CHAPTER 2

Identification of the firm's core competences

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- explain the difference between the resource-based view (RBV) and the market-orientation view (MOV)
- explain the connection between the RBV and RM
- describe and discuss the concept of the value chain

2.1 INTRODUCTION

Understanding competitive advantage is an ongoing challenge for decision makers. Historically, competitive advantage was thought of as a matter of position, where firms occupied a competitive space and built and defended market share. Competitive advantage depended on where the business was located, and where it chose to provide services. Stable environments allowed this strategy to be successful, particularly for large and dominant organisations in mature industries.

This ability to develop a sustained competitive advantage today is increasingly rare. A competitive advantage laboriously achieved can be quickly lost. Organisations sustain a competitive advantage only so long as the services they deliver and the manner in which they deliver them have attributes that correspond to the key buying criteria of a substantial number of customers. Sustained competitive advantage is the result of an enduring value differential between the products or services of one organisation and those of its competitors in the minds of customers. Therefore, organisations must consider more than the fit between the external environment and their present internal characteristics. They must anticipate what the rapidly changing environment will be like, and change their structures, cultures and other

relevant factors so as to reap the benefits of changing times. Sustained competitive advantage has become more of a matter of movement and ability to change than of location or position.

The question of an enduring value differential raises the issue of why a firm is able to achieve a competitive advantage. To answer this, it is necessary to examine why and how organisations differ in a strategic sense. Identifying strengths and weaknesses requires introspection and self-examination. It also requires much more systematic analysis than has been done in the past.

From capability to advantage

How well a company assembles the capabilities that a new business requires determines how successful it is at gaining and keeping positional advantage. Some capabilities are more important than others, and combinations are generally harder to imitate than individual capabilities. The business builder's challenge begins with the need to assemble the capabilities that are most critical to making money in the business. Lasting competitive advantage comes only when companies assemble combinations of capabilities that are difficult to imitate.

Competitive advantage may not call for superior capabilities in every area of a business. But control of the most important capabilities can determine how much of the value of a growing business will flow to its owner. For every opportunity, it is important to distinguish the capabilities that influence competitive success from those that are merely necessary to stay in business. Capabilities that are less critical can be outsourced or controlled by others.

2.2 ROOTS OF COMPETITIVE ADVANTAGE

Market orientation view (MOV)
Outside-in perspective. Adapting the firm's resources to market conditions and the competitive environment.

Two theoretical perspectives are particularly relevant for understanding how firms deploy scarce resources to create competitive excellence. These are: the **market orientation view (MOV)** and the **resource-based view (RBV)**.

There is, however, a potential conflict between these two perspectives in the sense that one (MOV) advocates the advantages of outward-looking responsiveness in adapting to market conditions, while the other (RBV) is inward looking and emphasises the rent-earning

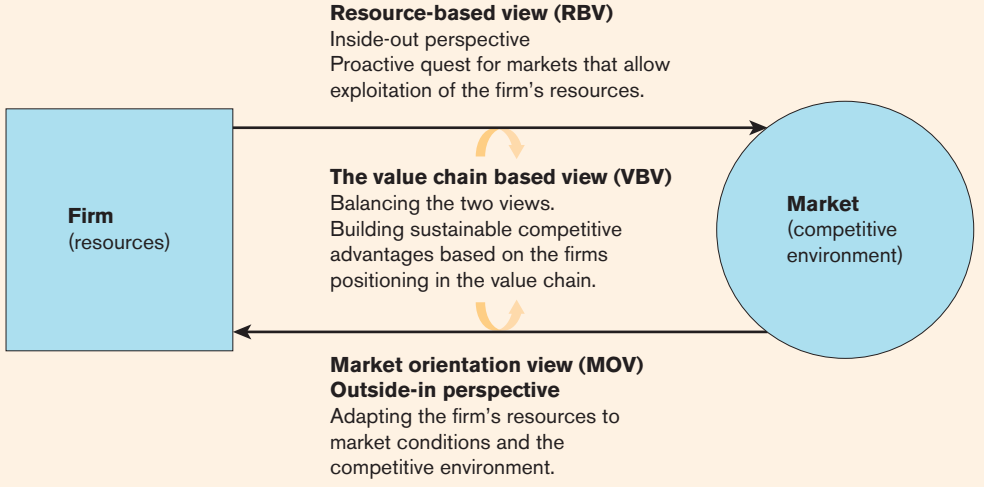

Figure 2.1 The resource-based view versus market orientation

Resource-based view (RBV)
Inside-out perspective. Proactive quest for markets that allows exploitation of the firm's resources.

Value chain based view (VBV)
Building sustainable competitive advantages based on the firm's positioning in the value chain.

characteristics of corporate resources and the development of corporate resources and capabilities. Quite simply, from a marketing viewpoint, if strategy becomes too deeply embedded in corporate capabilities, it runs the risk of ignoring the demands of changing, turbulent marketing environments. Yet from a resource-based perspective, marketing strategies that do not exploit a company's distinctive competences are likely to be ineffective and unprofitable.

However, we argue that the **value chain based view (VBV)** provides a way of reconciling this potential conflict – it represents a balanced view of the RBV and the MOV – see Figure 2.1.

We will now look at the two theoretical perspectives.

2.3 THE RESOURCE-BASED VIEW (RBV)

Most firms that apply a relationship marketing approach are probably somewhere in this stage of the transition process. A true transition towards a relationship marketing strategy requires a focus on competences and resources in the relationship (because partners in the relationship use each other's resources (Grönroos, 1996)). This section focuses on identification of a single firm's competences from an RBV.

According to the resource-based theory, which has its roots in economic theory (e.g. Penrose, 1959) and early strategy theory (Selznick, 1957; Ansoff, 1965), the long-term competitiveness of a company depends on its resources that differentiate it from its competitors, that are durable, and that are difficult to imitate and substitute (e.g. Grant, 1991; Fahy, 2002). Each firm is unique and this uniqueness stems from the resources it possesses, their compatibility with one another, and/or the way they are deployed. Furthermore, this uniqueness is relatively long lasting, because the resources of the company are relative immobile (Barney, 1991; Sharma and Erramilli, 2004).

Various definitions and classifications for resources have been proposed in the literature. The most important in the current context are briefly described here.

Resources

The resources of the firm in the competence-based approach are typically classified into two types: tangible and intangible resources. Tangible resources are inputs into a firm that can be seen, touched and/or quantified. They include assets such as plant and equipment, access to raw materials and finance, a trained and skilled workforce and a firm's organisational structure. Intangible resources range from intellectual property rights such as patents, trademarks and copyrights to the know-how of personnel, informal networks, organisational culture and a firm's reputation for its products (Deering *et al.*, 2008). The dividing line between the tangible and intangible is often unclear, and how they are classified varies a little from one writer to another. Despite the problems with classification, proponents of the competence-based approach agree on the relative importance of the two types of resource. Although it is clear that both types of resource are required for any business to operate, competence-based theorists argue that intangible resources are the most likely source of competitive advantage. The reason for this, it is argued, is that, being less visible, they are more difficult to understand and imitate than tangible resources. As such they are therefore more likely to be a source of competitive advantage (Collis and Montgomery, 2008).

I use the word 'resource' as the most generic term to qualify the basic unit of asset, skill, ability, expertise, knowledge, etc. owned and controlled by one firm. Grant (1991) describes six types of resource: technological, financial, physical, human, organisational and reputation. Resources are extremely diverse, as shown in Figure 2.2 (examples are given in brackets).

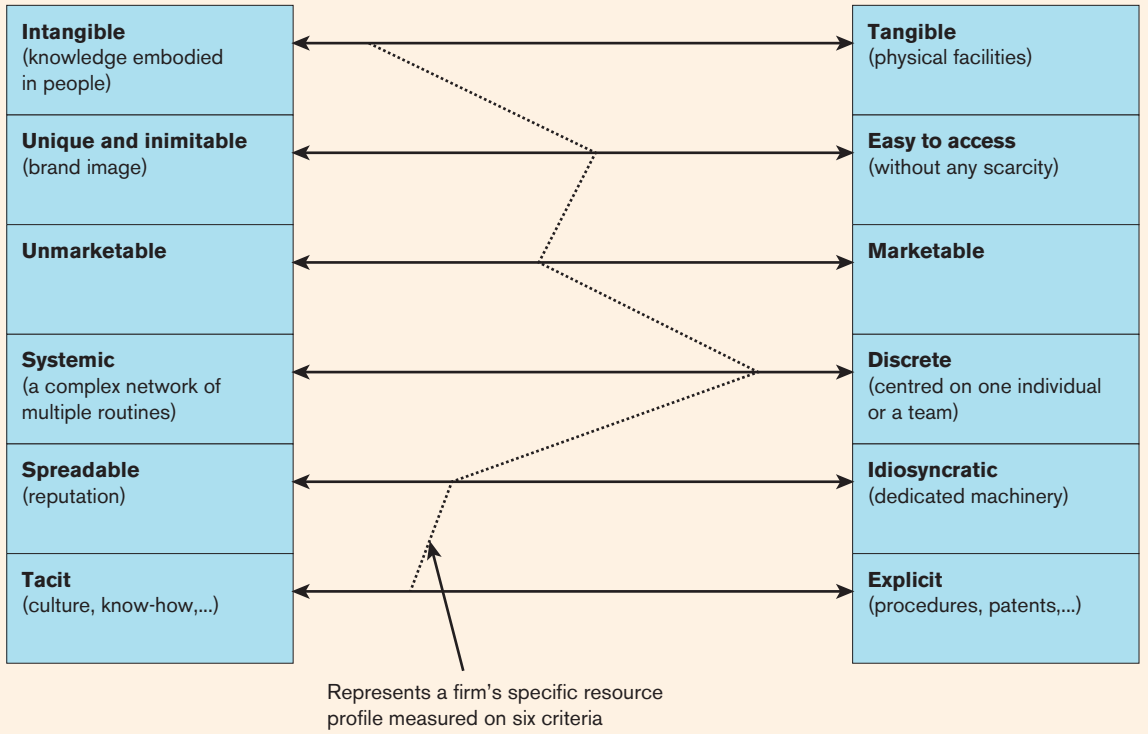

Figure 2.2 Resource profile

The dotted line in Figure 2.2 represents a specific resource (e.g. technical) measured on six criteria. However, the resource-based theory does not consider all resources possessed by a company, but focuses only on critical (or strategic) resources, i.e. those that are the basis of the company's sustainable competitive advantage. To determine such resources, various authors have proposed a number of 'tests' (see also Grant, 1991; Prahalad and Hamel, 1994; Trott, Maddocks and Wheeler, 2009), the most important of which are:

- competitive superiority test, which evaluates if and to what extent the research contributes to differentiating the company from its competitors;
- imitation test, which analyses actual and potential competitors' difficulties in imitating the resource, due, for example, to its physical uniqueness, path dependency, casual ambiguity or economic deterrence;
- duration test, which measures if the resource's benefits will also be generated in the long term;
- appropriateness test, which verifies if the company owning the resource is able to exploit the advantages generated in the market;
- substitutability test, which assesses how difficult it is for competitors to replace the resource with an alternative that gives the same advantages.

The very basis of RBV is to increase the ability of the firm to act upon, shape and transform its environment. The objective is no longer to adapt to the environmental forces but to choose a strategy that allows the best exploitation (the best return) of resources and competences given the external opportunities. It means taking into account the external opportunities but with the objective of creating value beyond existing market standards. As a consequence, the strategic options for a firm are derived from its resource profile: the business portfolio is an output of the search of applications carried out for one competence.

Competence

One resource – such as a privileged access to raw material – may be a source of competitive edge. However, a greater competitive advantage should emerge from competences, i.e. the combination of different types of resources. It is the way in which the resources are assembled, or combined, for the execution of an activity that creates the difference between firms. This distinctive combination of resources emerges through organisational learning. Competence examples may be found in engineering knowledge, production expertise or marketing abilities.

Competence may be described by the following three attributes:

1 *Proprietariness*: a competence is a firm-specific set of resources.
2 *Learning*: a competence results from years of experience accumulated in a small number of fields (where the firm may dominate).
3 *Pervasiveness*: a competence is diffused pervasively throughout the entire firm and exists within several product lines (or strategic business units (SBUs)).

