Study Notes

Paper P2
Performance Management (also relevant to paper P1) p50

Paper E2 Enterprise Management

Apple has earned a distinct competitive advantage in the technology market, but can this be attributed to the traditional positioning approach to strategic planning or to the emergent resource-based view?

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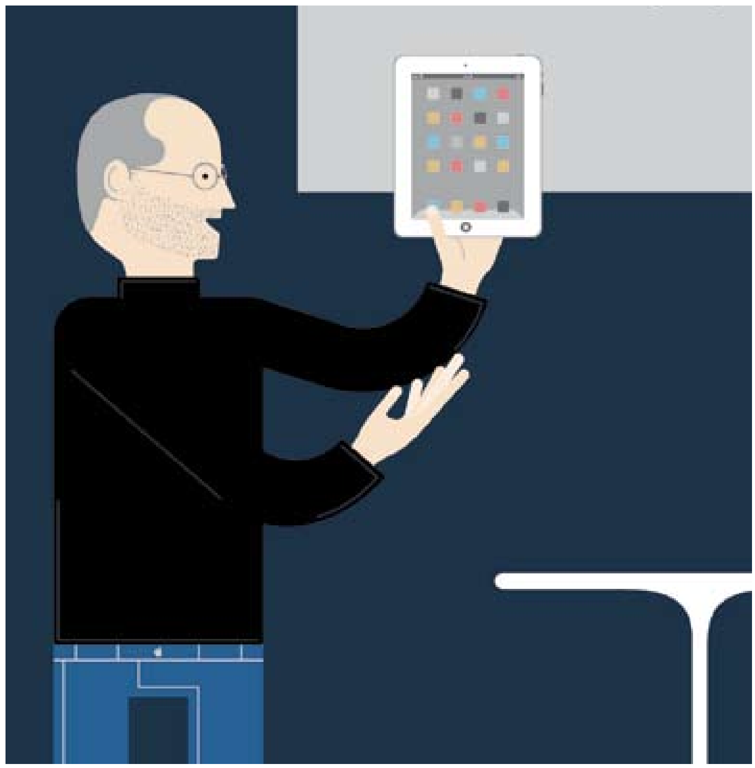

This January, at the end of the longest recession in decades, Apple cemented its place among the world's leading companies by announcing that buoyant sales of its iPad and iPhone had produced record quarterly results. The figures exceeded investors' expectations and assuaged their fears about the company after Steve Jobs' sudden decision to take medical leave from the role of CEO.

The company describes itself as follows: "Apple designs Macs, the best personal computers in the world, along with OS X, iLife, iWork and professional software. Apple leads the digital music revolution with its iPods and iTunes online store. Apple is reinventing the mobile phone with its revolutionary iPhone and App Store, and has recently introduced its magical iPad, which is defining the future of mobile media and computing devices."

These claims may seem excessive, but they do indicate the company's main areas of business and aspirations. Apple operates in a cutthroat and fast-changing market where a failure to compete with your rivals' latest products can have damaging consequences. Nokia provides a case in point: unable to develop a smartphone to compete with those

CORRECTION:
On page 45 of the April edition of FM, a study notes article states that:
"X's current WACC is: [Kd x 0.8] + [Kd(1 - t) x 0.2] = [(10% + 1.8{15% - 10%}) x 0.8] + [10%{1 - 0.3}) x 0.2] = 16.6%"
The first "Kd" in this statement should have read:
"X's current WACC is: [Ke x 0.8] + [Kd(1 - t) x 0.2] = [(10% + 1.8{15% - 10%}) x 0.8] + [10%{1 - 0.3}) x 0.2] = 16.6%"
A corrected version of this article is available at www.fm-magazine.com

Paper E2 Enterprise Management

of market leaders Apple and Google, it has been forced into an alliance with Microsoft.

