Chapter 3

Internal Analysis
Internal Analysis

- Identifying the strengths and weaknesses of the company
- Managers must understand:
  - The role of resources, capabilities, and distinctive competencies in the process by which companies create value and profit
  - The importance of superior efficiency, innovation, quality, and responsiveness to customers
  - The sources of their company's competitive advantage (strengths and weaknesses)

Competitive Advantage

- Competitive advantage
  - A firm's profitability is greater than the average profitability for all firms in its industry
- Sustained competitive advantage
  - A firm maintains competitive advantage for a number of years

Strategy, Resources, Capabilities, and Competencies

- Value Creation at Burberry
Strategy in Action

Southwest Airlines
Low Cost Structure

Running Case

Comparing Wal-Mart and Target

FILM

WAL*MART

Click for Video: Wal-Mart Global Facts

The Value Chain: Primary and Support Activities

Primary Activities
- Research and development
- Production
- Marketing and sales
- Company infrastructure
- Information systems
- Material management
- Human resources

Support Activities

Value Creation per Unit

\[ U - P = \text{Consumer surplus} \]
\[ P - C = \text{Profit margin} \]
\[ U - C = \text{Value created} \]

Value Creation and Pricing Options

There is a dynamic relationship among utility, pricing, demand, and costs.

Option 1: Raise prices to reflect value

Option 2: Lower prices to generate demand
Comparing Toyota and General Motors

Figure 3.4

Toyota creates more utility
Toyota can charge higher prices
Toyota is more profitable
Toyota has a lower cost structure

Superior value creation requires that the gap between perceived utility ($U$) and costs of production ($C$) be greater than that obtained by competitors.

Strategy in Action

- Competitive Advantage at Zara

Differentiation and Cost Structure: Roots of Competitive Advantage

Competitive Advantage: The Value Creation Cycle

The Generic Building Blocks of Competitive Advantage

Strategy in Action

- The Road to Ruin at DEC
The Durability of Competitive Advantage

The DURABILITY of a company's competitive advantage over its competitors depends on:

1. Barriers to Imitation
   - Making it difficult to copy a company's distinctive competencies
   - Imitating Resources
   - Imitating Capabilities

2. Capability of Competitors
   - Strategic commitment
   - Commitment to a particular way of doing business
   - Absorptive capacity
   - Ability to identify, value, assimilate, and use knowledge

3. Industry Dynamism
   - Ability of an industry to change rapidly

Competitors are also seeking to develop distinctive competencies that will give them a competitive edge.

Why Companies Fail

- Inertia
  - Companies find it difficult to change their strategies and structures
  - Prior strategic commitments
  - Limit a company's ability to imitate and cause competitive disadvantage
  - The Icarus paradox
    - A company can become so specialized based on past success that it loses sight of market realities
    - Craftsmen, builders, pioneers, salesmen

Avoiding Failure: Sustaining Competitive Advantage

1. Focus on the Building Blocks of Competitive Advantage
   - Develop distinctive competencies and superior performance in:
     - Efficiency
     - Quality
     - Innovation
     - Responsiveness to Customers

2. Institute Continuous Improvement and Learning
   - Recognize the importance of continuous learning within the organization

3. Track Best Practices and Use Benchmarking
   - Measure against the products and practices of the most efficient global competitors

4. Overcome Inertia
   - Overcome the internal forces that are barriers to change

Luck may play a role in success, so always exploit a lucky break - but remember: "The harder I work, the luckier I seem to get."

CLOSING CASE

- Southwest Airlines

Course Pack

- Marks & Spencer
End of Lecture 3
Regaining McDonald’s Competitive Advantage

McDonald’s is an extraordinarily successful enterprise.

Started in 1955, when the legendary Ray Kroc decided to franchise the McDonald brothers’ fast-food concept, McDonald’s has grown into the largest restaurant chain in the world with almost 32,000 stores in 120 countries.

