LEARNING OUTCOMES

After reading this chapter you should be able to:

➔ Distinguish elements of strategic capability in organisations: resources, competences, core competences and dynamic capabilities.

➔ Recognise the role of continual improvement in cost efficiency as a strategic capability.

➔ Analyse how strategic capabilities might provide sustainable competitive advantage on the basis of their value, rarity, inimitability and non-substitutability.

➔ Diagnose strategic capability by means of value chain analysis, activity mapping, benchmarking and SWOT analysis.

➔ Consider how managers can develop strategic capabilities of organisations.
Chapter 2 outlined how the external environment of an organisation can create both strategic opportunities and threats. However, Tesco, Sainsbury’s and Asda all compete in the same environment, yet Tesco is a superior performer. It is not the environment that distinguishes between them but their internal strategic capabilities. The importance of strategic capability is the focus of this chapter. There are three key concepts that underpin the discussion. The first is that organisations are not identical, but have different capabilities; they are ‘heterogeneous’ in this respect. The second is that it can be difficult for one organisation to obtain or copy the capabilities of another. For example, Sainsbury’s cannot readily obtain the whole of Tesco’s retail sites, its management or its experience. The third arises from these: if an organisation is to achieve competitive advantage, it will do so on the basis of capabilities that its rivals do not have or have difficulty in obtaining. In turn this helps explain how some organisations are able to achieve superior performance compared with others. They have capabilities that permit them to produce at lower cost or generate a superior product or service at standard cost in relation to other organisations with inferior capabilities. These concepts underlie what has become known as the resource-based view of strategy (though it might more appropriately be labelled the ‘capabilities view’): that the competitive advantage and superior performance of an organisation is explained by the distinctiveness of its capabilities.

The chapter has six sections:

- Section 3.2 discusses the foundations of strategic capability and considers the distinction between resources and competences.
- Section 3.3 is concerned with a vital basis of strategic capability of any organisation, namely the ability to achieve and continually improve cost efficiency.
- Section 3.4 considers what sort of capabilities allow organisations to sustain competitive advantage over time (in a public sector context the equivalent concern might be how some organisations sustain relative superior performance over time).
- Section 3.5 discusses how the concept of organisational knowledge relates to strategic capability and how it might contribute to competitive advantage of organisations.
- Section 3.6 moves on to consider different ways strategic capability might be analysed. These include value chain and value network analyses, activity mapping and benchmarking. The section concludes by explaining the use of SWOT analysis as a basis for pulling together the insights from the analyses of the environment (explained in Chapter 2) and of strategic capability in this chapter.
- Finally section 3.7 discusses how managers can develop strategic capability through internal and external development, the management of people and the building of dynamic capabilities.
Different writers, managers and consultants use different terms and concepts in explaining the importance of strategic capability. Given such differences, it is important to understand how the terms are used here. Overall, strategic capability can be defined as the resources and competences of an organisation needed for it to survive and prosper. Exhibit 3.1 shows the elements of strategic capability that are employed in the chapter to explain the concept.

### Exhibit 3.1 Strategic capabilities and competitive advantage

<table>
<thead>
<tr>
<th>Resources</th>
<th>Competences</th>
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<td>Capabilities for</td>
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### 3.2.1 Resources and competences

Perhaps the most basic concept is that of *resources*. **Tangible resources** are the physical assets of an organisation such as plant, people and finance. **Intangible resources** are non-physical assets such as information, reputation and knowledge. Typically, an organisation’s resources can be considered under the following four broad categories:

- **Physical resources** – such as the machines, buildings or the production capacity of the organisation. The nature of these resources, such as the age, condition, capacity and location of each resource, will determine the usefulness of such resources.
- **Financial resources** – such as capital, cash, debtors and creditors, and suppliers of money (shareholders, bankers, etc.).
- **Human resources** – including the mix (for example, demographic profile), skills and knowledge of employees and other people in an organisation’s networks.
● **Intellectual capital** – as an intangible resource – includes patents, brands, business systems and customer databases. An indication of the value of these is that when businesses are sold, part of the value is ‘goodwill’. In a knowledge-based economy intellectual capital is likely to be a major asset of many organisations.

Such resources are certainly important, but what an organisation does – how it employs and deploys these resources – matters at least as much as what resources it has. There would be no point in having state-of-the-art equipment or valuable knowledge or a valuable brand if they were not used effectively. The efficiency and effectiveness of physical or financial resources, or the people in an organisation, depends on not just their existence but how they are managed, the cooperation between people, their adaptability, their innovatory capacity, the relationship with customers and suppliers, and the experience and learning about what works well and what does not. The term **competences** is used to mean the skills and abilities by which resources are deployed effectively through an organisation’s activities and processes.

Within these broad definitions, other terms are commonly used. As the explanation proceeds, it might be useful to refer to the two examples provided in Exhibit 3.2, one relating the concepts to a business and the other to sport.

### 3.2.2 Threshold capabilities

A distinction needs to be made between capabilities (resources or competences) that are at a threshold level and those that might help the organisation achieve
Threshold capabilities are those capabilities needed for an organisation to meet the necessary requirements to compete in a given market. These could be threshold resources required to meet minimum customer requirements: for example, the increasing demands by modern multiple retailers of their suppliers mean that those suppliers have to possess a quite sophisticated IT infrastructure simply to stand a chance of meeting retailer requirements. Or they could be the threshold competences required to deploy resources so as to meet customers’ requirements and support particular strategies. Retailers do not simply expect suppliers to have the required IT infrastructure, but to be able to use it effectively so as to guarantee the required level of service.

Identifying and managing threshold capabilities raises at least two significant challenges:

- **Threshold levels of capability will change** as critical success factors change (see section 2.4.4) or through the activities of competitors and new entrants. To continue the example, suppliers to major retailers did not require the same level of IT and logistics support a decade ago. But the retailers’ drive to reduce costs, improve efficiency and ensure availability of merchandise to their customers means that their expectations of their suppliers have increased markedly in that time and continue to do so. So there is a need for those suppliers continuously to review and improve their logistics resource and competence base just to stay in business.

- **Trade-offs** may need to be made to achieve the threshold capability required for different sorts of customers. For example, businesses have found it difficult to compete in market segments that require large quantities of standard products as well as market segments that require added value specialist products. Typically, the first requires high-capacity, fast-throughput plant, standardised highly efficient systems and a low-cost labour force; the second a skilled labour force, flexible plant and a more innovative capacity. The danger is that an organisation fails to achieve the threshold capabilities required for either segment.

### 3.2.3 Unique resources and core competences

While threshold capabilities are important, they do not of themselves create competitive advantage or the basis of superior performance. These are dependent on an organisation having distinctive or unique capabilities that competitors will find difficult to imitate. This could be because the organisation has **unique resources** that critically underpin competitive advantage and that others cannot imitate or obtain – a long-established brand, for example. It is, however, more likely that an organisation achieves competitive advantage because it has distinctive, or core, competences. The concept of core competences was developed, most notably, by Gary Hamel and C.K. Prahalad. While various definitions exist, here **core competences** are taken to mean the skills and abilities by which resources are deployed through an organisation’s activities and processes such as to achieve competitive advantage in ways that others cannot imitate or obtain. For example, a supplier that achieves competitive advantage in a retail market
CHAPTER 3  STRATEGIC CAPABILITY

Illustration 3.1

Strategic capabilities

Executives emphasise different strategic capabilities in different organisations.

Freeport-McMoRan Copper and Gold, Inc. is an international mining company in North America. It claims a leading position in the mining industry on the basis of ‘large, long lived, geographically diverse assets and significant proven and probable reserves of copper, gold and molybdenum’. More specifically, in terms of its Indonesian operation it points to a ‘principal asset’ as the ‘world class Grasberg mine discovered in 1988’ which has ‘the world’s largest single copper reserve and world’s largest single gold reserve’.

Source: Annual Review 2006.

Daniel Bouton, Chairman and CEO of Société Générale, in response to the question: How do you maintain your competitive advantage in equity derivatives?

The barrier to entry is high, because of two significant costs. The first is IT. The systems you need to perform well cost at least $200 million a year, and it’s not something you can buy from Dell or SAP. The second is the sheer number of people you need to work on managing your risk. Before you launch a product, you need to have the front office guys that propose, calculate and write the first model. Then you need the IT guy that creates the IT system in order to be able to calculate risks every 10 seconds. And you need a good validating team in order to verify all the hypotheses. After that, you need high-quality middle and back office people.

Source: Interviewed by Clive Horwood in Euromoney, vol. 27, no. 447 (July 2006), pp. 84–89.

Tony Hall, Chief Executive of the Royal Opera House:

‘world-class’ is neither an idle nor boastful claim. In the context of the Royal Opera House the term refers to the quality of our people, the standards of our productions and the diversity of our work and initiatives. Unique? Unashamedly so. We shy away from labels such as ‘elite’, because of the obvious negative connotations of exclusiveness. But I want people to take away from here the fact that we are elite in the sense that we have the best singers, dancers, directors, designers, orchestra, chorus, backstage crew and administrative staff. We are also amongst the best in our ability to reach out to as wide and diverse a community as possible.

Source: Annual Review 2005/6, p. 11.