Two decades ago – and sometimes even today – Apple's achievements might have been attributed to some form of clever formal strategic planning. This would normally involve an appraisal of the organisation's strengths, weaknesses, opportunities and threats (Swot analysis) and the application of other frameworks – eg, Pest analysis and Michael Porter's five forces model. The aim of all this was to help the business position itself most favourably in relation to its rivals, suppliers, customers and other key stakeholders (the positioning approach), because competitive advantage was – and is – claimed to derive from a firm's ability to find the most advantageous position. At the same time, a number of generic strategies, including Porter's typology of cost leadership, differentiation and focus, offered a menu of policies from which a company might choose in order to gain an advantage. If it had access to cheap labour, for instance, it might take this opportunity by driving its costs down and undercutting its rivals – ie, pursuing a strategy of cost leadership. By contrast, an enterprise such as Apple, which set itself the goal of being an innovator, might build on the design skills it had acquired to pursue a differentiation strategy and compete on product quality.

But in recent years the emergence of resource-based theory has led to a change in thinking. It has shifted the emphasis of strategy development from an outside-in focus to an inside-out view. The new approach assumes that the secret of competitive advantage has more to do with identifying, developing and exploiting the organisation's core resources and capabilities (sometimes called "competences") than with trying to find the best position for the organisation in its environment. More particularly, the resource-based approach assumes that an organisation is a collection of resources and capabilities that are rare or even unique, and that these should provide the basis for its competitive strategy. Although companies can acquire new ones as they develop, it takes time to do this, so a firm already possessing a relevant set of value-adding resources can gain an advantage.

Feel or no feel?

The resource-based approach typically classifies resources into two types: tangible and intangible. The former are inputs that can be seen, touched and/or quantified. They include assets such as plant and equipment; access to raw materials and finance; and a skilled workforce. The latter include intellectual property rights such as patents and trademarks; the firm's reputation and organisational culture; and its employees' knowledge and informal networks. The dividing line between tangibles and intangibles is often unclear and theorists differ on how they classify them. Despite the classification problems, they do agree that, while both types are necessary for any business to work, intangible resources are the most likely source of competitive advantage. Their reasoning is that a company's intangible resources are harder for its rivals to understand, substitute or imitate.

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But merely possessing such resources is not the basis for achieving a competitive advantage; it's the way in which an organisation integrates them with each other to perform activities. The most important resources for any organisation, therefore, are the skills and knowledge of its employees. Acquired over time and embedded in the corporate culture, these are the resources that influence how the business operates and determines its success.

Of the various contributions to the resource-based approach, the theories of John Kay, visiting professor at the London School of Economics, seem particularly appropriate to an explanation of Apple's success. Kay believes that sustainable competitive advantage derives from three related sources: architecture, reputation and innovative capability.

An organisation's architecture is the system of relational contracts that exist both internally and externally. The internal architecture refers to relationships among employees. The external architecture refers to the company's relationships with customers and suppliers. The firm may also engage in collaborative relationships with rivals – as Apple has done with Microsoft. Kay argues that a business with a distinctive architecture can create an organisational knowledge that is more than the sum of its employees' efforts. To be sustainable, these relational contracts must be hard for rivals to identify and copy. Such relationships must be implicit, complex and subtle – the lack of formalisation makes imitation difficult and ensures that the architecture remains a source of advantage. This is particularly relevant in Apple's case. Industry analysts have long observed the great secrecy with which it guards its product development processes. The company's success in this area is a testament to its ability to surprise the market with its innovative products.

Reputation is especially important in markets where consumers can gauge the quality of a firm's products only from long-term experience. But, once trust has been established, it can give the company a distinctive capability. The brand loyalty of Apple's customers is legendary and the company has made the most of this when entering related markets.

According to some theorists, the ability to innovate successfully, as Apple has done in recent years, is the most important source of competitive advantage. Kay thinks this may derive partly from the internal architecture as innovation processes become embedded in organisational routines. By seeking patents and copyrights, organisations can protect innovative products and ensure that they gain full value from their R&D investments. But sometimes such safeguards may not be adequate in hyper-competitive high-tech markets. A more realistic course of action in such circumstances is a strategy of continuous product development that enables the business to stay ahead of its rivals. This seems to characterise Apple's current strategy.

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The height of ambition

A number of writers have referred to the notion of strategic intent (sometimes referred to as an organisation's determination to stretch its core competences). This term was coined by HR management professors Gary Hamel and C K Prahalad to describe how a firm would apply its resources to achieve what might at first seem impossible goals in the face of the competitive forces confronting it. Cases of strategic intent cited by various authors include:

- Otis Elevators calling on its staff to pursue the industry holy grail of finding a way to move people up and down a mile-high building.
- Texas Instruments urging its employees to "find new businesses in the white spaces" among its existing business units.
- DuPont asking its scientists to help the company "invent its way" out of its financial malaise.