EXHIBIT 2.1
Honda's competences in small engines

A famous example of a business strategy that was clearly based on a focus on a core competency is Honda's application of small engine technology to a variety of products requiring small engines (motorcycles, jet skis, lawn mowers, etc.).

When Honda introduced motorcycles in the US market, it had focused most of its attention on selling its higher value (but problem-plagued) motorcycles through a dealer network. At the same time, it introduced a series of much smaller motorcycles with little fanfare through sporting goods stores. While their larger motorcycles floundered competing against the likes of firmly established Harley-Davidson, Honda's smaller engine motorcycles found a ready audience with a more utilitarian 'nicest people' demographic group. This turned out to be Honda's beachhead into the US marketplace.

A small Honda gasoline engine
Source: © Lyroky/Alamy

The ability to concentrate on customers and understand their changing needs is the first step in the value chain based view.

Although it is true that the small engines in both the motorcycles and the scooters were Honda's core competence, that core competence alone did not ensure success. Honda succeeded because it also looked to the other end of the value chain – it listened to what the customer wanted.

It turned out to be both a customer and a product very different from what Honda had envisioned. Honda quickly refocused its distribution channels and adjusted its product mix to meet the unexpected market demand. In the long term, Honda was able to refocus its efforts and eventually capture market share in the higher value motorcycle market.

Sources: Adapted from Prahalad and Hamel (1990); Webb and Gile (2001).

Core competences
The principal distinctive capabilities possessed by a company – what it is really good at.

A **core competence**, as articulated by Prahalad and Hamel (1990), has three traits: it makes a contribution to perceived customer benefits; it is difficult for competitors to imitate; and it can be leveraged to a wide variety of markets. Knowing a firm's core competence is important for developing strategy. By concentrating on their core competence and outsourcing other activities, managers can use their company's resources in four ways: they maximise returns by focusing on what they do best; they provide formidable barriers against the entry of competitors; they fully utilise external suppliers' strengths and investment that they would not be able to duplicate; and they reduce investment and risk, shorten cycle times, and increase customer responsiveness.

Figure 2.3 shows the connection between resources, core competences, sustainable competitive advantages and competitive excellence.

Resources alone are not a basis for competitive advantage. It is the way in which resources are integrated with each other to perform a task or an activity that provides the capability for

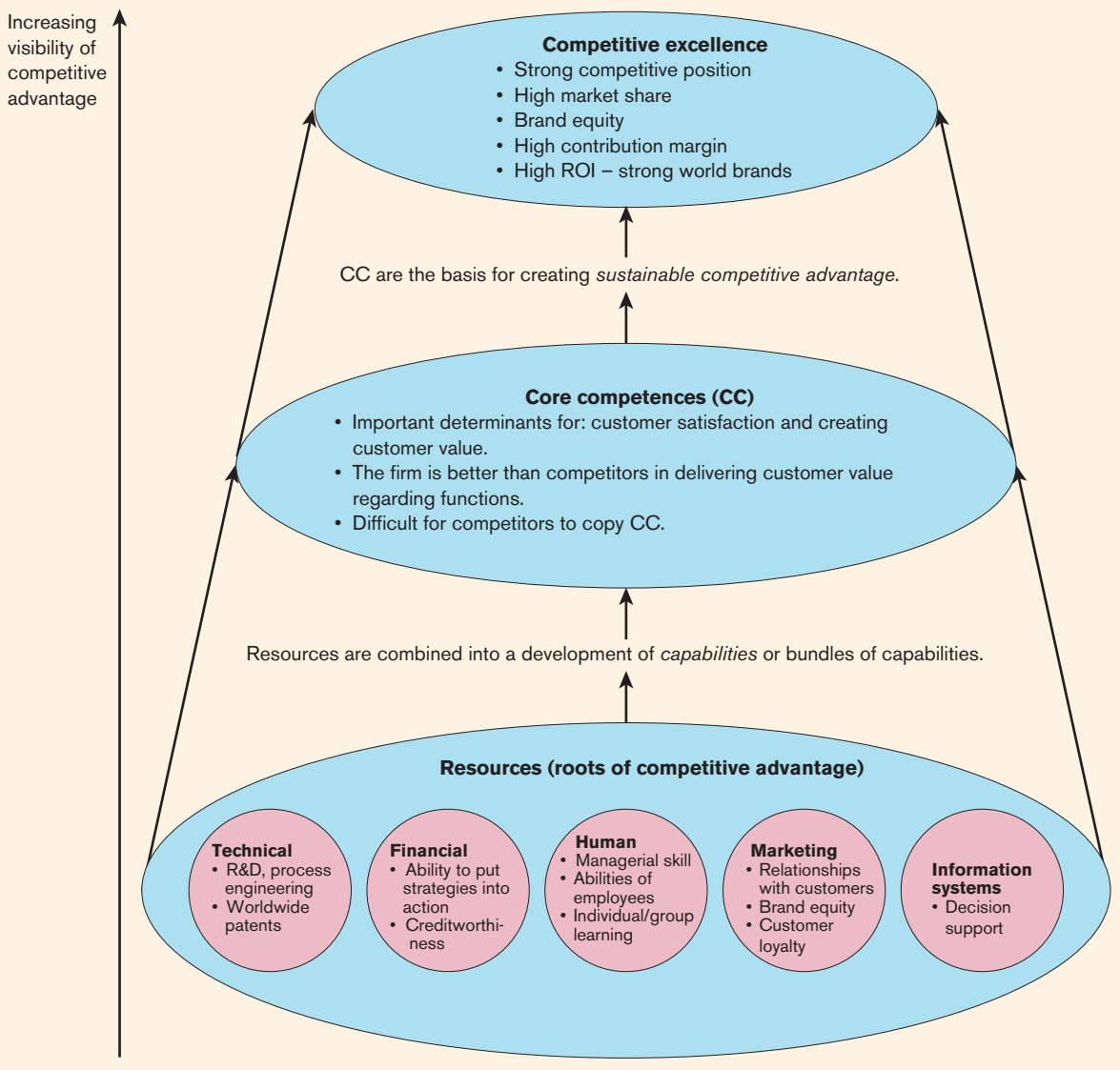

Figure 2.3 The roots of competition
Source: Inspiration from Grant (1991).

an organisation to compete successfully in the marketplace. This being the case, the most important resource for any organisation is the skill and knowledge possessed by the organisation's employees. It is this skill and knowledge acquired over time and embedded in the firm's culture that influences how it operates and determines its success.

Whether or not resources and capabilities have the potential to become core competences depends on how difficult they are for competitors to acquire and how valuable they are to the firm as a basis for competitive advantage. When they are rare, difficult to imitate, non-substitutable and they allow a firm to exploit opportunities or neutralise threats, then they can be considered core competences and serve as the basis of an organisation's sustained competitive advantage.

A resource becomes a source of sustainable competitive advantage only if it passes several tests. First, it must be competitively superior and valuable in the product market. Second, it must be difficult to imitate. Third, it must not be easy to replace by an alternative capability. Fourth, it must be durable. Fifth, it must be difficult to move. If the capability can move with an employee, it is the employee, not the corporation that will acquire the value.

Some individual capabilities may pass the tests. A world-class brand, for example, will continue to confer advantage on its owner. But few individual capabilities are unassailable, and even a first-to-market advantage can fade away without proper support. The key to sustaining competitive advantage as a business grows is to assemble a bundle of distinctive capabilities that together satisfy the criteria.

The capabilities in the bundle can be built in-house, borrowed by means of alliances, or acquired out of house. As each new capability is added to the bundle, greater competitive advantage accrues because the combination becomes more difficult for competitors to imitate or substitute, and more difficult for employees to acquire from the company.

Cardy and Selvarajan (2006) classify competences into two broad categories: *personal* or *corporate*. Personal competences are possessed by individuals and include characteristics such as knowledge, skills, abilities, experience and personality. Corporate competences belong to the organisation and are embedded processes and structures that tend to reside within the organisation, even when individuals leave. These two categories are not entirely independent. The collection of personal competences can form a way of doing things or a culture that becomes embedded in the organisation. In addition, corporate characteristics can determine the type of personal competences that will best work or fit in the organisation.

2.4 MARKET ORIENTATION VIEW (MOV) COMPARED TO THE RESOURCE-BASED VIEW

Business model
The fundamental strategy underlying the way a business unit operates.

Customer value
The difference relation between the values the customer gains from owning and using a product and the costs of obtaining the product.

The MOV or fit model suggests that the firm adapts its assets to its environmental constraints in order to obtain a fit with the environment. Basically, MOV is about adapting to the market environment (Kohli and Jaworski, 1990). It can be understood as a culture, rather than a set of behaviours and espoused values (Beverland and Lindgreen, 2005). MOV can be defined as a culture in which all employees are committed to the continuous creation of superior value for the customers (Vesanen, 2007). However, adaptation to different customers in different countries can be an expensive **business model**. In this regard you get very satisfied customers but the costs involved in producing this **customer value**/satisfaction might also be very high.

Table 2.1 summarises the main differences between the RBV and the MOV.

As both views (models) have advantages and disadvantages, a way of bridging the gap between the RBV and the MOV will now be covered.

Table 2.1 Main differences between the resource-based view and the market orientation view

	Market orientation view (MOV)	Resource-based view (RBV)
Basic principle	Adapt firm's resources to the requirements of its competitive environment, i.e. to key success factors	Pro-active quest for environments that allow the best exploitation of the firm's resources
Strategic analysis	Centred on industry structure and market attributes	Emphasis on internal diagnosis
Formulation process	Outside-in	Inside-out
Source for competitive edge	Market positioning in relation to local competitive environment	Firm's idiosyncratic set of resources and competences

2.5 THE VALUE CHAIN BASED VIEW (VBV)

The RBV focuses on what the firm has, whereas the VBV focuses on what the firm does. In addition, the VBV also integrates some elements of the MOV, but it does not ignore the costs of performing the activities.

Resources per se do not create value. Rather, value creation results from the activities in which the resources are applied.

The foundation of competitive advantage is a product and/or service that provides value to the business's customers (McPhee and Wheeler, 2006).

Perceived value is the *relation* between the benefits customers realise from using the product/service and the costs (direct and indirect) they incur in finding, acquiring and using it (see Figure 2.4). The higher this relationship is, the better the perceived value for the customer.

Please do not think of Figure 2.4 as a mathematical formula for calculating and exact measure of Customer Perceived Value (CPV). Instead, think of it as what the customer *gets* compared to what the customer *gives* in order to be able to use or consume the product or service. After the product or service has been purchased and is used or consumed, the level of the customer's satisfaction can be evaluated. If the actual customer satisfaction with the purchase and quality exceeds initial expectations, then the customer will tend to buy the product or service again and the customer may become loyal towards the company's product or service (brand loyalty).

The components driving customer benefits include product values, service values, technical values and commitment value. The components driving costs fall into two categories: those that relate to the price paid, and those representing the internal costs incurred by the customer. These components can be unbundled into salient attributes. Commitment to value, for example, includes investment in personnel and customer relations. Internal costs might reflect set-up time and expense, maintenance, training and energy.

If the benefits exceed the costs then a customer will at least consider purchasing your product. For example, the value to an industrial customer may be represented by the rate of return earned on the purchase of a new piece of equipment. If the cost reductions or revenue enhancements generated by the equipment justify the purchase price and operating costs of the equipment through an acceptable return on investment, then value has been created.

