Chapter 7

Analysing the internal environment

Learning outcomes

- After reading this chapter, you should be able to:
  - identify the strategic resources and capabilities of an organisation
  - explain how an organisation can use its resources and capabilities to develop or maintain its competitive advantage
  - explain the value chain of an organisation
  - use the value chain to identify resources and capabilities
  - appraise the resources and capabilities of the organisation as strengths or weaknesses.

Overview

- This chapter emphasises the importance of understanding the environment – not only the external opportunities and threats, but also the internal strengths and weaknesses of the organisation.
- Internal analysis is required to identify the organisation's strengths and weaknesses as a basis for competitive strategy.
- The importance of analysis of comparative strengths and weaknesses is stressed.
- The resource-based view (RBV) is discussed.

7.1 Introduction

- Many organisations use the SWOT method to identify, typically by brainstorming, opportunities and threats in the external environment and strengths and weaknesses in the internal environment.
- SWOT is an acronym for strengths, weaknesses, opportunities, and threats.
- However, just producing a list of strengths and weaknesses has marked shortcomings in establishing a strategy for the future that is aligned with the internal environment of the organisation.
- It is far more useful to have a framework to conduct internal analysis.

7.1 Introduction (cont.)

- The rise of the so-called 'resource-based view' (RBV) of the organisation springs from the strategic importance of understanding why organisations differ from each other, and why certain organisations are more successful and more profitable than others (Collis & Montgomery, 2005:27).
- Competitive advantage, or the lack thereof, is generally better explained by understanding the distinctive resources and capabilities of the firm than by understanding only its external environment.

7.2 The strategic importance of resources and capabilities

- The acceptance of the RBV rests on three important premises:
  - Resources determine the ***strategic direction*** of the organisation.
  - An understanding of distinctive resources and capabilities can help the organisation determine what it is capable of doing, rather than focusing on what its current business is.
  - Resources are the ***primary source** of profit* for the organisation.
  - Profitability is determined by two factors, namely the ***attractiveness of the industry*** in which the organisation competes, and its ability to establish a ***competitive advantage*** over its rivals.
  - While industry attractiveness is generally the domain of industry analysis, the RBV can provide significant insights as to why certain organisations are more successful than others – in other words, why some organisations have a competitive advantage over others.
  - ***Industry positioning*** alone does not explain differences in profitability among similar organisations with similar products in the same industry.

7.2 The strategic importance of resources and capabilities (cont.)

Various authors use the terms 'economic rent' and 'rent' interchangeably to describe the ability of resources to attract income. The value of a resource is, therefore, ultimately determined by its ability to generate rent.

There are three types of economic rent commonly mentioned in strategy literature:

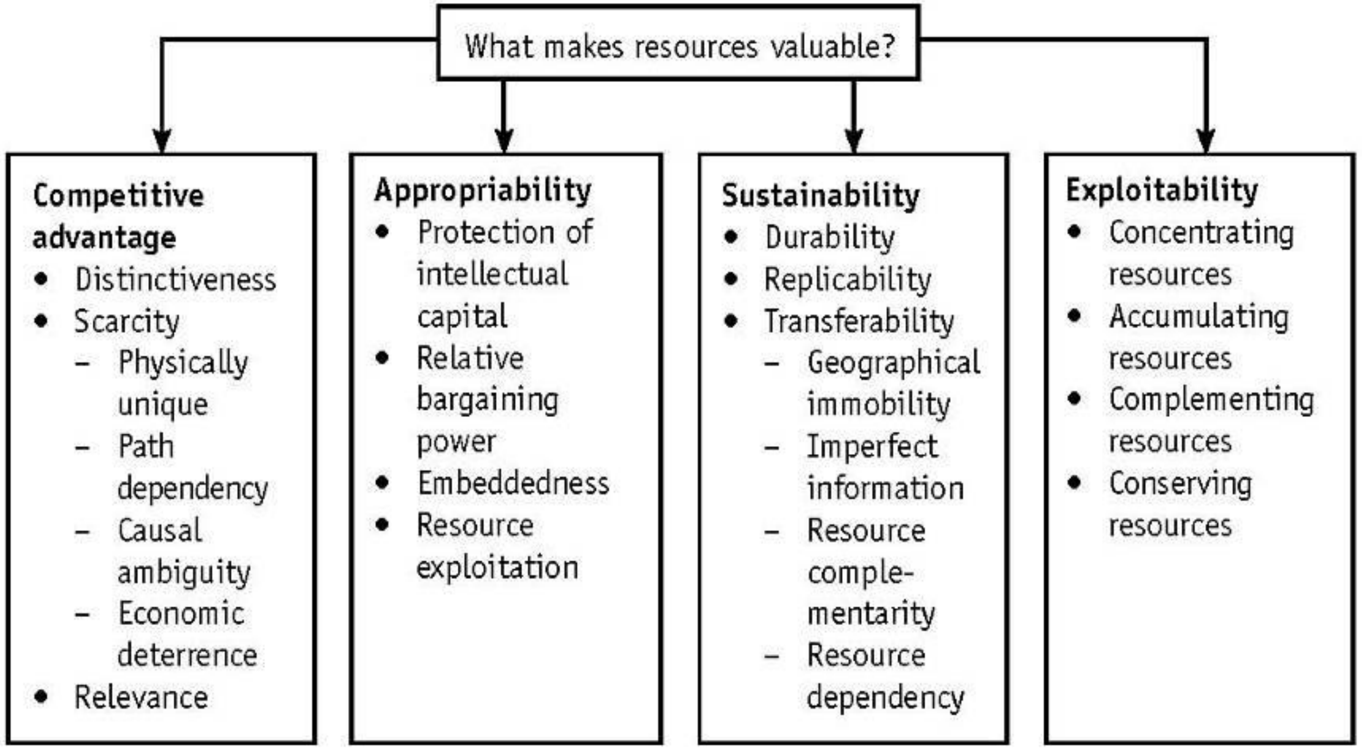
- **Ricardian rents** are rents associated with unique resources and capabilities, e.g. location.
- **Monopoly rents** are associated with a unique position in the market place, e.g. Eskom is South Africa's only licensed electricity utility.
- **Schumpeterian rents** refer to those returns appropriated by the organisation because of a new or innovative product that allows it temporarily to charge a price high above costs of production.

