WORKING PAPER
ITLS-WP-07-06

Achieving competitive advantage through strategic and operational partnering in the value chain: The Asia Pacific challenge

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May 2007

ISSN 1832-570X

INSTITUTE of TRANSPORT and LOGISTICS STUDIES
The Australian Key Centre in
Transport and Logistics Management

The University of Sydney
Established under the Australian Research Council's Key Centre Program.

NUMBER: Working Paper ITLS-WP-07-06

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ABSTRACT: The Asia Pacific region has witnessed many changes in recent years. For much of the last 15/20 years it has been the source of low-cost production of labour intensive products. More recently there has been a significant shift in economic and business activity. Following the initiative of Singapore, other Asian economies have sought to emulate Singapore's patterns of growth. Rather than be just another source of low-cost labour (competitive necessity) many are now seeking to create competitive advantage by pursuing government sponsored strategies to establish leadership in knowledge, technology, process and relationship management based industries raising interesting problems and opportunities for Australasian companies.

KEY WORDS: ***Operational outsourcing, strategic/transformational outsourcing, economic value added, enterprise value***

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DATE: May 2007

1. Introduction

The Asia Pacific region appears to offer opportunities and challenges over the coming decade. Callick (2005) [1} in a series of three articles identified many of the opportunities. He suggested these were huge following twelve years remorseless economic growth brought about by access to consumer credit and low global inflation; the increasing number of FTA's (Free Trade Agreements) has also had a major impact on the growth of consumer economies notably, Singapore (by no means recent but continuing to show significant growth), China, India, Indonesia, and South Korea. As these economies are encouraged to grow (for example in South Korea credit card interest is tax deductible) the opportunities for Australian consumer product companies increase rapidly. Other factors such as the rapidly expanding middle class population that is beginning to become homeowners, the ease of communications (through broadband networks) will offer opportunities for consumer durable products. In China this affluent group is now purchasing replacement cars, computers and other durables. As Callick suggests the heel has gone full circle and the Asian middle class population is now purchasing an increasing amount of the products they once only manufactured. Financial globalisation and the regionalisation of production in the period mid 1980s to the late 1990s resulted in a region-wide economic boom that has `created a new breed of urban professional. McKinsey's "Ten trends to watch in 2006" [2] offers the same perspective with an interesting statistic: as a consequence of economic liberalization, technological advances, capital market developments, and demographic shifts, the world has embarked on a massive realignment of economic activity. Asia (excluding Japan) accounts for 13 percent of world GDP.

While these comments can be seen as encouraging they do suggest the need for caution. Callick's comment concerning "purchasing the products that once they only manufactured" suggests the need for a structured approach to planning and managing operations in the Asia Pacific. This aggregate market, once considered only to have two characteristics (i.e., as a source of low cost labour, and more recently, as a market for bulk resources) is changing rapidly into a source of skilled, competitively priced labour, and at the same time is offering a high level of sophisticated processes and areas of developing specialisation. But it is also becoming an Asian middle class market for typically 'western' tastes; products and services that continue to have appeal in Sydney are now having appeal to large affluent groups throughout Asia, for example, it is estimated that Indonesia has a rapidly growing middle class population that is twice the size of the Australian population!!

Thus the opportunities confronting Australian and New Zealand companies are two-fold; they can be lucrative markets for the products and services of these companies and, concurrently, resource markets for skills and R&D expertise. The question confronting managers is how best to balance these opportunities. There are a number of possibilities:

- Manufacture in Asia Pacific locations to benefit from low costs, market potential and longer term development

- Assemble products in domestic base countries and outsource manufacturing to low-cost suppliers

- Take a medium-term perspective and source both tangible and intangible 'components' of the product from the most beneficial locations and suppliers

- Take a long-term strategic perspective and build towards a business model that will ensure an ongoing business that creates satisfactory stakeholder value.