We might justifiably add to this list Apple's target of becoming the leading innovator in the mobile phone and tablet PC market. Because the idea of strategic intent implies that an organisation's ambitions are temporarily beyond its capabilities, management academics have also considered how these might be best acquired. Because this is a developing field, a range of views exist. For example, Peter Senge and Chris Argyris stress the importance of internal methods of learning, while Hamel and Prahalad set more store by external tools such as licensing and alliances. Writers who favour the internal approach do so because they think it gives the advantages of secrecy, exclusivity and surprise. The proponents of external methods prefer these on the grounds of the flexibility and speed they offer.

Apple appears to have used both methods. It has nurtured internal learning to a point where its innovative capability to produce ever-better products is a constant source of surprise to outsiders. It has also formed alliances with a range of other organisations where these have been in its interests.

When Apple entered the mobile market in 2007, a survey asked senior executives worldwide to rank the 50 most innovative companies. For the third year running, Apple topped their list. A similar poll today would probably give the same result, but we shouldn't conclude that the ability to innovate is all that's needed for success. While the development of new products is clearly a great source of advantage, it's not enough on its own. New products need to be made efficiently at the right quality and delivered to the market at the right price. Apple has sometimes failed to do this – for instance, when it has had insufficient production capacity to satisfy demand. But the company's recent performance suggests that it has learned from such mistakes and developed core competences in other areas to enable it to remain the world's number-one technology company.

Exam practice

Now try the following question to test your understanding of resource-based view (the panel on the next page contains a model answer):

(a) Explain how you would formulate a strategy for your organisation using the insights developed by resource-based theorists (*15 marks*).

(b) Discuss the proposition that the resource-based approach to competitive advantage is of limited usefulness to managers (*10 marks*).

Paper E2
Enterprise Management

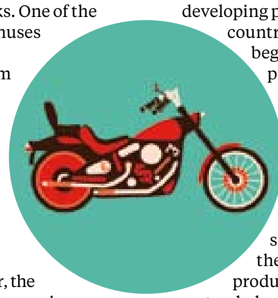
MODEL ANSWER TO THE EXAM PRACTICE QUESTION

(a) The resource-based view assumes that an advantage can be gained by exploiting a firm's resources and capabilities rather than securing it a favourable position in its environment. It also assumes, as Jay Barney has argued, that resources and capabilities must be valuable, rare and hard to copy or substitute. It follows, therefore, that these must be evaluated before a strategy can be formed.

Most theorists refer to resources as what a company possesses, and to its capabilities (or "competences") as the processes through which it uses its resources to work effectively – eg, delivering excellent service. Gerry Johnson and Kevan Scholes make the distinction between the "threshold" resources and competences that a firm must have merely to survive and the unique resources and core competences that underpin its advantage. Any analysis of resources and capabilities will, therefore, have a much better chance of creating a competitive strategy if it can identify the latter type. The classification of resources will depend partly on the industry, but one general classification might cover capital equipment (eg, buildings and plant); the skills and knowledge of staff; and items such as patents, customer databases etc.

Michael Porter's value chain is generally viewed as a useful means of analysing processes, as it provides a systematic ordering of activities for a typical manufacturer. The following example illustrates an application of this method, which can be used by any business (service companies may need to adapt it to make it relevant). Toyota's inbound logistics inventory and material control systems are widely recognised in the car industry for enabling the company to maintain enough inventory to meet demand by having parts delivered just in time before assembly. In respect of other primary activities in its value chain, such as operations, Toyota's efficient, automated plants are packed with quality-control systems. All this is supported by sales and marketing via global advertising and dealership networks offering warranties. And Toyota's value-chain activities are configured with those of its suppliers in a way that provides the core competences that give the company its competitive advantage.

