Components of value chain in organisations

Chapter 3

Q1. Define value creation and the components that can be used to determine value creation per unit. How is value creation related to competitive advantage?

The satisfaction that customers gain from the utility they derive from a product is the value they place on it. This leads to value creation which is defined as “ enhancing the value of a company’s products in customer’s perceptions.” Value creation is also called “ consumer surplus” by economists in the marketplace because the value placed upon a product by consumers is higher regardless of the pricing option the company chooses.

The components that can be used to determine value creation per unit are *V which is the value or utility a customer places on a product* and *C which is the average cost of production of a product.* Therefore, value creation is measured by V-C.

When a company creates value for its products, it can increase the prices of it products to reflect that value or expand its unit sales volume by keeping prices low and prompting more customers to buy that product. Attributes such as product performance, finer design, quality, after-sales service or design mark the value of a product. As customers perceive *V as greater,* they are ready to pay a higher price *(P increases).* Therefore, when a company creates more value for its customers, its profitability goes up thereby leading to competitive advantage over its rivals.

Q2. What is a value chain? Why is efficiency so important in an organizations value chain?

Every company performs a series of functional activities which transform inputs into outputs – this is known as value chain. Value chain activities consist of both primary activities (R&D, production, marketing & sales and customer service) and support activities (company infrastructure, information systems, HR and logistics). At each stage in the chain, value is added to the goods or services that consumer's buy.

Efficiency = outputs/inputs; this implies that efficiency is measured by the quantity of inputs required to produce a given output. . Efficiency is important in an organization's value chain because it can help an enterprise gain competitive advantage over its rivals if it operates efficiently. A company can lower its costs by being efficient because it would require fewer inputs to produce a specific output. Employee productivity is the most common means of measuring efficiency. For instance, if Ford employees take 25 hours to assemble a car and General Motors employees take 30 hours, we can say that Ford is more efficient than GM. Assuming that every other factor like wage rates is equal, the cost structure of Ford will be lower in contrast to GM. Therefore, efficiency leads to lower cost structures which help a company gain competitive advantage.

Q3. What building blocks can an organisation use to sustain competitive advantage?

Efficiency, Quality, Innovation and Responsiveness to Customers are the four building blocks that an organization can use to sustain competitive advantage. All the blocks are interrelated and affect each other. For instance, superior quality can result in higher efficiency and innovation can boost efficiency, quality and customer responsiveness. With greater efficiency, a company can lower its costs whereas it can both charge a higher price and lower its costs with superior quality. While a higher price can be charged for superior customer service; high-grade innovation can result in higher prices for product innovations or lower unit costs for process innovations. These building blocks add to direct overall profitability of an enterprise by helping the company create more value than the competitors. Therefore the company can enjoy a sustained competitive advantage.

Q4. What does an internal analysis help a company to determine? How does this contribute to the overall health (value creation, competitive advantage, profitability) of the company?

Internal analysis includes an analysis of the financial performance of the company, benchmarking the company’s performance against rivals and comparing the firm’s historic performance against it. This will help identify whether the strategies employed by the company contribute to its profitability or not. This type of internal analysis helps an enterprise determine if it is more profitable or less than its opponents and if it’s financial performance has been improving or degrading with time. In addition, it also helps determine if the strategies of the company are maximizing the profit and creating more value for the consumer; if the cost structure is in league with that of rivals and whether the firm is using its resources efficiently. Efficient utilization of resources and minimization of operating cost will lead to higher value creation which subsequently results in gaining a competitive advantage over the competing firms.

Profitability is the key measure of a company’s financial performance and it is calculated through calculating the return on invested capital (ROIC). ROIC is the net profit on the invested capital.

ROIC can be classified into – Return on Sales (Net profit/sales) and Capital Turnover (Sales/ Invested Capital). For a specific amount of sales, ROS can be increased by generating strategies that target reduction of COGS, sales force, marketing, admin expenses and R&D expenses. An increase in ROS in turn increases ROIC.

Additionally, managers can also increase sales revenue in contrast to invested capital which helps in increasing its capital turnover thereby leading to a firm’s increased profitability. Strategies designed to reduce working capital and fixed capital required to invest in property, plant and equipment can increase the capital turnover which can help a company gain cost advantage.

Q5. Why do companies fail? How does competitive advantage relate to failure?

When a company has lower than average profitability than its rivals or industry standards, it fails because it loses competitive advantage. Inertia, prior strategic commitments and the icarus paradox are some of the explanations for how competitive advantage relates to failure and why companies possibly fail.