Dave Swift, President of Whirlpool North America:

Executing our strategy requires a unique toolkit of competencies that we continue to build for our people globally. The starting point of building new competencies is what we call ‘Customer Excellence’ – our ability to proactively understand and anticipate the needs of customers. Customer Excellence is a collection of tools that allows our people to analytically assess and prioritize the needs and desires of customers along all aspects of the purchase cycle – from when they first might investigate an appliance on a web site, to the in-store experience on a retailer’s floor, to the features and aesthetics of the product, to the installation and service experience, and ultimately to their need to repeat this cycle. With these consumer insights in-hand, we then turn them into customer solutions through our innovation tools. As a result, our innovation capability has produced a robust pipeline of products, achieving a steady-state estimated value of over $3 billion. . . . Our knowledge of customers, coupled with our innovative customer solutions, is driving the attractiveness of our brands and creating greater value for our shareholders.


Questions

1  Categorise the range of capabilities highlighted by the executives in terms of section 3.2 and Exhibit 3.2.

2  With reference to section 3.4, which of the capabilities might be especially important in terms of achieving competitive advantage and why?

3  For an organisation of your choice undertake the same exercise as in questions 1 and 2 above.
might have done so on the basis of a unique resource such as a powerful brand, or by finding ways of providing service or building relationships with that retailer in ways that its competitors find difficult to imitate – a core competence. Section 3.4 of this chapter discusses in more depth the role played by unique resources and core competences in contributing to long-term competitive advantage.

Putting these concepts together, the summary argument is this. To survive and prosper an organisation needs to address the challenges of the environment that it faces, discussed in Chapter 2. In particular it must be capable of performing in terms of the critical success factors that arise from demands and needs of its customers, discussed in section 2.4.4. The strategic capability to do so is dependent on the resources and the competences it has. These must reach a threshold level in order for the organisation to survive. The further challenge is to achieve competitive advantage. This requires it to have strategic capabilities that its competitors find difficult to imitate or obtain. These could be unique resources but are more likely to be the core competences of the organisation. Illustration 3.1 shows how executives of different organisations describe the strategic capabilities of their organisations.

### 3.3 Cost Efficiency

Managers often refer to the management of costs as a key strategic capability. So it is. Moreover, understanding the management of cost efficiency as a strategic capability illustrates some of the points made in section 3.2.

Customers can benefit from cost efficiencies in terms of lower prices or more product features for the same price. The management of the cost base of an organisation could also be a basis for achieving competitive advantage (see sections 6.3.1 and 6.4.1). However, for many organisations the management of costs is becoming a threshold strategic capability for two reasons:

- **Customers do not value product features at any price.** If the price rises too high they will sacrifice value and opt for lower price. So the challenge is to ensure that an appropriate level of value is offered at an acceptable price. This means that everyone is forced to keep costs as low as possible, consistent with the value to be provided. Not to do so invites customers to switch products or invites competition.

- **Competitive rivalry** will continually require the driving down of costs because competitors will be trying to reduce their cost so as to underprice their rivals while offering similar value.

If cost is to be managed effectively, attention has to be paid to key *cost drivers* (see Exhibit 3.3), as follows:

- **Economies of scale** may be especially important in manufacturing organisations, since the high capital costs of plant need to be recovered over a high volume of output. Traditionally manufacturing sectors where this has been especially important have been motor vehicles, chemicals and metals. In other industries, such as drinks and tobacco and food, scale economies are important in distribution or marketing.
Supply costs can be important. Location may influence supply costs, which is why, historically, steel and glass manufacturing were close to raw material or energy sources. In some instances, ownership of raw materials was a unique resource, giving cost advantage. Supply costs are of particular importance to organisations that act as intermediaries, where the value added through their own activities is low and the need to identify and manage input costs is critically important to success. For example, retailers pay a great deal of attention to trying to achieve lower costs of supply than their competitors.

Product/process design also influences cost. Efficiency gains in production processes have been achieved by many organisations through improvements in capacity-fill, labour productivity, yield (from materials) or working capital utilisation. Understanding the relative importance of each of these to maintaining a competitive position is important. For example, in terms of managing capacity-fill: an unfilled seat in a plane, train or theatre cannot be ‘stocked’ for later sale. So marketing special offers (while protecting the core business) and having the IT systems to analyse and optimise revenue are important capabilities. Product design will also influence costs in other parts of the value system – for example, in distribution or after-sales service. In the photocopier market, for example, Canon eroded Xerox’s advantage (which was built on service and a support network) by designing a copier that needed far less servicing.

Experience can be a key source of cost efficiency and there is evidence it may provide competitive advantage in particular in terms of the relationship between the cumulative experience gained by an organisation and its unit costs – described as the experience curve. See Exhibit 3.4. The experience curve suggests that an organisation undertaking any activity develops competences in this activity over time and therefore does it more efficiently. Since companies with higher market share have more ‘cumulative experience’ – simply because high share gives them greater volumes of production or service – it follows that it is important to gain and hold market share, as discussed in Chapter 2. It is important to remember that it is the relative market share in
definable market segments that matters. There are important implications of the experience curve concept that could influence an organisation’s competitive position.

- **Growth is not optional** in many markets. If an organisation chooses to grow more slowly than the competition, it should expect the competitors to gain cost advantage in the longer term – through experience.

- **Unit costs should decline year on year** as a result of cumulative experience. In high-growth industries this will happen quickly, but even in mature industries this decline in costs should occur. Organisations that fail to achieve this are likely to suffer at the hands of competitors who do. The implication of this is that *continual reduction in costs is a necessity* for organisations in competitive markets. Even if it is not able to provide competitive advantage, it is a threshold competence for survival.

- **First-mover advantage** can be important. The organisation that moves down the experience curve by getting into a market first should be able to reduce its cost base because of the accumulated experience it builds up over its rivals by being first.

**3.4 CAPABILITIES FOR ACHIEVING AND SUSTAINING COMPETITIVE ADVANTAGE**

The lessons of sections 3.2 and 3.3 are these: if the capabilities of an organisation do not meet customer needs, at least to a threshold level, the organisation cannot survive; and if managers do not manage costs efficiently and continue to improve on this, it will be vulnerable to those who can. However, if the aim is to achieve *competitive advantage* then the further question is: what strategic
capabilities might provide competitive advantage in ways that can be sustained over time? If this is to be achieved, then other criteria are important.  

3.4.1 Value of strategic capabilities

It is important to emphasise that if an organisation seeks to build competitive advantage it must have capabilities that are of value to its customers. This may seem an obvious point to make but in practice it is often ignored or poorly understood. Managers may argue that some distinctive capability of their organisation is of value simply because it is distinctive. Having capabilities that are different from other organisations is not, of itself, a basis of competitive advantage. So the discussion in section 2.4.4 and the lessons it draws are important here too. Managers should consider carefully which of their organisation’s activities are especially important in providing such value. They should also consider which are less valued. Value chain analysis and activity mapping explained in sections 3.6.1 and 3.6.2 can help here.

3.4.2 Rarity of strategic capabilities

Competitive advantage might be achieved if a competitor possesses a unique or rare capability. This could take the form of unique resources. For example, some libraries have unique collections of books unavailable elsewhere; a company may have a powerful brand; retail stores may have prime locations. Some organisations have patented products or services that give them advantage – resources that may need to be defended by a willingness to bring litigation against illegal imitators. For service organisations unique resources may be intellectual capital – particularly talented individuals.

Competitive advantage could also be based on rare competences: for example, unique skills developed over time. However, there are three important points to bear in mind about the extent to which rarity of competences might provide sustainable competitive advantage:

- **Ease of transferability.** Rarity may depend on who owns the competence and how easily transferable it is. For example, the competitive advantage of some professional service organisations is built around the competence of specific individuals – such as a doctor in ‘leading-edge’ medicine, individual fund managers, the manager of a top sports team or the CEO of a business. But since these individuals may leave or join competitors, this resource may be a fragile basis of advantage. More durable advantage *may* be found in competences that exist for recruiting, training, motivating and rewarding such individuals or be embedded in the culture that attracts them to the organisation – so ensuring that they do not defect to ‘competitors’.

- **Sustainability.** It may be dangerous to assume that competences that are rare will remain so. Rarity *could be temporary.* If an organisation is successful on the basis of a unique set of competences, then competitors will seek to imitate or obtain those competences. So it may be necessary to consider other bases of sustainability.
Core rigidities. There is another danger of redundancy. Rare capabilities may come to be what Dorothy Leonard-Barton refers to as 'core rigidities', difficult to change and therefore damaging to the organisation. Managers may be so wedded to these bases of success that they perceive them as strengths of the organisation and ‘invent’ customer values around them.

3.4.3 Inimitable strategic capabilities

It should be clear by now that the search for strategic capability that provides sustainable competitive advantage is not straightforward. It involves identifying capabilities that are likely to be durable and which competitors find difficult to imitate or obtain.

