysis tool to help managers understand the parts of their operations that create value and those that do not. This template can be used to identify a firm‘s cost position and the means that might be used to facilitate implementation of a chosen business-level strategy.</td></tr>
<tr><td>See slide 29.</td><td>Key Terms
<u>Primary Activities</u> - involved with a product‘s physical creation, its sale and distribution to buyers, and its service after sale
<u>Support Activities</u> - provide the support needed by the primary activities to be implemented</td></tr>
<tr><td>See Figure 4.5: The Basic Value Chain (slide 30).

See Tables 4.6 and 4.7: Examining the Value-Creating Potential of Primary and Support Activities (slides 31-32).

See slide 33.</td><td>14. List some of the primary activities that are considered during a value-chain analysis.
a. Inbound logistics
b. Operations
c. Outbound logistics
d. Marketing and sales
e. Service
15. List some of the support activities that are considered during a value-chain analysis.
a. Procurement
b. Technological development
c. Human resource management
d. Firm infrastructure
16. To be a source of competitive advantage, what two conditions must a resource or capability meet?
a. The resource or capability must allow the firm to perform an activity in a manner superior to the way competitors perform it.
b. The resource or capability must allow the firm to perform a value-creating activity that competitors cannot perform.</td></tr>
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<tr><td colspan="2">Outsourcing - This section defines the practice of going outside of a firm to acquire value-creating activities, when it is a viable option to do so, and why this trend continues to increase at a rapid pace.</td></tr>
<tr><td>See slide 34.</td><td>Key Terms
<u>Outsourcing</u> - purchase of a value-creating activity from an external supplier</td></tr>
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See slide 35.	17. When is outsourcing value-creating activities a viable option for a firm? a. When a firm does not have capabilities in the areas needed to succeed b. When a firm lacks a resource or possesses inadequate skills essential to successfully implement a strategy c. When few organizations possess the resources and capabilities required to achieve competitive superiority in all primary and support activities necessary to compete d. When extensive internal capabilities exist for effectively coordinating external sourcing and internal core competencies.
See slide 36.	18. What are some of the benefits of outsourcing? a. Increased flexibility b. Mitigation of risks c. Reduced capital investments
See slide 37. See Additional Notes Below.	19. What skills are essential for managers who are responsible for outsourcing activities? a. Strategic thinking b. Deal making c. Partnership governance d. Managing change
	Additional Discussion Notes for Outsourcing - These notes include additional materials that cover outsourcing as a method for acquiring value-creating activities, using BMW USA as an example to illustrate the concept. In addition, the strategic rationale for outsourcing is discussed, including Apple® as an example to demonstrate the logic. **Outsourcing** Firms outsource to varying degrees. BMW USA, for example, outsources virtually everything and the plant here is primarily an assembly line plant. In contrast, Apple Computers manufactures virtually every component in house, right down to the proprietary software components that make up the operating system. There are benefits to each approach. Building everything in-house give the firm’s managers greater control over the quality of the components, while outsourcing pushes the burden of raw materials and works-in-process inventories off on the component suppliers and frees up capital for other uses. Using the preceeding examples, if BMW were to keep all processes in house, the plant would need to be exponentially larger. BMW would also then be required to tie up billions of dollars in capital to store raw materials for the various components on site and employ a vast labor

force for the manufacture and processing of the components. This would require a vast infrastructure to support the processes. Each year, when making changes to the new car models, a very large outlay of capital and resources to retool the entire operation would be required. By outsourcing the manufacture of these components, this burden is spread across many firms.

Strategic Rationales for Outsourcing

This diversification leads to a more efficient utilization of resources. For instance, if the new model required a new type of component that had never been previously incorporated into BMW cars, say a turbocharger, this would require adding an entire turbocharger manufacturing plant to the existing factory if everything were to be *insourced*. There would also be an engineering and learning curve associated with the development of this new component.

