5 Company Analysis: *Porter's Value Chain Concept*

Strategic company analysis

A company is a socioeconomic phenomenon focused on shaping the value system in the relationship with suppliers, distributors and customers.[1] There are two approaches to determine the paradigm of company success. These approaches model the company profile (its internal foundations and its created effects). The two approaches are as follows: (a) The conventional approach and (b) the contemporary approach. The *conventional approach* starts with the basic goal – the profit. The purpose of this approach is to strive towards an optimal combination of limited resources (maximal yield with reduced costs). According to Michael Porter, one of two sources of competitive advantage – low cost – can be found at the basis of this approach. In this approach, the underlying criteria for following a business strategy is the so-called *comparative advantage*. The effect should surpass the investment through the possibility of low prices or higher profit at identical prices in relation to competitors. The *contemporary approach* starts from the basic goal – economic added value. The purpose of this approach is to strive towards an optimal combination of limited resources (maximal yield with reduced costs). According to Michael Porter, the basic criteria for following business strategy is one of the two sources of competitive advantage – differentiation. This approach recognises the so-called *competitive advantage* as the main criteria for following a business strategy. The effect should surpass the investment through the possibility of higher prices or higher economic added value at increased prices in relation to competitors.

The new concept of organisation is composed of strategic business units – SBUs, which represent the infrastructure for achieving goals. In up-to-date practice, the companies have optimised their business operations following the logics of SBUs (Mašić, 2014), whereas companies will optimise their business operations following the essential core competences in its future practical work. The two concepts of organisational structure change are shown in Table 5.1.

According to Michael Porter (1980), the direction of strategic business unit operations can be offensive and defensive, i.e. oriented towards positioning starting from a given schedule of factors which define the industry

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Table 5.1 Two concepts: strategic business unit or essential core competences

Characteristics	*Strategic business unit*	*Essential core competences*
Competition framework	Competitiveness among companies to establish a position	Companies competing to build core competences
Organisational structure	Portfolio of associated jobs in terms of the product-market relation	Portfolio of core competence in terms of the product-job relation
Unit status	Autonomy is sacred; SBU is the source of all resources	Alliance is sacred; SBU is the reservoir of all resources
Resource allocation	Particular businesses are analysis units; individual capital allocation	Core competences are analysis units; collective capital allocation
Added value	Optimising the yield on invested capital through capital allocation and business balance	Creating the architecture strategy by building core competence and securing the future

Source: Adapted from Prahalad and Hamel (1990).

structure, occupying such a position to successfully amortise the effect of unfavourable circumstances and focusing its activities at areas where the effect of the given factors is the weakest.

This influences the balance of given factors by actively influencing the constellation of the previously mentioned industry structure factors by means of different innovations or integrations, securing a perspective of business development in an industry. The result of such actions can be the utilisation of expected changes by relying on a timely application of new opportunities which will arise in an anticipated evolution of industry business conditions. A strategic business unit is *the smallest organisational part of a company for which there is a possibility of forming a business strategy* (Todorović et al., 2000).

After a company defines its mission,[2] vision[3] and goals,[4] it positions its own business in a company value chain. Following the logic of a systematic approach in the context of input-output relations, the company takes over the supplier value as its input to transform the respective value into a new value which is transferred to customers via distributors. This means that the company value chain describes the way of observing the business process as a chain of activities transforming inputs into buyer outputs. It also adds value to the final product in the process (Šunje, 2002).

The concept of added value analysis was introduced by Michael Porter (1985) who based his research on accounting practices of calculating added value through individual stages in the production process. This has led Michael Porter to transfer the idea to a company as a whole, proving that there is a necessity for a separate research of each individual activity in order to determine the sources of competitive advantage (Tipurić et al., 2010). Such an approach creates the possibility of treating the value chain as a separate unity, but keeping in mind that the company value chain is just a part of industry chain forming the following: (a) Upstream value, (b) channel value and (c) downstream value. Sustaining competitive advantage depends on the manner in which the company manages its own value chain. This leads to the creation of the *value system*. The basis of business operations is the business model which is most accurately described by the configuration of activities. Today, it is possible to measure and quantify the contribution of each individual activity due to modern development. Michael Porter defines the activity configuration as a value chain. Value chain, in its formation phase, copied the value chain rationale called the *thread* (French *filirere*), which describes the physical flow of the input, operations and output reflecting the relations in a particular period of time. Value chain[5] is a *concept that facilitates the disaggregation of a business into strategically relevant activities*. The process offers an easier way of considering the value chain and identifying the activities where there is a key competence which can be exploited through business strategy. Focusing on the activities within the value chain provides an insight into activities which can be utilised to create competitive advantage. Value chain generates a value which represents the amount a buyer is willing to pay for the product. Buyer value is calculated using three core groups of activities:

1 Activities differentiating a product from other same products;
2 Activities creating low cost of a product compared with other same products;
3 Activities that offer the possibility of quickly meeting the buyer's demands.

Such defined value is characterised by *total revenue*. A company generates *profit* if *the value* surpasses *the expenses*. Consequently, the analysis of creating and sustaining competitive advantage focuses on *value* rather than *cost*. This is the purpose of a business strategy, particularly to differentiate between business strategy and operational effectiveness. The company value chain portraits the total value, i.e. it consists of activities and profit (Todorović et al., 2000).

A company has to analyse the three aforementioned activities, irrespective of whether it conducts them or not since it is the sole condition for creating a value system to be used as a platform for building competitive advantage. The following needs to be defined in the process (Đuričin et al., 2015):

a The most critical activities in a value chain which either reduce costs or increase value;
b Key expenses or leading activities in a value chain which either reduce costs or increase value;
c The most important relations in a value chain which either reduce costs or increase value.

Activities include physical steps to be taken to create a product, whereas the profit is the difference between total income and total cost. Activities are identified solely at companies whereas profit is identified at companies and at suppliers and distributors too, since it is a part of total cost covered by the buyer. Correlating is important since the supplier, the distributor and the buyer all influence the value in a value system. Only a handful of companies cover each and every activity in a value chain. Ford Motor Company can serve as an example since it has been completely vertically integrated[6] from producing steel to selling cars. However, it had a negative effect on the employees who were being exploited. Charlie Chaplin pointed out their status in the company as well as the general exploitation of workers in his popular parody *Modern Times.*[7] There are no two identical company value chains. Although some companies try to copy value chains, Michael Porter warns against such attempts since the differences existing among company value chains of competitors present the key sources of competitive advantage.

In order to identify the differences, Michael Porter (1985) states that the following three steps need to be taken:

1 Analyse activities following the product lines to identify weak and strong sides;
2 Identify connections between value chains of different product lines to determine the effect of cost and value of one value chain on the cost and value of another value chain;
3 Identify the synergy between the value chain and different product lines.

Companies most often unite different businesses, each representing an autonomous unit which demands a business strategy to be shaped. Most corporations are involved in hundreds and even thousands of activities in the process of input to output conversion. The company cannot increase value or reduce costs by considering the activities as a whole. Creating and sustaining competitive advantage comes from various separate activities conducted by a company On Competition. The basic features of a strategic business unit are as follows:

1 That it has its own business operations;
2 That it has its own competitors;
3 That it has its own manager.

Some strategic business units can be merged either due to their scale or connection in terms of identical suppliers, identical distributor or identical customers. Michael Porter highlights the correlation of strategic business units. Such correlation is established by iterating several mutually connected steps:

First, *to identify the basic correlations within the company* which are really or potentially present between strategic units of a newly founded company since all the specific activities need to be identified to represent the foundation

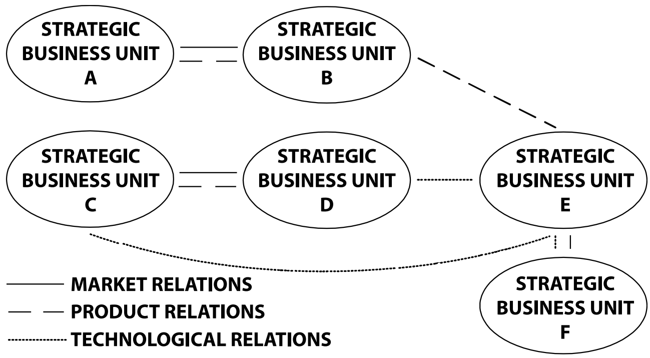

Figure 5.1 The correlation of strategic business units in a company.