At the risk of overgeneralisation, it is unusual for competitive advantage to be explainable by differences in the tangible resources of organisations, since over time these can usually be imitated or traded. Advantage is more likely to be determined by the way in which resources are deployed to create competences in the organisation’s activities. For example, as suggested earlier, an IT system itself will not improve an organisation’s competitive standing: it is how it is used that matters. Indeed, what will probably make most difference is how the system is used to bring together customer needs with activities and knowledge both inside and outside the organisation. It is therefore to do with linking sets of competences. So, extending the earlier definition, core competences are likely to be the skills and abilities to link activities or processes through which resources are deployed so as to achieve competitive advantage. In order to achieve this advantage, core competences therefore need to fulfil the following criteria:

- They must relate to an activity or process that underpins the value in the product or service features – as seen through the eyes of the customer (or other powerful stakeholder). This is the value criterion discussed earlier.
- The competences must lead to levels of performance that are significantly better than competitors (or similar organisations in the public sector).
- The competences must be difficult for competitors to imitate – or inimitable.

With regard to this third requirement of inimitability, Exhibit 3.5 summarises how this might be achieved and Illustration 3.2 also gives an example. The three main reasons are:

Complexity

The core competences of an organisation may be difficult to imitate because they are complex. This may be for two main reasons.

- Internal linkages. It may be the ability to link activities and processes that, together, deliver customer value. The managers in Plasco (see Illustration 3.2) talked about ‘flexibility’ and ‘innovation’, but ‘flexibility’ or ‘innovation’ are themselves made up of and dependent on sets of related activities as Illustration 3.2 shows. Section 3.6.2 and Exhibit 3.8 below show how such linked sets of activities might be mapped so that they can be better understood. However, even if a competitor possessed such a map, it is unlikely that it would be able to replicate the sort of complexity it represents.
Strategic capability for Plasco

Strategic capability underpinning competitive success may be based on complex linkages rooted in the history and culture of an organisation.

Plasco, a manufacturer of plastics goods, had won several major retail accounts from competitors. Managers were keen to understand the bases of these successes as a way of understanding strategic capabilities better. To do this they undertook an analysis of customer value (as explained in section 2.4.4). From this they identified that the major retailers with whom it had been successful particularly valued a powerful brand, a good product range, innovation, good service and reliable delivery. In particular, Plasco was outperforming competitors when it came to delivery, service and product range.

They then undertook an activity mapping exercise, as explained in section 3.6.2 (see Exhibit 3.8). Some of what emerged from this the senior management knew about; but they were not aware of some of the other explanations for success that emerged.

When they analysed the bases of reliable delivery, they could not find reasons why they were outperforming competitors. The logistics of the company were no different from other companies. They were essential but not unique – threshold resources and competences.

When they examined the activities that gave rise to the good service they provided, however, they found other explanations. They were readily able to identify that much was down to their having a more flexible approach than their competitors, the main one of which was a major US multinational. But the explanations for this flexibility were less obvious. The flexibility took form, for example, in the ability to amend the requirements of the retailers’ orders at short notice; or when the buyers in the retailers had made an error, to ‘bale them out’ by taking back stock that had been delivered. What was much less obvious were the activities underpinning this flexibility. The mapping surfaced some explanations:

- The junior manager and staff within the firm were ‘bending the rules’ to take back goods from the major retailers when, strictly speaking, the policies and systems of the business did not allow it.
- Plant utilisation was relatively lower and less automated than competitors, so it was easier to change production runs at short notice. Company policy, on the other hand, was to improve productivity through increased utilisation and to begin to automate the plans. Lower levels of production management were not anxious to do this, knowing that if they did, it would reduce the flexibility and therefore diminish their ability to provide the service customers wanted.

Much of this was down to the knowledge of quite junior managers, sales representatives and staff in the factory as to ‘how to work the system’ and how to work together to solve the retailers’ problems. This was not a matter of company policy or formal training, but custom and practice that had built up over the years. The result was a relationship between sales personnel and retail buyers in which buyers were encouraged to ‘ask the impossible’ of the company when difficulties arose.

Sound logistics and good-quality products were vital, but the core competences which underpinned their success were the result of linked sets of activities built up over the years which it was difficult, not only for competitors but also for people in the organisation, to identify clearly.

Questions
1. Why might it be difficult for a large, automated US plastics manufacturer to deal with retailers in the same way as Plasco?
2. How should Plasco senior managers respond to the explanations of strategic capability surfaced by the mapping?
3. What could erode the bases of competitive advantage that Plasco has?
● External interconnectedness. Organisations can make it difficult for others to imitate or obtain their bases of competitive advantage by developing activities together with the customer on which the customer is dependent on them. This is sometimes referred to as co-specialisation. For example, an industrial lubricants business moved away from just selling its products to customers by coming to agreements with them to manage the applications of lubricants within the customers’ sites against agreed targets on cost savings. The more efficient the use of lubricants, the more both parties benefited. Similarly software businesses can achieve advantage by developing computer programs that are distinctively beneficial to specific customer needs.

Culture and history

Core competences may become embedded in an organisation’s culture. Indeed, managers within an organisation may not understand them explicitly themselves. So coordination between various activities occurs ‘naturally’ because people know their part in the wider picture or it is simply ‘taken for granted’ that activities are done in particular ways. For example, in Plasco the experience in rapid changes in production runs and the close links between sales personnel, production and despatch were not planned or formalised: they were the way the firm had come to operate over the years.

Linked to this cultural embeddedness, therefore, is the likelihood that such competences have developed over time and in a particular way. The origins and history by which competences have developed over time are referred to as path.
dependency\(^{11}\) are specific to the organisation and cannot be imitated (also see section 5.3.1). Again, however, it should be noted that there is a danger that culturally embedded competences built up over time become so embedded that they are difficult to change: they become core rigidities.

**Causal ambiguity\(^{12}\)**

Another reason why competences might be difficult to imitate is that competitors find it difficult to discern the causes and effects underpinning an organisation’s advantage. This is called *causal ambiguity*. This could relate to any or all of the aspects of strategic capability discussed in the preceding sections of this chapter. Causal ambiguity may exist in two different forms:\(^{13}\)

- **Characteristic ambiguity** – where the significance of the characteristic itself is difficult to discern or comprehend, perhaps because it is based on tacit knowledge or rooted in the organisation’s culture. For example, it is quite possible that the ‘rule bending’ in Plasco would have been counter-cultural for its US rival and therefore not readily identified or seen as relevant or significant.

- **Linkage ambiguity** – where competitors cannot discern which activities and processes are dependent on which others to form linkages that create core competences. It would be difficult for competitors to understand the cause and effect linkages in Plasco given that the management of Plasco did not fully comprehend them themselves.

**3.4.4 Non-substitutability of strategic capabilities\(^{14}\)**

Providing value to customers and possessing competences that are complex, culturally embedded and causally ambiguous may mean that it is very difficult for organisations to copy them. However, the organisation may still be at risk from substitution. Substitution could take two different forms:

- **Product or service substitution.** As already discussed in Chapter 2 in relation to the five forces model of competition, a product or service as a whole might be a victim of substitution. For example, increasingly e-mail systems have substituted for postal systems. No matter how complex and culturally embedded were the competences of the postal service, it could not avoid this sort of substitution.

- **Competence substitution.** Substitution might, however, not be at the product or service level but at the competence level. For example, task-based industries have often suffered because of an over-reliance on the competences of skilled craftworkers that have been replaced by expert systems and mechanisation.

In summary and from a resource-based view of organisations, managers need to consider whether their organisation has strategic capabilities to achieve and sustain competitive advantage. To do so they need to consider how and to what extent it has capabilities which are (i) valuable to buyers, (ii) rare, (iii) inimitable and (iv) non-substitutable. If such capabilities for competitive advantage do not exist, then managers need to consider if they can be developed. How this might be done is considered in section 3.7 below.
3.4.5 Dynamic capabilities

The discussion so far has tended to assume that strategic capabilities can provide sustainable competitive advantage over time: that they are durable. However, managers often claim that hypercompetitive conditions (see section 2.3.2) are becoming increasingly prevalent. Technology is giving rise to innovation at a faster rate and therefore greater capacity for imitation and substitution of existing products and services. None the less, even in such circumstances, some firms do achieve competitive advantage over others. To explain this, more emphasis has to be placed on the organisation’s capability to change, innovate, to be flexible and to learn how to adapt to a rapidly changing environment.

David Teece\(^\text{15}\) argued that the strategic capabilities that achieve competitive advantage in such dynamic conditions are dynamic capabilities, by which he means an organisation’s ability to renew and recreate its strategic capabilities to meet the needs of a changing environment.\(^\text{16}\) Dynamic capabilities may be relatively formal, such as systems for new product development or procedures for agreement for capital expenditure. They may take the form of major strategic moves, such as acquisitions or alliances by which new skills are learned by the organisation. Or they may be more informal, such as the way in which decisions get taken faster than usual when a fast response is needed. They could also take the form of embedded ‘organisational knowledge’ (see section 3.5 below) about how to deal with particular circumstances the organisation faces, or how to innovate. Indeed, dynamic capabilities are likely to have both formal and informal, visible and invisible, characteristics associated with them. For example, Kathy Eisenhardt\(^\text{17}\) has shown that successful acquisition processes that bring in new knowledge to organisations depend on high-quality pre- and post-acquisition analysis of how the acquisition can be integrated into the new organisation so as to capture synergies and bases of learning from that acquisition. However, hand in hand with these formal procedures will be more informal ways of doing things in the acquisition process built on informal personal relationships and the exchange of knowledge in more informal ways.

In summary, whereas in more stable conditions competitive advantage might be achieved by building capabilities that may be durable over time, in more dynamic conditions competitive advantage requires the building of capacity to change, innovate and learn – to build dynamic capabilities. Illustration 3.3 provides an example.