Thus, the value of products is a function of buyer purchasing criteria (Porter, 1985, pp. 141–3). Variation in buyer purchasing criteria gives rise to selective adaptation of products or differentiation. Differentiated products can command a higher price if they provide a better match with buyer purchasing criteria. Customer value is defined either by the cost reductions that the product can provide in the customer's activities or by the performance

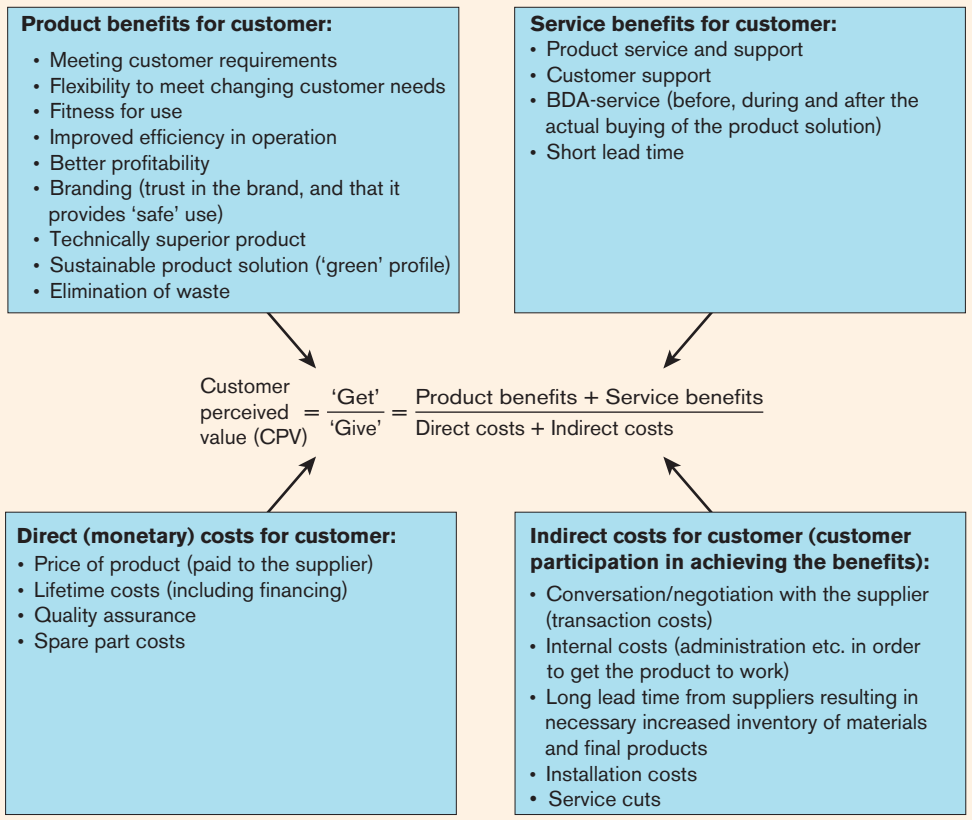

Figure 2.4 The concept of customer perceived value

Sources: Adapted from Anderson *et al.* (2007; 2008); McGrath and Keil (2007); and Smith and Nagle (2005).

improvements that the customer can gain by using the product. Porter's generic strategies of cost or differentiation (1980) are aimed at improving either the cost or value of a product relative to the average of the industry.

Technology development is performed to either reduce the cost of a product, particularly through process improvements, or to raise the commendable price by improving the adaptation of the product to buyer purchasing criteria.

EXHIBIT 2.2
The value chain of Acme Axles, Inc.

Acme Axles, Inc. (a disguised name) makes custom-designed axles, wheels and related parts for trailers, tractors, generators, welders and other equipment requiring axle systems. Acme differentiates itself from competitors by providing fast on-time delivery of high-quality, custom-designed axles.

The value chain outline for Acme and the axle industry is shown in Figure 2.5.

There are three levels of value chain analysis:

- The industry value chain consists of the different firms in the vertical supply chain.
- The company's (Acme Axle, Inc.) internal value chain consists of the different functions in the company.
- Operational activities of a certain function (only the detailed description of operational activities is shown).

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EXHIBIT 2.2
The value chain of Acme Axles, Inc. (*continued*)

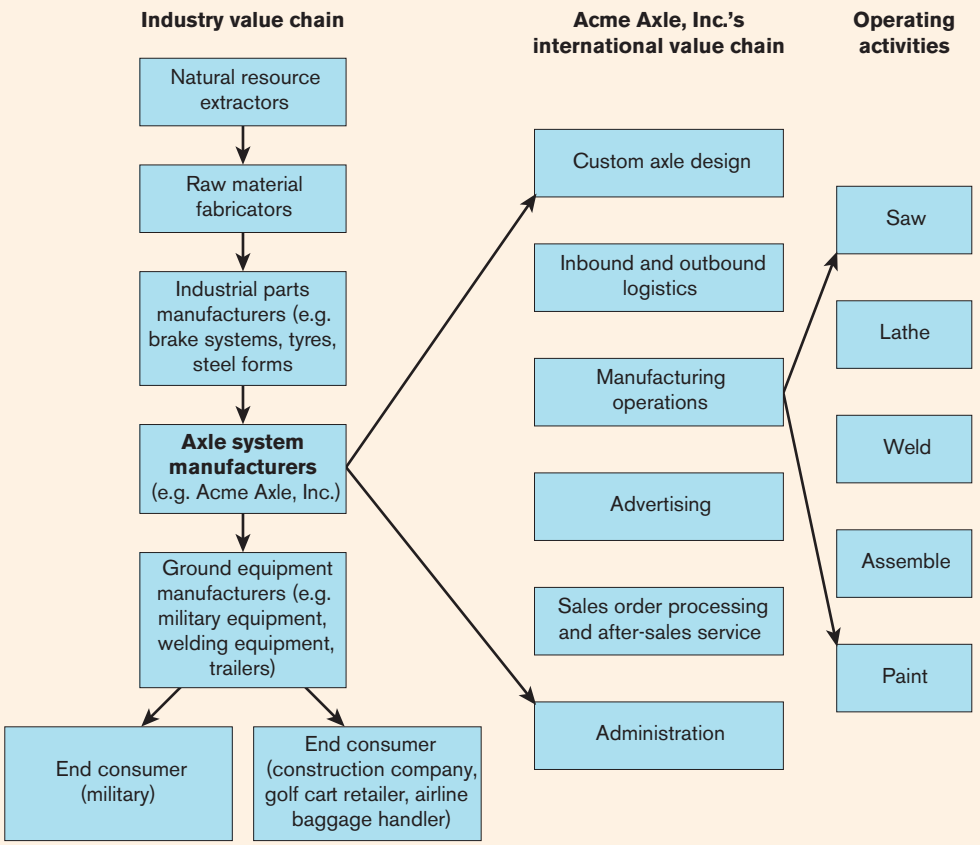


Figure 2.5 The value chain of Acme Axles, Inc.

Natural resource extraction (i.e. ore mining and rubber plantations), raw material fabrication (i.e. steel foundries and tyre manufacturers), and industrial parts manufacturing are the supplier links in the value chain. Customer links include military and non-military ground equipment manufacturing. These downstream manufacturers use the axle systems as components of the equipment, such as welding trailers, airport baggage handling trailers, golf carts and tractors.

Source: Adapted from Donelan and Kaplan (1998).

Perception
The process by which people select, organise and interpret sensory stimulation into a meaningful picture of the world.

Understanding customers' **perceptions** of value is key to this part of the process and is one where many companies fall down. Too often, management determines what it believes the customer wants, develops and makes the product, then adds up the costs of production and puts a standard margin on top of that. The major problems with this approach are that the product may not effectively address changing customer needs and that the price may be too high for created customer value.

Value-driven companies spend enough time with customers to obtain a fundamental understanding of their customers' businesses and of their current and latent needs. They want to understand what product features really provide customer benefits, and which ones are

merely going to add to the product cost without giving customers any additional reason to buy. They also determine the price that will deliver value to their customers early in the product development process. From that, they deduct their target profit and give their engineers and operations people firm targets for the cost of the final product or its components.

Superior value

Delivering value may not be enough to achieve competitive advantage though. Excellent quality is no advantage if your competitors all have similar offerings. Competitive advantage requires that the value of your product or service is superior to that of your competitors. The major challenge here is that your competitors are providing a moving target by continuously improving the value they provide.

Competitive advantage can be accomplished by providing the greatest level of benefits through a differentiation strategy. It can also be accomplished by enabling a customer to achieve the 'lowest life cycle cost' compared to comparable products. It is important to recognise that lowest life cycle cost does not require the lowest purchase price. Lowest life cycle cost can be achieved by helping the customer reduce start-up, training or maintenance costs.

The value chain

Porter's work (1985) is the key reference on value chains and value configuration analysis for competitive advantage.

Value chains are created by transforming a set of inputs into more refined outputs. The strategic challenges associated with managing a value chain are related to manufacturing products with the right quality at the lowest possible cost. The ways to reduce costs – or increase value – are primarily found through economies of scale, efficient capacity utilisation, learning effects, product and information flows, and quality measures. Critical drivers of value creation in chains also include the interrelationships between primary activities, on the one hand, and product development, marketing and service, i.e. support activities, on the other hand.

The firm's value chain as, for example, shown in Figure 2.5 provides a systematic means of displaying and categorising activities. The activities performed by a firm in any industry can be grouped into the nine generic categories.

At each stage of the value chain there exists an opportunity to contribute positively to the firm's competitive strategy by performing some activity or process in a way that is better than the competitors, and so providing some uniqueness or advantage. If a firm attains such a competitive advantage that is sustainable, defensible, profitable and valued by the market, then it may earn high rates of return, even though the industry may be unfavourable and the average profitability of the industry modest.

In competitive terms, value is the amount that buyers are *willing to pay for what a firm provides them (perceived value)* less the sacrifices that the customers offer to obtain access to the value (e.g. money, time). A firm is profitable if the value it commands exceeds the costs involved in creating the product. According to the 'formula' in Figure 2.4, it is implied that customer perceived value should be higher than 1. Creating value for buyers that exceeds the cost of doing so is the goal of any generic strategy. Value, instead of cost, must be used in analysing competitive position, since firms often deliberately raise their costs in order to command a premium price via differentiation. The concept of buyers' perceived value will be discussed further in this chapter.

The value chain displays total value and consists of value activities and margin. Value activities are the physically and technologically distinct activities that a firm performs. These are the building blocks by which a firm creates a product that is valuable to its buyers. Margin is the difference between total value (price) and the collective cost of performing the value activities.

Competitive advantage is a function of either providing comparable buyer value more efficiently than competitors (lower cost), or performing activities at comparable cost but in unique ways that create more customer value than the competitors are able to offer and,

hence, command a premium price (differentiation). The firm might be able to identify elements of the value chain that are not worth the costs. These can then be unbundled and produced outside the firm (outsourced) at a lower price.

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, its sale and transfer to the buyer, and after-sales 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 firm-wide functions.

Primary activities

The primary activities of the organisation are grouped into five main areas: inbound **logistics**, operations, outbound logistics, marketing and sales, and service.

Logistics
The activities involved in moving raw materials and parts into a firm, moving in-process inventory through the firm, and moving finished goods out of the firm.

1. Inbound logistics are the activities concerned with receiving, storing and distributing the inputs to the product/service. These include materials, handling, stock control, transport, etc.
2. Operations transform these various inputs into the final product or service: machining, packaging, assembly, testing, etc.
3. Outbound logistics collect, store and distribute the product to customers. For tangible products this would involve warehousing, material handling, transport, etc.; in the case of services it may be more concerned with arrangements for bringing customers to the service if it is in a fixed location (e.g. sports events).

User
The buying-centre role played by the organisational member who will actually use the product.

Advertising
Non-personal communication that is paid for by an identified sponsor, and involves either mass communication via newspapers, magazines, radio, television, and other media (e.g. billboards, bus stop signage) or direct-to-consumer communication via direct mail.

4. Marketing and sales provide the means whereby consumers/**users** are made aware of the product or service and are able to purchase it. This would include sales administration, **advertising**, selling, etc. In public services, communication networks, which help users access a particular service, are often important.
5. Services cover all the activities that enhance or maintain the value of a product or service, such as installation, repair, training and spare parts.

Each of these groups of primary activities is linked to support activities.

Support activities

These can be divided into four areas.