For decades, McDonald’s success was grounded in a simple formula: give consumers value for money, good quick service, and consistent quality in a clean environment and they will come back, time and time again. To deliver value for money and consistent quality, it standardized the process of order taking, making food, and service. Standardized processes raised the productivity of employees while ensuring that customers had the same experience in any restaurant. McDonald’s also developed close ties with wholesalers and food producers, managing its supply chain to reduce costs. As it became larger, its buying power enabled it to realize economies of scale in purchasing and to pass on cost savings to customers in the form of low-priced meals, which drove forward demand. And then there was the ubiquity of McDonald's: wherever people went, they could find one of their restaurants. This, coupled with the consistent experience and low prices, drove brand loyalty.
The formula worked well until the late 1990s and early 2000s. By then, McDonald's was under attack for contributing to obesity. Its low-priced, high-fat foods were dangerous, claimed the critics. The company's image was tarnished by the best-selling book, *Fast Food Nation*, and by the documentary, *Super Size Me*, which featured a journalist who rapidly gained weight by eating only McDonald's "super size" meals for a month. By 2002, sales were stagnating, and profits were falling. It seemed that McDonald's had lost its edge.

What followed was a classic corporate makeover that has enabled the company to regain its competitive advantage. First, top management was changed. Then, the emphasis was shifted. McDonald's scrapped its supersize menu and added healthier options, such as salads and apple slices. Executives mined data to see what people were eating and found that people were eating more chicken and less beef. So they emphasized chicken, adding grilled chicken sandwiches, wraps with chicken, Southern-style chicken sandwiches, and, most recently, chicken for breakfast. To be sure, the company still sells many low-cost "dollar meals" consisting of cheeseburgers and fries. Indeed, in the recessionary environment of 2008–2009, sales of dollar meals surged. However, chicken sales doubled at McDonald's between 2002 and 2008, and the company now buys more chicken than beef. The company also decided to use white chicken only, ending the speculation about the "mystery meat" in chicken McNuggets.

The company also changed its emphasis on beverages. For decades, beverages were afterthoughts at McDonald's, but executives could not help but note the rapid growth of Starbucks. In 2006, McDonald's decided to offer better coffee, including lattes. McDonald's improved the quality of its coffee by buying high-quality beans, using better equipment, and filtering its water. The company did not lose sight of the need to keep costs low and service quick, however, and has been adding coffee-making machines that produce lattes and cappuccinos in 45 seconds at the push of a button. Starbucks it is not, but for many people, a latte from the McDonald's drive-through window is good enough. Today, the machines have been installed in almost half of the stores in the United States.

The next change is in the design of the restaurants. The aging design is being phased out, to be replaced with sleek new buildings with trendy furnishings and lights, wide screen TVs, and Wi-Fi connections. The idea is to raise the perception of quality and, thereby, capture more customers.

Thus far, the changes seem to be working. Both sales and profits have been growing at a healthy clip, despite a difficult economic environment. In 2008, net profits were $4 billion, up from $1.7 billion in 2002, while revenues expanded from $15.4 billion to $24 billion. Profitability has also improved, with McDonald's return on invested capital (ROIC) increasing from 9.4% in 2002 to 18% in 2008.
Value Creation at Burberry

When Rose Marie Bravo, the highly regarded president of Saks Fifth Avenue, announced in 1997 that she was leaving to become CEO of the ailing British fashion house Burberry, people thought she was crazy. Burberry, best known as a designer of raincoats with the trademark tartan linings, had been described as an outdated, stuffy business with a fashion cachet of almost zero. When she stepped down from the Burberry position in 2006, Bravo was heralded in Britain and the United States as one of the world’s best managers. During her tenure, she had engineered a remarkable turnaround, leading a transformation of Burberry into what one commentator called an “achingly hip” high-end fashion brand whose famous tartan bedecks everything from raincoats to bikinis and handbags to luggage in a riot of color from pink to blue to purple. In less than a decade, Burberry had become one of the most valuable luxury fashion brands in the world.

When asked how she achieved the transformation, Bravo explained that there was hidden brand value that was unleashed by constant creativity and innovation. Bravo hired world-class designers to redesign Burberry’s tired fashion line and bought in Christopher Bailey, one of the very best, to lead the design team. The marketing department worked closely with advertisers to develop hip ads that would appeal to a younger, well-heeled audience. The ads featured supermodel Kate Moss promoting the line, using a top fashion photographer to shoot the model wearing Burberry. Burberry exercised tight control over distribution, pulling its products from stores whose image was not consistent with the brand, and expanding its own chain of Burberry stores.