But even giants such as Toyota must always benchmark their value-chain activities. In 2009 it had to recall millions of cars owing to faults with key components. Such cases highlight the need for vigilance and the importance of upgrading resources constantly. Because resources depreciate and capabilities can be imitated over time, there is a constant need to monitor any erosion, checking that the organisation is not falling behind. There is a particular need to retain individuals whose skills are crucial to the organisation's core competences. Examples include the investment banking sector, where a few talented people often earn billions for their banks. One of the reasons why large bonuses are paid is to prevent these individuals from being recruited by rival banks.



The control that a firm has over the mobility of its capabilities varies among industries. In some, the nature of organisational routines – in particular, the tacit knowledge and unconscious coordination embedded in the culture – makes them hard to replicate in a new setting. In others, the dependence of an organisation on the skills of a few people means that a loss of capability to the competition poses a real threat.

Formulating strategy using a resource-based framework involves reviewing the information on strengths and weaknesses gained from benchmarking and choosing a strategy that builds on the strengths and compensates for the weaknesses. An example of this is the way in which Harley-Davidson restored its fortunes in the mid-eighties. The key to its success was the management's recognition that the sole durable, irreplaceable asset was the Harley image of individuality and ruggedness – and the loyalty that this inspired. In almost every other aspect of performance, including cost and quality, the firm trailed its Japanese rivals. It decided to build on its image while minimising its failings in other areas. The motorbikes it introduced in this period were based on traditional design features, while the marketing strategy involved extending the appeal of the Harley image from its traditional customer base to a more wealthy clientele. The firm exploited the brand via extensive licensing and at the same time protected it by imposing tougher controls on dealers. While Harley also improved the quality of its bikes over this period, it was the broadening of their market appeal that proved vital.

The final stage of strategy formulation is the identification of resource gaps and the development of resources and capabilities to extend positions of competitive advantage into the future. Matsushita provides an example of this process. When developing production in a foreign country, the firm typically began by making simple products such as batteries and then moved on to producing goods requiring greater manufacturing and marketing sophistication. The skills learned during the production of simple products were refined and extended, enabling the firm to make more complex products. This strategy of developing capabilities that can then be used as the basis for broadening the product range is commonly applied by companies pursuing strategies of related diversification.

(b) The fact that the resource-based view is now standard textbook fare – and that managers increasingly talk of "building core competences to gain a competitive advantage" – might suggest that questions about its usefulness are superfluous. Yet numerous writers have their doubts. One of their objections concerns the theory that states that capabilities lead to competitive advantage because they are rare and valuable, and then defines competitive advantage in terms of rarity and value. This, the critics argue, verges on tautology (a statement that is necessarily true).

Others have similarly argued that to say that one business performs better than another because it has superior resources or is better at doing certain things is stating the obvious. As some researchers rightly point out, such statements can be helpful only if it's possible to specify which capabilities are important – and why.

A further objection concerns the lack of specificity in much of the literature on the resource-based view. For instance, the claimed importance of "tacit knowledge" as a basis of competitive advantage, while plausible in theory, is hard to deal with, especially as it's inherently unknowable. This is also the case for other claims about the bases of competitive advantage – eg, "reputation" and "organisational culture". Such terms mean little unless we can be specific about the activities that comprise them.

Barney, one of the main exponents of the resource-based approach, admits that some of these points are valid, but he maintains that it is of practical use to managers because it highlights the need to identify and develop the most critical capabilities.

Other problems with the resource-based view include the argument that, because of its focus on particular products and markets, it may point to strategies that deplete a firm's wider core competence. For example, by deciding to withdraw from a market or cut costs by outsourcing, it risks losing crucial sources of organisational learning.

Even when a firm is involved in a range of industries and has a unique core competence across them all, there is no guarantee of an advantage against more focused players in each market. For example, in the eighties IBM had a unique global architecture and reputation, and it owned proprietary technology, but this did not save it from being beaten by focused rivals in each of its sub-industries.

Lastly, the resource-based approach starts with a decision about what makes the organisation unique, and builds strategy on the core competences identified. It necessarily involves finding an appropriate environment and/or adaptation of the environment to fit the business. But few businesses are large enough to be able to shape their environment.

Illustration: Denis Carrier/Dutch Uncle

Further reading A Norton and J Hughes, *Enterprise Management – CIMA Official Learning System*, CIMA Publishing, 2009.