Adding value to the supply chain – Porters value chain

Understanding how your company creates value, and looking for ways to add more value, are critical elements in developing a competitive strategy.

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ADDING VALUE TO THE SUPPLY CHAIN

PORTERS VALUE CHAIN

"Of the many changes that have taken place in management thinking over the last 30 years or so, perhaps the most significant has been the emphasis placed on the search for strategies that will provide superior value in the eyes of the customer. To a large extent, the credit for this must go to Michael Porter, the Harvard Business School Professor who, through his research and writing has alerted managers and strategists to the central importance of competitive relativities in achieving success in the marketplace.

One concept in particular that Porter has brought to a wider audience is the **'the Value Chain'.**
These activities are integrating functions that cut across the functions of the firm. Competitive advantage is derived from the way in which firms organise and perform these activities within the value chain. To gain a competitive advantage over its rivals, a firm must deliver value to its customers by performing these activities more efficiently than its competitors or by performing the activities in a unique way that creates greater differentiation."

Source: ***Logistics and Supply Chain Management 5th edition*** **by Martin Christopher**

Definitions

Michael Porter first introduced the concept of 'The Value Chain' in his influential book *Competitive Advantage* in 1985. He argues that understanding how your company creates value and looking for ways to add more value, are critical elements in developing a competitive strategy.

The Value Chain is the activities involved in delivering value to customers

Value Creation is the ways in which you can create added value for the customers of your product. Adding value creates higher profitability for an organisation.

Higher profitability through introducing added value is the basis of **Competitive Advantage**.

Value Chain Analysis is a strategic tool used to analyse internal business activities and recognise which activities are the most valuable.

These can be the source of **cost advantage** or **differentiation advantage** to the business.
The business that competes through cost advantage will try and perform internal activities at lower costs than competitors would do. The business that seeks differentiation advantage will try to perform its activities better than its competitors.

The more value an organisation creates, the more profitable it is likely to be. And when you provide more value to your customers, you build Competitive Advantage in the marketplace. If you can shorten the Value Chain and satisfy your customers earlier and more quickly, then you can derive even greater advantage.

The Use of the Value Chain concept within business

"The value chain disaggregates a firm into its strategically relevant activities in order to understand the behavior of costs and the existing and potential sources of differentiation. A firm gains competitive advantage by performing these strategically important activities more cheaply or better than its competitors. Competitive advantage cannot be understood by looking at a firm as a whole. It stems from the many discrete activities a firm performs in designing, producing, marketing, delivering and supporting its product. Each of these activities can contribute to a firms relative cost position and create a basis for differentiation…"
Taken from *Competitive Advantage: Creating and Sustaining Superior Performance* by Michael Porter 1985

Dr Porter proposed a general-purpose value chain model that companies can use to examine all of their activities and see how they are connected.

It breaks down an organisation's activities into strategically relevant pieces, so that a fuller picture of the cost drivers and sources of differentiation can be seen, and then appropriate changes can be made.

He divides a business's activities into primary and support activities.

Primary Activities relate directly to the physical creation, sale, maintenance and support of a product or service, such as Inbound Logistics, Operations, Outbound Logistics, Marketing and Sales, Service.

Support Activities support the primary functions above, for example, Procurement, Human Resources, Technology, and Infrastructure.

Companies use these Primary and Support activities as "building blocks" to create a valuable product or service. The choices about how the activities in the value chain are configured become part of company strategy.