1. *Procurement*: this refers to the process of acquiring the various resource inputs to the primary activities (not to the resources themselves). As such, it occurs in many parts of the organisation.
2. *Technology development*: all value activities have a 'technology', even if it is simply know-how. The key technologies may be concerned directly with the product (e.g. R&D, product design) or with processes (e.g. process development) or with a particular resource (e.g. raw material improvements).
3. *Human resource management*: this is a particularly important area that transcends all primary activities. It is concerned with the activities involved in recruiting, training, developing and rewarding people within the organisation.
4. *Infrastructure*: the systems of planning, finance, quality control, etc., are crucially important to an organisation's strategic capability in all primary activities. Infrastructure also consists of the structures and routines of the organisation that sustain its culture.

Having looked at Porter's complex value chain model, a simplified version will be used in most parts of this book (Figure 2.6). This simplified version of the value chain is characterised by the fact that it contains only the primary activities of the firm.

As indicated in Figure 2.6, a distinction is also made between the production-oriented 'upstream' activities and the more marketing-oriented 'downstream' activities.

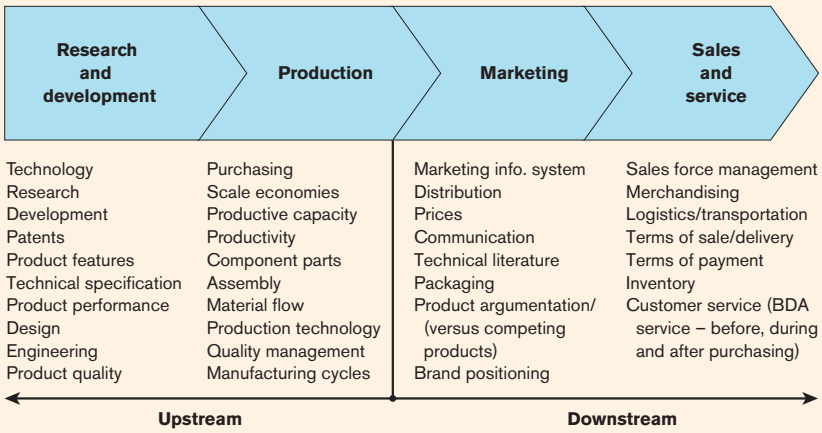


Figure 2.6 A simplified version of the value chain

Source: Hollensen, S. (2001) *Global Marketing: A Market Reponsive Approach*, 2nd ed., Financial Times-Prentice Hall, Harlow, p. 16. Reproduced with permission.

EXHIBIT 2.3
Nike's value chain

In the 1980s, Nike learned that manufacturing had become a commodity that could be outsourced for less cost and better quality than it could achieve with its internal resources. Nike realised that its core competences were in product development and marketing, and so management grew the company around a strategy of designing innovative products that met evolving customer needs.

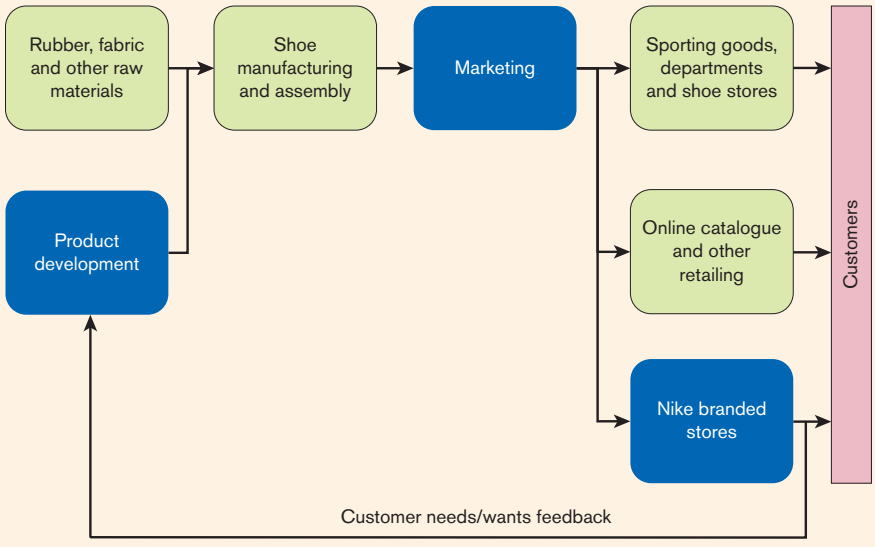


Figure 2.7 Nike's simplified value chain

The value chain in Figure 2.7 shows a simplified view of the athletic-shoe industry. Nike owns and controls just three elements: product development, marketing and its branded retail stores. Both serve Nike's strategic purpose: by owning and operating its branded stores the firm obtains valuable feedback directly from customers, which drives new product development. For B2B service providers seeking to do business with Nike, this suggests that some of the most lucrative opportunities are in supporting new-product development (shoe design and materials technologies), branded-store architecture and choosing store locations.

Sources: Adapted from Ramaswamy (2008); Crain and Abraham (2008), pp. 34–5.

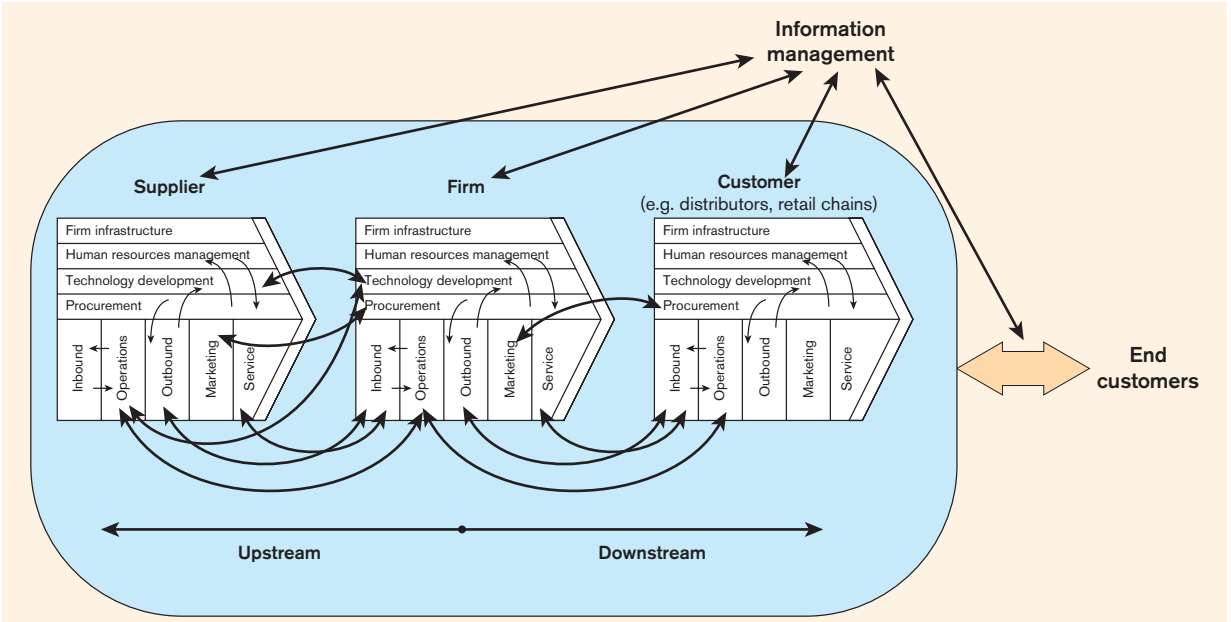


Figure 2.8 Model of some inter- and intra-firm relationships

Source: Adapted from Lings, I. N. (2000) Internal marketing and supply chain management, *Journal of Services Marketing*, 14(1): 34. Copyright © Emerald Publishing Group. All rights reserved. Reproduced with permission.

From value chain to value constellation

As markets are getting more complex the value chain of the single firm cannot be seen independently from the value chains of other actors in the market network (Prahalad and Ramaswamy, 2000).

Normann and Ramirez (1993) argue that strategic analysis should focus on the value-creating system itself within the different players – suppliers, business partners, customers and internal employees should work together to co-produce value.

Although value activities are the building blocks of competitive advantage, the value chain is not a collection of independent activities, but a system of interdependent activities. The value chains of different players are related to each other by linkages within the total industry (Jonk *et al.*, 2008). Linkages are relationships between the way in which one value activity is performed and the cost or performance of another.

In understanding the competitive advantage of an organisation, the strategic importance of the following types of linkage should be analysed in order to assess how they contribute to cost reduction or value added. There are two kinds of linkage (Figure 2.8):

- *Internal linkages* between activities within the same value chain, but perhaps on different planning levels within the firm.
- *External linkages* between different value chains 'owned' by the different players in the total value system.

Normann and Ramirez (1993) use the term value constellation to describe the 'chain' of different players' value chains and their relationships (see Figure 2.8). Figure 2.8 also stresses the importance of information management as a tool for coordinating information between the different players in the value chain.

Prosumer
A contraction of *pro*ducer and con*sumer*. Prosumers are half consumers and half proactive producers of the value creation.

The global furniture chain IKEA is used as an example of the new logic of value. IKEA's goal is not to create value for customers but to mobilise customers to create their own value from the company's various offerings (see Figure 2.9). IKEA's strategy is based on cost leadership (high volume production and standardised items) combined with turning consumers into **prosumers**, where IKEA's customers are expected to supply their time for assembly work after purchase.

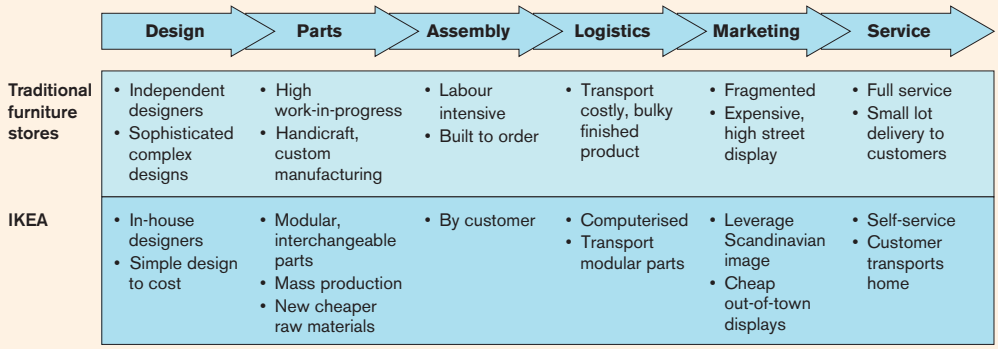


Figure 2.9 The business system of IKEA

Source: From Kumar, N., Scheer L. and Kotler, P. (2000) From market driven to market driving, *European Management Journal*, 18(2). Copyright © 2000 Elsevier. Reproduced with permission.

Internal linkages

There may be important links between the primary activities. In particular, choices will have been made about these relationships and how they influence value creation and strategic capability. For example, a decision to hold high levels of finished stock might ease production scheduling problems and provide a faster response time to the customer. However, it will probably add to the overall cost of operations. An assessment needs to be made of whether the added value of extra stock is greater than the added cost. Sub-optimisation of the single value chain activities should be avoided. It is easy to miss this point in an analysis if, for example, the marketing activities and operations are assessed separately. The operations may look good because they are geared to high-volume, low-variety, low-unit-cost production. However, at the same time the marketing team may be selling quickness, flexibility and variety to the customers. When put together these two positions representing potential strengths are weaknesses, because they are not in harmony, which is what a value chain requires. The link between a primary activity and a support activity may be the basis of competitive advantage. For example, an organisation may have a unique system for procuring materials. Many international hotels and travel companies use their computer systems to provide immediate quotations and bookings worldwide from local access points.

External linkages

One of the key features of most industries is that a single organisation rarely undertakes all value activities from product design to distribution to the final consumer. There is usually a specialisation of roles, and any single organisation usually participates in the wider value system, which creates a product or service. In understanding how value is created, it is not enough to look at the firm's internal value chain alone. Much of the value creation will occur in the supply and distribution chains, and this whole process needs to be analysed and understood.

Suppliers have value chains (upstream value) that create and deliver the purchased inputs used in a firm's chain. Suppliers not only deliver a product, but also can influence a firm's performance in many other ways. For example, Benetton, the Italian fashion company, managed to sustain an elaborate network of suppliers, agents and independent retail outlets as the basis of its rapid and successful international development during the 1970s and 1980s.