For any of these options to be pursued the implications of each for the organisation require evaluation and this requires a structured approach. Two studies have been undertaken by the Australian Industry Group *Manufacturing Futures – Achieving Global Fitness, April 2006* and *Australian Manufacturing and China, August 2006* [3]. The findings from the reports suggest that a number of Australian companies have identified with the problems *and* the opportunities. The respondents gave; speed-to-market, ability to customise, after sales service, the ability to integrate processes, unique design abilities, brand equity, distribution arrangements and high capital intensity, as features that afford *competitive advantage*. When questioned about their *responses* they gave; new product development, using more imported materials, off-shore production, and skills acquisition and upskilling as responses. The respondents were asked their views on *opportunities* in China and the Asia Pacific area. They perceived these as; increasing exports to china, making greater use of Chinese inputs in domestic production, selling completed Chinese products on the domestic market, and establishing operations in China.

While the strategist would argue that operational considerations follow strategy decisions, the reality of the response of the industrialised countries industries has been to address the short and medium term before the long term in an attempt to shore up immediate problems that mostly concern pricing response and profit maintenance. Therefore we will tackle the issues first from an operational perspective.

2. An Operational Management Perspective of Performance management

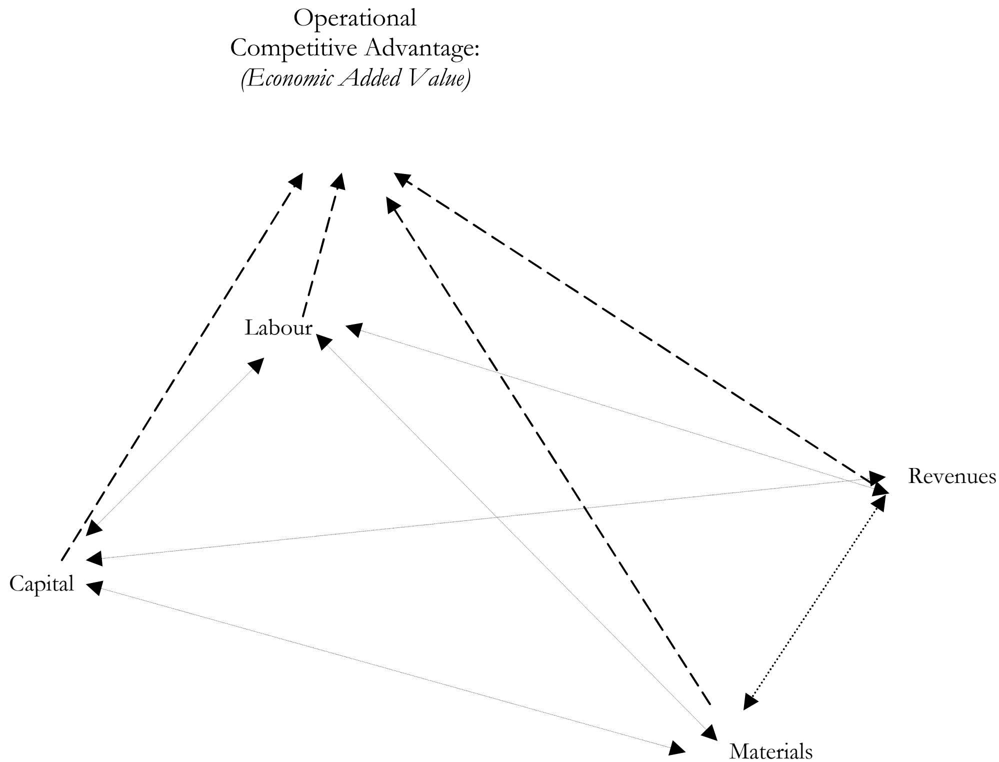
Business decisions require performance measures. In the short/medium term managers have decision options over labour, materials, and capital inputs, and revenue generation options. The choices that can be made essentially concern trade-off alternatives among these alternatives in an attempt to achieve an optimal level of performance that will appeal to shareholders. **Fig 1** proposes a simple approach using the EVA model currently popular with investors and corporate managers.

2.1 Economic Value Added (EVA)

Stern Stewart [4] developed this concept into a performance measure that has become widely accepted as a financial performance metric. EVA (economic value added) uses a similar approach to Kay (1993) [5]; the EVA concept of *applied capital* takes the view that in an operating period (typically an accounting year) an amount of capital is consumed in the outputs of the organisation and as such should be deducted from the operating profit of the business.

