



Resources: The Essence of Corporate Advantage

“Some genius invented the Oreo. We’re just living off the inheritance.”¹

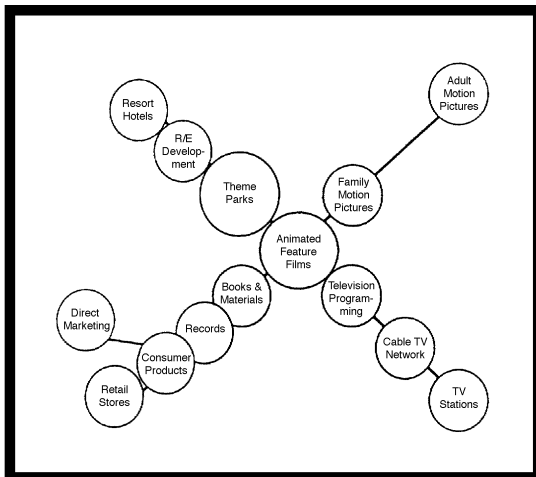
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The Core Competence Trap

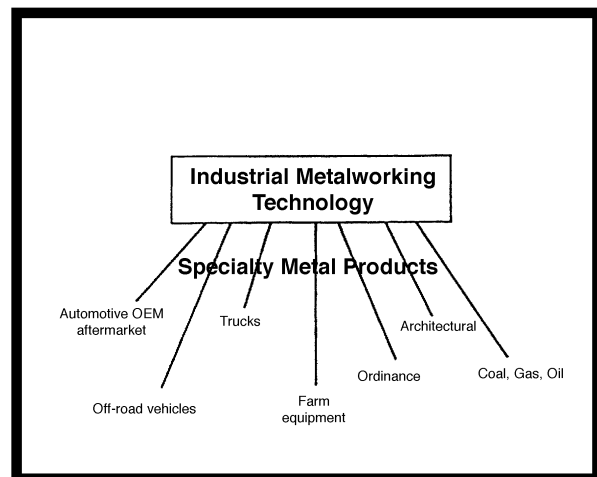
It may sound comforting to hear that your company should “stick to the knitting” or discover and cling to its core competence. While emotionally and even intellectually appealing, taken at face value these simple notions can be dangerously misleading.

Consider the histories of two firms—the Walt Disney Company and Masco Corporation. Both followed a strategy of highly related diversification. Both built a set of businesses around one core—in Disney’s case an assortment of cartoon characters, in Masco’s a set of metalworking skills.

Walt Disney Company



Masco Corporation



¹Burrough, Bryan and John Helyar, *Barbarians at the Gate*, Harper and Row, New York, 1990, p. vii.

Professor Cynthia A. Montgomery prepared this note as the basis for class discussion.

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Despite their similarities, these strategies produced very different outcomes. Disney's related strategy has proven exceptionally successful and has led to further diversified expansion. Masco's, on the other hand, has prompted a redirection of corporate strategy. What explains this difference?

A resource-based view of the firm provides one explanation. This view sees a firm through the perspective of its resources. Of central concern is the value of the resources, how they are grown and nurtured, and how they are leveraged to create competitive and corporate advantage.

The Nature of Resources

What are resources? And what makes them valuable? Webster's Dictionary defined a resource as:

a new or reserve source of supply or support; an available means; an immediate and possible source of revenue; something to which one has recourse in difficulty.²

Resources can be classified in many ways. In particular, it is helpful to differentiate among physical, human, and organizational resources.

Physical capital resources include the physical technology used in a firm, a firm's plant and equipment, its geographic location, its access to raw materials, etc. Human capital resources include the training, experience, judgment, intelligence, relationships, and insight of individual managers and workers in a firm. Organizational capital resources include a firm's formal reporting structure, its formal and informal planning, controlling, and coordinating systems, as well as informal relationship among groups within a firm, and between a firm and its environment.³

The challenge for the manager is to understand the difference between valuable and pedestrian resources and to make investments and craft strategies that reflect this difference.

Six attributes are particularly important in describing resources:

- Customer Demand
- Substitutability
- Appropriability
- Capacity
- Imitability
- Fungibility

Other things being equal, a resource is valuable if there is viable customer demand; if there are no substitutes; if the firm can capture (appropriate) the returns it generates; if a firm has an abundant capacity of it; and, if it is not imitable by competitors. Further, if such resources can be applied in more than one setting, they can provide the basis for a multi-business firm.