In addition, products pass through the value chain channels (channel value) on their way to the buyer. Channels perform additional activities that affect the buyer and influence the firm's own activities. A firm's product eventually becomes part of its buyer's value chain. The ultimate basis for differentiation is a firm and its product's role in the buyer's value chain, which determine the buyer's needs. Gaining and sustaining competitive advantage

depends on understanding not only a firm's value chain, but how the firm fits into the overall value system.

There are often circumstances where the overall cost can be reduced (or value increased) by collaborative arrangements between different organisations in the value system. It will be seen in Chapter 9 that this is often the rationale behind joint ventures (e.g. sharing technology in the international motor manufacture and electronics industries).

Customer value proposition (CVP)

A successful company will try to find a way to create value for the customers – that is, a way to help customers to solve a problem or get an important job done (Johnson *et al.*, 2008). Once we understand the 'job' and all its dimensions, including the full process for how to get it done, we can design the offering (= customer value proposition).

A conventional view of the value proposition is provided by Knox *et al.* (2003) in their review of approaches to customer relationship management. They say a value proposition is:

> an offer defined in terms of the target customers, the benefits offered to these customers, and the price charged relative to the competition.

However, some branding advocates believe that the value proposition is more than the sum of product features, prices and benefits. They argue that it also encompasses the totality of the experience that the customer has when selecting, purchasing and using the product. These customer experiences and also the service quality are very important elements in the process of designing the CVP. For example, Molineux (2002) states that:

> the value proposition describes the total customer experience with the firm and in its alliance partners over time, rather than [being limited to] that communicated at the point of sale.

2.6 VALUE SHOP AND THE 'SERVICE VALUE CHAIN'

Michael Porter's value chain model claims to identify the sequence of key generic activities that businesses perform in order to generate value for customers. Since its introduction in 1985, this model has dominated the thinking of business executives. Yet a growing number of services businesses, including banks, hospitals, insurance companies, business consulting services and telecommunications companies, have found that the traditional value chain model does not fit the reality of their service industry sectors. Stabell and Fjeldstad (1998) identified two new models of value creation – **value shops** and **value networks**. Fjeldstad and Stabell argue that the value chain is a model for making products, while the value shop is a model for solving customer or client problems in a service environment. The value network is a model for mediating exchanges between customers. Each model utilises a different set of core activities to create and deliver distinct forms of value to customers.

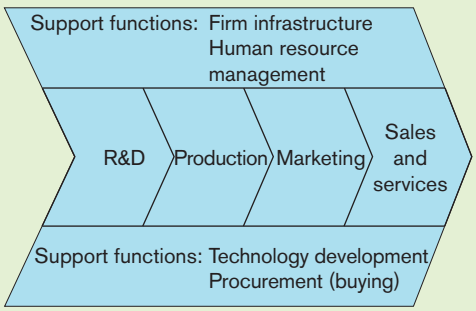
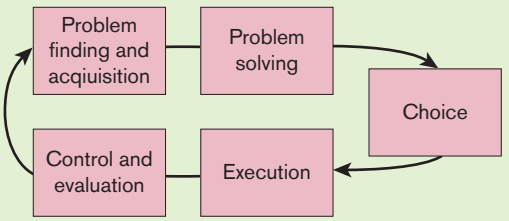
Value shop
A model for solving problems in a service environment. Similar to workshops. Value is created by mobilising resources and deploying them to solve a specific customer problem.

Value network
The formation of several firms' value chains into a network, where each company contributes a small part to the total value chain.

The main differences between the two types of value chains are illustrated in Table 2.2.

Value shops (as in workshops, not retail stores) create value by mobilising resources (e.g. people, knowledge and skills) and deploying them to solve specific problems such as curing an illness, delivering airline services to the passengers or delivering a solution to a business problem. Shops are organised around making and executing decisions – identifying and assessing problems or opportunities, developing alternative solutions or approaches, choosing one, executing it and evaluating the results. This model applies to most service-oriented organisations such as building contractors, consultancies and legal organisations. However, it also applies to organisations that are primarily configured to identify and exploit specific market opportunities, such as developing a new drug, drilling a potential oilfield or designing a new aircraft.

Table 2.2 The traditional value chain versus the service value chain

Traditional value chain model	Service value chain ('value shop') model
Value creation through transformation of inputs (raw material and components) to products.	Value creation through customer problem solving. Value is created by mobilising resources and activities to resolve a particular and unique customer problem. Customer value is not related to the solution itself but to the value of solving the problem.
Sequential process ('first we develop the product, then we produce it, and finally we sell it').	Cyclical and iterative process.
	
The traditional value chain consists of primary and support activities: *Primary activities* are directly involved in creating and bringing value to customers: upstream (product development and production) and downstream activities (marketing and sales and service). *Support activities* that enable and improve the performance of the primary activities are procurement, technology development, human resource management and firm infrastructure.	The primary activities of a value shop are: **1** *Problem finding*: activities associated with the recording, reviewing and formulating of the problem to be solved and choosing the overall approach to solving the problem. **2** *Problem solving*: activities associated with generating and evaluating alternative solutions. **3** *Choice*: activities associated with choosing among alternative problem solutions. **4** *Execution*: activities associated with communicating, organising and implementing the chosen solution. **5** *Control and evaluation*: activities associated with measuring and evaluating to what extent implementation has solved the initial situation.
Examples: Production and sale of furniture, consumer food products, electronic products and other mass products.	Examples: Banks, hospitals, insurance companies, business consulting services and telecommunications companies.

Source: After Stabell, C. B. and Fjeldstad, Ø. B. (1998) Configuring value for competitive advantage: on chains, shops and networks, *Strategic Management* 19: 413–37. Reproduced with permission from John Wiley & Sons.

Different parts of a typical business may exhibit characteristics of different configurations. For example, production and distribution may resemble a value chain, research and development a value shop.

Value shops make use of specialised knowledge-based systems to support the task of creating solutions to problems. However, the challenge is to provide an integrated set of applications that enable seamless execution across the entire problem-solving or opportunity-exploitation

process. Several key technologies and applications are emerging in value shops – many focus on utilising people and knowledge better. Groupware, intranets, desktop videoconferencing and shared electronic workspaces enhance communication and collaboration between people, essential to mobilising people and knowledge across value shops. Integrating project planning with execution is proving crucial, for example, in pharmaceutical development, where bringing a new drug through the long, complex approval process a few months early can mean millions of dollars in revenue. Technologies such as inference engines and neural networks can help to make knowledge about problems and the process for solving them explicit and accessible.

The term 'value network' is widely used but imprecisely defined. It often refers to a group of companies, each specialising in one piece of the value chain, and linked together in some virtual way to create and deliver products and services. Stabell and Fjelstad (1998) define value networks quite differently – not as networks of affiliated companies, but as a business model for a single company that mediates interactions and exchanges across a network of its customers. This model clearly applies best to telecommunications companies, but also to insurance companies and banks, whose business, essentially, is mediating between customers with different financial needs – some saving, some borrowing, for example. Key activities include operating the customer-connecting infrastructure, promoting the network, managing contracts and relationships, and providing services.

Some of the most IT-intensive businesses in the world are value networks – banks, airlines and telecommunications companies, for instance. Most of their technology provides the basic infrastructure of the 'network' to mediate exchanges between customers. But the competitive landscape is now shifting beyond automation and efficient transaction processing to monitoring and exploiting information about customer behaviour.

The aim is to add more value to customer exchanges through better understanding of usage patterns, exchange opportunities, shared interests and so on. Data mining and visualisation tools, for example, can be used to identify both positive and negative connections between customers.

Competitive success often depends on more than simply performing your primary model well. It may also require the delivery of additional kinds of complementary value. Adopting attributes of a second value configuration model can be a powerful way to differentiate your value proposition or defend it against competitors pursuing a value model different to your own. It is essential, however, to pursue another model only in ways that leverage the primary model. For example, Harley-Davidson's primary model is the chain – it makes and sells products. Forming the Harley Owners Group (HOG) – a network of customers – added value to the primary model by reinforcing the brand identity, building loyalty and providing valuable information and feedback about customers' behaviours and preferences (see pages 454–9). Amazon.com is a value chain like other book distributors, and initially used technology to make the process vastly more efficient. Now, with its book recommendations and special interest groups, it is adding the characteristics of a value network. Our research suggests that the value network in particular offers opportunities for many existing businesses to add more value to their customers, and for new entrants to capture market share from those who offer less value to their customers.

Combining the 'product value chain' and the 'service value chain'

Blomstermo *et al.* (2006) make a distinction between *hard* and *soft services*. Hard services are those where production and consumption can be decoupled. For example software services can be transferred into a CD, or some other tangible medium, which can be mass-produced, making standardisation possible. With soft services, where production and consumption occur simultaneously, the customer acts as a coproducer, and decoupling is not viable. The soft-service provider must be present abroad from its first day of foreign operations. Figure 2.10 is mainly valid for soft services, but at the same time in more and more industries we see that physical products and services are combined.

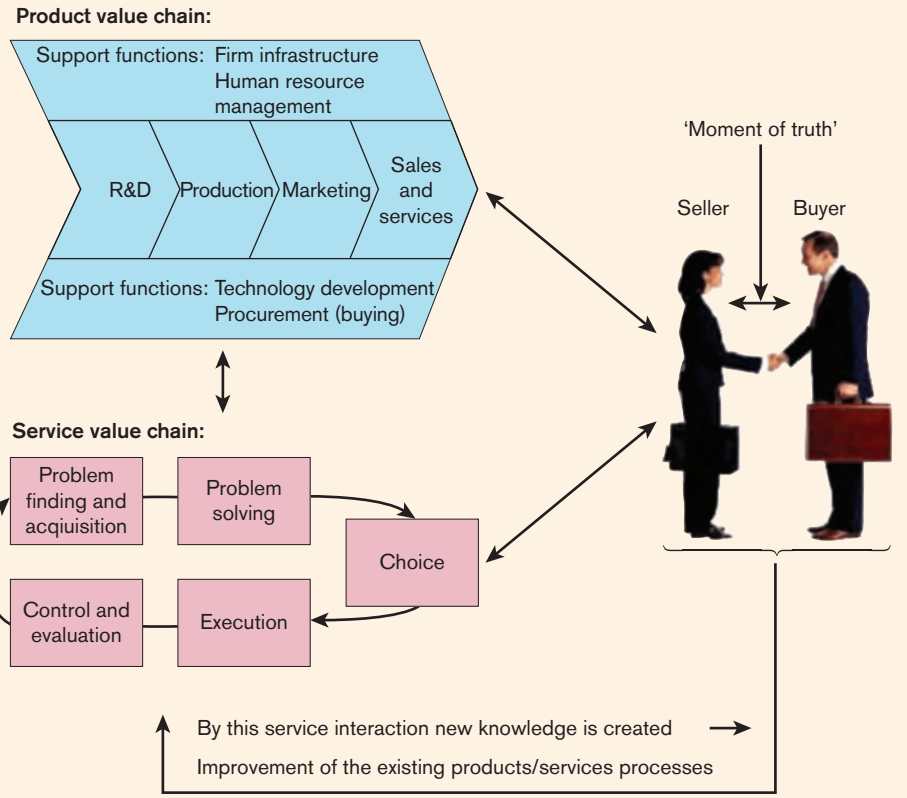


Figure 2.10 Combining the 'product value chain' with the 'service value chain'

Most product companies offer services to protect or enhance the value of their product businesses. Cisco, for instance, built its installation, maintenance and network-design service business to ensure high-quality product support and to strengthen relationships with enterprise and telecom customers. A company may also find itself drawn into services when it realises that competitors use its products to offer services of value. If it does nothing, it risks not only the commoditisation of its own products – something that is occurring in most product markets, irrespective of the services on offer – but also the loss of customer relationships. To make existing service groups profitable – or to succeed in launching a new embedded service business – executives of product companies must decide whether the primary focus of service units should be to support existing product businesses or to grow as a new and independent platform.

