

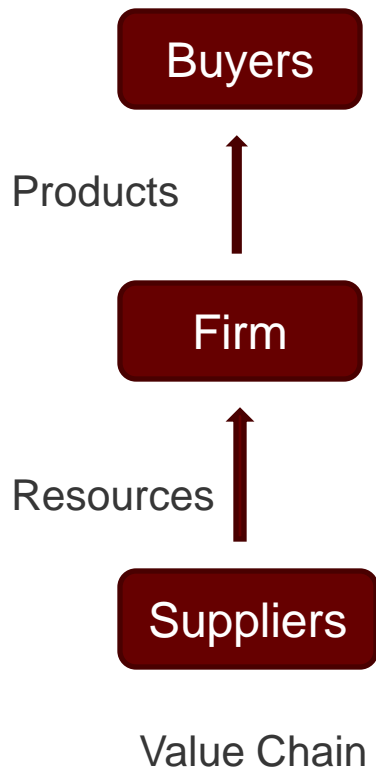
# Industry/Strategy: Value Creation

- > Toy Economy
- > How is value created?
- > Key Takeaways

# What is an Industry?



# Consider a toy economy



- > An economy will consist of some firms, some buyers, and some suppliers that together will create some value.
- > Together these can be said to form a value chain...but why?
- > How is value being created in this economy?

# How is value created?



# Some concepts defined

Value chain:

The value chain categorizes the generic value-adding activities of an economy

Opportunity cost for a supplier:

Opportunity cost or economic opportunity loss is the value of the next best alternative foregone as the result of making a decision.

Willingness to pay for a buyer:

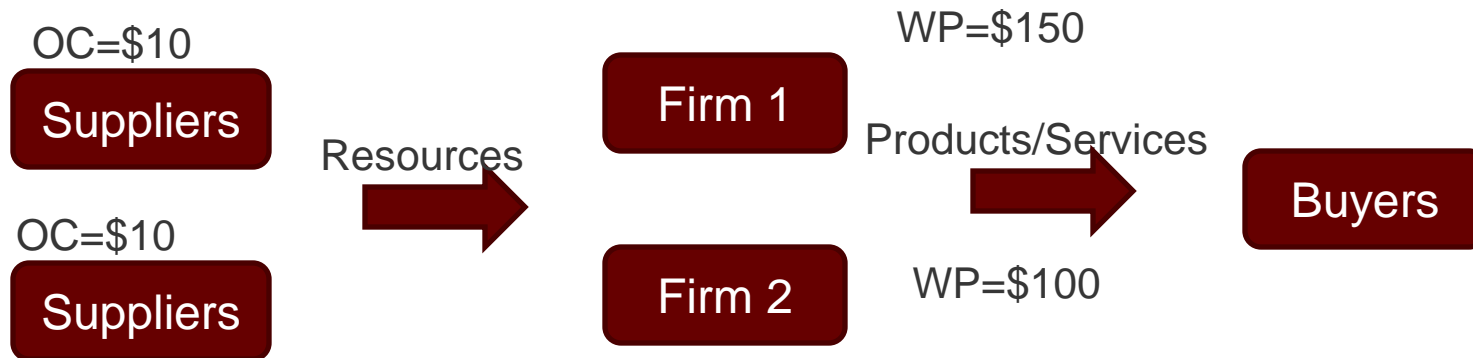
Willingness to pay refers to the value of a good to a buyer as what they are willing to pay, sacrifice or exchange for it.