Inertia: Companies find it difficult to adapt their strategies to changing competitive conditions due to power struggles and hierarchical resistance. IBM can be cited as an example to explain inertia. As the market focus changed mainstream computers to personal computers, IBM lost over 30 years of competitive advantage as the company found it difficult to adapt to changing conditions. This happened because the cost of computer power decreased due to innovations in microprocessor chips. Companies might also fail to change their organization capabilities (the way they make decisions and manage their processes) which lead to competitive disadvantage.

Prior Strategic Commitments: Existing strategic commitments also lead to competitive disadvantage as they confine a firm's ability to imitate rivals. For instance, IBM invested heavily in mainframe computers which included sales and manufacturing facilities. This strategic commitment towards mainstream computers made it difficult for IBM to switch to personal computers. Therefore, organizations must make sure that they are not over committed by making themselves aware of emerging technologies.

Icarus Paradox: Successful companies become complacent and behave in such a way that they become blind to the dangers that other developments pose leading to their downfall. They become nearsighted and assume that the same success strategy will lead to future success as well and miss out on market realities that might be needed to take competitive advantage.

When a company's average profitability is markedly lower than its competitors, it loses the ability to attract and generate resources and also fails to attract investors as the capital is reducing drastically. Thus, competitive disadvantage leads to the failure of companies.

Chapter 4

Q1. What are functional level strategies? How can functional level strategy contribute to efficiency?

Functional-level strategies are a set of actions that help companies to enhance the effectiveness of valuable resources to achieve superior efficiency, innovation, quality and customer responsiveness. These strategies help companies to lower their cost structures. Organisations can attain efficiency with the following steps at the functional level:

℗ Economies of Scale: Managers must exploit economies of scale by spreading fixed costs over large production volumes and achieving division of labour and specialization. For example, Microsoft spent a humongous $5 billion on the development of Windows 8 OS. However, it realized economies of scale because of its trivial cost of installing additional copies of Windows 8 on new PC's for zero cost as the master copy was already produced. This resulted in Microsoft's efficiency and profitability despite high fixed costs but marginal incremental costs. Microsoft increased its sales rapidly by spreading fixed costs over a large unit volume. Division of labour and specialization are another source of scale economies which boost employee productivity and lower manufacturing costs. Knowing the extent of economies and diseconomies of scale contribute to a company's efficiency.

℗ Learning Effects: Over time, management and labour gather valuable process knowledge that results in cost savings and higher productivity as they learn how to best carry out tasks by repetition. This efficiency leads to a higher return on sales and return on invested capital as it reduces the cost of goods sold as a percentage of revenues.

℗ Experience Curve: It is the systematic lowering of cost structure and unit costs with increases in accumulated output which leads to improved efficiency in the life of the product. Industries that mass-produce a standardized output bear high significance to this concept. For example, in the manufacture of semiconductor chips, the experience curve effect improves with the number of batches already processed. Once a company is down the experience curve, it gains a low-cost position as it achieves superior efficiency and gains a competitive advantage over its rivals as in the case of Intel. Nonetheless, neither the learning effect nor economies of scale lasts forever indicating that managers should not get complacent because t he cost advantages gained from the experience effects might be impacted adversely upon the introduction of a new technology.

℗ Flexible Production Systems: Wider variety of products can be produced at a time at a unit cost that could be attained only through mass production via flexible production systems. These technologies enable better scheduling which increase utilization of individual machines, improve quality control and reduce set up times of complex equipment. In contrast to mass production, flexible production systems reduce the unit costs and increase efficiency. For example, Ford deducted $2 billion from its cost structure by employing flexible production technologies in its automotive plants. This enabled Ford to produce multiple models from the same line.

℗ Mass Customization: Low cost and differentiation through product customization were considered incompatible earlier, but mass customization makes this possible. It is a company’s ability to use flexible production systems to align these two goals.

℗ Marketing: The position that a company takes with regard to pricing, promotion, advertising, distribution, product design etc are known as the marketing strategy and it can have a siginificant impact on the efficiency and cost structure of a company. For example, marketing can reduce customer churn rates thereby resulting in lower cost structures and improved efficiency.

℗ Materials Management and Just-in-Time Systems: Materials management involves management of activities related to carrying inputs to a production facility, production of outputs and making them reach the customer through distribution channels. About 50% to 70% of the revenue is spent on transportation of materials which implies that even marginal reduction of these costs can lead to substantial profits. Adopting the Just-In-Time inventory system makes material management efficient as it reduces inventory storage costs and working capital by bringing inputs for a production process just in time.