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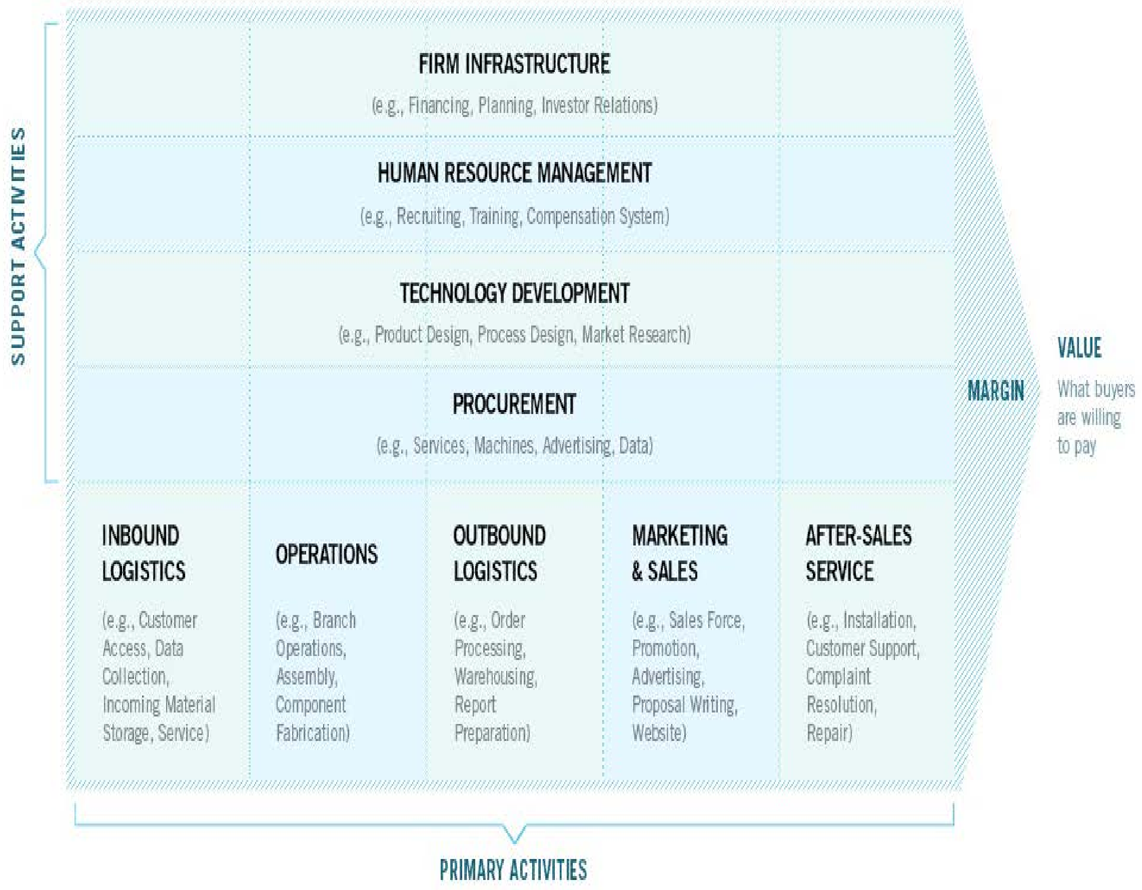
The Value Chain Model

This is how Porter demonstrates the links between the different company activities and where value can be created.



The Value Chain Model, Source https://www.isc.hbs.edu/about-michael-porter/Pages/default.aspx

The dotted lines above show that each support activity can play a role in each primary activity. For example, procurement supports operations with certain activities, but it also supports marketing and sales with other activities.

Primary Activities

Porter's examples of primary activities are:

- Inbound logistics – These are all the processes related to receiving, storing, and distributing inputs internally. Supplier relationships can be a key factor in creating value here.
- Operations – These are the transformation activities that change inputs into outputs that are sold to customers. Here your operational systems can create value.

- Outbound logistics – These activities deliver your product or service to your customer. These are things like collection, storage, and distribution systems, and they may be internal or external to your organisation.
- Marketing and sales – These are the processes you use to persuade clients to purchase from you instead of your competitors. The benefits you offer, and how well you communicate them, are sources of value here.
- Service – These are the activities related to maintaining the value of your product or service to your customers, once it's been purchased.

The key goal of primary activities is to create value that exceeds the cost of performing the activity, thereby generating higher organisational sales and profits.

Support Activities

Support Activities support the Primary functions above.

- Procurement (purchasing) – This is what the organisation does to get the resources it needs to operate. This includes finding vendors and negotiating the best prices.
- Human resource management – This is how well a company recruits, hires, trains, motivates, rewards, and retains its workers. People are a significant source of value, so businesses can create a clear advantage with good HR practices.
- Technological development – These activities relate to managing and processing information, as well as protecting a company's knowledge base. Minimising information technology costs, staying current with technological advances, and maintaining technical excellence are sources of value creation.
- Infrastructure – These are a company's support systems, and the functions that allow it to maintain daily operations. Accounting, legal, administrative, and general management are examples of necessary infrastructure that businesses can use to their advantage.