# But why these concepts?



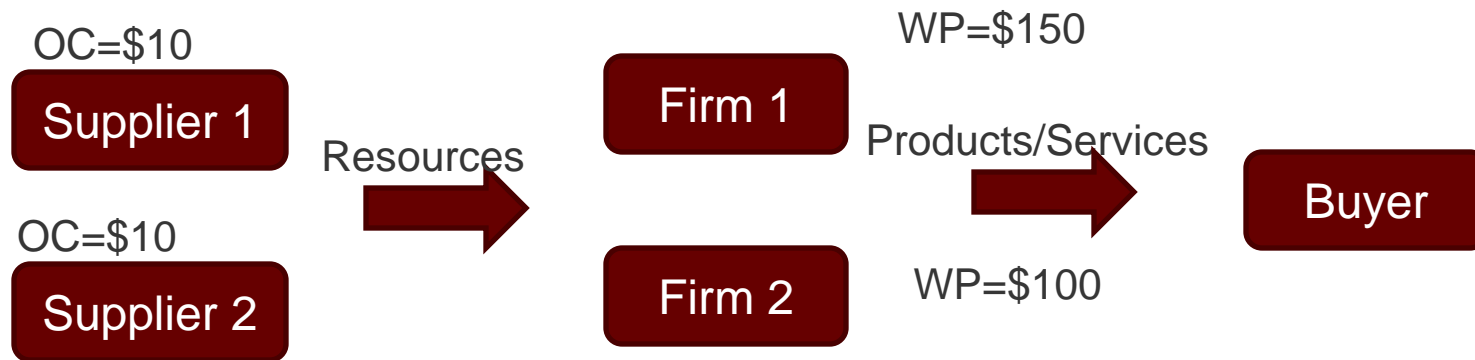
- > OC and WP bound our economy
- > For now, assume anything outside of this is outside our economy
- > Total Value created =  $WP - OC$

# A Toy Economy: Example



Consider 2 suppliers, 1 buyer and 2 firms. Assume the suppliers have the same raw materials and so relatively the same opportunity cost of \$ 10. Firm 1 has a premier product and consequently the buyer can pay \$ 150 while the buyer pays \$ 100 for the other firm. Only 1 transaction at a time i.e. the buyer and supplier can choose only one firm at a time.

# A Toy Economy: What is total value created? Who gets what?



## Two Steps:

Step 1: Find the total value created in this industry.

$$\text{Total Value created} = \text{WP} - \text{OC}$$

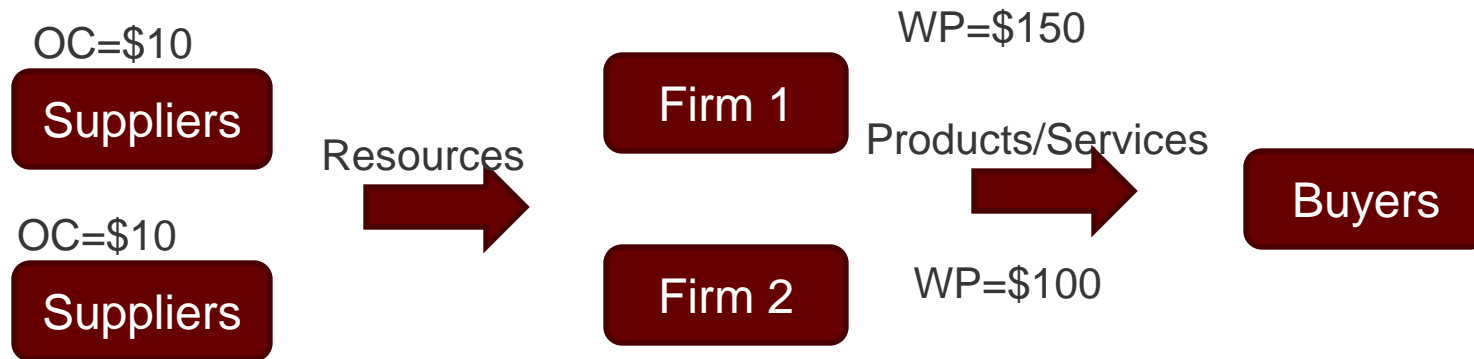
Go for the highest possible. Why?

Step 2: Find the maximum value that can be captured by a player.

$$\text{Value added} = \text{Total Value created} - \text{Value created by all others.}$$