3.5 Organisational knowledge

As interest in strategic capabilities has grown, writers have come to emphasise the importance of organisational knowledge. Organisational knowledge is the collective experience accumulated through systems, routines and activities of sharing across the organisation. As such it is closely related to what has so far been discussed as the competences of an organisation.

There are several reasons why organisational knowledge has been highlighted as important. First, as organisations become more complex and larger, the need to share what people know becomes more of a challenge. Second, information systems have started to provide more sophisticated ways of doing this.\(^\text{19}\) And
CHAPTER 3  STRATEGIC CAPABILITY

Illustration 3.3

Building dynamic capabilities in a new venture

Networks and partnerships can be a source of dynamic capabilities and learning for firms and for managers.

HMD Clinical is an Edinburgh-based clinical technological new venture that seeks to make large-scale clinical trials more efficient for drug development companies. HMD initially provided bespoke services using telephony technology (for example, interactive voice recognition) to monitor clinical trials. However, this was problematic, principally due to human error. HMD therefore sought to develop a product based on another technology – radiofrequency identification. HMD felt this would also offer the prospect of market diversification, especially through international expansion. However, making changes to the company’s product market domain called for capabilities to expand or modify HMD’s current configuration of resources and capabilities – in other words, for dynamic capabilities.

HMD decided to partner with a large established firm, which HMD saw as a potential source of legitimacy, resources and opportunities: Sun Microsystems, a multinational corporation with a significant presence in Scotland. Co-founder Ian Davison commented, ‘There’s a certain cache in being associated with a big company.’ Sun was interested in HMD’s product idea and within months there was progress in establishing the alliance. Davison believes that considerable benefit was derived by HMD: ‘We got what we wanted out of the relationship because we managed to build a prototype using the Sun technology.’ HMD’s experience also illustrates the building of dynamic capabilities at various levels.

Opportunities arose for mutual learning. From HMD’s perspective, the venture benefited from exposure to new technological ideas. Of particular advantage was Sun’s ability to tap into its widespread resources and capabilities elsewhere in the UK and beyond (for example, Western Europe). Also, Sun’s reputation opened doors for HMD. When the prototype was built, HMD made a joint sales call with Sun to a prospective international customer and a demonstration was subsequently held on Sun’s Scottish premises. Such activities facilitated experiential learning about processes such as product development and sales.

Product development. In developing a prototype with Sun, HMD engaged in integrating resources and capabilities to achieve synergies; for example, its own customer-centric technological knowledge in the clinical trials domain was combined with Sun’s hardware technology architecture.

Alliancing. Through inputs from a public sector intermediary, HMD gained vital knowledge about formal aspects of alliancing, such as the legalities of sharing intellectual property; equally, HMD came to appreciate the utility of informal social networking in ensuring the smooth progress of joint activity.

Strategic decision making. HMD was able to build new thinking within the firm in terms of, for example, the identification of external knowledge sources as evident from subsequent decisions to expand the alliance to include a third partner.

At the individual level within HMD managers also learned ‘new tricks’ by engaging in informal routines such as brainstorming sessions and everyday activities such as negotiating. Managers claimed that such learning would help HMD approach its next alliance by replicating certain aspects while modifying others. Davison commented: ‘In future we would approach this sort of relationship in a broadly similar manner [but] I think we would attempt to set some clearer company goals and boundaries at the outset.’

Prepared by Shameen Prashantham, Department of Management, University of Glasgow.

Questions

1. At what levels could dynamic capabilities benefit organisations?
2. How do network relationships, such as strategic partnerships, potentially contribute to dynamic capability development?
3. What other joint activity within, and across, organisations could give rise to dynamic capabilities? How?
4. Can dynamic capability development be deliberately planned? How?
third, as explained already in this chapter, it is less likely that organisations will achieve competitive advantage through their physical resources and more likely that it will be achieved through the way they do things and their accumulated experience. So knowledge about how to do things that draws on that experience becomes crucially important.

Two points should be highlighted here:

- **Explicit and tacit organisational knowledge.** Organisational knowledge may take different forms. Nonaka and Takeuchi\(^{20}\) distinguish between two types of knowledge. **Explicit knowledge** is codified, and ‘objective’ knowledge is transmitted in formal systematic ways. It may, indeed, take the form of a codified information resource such as a systems manual. In contrast, **tacit knowledge** is personal, context specific and therefore hard to formalise and communicate. As for individuals, organisational competence usually requires both kinds of knowledge. For example, a learner driver uses explicit knowledge, probably taught by an instructor, to develop knowledge on how to drive a car. The tacit knowledge required is, however, achieved through practical experience of driving. Arguably, the more formal and systematic the system of knowledge, the greater is the danger of imitation, and therefore the less valuable the knowledge becomes in competitive strategy terms. If knowledge can be codified, then there is more of a chance of it being copied. Non-imitatable competitive advantage is much more likely to exist where knowledge is lodged in the experience of groups of individuals.

- **Communities of practice.** The sharing of knowledge and experience in organisations is an essentially social and cultural process relying on **communities of practice**\(^{21}\) developing and sharing information because it is mutually beneficial. This may happen through formal systems such as the Internet but it is also highly dependent on social contact and trust. Indeed, exchange of knowledge is more likely to occur in **cultures of trust** without strong hierarchical or functional boundaries. For example, organisations have tried to improve the sharing of knowledge by setting up IT-based systems to do it. However, there has been an increasing realisation that, while some of this knowledge can be codified and built into computer-based systems, it is very difficult to codify knowledge where its value is especially dependent on knowledge sharing.

These observations in turn flag up the links between organisational knowledge and other concepts discussed in this book. Organisational knowledge may be beneficial but needs to develop as the environment changes. As such, organisational knowledge and learning are closely linked concepts. In turn both need to be thought of in terms of the **dynamic capabilities** to adapt to changing conditions referred to in section 3.4.5 above. The links between knowledge, experience and social interaction also need to be considered in relation to cultural aspects of strategy addressed further in Chapter 5.

So far this chapter has been concerned with explaining strategic capability and associated concepts. This section now provides some ways in which strategic capabilities can be diagnosed.
3.6.1 The value chain and value network

If organisations are to achieve competitive advantage by delivering value to customers, managers need to understand which activities they undertake are especially important in creating that value and which are not. Value chain and value network concepts can be helpful in understanding this.

The value chain

The value chain describes the categories of activities within and around an organisation, which together create a product or service. The concept was developed in relation to competitive strategy by Michael Porter. Exhibit 3.6 is a representation of a value chain. Primary activities are directly concerned with the creation or delivery of a product or service. For example, for a manufacturing business:

- **Inbound logistics** are activities concerned with receiving, storing and distributing inputs to the product or service including materials handling, stock control, transport, etc.
- **Operations** transform these inputs into the final product or service: machining, packaging, assembly, testing, etc.
- **Outbound logistics** collect, store and distribute the product to customers, for example warehousing, materials handling, distribution, etc.
- **Marketing and sales** provide the means whereby consumers/users are made aware of the product or service and are able to purchase it. This includes sales administration, advertising and selling.
- **Service** includes those activities that enhance or maintain the value of a product or service, such as installation, repair, training and spares.

Source: Adapted with the permission of The Free Press, a Division of Simon & Schuster Adult Publishing Group, from Competitive Advantage: Creating and Sustaining Superior Performance by Michael E. Porter. Copyright © 1985, 1998 by Michael E. Porter. All rights reserved.
Each of these groups of primary activities is linked to support activities. Support activities help to improve the effectiveness or efficiency of primary activities:

- **Procurement.** The processes that occur in many parts of the organisation for acquiring the various resource inputs to the primary activities.

- **Technology development.** All value activities have a ‘technology’, even if it is just know-how. Technologies may be concerned directly with a product (for example, R&D, product design) or with processes (for example, process development) or with a particular resource (for example, raw materials improvements).

- **Human resource management.** This transcends all primary activities. It is concerned with those activities involved in recruiting, managing, training, developing and rewarding people within the organisation.

- **Infrastructure.** The formal systems of planning, finance, quality control, information management, and the structures and routines that are part of an organisation’s culture (see section 5.4).

The value chain can help with the analysis of the strategic position of an organisation in two different ways.

- As generic descriptions of activities that can help managers understand if there is a cluster of activities providing benefit to customers located within particular areas of the value chain. Perhaps a business is especially good at outbound logistics linked to its marketing and sales operation and supported by its technology development. It might be less good in terms of its operations and its inbound logistics. The value chain also prompts managers to think about the role different activities play. For example, in a local family-run sandwich bar, is sandwich making best thought of as ‘operations’ or as ‘marketing and sales’, given that its reputation and appeal may rely on the social relations and banter between customers and sandwich makers? Arguably it is ‘operations’ if done badly but ‘marketing and sales’ if done well.

- In terms of the cost and value of activities. Illustration 3.4 shows this in relation to fish farming. Value chain analysis was used by Ugandan fish farmers as a way of identifying what they should focus on in developing a more profitable business model.