The advantage of both measures is that they provide a realistic measure of value creation in the short term. However care is required when calculating the cost of applied capital

because strictly it should only be the capital expenditure directly involved in generating the period profit, other measures are required if a longer period is to be considered. The notion of capital is a comprehensive calculation including tangible fixed assets, working capital and *could include intangibles,* such as capitalised expenses to maintain brands, specific customer/period focused R&D and management development expenditure where this too is relevant to the period operating profit.



EVA as an Operational Performance Measure

Fig 1: Increasing Competitive Advantage by optimising the Operational Resources Mix

A positive EVA indicates management is creating value for the shareholder, while negative values suggest value is being destroyed. Essentially EVA measures a company's success over the previous year; other measures are required if longer term time periods are under consideration *and* particularly if strategic alternatives are to be evaluated. Typical information inputs are those that can be managed in the short/medium terms and show responses. Within the context of this discussion it is clear that outsourcing decisions can have a significant impact on the EVA performance in the short/medium term time period.

EVA **Characteristics**	**Shareholder Value Drivers**	**Management Variables**
Operating Profit less	Profitability	• Revenues • *less* discounts allowed • *plus* supplier bonuses • Interest • *"Operating Profit"*
Cost of Capital for the period = $value of the Capital Employed (Capital Employed X Weighted Average Cost of Capital	Productivity	• Changes Fixed Asset values • Changes in Working Capital values • *"Revenues"/Total Assets*
= Economic Value Added	Cash flow	• Operating Profit +/- • Increases/Decreases in cash flow from assets +/- • Increases/Decreases in strategic cash flow +/- • Increases/Decreases in equity/debt funds +/- • *Free Cash Flow Generated*

3. A strategic management perspective of performance management

With the best will in the world any organisation cannot succeed in the long-term without a *viable* business model and while this would appear a statement of the obvious, it does not appear to be the primary objective of many organisations. Often the problem is one of an unwillingness to "step outside the square" and ask a few "what if questions"; for example what if we switched the corporate focus away from reducing cost towards one of revenue led profitability, and/or what if we shifted our focus to capturing a share of market-added-value rather than market share by focusing on our exclusive assets, processes and capabilities. Current thinking amongst the successful organisations suggests that this is occurring. For example, Fonterra the New Zealand based dairy produce global operation, appears to be doing just that. Fonterra has a successful dairy processing activity that supplies input to the major branded food producers and has an increasing number of global partnerships that produce consumer brands across a range of international markets. This flexible approach to organisational structure appears to show success.

One possible explanation for the cost-led strategies of many organisations is that it is easy. The traditional approach to outsourcing has encouraged this behaviour. It is low risk; the organisation maintains control and remains competitive - in the short-term! The evidence above suggests significant changes are occurring in the Asia Pacific business environment. It follows that if the "traditional" approach is maintained many of the markets that now offer opportunity to establish knowledge led advantage (or for that matter technology, process or relationship led advantage) will disappear as competition from the rapidly developing Asian countries accelerates.

How then can Australian and New Zealand organisations compete? One requirement is a change of approach to strategy, structure and implementation. A shift of emphasis away from *owning* resources towards *managing or coordinating* them is essential (Normann: 2001) [6]. So too is a perspective on what comprises a market; the Fonterra example is but one in which an organisation has found market opportunity by adapting its view of the "market". Recent practice of *Market Opportunity Analysis* suggests that opportunities can be found in a number of alternative approaches, these may be

considered as vertical, horizontal and integrated structure options. *Vertical markets* are based upon the industry value chain. They represent opportunities for organisations within the industry value to move forward or backward within the value chain and expand their activities to include processes for which they identify opportunity to increase the added value captured by the value chain. *Horizontal markets* exist in markets for which substitute products, services and delivery alternatives become available. These markets may be based upon *product developments, service developments* or *market (segment) developments.* And in *integrated markets* value is added using *partnership innovation*. Partnership innovation combines elements of process innovation management and product innovation management within a network structure that neither partner can create using its own resources to meet customer/market determined expectations for product and/or service performance at an economic (viable) cost, (Best: 2004, Walters and Rainbird: 2007) [7] [8].