²Webster's Seventh New Collegiate Dictionary, G & C Merriam Company, 1967.

³The division of resources into three classes was made by Jay B. Barney in "Firm Resources and Sustained Competitive Advantage," Working Paper #89-016, Texas A&M University.

Customer Demand

Value depends on having a customer who is willing to pay for the product or service the resource provides. If there is no customer, or if the customer is not willing to pay a sufficient price, the resource will not support unusual returns.

Substitutability

Substitution involves replacing one resource with another. Although it is doubtful that a competitor could establish a set of high street locations to rival those of Marks and Spencer, perhaps it could create a substitute for that impenetrable advantage, e.g. catalog shopping or a chain of stores in suburban shopping centers.

Appropriability

Appropriability describes the ease with which a firm can capture the returns generated by its resources. While it seems that a firm with rare resources should be able to seize the value they create, often this is not the case. A host of other players, inside and outside the firm, may bargain for and receive a substantial share of the gains. For example, biotech firms lacking their own distribution networks often pay large premiums to pharmaceutical companies to get their products to the customer.

Capacity

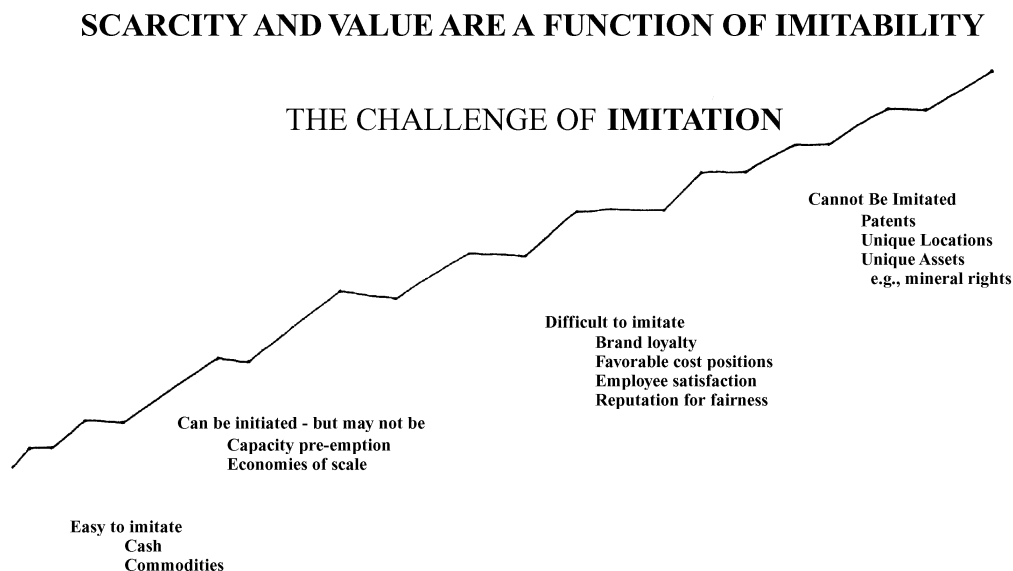
Capacity levels of some resources are fixed, others are variable. A stamping machine, for example, has a finite capacity, but a brand name or a company's reputation for fairness are not bounded in the same way. Unlike many physical resources, intangible resources such as brand names or corporate reputations may expand rather than contract with use. This property often makes intangible resources among the most valuable in a company and an important base for diversified expansion.

It is also important to distinguish between short-term and long-term capacity. Resources accumulate and decay at different rates. Assigning meaningful decay rates to physical resources is difficult, but the task is ever more onerous when dealing with intangible resources. Economists have traditionally assigned decay rates of .3 and .1 per year to a firm's investments in advertising and R&D respectively, yet judging the value or capacity of intangible resources in practice is extraordinary difficult.

Imitability

While all of the above factors are important, imitability is at the heart of value creation. At issue is whether or not a competitor can acquire the resources that singly or in combination support another firm's corporate advantage.

Resources are scarce if they cannot be imitated or if competitors who could in principal imitate them choose not to.⁴ The figure below illustrates the range of resource imitability.



In the top right are unique resources that by definition cannot be imitated. These include such things as patents, mineral rights, copyrights, etc. Although this kind of resource sounds ideal, and sometimes is, we have learned that resources that are truly unique in a competitive sense are very rare and often do not provide the level or duration of advantage a firm might hope. Substitutes, for example, often diminish the value of product patents.