### The value network

A single organisation rarely undertakes in-house all of the value activities from design through to delivery of the final product or service to the final consumer. There is usually specialisation of role so any one organisation is part of a wider value network. The value network is the set of interorganisational links and relationships that are necessary to create a product or service (see Exhibit 3.7). So an organisation needs to be clear about what activities it ought to undertake itself and which it should not and, perhaps, should outsource. However, since much of the cost and value creation will occur in the supply and distribution chains, managers need to understand this whole process and how they can manage these linkages and relationships to improve customer value. It is not sufficient to look within the organisation alone. For example, the quality of a cooker or a
television when it reaches the final purchaser is influenced not only by the activities undertaken within the manufacturing company itself, but also by the quality of components from suppliers and the performance of the distributors. It is therefore important that managers understand the bases of their organisation’s strategic capabilities in relation to the wider value network. Four key issues are:

- Which activities are centrally important to an organisation’s strategic capability and which less central? A firm in a highly competitive market may have to cut costs in key areas and decide it can only do so by outsourcing to lower-cost producers. Another firm may decide that it is important to retain direct control of centrally important capabilities, especially if they relate to activities and processes that it believes are central to its achieving competitive advantage. For example, diamond cutting businesses have traditionally had to source rough diamonds from the giant De Beers. However, in a revolutionary move...
the Lev Levice Group decided to invest in its own diamond mining operations, arguing: ‘Nothing is stable unless you own your own mine.’

- **Where are the profit pools?** Profit pools refer to the different levels of profit available at different parts of the value network. Some parts of a value network may be inherently more profitable than others because of the differences in competitive intensity. For example, in the computer industry microprocessors and software have historically been more profitable than hardware manufacture. The strategic question becomes whether it is possible to focus on the areas of greatest profit potential. Care has to be exercised here. It is one thing to identify such potential; it is another to be successful in it given the capabilities the organisation has. For example, in the 1990s many car manufacturers recognised that greater profit potential lay in services such as car hire and financing rather than manufacturing but they did not have the relevant competences to succeed in such sectors.
The ‘make or buy’ decision for a particular activity or component is therefore critical. This is the outsourcing decision. There are businesses that now offer the benefits of outsourcing (see the discussion in section 12.4.2). Of course, the more an organisation outsources, the more its ability to influence the performance of other organisations in the value network may become a critically important competence in itself and even a source of competitive advantage.

Partnering. Who might be the best partners in the parts of the value network? And what kind of relationships are important to develop with each partner? For example, should they be regarded as suppliers or should they be regarded as alliance partners (see section 10.2.3)? Some businesses have benefited from closer relationships with suppliers such that they increasingly cooperate on such things as market intelligence, product design and R&D.

### 3.6.2 Activity maps

Managers often find it difficult to identify with any clarity the strategic capability of their organisation. Too often they highlight capabilities not valued by customers but seen as important within the organisation, perhaps because they were valuable in the past. Or they highlight what are, in fact, critical success factors (product features particularly valued by customers) like ‘good service’ or ‘reliable delivery’, whereas strategic capability is about the resources, processes and activities that underpin the ability to meet such critical success factors. Or they identify capabilities at too generic a level. This is not surprising given that strategic capability is likely to be rooted in a complex, causally ambiguous set of linked activities (see section 3.4.3). But if they are to be managed proactively,
finding a way of identifying and understanding capabilities and the linkages that are likely to characterise competences is important.

One way of undertaking such diagnosis is by means of an activity map that tries to show how the different activities of an organisation are linked together. Illustration 3.2 described the search by Plasco’s management for the company’s strategic capabilities using activity mapping. There are computer programs in existence that can be used, or such analysis may be done more basically, for example by drawing network diagrams, as shown in Exhibit 3.8. This map was generated by groups of managers from within the organisation, working with a facilitator, mapping the activities of their organisation on a large blank wall initially by using Post-Its.
They began by undertaking a competitor analysis as explained in section 2.4.4. The aim here was to identify (i) the critical success factors in relation to their customers and (ii) on which of these their business outperformed competitors. They identified the critical success factors of brand reputation, product range, innovation, excellence of service and reliability of delivery and that Plasco was seen as particularly successful in relation to competitors in terms of its level of service and its product range. Managers were relatively easily able to identify what Porter refers to as higher order strategic themes: that the main benefits offered were to do with flexibility and rapid response. But the reasons why Plasco outperformed competitors did not emerge until these themes themselves were ‘unpacked’ by identifying the resources and competences that underpinned them. To do this managers kept asking themselves more and more specifically what activities ‘delivered’ the customer benefits. Exhibit 3.8 is only a selection of these activities. The eventual map consisted of hundreds of Post-Its, each representing an activity in some way contributing to strategic capability. The activity-based competences described in Illustration 3.2 and summarised in Exhibit 3.8 emerged from this diagnostic process.

General lessons that can be drawn from such maps about how competitive advantage is achieved and the relationship between competences and competitive advantage include:

- **Consistency and reinforcement.** The different activities that create value to customers are likely to be pulling in the same direction and supporting rather than opposing each other (for example, in Plasco an open management style facilitated rule bending and in turn flexibility).

- **Difficulties of imitation.** It is more difficult for a competitor to imitate a mix of linked activities than to imitate any given one. In Plasco such linked activities had been built up over years, culturally embedded, were complex and causally ambiguous – the lessons of section 3.4.3. If the multinational competitor of Plasco decided to try to compete on the same basis of flexibility it would have no comparable experience to draw on to do this.

- **Trade-offs.** Even if imitation were possible it could pose another problem for competitors. For example, Plasco’s international competitor might place in jeopardy its current position with its existing customers that it is satisfying through more standardised mass production.

### 3.6.3 Benchmarking

This section considers the value of benchmarking, which can be used as a way of understanding how an organisation’s strategic capability, in terms of internal processes, compare with those of other organisations.

There are different approaches to benchmarking:

- **Historical benchmarking.** Organisations may consider their performance in relation to previous years in order to identify any significant changes. The danger is that this can lead to complacency since it is the rate of improvement compared with that of competitors that is really important.
● **Industry/sector benchmarking.** Insights about performance standards can be gleaned by looking at the comparative performance of other organisations in the same industry sector or between similar service providers against a set of performance indicators. Some public sector organisations have, in effect, acknowledged the existence of strategic groups by benchmarking against similar organisations rather than against everybody: for example, local government services and police treat ‘urban’ differently from ‘rural’ in their benchmarking and league tables. An overriding danger of industry norm comparisons (whether in the private or public sector) is, however, that the whole industry may be performing badly and losing out competitively to other industries that can satisfy customers’ needs in different ways. Another danger with benchmarking within an industry is that the boundaries of industries are blurring through competitive activity and industry convergence. For example, supermarkets are (incrementally) entering retail banking and their benchmarking needs to reflect this (as does the benchmarking of the traditional retail banks).

● **Best-in-class benchmarking.** Best-in-class benchmarking compares an organisation’s performance against ‘best-in-class’ performance – wherever that is found – and therefore seeks to overcome the limitations of other approaches. It may also help challenge managers’ mindsets that acceptable improvements in performance will result from incremental changes in resources or competences. It can therefore encourage a more fundamental reconsideration of how to improve organisational competences. For example, British Airways improved aircraft maintenance, refuelling and turnaround time by studying the processes surrounding Formula One Grand Prix motor racing pit stops. A police force wishing to improve the way in which it responded to emergency telephone calls studied call centre operations in the banking and IT sectors.

The importance of benchmarking is, then, not so much in the detailed ‘mechanics’ of comparison but in the impact that these comparisons might have on behaviours. It can be usefully regarded as a process for gaining momentum for improvement and change. But it has dangers too:

● **Measurement distortion.** Benchmarking can lead to a situation where you get what you measure and this may not be what is intended strategically. It can therefore result in changes in behaviour that are unintended or dysfunctional. For example, the university sector in the UK has been subjected to rankings in league tables on research output, teaching quality and the success of graduating students in terms of employment and starting salaries. This has resulted in academics being ‘forced’ to orientate their published research to certain types of academic journals that may have little to do directly with the quality of the education in universities.

● **Surface comparisons.** Benchmarking compares inputs (resources), outputs or outcomes; it does not identify the reasons for the good or poor performance of organisations since the process does not compare competences directly. For example, it may demonstrate that one organisation is poorer at customer service than another but not show the underlying reasons. However, if well directed it could encourage managers to seek out these reasons and hence understand how competences could be improved.
SWOT analysis of Pharmcare

A SWOT analysis explores the relationship between the environmental influences and the strategic capabilities of an organisation compared with its competitors.