There other requirements. For example the acceptance of the notion that *flexibility*, even *agility* is becoming essential characteristics of current competitive business structures and it is likely these features appear will be more effective in a partnership structure. Traditionally, organisations and their environments were conceived as quite distinct from one another in relatively simple and undifferentiated markets. More recently groups of interrelated organisations now occupy niches or 'resource spaces' such as industries and markets (Cameron & Zammuto, 1983) [9] and form strategic alliances to pursue joint ventures. Under these new organisational arrangements, temporary networks exploit new market opportunities, and shared costs, skills, and access to emerging global markets (Byrne & Brandt, 1992) [10]. The *virtual value business organisation* is at a further step along the evolutionary scale. It does not enter a pre-existing market arena: rather, boundaries between stakeholders merge and shift constantly as interdependent enterprises respond dynamically to changing patterns of consumer demand and market structures, as well as innovations in technology and knowledge management. Processes of value creation link all system participants in shifting spirals of relationship building, resource sharing and exchange.

Accepting this concept is one thing, applying it is something further. Earlier we commented on the most widely accepted view and application of outsourcing. This can be expressed as:

Operational Outsourcing: is considered an efficient means of reducing cost and increasing the profitability and productivity of an organisation by transferring some (or all) of the processes or activities to outside providers.

And as suggested this may be a short-term (and a short sighted) view of the benefits that can be obtained from partnerships.

There are organisations that do incorporate such approaches. Consider Gottfredson et al (2005) [11] who discuss capabilities from a strategic sourcing perspective and argue that:

"Now globalization, aided by rapid technology innovation, is changing the basis of competition. It's no longer a company's ownership of capabilities that matters but rather its ability to control and make the most of critical capabilities, whether or not they are on the company's balance sheet. … Outsourcing is becoming so sophisticated that

even core functions can and often should be moved outside. And that, in turn, is changing the way firms think about their organizations, their value chains, and their competitive positions".

The authors suggest that "forward thinking" organisations are using "capability sourcing" to make their value chains more flexible. They also suggest that this approach questions whether all activities should be outsourced. They identify a number of companies who have focused on their brand strength on which to continue to build their businesses. Companies such as Virgin and Nike are offered as` examples. Capability sourcing is based upon a rigorous assessment of an organisation's capabilities to determine which match the requirements of an identified opportunity and where there are "capability gaps".

The authors provide ample evidence in support of their argument that by the 1980s the basis of competition shifted from "hard assets to intangible capabilities". Wal-Mart is cited as moving away from traditional retailing capabilities towards a proprietary approach to relationship management within its supply chain. The US automotive industry responded to the growth of market share of its Japanese competitors by moving design, engineering and manufacturing work to specialist partners. Strategic sourcing relationships were established for complex assemblies with agreement to sharing cost accounting data *and* cost savings. American Express outsourced its transaction-processing to First Data, a new organisation in 1992. Gottfredson et al make an interesting and very significant point with this example: American Express realised that while this process was core to their business it was becoming "commododitised" and therefore declining in its importance as an element of competitive advantage. With the processing outsourced to a reliable partner they were then able to focus on the card issuing aspect of the business.

This suggests that traditional outsourcing has matured and has a broader concept, one encompassing the entire business rather than just inputs and a more useful definition would be:

Strategic Outsourcing: A long-term strategic perspective of partnership decisions. Constant evaluation of the role all resources (assets, processes and capabilities – core and non-core) in developing strategic competitive advantage and the growth of corporate value; increasing the productivity of existing expertise by making better use of collaborative external resources.

3.1 Enterprise Value

In a discussion on "the philosophies of risk, shareholder value and the CEO", Knight and Pretty (2000) [12] offer another interesting model of the business. They suggested that the value of a quoted company *has three components: tangible value, premium value, and latent value. Tangible assets* will sustain the company's value in times of crisis (typically its tangible core assets, capabilities and processes. *Premium value* represents the value in excess of book value at which the company trades in the open market (comprising intangible assets such as brands, intellectual property, etc) and; *latent value* that represents value that might include operating efficiencies yet to be realised due to productivity increases and potential consolidation.