7.2 The strategic importance of resources and capabilities (cont.)

- Figure 7.1 provides a summary of the factors that determine the value of resources. In short, the value of resources is determined by:
  - the extent to which resources are a viable source of competitive advantage
  - the extent to which such a competitive advantage is sustainable over time
  - the extent to which the organisation is in a position to appropriate the returns generated by the resources and the extent to which resources can be exploited for future.

7.2 The strategic importance of resources and capabilities (cont.)

Figure 7.1 The determinants of resource value



7.2.1 Competitive advantage

- If a resource meets customer needs at a price that customers are willing to pay, there is a demand for it.
- However, the resource is more valuable if it can establish a *competitive advantage*.
- This means that the resource can meet customer needs better than the competition.
- Thus, the concept of *distinctive capability* and its role in creating competitive advantage become important in understanding the value of resources.
- A resource is also more valuable if it is scarce, in other words it is not widely available, and it should also be *relevant* to the key success factors in the market.

7.2.1 Competitive advantage (cont.)

- There are four determinants of the scarcity of resources:
  - *Physical uniqueness*: In the first place, resources can be physically unique. Real estate, mineral rights, government licenses, and patents are examples of resources that cannot or may not be physically copied.
  - *Path dependency*: A second source of scarcity is path dependency. Certain resources are built over time in ways that cannot be replicated. Brand image, organizational culture, and company reputation are examples of resources that cannot be replicated unless the same sequence of events is followed that led to the original resource being created in the first place.
  - *Causal ambiguity*: In many instances, it may be difficult, even impossible, for competitors to work out exactly what the truly valuable resource of a rival is, or how to duplicate it.
  - E*conomic deterrence*: Occurs when economic realities make it unattractive for rivals to invest in certain resources.

7.2.2 Sustainability

- To create a *sustainable competitive advantage*, a resource must be in short supply over a period of time, in other words it must be both scarce and *durable*.
- In addition, the organisation should be able to *replicate* the resources and capabilities in other markets or products.
- The organisation must also protect the resources from imitation by rivals by ensuring that they are not too easily transferable.
- However, they must be transferable enough to replicate.

7.2.2 Sustainability (cont.)

- There are four barriers to transferability that will make it difficult for competitors to successfully transfer resources for their own benefit:
  - *Geographical immobility*: In the first place, resources may be geographically immobile, for example mineral deposits.
  - *Imperfect information*: This means that competitors may find it difficult to obtain sufficient information to evaluate resources and capabilities, and may then end up not being sure what the appropriate price is to pay.
  - *Resource complementarity*: Separating a resource, such as a brand, from its context can cause a loss in value. Thus, the resource may be dependent on its context and complementary resources and will be less productive in a different setting.
  - *Resource dependency*: This also plays a key role since capabilities are combinations of resources that work together. Separating one aspect, for example a team of people, from the whole may reduce its efficiency.

7.2.3 Appropriability

- The third critical determinant of the value of resources centres on the question of who captures the value generated by resources.
- Generally, the owner of the resource captures most of the value created by the resource.
- This concept is referred to as *appropriability*, and it explains why internally developed resources are generally more valuable than resources bought or used under license.
- The more embedded the resources are within the organisation, the greater the ability of the organisation to appropriate the value flowing to those resources.

7.2.3 Appropriability (cont.)

- There are four aspects that determine the potential of an organisation to capture the rent generated by its resources and capabilities:
  - *Protection of intellectual capital*: First, to what extent can the intellectual property and intellectual capital of the organisation be protected?
  - *Relative bargaining power*: This can play a role when individual members of an organisation have high bargaining power as they can then appropriate more of the rent.
  - *Embeddedness*: In some instances, the individual competencies of team members may be so embedded in the organisation's processes that they reduce the bargaining power of the individual – in other words, the organisation is in a position to appropriate more of the value than individual employees.
  - *Resource exploitation*: Also important when considering this aspect is the issue of resource exploitation. Some organisations are better at leveraging resources, and this enables them to capture more of the value generated.