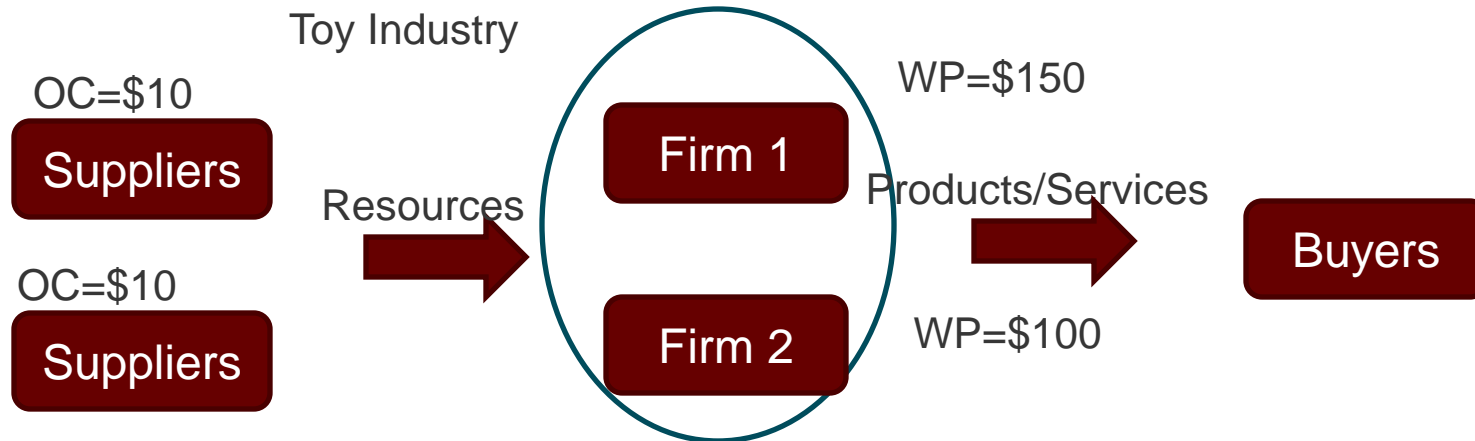
Why is this equal to value added?

# A Toy Economy: Bargaining upper bound



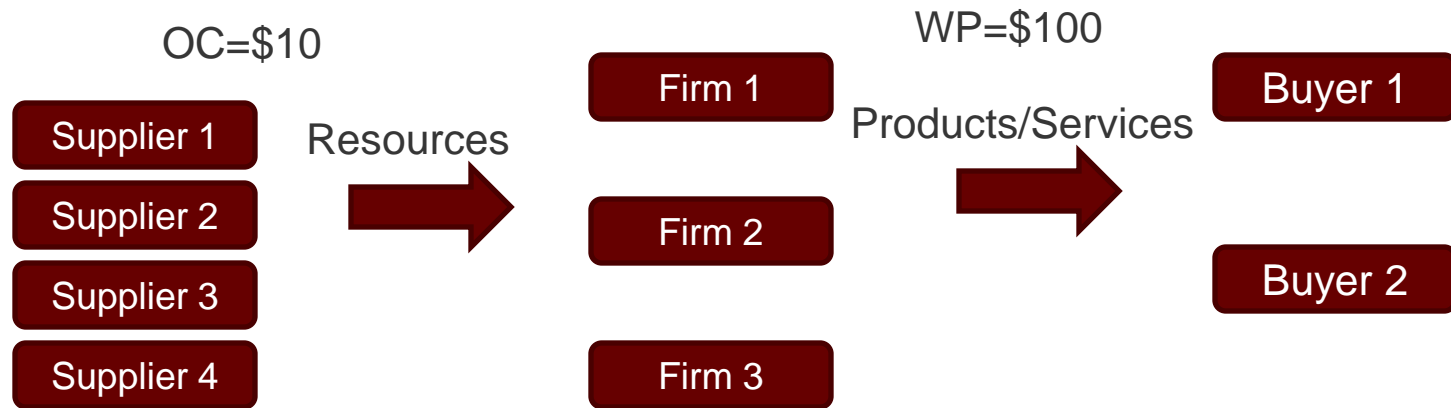
- > Max. value that can be appropriated by the supplier =
- > Max value that can be appropriated by the Firm 1 =
- > Max value that can be appropriated by the Firm 2 =
- > Max. value that can be appropriated by the buyer =
- > Why can't the Firm 1 appropriate more? Say \$ 55