The *enterprise value model* described by the authors has a simple structure and is shown as **Fig 3**.

Knight and Pretty discuss enterprise value from a risk management perspective. They argue that it is the role of the chief executive to identify the risk confronting the organisation and to make decisions. Their thesis is that it is the role of the chief executive to identify and realise sources of value and the risk each presents to the organisation, by doing so an *optimal* growth strategy will be evolved in which returns will be achieved at acceptable levels of risk. *Enterprise Value* is the aggregate net present value of the three components.

Enterprise Value = *f* (Latent Value (Consolidation & Productivity) + Tangible Value (Tangible assets) + Premium Value (Intangible Assets))

or :

Enterprise Value = *f* (NPV of returns on on existing asset efficiency improvements + NPV of returns on fixed and working capital + NPV of returns intangible assets)

Fig 3: The Enterprise Value Model described by Knight and Pretty has a simple structure

The enterprise value model has obvious attraction. It offers not only the facility to consider the enterprise as a number of individual (but related) components but also the facility to explore strategic growth alternatives. The investment market view, suggested by Rappaport (1986) [13], Reimann (1985) [14], and Copeland et al (1995) [15] considers that a business is worth (i.e. the enterprise value), the net present value of its future cash flows discounted at an appropriate cost of capital. This approach avoids the inadequacies of traditional financial measurements and recognises the time preference for money and the risk of an investment. This is suggested by Knight and Pretty as a means for measuring tangible value where future cash flows are discounted at a relevant cost of capital. No proposals were made for either premium or latent value. Given the Brookings Institution [16] findings, this is an important consideration, one requiring attention due to either the increasing leverage of partners' fixed assets (the Dell approach) or the increasing importance of intangible assets (such as brand values and innovative RD and D) or clearly the two together.

It follows that given three growth options the innovative organisation will identify an option (or perhaps a combination of options) that offers the highest NPV. Further, the options may require searching for suitable partners to contribute to the required competencies/capabilities. The major benefit of the model is that it encourages the search for strategic alternatives that may create significantly larger opportunities for competitive advantage. **Fig 4** illustrates the role of Enterprise Value as a long-term planning model; it uses the notion that in the long-term an organisation will use the strategic resource mix that identifies with success in the industry sector or market/segment that it currently operates in or is exploring entry potential. (See Walters and Rainbird: op cit) The concept of the virtual organisation is that by integrating organisations who offer expertise and specialist skills a more *strategically effective* market response can be made. This

suggests that aggregate risk is therefore lower as each organisation has the "strategically optimal" resource base. Taken further it also implies that any single organisation attempting to compete would not have the skills and expertise of their virtual competitor and this would be reflected in the comparative weighted average cost of capital (WACC)interest rates. Should an individual organisation wish to expand and increase its funding to do so it would more than likely discover that the cost of borrowing would be higher than its current WACC. Organisations evaluating the alternative structures would have access to this information and should use the alternative WACC rates as the input rates for arriving at the NPV of the free cash flows produced by each alternative.