7.2.4 Exploitability

- Concentrating resources
  - *Converging* resources on a few selected strategic goals
  - *Focusing* efforts on single priorities sequentially
  - *Targeting* highest impact activities first
- Accumulating resources
  - *Mine experience* to learn as quickly as possible
  - *Borrowing* from other organisations
- Complementing resources
  - *Blending* by linking capabilities
  - *Balancing*
- Conserving resources
  - *Recycling*
  - *Co-opting* through collaboration

7.2.5 Developing resources and capabilities

- *Acquisition* of a different organisation that possesses the required resources and capabilities.
- *Internal creation* – Creating new capabilities internally is a possibility, but is also a risky proposition. Often the capital raised, new people hired, and new processes created are simply absorbed into existing processes and structures, and disappear without a trace.
- *Creation of a separate spin-out organisation* – Capabilities can also be created through a spin-out organisation where a separate, small start-up organisation is established as a mechanism for developing the required resources and capabilities.

7.2.5 Developing resources and capabilities (cont.)

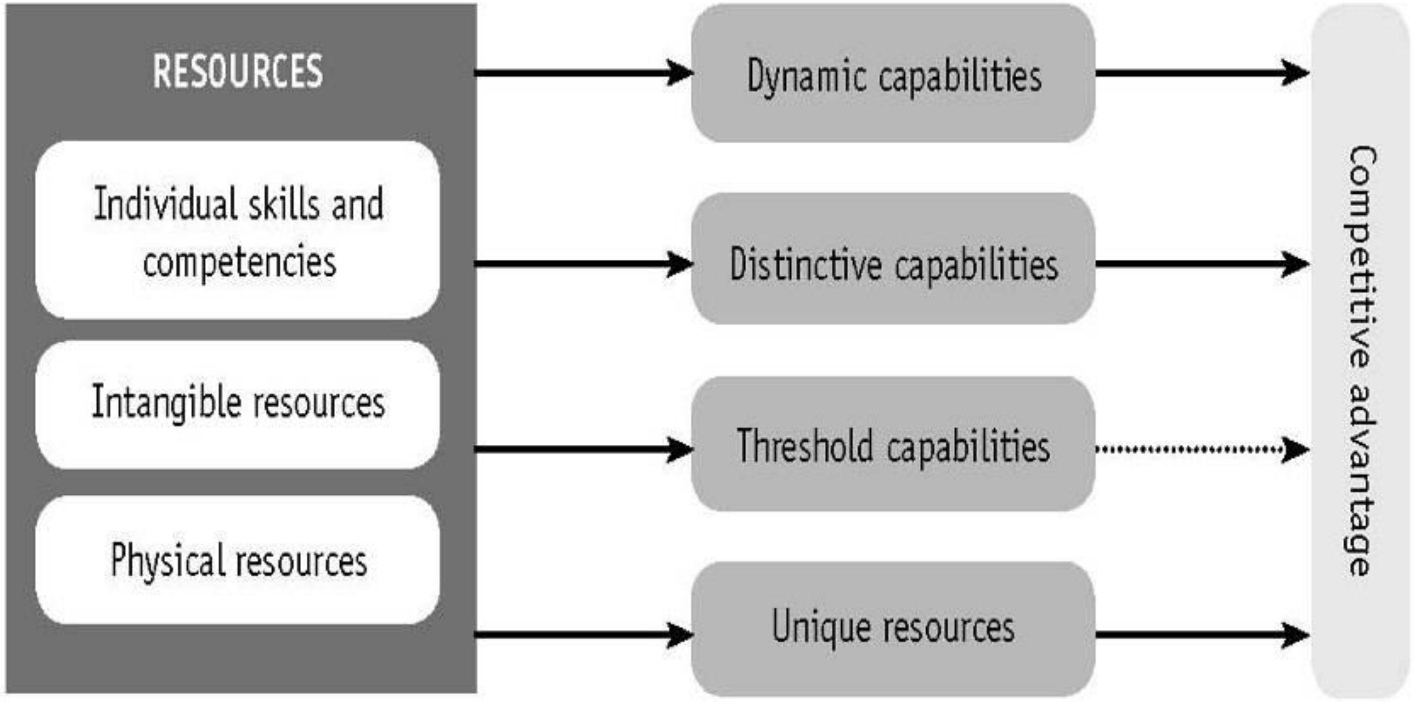
- Using resources and capabilities to develop competitive advantage (Marvel and Apple Case example):
  - Unique resources
  - Dynamic capabilities
  - Resource replication
  - Using hidden resources.