# A Toy Economy: So what do we learn?



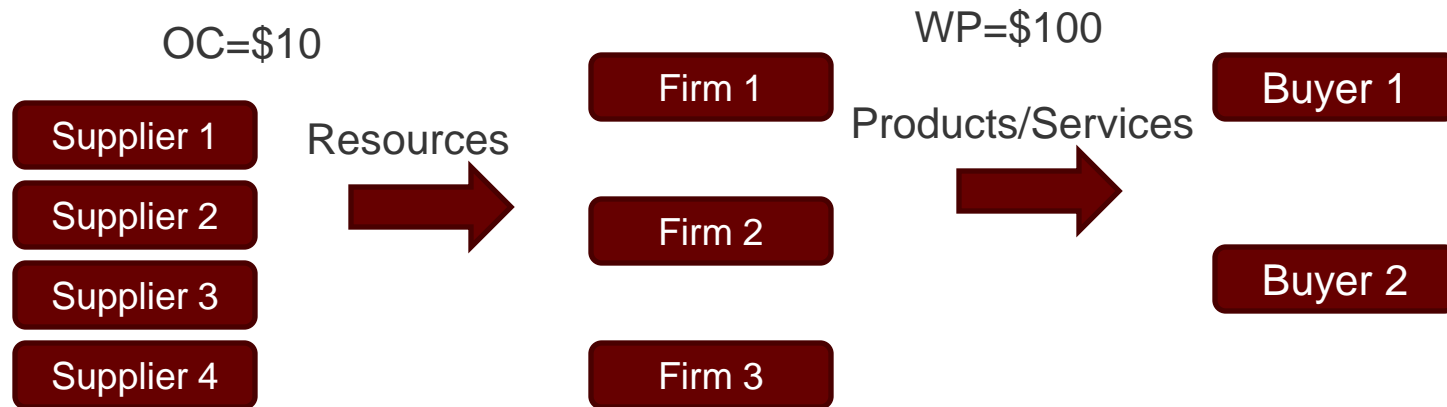
- > In this industry of two firms, the maximum value generated is \$50 and all of it can be appropriated by Firm 1.
- > So when can you capture more value?

# Another Toy Economy: Example



Consider 4 suppliers, 2 buyers and 3 firms. Assume the suppliers have the same raw materials and so relatively the same opportunity cost of \$ 10. Both buyers have a willingness to pay of \$100 for all the three firms' products. Only 1 transaction at a time i.e. one buyer or one supplier can choose only one firm at a time to transact. Two buyers will imply two transaction and same for suppliers.

# Another Economy: What is total value created? Who gets what?



## Two Steps:

Step 1: Find the total value created in this industry.

$$\text{Total Value created} = \text{WP} - \text{OC}$$

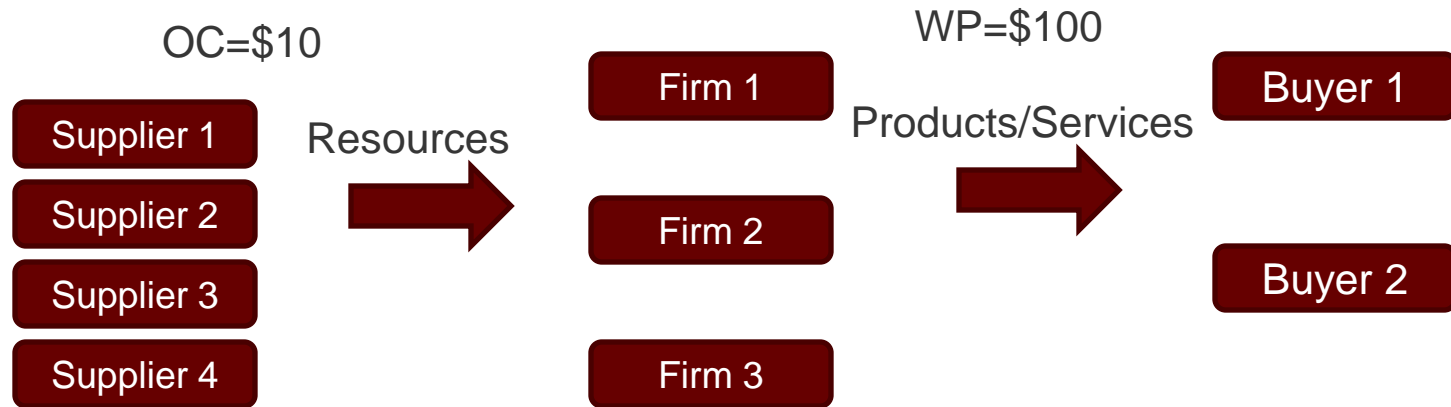
Go for the highest possible. Why?