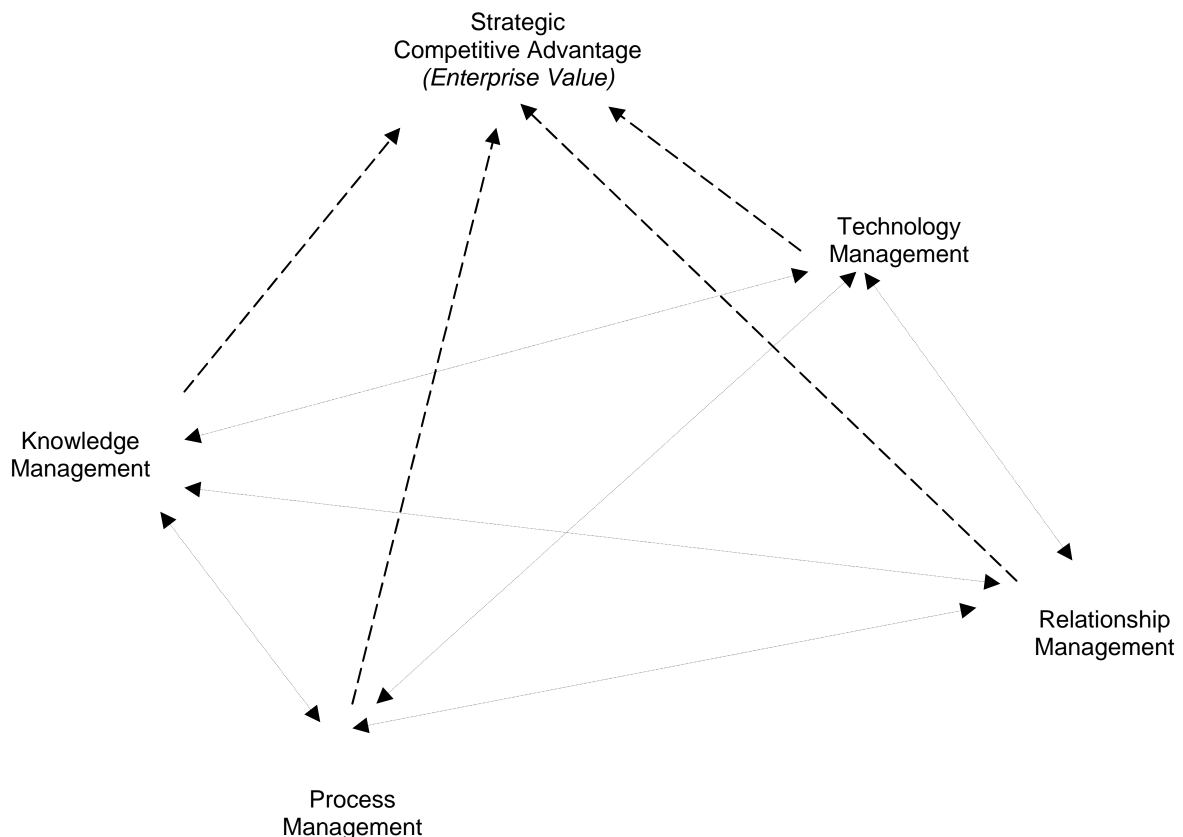


Fig 4: Increasing Competitive Advantage by optimising the Strategic Resources Mix

4. Concluding Comments

To be successful in any market in the 21st Century any organisation will a *viable* business model and while this would appear a statement of the obvious, it does not appear to be the primary objective of many organisations. Often the problem is one of an unwillingness to "step outside the square" and ask a few "what if questions"; for example what if we switched the corporate focus away from reducing cost towards one of revenue led profitability, and/or what if we shifted our focus to capturing a share of market-added-value rather than market share by focusing on our exclusive assets, processes and capabilities. Current thinking amongst the successful organisations suggests that this is occurring. One possible explanation for the cost-led strategies of many organisations is that it is easy. The traditional approach to outsourcing has

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The results of the AIG and the comments made by Engardio (2006) [17] support the earlier comment that successful companies are accepting the notion of a strategic approach towards *transformational outsourcing*. Applying their findings to the short/medium term and long-term models proposed in this paper not only demonstrates fit but also shows a logic appearing whereby they are gaining competitive advantage from synergy. Many of the activities attributed to the companies interviewed are combining the effectiveness of the activities across two or more of the model characteristics. These are shown for both the short/medium term **Fig 5** and long term **Fig 6.**

Fig 5 illustrates a number of actual (from research) and *hypothetical* (potential) examples of partnerships aimed at improving short-term performance (EVA); clearly performance improvement can be measured by an increase in year on year EVA. It is interesting to note that the 'actual' examples share process efficiency improvements that maintain competitiveness. For example Codan has designed its products around modular assembly to reduce costs, while GPC electronics has used process design to improve both supplier and customer response times thereby improving it's operating and cash cycles.

Fig 6 illustrates long-term examples, actual and *hypothetical indication* using the format of **Fig 5.** In **Fig 6** the actual examples share a common strategy, one in which intellectual property (IP) is protected by innovative process design. For example, Bosch have customised their manufacturing processes to protect their IP; Wyeth (pharmaceuticals) has designed its processes around IT platforms and has subsequently outsourced its operations to low cost suppliers, and; Ford has decided to use IP service as its entry point into Asia.