When a company chooses a business design for delivering embedded *services* to customers, it should remember that its strategic intent affects which elements of the delivery life cycle are most important. If the aim is to protect or enhance the *value* of a product, the company should integrate the system for delivering it and the associated *services* in order to promote the development of product designs that simplify the task of *service* (e.g. by using fewer subsystems or integrating diagnostic software). This approach involves minimising the footprint of *service* delivery and incorporating support into the product whenever possible. If the company wants the *service* business to be an independent growth platform, however, it should focus most of its delivery efforts on constantly reducing unit costs and making the *services* more productive (Auguste *et al.*, 2006).

In the 'moment of truth' (e.g. in a consultancy service situation), the seller represents all the functions of the focal company's 'product' and 'service' value chain – at the same time. The seller (the product and service provider) and the buyer create a service in an interaction process: 'The service is being created and consumed as it is produced.' Good representatives

on the seller's side are vital to service brands' successes, being ultimately responsible for delivering the seller's promise. As such a shared understanding of the service brand's values needs to be anchored in their minds and hearts to encourage brand-supporting behaviour. This internal brand-building process becomes more challenging as service brands expand internationally drawing on workers from different global domains.

Figure 2.10 also shows the cyclic nature of the service interaction ('moment of truth') where the post-evaluation of the service value chain gives input for the possible redesign of the 'product value chain'. The interaction shown in Figure 2.10 could also be an illustration or a snapshot of a negotiation process between seller and buyer, where the seller represents a branded company, which is selling its projects as a combination of 'hardware' (physical products) and 'software' (services).

Anyway, one of the purposes with the 'learning nature' of the overall decision cycle in Figure 2.10 is to pick up the 'best practices' among different kinds of international buyer–seller interactions. This would lead to implications for a better set-up of:

- the 'service value chain' (value shop)
- the 'product value chain'
- the combination of the service and product value chains.

2.7 INTERNATIONALISING THE VALUE CHAIN

International configuration and coordination of activities

Glocalisation
The development and selling of products or services intended for the global market, but adapted to suit local culture and behaviour. (Think globally, act locally.)

All internationally oriented firms must consider an eventual internationalisation of the value chain's functions. The firm must decide whether the responsibility for the single value chain function is to be moved to the international markets or is best handled centrally from head office. Principally, the value chain function should be carried out where there is the highest competence (and the most cost effectiveness), and this is not necessarily at head office (Bellin and Pham, 2007).

The two extremes in 'global marketing' (globalisation and localisation) can be combined into the so-called '**glocalisation**' framework, as shown in Figure 2.11.

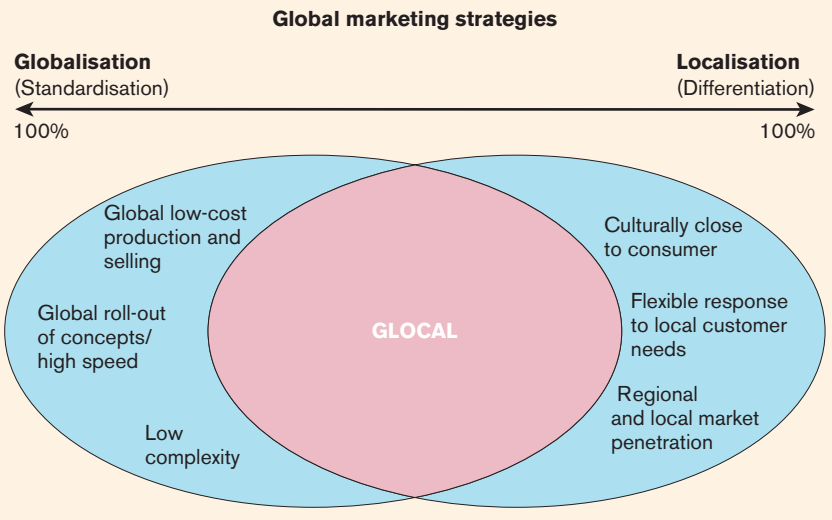


Figure 2.11 The glocalisation frame work

Diffusion
The spread of a new product through society.

This global marketing strategy strives to achieve the slogan 'Think globally but act locally' (the so-called glocalisation framework), through dynamic interdependence between headquarters and subsidiaries. Organisations following such a strategy coordinate their efforts, ensuring local flexibility while exploiting the benefits of global integration and efficiencies, as well as ensuring worldwide **diffusion** of innovation. A key element in knowledge management is the continuous learning from experiences. In practical terms, the aim of knowledge management as a learning-focused activity across borders is to keep track of valuable capabilities used in one market that could be used elsewhere (in other geographic markets), so that firms can continually update their knowledge. However, knowledge developed and used in one cultural context is not always easily transferred to another. The lack of personal relationships, the absence of trust and 'cultural distance' all conspire to create resistance, friction and misunderstandings in cross-cultural knowledge management.

With globalisation becoming a centerpiece in the business strategy of many firms – be they engaged in product development or providing services – the ability to manage the 'global knowledge engine' to achieve a competitive edge in today's knowledge-intensive economy is one of the keys to sustainable competitiveness. But in the context of global marketing the management of knowledge is *de facto* a cross-cultural activity, whose key task is to foster and continually upgrade collaborative cross-cultural learning. Of course, the kind and/or type of knowledge that is strategic for an organisation and which needs to be managed for competitiveness varies depending on the business context and the value of different types of knowledge associated with it.

A distinction immediately arises between the activities labelled downstream on Figure 2.6 and those labelled upstream activities. The location of downstream activities, those more related to the buyer, is usually tied to where the buyer is located. If a firm is going to sell in Australia, for example, it must usually provide service in Australia, and it must have salespeople stationed in Australia. In some industries it is possible to have a single salesforce that travels to the buyer's country and back again; other specific downstream activities, such as the production of advertising copy, can sometimes also be performed centrally. More typically, however, the firm must locate the capability to perform downstream activities in each of the countries in which it operates. In contrast, upstream activities and support activities are more independent of where the buyer is located (Figure 2.12). However, if the export markets are culturally close to the home market, it may be relevant to control the entire value chain from head office (home market).

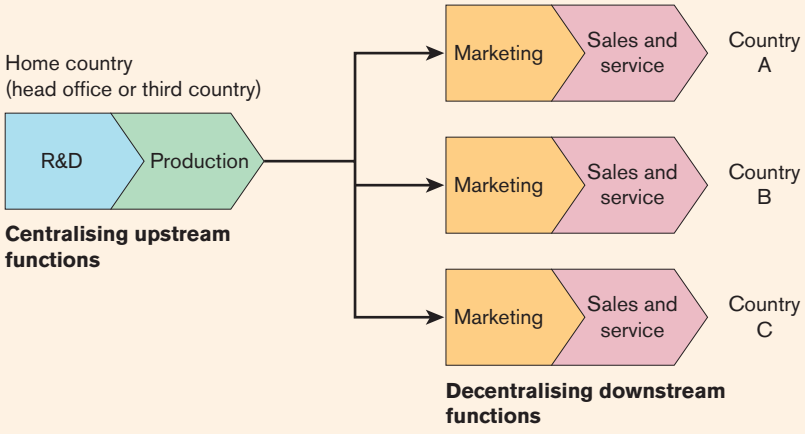


Figure 2.12 Centralising the upstream activities and decentralising the downstream activities

This distinction carries some interesting implications. First, downstream activities create competitive advantages that are largely country specific: a firm's reputation, brand name and service network in a country grow largely out of its activities and create entry/mobility barriers largely in that country alone. Competitive advantage in upstream and support activities often grows more out of the entire system of countries in which a firm competes than from its position in any single country.

Second, in industries where downstream activities or other buyer-tied activities are vital to competitive advantage, there tends to be a more multidomestic pattern of international competition. In many service industries, for example, not only downstream activities but frequently upstream activities are tied to buyer location, and global strategies are comparatively less common. In industries where upstream and support activities such as technology development and operations are crucial to competitive advantage, global competition is more common. For example, there may be a large need in firms to centralise and coordinate the production function worldwide to be able to create rational production units that are able to exploit economies of scale.

Furthermore, as customers increasingly join regional cooperative buying organisations, it is becoming more and more difficult to sustain a price differentiation across markets. This will put pressure on the firm to coordinate a European price policy.

The distinctive issues of international strategies, in contrast to domestic, can be summarised in two key dimensions of how a firm competes internationally. The first is called the *configuration* of a firm's worldwide activities, or the location in the world where each activity in the value chain is performed, including the number of places. For example, a company can locate different parts of its value chain in different places – for instance, factories in China, call centres in India, and retail shops in Europe. IBM is an example of a company that exploits wage differentials by increasing the number of employees in India from 9,000 in 2004 to 50,000 by mid-2007 and by planning for massive additional growth. Most of these employees are in IBM Global Services, the part of the company that is growing fastest but has the lowest margins – which the Indian employees are supposed to improve, by reducing (wage) costs rather than raising the prices (Ghemawat, 2007).

The second dimension is called *coordination*, which refers to how identical or linked activities performed in different countries are coordinated with each other (Porter, 1986; Sanchez, 2007).

2.8 THE VIRTUAL VALUE CHAIN

By introducing the virtual value chain, Rayport and Sviokla (1996) have extended the conventional value chain model, which treats information as a supporting element in the value-adding process (see Figure 2.13).

Each of the physical value chain activities might make use of one or all four information processing stages of the virtual value chain, in order to create extra value for the customer. That is the reason for the horizontal double arrows (in Figure 2.13) between the different physical and virtual value chain activities.

In this way (in relation to Figure 2.13), information can be captured at all stages of the physical value chain. Obviously such information can be used to improve performance at each stage of the physical value chain and to coordinate across it. However, it can also be analysed and repackaged to build content-based products or to create a new line of business.

A company can use its information to reach out to other companies' customers or operations, thereby rearranging the value system of an industry. The result might be that traditional industry sector boundaries disappear. The CEO of Amazon.com, Jeffrey P. Bezos, clearly sees his business as not bookselling, but the information-broker business.

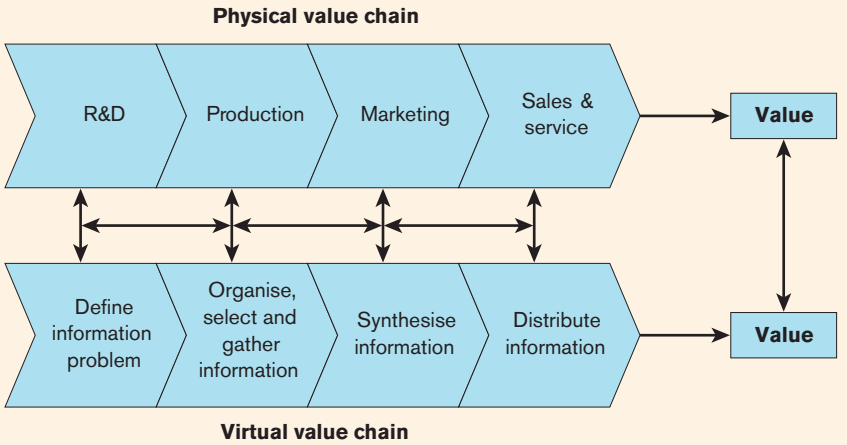


Figure 2.13 The virtual value chain as a supplement to the physical value chain

Online customer value proposition (OCVP)

Regarding the customer value proposition that can be created along the virtual value chain, it is very important to develop a profound understanding of the customer's online experience. Marketers must understand specific characteristics of online channels and the benefits they offer to customers. To help formulate the online customer value proposition (OCVP) we need to consider the special characteristics of the Internet and its online services as perceived by customers using them. Six criteria can be used to determine the sustainability of the formulated OCVP, in order to reach online customers (Chaffey, 2005):

1 *Content*: online content is rich, which means it provides something that other channels cannot. Often this means more detailed, in-depth information to support the buying process or product usage. However, often online product catalogues simply replicate what is in offline catalogues without adding extra information, images or example applications. Messaging through e-mail and SMS is also key to providing unique content – these media can be used to deliver timely, relevant media to individuals. As well as text-based content, which is king for business-to-business, there is also interactive content, which is king for consumer sites and particularly brands. FMCG brands now use the Web to deliver what they term as 'digital assets', which support offline branding campaigns.

Customisation
Making something (product/service) according to a customer's individual requirements.