Step 2: Find the maximum value that can be captured by a player.

$$\text{Value added} = \text{Total Value created} - \text{Value created by all others.}$$

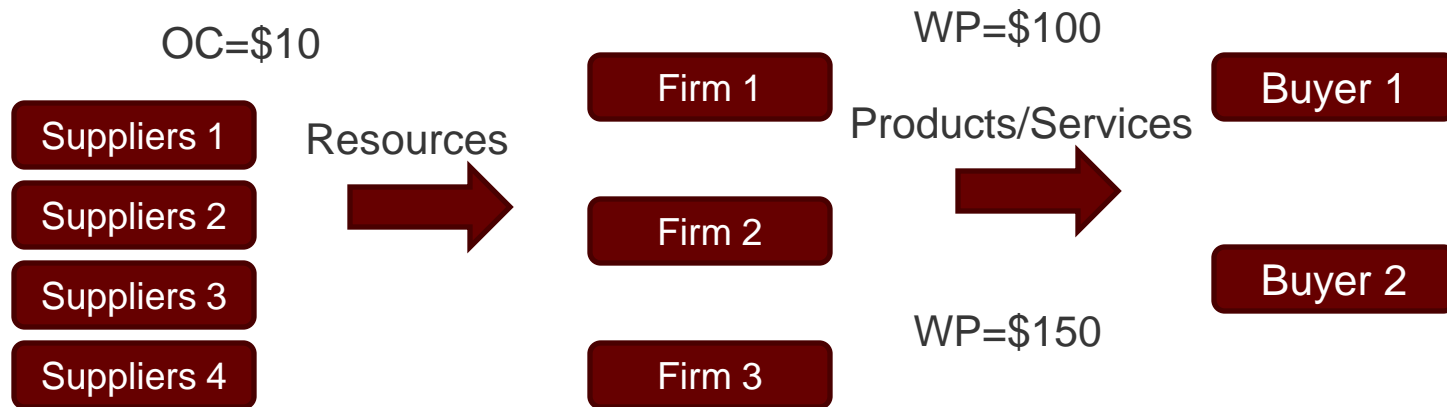
Why is this equal to value added?

# Another Toy Economy: Bargaining upper bound



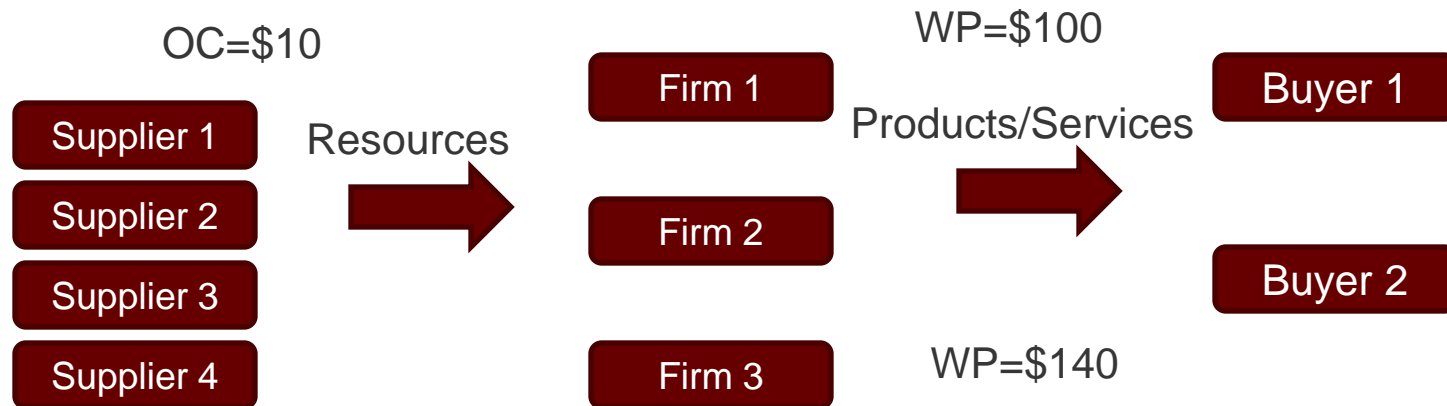
- > Max. value that can be appropriated by any supplier =
- > Max value that can be appropriated by any Firm =
- > Max value that can be appropriated by the Buyer 1 =
- > Max. value that can be appropriated by Buyer 2 =
- > So can you tell me when a firm can gain value in an economy?