Clearly there may be other approaches that meet the need of a balanced response to the operational and strategic opportunities within the Asia Pacific region and the models presented here suggest a logic that requires further research.

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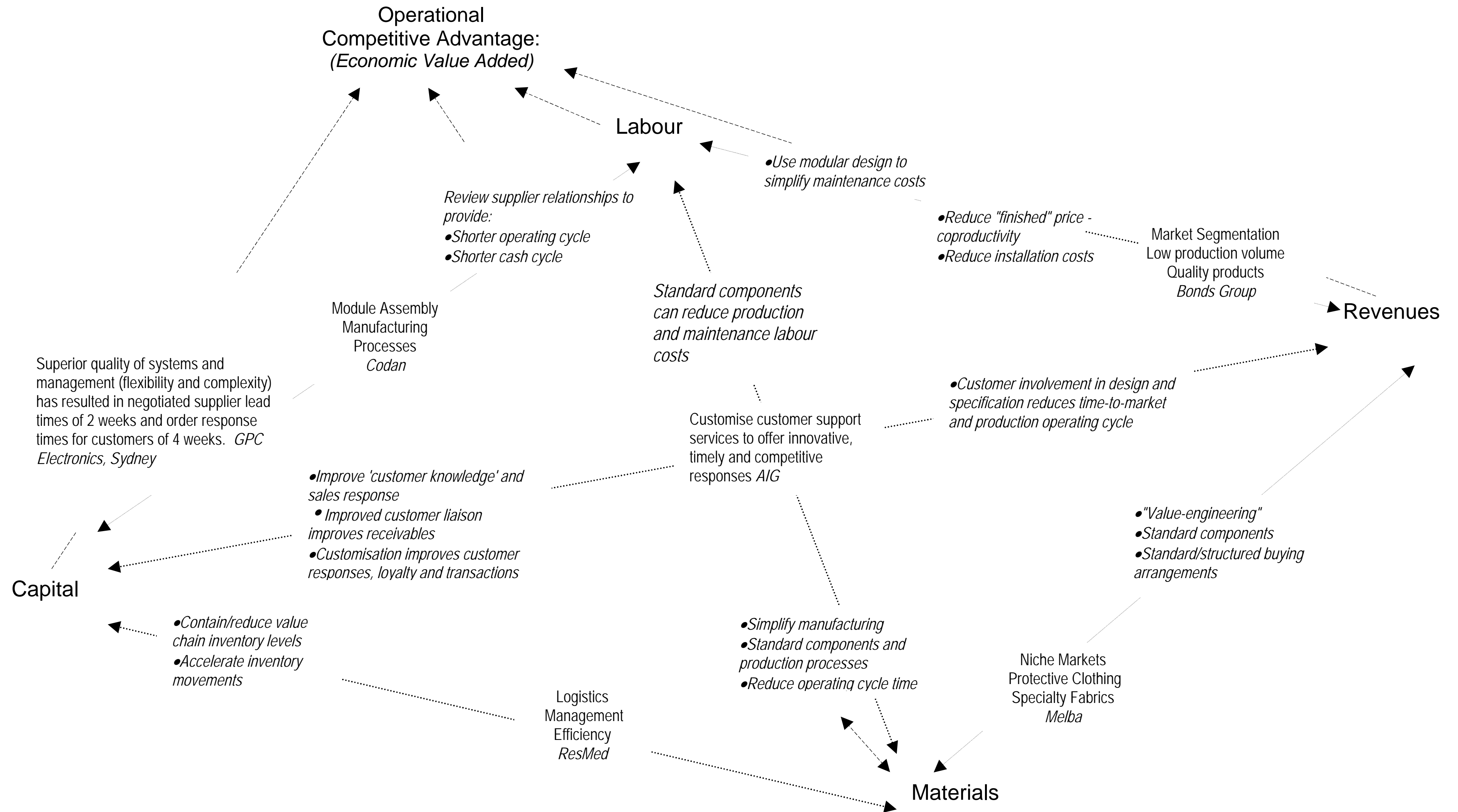