Source: Adapted from Porter (1985:369).

for future repositioning and organisation of strategic business units. This means that it is necessary to evaluate which of the activities can be common for particular strategic business units. Figure 5.1 illustrates a correlation matrix in a company with a smaller number of strategic business units.

It offers the opportunity of grouping strategic business units with particularly strong correlations and it can facilitate their visualisation as a cornerstone for certain business functions. Disregarding the manner of their presentation, potential correlations must be clearly set apart from those which are actually realised in practice. Different strategic business groups are often correlated in different ways. One strategic business unit can be associated with the market, whereas another one can be associated with production. Figure 5.2 illustrates the correlation matrix of a company with a larger number of business units.

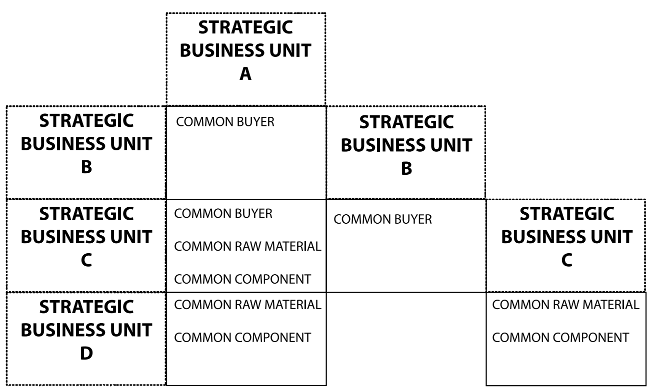

Figure 5.2 The correlations among strategic business units in a company (correlation matrix).

Source: Adapted from Porter (1985:369).

In order to identify the correlations in an easier way, each company can be divided into such strategic business unit groups which have different correlations but their quantity is relatively small compared with the possible number and correlation type of strategic business units of other groups.

Second, *to determine the basic correlations outside the organisation*, i.e. to identify the relation between the existing strategic business units and other businesses which are currently not a part of the company portfolio.

A company needs to be careful in selecting those activities which are essential in a value chain for an opportunity to locate related businesses to share their activities with in the future. It is highly advisable to use the same formula to identify completely new relations never used before by a single competitor and which can be fitted into the company.

Third, *to identify possible side correlations*. This step follows the identification of basic correlations. It includes considering activities individually in a value chain where a company has valuable innovations that can be used in other strategic business units. In addition, this process includes the identification of new businesses which can be an asset to existing strategic business units of a company. Possible side correlations manifest themselves as a similarity in the configuration of activities in a value chain.

Fourth, *to identify the correlations with the competitors*. This means that a company needs to determine the multiple competitors which are an actual or potential adversary in more than one business. The existence of multiple competitors indicates the existence of correlations and it can aid in their identification. After a company determines the existence of such competition, it must record each type of correlation within each competitor portfolio. However, they are often different and involve different type of work making it difficult to identify with them.

Fifth, *the importance of correlation for competitive advantage*. Despite a host of overall relations, there is only a handful of those that strategically matter. The competitive advantage resulting from basic correlations from within a company serves as a benefit for sharing activities, sharing costs and difficulties with correlation integration. Common activities must be measured against respective competitor activities in all the mentioned dimensions. The side relations lead to competitive advantage if the benefit of the know-how transfer surpasses its costs.

Sixth, *developing a horizontal integration to enhance the most important correlations* which can be achieved in the following ways:

1 Distributing appropriate activities in the value chain for an easier coordination of the stated activities for everyone;
2 Coordinating the strategic positioning of particular strategic business units;
3 Separately observing the aims of individual strategic business units by equally including all participants in the discussion;

4 Coordinating offensive and defensive business strategies towards multiple competitors and competitors with different correlations;
5 Diversifying in order to reinforce the important correlations which will result in the creation of completely new unknown relations;
6 Using relevant basic relations of formal programmes of personal innovation transferal exchange;
7 Selling strategic business units which do not have significant common ground with others, making their relations notably difficult.