Bravo also noted that “Creativity doesn’t just come from designers … ideas can come from the sales floor, the marketing department, even from accountants, believe or not. People at whatever level they are working have a point of view and have something to say that is worth listening to.” Bravo emphasized the importance of teamwork. “One of the things I think people overlook is the quality of the team. It isn’t one person, and it isn’t two people. It is a whole group of people—a team that works cohesively toward a goal—that makes something happen or not.” She noted that her job is to build the team and then motivate them, “keeping them on track, making sure that they are following the vision.”

Strategy in Action

**Southwest Airlines’ Low Cost Structure**

Southwest Airlines has long been one of the standout performers in the U.S. airline industry. It is famous for its low fares, which are generally some 30 percent below those of its major rivals, and these are balanced by an even lower cost structure, which has enabled it to record superior profitability even in bad years such as 2003, when the industry faced slumping demand. Southwest was the only airline among the top eight in the United States to show a profit for the quarter immediately following the September 11 terrorist attacks on the World Trade Center and the Pentagon.

A major source of Southwest’s low cost structure seems to be its very high employee productivity. One way the airlines measure employee productivity is by the ratio of employees to passengers carried. According to figures from company 10-K statements, in 2003 Southwest had an employee-to-passenger ratio of 1 to 1,999, one of the best in the industry. By comparison, the ratio at one of the better major airlines, Continental, was 1 to 1,420. These figures suggest that, holding size constant, Southwest runs its operation with far fewer people than competitors. How does it do this?

First, Southwest devotes enormous attention to the people it hires. On average, the company hires only 3 percent of those interviewed in a year. When hiring, it emphasizes teamwork and a positive attitude. Southwest rationalizes that skills can be taught but a positive attitude and a willingness to pitch in cannot. Southwest also creates incentives for its employees to work hard. All employees are covered by a profit-sharing plan, and at least 25 percent of an employee’s share of the profit-sharing plan has to be invested in Southwest Airlines stock. This gives rise to a simple formula; the harder employees work, the more profitable Southwest becomes, and the richer the employees get. The results are clear. At other airlines, one would never see a pilot helping to check passengers onto the plane. At Southwest, pilots and flight attendants have been known to help clean the aircraft and check in passengers at the gate. They do this to turn around an aircraft as quickly as possible and get it into the air again, because an aircraft doesn’t make money when it is sitting on the ground.

Southwest also reduces its costs by striving to keep its operations as simple as possible. By operating only one type of plane, the Boeing 737, it reduces training costs, maintenance costs, and inventory costs while increasing efficiency in crew and flight scheduling. The operation is nearly ticketless, which reduces cost and back-office accounting functions. Because there is no seat assignment, costs are again reduced. There are no meals or movies in flight, and the airline will not transfer baggage to other airlines, reducing the need for baggage handlers. Another major difference between Southwest and most other airlines is that Southwest flies point to point rather than operating from congested airport hubs. As a result, its costs are lower because there is no need for dozens of gates and thousands of employees to handle banks of flights that come in and then disperse within a two-hour window, leaving the hub empty until the next flights a few hours later.

However, success can bring its own problems, and this is starting to occur at Southwest. While other airlines have been able to get significant pay concessions from their employees in recent years, employees at Southwest have successfully lobbied for higher pay. After two years of sometimes bitter disputes, which have damaged the once harmonious culture at Southwest, in mid 2004 the company’s airlines attendants won a 31 percent pay increase spread out over five years. With mechanics and pilots set to enter negotiations next, some observers are now worrying that Southwest’s cost structure will rise, eroding the airline’s cost-based competitive advantage.6
CHAPTER 3  Internal Analysis: Distinctive Competencies, Competitive Advantage, and Profitability

FIGURE 3.8
Competitive Advantage and the Value Creation Cycle

Distinctive competencies are firm-specific strengths that allow a company to achieve superior efficiency, quality innovation, and responsiveness to customers.

