Organizational structure and the value chain

The value chain disaggregates a firm into its strategically relevant activities in order to understand the behavior of costs and the existing and potential sources of differentiation. A firm gains advantage by performing these strategically important activities more cheaply or better than its competitors. Every firm is a collection of activities that are performed to design, produce, deliver, market and support its product. All these activities can be represented using a value chain. A firm's value chain and the way it performs individual activities are a reflection of its history, its strategy, its approach to implementing its strategy, and the underlying economics of the activities themselves.

The relevant level for constructing a value chain is a firm's activities in a particular industry (the business unit). An industry- or sector- wide value chain is too broad, because it may obscure important sources of competitive advantage. Though firms in the same industry may have similar chains the value chains of competitors often differ. People Express and United Airlines both compete in the airline industry, for example, but they have very different value chains embodying significant differences in boarding gate operations, crew policies, and aircraft operations. Differences among competitor value chains are a key source of competitive advantage. Michael

Porter has written about the competitive advantage from his point of view. A firm's value chain in an industry may vary somewhat for different items in its product line, or different buyers, geographic areas, or distribution channels.

Value, instead of cost, must be used in analyzing competitive position since firms often deliberately raise their cost in order to command a premium price

via differentiation. The value chain displays total value, and consists of value activities and margin. Value activities are the physically and technologically distinct activities a firm performs. These are the building blocks by which a firm creates a product valuable to its buyers. Margin is the difference between total value and the collective cost of performing the value activities. Margin can be measured in a variety of ways.

Every value activity employs purchased inputs, human resources (labor and management), and some form of technology to perform its function. Each value activity also uses and creates information, such as buyer data (order entry), performance parameters (testing), and product failure statistics. Value activities may also create financial assets such as inventory and accounts receivable, or liabilities such as accounts payable.

Value activities can be divided into two broad types, primary activities and support activities. Primary activities, are the activities involved in the physical creation of the product and its sale and transfer to the buyer as well as after- sale assistance. In any firm, primary activities can be divided into the five generic categories. Support activities support the primary activities and each other by providing purchased inputs, technology, human resources, and various functions.

In his book Competitive Advantage (1985), Michael Porter stated that comparing the value chains of competitors exposes differences that determine competitive advantage. Everything a firm does should be captured in a primary or support activity. Value activity labels are arbitrary and should be chosen to provide the best insight into the business.

Buyers also have value chains, and a firm's product represents a purchased input to the buyer's chain. A car is used for the trip to work and for shopping and leisure, while a, food product is consumed as part of the process of preparing and eating meals.

Industry structure both shapes the value chain of a firm and is a reflection of the collective value chains of competitors. Structure determines the bargaining relationships with buyers and suppliers that are reflected in both the configuration of a firm's value chain and how margins are divided with buyers, suppliers, and coalition partners. The threat of substitution to an industry influences the value activities desired by buyers. Entry barriers bear on the sustainability of various value chain configurations.

The value chain is a basic tool for diagnosing competitive advantage and finding ways to create and sustain it, the subject that will dominate the chapters that follow. However, the value chain can also play a valuable role in designing organizational structure. Organizational structure groups certain activities together under organizational units such as marketing or production. The logic of those groupings is that activities have similarities that should be exploited by putting them together in a department; at the same time, departments are separated from other groups of activities because of their differences. This separation of like activities is what organizational theorists call " differentiation." With separation of organizational units comes the need to coordinate them, usually termed " integration." Thus integrating mechanisms must be established in a firm to ensure that the required coordination takes place. Organizational structure balances the benefits of separation and integration.

Figure 1: Organizational structure & the value chain

The value chain provides a systematic way to divide a firm into the activities, and thus can be used to examine how the activities in a firm are and could be grouped. Figure 1, a figure of the book “ Competitive Advantage” shows a value chain with a typical organizational structure superimposed. Organizational boundaries are often not drawn around the groups of activities that are most similar in economic terms, Moreover, organizational units such as the purchasing and R&D departments frequently contain only fraction of the similar activities being performed in a firm.

The need for integration among organizational units is a manifestation of linkages. There are often many linkages within the value chain, and organizational structure often fails to provide mechanisms to coordinate or optimize them. The information necessary for coordinating or optimizing linkages is also rarely collected throughout the chain. Managers of support activities such as human resource management and technology development often do not have a clear view of how they relate to the firm’s overall competitive position, something the value chain highlights. Finally, vertical linkages are often not well provided for in organizational structure.

A firm may be able to draw unit boundaries more in tune with its sources of competitive advantage and provide for the appropriate types of coordination by relating its organizational structure to the value chain, and the linkages within it and with suppliers or channels. An organizational structure that corresponds to the value chain will improve a firm’s ability to create and

sustain competitive advantage. While this subject cannot be treated in detail here, it remains an important issue in the implementation of strategy.