2 **Customisation**: in this case mass customisation of content whether received as website pages or e-mail alerts and commonly known as personalisation. Of course, Amazon is quoted many times as an example of this, and it actually has a 'Director of Personalisation'. The ability for a subscriber to an online e-mail service to tailor their messages by selectively opting-in to particular types of message is a further example of customisation.

3 *Community*: these days this is also known as 'social networks'. Online channels such as the Internet are known as 'many-to-many' media, meaning that your audiences can contribute to the content.

4 *Convenience*: this is the ability to select and purchase, and in some cases use products, from your desktop at any time: the classic 24 × 7 × 365 availability of a service. Online usage of products is, of course, restricted to digital products such as music or other data services. Amazon has advertised offline using a creative showing a Christmas shopper battling in queues clutching several bags to reinforce the convenience message.

5 *Choice*: the Web gives a wider choice of products and suppliers than via conventional distribution channels. For example, Tesco.com provides Tesco with a platform to give

consumers a wider choice of products (financial, travel, white goods) with more detailed information than is physically available in store.

6 *Cost reduction*: the Internet is widely perceived as a relatively low-cost place of purchase. A key component of the low-cost airline carriers' OCVP is that it is cheaper than phone bookings. This simple price differential, together with the limited change behaviour required from phone booking to online booking, has been a key factor in, for example, Ryanair's online ticketing channel effectively replacing all other booking modes.

2.9 SUMMARY

Competences are the skills, knowledge and technologies that an organisation possesses on which its success depends. Although an organisation will need to reach a threshold level of competence in all its activities, it is likely that only some of these activities are core competences. These core competences underpin the ability of the organisation to outperform the competition and therefore must be defended and nurtured. Core competences concern those resources that are fundamental to a company's strategic position.

In the chapter, three basic perspectives on identification of core competences have been presented:

- resource-based view (RBV): an inside-out perspective;
- market orientation view (MOV): an outside-in perspective;
- value chain based view (VBV): between the RBV and the MOV.

The RBV emphasises the importance of firm-specific assets and knowledge. The underlying approach of the RBV is to see the firm as a bundle of tangible and intangible resources, and to see some of these resources as costly to copy and trade. A firm's resource position can lead to sustained competitive advantage.

Especially in knowledge-intensive firms, distinctive capabilities consist of intangible resources.

In contrast to the MOV, which takes the environment as the critical factor determining an organisation's strategy, the RBV assumes that the key factors for success lie within the firm itself in terms of its resources, capabilities and competences. The choice of the firm's strategy is not dictated by the constraints of the environment but is influenced more by calculations of how the organisation can best exploit its core competence relative to the opportunities in the external environment.

The MOV is basically about adapting to the market environment by concentrating mainly on customers and their needs.

The VBV integrates elements of both the RBV and the MOV, but it does so without ignoring the costs of performing the activities. The value chain provides a systematic means of displaying and categorising activities. Value activities can be divided in different ways:

- primary and support activities;
- upstream and downstream activities.

At each stage of the value chain the firm seeks to add value and thus compete with its rivals. The simplified version of the value chain used throughout the book contains only the primary activities of the firm. The value chain is not a collection of independent activities but a system of interdependent activities. The firm's value chain activities are also related to other actors' value chains. Competitive advantages are created if the firm can:

- offer better perceived value for customers;
- perform the value chain activities at a lower cost than competitors.

CASE STUDY 2.1

Senseo

Competition is coming up in the coffee pod machine market

A very brief history of coffee

Coffee was first consumed in the ninth century, when it was discovered in the highlands of Ethiopia. From there it spread to Egypt and Yemen, and by the fifteenth century had reached Azerbaijan, Persia, Turkey and northern Africa. From the Muslim world, coffee spread to Italy, then to the rest of Europe, to Indonesia, and to the Americas.

Coffee has played an important role in many societies throughout modern history. In Africa and Yemen, it was used in religious ceremonies. As a result, the Ethiopian Church banned its secular consumption. It was banned in Ottoman Turkey in the seventeenth century for political reasons, and was associated with rebellious political activities in Europe.

For many decades almost all coffee has been sold as filter coffee in package sizes of one pound (500 grams). However, during the last decade things have changed. New products and package sizes have been introduced. The present case deals with a few of these new innovations. Today coffee has become a popular drink around the world and comes in many variations, both in terms of roasting and of brewing.

Spurred by the strength of coffee bar culture in many developed markets, manufacturers have attempted to increase value sales by introducing a similar 'café experience' at home. The battle among coffee makers for at-home use has intensified, with leading coffee players, such as Procter & Gamble, Kraft Foods and Philips & Sara Lee (Senseo), launching single-service pod machines which can brew a high-quality cup of coffee in less than one minute.

The influence of specialist coffee shops with their speciality coffee products based on espresso fresh coffee beans has significantly influenced the consumption habits of younger people especially. These consumers have increasingly abandoned classic filter coffee and embraced the Italian-American varieties of espresso fresh coffee beans and coffee pods/capsules. The coffee produced by espresso/café crema grinders and pod/capsule machines have two things in common: less caffeine and a milder taste than traditional filter coffee, while providing the 'crema' effect enjoyed by many consumers.

The history and categorisation of the coffee maker

Before the coffee maker was invented, coffee was prepared in boiling water. The beans were roasted on an open fire and then added to boiling water for consumption. This process did not bring the desired taste and aroma, and hence coffee lovers started to devise ways to come up with a machine or a coffee maker that would prepare tasty coffee.

In 1912 Frau Benz invented the Melitta coffee filter, which is an efficient disposal method for coffee. Earlier, for the filtering purpose of coffee, linen or cloth was used.

Roughly, the coffee maker market can be categorised into three types:

- traditional filter machines
- espresso machines
- pod coffee machines (this is a sector that was actually pioneered by Nespresso, but the market leader now is Senseo; their growth is driven by their ease of use and affordable pricing – later described more in-depth).

These three categories are by no means complete; there are still so many categories that are not covered.

A new and innovative coffee maker was invented in the 1960s called the filter-type coffee maker, which has more advanced features than the earlier varieties. Developed more with the passage of time, this new design came to be manufactured by many companies and its demand rose in the market. The leading brands in this market have been Melitta and Mr Coffee brand, which was manufactured with an automatic drip process. Joe DiMaggio was its spokesperson from 1974. Today, Mr Coffee holds a major part of the market share in the world.

An espresso coffee drink gives more energy and is tastier than the other coffee drinks. The first espresso maker was invented by a manufacturing company owned by Lugia Bezzer in 1901 in Italy. Mr Bezzer was simply looking for a way to help speed up his employee's coffee breaks. He figured out that if pressure was applied in the brewing process, the drink could be made in a lot less time. Nicknamed 'the fast coffee

Table 2.3 The global market for coffee machines (2008)

	Retail volume (million units)
Western Europe	17.8
Eastern Europe	0.6
North America	28.4
Latin America and Carribbean	4.1
Asia-Pacific (minus Australia and NZ)	2.9
Australia and NZ	0.3
Africa and Middle East	0.7
World total	54.8

Source: Adapted from Euromonitor International (www.euromonitor.com.).

machine', the espresso machine patent was sold in 1905. The new owner, Desidero Pavoni, developed an espresso machine that used a piston pump to force water through a tube and into the coffee.

The commercial espresso machine was invented in 1946. Since then, the espresso maker under different brands began to be produced by many companies. Some of the prominent brands include Juda, Mr Coffee, Kitchenaid and Braun. The modern espresso machines come with various features, styles, colours and prices.

The world market for coffee machines (coffee makers) is shown in Table 2.3.

As can be seen in Table 2.3 the market volumes vary a lot between the regions, but there are also huge differences within the different world regions. For example, in the Western European market the overall picture for the coffee machine market (divided into the three categories) is shown in Table 2.4.

The stock of coffee machines in Europe is estimated to be 100 million units. Traditional filter coffee machines still have the highest volume market share (55 per cent). There is a considerable trend towards espresso full-automatic and an extremely strong trend towards espresso-portioned machines. Low-comfort and low-quality machines (hand-operated espresso piston, pad-filters, combis) are losing market share.

Across the Western European region, the national markets are very different. There are countries such as Italy, Switzerland and Portugal with a huge market share of espresso machines (over 70 per cent). On the other

Table 2.4 The Western European coffee machine market

Category	Typical brands	Sold units in millions, 2008	Typical price, (€), 2008	Value (€m), 2008
Traditional filter machines	Melitta, Mr Coffee	10.0	€30	€300m
Pod coffee machines	Nespresso, Senseo	3.5	€70	€245m
Espresso machines	De Longhi, Jura, Krups & Rowenta, Rotel	4.3	€200	€860m
Total		17.8		€1,405m

Source: Adapted from Nipkow, J. and Bush, E. (2008) Coffee machines: recommendations for policy design, 7 August, Topten International Group Report (www.topten.info). Reproduced with permission.

hand, some countries still have a very low market share of espresso machines, e.g. Belgium, Germany and the Netherlands (lower than 20 per cent). In Belgium or the Netherlands pad-filters are quite popular with a market share of about 40 per cent. Furthermore, it is interesting to have a look at the market values. Assuming roughly that typical prices are €30 for filter machines, €70 for single-serve coffee pod systems and €200 for espresso machines, there evolves an opposite picture. Espresso machines, are strongly dominating the market in value (see Table 2.4).

The remainder of this case deals with the single-serve coffee pod system.

The single-serve coffee pod system

While the single-serve brewing concept has proved successful in Western Europe, particularly in the Netherlands and France, the trend is still in its early stages in the US, and is yet to impact most developing markets, where disposable incomes have not reached levels that would sustain demand. However, manufacturers hope that the concept will take hold with American consumers because it allows coffee to be made quickly, cleanly and in small quantities. That said, product choice remains limited, and with 'closed' systems, consumers must stick to buying coffee pods compatible with their single-serve machine.

As consumers face growing choices of new-style coffee makers for home use, one of the deciding factors could be the availability of pods. After consumers have made their machine choice, probably based on price and the physical aspects of each machine, having easy access to the coffee pods themselves will be key. Flexibility may also turn out to be a competitive advantage. In addition to coffee, the Tassimo system allows consumers to make hot chocolate or tea, a feature rival Senseo offers only on upmarket models with specially purchased pods. On the other hand, Melitta One:One decided that the battle for pod control could only be won by revamping its pods to fit both its own system and those machines marketed by competitors.

Coffee pods and capsules largely imitate the benefits of freshly prepared espresso/café crema with the added benefit of convenience. They require less preparation time and offer standard one- or two-cup sizes, which appeal to single people. This segment has grown a lot to account (in e.g. Germany) for 10 per cent of retail value sales of fresh ground coffee in 2008. Due to the much higher unit prices of coffee pods, it accounted for only just over 5 per cent of retail volume sales of fresh ground coffee in the same year.

Senseo

The basis for the success of coffee pods was provided in 2001, when Philips introduced coffee pod machines under the Senseo brand. These machines are geared towards the use of coffee pods produced by Douwe Egberts.

So the Senseo coffee pod system is the result of a partnership between electronics expert Philips (supplier of the Senseo machine) and coffee roaster Douwe Egberts (supplier of the coffee pods) – both world-renowned companies from the Netherlands. Coffee pods are tiny packages weighing 5–10 grams. A traditional bag contains 25 pods – a pod is put into the machine and within 45 seconds or so it transforms into one cup of coffee (0.15–0.25 litres).

Philips Senso coffee machine, Latte Select
Source: Courtesy of Philips Consumer Electronics

A brief presentation of the two alliance partners

Philips

Royal Philips Electronics of the Netherlands is one of the world's biggest electronics companies and Europe's largest, with sales of €26.4 billion in 2008. With activities in the three interlocking domains of healthcare, lifestyle and technology and 121,400 employees in more than 60 countries, it has market leadership positions in medical diagnostic imaging and patient monitoring, colour television sets, electric shavers, lighting and silicon system solutions.