7.3 Identification of resources and capabilities

- Identifying resources
    - Physical resources
    - Intangible resources
    - Human resources
- Identifying capabilities-Types of capabilities
        - Threshold capabilities
        - Distinctive capabilities
        - Dynamic capabilities
    - Functional analysis
    - Value chain analysis
    - Architecture, reputation and innovation
    - Knowledge and capabilities

7.3 Identification of resources and capabilities (cont.)

Figure 7.2 A summary of the RBV



7.3.2.2 Functional analysis as a framework for identifying distinctive capabilities

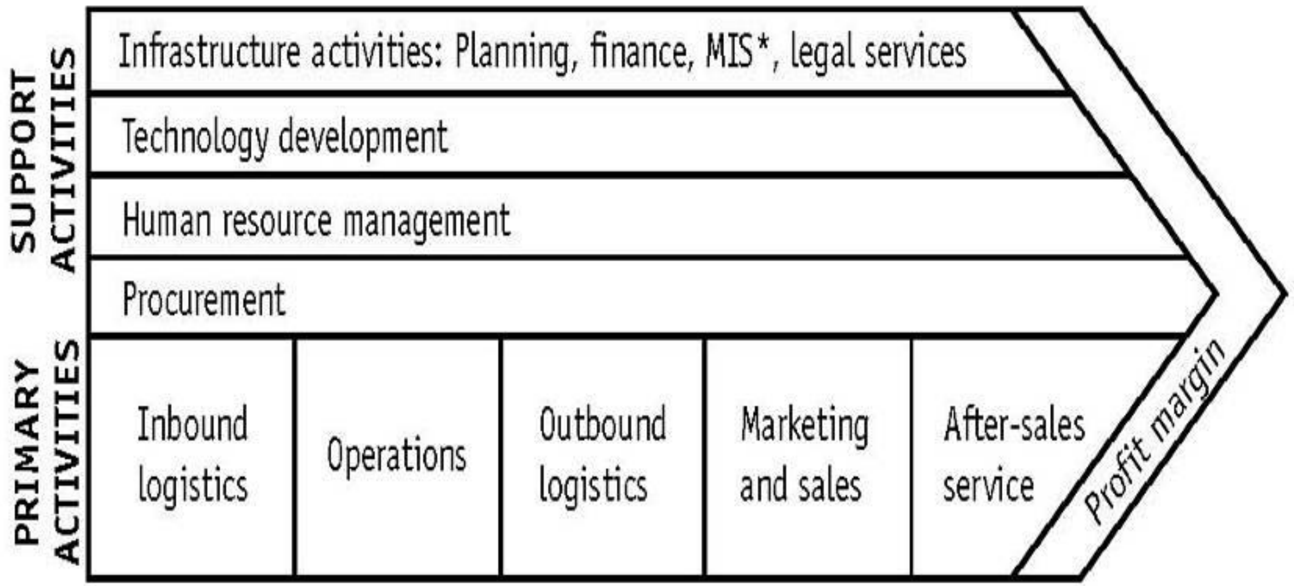
- Each organisation has certain principal functional areas according to which it operates.
- Typical functional areas that can be used in such an analysis include the following:
  - corporate management (corporate head office functions)
  - research and development
  - human resources (HR)
  - finance
  - marketing
  - customer care
  - sales
  - production or operations
  - logistics or supply chain management.

Table 7.1 Examples of functional analysis of capabilities

FUNCTIONAL AREA	EXAMPLES OF DISTINCTIVE CAPABILITIES
Corporate management	*Bidvest* is a South African-based conglomerate that manages some 70 diverse businesses and more than 105 000 employees worldwide. *Bidvest* follows a corporate philosophy of decentralised management, entrepreneurial businesses, incentivisation and a sense of personal ownership[30].
Research and development	From its roots in the production of synthetic fuel from coal, *Sasol* has developed into one of the leading producers of fuel and chemicals in the world, adding value to coal, oil, and gas reserves to produce products for industrial and consumer use.
Marketing	Marketing efforts by the South African retailer, *Shoprite*, to rebrand *Checkers*, using for example celebrity chef Gordon Ramsay to sing the praises of *Checkers*' meat, has been very successful, contributing to *Shoprite* being regarded as the most valuable retail brand in South Africa in 2012[31].
Product design	*Bell Equipment Company* achieved a strong position (second only to Volvo) in the global ADT market with its proprietary articulated dump truck (ADT) technology developed over decades.
Operations	*BMW South Africa* began exporting BMW 3 Series vehicles to China in 2012 after receiving a China Quality Certification clearance permit. The Rosslyn Plant was awarded the China Quality Certification following a comprehensive audit which confirmed that the plant's production and quality management systems met global standards[32].
Logistics or supply chain management	*Amalgamated Beverage Industries* (ABI), the soft-drink division of South African Breweries, is the leading distributor for Coca-Cola products in South Africa. They also have a distribution agreement with Appletiser. ABI serves more than 40 000 customers with more than 260 fast-moving stock units[33].