If there are several models of correlations within a company, including different groups of strategic business units, the implementation of the tactics mentioned earlier can lead to activity overlapping. When this happens, it is necessary to stimulate those relations which have the biggest influence on competitive advantage even if that subsequently results in higher costs. Organisational mechanisms are established to complete this task and they enable a simultaneous progression of correlation of different strategic business units.

Seventh, *the movement of horizontal organisational mechanisms* with the aim of successful strategy implementation is an important step for the entire process of shaping the business strategy since companies cannot successfully utilise correlations without horizontal structure which offers coordination and the transfer of competencies using connections among strategic business units. That is why the processes of defining strategic business units including classifications in appropriate groups to achieve maximum mutual coordination are vital. Creating and sustaining competitive advantage of a company does not solely depend on its value chain, it depends on its value system, too. Value chain is formed at the industry level. Michael Porter (1985) differentiates two important elements within the concept of a value chain:

1 Different activities conducted in particular chain connections;
2 The concept of a value chain with more connections called a value system.

If a company has a single product (or if it is non-diversified), the value chain is formed at the company level and it consists of its activities. If a company has multiple products (or if it is diversified), the value chain is formed at the strategic business unit level and consists of strategic business unit activities (Figure 5.3).

Such a relation requires an agreement on the company – *strategic business units* relation[8] concerning:

1 The planned changes in the strategic business unit portfolio (changes planned by the company and changes to be planned by the strategic business unit), i.e. demands the decisions on issues such as which

strategic business units will grow, which will consolidate, which will be liquidated and which will be renewed. Such decision-making requires distribution of needed resources to reach the portfolio development of strategic business units in a company.

2 The business area where the strategic business unit will operate (which business area will be covered by the company and which business it will assign to the strategic business unit), i.e. demands a decision on the connection between strategic business units which should lead to certain synergic effects.

3 The operational limitations in relation to other strategic business units (which operations are allowed by the companies and which operations it will pass on to the strategic business unit for it to decide on the permission), i.e. it demands a decision on balancing the relations between the sales scale and income to be achieved by the strategic business unit. Such decision-making requires an assessment of the acceptable level of strategic business unit profit oscillation within a company, too.

4 The needed capital for investing in the development of strategic business units (which investments does the company need and which investments it believes the strategic unit business will need), i.e. it demands a decision on the question of balancing money flows in strategic business units. In addition, such decision-making requires an estimate for increasing long-term and permanent capital of strategic business units in a company.

5 The expected results to be reached by a strategic business unit (the results of the company and the expected results of the strategic business unit), i.e. it demands a decision on the results to be reached by each individual strategic business unit. In addition, such decision-making requires a common definition of clear and scalable goals of strategic business units in a company.

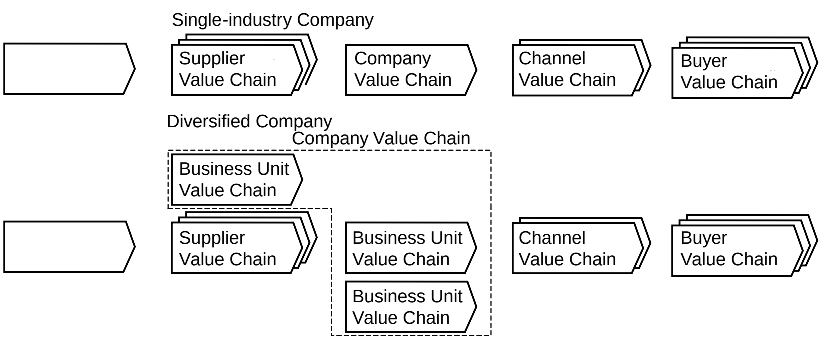

Figure 5.3 Value system.

Source: Adapted from Porter (1985:35).