The middle ground of this figure captures the vast territory of resources that are difficult to imitate or uncertainly imitable. Resources fall in this category for a number of reasons, including:

Identification Difficulties This simply means that the linkages between a firm's particular advantage and its underlying resources are not clear. In other words, it is difficult to say which of a firm's resources individually or in combination create and sustain the firm's advantage.

Unknown Recipes Here a competitor may be able to identify the resources supporting a firm's advantage, but it may not be able to imitate them because they are part of very complex and opaque social phenomena. Examples of such resources include a high quality organizational culture or large sets of procedures yielding low costs. Often these resources embody tacit knowledge and intricate organization routines that members of the firm itself could not fully specify.

Time Lags Many resources are in principal easy to imitate, but in reality to do so requires much time. In such circumstances it may be practically impossible to catch up to a competitor who has a

⁴The latter can occur in situations of capacity preemption where one firm makes a sizeable investment in assets that are specific to a given market. Because the assets cannot be redeployed, i.e. they are sunk in a given market, they can signal what has been termed a "credible commitment" that a firm intends to stay in the market and, if necessary, 'fight it out' with competitors. Faced with such a situation, potential competitors may choose not to enter the market if it is too small to profitably support two players the size of the first. Preemptive situations like this, to the extent that they exist, can be valuable. However, it is important to distinguish these single market settings with initially homogeneous players from those where resources are uncertainly imitable or unique and can be transferred across multiple markets.

long enough head start. Dierickx and Cool cite the following dialogue between a British Lord and his American visitor as an example:

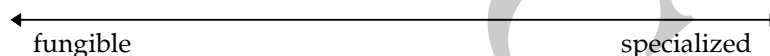
American Visitor: "How come you got such a gorgeous lawn?"
 British Lord: "Well, the quality of the soil is, I dare say, of the utmost importance."
 American Visitor: "No problem."
 British Lord: "Furthermore, one does need the finest quality seed and fertilizers."
 American Visitor: "Big deal."
 British Lord: "Of course, daily watering and weekly mowing are jolly important."
 American Visitor: "No sweat, just leave it to me!"
 British Lord: "That's it."
 American Visitor: "No kidding?!"
 British Lord: "Oh, absolutely. There is nothing to it, old boy; just keep it up for five centuries."⁵

In some cases resource gaps can be closed by extremely high spending in the short term, but such a path is often very expensive, ineffective, or both. For example, crash R&D programs often are more costly and less effective than programs progressing at a natural pace.

Clearly many resources do not fit neatly into one of these categories. For example, a reputation for high quality products or the loyalty of one's employees may present both time lags and unknown recipes. Further, many resources are more valuable in combination than individually. A new product delivery system, for example, may combine several individual resources into a complex whole that itself is very difficult to imitate. Lastly, it is important to note that what makes resources difficult to imitate by another firm often also makes them difficult to **replicate** by the firm itself.

Fungibility

Resources differ in specificity. Highly fungible resources can be applied in many markets. Highly specialized resources, on the other hand, can be applied in only one or in a very narrow set of applications. To be the basis for a diversified firm, resources must be fungible to some degree.

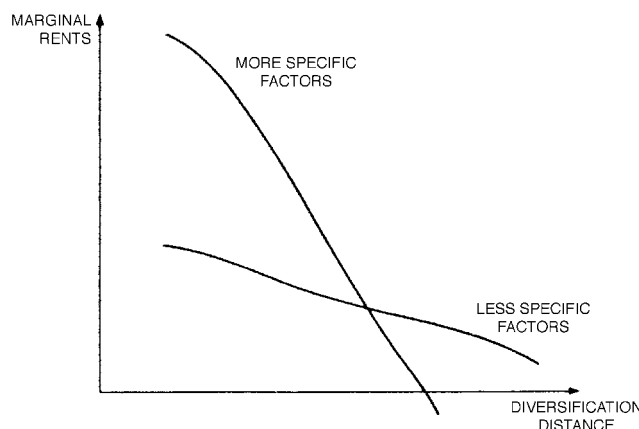


Fungible resources include such things as general management skills, multi-purpose machinery, some kinds of scientific knowhow, etc. Cash is an extreme example of a fungible resource for, as we know, it can be used in countless situations. Although fungible resources can be easily transferred across markets, they are often less valuable than specialized resources because they are usually in greater supply (i.e., there is a correlation between fungibility and scarcity).

Examples of specialized resources are expertise in narrow scientific disciplines, product formulas, and some product-specific brand names. These are often instrumental in securing a competitive advantage within an industry but their value often drops quickly as they are moved away from the initial setting.