Porter further sub-divides each primary and support activity into three sub-activities:

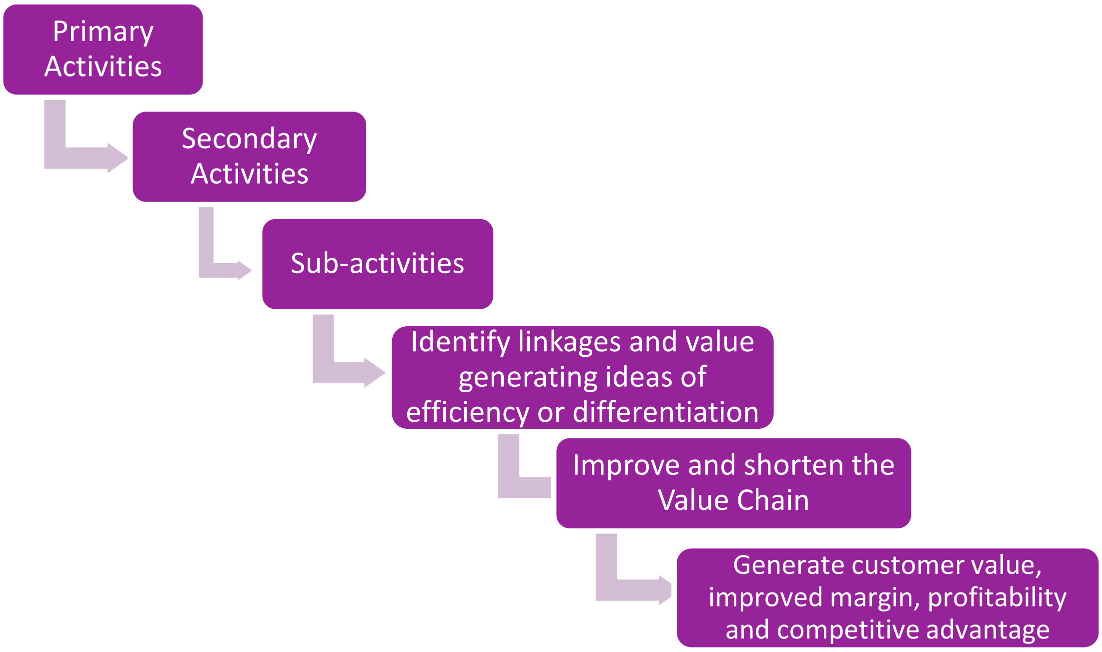
Sub-activities

- Direct activities which create value by themselves.
- Indirect activities which allow direct activities to run smoothly.
- Quality assurance activities which ensure that both direct and indirect activities meet the necessary standards.

The process is then to look at each support activity (human resource management, technology development and procurement and infrastructure) and determine the sub-activities that create value within each primary activity e.g. consider how human resource management adds value to marketing and Ssles, by looking at the direct, indirect, and quality assurance sub-activities.

For example, there may be a link between developing the sales force (an HR investment) and sales volumes. There may be another link between order turnaround times and service phone calls from frustrated customers waiting for deliveries.

Flow of Value Chain Analysis



In this way, you can add value by improving operational effectiveness and shortening the value chain. This allows a company to improve its processes by reducing mistakes, increasing automation, upskilling staff, eliminating waste. Porter argues that operational effectiveness means performing similar activities better than rivals perform them. For example, Walmart became the best at inbound logistics, driving down the wholesale cost of goods and passing on (part) of the savings to customers.

The value chain analysis can also identify areas where your value comes not through being better than your rivals but by being different from your rivals. Differentiation through expertise, through re-thinking a standard approach to the market, offers another route to competitive advantage. For example, Amazon re-invented the traditional book sales market and became the best at outbound logistics, making it easy to buy books and subsequently many other items through Amazon Web Services (AWS)

Examples of shortening the Value Chain

Digital technologies and automated infrastructure offer up many opportunities to shorten the value chain that links products or services to consumers. Products are moving from idea to market faster, thereby generating improved competitive advantage.