The company-strategic business unit agreement can be reached to include both the lower and higher levels (top managers and strategic business unit managers) in the process of setting aims. Therefore, it is advisable for these levels to work together when setting aims to facilitate their implementation. In order to properly set the strategic aims, it is possible to use the management by objectives – MBO to promote the idea on the need of cooperation during the process of forming strategic goals which have been agreed upon (based on mutually agreement) by senior managers (top managers) and junior managers (strategic business unit managers). Management by objectives has gained high popularity in the 1960s and 1970s and it was used by many companies not only in its origin country of the USA but also the whole world. Management by objectives is focused on reaching aims that have been mutually defined and revised by top managers and strategic business unit managers. It should be noted that the process of management by objectives must start from top managers by transforming the company aims into specific aims of strategic business units. However, the process must follow the bottom-up procedure by including the strategic business unit managers into the process of setting the strategic aims of the company. Hence, the following needs to be closely considered (Hicks and Gullet, 1972):

1 *The type, significance and mutual coordination of goals*– respecting the fact that there are classifications of strategic goals according to different aspects which are used to facilitate the application of this concept, the role and significance of goals on the level of a company as an entity and strategic business units as its components is highlighted.
2 *Mechanisms, benefits and the degree of setting goals* – abandoning the autocratic approach which is replaced by the democratic one, highlighting the benefits of participation which should result in an agreement-based strategic goal definition as the most efficient mechanism at the level of a company as an entity and strategic business units as its components.
3 *Executives, monitoring and the analysis of goal realisation* – controlling the realisation of goals by all included in the defining process, regularly holding meetings and highlighting the role and significance of self-control on the level of a company as an entity and strategic business units as its components.

Michael Porter (1991) identifies the criteria applied in the practice of diversified companies during the conceptualisation of the mix of strategic business units. Namely, he differentiates the four following approaches:

1 Concept of portfolio management;
2 Reducing cost by restructuring;
3 Transfer of core competences;
4 Sharing of activities.

The portfolio management concept is mostly associated with successful, overrated and developed strategic business units. Michael Porter (1987) argues that the concept of portfolio management offers a type of optimisation or a schedule of activities. Top management appears in a role of an auditor conducting a regular business audit.

Reducing cost by restructuring is mostly associated with unsuccessful, underrated and undeveloped strategic business units. Top management appears in the role of a restructurer conducting special business restructuring. Michael Porter (1987) believes that restructuring offers a type of cost reduction.

The other two concepts (*key competencies transfer* and *mutual utilisation of activities*) are based on studying the strategic business units to achieve competitive advantage. Namely, the optimisation of the mix of strategic business units has the aim of creating premises for creating synergy based on a better distribution of cost and assets throughout the activities in a value chain of a company. Considering the fact that each strategic business unit is a value chain per se, there is a tendency to consider the capitalisation of the relations among strategic business units. Such relations are considered from the following aspects (Todorović et al., 2000):

1 Transfer of core competences from one strategic business unit to some of the activities in a value chain of another strategic business unit;
2 The possibility of a mutual utilisation of some of the activities in a value chain by multiple strategic business units.

The realisation of the aforementioned concepts depends on several premises. The most important ones are the following (Montgomery and Porter, 1991):

1 The existence of similarity, i.e. coherency among activities in a value chain of strategic business units;
2 The possibility to achieve sufficient competitive advantage by a transfer of core competences and mutual utilisation of activities in a value chain.

It is evident that each approach has its benefits and limitations and it is up to the top management to determine their attractiveness and the possibility of combining. Such an action requires a detailed analysis including an interactive procedure.

Constructs of strategic company analysis

A strategic organisational analysis includes the following:

1 Value chain analysis;
2 Strategic activities analysis;
3 The analysis of competitors from the company perspective.

Value chain analysis

Michael Porter (1985) suggest a procedure for analysing the value chain by disaggregating it into activities. Chain value activities of a company represent only a part of activities called the value system. Each product line has its value chain; hence, a company can be seen as a group of different value chains. The value chain is formulated at the level of a strategic business unit in diversified company (Đuričin et al., 2015). Recognised as a set of relative activities, a value chain is united by the internal and external company relations. The relations are links between (a) the way a particular value activity is conducted and (b) the cost of conducting another value activity. The sum of internal and external links of an activity forms the *configuration of value chain activities in a* company. Their importance is recognised in the possibility of creating and sustaining competitive advantage in two ways: (a) Forming an optimal configuration and (b) mutually coordinating activities. There are a host (Porter, 2007) of relations used in a value chain: The same function can be completed in different ways, the cost of conducting direct activities can be reduced through enhancements, the need for long-term product service, quality assurance functions can be reduced and completed in a different way and similar.