(a) SWOT analysis for Pharmcare

<table>
<thead>
<tr>
<th>Environmental change (opportunities and threats)</th>
<th>Health care rationing</th>
<th>Complex and changing buying structures</th>
<th>Increased integration of health care</th>
<th>Informed patients</th>
<th>+</th>
<th>–</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strengths</td>
<td>Flexible salesforce</td>
<td>+3</td>
<td>+5</td>
<td>+2</td>
<td>+2</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Economics of scale</td>
<td>0</td>
<td>0</td>
<td>+3</td>
<td>+3</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Strong brand name</td>
<td>+2</td>
<td>–1</td>
<td>0</td>
<td>–1</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Health care education department</td>
<td>+4</td>
<td>+3</td>
<td>+4</td>
<td>+5</td>
<td>16</td>
</tr>
<tr>
<td>Weaknesses</td>
<td>Limited competences in biotechnology and genetics</td>
<td>0</td>
<td>0</td>
<td>–4</td>
<td>–3</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Ever lower R&amp;D productivity</td>
<td>–3</td>
<td>–2</td>
<td>–1</td>
<td>–2</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Weak ICT competences</td>
<td>–2</td>
<td>–2</td>
<td>–5</td>
<td>–5</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Over-reliance on leading product</td>
<td>0</td>
<td>–1</td>
<td>0</td>
<td>–3</td>
<td>0</td>
</tr>
<tr>
<td>Environmental impact scores</td>
<td>+9</td>
<td>+9</td>
<td>+9</td>
<td>+10</td>
<td>–12</td>
<td></td>
</tr>
<tr>
<td></td>
<td>–6</td>
<td>–5</td>
<td>–14</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(b) Competitor SWOT analyses

<table>
<thead>
<tr>
<th>Environmental change (opportunities and threats)</th>
<th>Health care rationing</th>
<th>Complex and changing buying structures</th>
<th>Increased integration of health care</th>
<th>Informed and passionate patients</th>
<th>Overall impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharmcare</td>
<td>Big global player</td>
<td>–3</td>
<td>Struggling to prove cost-effectiveness of new drugs to new regulators of health care rationing</td>
<td>–3</td>
<td>Weak ICT and lack of integration following mergers means sales, research and admin are underperforming</td>
</tr>
<tr>
<td></td>
<td>Suffering fall in share price, low research productivity and post mega-merger bureaucracy</td>
<td>+6</td>
<td>Well-known brand, a flexible salesforce combined with a new health care education department creates positive synergy</td>
<td>–2</td>
<td>Have yet to get into the groove of patient power fuelled by the Internet</td>
</tr>
<tr>
<td></td>
<td>Flexibility and lack of synergy</td>
<td>+4</td>
<td>Traditional salesforce not helped by marketing which can be unaccommodating of national differences</td>
<td>+8</td>
<td>Alliances with equipment manufacturers but little work done across alliance to show dual use of drugs and new surgical techniques</td>
</tr>
<tr>
<td>Company W</td>
<td>Big pharma with patchy response to change, losing ground in new areas of competition</td>
<td>–3</td>
<td>Focus on innovative new drugs</td>
<td>–3</td>
<td>Patients will fight for advances in treatment areas where little recent progress has been made</td>
</tr>
<tr>
<td></td>
<td></td>
<td>+2</td>
<td>Able possibly to bypass these with innovative cost effective drugs(s)</td>
<td>+2</td>
<td>Innovative drugs can help integrate health care through enabling patients to stay at home</td>
</tr>
<tr>
<td>Organisation X</td>
<td>Partnership between a charity managed by people with venture capital experience and top hospital geneticists</td>
<td>–3</td>
<td>Potentially able to deliver rapid advances in genetic-based illnesses</td>
<td>+3</td>
<td>New recruits in the ICT department have worked cross-functionally to involve patients like never before</td>
</tr>
<tr>
<td>Company Y</td>
<td>Only develops drugs for less common diseases</td>
<td>+2</td>
<td>Focus on small market segments so not as vulnerable to overall market structure, but innovative approach might be risky</td>
<td>–1</td>
<td>Toll-free call centres for sufferers of less common illnesses</td>
</tr>
<tr>
<td></td>
<td></td>
<td>+3</td>
<td>Focus on small market segments so not as vulnerable to overall market structure, but innovative approach might be risky</td>
<td>+1</td>
<td>Innovative use of web to show why products still worthwhile developing even for less common illnesses</td>
</tr>
</tbody>
</table>

Questions

1. What does the SWOT analysis tell us about the competitive position of Pharmcare with the industry as a whole?
2. How readily do you think executives of Pharmcare identify the strengths and weaknesses of competitors?
3. Identify the benefits and dangers (other than those identified in the text) of a SWOT analysis such as that in the illustration.

Prepared by Jill Shepherd, Segal Graduate School of Business, Simon Fraser University, Vancouver, Canada.
The key ‘strategic messages’ from both the business environment (Chapter 2) and this chapter can be summarised in the form of an analysis of strengths, weaknesses, opportunities and threats (SWOT). SWOT summarises the key issues from the business environment and the strategic capability of an organisation that are most likely to impact on strategy development. This can also be useful as a basis against which to generate strategic options and assess future courses of action.

The aim is to identify the extent to which strengths and weaknesses are relevant to, or capable of dealing with, the changes taking place in the business environment. However, in the context of this chapter, if the strategic capability of an organisation is to be understood, it must be remembered that it is not absolute but relative to its competitors. So SWOT analysis is really only useful if it is comparative – if it examines strengths, weaknesses, opportunities and threats in relation to competitors. Illustration 3.5 takes the example of a pharmaceuticals firm (Pharmcare). It assumes that key environmental impacts have been identified from analyses explained in Chapter 2 and that major strengths and weaknesses have been identified using the analytic tools explained in this chapter. A scoring mechanism (plus 5 to minus 5) is used as a means of getting managers to assess the interrelationship between the environmental impacts and the strengths and weaknesses of the firm. A positive (+) denotes that the strength of the company would help it take advantage of, or counteract, a problem arising from an environmental change or that a weakness would be offset by that change. A negative (–) score denotes that the strength would be reduced or that a weakness would prevent the organisation from overcoming problems associated with that change.

Pharmcare’s share price had been declining because investors were concerned that its strong market position was under threat. This had not been improved by a merger that was proving problematic. The pharmaceutical market was changing with new ways of doing business, driven by new technology, the quest to provide medicines at lower cost and politicians seeking ways to cope with soaring health care costs and an evermore informed patient. But was Pharmcare keeping pace? The strategic review of the firm’s position (Illustration 3.5a) confirmed its strengths of a flexible salesforce, well-known brand name and new health care department. However, there were major weaknesses, namely relative failure on low-cost drugs, competence in information and communication technology (ICT) and a failure to get to grips with increasingly well-informed users. When the impact of environmental forces on competitors was analysed (Illustration 3.5b), it showed that Pharmcare was still outperforming its traditional competitor (Company W), but potentially vulnerable to changing dynamics in the general industry structure courtesy of niche players (X and Y).

A SWOT analysis should help focus discussion on future choices and the extent to which an organisation is capable of supporting these strategies. There are, however, two main dangers:

- A SWOT exercise can generate very long lists of apparent strengths, weaknesses, opportunities and threats, whereas what matters is to be clear about what is really important and what is less important.
3.7 MANAGING STRATEGIC CAPABILITY

The previous section has been concerned with diagnosing strategic capability. This section considers what managers might do, other than such diagnosis, to manage and improve the strategic capability of their organisation.

3.7.1 Limitations in managing strategic capabilities

One lesson that emerges from an understanding of strategic capabilities is that the most valuable bases of strategic capability may lie in aspects of the organisation that are difficult to discern or be specific about. So, how is it possible to manage that which it is not always easy to be clear about? For example, in the Plasco illustration, some of the capabilities of that organisation were lodged in activities that the top management were not directly managing. It is important to understand what managers might be able to do and what they cannot do in terms of how much they understand and how much they value bases of strategic capability. There may be different circumstances:

- **Competences are valued but not understood.** Managers may know that there are activities in their organisation that have a positive impact and may value them, but may not understand just how such positive impact arises. For example, the delivery of value may be dependent on highly specialised skills as in a cutting-edge hi-tech firm, or on complex linkages far down in the organisation. The lesson here is that managers may have to be careful about disturbing the bases of such capabilities while ensuring that they monitor the outputs and benefits created for customers.

- **Competences are not valued.** Managers may know that activities and processes exist in the organisation but not recognise their positive impact or value such activities. There are dangers here that managers take the wrong course of action. For example, they may cut out areas of activity that create actual or potential competitive advantage, perhaps because they are intent on cutting costs. Plasco managers might, for example, have sought to improve production efficiency so that they could have reduced flexibility. It would be wise to understand the value-creating capabilities more clearly using value chain analysis or activity mapping before as Plasco managers did before taking such decisions.

- **Competences are recognised, valued and understood.** This might be the outcome of the sort of analysis done by Plasco. Here managers may be able to nurture and further develop such competences, for example by ensuring that overall company policies support and enhance them. The danger can be that top
management may seek to preserve such capabilities by over-formalising or codifying them such that they become ‘set in stone’.

### 3.7.2 Developing strategic capabilities

There are different ways in which managers might develop strategic capabilities:

- **Adding and changing capabilities.** Could capabilities be added, or changed so that they become more reinforcing of outcomes that deliver against critical success factors? For example, in Plasco, could even faster internal ways of responding to customer needs be found?

- **Extending capabilities.** Managers might identify strategic capabilities in one area of the business, perhaps customer service in one geographic business unit of a multinational, that are not present in other business units. They might then seek to extend this throughout all the business units. Whilst this seems straightforward, studies find it is not. The capabilities of one part of an organisation might not be easily transferred to another because of the problems of managing change (see Chapter 14).

- **Stretching capabilities.** Managers may see the opportunity to build new products or services out of existing capabilities. Indeed, building new businesses in this way is the basis of related diversification, as explained in section 7.3.1.