For manufacturers or retailers, direct customer relationships help them to be more responsive and to better sense and satisfy customer preferences for personalisation and co-creation.

Many of today's hardware start up's are using social media and digital platforms such as Kickstarter to connect directly with customers, building affinity for both product and company even before the launch.

Innovations such as 3D printing and on-demand fulfilment reduce or can even eliminate elements of traditional supply, such as the need to invest in inventory, further shifting the economics of the value chain and lowering barriers to competition.

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By releasing a few limited edition designs every week for pre-order, clothing start up BetaBrand receives constant demand data and customer feedback, reduced risk of carrying excess inventory and eliminating waste.

New market entrants experimenting with blockchain technology may discover further opportunities for removing significant parts of the value chain, built around validation, tracking, clearing, and risk mitigation.
On the downside, if an incumbent tries to shorten the value chain by going direct to the customer, large capital investments in infrastructure (IT systems, trucks, warehouses, and distribution centres) that supported inventory build-up may become obsolete and have to be written down.

Also, healthcare providers may be at risk in the future as developments in telemedicine continue to improve direct customer relationships and reduce the relatively high cost of the infrastructure that currently supports care.

How to re-discover your core competitiveness

Porter's advice to those companies who want to understand their company's 'value' and re-discover its core competitiveness is to ask these questions:

Which of our product or service varieties are the most distinctive?
Which of our product or service varieties are the most profitable?
Which of our customers are the most satisfied?
Which customers, channels or purchase occasions are the most profitable?
Which of the activities in our value chain are the most different and effective?

Limitations of the Value Chain concept

There are a number of perceived limitations to Porters value chain concept:

- The focus on products rather than services
  The model focuses on products rather than services, as do many tools from that more manufacturing dominated era, making it less easy to see the model's application to the newer services sector. However, services may not be physical in the same way as a product but the primary and support elements of service provision in a business still exist and resources will be used to turn expertise into services which the end customer needs and can generate competitive advantage

- The difficulty in measuring cost and value.
  It is hard to achieve the level of cost breakdown required to determine 'value'. Conventional accounting systems are orientated to internal functions rather than external outputs. Companies generally do not have the cost breakdown of each individual element of their internal process, let alone an approach to track their value. The true costs of servicing different customers, market segments or retail channels is just not available and financial software which may provide product costs generally do not have customer costs.

- The underplaying of the contribution of procurement.
  More recently the classic value chain approach has been criticised due to the casting of procurement in a support role. It is likely that during the late 1970s and early 1980s when Michael Porter was undertaking his research, procurement was more of a back-office, support function rather than the more dynamic supply chain influencing function we see in many organisations today.

The role of Procurement in the Value Chain

There has been a growing recognition of the critical role that procurement plays in creating and sustaining competitive advantage as part of an integrated logistics process. Leading edge organisations now routinely include supply issues in the development of their strategic plans. Not only is the cost of purchased materials and supplies a significant part of the total costs in most organisations, but there is a major opportunity for leveraging capabilities and competencies of suppliers through closer integration of the buyers and suppliers processes. In this way procurement plays a significant role within the value chain. With the emergence of the supply chain concept that includes procurement as well as logistics, it could be argued that supply chain has become a primary rather than support activity in the value chain model.

Additionally, procurement can use value chain analysis to understand suppliers' costs. Having this information is invaluable when negotiating or partnering with suppliers to understand real value drivers, find innovation and generate cost reductions.

Outsourcing elements of an internal process to those with enhanced expertise is now commonplace and Procurements role in developing supply market capability and in managing these complex contracts and relationships comes directly from value chain analysis activities.

"The implication of Michael Porter's thesis is that organisations should look at each activity in their value chain and assess whether they have real competitive advantage in the activity. If they do not, the argument goes, then perhaps they should consider outsourcing that activity to a partner who can provide that cost or value advantage. This logic is now widely accepted and has led to the dramatic upsurge in outsourcing activity that can be witnesses in almost every industry. The value chain thereby assists the managers to examine the costs and performance in each value creating activity and identify ways to improve these activities."