Identifying the relations is a process of finding ways in which each company locates the path of influence of each activity which creates costs and higher value compared with another activity. However, establishing quality relations is possible if a company has quality information at its disposal. The lack of information or incorrect information such as imprecise data can result in cost increase and value decrease. This phenomenon is known as the *bullwhip effect* (Russel and Taylor, 2009). This effect occurs when all value chains in a value system make decisions from the aspect of their own interest or lack precise information on the demand of an adjacent value chain in a value system. This can result in, for example, an increased level of safety stock.

Value chain activities surpass the company and the configuration, i.e. the relations of activities are spread on the value chain of the company, the distributors value chain and the buyer value chain. Establishing the complete configuration provides the company with the opportunity for profit from both founding and managing the relations among value chain activities of a company and from founding and managing relations among value chain activities of the supplier, value chain activities of distributors and value chain activities of the buyer. The configuration of relations covering both the supplier value chain and the distributor value chain is known as the *vertical relation* in literature, whereas the configuration of relations covering the buyer value chain is known as the *horizontal relation* in literature. The aim of establishing a complete activity configuration is to establish a certain order in a company. Establishing an order requires the coordination between value chain activities.

Tasks scheduled to be completed by the company must be mutually coordinated by unification and management to fulfil the previously set aims. The background of failure in fulfilling aims can be found in bad coordination of activities in a value chain of a company. An important notion of a value chain analysis is to break down the chain into activities starting from initial raw material to end customers and strategically relevant segments to understand the cost drivers and the differentiation drivers (Shank and Govindarajan, 1992). Value chain analysis explains the way in which the business process creates buyer value. It is evident that it can be done through two sources of competitive advantage (overall low cost and differentiation). Consequently, the value chain analysis disaggregates the business process into activities occurring within the process, starting from business process input to business process output.

Value chain of a company is being recognised as a utility diagnostic tool to identify the profitability of each phase in the business process. The analysis attempts to determine the costs of these activities to reveal whether a company has got the low cost advantage in relation to competitors. This forms the foundation of Michael Porter's attitude of company inaptness as a unit to locate the sources of competitive advantage. Namely, he argues that each individual activity must be considered independently and separately from others to identify its influence. That is the reason why activity features are examined to determine the way in which each activity participating in the value chain can lead to company product differentiation. Independent of the value chain area in which the given corporation operates, there is always the zone of primary expertise. Namely, this is the value chain gravity centre, the zone of the highest expertise and the possibility which presents the source of competitive advantage. The gravity centre is usually associated with activities conducted by the corporation to start off with its business operations. It is a question of *core business* (Đuričin et al., 2015). Nowadays, it is becoming an increasing trend for company to seek personal solutions in fundamental changes of their position in an industry where they operate. Company are increasingly following the technological trends, i.e. making notable changes in their core business through technological strategy.

According to Michael Porter (1980), the technological strategy determines the ways in which a company can create and use technology. Since technological changes affect the industry structure, the technological strategy is an important element of the overall strategy of a company (Figure 5.4).

Michael Porter believes that the technological strategy is a powerful tool for following the sources of competitive advantage. In his opinion, it is often wrongly assumed that a change in the process should cover its cost and that product change should yield differentiation. That is the reason why the revision of technologies at the disposal of the company needs to indicate areas in which a company should favour the option of cost reduction and

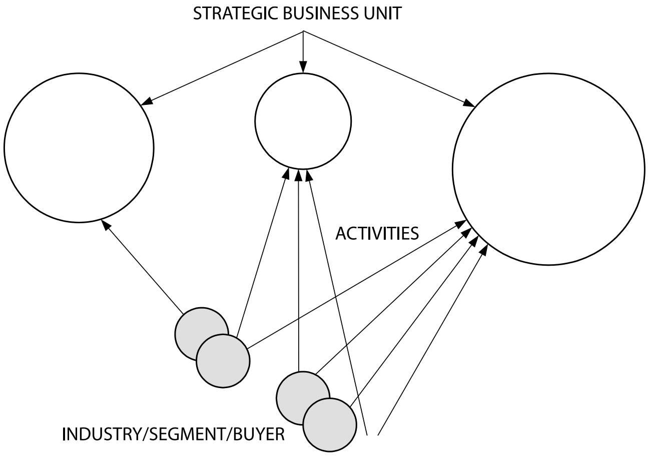

Figure 5.4 Activity identification.