- **Entrepreneurial bricolage.** There is evidence that strategic capabilities may be built by exploiting resources, skills and knowledge that have been ignored or rejected by others; indeed that this is often what entrepreneurs who develop new business models do. For example, the development of Danish wind turbines was based on improvising around available ‘modest resources’ and the skills of a ‘constellation of different players’; social networks ignored by others have been used for building technology businesses and information systems designers experiment with different configurations to create new systems drawing from their and others’ experience.

- **Ceasing activities.** Could current activities not central to the delivery of value to customers be done away with, outsourced or reduced in cost? This is what new industry entrants, such as Ryanair or easyJet in the airline industry, did to create new business models for low-cost airlines.

- **External capability development.** There may be ways of developing capabilities by looking externally. For example, managers may seek to develop or learn new capabilities by acquisition or by entering into alliances and joint ventures (see section 10.2.3).

### 3.7.3 Managing people for capability development

One of the lessons of this chapter is that strategic capability often lies in the day-to-day activities that people undertake in organisations, so developing the ability of people to recognise the relevance of what they do in terms of the strategic capability of the organisation is important. More specifically:
Targeted training and development may be possible. Often companies design training and development programmes that are very general. For strategic purposes it may be important to target the development of competences which can provide competitive advantage. For example, an engineering business, whilst acknowledging the abilities its personnel had in the technical aspects of engineering products, recognised that these were attributes that competitors had too, and that there was a need to develop people’s abilities to innovate more around value-adding customer service. The business therefore changed its training and development programmes to emphasise these requirements.

Staffing policies might be employed to develop particular competences. For example, an oil company that sought to build its competitive advantage around the building of close customer relationships in markets for industrial oils did so by ensuring that senior field managers with an aptitude for this were promoted and sent to different parts of the world that needed to be developed in such ways.

Organisational learning may be recognised as central, particularly in fast-changing conditions. Here successful firms may be those that have grown the dynamic capabilities (see section 3.4.5) to readjust required competences continually. In effect their competence becomes that of learning and development. In this context the characteristics of what has become known as a ‘learning organisation’ may become especially important (see section 11.5.2). Since this may require the acceptance that different, even conflicting ideas and views are valuable and that experimentation is the norm, managers need to consider how to protect and foster such behaviour. For example, it may be that those within the organisation who show most ability to contribute to such learning are the least powerful, perhaps quite junior in the hierarchy. They may need the protection of more powerful people.

Develop people’s awareness that what they do in their jobs can matter at the strategic level. It is a common complaint in organisations that ‘no one values what I do’. Helping people see how their work relates to the bigger strategic picture can both enhance the likelihood that they will, indeed, contribute positively to helping achieve competitive success and increase their motivation to do so.

Illustration 3.6 summarises a key debate that writers on the strategic capabilities are pursuing.
Strategic capability is concerned with the adequacy and suitability of resources and competences required for an organisation to survive and prosper. Strategic capabilities comprise resources and competences, which are the way such resources are used and deployed.

- If organisations are to achieve competitive advantage, they require resources and competences which are both valuable to customers and difficult for competitors to imitate (such competences are known as core competences).

- The continual improvement of cost efficiency is a vital strategic capability if an organisation is to continue to prosper.

- The sustainability of competitive advantage is likely to depend on strategic capabilities being of value to customers, rare, inimitable or non-substitutable.

- In dynamic conditions, it is unlikely that such strategic capabilities will remain stable. In such circumstances dynamic capabilities are important, that is the ability to change strategic capabilities continually.

Ways of diagnosing organisational capabilities include:

- Analysing an organisation’s value chain and value network as a basis of understanding how value to a customer is created and can be developed.

- Activity mapping as a means of identifying more detailed activities which underpin strategic capabilities.

- Benchmarking as means of understanding the relative performance of organisations and challenging the assumptions managers have about the performance of their organisation.

- SWOT analysis as a way of drawing together an understanding of strengths, weaknesses, opportunities and threats an organisation faces.

Managers need to think about how and to what extent they can manage the development of the strategic capabilities of their organisation by stretching and adding to such capabilities and by the way they manage people in their organisation.
The resource-based view of competitive advantage: is it useful to managers?

The view that the management of strategic capability is central for achieving competitive advantage has been questioned.

Since the early 1990s, the resource-based view (RBV) of strategy has become highly influential. Much academic research is carried out on it and managers readily talk about the importance of building on core competences to gain competitive advantage. However, two US academics, Richard Priem and John Butler, have raised questions about the value of RBV.

The critique

In the context of this chapter, two of Priem and Butler’s observations are especially significant:

1. The risk of tautology. The underlying explanation of RBV is that the resource characteristics (or capabilities) that lead to competitive advantage are those that are valuable and rare. Since competitive advantage is defined in terms of value and rarity, they argue that this verges on tautology. To say that a business performs better than another because it has superior resources or is better at some things than other businesses is not helpful unless it is possible to be specific about what capabilities are important, why and how they can be managed.

2. The lack of specificity. However, there is typically little specific in what is written about RBV. And some would say the same is true when managers talk about capabilities or competences. ‘Top management skills’ or ‘innovatory capacity’ mean little without being specific about the activities and processes that comprise them. And there is relatively little research that identifies such specifics or how they can be managed. Priem and Butler suggest this is particularly so with regard to the argued importance of tacit knowledge in bestowing competitive advantage: ‘This may be descriptively correct, but it is likely to be quite difficult for practitioners to effectively manipulate that which is inherently unknowable.’ (The problem raised at the beginning of section 3.6.2.)

The response

Jay Barney, one of the main proponents of RBV, accepts that there is a need to understand more about how resources are used and how people behave in bestowing competitive advantage. However, he defends the managerial relevance of RBV because he believes it highlights that managers need to identify and develop the most critical capabilities of a firm.

In his earlier writing Barney had argued that an organisation’s culture could be a source of sustainable advantage provided it was valuable, rare and difficult to imitate. In such circumstances he suggested managers should ‘nurture these cultures’. However, he went on to argue that:

If one firm is able to modify its culture, then it is likely that others can as well. In this case the advantages associated with the culture are imitable and thus only a source of normal economic performance. Only when it is not possible to manage a firm’s culture in a planned way does that culture have the potential of generating expected sustained superior financial performance.

In other words, he argues that valuable sources of competitive advantage are the intangible assets and resources or competences embedded in a culture in such a way that not only can competitors not imitate them, but managers cannot manage them.

Priem and Butler would no doubt argue that this makes their point: that RBV is not very helpful in providing practical help to managers.

Notes


Questions

1. How specific would the identification of strategic capabilities need to be to permit them to be managed to achieve competitive advantage?
2. Do you agree that if it were possible to identify and manage such capabilities they would be imitated?
3. Is the RBV useful?
Work assignments

✱ Denotes more advanced work assignments. * Refers to a case study in the Text and Cases edition.

3.1 Using Exhibits 3.1 and 3.2 identify the resources and competences of an organisation with which you are familiar. You can answer this in relation to Amazon* or Formula One* if you so wish.

3.2 ✱ Undertake an analysis of the strategic capability of an organisation with which you are familiar in order to identify which capabilities, if any, meet the criteria of (a) value, (b) rarity, (c) robustness and (d) inimitability (see section 3.4). You can answer this in relation to Amazon* or Formula One* if you so wish.

3.3 ✱ For an industry or public service consider how the strategic capabilities that have been the basis of competitive advantage (or best value in the public sector) have changed over time. Why have these changes occurred? How did the relative strengths of different companies or service providers change over this period? Why?

3.4 Map out a value chain/network analysis for an organisation of your choice (referring to Illustration 3.4 could be helpful). You can answer this in relation to a case study in the book such as eBay, Tesco, Tui* or Ryanair* if you wish.

3.5 ❌ For a benchmarking exercise which you have access to, make a critical assessment of the benefits and dangers of the approach that was taken.

Integrative assignment

3.6 Prepare a SWOT analysis for an organisation of your choice and in relation to competitors (see Illustration 3.5). Explain why you have chosen each of the factors you have included in the analysis, in particular their relationship to other analyses you have undertaken in Chapters 2 and 3. What are the conclusions you arrive at from your analysis?

An extensive range of additional materials, including audio summaries, weblinks to organisations featured in the text, definitions of key concepts and self-assessment questions, can be found on the Exploring Corporate Strategy Companion Website at www.pearsoned.co.uk/ecs

Recommended key readings


For an understanding of the challenges of managing capability development see C. Bowman and N. Collier, ‘A contingency approach to resource-


References

1. Extraordinary profits as defined here are also sometimes referred to by economists as rents. For an explanation related to strategy, see R. Perman and J. Scoular, Business Economics, Oxford University Press, 1999, pp. 67–73.


5. Perman and Scoular discuss economies of scale and differences between industry sectors in pages 91–100 of their book (see reference 1).


7. The headings used in this chapter are those used most commonly by writers in academic papers on RBV. These are sometimes referred to as VRIN, which stands for Valuable, Rare, difficult to Imitate and non-Substitutable, and were first identified by J. Barney, ‘Firm resources and sustained competitive advantage’, Journal of Management, vol. 17, no. 1 (1991), pp. 99–120.