A company develops a business model that uses its distinctive competencies to differentiate its products and/or lower its cost structure.

A company implements a set of strategies to configure its value chain to create distinctive competencies that give it a competitive advantage.

Business Model

Competitive Advantage
and
Superior Profitability

Strategies

Distinctive Competencies
RUNNING CASE

Comparing Walmart and Target

For the financial year ending January 2008, Walmart earned a ROIC of 14.1%, while Target earned a respectable 10.6%. Walmart’s superior profitability can be understood in terms of the impact of its strategies on the various ratios identified in Figure 3.9. These are summarized in Figure 3.10.

First, note that Walmart has a lower ROS than Target. This is because Walmart’s COGS as a percentage of sales are higher than Target’s (76.5% versus 66.1%). For a retailer, the COGS reflect the price that Walmart ‘pays’ to its suppliers for merchandise. The lower COGS/Sales ratio implies that Walmart does not mark up prices as much as Target—its profit margin on each item sold is lower. Consistent with its long-time strategic goal, Walmart passes on the low prices it gets from suppliers to customers. Walmart’s higher COGS/Sales ratio reflects its strategy of being the lowest-price retailer.
3.2 STRATEGY IN ACTION

Competitive Advantage at Zara

The fashion retailer Zara is one of Spain's fastest growing and most successful companies with sales of some $8.5 billion and a network of 2,800 stores in 64 countries. Zara's competitive advantage centers on one thing—speed. While it takes most fashion houses six to nine months to go from design to having merchandise delivered to a store, Zara can pull off the entire process in just five weeks. This rapid response time enables Zara to quickly respond to changing fashions.

Zara achieves this by breaking many of the rules of operation in the fashion business. While most fashion houses outsource production, Zara has its own factories and keeps about half of its production in-house. Zara also has its own designers and stores. Its designers are in constant contact with the stores, not only tracking what is selling on a real-time basis through information systems but also talking to store managers once a week to get their subjective impressions of what is hot. This information supplements data gathered from other sources, such as fashion shows.

Drawing on this information, Zara's designers create approximately 40,000 new designs per year from which 10,000 are selected for production. Zara then purchases basic textiles from global suppliers but performs capital intensive production activities in its own factories. These factories use computer-controlled machinery to cut pieces for garments. Zara does not produce in large volumes to attain economies of scale; instead it produces in small lots. Labor-intensive activities, such as sewing, are performed by subcontractors located close to Zara's factories. Zara makes a practice of having more production capacity than necessary, so that if an emerging fashion trend is spotted, the company can quickly respond by designing garments and ramping up production.

Once garments have been made, they are delivered to one of Zara's warehouses and then shipped to its stores weekly. Zara deliberately underproduces products, supplying small batches of products in hot demand before quickly shifting to the next fashion trend. Often the merchandise sells out quickly. The empty shelves in Zara stores create a scarcity value—which helps to generate demand. Customers quickly snap up products they like because they know they may soon be out of stock and not produced again.

As a result of this strategy, which is supported by competencies in design, information systems, and logistics management, Zara carries fewer inventories than competitors (Zara's inventory amounts to about 10% of sales, compared to 15% at rival stores like Gap Inc. and Benetton). This means fewer price reductions to move products that have not sold and higher profit margins.

Digital Equipment Corporation (DEC) was one of the premier computer companies of the 1970s and 1980s. DEC's original success was founded on the minicomputer, a cheaper, more flexible version of its mainframe cousins that Ken Olson and his brilliant team of engineers invented in the 1960s. They then improved on their original minicomputers until they could not be beat for quality and reliability. In the 1970s, their VAX series of minicomputers was widely regarded as the most reliable series of computers ever produced, and DEC was rewarded by high profit rates and rapid growth. By 1990, it was number 27 on the Fortune 500 list of the largest corporations in America.