"The effect of outsourcing is to extend the value chain beyond the boundaries of the business. In other words, the supply chain becomes the value chain. Value (and cost) is not just created by the focal firm in the network, but by all the entities that connect to each other. This 'extended enterprise', as some have termed it becomes the vehicle through which competitive advantage is gained or lost.

The value chain analysis developed by Porter demonstrates that the Procurement function which interacts across all functions internally and the external marketplace have tremendous potential to provide value."

Taken from *Logistics and Supply Chain Management 5th edition* by Martin Christopher

The Future of Value Chain – Creating Shared Value

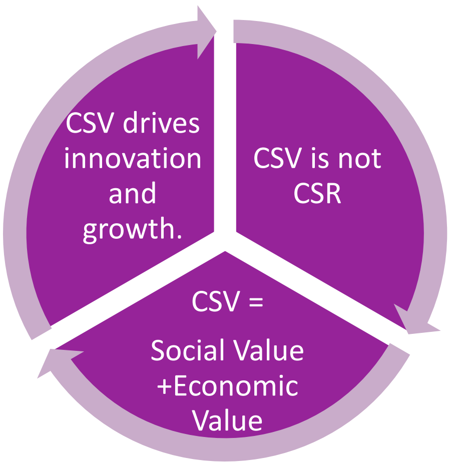
Dr Porter has developed the idea of the value chain and its influence beyond the world of business. In his 2011 paper with Mark Kramer, he introduced the concept of creating shared value, which is a framework for creating economic value while simultaneously addressing societal needs and challenges.

"Companies have overlooked opportunities to meet fundamental societal needs and misunderstood how societal harms and weaknesses affect value chains. Our field of vision has simply been too narrow." Michael Porter

Through CSV or creating shared value opportunities, companies can create economic value by creating societal value. Porter outlines three distinct ways to do this:

- by reconceiving needs, products and customers and meeting societal needs through products and serving unserved or underserved customers
- by redefining productivity in the value chain through utilising resources, energy, suppliers, logistics, and employees differently
- by improving the local and regional business environment, improving skills, the supplier base, the regulatory environment, and the supporting institutions that affect the business and on which it depends.

The Virtuous Circle of Shared Value



The Virtuous Circle of	Shared Value
CSV is not CSR	Creating shared value goes beyond philanthropy or corporate social responsibility
CSV= Social Value + Economic value	Creating Shared Value is addressing societal needs and challenges in a business model.
CSV drives innovation and growth	Creating shared value will drive the next wave of innovation and productivity in the global economy.

Each of these elements is part of the virtuous circle of shared value. Improving value in one area gives rise to opportunities in the others.

These ideas are changing the way companies approach philanthropy and corporate social responsibility. Value can be created not just for customers of businesses but for members of society.

Case Studies

Ikea disrupts the customer offering

The Swedish home furnishings giant, IKEA's value proposition is to provide good design and function at a low price. Its target customer is what IKEA calls the person 'with a thin wallet'. In choosing its particular kind of value and the activities needed to deliver it for its customers, IKEA has accepted a set of limits: it does *not* meet *all* the needs of *all* customers.

In every major value-adding step in the process of creating and selling home furnishings, IKEA has made different choices from the 'traditional' home furnishings retailer.

IKEA v Traditional Furniture Retailers

IKEA	TRADITIONAL FURNITURE RETAILER
Product	**Product**
Low priced, modular, ready-to-assemble designs	Higher priced, fully assembled product
No custom options	Customisation of fabrics, colours, finishes and sizes
Furniture design driven by manufacturing cost, assembly simplicity and style.	Design driven by image, materials, varieties
Value Chain	**Value Chain**
Centralised, in-house design of all products	Source some or all lines from outside suppliers
All styles on display in large warehouse stores	Medium-sized showrooms with limited portion of available models on display
Large on-site inventories	Limited inventories/order with lead time
Limited sales help, but extensive customer information	Extensive sales assistance
Long hours of operation	Traditional retail hours

Their philosophy is, "We can't do this alone. Our business idea is based on a partnership with the customer. First, we do our part… then you do your part... So together we save money."