Sara Lee/Douwe Egberts (DE)

Douwe Egberts was founded in the middle of the eighteenth century by the Dutch entrepreneur Egbert Douwes and his wife Akke Thysses. The company's activities included coffee, tea and household and bodycare products. Soon they developed a reputation regionally by also supplying shop owners elsewhere, thereby spreading the Douwe Egberts brand around the country. Gradually, Douwes and his descendants built a company that grew to become the Dutch market leader for its core products, coffee and tea. Since 1978 Douwe Egberts has been allied to the Sara Lee Corporation, which opened new horizons worldwide. Today Douwe Egberts is the second largest coffee roaster in the world and the company employs over 26,000 people worldwide.

The company prospered, and continued to grow throughout the Netherlands, but it was not until the mid-twentieth century that it expanded beyond the borders of its homeland. In 1948, Douwe Egberts began selling coffee, tea and tobacco in Belgium. Over the next 20 years, the company added sales in Belgium, France and Spain. In 1978, the company was acquired by international food corporation Sara Lee. Since then, Sara Lee and Douwe Egberts has become familiarly known as Sara Lee/DE.

The Douwe Egberts brands include Pickwick tea, Douwe Egberts coffee, Piazza d'Oro espresso, Cafitesse, Pilao coffee and, of course, the Senseo system. Sara Lee sells products in nearly 200 countries. The Sara Lee brands include Sara Lee, Earth Grains, Hillshire Farm, Jimmy Dean, Ball Park, Bimbo, Kiwi, Ambi Pur, Sanex, and, of course, Douwe Egberts. Sara Lee/DE's part of the partnership is, of course, coffee. Douwe Egberts offers a wide variety of coffee blends to suit most tastes, as well as tea in pods to fit the Senseo machine. The current blends include Sumatra, Brazil, Kenya and Colombia, each of them with the characteristics common to the named region. In addition, there are selected speciality beverages, including espresso, cappuccino and Café Noir, a sweet, dark blend with a chocolate finish. There are also flavoured pods, which include Paris (vanilla caramel), Vienna (hazelnut, vanilla and mocha), and a number of limited edition varieties that are currently only available in select European locations. For tea lovers, Douwe Egberts offers Earl Grey and Minty Green T-pods for the Senseo.

In 1998, Sara Lee/DE filed a patent in Belgium to protect their use of the coffee pod system. The patent was challenged after the Senseo machine hit the market and competitors realised that the patent prevented them from manufacturing coffee pods. The patent was successfully challenged in the Belgian court. As of 2004, the year that the Senseo was introduced in the US, other companies have the legal right to make and sell coffee pods that fit the Senseo system. In addition, several pod makers on the market allow consumers to make their own coffee pods. This allows flexibility in making the coffee or tea of your choice, utilising the Senseo brewing system.

Working in tandem, the two companies developed every aspect of Senseo – from its patented coffee machine and the brewing process to its one-of-a-kind coffee pods. The machine uses single-portion Senseo coffee pods, containing the finest ground coffee, to guarantee a perfect cup every time it is used. Senseo has now been launched in more than a dozen countries worldwide. The biggest markets are Austria, Australia, Belgium, China, Denmark, France, Germany, the Netherlands, the UK and the USA.

Since Philips and Douwe Egberts introduced the coffee pod machine in spring 2001 it has sold more than 15 million units and more than 8 billion coffee pods in the first seven years of its lifetime. It is estimated that over 5 million coffee pod machines were sold in Germany by mid-2007. As coffee made from coffee pod machines is very expensive when consumed in large quantities, these machines are used as an additional coffee option rather than as a replacement for standard coffee machines. The typical owner of a coffee pod machine is young (40 years old and under), but owners include single people, couples and adults with small children.

When the Senseo coffee pod machine was introduced the end-user price was around €75; the current recommended price is €69, but in spring 2009 it was available for around €58.

It is reported that almost one-third of Dutch households own a Senseo machine, and the figure is expected to climb steadily in the years to come. Although most Dutch households continue to use both conventional filter coffee machines and single-serve coffee systems, unit sales of the latter in recent years have

outperformed the former. Nevertheless, industry experts suggest that it will take a long time for conventional filter machines to disappear completely (just like it took many years for colour TV to supersede black and white TV or DVDs to oust VHS). Many Dutch households are expected to continue to use conventional machines when holding a party and the Senseo-type machines for everyday use. The consumption behaviour of Dutch households is suggested to be a rough model of the average household within the EU.

Competitive advantages of Senseo

Low-cost followers from China, used to selling cheaper filter coffee machines, have had problems catching up on this alliance, because they cannot easily copy the tight collaboration between Philips and Sara Lee's Douwe Egberts subsidiary that produces the coffee packets designed especially for the Senseo machine.

When big retail chains like Aldi and Wal-Mart see a product like this, they usually go to China and ask for something similar. But in the Senseo case it is not so easy, because the main profits from the Senseo concept come partly from coffee machines but mainly from coffee pods. It is very difficult for the Chinese competitors who have to recoup that money from machines alone.

Presently the market price for a traditional cup of filter coffee lies somewhere between 4 and 5 cents, whereas the price of a cup of pod coffee (7–10 grams) varies between 16 cents (Senseo) and 30–32 cents (Nespresso and Tchibo). Thus, for obvious reasons, coffee producers are very interested in the 'sky high' profit margins of the pods compared to the ruinous price levels of the traditional coffee package sizes (400 and 500 grams).[1]

Once the pods were introduced, no one had the slightest idea that this market niche would develop so fast and be so successful. While the competition in the ordinary coffee market continues to be as fierce as ever, the price competition in the pod market, while present, somehow appears to exist in a different world. It seems that many consumers do not mentally 'think' in unit or kilo prices.

As an industry executive recently remarked, 'Suddenly it has become possible to earn money by simply selling coffee.' For a generation or so coffee has been a typical discount product. In a lot of European markets, traditional coffee has been used by retailers (supermarkets, discount stores) as a promotional tool for generating store traffic. In TV ads and sales fliers specific brands are often on promotion. The retailer is losing money on the promoted coffee brand. However, once the consumer enters the store for buying the brand she/he will normally continue shopping in the same retail store and thus buy a lot of products that are not on promotion, thereby more than compensating for the loss generated by the promoted brand.

In 2004 the German market for pods was 2,750 tonnes (30 per cent up from 2003). Senseo alone sold 650 million pods. The same year Nestlé globally sold 1.3 billion pods (34 per cent up from 2003). During 2003 and 2004 Philips sold 2 million Senseo coffee machines. When Tchibo launched its Cafissimo machine the 60,000 units available were sold within two days! Because the machines are sold below production prices (€69–99), the producer of the machines is being compensated by the coffee producers. For instance, Philips obtains part of the profit generated by the sales of the Senseo pods.

Instead of bringing in two constituent brands (Philips and Sara Lee) to create a third brand (Senseo), the alliance team introduced a co-branding strategy, leveraging the equity in the Douwe Egberts brand to give credibility to the new composite brand, Senseo, forming a separate and unique product, thus ensuring single-minded focus.

Creating an overall identity that transparently links the coffee and appliance as part of one lock-and-key system, and building consumer intimacy around this, was a crucial building block to success, something from which our local equivalent can learn. Not only has this alliance brought an innovation to consumers, but it has also given Philips a chance to boost its brand by partnering with a reputable multinational; and Douwe Egberts has benefited from creating a new segment within coffee.

It is essential to ensure that both partners are aligned behind the collaboration, that the key people involved in managing the collaboration have the personal skills to make the collaboration a success, and that a sound co-branding strategy exists for the new product. In addition, there must be a commitment in funding that allows the partners to fully exploit the new product to the target market, creating demand and thus ensuring trade support. Creating a new category through shifting consumer behaviour requires a long-term commitment and an investment strategy to match. In the USA alone, for every dollar Procter & Gamble and Sara Lee have reaped selling coffee for their 'revolutionary' single-cup systems, they have spent three on marketing.

Invariably there will always be issues around the area of intellectual property, and financial arrangements. In the case of the Senseo collaboration, it was agreed that

[1]The strategy of developing mini-packages (where the kilo price is much higher) represents a current retail trend. For instance the German candy producer Haribo has for some time sold a unit package containing 10–25 mini-packages.

Philips would hold the intellectual property for the coffee machine, whilst Douwe Egberts would retain it for the coffee. And in order to ensure that Philips were aligned to view Senseo as a longer-term proposition, Douwe Egberts allowed Philips a share of royalties in the Senseo coffee brand.

A new model of the Senseo machine – the Senseo New Generation – was launched in selected markets in 2007. This updated version allows the user to adjust the height of the mechanism to accommodate larger cups or mugs, has an indicator light function which shows when there is insufficient water for two cups (as opposed to the previous model which only showed whether there was sufficient water left for one cup), features a larger water reservoir and has an option which allows the user to adjust the amount of hot water used per cup.

Competition is coming up

Following the success of Senseo, other branded manufacturers and the leading discounters copied Douwe Egberts's coffee pods and introduced their own for Senseo machines. The pod machines were also copied.

The battle among coffee makers for at-home use intensified in 2005. As a result of the growing competition from me-too products, Douwe Egberts started to seek legal protection for its coffee pods and it tried to prohibit the distribution of the me-too coffee pods. However, in 2006, the European patent covering the Senseo pods was completely revoked on appeal by the European Patent Office. Following the success of Senseo, the leading coffee companies jumped on the bandwagon and introduced not only their own coffee pods but also a similar system based on capsules. In 2005, Tchibo introduced a machine and capsules under Cafissimo, Kraft Foods/Braun introduced Tassimo and, in September 2006, Nestlé and the machine manufacturer Krups introduced Dolce Gusto to Germany.

Unlike the Nespresso system, which has been on the market for over ten years and is positioned as a top-end premium product, Dolce Gusto is a mass product and, like most products by Nestlé, it offers extra amounts of milk foam. All of these new systems are 'closed' systems, which means, for example, that consumers can only use capsules manufactured by Tchibo together with the 'Cafissimo' machine. However, most of the leading brands continue to offer coffee pods that can be used in the Senseo and similar machines.

The only temporary loser in this game was Melitta Unternehmensgruppe Bentz KG, which introduced the 'MyCup' coffee pod system in autumn 2004, as its differently shaped pods were not compatible with the coffee machines of other manufacturers. Consumers refused to buy these coffee pods and Melitta temporarily withdrew its coffee pod system. It launched universal coffee pods in the beginning of 2007 but also kept the differently shaped 'MyCup' pods in its range. At the same time, Melitta launched another product: empty pod sachets that can be filled with coffee of choice by the consumer, significantly reducing the cost per cup. However, as these sachets are awkward to handle, it is uncertain if they will catch on with consumers.

Private labelling – for example in Germany

In Europe, the private label plays an ever-increasing role in coffee pods, especially in Germany. Here the private labels accounted for over a 45 per cent share of retail volume sales in 2008, as many German consumers remain extremely price conscious. In the traditional fresh ground coffee category, private labels accounted for a 33 percent share of retail volume sales in 2008.

The discounter Aldi continues to play a major role in private labels in all coffee categories. In 2008, Aldi led in coffee pods (25 per cent share of retail volume sales) and whole coffee beans (18 per cent retail volume share). Only in traditional fresh ground coffee are the giant branded players Kraft Foods and Tchibo ahead of Aldi in terms of retail volume shares.

The continued success of Aldi is not simply due to low prices. In 2006, Aldi's fresh ground coffee and coffee pods were rated as 'very good' by the leading consumer magazine *Stiftung Warentest*. In fact, Aldi's coffee pods came out on top, ahead of more premium and more expensive branded products. Quality is very important to German consumers who are prepared to search for tasty products at low prices.

QUESTIONS

1. How do you define and explain Senseo's core competence?
2. Some experts think that consumer interest in coffee pods comprises a fad that will fade away within a few years. Others believe that pods over time will replace filter coffee. What do you think? Please present arguments on the basis of international lifestyle trends.

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QUESTIONS FOR DISCUSSION

1. Explain the differences between the RBV, the MOV and the VBV.
2. What is the connection between the RBV and the RM approach?
3. What is the purpose of the value chain?
4. Why is it relevant to make a split between upstream and downstream activities in the value chain?
5. Is the value chain also a relevant model for services?
6. How can the firm create competitive advantage by the use of resources and competences in the firm?

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