Buoyed by its success, DEC turned into an engineering monoculture: its engineers became idols; its marketing and accounting staff, however, were barely tolerated. Component specs and design standards were all that senior managers understood. Technological fine-tuning became such an obsession that the needs of customers for smaller, more economical, user-friendly computers were ignored. DEC's personal computers, for example, bombed because they were out of touch with the needs of customers, and the company failed to respond to the threat to its core market presented by the rise of computer workstations and client-server architecture. Indeed, Ken Olson was known for dismissing such new products. He once said, “We always say that customers are right, but they are not always right.” Perhaps. But DEC, blinded by its early success, failed to remain responsive to its customers and changing market conditions.

By the early 1990s, DEC was in deep trouble. Olson was forced out in July 1992, and the company lost billions of dollars between 1992 and 1995. It returned to profitability in 1996, primarily because of the success of a turnaround strategy aimed at reorienting the company to serve precisely those areas that Olson had dismissed. In 1998, the company was acquired by Compaq Computer Corporation and disappeared from the business landscape as an independent entity.
Southwest Airlines

Southwest Airlines has long been one of the standout performers in the U.S. airline industry. It is famous for its low fares, which are often some 30% lower than those of its major rivals. These are balanced by an even lower cost structure, enabling it to record superior profitability even in bad years such as 2002, when the industry faced slumping demand in the wake of the September 11 terrorist attacks. Indeed, from 2001 to 2005, quite possibly the worst four years in the history of the airline industry, while every other major airline lost money, Southwest made money every year and earned an ROIC of 5.8%. Even in 2008, an awful year for most airlines, Southwest made a profit and earned an ROIC of 4%.

Southwest operates somewhat differently from many of its competitors. While operators like American Airlines and United Airlines route passengers through hubs, Southwest Airlines flies point-to-point, often through smaller airports. By competing in a way that other airlines do not, Southwest has found that it can capture enough demand to keep its planes full. Moreover, because it avoids many hubs, Southwest has experienced fewer delays. In the first eight months of 2008, Southwest planes arrived on schedule 80% of the time, compared to 76% at United and 74% at Continental.

Southwest flies only one type of plane, the Boeing 737. This reduces training costs, maintenance costs, and inventory costs while increasing efficiency in crew and flight scheduling. The operation is nearly ticketless, with no seat assignments, which reduces cost and back-office accounting functions. There are no meals or movies in flight, and the airline will not transfer baggage to other airlines, reducing the need for baggage handlers.

Southwest also has high employee productivity. One-way airlines measure employee productivity by the ratio of employees to passengers carried. According to figures from company 10-K statements, in 2008 Southwest had an employee-to-passenger ratio of 1 to 2,400, the best in the industry. By comparison, the ratio at United Airlines was 1 to 1,175 and, at Continental, it was 1 to 1,125.

Southwest devotes enormous attention to the people it hires. On average, the company hires only 3% of those interviewed in a year. When hiring, it emphasizes teamwork and a positive attitude. Southwest rationalizes that skills can be taught, but a positive attitude and a willingness to pitch in cannot. Southwest also creates incentives for its employees to work hard. All employees are covered by a profit-sharing plan, and at least 25% of an employee's share of the profit-sharing plan has to be invested in Southwest Airlines stock. This gives rise to a simple formula: the harder employees work, the more profitable Southwest becomes, and the richer the employees get. The results are clear. At other airlines, one would never see a pilot helping to check passengers onto the plane. At Southwest, pilots and flight attendants have been known to help clean the aircraft and check in passengers at the gate. They do this to turn around an aircraft as quickly as possible and get it into the air again because an aircraft does not make money while it is on the ground. This flexible and motivated workforce leads to higher productivity and reduces the company's need for more employees.

Because Southwest flies point-to-point rather than through congested airport hubs, there is no need for dozens of gates and thousands of employees to handle banks of flights that come in and then disperse within a two-hour window, leaving the hub empty until the next flights a few hours later. The result: Southwest can operate with far fewer employees than airlines that fly through hubs.