℗ Information Systems: The rise of computers, internet, corporate intranets, high-bandwidth fiber optics and digital wireless technology has increased the efficiency of companies while lowering cost structures. For example, Cisco attained significant cost savings by digitalizing its ordering and customer service functions. With online functions, CISCO could save $20 million a year and could operate with just 300 service agents in place of 900 if its functions were manual.

℗ Human Resource Strategy: One of the most important determinants of a company’s efficiency is employee productivity. Productive employees can help the company lower its revenue generating costs; boost the return on sales and ROIC. Therefore human resource strategies like hiring, training and pay to performance can enhance employee productivity.

℗ Infrastructure: Infrastructure is the blanket under which all the value-creation activities in a company take place. Therefore fine infrastructure boosts efficiency and lowers cost structure. Strong strategic leadership should focus on building a companywide commitment to efficiency so that the company can realise its vision.

Q2. Describe economies of scale and its relation to competitive advantage. What strategic significance do economies of scale have?

Economies of scale can be defined as a company benefitting from keeping its prices low and increasing volume as a result of unit cost reductions with expanded output. It has two sources – fixed costs and division of labour and specialization. The ability of a company to spread fixed costs over a large unit volume can help realize economies of scale leading to efficiency and profitability. As mentioned in response 1, Microsoft spent a humongous $5 billion on the development of Windows 8 OS. However, it realized economies of scale because of its trivial cost of installing additional copies of Windows 8 on new PC's for zero cost as the master copy was already produced. This resulted in Microsoft's efficiency and profitability despite high fixed costs. Microsoft increased its sales rapidly by spreading fixed costs over a large unit volume. Division of labour and specialization are another source of scale economies which boost employee productivity and lower manufacturing costs. When Employee productivity, lower cost structures and efficiency help a company achieve greater than average profitability over its rivals thereby leading to competitive advantage.

In order to drive strategy, managers need to understand how the cost structure of their firm varies with output. After some level of output, unit costs might increase due to production volume increases and bureaucracy related to large scale firms which is why managers need to know how to strategise to choose the right level of output to take advantage of scale economies and where diseconomies of scale being to occur.

Q3. How does innovation relate to competitive advantage? What can be done to sustain innovation?

Innovative products can satisfy consumer needs, enhance the quality existing products and can reduce manufacturing costs of products. This results in the company being able to differentiate its products and charging a premium price and lower its cost structure in contrast to rivals which gives it a competitive edge. Latest product launches are major contributors to superior profitability which ultimately helps a firm gain competitive advantage and a foothold in the market.

However, enterprises must make sure that they are continually committed to innovation to maintain their competitive advantage since successful innovations are often imitated by rival companies. The failure rate of innovative products is quite high despite innovation being a source of competitive advantage. Therefore sustaining innovation becomes all the more important for companies. This can be done by ensuring that there is tight integration between R&D, production and marketing. Development costs can be lowered and products can be sped up to the market by integrating R&D and production. Cross-functional product development teams consisting of representatives from R&D, production and marketing is one of the best ways to achieve cross-functional integration. The ability to develop innovative products and processes depends on how effectively R&D can coordinate with marketing and production.

Q4. How do customer relations contribute to competitive advantage? What is the effect of customer relations on value creation and its components?

Customer relations function with the primary aim of increasing customer responsiveness where the company must strive to give customers what they want at the right time and at a price they are ready to pay. However, companies must do this without putting its long-term profitability at stake. Once superior customer responsiveness is achieved, it can be a key differentiating factor in building a company’s brand loyalty. Strong product differentiation and brand loyalty help develop great customer relations and thus give an enterprise more greater pricing options where it can charge a premium price for its products as in the case of Apple or lower the prices and sell larger volume of goods. This eventually creates competitive advantage for a company. Similarly, companies can also gain competitive advantage by customizing products to meet customer needs thereby improving customer relations. Amazon is a great example of customization where it provides product recommendations based on the purchase history of customers. Amazon gained significant competitive advantage due to this particular strategy.

As mentioned in response 1 of Chapter 3, V which is the value or utility a customer places on a product and C which is the average cost of production of a product including the opportunity cost and P the price that a company charges for the product are the components of value creation. The cost of making a product according to customer demands might be high in the initial stages but it helps build customer relations which is why, despite product customizations leading to increased costs, companies can achieve economies of scale by using flexible manufacturing systems. They also help keep the costs in check. Customers also tend to value a product more once customer relations are developed and a product or service satisfies their needs. This leads to more pricing options for the company with respect to the product they are selling.

References:

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