Fig 5: Identified Corporate Operational Responses to Market Place Challenges

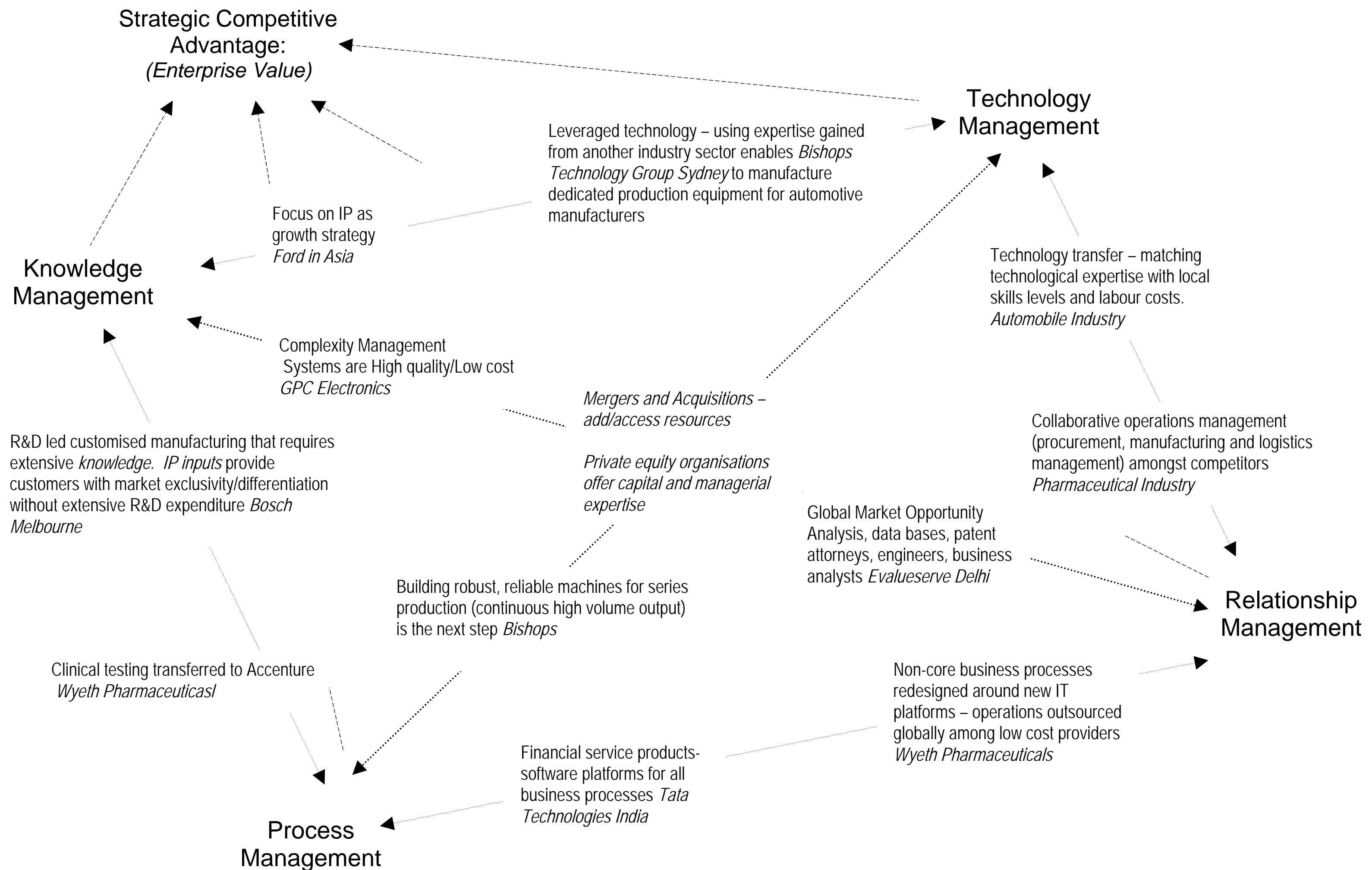

Fig 6: Identified Corporate Strategic Responses to Market Place Challenges