Value-Chain Approach to Internal Analysis

Meaning

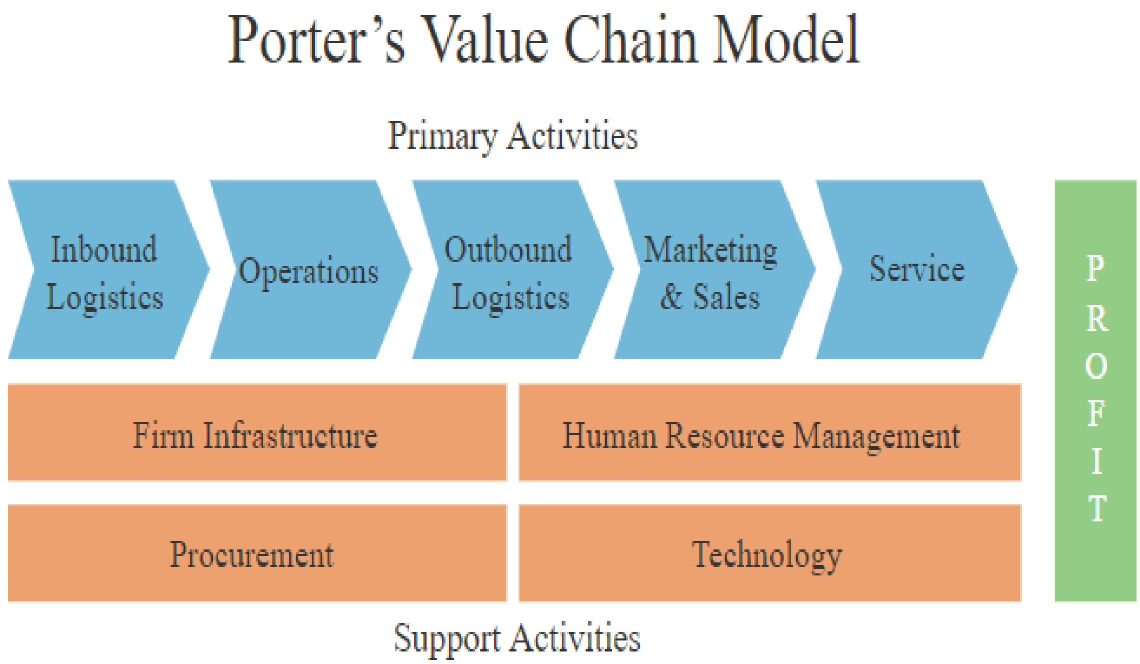
is a process where a firm identifies its primary and support activities that add value to its final product and then analyze these activities to reduce costs or increase differentiation.

Value chain represents the internal activities a firm engages in when transforming inputs into outputs.

Value chain analysis is a strategy tool used to analyze internal firm activities. Its goal is to recognize, which activities are the most valuable (i.e. are the source of cost or differentiation advantage) to the firm and which ones could be improved to provide competitive advantage. In other words, by looking into internal activities, the analysis reveals where a firm's competitive advantages or disadvantages are. The firm that competes through differentiation advantage will try to perform its activities better than competitors would do. If it competes through cost advantage, it will try to perform internal activities at lower costs than competitors would do. When a company is capable of producing goods at lower costs than the market price or to provide superior products, it earns profits.

M. Porter introduced the generic value chain model in 1985. Value chain represents all the internal activities a firm engages in to produce goods and services. VC is formed of primary activities that add value to the final product directly and support activities that add value indirectly.

Although, primary activities add value directly to the production process, they are not necessarily more important than support activities. Nowadays, competitive advantage mainly derives from technological improvements or innovations in business models or processes. Therefore, such support activities as 'information systems', 'R&D' or 'general management' are usually the most important source of differentiation advantage. On the other hand, primary activities are usually the source of cost advantage, where costs can be easily identified for each activity and properly managed.



Cost Drivers of Value Chain Analysis

Cost advantage results from a reduction in costs associated with activities in a value chain. After the value chain has been defined, it's important to associate costs to the activities and then make adjustments for efficiency. Porter's 10 cost drivers are factors that can impact the cost of an activity. An organization can aim to control these cost drivers in order to improve efficiency, add value, and differentiate.