⁵Dierickx, Ingemar and Karel Cool, "Asset Stock Accumulation and Sustainability of Competitive Advantage," *Management Science*, December 1989, p.1507.

HYPOTHESIZED RELATIONSHIP BETWEEN DIVERSIFICATION DISTANCE AND MARGINAL RENTS FOR DIFFERENT DEGREES OF FACTOR SPECIFICITY



Source: "Diversification, Ricardian Rents, and Tobin's q "⁶

Corporate advantage is often derived from resources that are somewhere in between highly fungible and highly specialized. These are resources that are flexible enough to be leveraged in multiple markets yet specialized enough to be an important source of value creation within those markets. Examples of such resources include corporate reputations, distribution networks, and brand names.

Economic Rents

If one thinks of a firm as a collection of resources, one can interpret profits in this light.⁷ This point was first raised in the early 1800s, when David Ricardo argued for the abolition of England's Corn Laws. Central to his argument was the insight that land differed in fertility and that the profits derived not from the production of corn per se but from the quality of the land. Thus, the returns should be thought of as rent on the resource (land), not profit on the production of corn:

Corn is not [priced] high because a rent is paid, but a rent is paid because corn is [priced] high; and it has been justly observed that no reduction would take place in the price of corn, although the landlord should forego the whole of their rent.

Ricardo referred to such rents as **scarcity rents**, others following him have used the term **Ricardian rents**. For a manager, the significance of this insight is that ultimately it is a firm's resources that determine its rent-generating potential.

Stocks and Flows

A new CEO inherits a set of tangible and intangible resources. These are usually numerous and of varying quality and are considered the **stock** of the firm. Often such resource stocks have been accumulated over a great number of years, and the individual resources may have been combined in a myriad of ways to support the firm's efforts in different product markets. Indeed the resources themselves are often complex intertwinings between a firm and its competitive position in specific markets (e.g., the low cost producer in arc welding) rather than an absolute attribute. Although there are exceptions, generally speaking the resource stock of a firm cannot change quickly.

⁶Montgomery, Cynthia A. and Birger Wernerfelt, *RAND Journal of Economics*, Vol.19, No.4, Winter 1988, p.626.

⁷This discussion of rent follows from Richard Rumelt, "Theory, Strategy, and Entrepreneurship," *Competitive Challenge*, David Teece, ed., Ballinger, 1987.

The job of the CEO is to make choices about the deployment of the resource stock and its maintenance and growth through time. These decisions, which embody the **flow** (deployment) of resources, constitute the strategy of the firm. Over time these flows, with some decay and accumulation, will become part of the firm's resource stock, and thus the legacy will continue.

Revisiting Disney and Masco

Returning to the Walt Disney Company and Masco Corporation, the resource-based view of the firm can help us understand why two firms following related diversification strategies experienced such different results.

Through sixty-plus years Disney management created a set of resources that have many applications and are difficult if not impossible for their competitors to imitate. Several of these are intangible, including the characters themselves, Disney's reputation for wholesome family entertainment, the company's management systems and culture, and its expertise in cartoon and screen production. These resources have the special character of not being consumed in usage—in fact, through careful application, they have grown rather than shrunk. Further, the resources are both fungible and specialized: they have been applied in many settings where they have been instrumental in creating competitive advantage. These properties are ideal for resources supporting diversified expansion.

Quite in contrast, Masco Corporation's tightly woven corporate strategy ultimately did not produce unusually high profits. The company assembled a set of metalworking skills that was broader than those of its competitors, but the individual skills themselves were imitable. Many could be supplied by a host of competing firms. Further, Masco's efforts to combine these skills and leverage them across many markets did not add significant value. This illustrates how dependent a firm's corporate strategy is upon the fundamental properties of its resources. Unless something can be done at the business or corporate level to make the resources difficult to imitate and especially valuable to the customer, it is not likely they will generate above-average returns. Recognizing this, Masco restructured in 1984 and separated the businesses in its traditional core from its more profitable and faster growing businesses.

While the resource-based view of strategy offers a number of insights about the ways in which firms create value at both the corporate and business levels, like other approaches, it is not a panacea. Perhaps its most vulnerable point lies in the subjective evaluations managers must make in evaluating their firm's resource stocks. Nearly every firm has a sales force, for example, but most of these are of average quality. Sorting out what is special about a firm, or what could be made special, requires disciplined analysis and keen judgment.