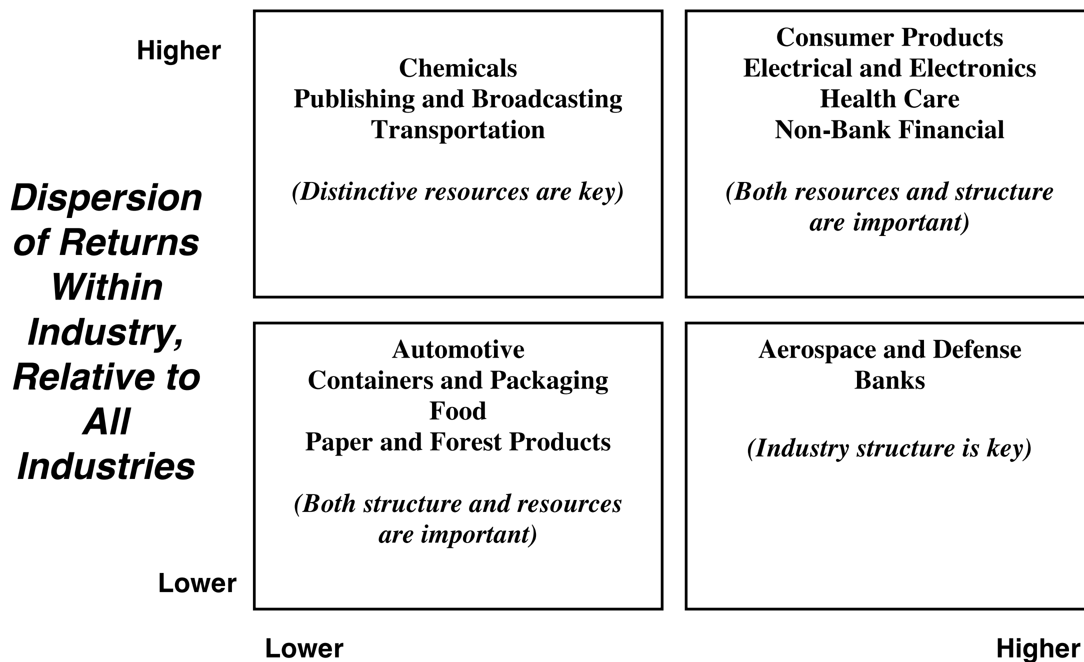
Resource Based Strategy

Attached is a recent article from the Reinsurance Reporter, published by Lincoln National Corporation, that provides a quick summary of our views on the subject of resource based strategy. In addition to the material it contains, there are four additional points to keep in mind on this subject:

Not All Industries are Alike

First, while our conclusion is that industry structure and distinctive resources are both important sources of superior corporate performance, they are not equally important in all industries. Consider the examples in the following chart, which is based on our analysis of total shareholder returns in 1996 for the companies comprising the S&P 500:



As you can see, there are substantial differences between industries in terms of both average returns (which reflect structural factors) and the dispersion of returns between firms (which reflects the extent to which distinctive resources

can be used to gain competitive advantage). In the short term at least, this suggests there is no single "best" approach to the problem of formulating effective strategy.

Which Came First, the Chicken or the Egg?

Over the middle and long term dynamic forces seem to muddle the whole issue of "industry structure" versus "distinctive resources." On the one hand, a company can generate superior returns by increasing its market power through economies of scale and scope (e.g., by pursuing a consolidation strategy). Its success, however, will lead customers, suppliers, producers of substitutes, and/or competitors (both existing and potential) to try to regain power by developing new distinctive resources and sources of competitive advantage.

If a number of competitors do this successfully, it will increase the industry's power versus other players in the system, causing the industry's average returns to increase, and outside analysts to characterize it as "structurally attractive." As this simple example shows, once the dynamic nature of the problem is taken into account, it is clear that the relationship between industry structure and distinctive resources is a complex one, characterized by positive and negative feedback loops that give rise to non-linear effects. In other words, when formulating medium and long term strategy one must take both structure and resources (and their interaction) into account.

Does Scarce Equal Unique?

Underlying the resource based approach to strategy is the fundmental idea that excess returns (i.e., returns greater than the cost of capital, which are also known to economists as "economic rents") will be earned on resources that are both valuable and scarce. But what do "valuable" and "scarce" really mean in practice? With respect to the former, the practical answer seems reasonably clear: a resource can be considered valuable if it leads to superior performance in an area that is a high priority to a company's customers or to a significant cost advantage versus competitors. In other words, a resource is valuable if it leads customers to prefer your product over others, or investors to prefer your shares.

But what does it mean for a valuable resource to be scarce? Does it mean you are the only company that possesses it? Many companies that have applied this standard have concluded that they have no distinctive resources, because one or two other companies also had access to the assets or capabilities in

question. Our conclusion, however, is that uniqueness is too harsh a test. The real question is whether enough firms have (or will have) access to the resource in question to compete away all potential excess returns from its use.

Consider two chemical firms which, alone among their competitors have access to the world's two lowest cost natural gas fields. As a result, they enjoy substantial cost advantages over other companies in their industry (assuming industry demand is expected to be greater than their combined production capacity). If these companies applied the uniqueness standard, they would come to the absurd conclusion that their respective natural gas deposits were not distinctive assets, when in fact just the opposite appears to be true.

Scarcity, therefore, comes down to three questions: How many other firms possess this asset or capability? How likely are other companies to either copy or develop substitutes for it within the time frame covered by your strategy? And if they do, will enough firms then possess this resource to eliminate the excess returns generated by its use?

You Don't Get Something for Nothing

In many cases, the scarcity of a resource reflects its underlying complexity. For example, many distinctive capabilities are based on substantial amounts of tacit knowledge spread across a large group of people. Both of these factors make it difficult for competitors to copy the distinctive resource in question. However, these same factors may also make it difficult for the company possessing the resource to change its strategy when confronted with a major change in its environment. As we discussed at more length in our Summer 1998 *Management Insights*, the best way for a company to manage this risk is to ensure that its internal complexity (i.e., the number of key elements in its strategy, and the intensity of interrelationships between them) is equal to its external complexity (i.e., number and intensity of its relationships with customers and suppliers).

Bristol Partners, Inc. is a general management consulting firm that makes substantial long term equity investments in all its clients. We don't work for competitors, highly leverage client staff, and help them to understand, integrate, and resolve strategic, organizational, and financial problems. We can be reached on (415) 438-3300, or at info@bristolpartners.com.