7.3.2.3 The value chain as a framework for identifying capabilities

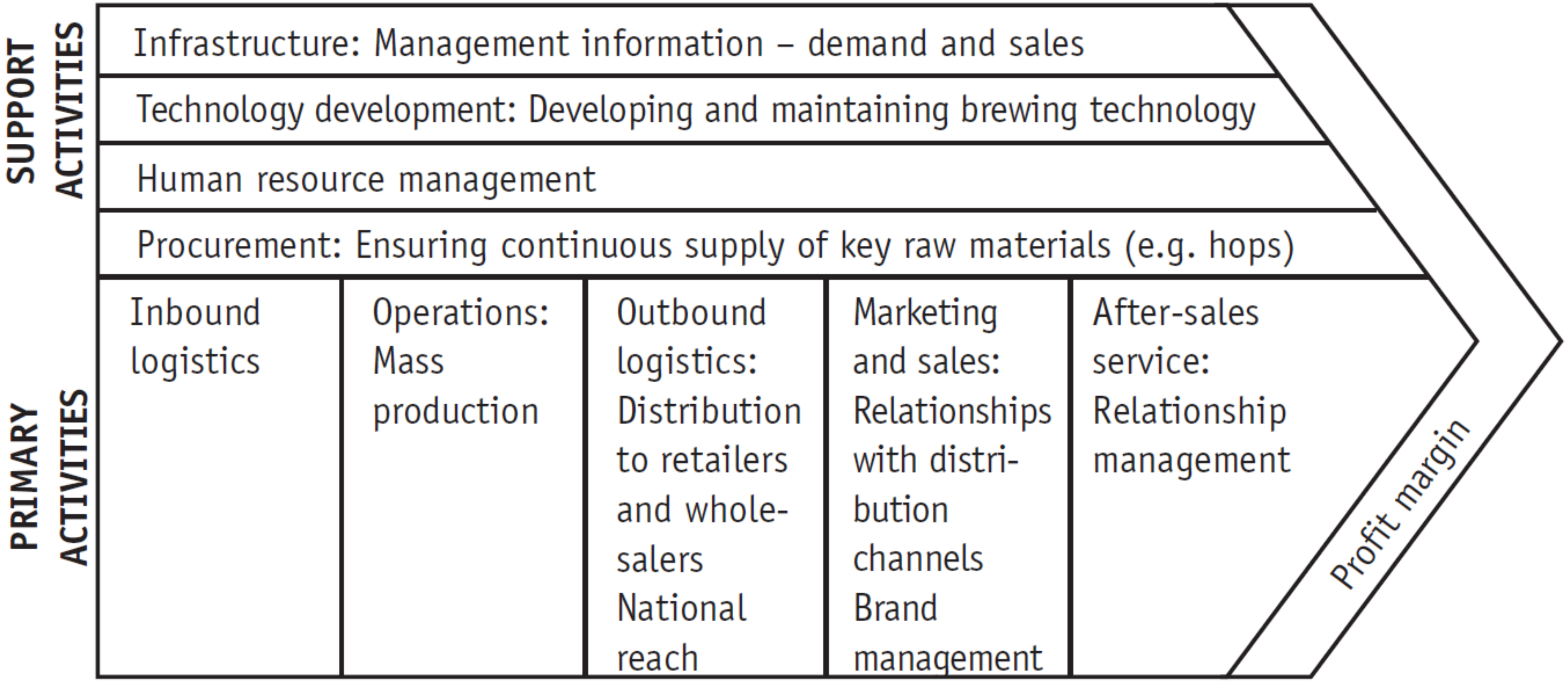
Figure 7.3 The value chain[27]



*Management information systems

7.3.2.3 The value chain as a framework for identifying capabilities (cont.)

Figure 7.4 Example of capabilities in the value chain – South African Breweries

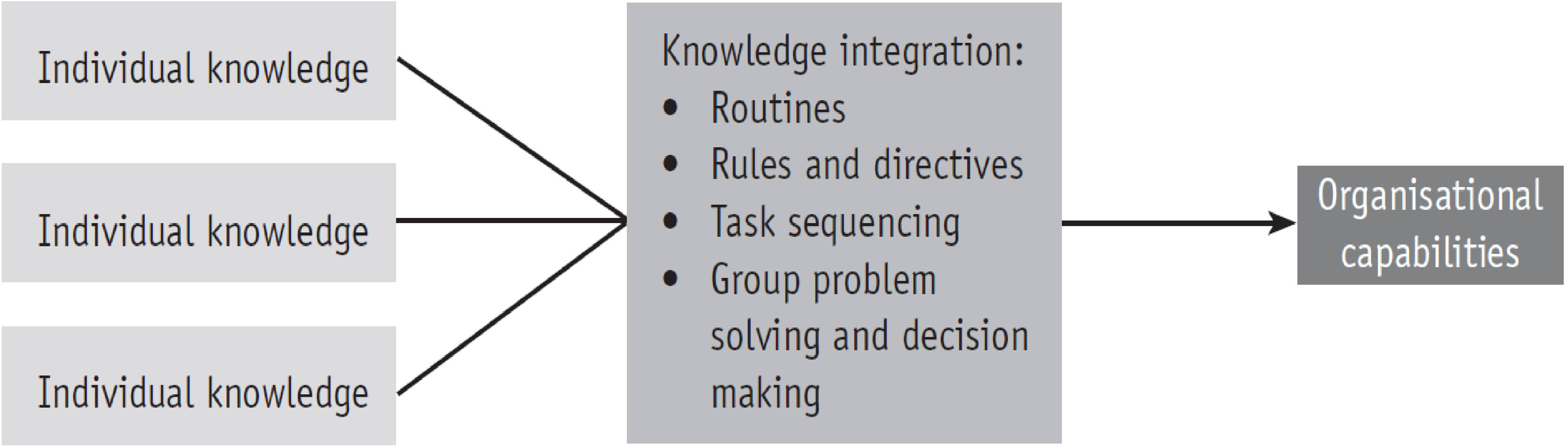


7.3.2.4 Architecture, reputation, and innovation

- ***Architecture*** refers to the network of relationships and contracts both inside and outside the organisation.
- The ability to enhance ***reputation*** is particularly beneficial in long-term relationships that take time to build, and is difficult to imitate.
- Certain organisations have built their success on ***innovation***. Their ability to innovate builds on their structure, culture, procedure and rewards.

