Organisational Capability as a Source of Competitive Advantage

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1. Sources of Competitive Advantage

1.1 Competitive Positioning

Most Chief Executives when asked about the source of their business’ competitive advantage will respond with something about differentiation, or cost competitiveness, or possibly something about efficient operations or customer connectivity. The basic ideas behind these responses come from Michael Porter.

Porter, a professor at Harvard, emphasises the need for strategic fit, in which an organisation adapts its resources to take advantage of opportunities provided by its environment. This involves selecting one of three generic strategies (differentiation, cost leadership or focus) and then supporting this strategy through a system of integrated and coherent activities. Porter also explains that developing strategy involves making trade-offs – deciding not to do something so that the company can concentrate on what it is going to do.

Once a strategy has been chosen and implemented, competitive advantage can be extended by improving operational efficiency. But operational efficiency will not provide an ongoing competitive advantage on its own.

However, there are other sources of competitive advantage and there is a growing belief that these approaches are more sustainable over the longer-term.

1.2 Core Competencies

In the early 1990s, organisations started to realise that they could leverage their own resources or core competencies to provide competitive advantage. The originators of this concept, Gary Hamel at London Business School and C.K. Prahalad at Michigan, explain that core competencies describe what an organisation is uniquely capable of doing. Their examples of core competencies include Sony’s capabilities in miniaturisation which allow it to make everything from the Walkman to video cameras to notebook computers. Hamel and Prahalad explain that the skills and capabilities required for miniaturisation, for example a deep understanding of customer needs and technological possibilities, take many years to develop and hence are not readily available to competitors.

Core competencies are built partly upon people’s skills and abilities, but they tend to focus even more on other aspects of an organisation such as particular business processes, technology and customer loyalty.
1.3 Organisational Capability

The concept of organisational capability builds on the idea of core competency by recognising that it is people and the way they are managed and developed that are an organisation’s most important source of competitive advantage. Growing evidence to support this claim is described within my book (Ingham, 2006).

Organisational capabilities generally fall within one of the following three categories:

- Human capital, which is built upon the abilities of individual people
- Organisational capital, which is about how effectively the organisation helps people to do their work
- Social capital, which is about the networks and relationships between the people working in the organisation
- Customer capital, which is about the relationships between the organisation and its customers, often supported by corporate and / or product brands.

1.3.1 Ulrich: Capitalising on Capabilities

The term ‘organisational capability’ was actually introduced, or at least adopted for the HR field, by Dave Ulrich. He explained that organisational capability enabled an inside-out approach to business strategy and he defined organisational capability as ‘Things a company knows how to do well, the ability of an organisation to use resources, get things done, and behave in ways that lead to accomplishment’ (Ulrich, 2003).

Ulrich (2004) has identified eleven intangible capabilities he believes are important to business effectiveness and that I have categorised as follows:

Customer capital
- Customer connectivity: building enduring relationships or trust with targeted customers.

Human capital
- Talent: attracting, motivating and retaining competent and committed people
- Leadership: embedding leaders throughout the organisation.

Organisational capital
- Speed: making important changes rapidly
- Accountability: demanding high performance from employees
- Learning: generating ideas with impact
- Innovation: developing breakthrough products and processes
- Efficiency: managing costs.

Social capital
- Shared mind-set and coherent brand identity: ensuring positive, consistent perceptions of the company among employees and customers
- Collaboration: working effectively across organisational boundaries
• Strategic unity: articulating and sharing a strategic viewpoint.

Ulrich also describes how an organisation needs to pick intangibles that fit with its business strategy, emphasising, for example:

• Collaboration if the business strategy is about managing alliances
• Learning if the strategy is about sharing knowledge across global business
• Talent if the employer is trying to grow in new industries
• Speed if the organisation is trying to compete on cycle time.

1.3.2 The Work Foundation: The Company Performance Index

The Work Foundation has conducted research placing 3000 companies in a league depending on how they handle customers and markets; shareholders and governance systems; stakeholder relationships; human resources practices and the management of innovation and creativity, which together, form an overall Company Performance Index (CPI).

During a thirteen month period when the UK stock market grew by fourteen per cent, companies at the top of the Work Foundation’s index experienced a twenty six per cent gain in market value and companies at the bottom of the index gained just a six per cent increase.