# Toy Economy: Exercise



Consider 4 suppliers, 2 buyers and 3 firms. Assume the suppliers have the same raw materials and so relatively the same opportunity cost of \$ 10. Both buyers have a willingness to pay of \$100 for two firms' products and a WP of \$ 140 for Firm 3's products. Only 1 transaction at a time i.e. one buyer or one supplier can choose only one firm at a time to transact. Two buyers will imply two transaction and same for suppliers.

# Toy Economy: Exercise

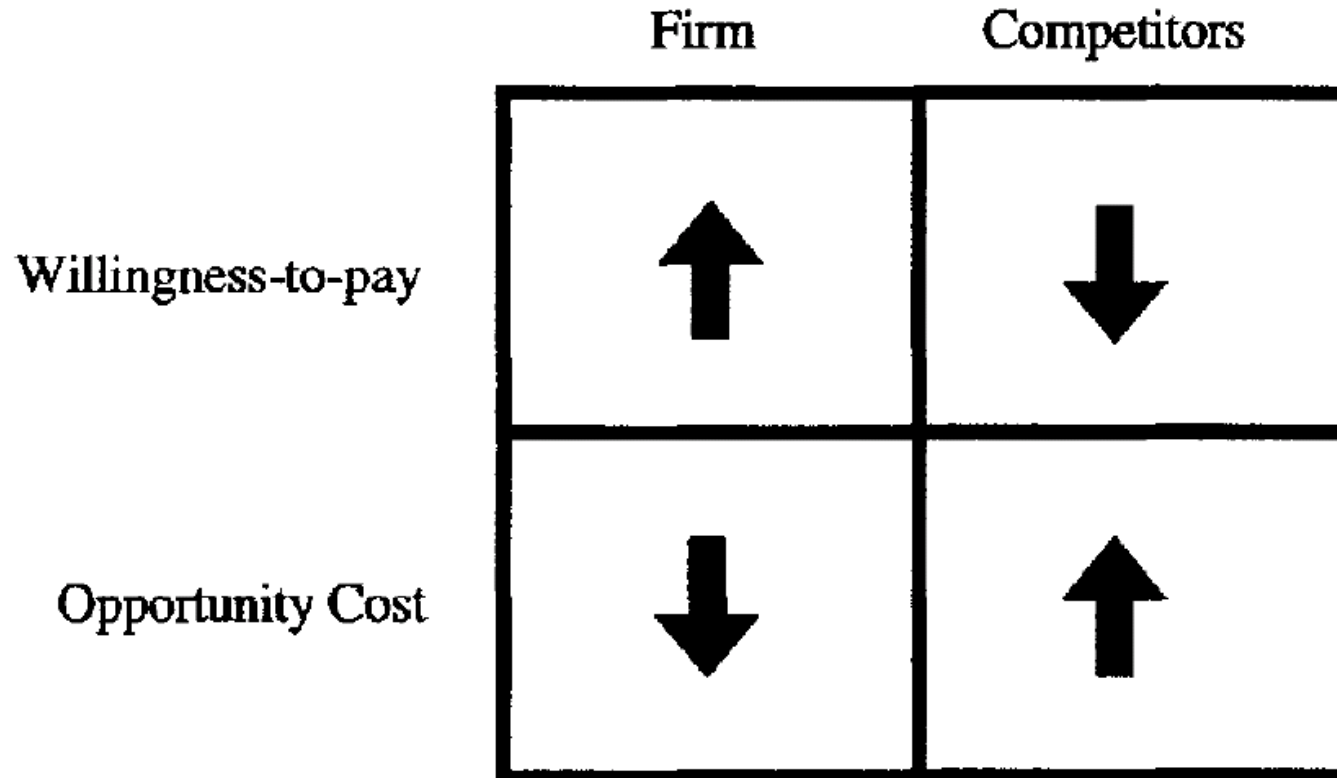


- > Max. value that can be appropriated by any supplier =
- > Max value that can be appropriated by any Firm 1 =
- > Max value that can be appropriated by any Firm 2 =
- > Max value that can be appropriated by any Firm 3 =
- > Max value that can be appropriated by the Buyer 1 =
- > Max. value that can be appropriated by Buyer 2 =
- > So what do we learn?