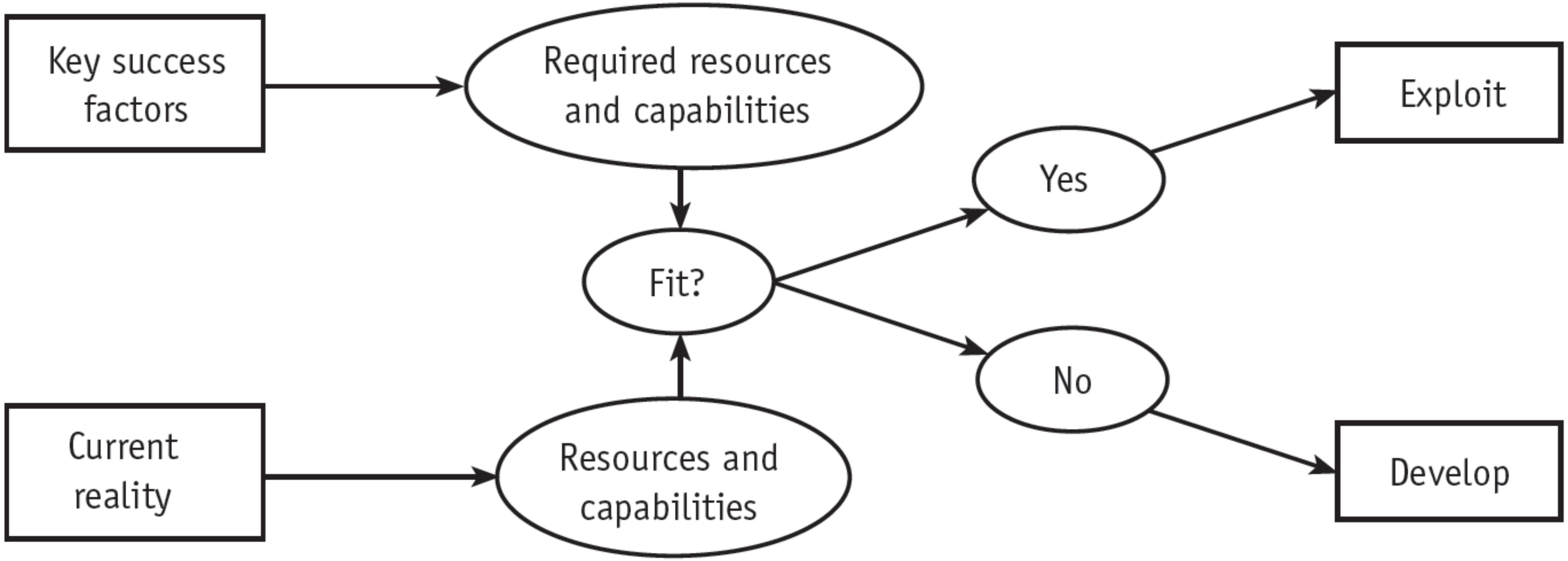
7.3.2.5 Knowledge and capabilities

Figure 7.5 Knowledge as building blocks of organisational capabilities



7.4 Internal analysis and industry key success factors

Figure 7.6 Using key success factors to identify capability gaps[44]



7.5 Dynamic views of strategy

The nature of dynamic capabilities

- Dynamic capabilities describe an organisation's 'ability to integrate, build and reconfigure internal and external competences to address rapidly changing environments'. This definition rests on two principles:
  - Distinctive capabilities can and must change over time.
  - The volatility of the environment is a strong indicator of the need and tempo of change required.
- Ghemawat suggested that the dynamic approach attempts to link the organisation's past to its future, and in this way tries to answer three questions
  - What did the organisation do well in the past?
  - W hat can the organisation do well today?
  - W hat must the organisation be able to do well in the future?

7.5 Dynamic views of strategy (cont.)

Figure 7.7 A dynamic view of strategy[50]

7.5 Dynamic views of strategy (cont.)

Two potential outcomes of dynamic strategy:

- **Lock-in:** Because of the size of the investment, it is not feasible to withdraw from the decision.
- **Lock-out:** If the window of opportunity is missed, it may mean that the organisation is effectively locked out.