The Work Foundation has identified five ‘intangible factors of production’ that translate the five process areas of the CPI into productive action. Again, using my categorisations, these intangibles are:

Human capital
• Leadership: visible and accessible leadership and management, combined with high expectations from those in decision making roles

Organisation capital
• Structure: unique organisational structure resulting from geography, size and history, that enables continued success rather than being a specific driver of that success
• Process: a higher degree of informality and continued dialogue supported by simple – though not simplistic – processes that allow faster decision-making

Social capital
• Communication: openly sharing information between peers and networks or managers than need timely and accurate information in order to get the best job done
• Culture and Employee Relations: a distrust of the status quo, valuing quality rather than quantity, a focus on the long-term and on outcomes; a positive climate characterised – not codified – by pride; innovation and strong interpersonal relations,
The research (The Work Foundation, 2005) concluded that achieving high performance is about developing best fit between a company’s strategic choices over their business goals and the practices they choose to achieve these goals. It also noted that: ‘The exact ‘fit’ will depend on a myriad of external and internal factors such as history of the organisation, its geography, its sector and its position within that sector.’

1.3.3 Nohria: What Really Works

However, there are many other lists of capability too. One example is Harvard professor, Nitin Nohria’s study into the ‘must-have’ management practices that produce superior results (Nohria, 2003). Nohria has identified that what he calls ‘evergreen’ companies have a strong grasp of the business basics: strategy, execution, culture and structure; and that they also supplement this with mastery of two out of four secondary management practices: talent, leadership, innovation, and mergers and partnerships.

It is important to note that competitive strategy is still important. An increasing focus on internal capability should not result in a decreasing focus on external positioning. But the research does provide some evidence that an inside out approach is more successful that a purely externally focused one. Nohria found that what was much more important than the positioning itself, was that this positioning is well defined, clearly communicated and understood; and that it is well supported by great execution and a supporting structure, culture etc.

2. The Growing Importance of Organisational Capability

2.1 Market-to-Book Value

The growing importance of organisational capability can be seen in the fact that companies’ market to book value (the ratio of their capital market value to their net asset value as stated on their balance sheets), has increased dramatically since the 1980s. In research for the Brookings Institution, Baruch Lev, Professor in Accounting and Finance at New York University, notes that the mean market to book ratio of the Standard & Poor’s 500 companies had increased from about 1.6 in 1980 to about 4.2 at the time of writing (2001). It is generally accepted that main reason for this change is that the market sees something of greater worth than the physical assets recorded in financial accounts. This additional value is due to the company’s organisational capability.

These findings have been supported by recent research from McKinsey (Devan et al, 2007). The firm has found that companies which have outperformed their competitors on both revenue growth and profitability over the last decade have typically grown through an inside-out approach to strategy based upon organisational capability, rather than by acquisitions, and therefore have higher market-to-book values than their competitors.

But why has organisational capability become so important?
2.2 Growing access to Financial Capital

Financial capital is the key resource that underpins Michael Porter’s approach to competitive strategy. But financial capital is no longer the scarce resource that constrains growth. Global capital markets move money around so quickly that having preferential access to capital no longer brings competitive advantage. In addition, increasing industry capacity has reduced the demand for financial capital. Many companies have more financial capital than they are able to use to generate margin at sufficiently high returns for their shareholders. When this is the case, companies spend their excess capital on mergers and acquisitions. If even this does not generate sufficient returns, companies buy back their own shares.

2.3 Declining access to Human Capital

In the UK and many other countries, changing demographics mean that the availability of human capital often feels like it is decreasing. In fact, this is often not necessarily the case, as it may just be that organisations need to be more flexible in where they find their talent – for example, through the employment of more women and older workers. However, significant cultural change will often be required before organisations can fully access these wider talent pools.

So just as financial capital is becoming more accessible, human capital is becoming rarer, at least until we learn to use what is available more intelligently.

2.4 Increased Competition

Increased competition and the knowledge economy are making it harder to sustain a secure external positioning that provides ongoing competitive advantage.

A focus on organisational capability also recognises that organisations compete for talent, and that having a clear capability helps to signal to current and potential employees what the organisation is about. This helps to position the organisation as an employer of choice for the type of people that it wants to employ.

2.5 The Value Agenda

One consequence of increased competition is that organisations are searching for new ways to create value. The principle of created value is that continuous improvements are no longer enough. Created value surprises competitors and changes the nature of the competition. This is explained in the next section of the white paper.

3. Creating Value through Organisational Capability

This model is called the Value Triangle. It suggests that HR can provide value to the business in three different ways:
At the bottom of the triangle, HR provides value for money when it increases the efficiency of HR activities. This may not improve customer satisfaction or help deliver business results, but it is still useful value to have. An example would be improving a recruitment process by automating relationships between suppliers, HR and line management to reduce the time to fill vacant positions.