'If customers can do simple things like pick up their purchases and assemble them at home, we'll keep prices low.' Source: IKEA website 2004.

Ikea offers customers more than just low prices; it has changed the model of how businesses interact with customers by cultivating a shift in customer mind-set. This is reinforced through the provision of childcare facilities, in-store restaurants, pens and paper and tape measures. This fundamentally changes the furniture buying experience in such a way that it is difficult for competitors to replicate.

Ikea shortened the value chain by setting the price tag and then designing, sourcing materials. Finding suppliers to fit the price also helped IKEA to reduce the costs by 30% and pass those savings onto customers. Flat packing has allowed IKEA to ship six times more units per shipment than if it were to ship assembled furniture, but this is only viable because it has effectively moved this stage of the value chain to the customer. As a result of innovative delivery and customer engagement, by 2002, less than 20 years after entering the US market, IKEA had become the world's largest furniture retailer with $12bn in global sales.

How does Procurement Add Value to the Supply Chain?

Isn't Value Chain Management the same as Supply Chain Management?
Taken from: Deloitte Insights, Shorten the Value Chain January 2016 by John Hagel III, Seely Brown, Maggie Wooll, Andrew de Maar

While a supply chain is orientated around the flow of inputs and outputs from raw materials to finished goods, a value chain is orientated around the generation of value for the customer, as defined by the customer. Supply chain efforts will tend towards integrating processes and improving efficiency in ways that incrementally reduce cost for the company. Value chain restructuring on the other hand focuses on new approaches which might be used at each stage to meet evolving customer need in significantly different ways to in order to deliver greater value to the customer.

Supply chain management focuses largely on optimising efficiency, often through incremental changes in the physical movement and management materials. It is an important and well established area of practice. Shortening the value chain fundamentally changes the economics of value creation in a market by eliminating or shifting stages of the value chain. Shortening the value chain is in effect broader and more transformative than supply chain optimisation and is driven by innovations in product development and customer engagement.

What Value does Procurement add to the business?

Taken from AT Kearney, 'the future of Procurement: rediscovering the fundamentals.'
https://www.kearney.com/procurement/article/?/a/the-future-of-procurement-rediscovering-the-fundamentals

In a recent paper by AT Kearney,' The future of procurement: rediscovering the fundamentals' they ask the question, also posed by Value Chain Analysis, What value does procurement add to the business? And they come to a very similar conclusion.

"In its simplest terms, the real reason procurement exists is to enable a business to turn supply-market capabilities into value for end customers. This can be known as disruptive procurement and is the essence of the premise behind the Porters value chain as applied to procurement. This has already happened with high technology OEM's in the high-tech, telecoms, automotive and aerospace industries to name a few. From an operations perspective, they are procurement businesses that effectively design, procure and outsource manufacturing." "All too often these tenets are abandoned because procurement lack the basic insight and understanding to harness supply-market power and instead focus on cost savings, arguing over contract terms that never get implemented and slowing down users who want to buy things, in the name of 'control'. To be fair, procurement is not alone in this. Other supporting business functions have remained mired in similar

levels of immaturity. Finance spends much of its energy on bookkeeping rather than driving effective capitalisation. Human resources spend its time on processes and administration rather than motivating and enabling the workforce. IT focuses on limiting what users can do or not do instead of harnessing technology to help businesses compete in the marketplace.
Procurement of the future will align to the customer and offer teams to shape categories that directly impact on the product-customer offering.

Author

Susan has worked in corporate industry within procurement for many years, undertaking everything from expediting, through contract negotiation, to strategy development and large scale change management initiatives.
She is now focusing on project procurement, commercial training, coaching and technical authoring through her own business.

Susan is a great contributor to CIPS and has been involved with CIPS through her chairmanship of the Birmingham branch and participation in the annual Negotiation Challenge events.

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Further reading

https://www.isc.hbs.edu/about-michael-porter/Pages/default.aspx
Competitive Advantage: Creating and Sustaining Superior Performance by Michael Porter 1985
Logistics and Supply Chain Management 5th edition by Martin Christopher 2017

Chartered Institute of Procurement & Supply