Using an outsourcing strategy allows BMW to shop for a contract with the manufacturer of highest quality product at the best price currently on the market. In doing so, not only will BMW be freeing up resources that can be better utilized elsewhere in the firm, they are also capitalizing on the expertise of the supplier.

In contrast, Apple does virtually everything in house. The problems that this practice created for the company illustrate the issues that can arise from this type of strategy. For example, the firm had a limited number of design and engineering teams at its disposal. This led to very long lead times in the designing and manufacturing of individual components that went into several of its personal computer models. By the time these models were completed and released onto the market, they had been made obsolete by models previously released by Apples competitors, most notably Compaq and IBM. This is illustrated with Apple's release of the Mac Portable in 1989. This machine took nearly three years to develop and weighed nearly 17 pounds when released. Sales of the machine were nearly nonexistent; Compaq's LTE, released six weeks after the Mac Portable, was 18 months in development and weighed just less than 7 pounds.

When Core Competencies Lose Their Value - This section discusses conditions that are created externally as well as internally to the organization to diminish the value of core competencies. (See slide 38.)

Firm Performance - This section identifies high performance results as the primary objective of using the tools of internal analysis, and addresses the multi-dimensional nature of firm performance measurements. Additionally, stakeholder expectations and their response to firm performance are discussed.

Stakeholder Objectives and Power - This section evaluates the varying dependencies between firms and their stakeholders, the factors that influence firms' positions relative to the perceived power of stakeholders, and the resulting priorities and trade-offs for firms.	
See slide 39.	**Key Terms** ▪ Economic Power - comes from the ability to withhold economic support from the firm ▪ Political Power - results from the ability to influence others to withhold economic support or to change the rules of the game ▪ Formal Power - refers to laws or regulations that specify the legal relationship existing between a firm and a particular stakeholder group
See slide 40.	20. What is the most critical criterion in prioritizing stakeholders, and how is this criterion categorized for better understanding. a. Power - economic b. Power - political c. Power - formal 21. How do levels of financial returns earned by firms affect their efforts to satisfy multiple stakeholder expectations? a. When firms earn high economic returns, the challenge of balancing stakeholder interests is lessened substantially - a firm can more easily satisfy multiple stakeholders simultaneously. b. When firms earn average economic returns, the firm is unable to maximize the interests of all stakeholders. The objective then becomes one of at least minimally satisfying each stakeholder, and trade-off decisions are made in light of how dependent the firm is on the support of its stakeholder groups. c. When firms earn below-average returns, the managerial challenge is to minimize the amount of support withdrawn by stakeholders.

Measures of Firm Performance - This section categorizes firm performance into three types of measurement (based on three primary stakeholder groups) and presents the needs of other key stakeholders that are important to the success of the firm. The reconciliation of risk levels and expected returns is also discussed.	
See slide 42.	**Key Terms** ▪ Risk - investor uncertainty about the economic gains or losses that will result from a particular investment

See slide 41. See Table 4.8: Firm Performance from a Capital Market Perspective (slide 43). See Table 4.9: Other Measures of Firm Performance (slide 44).	22. What three categories of firm performance address the primary stakeholders of an organization? a. Capital market performance measures b. Product market performance measures c. Organizational stakeholder performance measures

Balancing Stakeholder Performance - This section re-emphasizes the conflicting nature of stakeholder expectations and that optimal value creation requires a balance of stakeholder interests.

Sustainable Development - This section adds social responsibility to the discussion of internal strategic considerations for firms and discusses the need for firms to exceed legal and moral requirements to find ways for value-creating activities to benefit society.

See slide 45.	**Key Terms** ▪ Sustainable Development - business growth that does not deplete the natural environment or damage society

Ethical Questions - Recognizing the need for firms to effectively interact with stakeholders during the strategic management process, all strategic management topics have an ethical dimension. A list of ethical questions appears after the Summary section of each chapter in the textbook. The topic of ethics is best covered throughout the course to emphasize its prevalence and importance. We recommend posing at least one of these questions during your class time to stimulate discussion of ethical issues relevant to the chapter material that you are covering. (See slides 46-52.)