# Entrepreneurship

- > An entrepreneur is one who **creates value** by engaging in one or more of the following
  - > the introduction of new goods or an improvement in the quality of an existing good [differentiation]
  - > the introduction of a new method of production [low cost]
  - > the opening of a new market [one or both]
  - > the conquest of a new supply of raw-materials [low cost]
  - > The creation of a new organization type [one or both]
- > Entrepreneurship not restricted to new startups
- > Entrepreneurial function separate from the managerial function

# So how do you gain value?



**Value creation is creation of favorable asymmetry—the essence of entrepreneurship**

# Increase WP

- > Classic differentiation strategy (publishing, software services, film, new media, consumer electronics)
  - Add value and increase willingness to pay

321 19th Ave S, Minneapolis, MN 55455

1901 Minnehaha Ave, Minneapolis, Hennepin, MN

Also available: [By car](#) [Walking](#)

Suggested trips leaving at Jan 25, 2009 4:04pm

1: 4:04pm - 4:12pm (7 mins)

2: Walking (11 mins)

**Transit directions to 1901 Minnehaha Ave, Minneapolis, MN 55404**

321 19th Ave S, Minneapolis, MN 55455

Showing Trip 1 Travel time: about 7 mins

[Walk to Cedar Av S & Riverside Plaza](#)  
About 4 mins

[Show details](#)

[Bus - 22 - Lyndale NBCTOVA Med Ctr -](#)  
Direction: South 22G Cedar-28Av/VA Med Ctr/Via Duplet  
Service run by Metro Transit

4:08pm Depart Cedar Av S & Riverside Plaza  
3 mins

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▼ Directions from A to B:

**START** 1: Start out going NORTH on MINNEHAHA AVE/CR-152 toward 19TH AVE S. Continue to follow CR-152. 0.4 mi [Map](#)

2: Turn SLIGHT RIGHT onto RIVERSIDE AVE/CR-48. 0.1 mi [Map](#) | [Avoid](#)

3: Turn LEFT onto 19TH AVE S. 0.1 mi [Map](#) | [Avoid](#)

**END** 4: End at 321 19th Ave S Minneapolis, MN 55455-0438 [Map](#)

Estimated Time: 2 minutes Estimated Distance: 0.62 miles

# Increase WP contd.

- > Increasing your willingness to pay
  - > Classic differentiation strategy
    - Branding in commodity markets

\$ 6.99



\$ 3.29



- > If you are in a differentiated market, you must be able to add value and distinguish yourself

# Reduce your OC

## > Lowering your opportunity cost

### > Classic cost leadership

- Scale economies
- Scope economies

The Walmart logo, featuring the word "WAL\*MART" in blue capital letters with a yellow star between the asterisk and the "M".The Microsoft Office logo, featuring the word "Microsoft" in a small font above the word "Office" in a larger font, with a colorful four-square icon to the right.

### > Reduce cost of doing business

- Better process
- Ease of manufacturing

The Southwest Airlines logo, featuring a stylized airplane in blue and red above the words "SOUTHWEST AIRLINES" in bold black capital letters.

# Reduce others WP

> Lowering willingness to pay for others

> Negative advertising

Our friends the Mac and PC



> Switching costs using externalities



# Increase other OC

- > Raising other supplier opportunity cost
  - > Preferential agreements
  
  - > Catch them young
    - CAD/CAM software
  
  - > Supplier switching costs (Retraining costs)
    - Proprietary software

# Key Takeaways

- > Value is created when you can create some added value in a value chain—either by increasing the WP for buyers or reducing OC for suppliers.
- > Offering undifferentiated products and services drive down value added to ZERO
- > Industry—A group of firms offering similar products or services by taking raw materials from suppliers and selling them to buyers.
- > Your industry has to create value and you have to be that firm that does it.