15. David Teece has written about dynamic capabilities in the paper referred to in reference 2. Also see C. Helfat, S. Finkelshteyn, W. Mitchell, M. Peteraf, H. Singh, D. Teece and S. Winter, Dynamic Capabilities: Understanding strategic change in organizations, Blackwell Publishing, 2007. Different writers have different views on what dynamic capabilities are but tend to emphasise relatively formal organisational processes such as product development, alliances and particular ways of taking decisions in firms. For example, K.M. Eisenhardt and J.A. Martin,
Dynamic capabilities: what are they?, *Strategic Management Journal*, vol. 21, nos 10/11 (2000), pp. 1105–1121. M. Zollo and S. Winter, ‘Deliberate learning and the evolution of dynamic capabilities’, *Organization Science*, vol. 13, no. 3 (2002), pp. 339–351. A different view is that dynamic capabilities are about organisational learning (see the Commentary to Part I) which places more emphasis on the way the organisation is run, on the capacity of its culture to allow for or facilitate learning and adaptation.


17. See Eisenhardt and Martin, reference 15.


19. Indeed Peter Drucker (see *Management Challenges for the 21st Century*, Butterworth–Heinemann, 1999) and others have referred to the growth of a ‘knowledge-based economy’.


32. See A. Murdoch, ‘Lateral benchmarking, or what Formula One taught an airline’, *Management Today*, November (1997), pp. 64–67. See also the Formula One case study in the case study section of this book (Text and Cases version only).


35. This section draws on the work of Veronique Ambrosini; see reference 28.


38. In their 1990 paper, Hamel and Prahalad (see reference 4) discuss the stretching of competences as the basis of related diversification.


In 2006, there were over 200 million eBayers worldwide. For around 750,000 people, eBay (http://www.ebay.com/) was their primary source of income. A survivor of the dot.com bust of the late 1990s, eBay represents a new business model courtesy of the Internet. Whatever statistics you choose – from most expensive item sold to number of auctions in any one day – the numbers amaze.

‘This is a whole new way of doing business,’ says Meg Whitman, the CEO and President since 1998. ‘We’re creating something that didn’t exist before.’

**eBay’s business model**

Value in eBay is created by providing a virtual worldwide market for buyers and sellers and collecting a tax on transactions as they happen. The business model of eBay relies on its customers being the organisation’s product development team, sales- and marketing force, merchandising department and the security department. It is arguably the first web 2.0 company.

According to eBay managers, of key importance is listening to customers: keeping up with what they want to sell, buy and how they want to do it. If customers speak, eBay listens. Technology allows every move of every potential customer to be traced, yielding rich information. Conventional companies might spend big money on getting to know their customers and persuading them to provide feedback; for eBay such feedback is often free and offered without the need for enticement. Even so some of the company’s most effective ways of getting user input do not rely on the net and do not come free. eBay organises Voice of the Customer groups which involve flying in a new group of about 10 sellers and buyers from around the country to its offices every few months to discuss the company in depth. Teleconferences are held for new features and policies, however small a change they involve.

Even workshops and classes are held to teach people how to make the most of the site. Participants tend to double their selling activity on eBay after taking a class. Others run their own websites offering advice on how to sell on eBay. Rumours have it that buyers have devised computer programs that place bids in the last moment. Sellers that leave the site unable to compete any more are known to write blogs on what went wrong to help others.

The company is governed from both outside and within. The eBay system has a source of automatic control in the form of buyers and sellers rating each other on each transaction, creating rules and norms. Both buyers and sellers build up reputations which are valuable, in turn encouraging further good behaviour in themselves and others. Sales of illegal products are dealt with by withdrawing what is on sale and invariably banning the seller.

**eBay’s management**

Meg Whitman’s style and past have heavily influenced the management of eBay. When she joined the
company in 1998, it was more of a collection of geeks, handpicked by the pony-tailed founder Pierre Omidyar, than a blue-chip, something which underpinned Omidyar’s recruitment of Meg. Meg, an ex-consultant, filled many of the senior management roles including the head of the US business, head of international operations and vice president of consumer marketing with consultants. The result: eBay has become data and metric driven. ‘If you can’t measure it, you can’t control it’, Meg says. Whereas in the early days you could touch and feel the way the organisation worked, its current size means it needs to be measured. Category managers, reminiscent of Meg’s days in Procter and Gamble, are expected to spend their days measuring and acting upon data within their fiefdom.

However, unlike their counterparts in Procter and Gamble, category managers in eBay can only indirectly control their products. They have no stock to reorder once levels of toothpaste or washing-up liquid run low on the supermarket shelves. They provide tools to buy and sell more effectively:

What they can do is endlessly try to eke out small wins in their categories – say, a slight jump in scrap-metal listings or new bidders for comic books. To get there, they use marketing and merchandising schemes such as enhancing the presentation of their users’ products and giving them tools to buy and sell better.

Over and above this unusual existence, the work environment can be tough and ultra competitive, say ex-eBayers. Changes often come only after PowerPoint slides are exchanged and refined at a low level, eventually presented at a senior level and after the change has been approved in a sign-off procedure which includes every department.

In time eBay has upgraded its ability to ensure the technology does not rule. Until the late 1990s, the site was plagued with outages, including one in 1999 which shut the site down for 22 hours courtesy of software problems and no backup systems. Former Gateway Inc. Chief Information Officer Maynard Webb, who joined as president of eBay’s technology unit, quickly took action to upgrade systems. Its use of technology is upgraded constantly. In 2005, Chris Corrado was appointed Senior Vice President and Chief Technology Officer. In eBay’s press release COO Maynard Webb said:

Chris is one of the leading technology platform experts in the corporate world, and we are thrilled that he is joining us. It is testament to the tremendous reputation of the eBay technology organization that we were able to bring Chris to the team.

Meg is a leader who buys into the company in more ways than one. Having auctioned some $35,000 (£28,000; €19,500) worth of furnishings in her ski condo in Colorado to understand the selling experience, she became a top seller among the company’s employees and ensured that her learning from the experience was listened to by fellow top execs. Meg is also known for listening carefully to her employees and expects her managers to do the same. As the business is as much, if not more, its customers, any false move can cause revolts within the community that is eBay.

Most of all, eBay tries to stay aware and flexible. Nearly all of its fastest-growing new categories emerged from registering seller activity in the area and quietly giving it a nudge at the right moment. For example, after noticing a few car sales, eBay created a separate site called eBay Motors in 1999, with special features such as vehicle inspections and shipping. Some four years later, eBay expects to gross some $1 billion worth of autos and parts, many of which are sold by professional dealers.

The democratic underpinning of eBay, whilst easily embraced by customers, can, however, take some getting used to. New managers take time to understand the ethos. ‘Some of the terms you learn in business school – drive, force, commit – don’t apply,’ says former PepsiCo Inc. exec William C. Cobb, now President eBay North America, with a background in restaurants and PepsiCo, ‘We’re over here listening, adapting, enabling.’

**Competition and cooperation**

As the Internet has become a more competitive arena eBay has not stood still. In 2005 it bought Skype, the Internet telephony organisation (http://www.skype.com/), surrounded by much debate in the press as to the logic of the $2.6bn deal. With Skype, eBay argues it can create an unparalleled e-commerce engine, pointing to the 2002 purchase of online payment system PayPal (http://www.paypal.com/) that spurred on the business
CHAPTER 3 STRATEGIC CAPABILITY

at that time. All three benefit from so-called network effects – the more members, the more valuable the company – and eBay has to be a world leader in managing network effects.

In 2006 it also announced a deal with Google. eBay is one of Google’s biggest advert customers. Google in turn is attracted to eBay’s Skype customers for click-to-call adverts. This deal was after eBay signed an advertising deal with Yahoo! which made some think eBay was teaming up with Yahoo! against Google’s dominance. But in the interconnected world of the Internet, defining competition and cooperation is a new game. eBay also formed a partnership between Baidu Inc., a Chinese web portal bought by eBay in 2002, and eBay EachNet. Baidu promotes PayPal Beibao as the preferred payment method on Baidu whilst EachNet uses Baidu as its exclusive search provider. The development of a co-branded toolbar is set to cement the partnership. So whilst in the West Yahoo! and eBay are partnering against Google, in the East Yahoo! is a rival.

Despite eBay being the Internet auction phenomenon, it does not do as well in the East as the West. It pulled out of Japan, is suffering in Taiwan and lags behind a rival in China. In Korea, GMarket, partly owned by Yahoo!, is more or less equal in size to eBay’s Internet Auction. GMarket offers less emphasis on open auctions than eBay, although eBay now does have eBay Express where new products from multiple sellers can be purchased in one transaction backed as ever by customer support including live chat.

Innovative marketing that makes the experience fun for shoppers and helps sellers improve their performance is perhaps another way GMarket differentiates itself from eBay. GMarket has itself attracted imitators.

Once a web 2.0 company always a web 2.0 company? Although the news did not produce much reaction when announced during an eBay Live! Session, in 2006 eBay created eBay Wiki (http://www.ebaywiki.com/), hosted by Jotspot, allowing people to contribute their knowledge of eBay to others, along with eBay blogs (http://blogs.ebay.com/). But eBay has always been about community so perhaps they will catch on in time.

Questions

1 Analyse eBay’s strategic capability using an analytical framework(s) from the chapter.

2 What are the capabilities that have provided eBay with competitive advantage and why?

3 Using the concepts of sustainability and dynamic capabilities, how would you manage this capability (create new resources and competences, invest/divest in others, extend others), given:
   (a) New entrants in the marketplace?
   (b) The changing nature of eBay?