Case Discussion Questions
1. How would you characterize the business model of Southwest Airlines? How does this differ from the business model used at many other airlines, such as United and American Airlines?
2. Identify the resources, capabilities, and distinctive competencies of Southwest Airlines.
3. How do Southwest's resources, capabilities, and distinctive competencies translate into superior financial performance?
4. How secure is Southwest's competitive advantage? What are the barriers to imitation here?
MARKS & SPENCER (M&S) is a British retailing institution. Founded in 1884 by Michael Marks, a Polish Jew who had emigrated to England, the company has been a national chain since the early 1900s. By 1926, the company had a branch in every major town in the country and had become Britain's largest retailer, a position it still holds in 2000. Primarily a supplier of clothing and foodstuffs, M&S is one of the world's most profitable retailers. In 1999, M&S's 300 United Kingdom stores had sales of over 7 billion pounds sterling, accounted for 15 percent of all retail clothing sales in the United Kingdom and 5 percent of all food sales. According to the Guinness Book of Records, in 1991 the company's flagship store at Marble Arch in London had a turnover of $3,700 per square foot—more than any other department store in the world.

M&S provides a selective range of clothing and food items aimed at rapid turnover. The firm sells all its products under its own St. Michael's label. M&S offers high-quality products at moderate rather than low prices. This combination of high quality and reasonable price encourages customers to associate M&S with value for money, and the firm's ability to deliver this combination consistently over the years has built up enormous customer goodwill in Britain. So strong is M&S's reputation among British consumers that the company does no advertising in that market.

To achieve the combination of moderate prices and high quality, M&S works very closely with its suppliers, many of whom have been selling a major portion of their output to M&S for generations. The focus on quality is reinforced by M&S's practice of having its technical people work closely with suppliers on product design. Suppliers are more than willing to respond to the firm's demands, for they know that M&S is loyal to its suppliers and as it grows so do they. The sales volume generated by M&S's strategy of providing only a selective range of clothing and food enables M&S's suppliers to realize substantial economies of scale from large production runs. These cost savings are then passed on to M&S in the form of lower prices. In turn, M&S passes on part of the savings to the consumer.

Crucial to M&S's effectiveness is a clear focus on the customer. The tone is set by top management. Each senior manager makes a habit of wearing M&S clothes and eating M&S food. Thus, managers develop an understanding of what it is that customers want and like about M&S products; by staying close to the customer, they can improve the quality and design of the products they offer. The customer focus is reinforced at the store level by store managers who monitor sales volume and quickly identify lines that are selling and those that are not. Then store managers can transmit this information to suppliers, which have the capacity to quickly modify their production, increasing the output of lines that are selling well and reducing the output of lines that are not moving.

Another central feature of M&S is its pioneering approach to human relations. Long before it became fashionable to do so, M&S had developed a commitment to the well-being of its employees. M&S has always viewed itself as a family business with a broad responsibility for the welfare of its employees. It offers employees medical and pension plans that provide benefits that are well above the industry average. The company pays its employees at a rate that is also well above the industry average, and it makes a practice of promoting employees from within, rather than hiring from outside. Furthermore, there are a series of in-store amenities for employees, including subsidized cafeterias, medical services, recreation rooms, and hairdressing salons. The reward for M&S is the trust and loyalty of its employees and, ultimately, high employee productivity.

Just as vital is the company's commitment to simplifying its operating structure and strategic control systems.
M&S has a very flat hierarchy; there is little in the way of intervening management layers between store managers and top management. The firm utilizes just two profit margins, one for foodstuffs and one for clothing. This practice reduces bureaucracy and frees its store managers from worrying about pricing issues. Instead, they are encouraged to focus on maximizing sales volume. A store's performance is assessed by its sales volume. Control is achieved partly through formal budgetary procedures and partly through an informal probing process, in which top management drops in unannounced at stores and quizzes managers there about the store. In a typical year, just about every store in Britain will receive at least one unannounced visit from top management. This keeps store managers on their toes and constantly alert to the need to provide the kind of value-for-money products that customers have come to associate with M&S.

Case Discussion Questions

1. What do you think is the source of Marks & Spencer's competitive advantage?

2. Marks & Spencer has managed to maintain its competitive advantage in British retailing for more than fifty years. Why, do you think, have rival firms found Marks & Spencer's competitive position so difficult to attack?