Source: Đuričin et al. (2015:399).

areas where it should favour the option of differentiation as a source of competitive advantage.

The selection of a specific technology in a value chain to be focused on is important due to the relations between technological change and competitive advantage. A company should divert its attention to the technologies that have the biggest direct or indirect influence on low cost or differentiation. The premise is to always balance the cost of technology enhancements with its following benefits on the strategic positioning of a company in its environment. It should be noted that low cost orientation does not consequently rule out differentiation. Each activity in a value chain is different both in terms of strategy and technology. The activities are separable sequences of a business process which consume either time or resources where value or cost drivers operate. A strategic business unit corresponds with the market, segment or buyer through activities (Đuričin et al., 2015).

Michael Porter has significantly improved the analysis of business process disaggregation into activities considering the specific relations within the activities themselves in the process. Consequently, the business process is perceived as an activity chain rather than a series of business functions. The value chain idea is actually founded on a process-based perspective of a company. It presents a way of overviewing the company production as a system comprised of subsystems with individual inputs, transformation procedures and individual outputs. Activity identification involves the disaggregation of the business process and its classification into two basic groups (Porter, 1980): (1) Primary activities and (2) support activities (Figure 5.5).

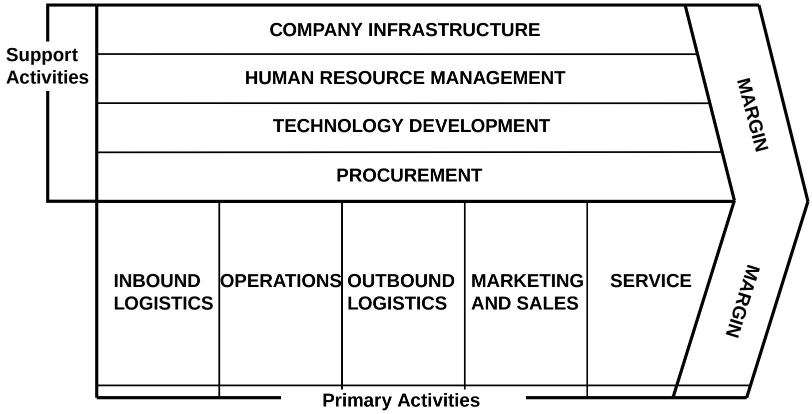

Figure 5.5 Porter's value chain concept.

Source: Porter (1985:37).

Primary activities include all the procedures involved in the final product production and its delivery to customers. These activities include the following: Inbound logistics, operations, outbound logistics, marketing and product sales (Pearce and Robinson, 2000).

- *Inbound logistics*: Activities, costs and assets related to the supply of fuel, energy, raw material, materials, parts, merchandise, and consumables provided by suppliers including reception, storage, input issuing, the handling of material in warehouses, workplace delivery, supply management and return to suppliers.
- *Operations*: Activities, costs and assets related to the transfer of input into outputs concerning the productions, assembling, testing, packing, equipment and installation maintenance, quality assurance and environmental protection.
- *Outbound logistic*: Activities, costs and assets related to the physical product distribution to customers concerning the storage of final products, warehouse manipulation, order processing, selection, packing, delivery and distribution operations.
- *Marketing and sales*: Activities, costs and assets related to the efforts of sales forces, marketing and promotions, market research and distributor planning and support.
- *Service*: Activities, costs and assets related to ensuring customer assistance such as assembling, spare part delivery, maintenance and fixing, technical assistance, buyer information and complaints.

Support activities include the company infrastructure which supports the normal conduction of primary activities including the company