1. Economies of scale
2. Learning and spillovers
3. Pattern of capacity utilization
4. Linkages
5. Interrelationships
6. Integration
7. Timing

8. Organization policies

9. Location

10. Institutional factors

Value chain analysis is more than a straightforward cost-to-profit model. It expands on the principles of economies of scale and capacity. There are limits to lowering costs and increasing capacity that can inhibit business growth. Value chain analysis stresses that competitive differentiation can also focus on the perceived value to the customer that justifies a product's price tag. Finding these perceived values could mean the difference between getting a consumer to spend three dollars on a cup of Starbuck's coffee rather than one dollar on a competitor's discount brand.

Value Chain Analysis Steps

Value chain analyses require research and can take time to develop. Below are the general steps it takes to create a value chain analysis:

1. Determine the business' primary and support activities.

Together, the primary and support activities make up the value chain. And they include each action required in the development of a product or service, from raw material to final product.

2. Analyze the value and cost of the activities.

The team tasked with creating the value chain analysis should brainstorm ways each activity provides value to customers and the business as a whole. Compare the activity to the competitive advantage you're trying to achieve (cost leadership or differentiation) and see if it supports the goal.

After the value analysis is complete, take a look at the cost of the activities. Is the activity labor intensive? How much does X raw material cost? Asking questions similar to these will help identify which activities are cost-effective and which are not. This where areas for improvement can be identified.

3. Identify opportunities to gain a competitive advantage.

Once the value chain analysis is complete, the primary stakeholders in the business can see an overview of where the business is excelling and where improvements can be made operationally.

Begin with the improvements that take minor changes and provide high-impact results. After the easy wins are identified and actioned, you and your team can tackle the bigger challenges that might be hindering efficiency.

The value chain analysis gives businesses a clear idea of how to adjust their actions and processes to provide the most value to their target market and increase profit margins for the company.

Primary and Support Activities

Identifying the primary and support activities is the first step in creating a value chain analysis. These are the key processes and systems a business uses to develop is product or service.

Primary Activities

There are five primary activities and they include all the actions that go into the creation of a business' offering.

1. Inbound Logistics

This is how materials and resources are gained from suppliers before the final product or service can be developed.

2. Operations

Operations are how the materials and resources are produced, resulting in a final product or service.

3. Outbound Logistics

Once a product or service is finished, it needs to be distributed. Outbound logistics describes this delivery process.

4. Marketing and Sales

This is how your product or service is presented and sold to your ideal target market.

5. Services

This is the support a business provides for the customer which can include support and training for the product, warranties, and guarantees.

Support Activities

Support activities help the primary activities in creating an advantage over competitors, and they include:

1. Firm Infrastructure

This entails all the management, financial, and legal systems a business has in place to make business decisions and effectively manage resources.

2. Human Resource Management

Human resource management encompasses all the processes and systems involved in managing employees and hiring new staff. This is especially important for companies that provide in-person service, and excellent employees can be a competitive advantage.

3. Technology Development

Technology development helps a business innovate. And technology can be used in various steps of the value chain to gain an advantage over competitors by increasing efficiency or decreasing production costs.

4. Procurement

This is how the resources and materials for a product are sourced and suppliers are found. The goal is to find quality supplies that fit the business' budget.

Value Chain Analysis Example

- **Food and Beverage:** Selecting and sourcing high-quality coffee beans, developing loyalty through excellent customer service, and aggressively marketing their brand were key elements in Starbucks' creation of a unique identity and a robust competitive edge. Rather than focusing on premium pricing, Pizza Hut outpaced the competition by offering fast delivery of a less expensive product.

- **Delivery Service:** To increase market share and brand loyalty, FedEx's value chain emphasizes and invests in employee development through excellent human resources initiatives and infrastructure improvements.
- **Retail:** Walmart is constantly performing value chain analysis in order to keep costs low for their customers. From regularly evaluating suppliers and integrating in-store and online shopping experiences to remaining innovative in order to differentiate, Walmart is driven by their commitment to helping people save money.