The next level is adding value. This is about helping the business to implement its strategies by translating business objectives into people management activities. Another recruitment example at this level might be helping a business achieve its growth objectives by launching a campaign to fill a number of new positions.

And the top level is creating value. Here, HR generates value for the business through its own activity, rather than by how its activities support the business as a whole. So, whereas adding value provides an organisation with the ability to implement its business objectives, creating value develops new capability that enables the organisation to set different or more stretching business goals. A recruitment example would be developing an employer brand to position an organisation as an employer of choice, and by doing so, significantly speeding up its growth.

Creating value is largely about developing organisational capability. This provides an even more important role for organisational capability than Ulrich and Nohria have in mind when they talk about capability as something that can help an organisation achieve its objectives. Creating value organisational capability informs the organisation's business objectives, it does not just help the organisation to meet them.

4. Implications of a Focus on Organisational Capability

Each of the statements in the earlier definition of created value have consequences for the way that an organisation needs to manage people to create organisational capability.
These are reviewed below:

### 4.1 Driving and Accelerating Business Strategy

If organisational capability drives business strategy, this means that people management strategy does not always have to be about supporting the business strategy. Sometimes, and at least on some occasions, the business strategy should be informed by the people management strategy, rather than just the other way around.

One good example comes from my own experience working as an HR Director at Ernst & Young, one of the big four professional services firms. Our people management strategy did support our business strategy. So in broad terms, the type of work available from our clients dictated the nature of our recruitment and development activities to provide us with employees of the required skills. However, our business strategy was also informed, to at least some extent, by the interests and requirements of our people. We knew that if we wanted the very best people, we had to offer them the most interesting and developmental work they could find. So we moved away from some types of work, and some types of clients, because this was not offering the right opportunities that developing and retaining our people required.

### 4.2 Creating Capability for the Future

The consequence of this focus on the future is that we are able to loose the blinkers, the constraints of the current state, and start to develop more innovative approaches to people management. And because we are also focused on developing the capability that is right for a particular organisation at a particular point in time, we can also start to move beyond generic best practices that apply across most similar organisations, to develop unique, best fit approaches, that would probably not look right elsewhere, but which provide a great way to develop the particular organisational capability required by one particular organisation.

Microsoft provides a good example. Microsoft has been very good in maintaining a clear focus on the type of people the company needs to deliver its business strategy. But then, in addition to this, Microsoft has developed an employment proposition that will attract the sort of people it wants to recruit and employ. And Microsoft’s HR and management processes deliver this proposition throughout the employment experience. So there is a very tight alignment between the company’s business strategy, its people, and its HR processes.

This alignment is as much about what Microsoft does not do as what it does. So going back to competitive strategy, Michael Porter talks about strategy requiring trade-offs – decisions not to do something so that the company can concentrate on what it is going to do. The same applies for organisational capability. Microsoft’s trade-off, until recently, was that it was not going to focus heavily on work-life balance. In fact, the company was well known for saying that it wanted people who sought balance over their working life. This would not appeal to everyone, but at the time, this was not an issue for the people they were recruiting, and it probably helped
to differentiate the company positively from its competitors.

London Business School professor, Lynda Gratton, calls these innovative, best fit approaches, signature processes, or more appropriately, signature experiences (Gratton, 2007), and emphasises the additional benefits they have in helping people figure out what the organisation is about, and providing them with meaning in their work.

4.3 Maximising the Potential of People

If we are serious about the potential of our people, we need to start treating them as individuals, not as some sort of generic human resource. Organisations need to focus carefully on their people’s skills, capabilities and experiences and what this means in terms of what people can provide for the organisation. So we need to focus activity on, and to personalise activity to, individual employees.

Gratton (2007) lists six different ways in which work can meet peoples’ needs:

- Expressive Legacy
- Secure Progress
- Individual expertise and team success
- Risk and reward
- Flexible support
- Low obligation and easy income.

Each of these ways will appeal to a different type of person; a different engagement type

A number of organisations have completed similar analysis based upon their engagement surveys, in order to focus their communications and help managers identify the best ways to engage their employees. However, to be really effective, managers do need to treat each individual as exactly this, that is an individual, rather than someone of a particular type. This is the only way they will maximise the potential and performance of each person over as long a time-period as possible, in order to maximise their organisational capability too.

5. Summary

The impact of an organisation taking this perspective is quite substantial.

Truly focusing on organisational capability takes an organisation far beyond repeating the tired phrase ‘people are our most important assets’. Once people, the relevant attributes of the organisation and the relationships of people within the organisation are seen as core components of organisational capability and a vital source of competitive advantage, they tend to be treated in a very different way.
References


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