7.6 Identifying strengths and weaknesses

7.6.1 Value chain analysis

Uses of value chain analysis:

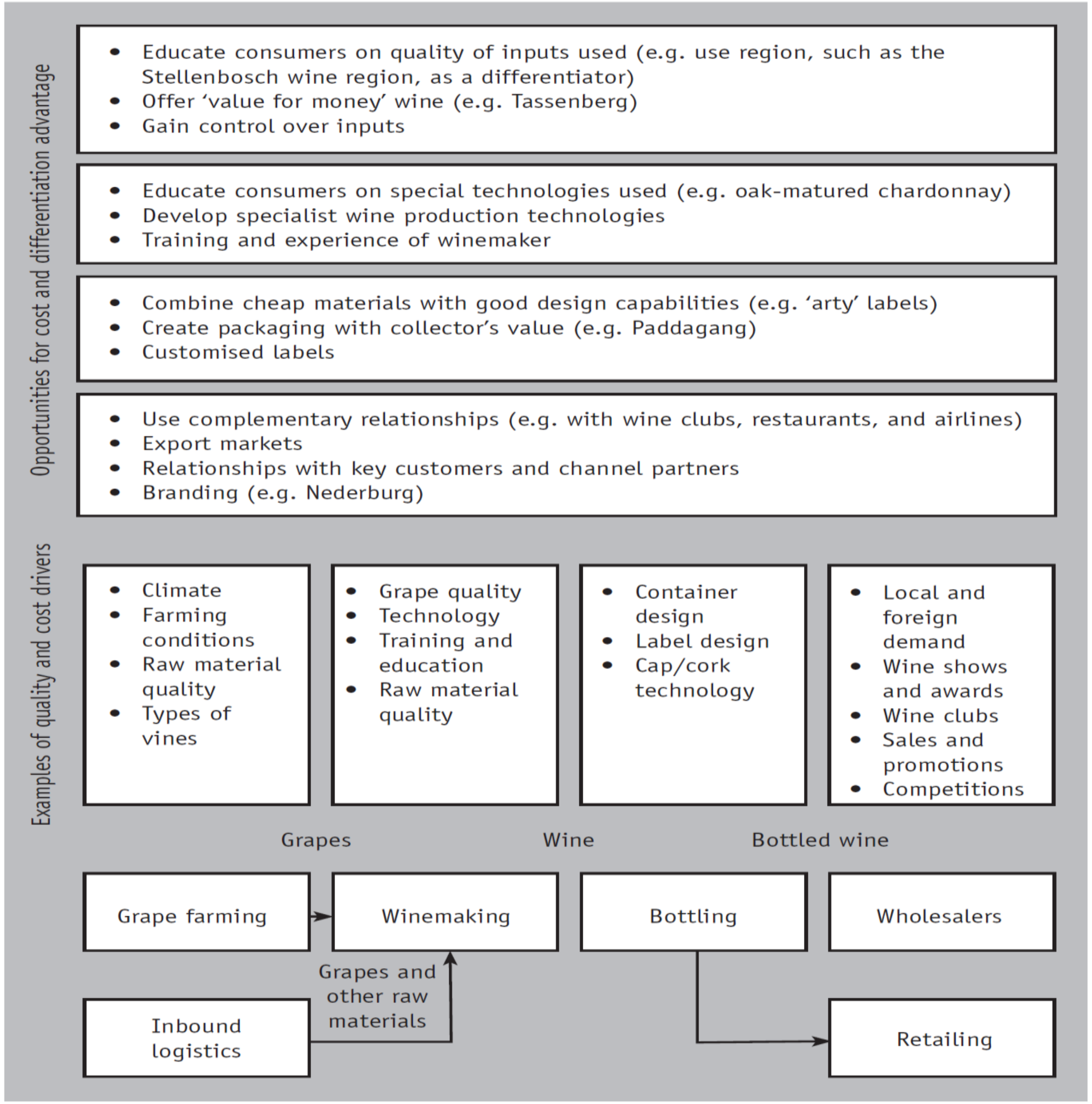
- Determining the relative importance of each activity with respect to total cost.
- Identifying the cost drivers of each activity and how efficiently the organisation performs each activity compared to competitors
- Understanding the influence of the cost of one activity on the cost of other activities.
- Identifying activities that are candidates for outsourcing (e.g. where other organisations can perform the activities at lower cost).

7.6.1 Value chain analysis (cont.)

- The process of using the value chain for cost and differentiation analysis for the purpose of identifying strength and weaknesses can be outlined as follows:
  - *Step 1*: Identify the component activities of the value chain, in other words the primary and support activities that make up the organisation's value chain.
  - *Step 2*: Establish the cost of each activity, and focus on those activities that are the most important contributors of cost.
  - *Step 3*: Compare costs and differentiation drivers per activity with competitors to establish competitive benchmarks.
  - *Step 4*: Identify cost and differentiation drivers, in other words, those things that have the most impact on the cost of the activity or on the perception.
  - *Step 5*: Identify opportunities for reducing costs or for improving quality.

7.6.1 Value chain analysis (cont.)

Figure 7.9 Wine industry value chain[55]



7.6.2 The role of benchmarking

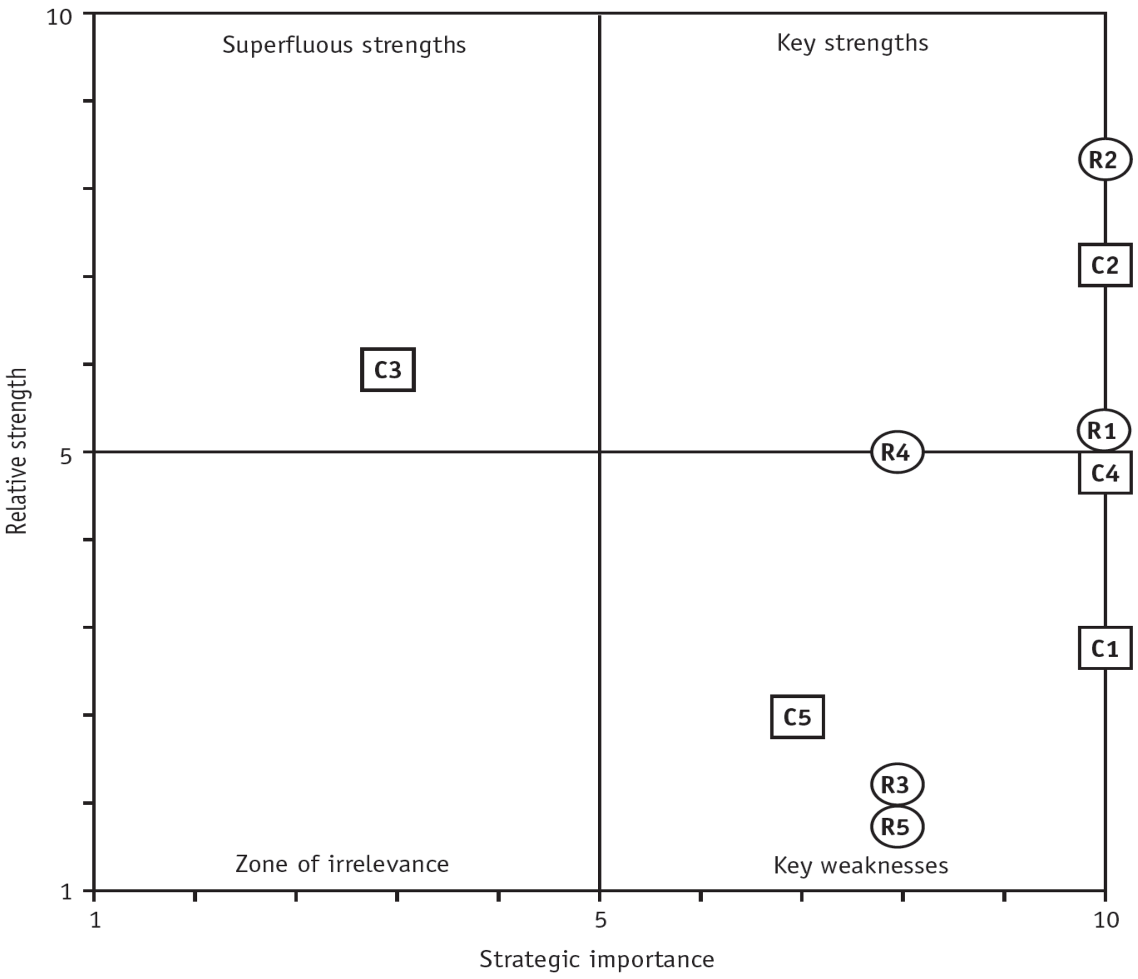
- Types of benchmarking:
  - **Historical benchmarking** occurs when organisations compare their performance to their own performance in previous years.
  - **Industry benchmarking** is used to compare the organisation's performance and processes across a number of performance indicators with the industry or other similar organisations.
  - **Best-in-class benchmarking** may be used to seek comparisons more widely than just the industry.

7.6.3 A practical framework for the appraisal of resources and capabilities

- *Step 1:* Identify key resources and capabilities
- *Step 2:* Appraise resources and capabilities according to:
  - strategic importance
  - relative strength
- *Step 3:* Develop strategy implications based on:
  - key strengths
  - key weaknesses
  - superfluous strengths
  - irrelevant factors

An example of a visual output of appraising resources and capabilities

Figure 7.10 Appraising CSM's resources and capabilities – a visual summary



Step 3: Developing strategy implications

- The visual depiction of strengths and weaknesses provides a strong message about the future strategic direction of the organisation.
- Key strengths are those resources and capabilities that are critical to the future success of the organisation.
- They should, therefore, be nurtured and used as a basis for building and extending competitive advantage.
- Key weaknesses are areas that are critical for future success, but where the organisation underperforms its competition.
- It therefore provides clues to identify the resources and capabilities that need to be addressed.

7.7 Summary

- Understanding of the strategic value of resources and capabilities and their role in establishing competitive advantage is crucial to internal analysis.
- Distinctive capabilities form a more lasting basis for strategic success that simply striving for a strong position in the industry.
- A functional framework and the value chain were explored as useful frameworks for identifying distinctive resources and capabilities.
- The roles of architecture, reputation, innovation and knowledge as key drivers of capabilities were also explored.

Discussion questions

1. Explain the relationship between resources and capabilities.
2. Discuss the reasons for the importance of brand value from a resource-based perspective.
3. Explain the importance of knowledge in establishing competitive advantage.
4. Compare and contrast the functional and value chain approaches for the identification of organisational capabilities.
5. Find an example of dynamic capabilities in an organisation of your choice.