Here is a five-step method for discovering a customer’s particular strategic needs based on a unique application of value-chain analysis. Performing this analysis on important customers helps identify high-value new business opportunities. It also can strengthen relationships with customers by clarifying their strategic priorities, regardless of whether their needs are based on a differentiation or low-cost strategy or whether that strategy is implicit or explicit.

Value-chain analysis is used for many purposes, but the process of examining customers’ value chains is relatively new. In our five-step process, Step 1 explains how internal and external value chains can be used separately and in related ways. Step 2 shows how to construct a customer’s value chain. Step 3 shows how to identify the customer’s business strategy by examining this value chain and using other kinds of information. Step 4 explains how to use additional information and intelligence to leverage that understanding into strategic needs and priorities. Finally, Step 5 explains how a firm’s marketing function can best use this method of value-chain analysis as a new strategic capability.

Step 1: An overview of value-chain analysis

Value chains may be defined in two ways: (1) within a company they describe the various value-added stages from purchasing materials to distributing, selling, and servicing the final product (Porter’s 1985 concept) and (2) they also delineate the value-added stages from raw material to end-user as a product is manufactured and distributed, with each stage representing an industry. For convenience, we will refer to these two definitions as “internal” and “external” value chains, respectively.

The internal value chain is a key concept in the field of strategic management that has been thoroughly explored. In contrast, the external value chain has not been studied as extensively. The external value chain consists of the important upstream/supply and downstream/distribution processes. However, even though these processes occur outside the corporation, the strategic opportunities they reveal and areas of risk they highlight warrant careful study. Consider:

- Outsourcing – involves transferring certain primary or support functions in the internal value chain to the external value chain.
- Vertical integration – involves taking control of one or more additional stages of the external value chain and making them internal.
- Horizontal expansion – involves new product lines or expanded channels of distribution, including geographic expansion.
- Strategic alliances with suppliers – involves more closely managing external suppliers as if they were part of the company’s internal value chain, but without actually owning them (for example, Toyota’s Kaizen system, wherein key suppliers are located very near a
factory and receive all kinds of help and training from Toyota to ensure smooth and efficient production).

One of the most complex value chains today can be found in the oil industry (see Exhibit 1). This chain has nearly 30 significant elements, starting with the search for oil (at the upstream end) and including field production, transportation (pipelines and supertankers), refining and processing and, lastly, consumer gas stations (at the “downstream” end). Internally, the oil-industry value chain processes a broad range of products, including such major categories as oil/lubricants, gasoline, petrochemicals (plastics), fertilizers/pesticides, natural gas, power generation/electricity, and convenience stores. The firms that are considered major integrated oil companies participate in a significant number – sometimes all – of these external (upstream and downstream) and internal value-chain elements.

In a 2006 issue of *Strategy & Leadership*, authors Wayne McPhee and David Wheeler suggested that strategists should use Porter’s concept to consider value-chain operations beyond the boundaries of the firm (see Exhibit 2).[5] (The figure shows Porter’s original concept of an internal value chain as well as several “external” additions suggested by the McPhee and Wheeler.) Since its introduction, value-chain analysis has proven immensely valuable in three principal ways – cost analysis and reduction, differentiation, and product development – but the standard practice was for firms to analyze only their own value chain.

**Step 2: How to construct a customer’s value chain**

First, recognize that you need to construct both internal and external value chains for a particular customer. The internal value chain follows Porter’s original concept, which includes value-added steps from purchasing to distribution as well as support functions such as R&D and human resources. It’s tempting to let this generic diagram serve as the customer’s value chain, but it must be tailored to the particular customer. To produce a useful value-chain analysis, members of your engineering or sales team should ask the customer
how its business processes add value and whether any have unique best-practice features. To perform the external value-chain analysis, team members should ask the customer a set of getting-to-know-you questions. What does your supply chain (the upstream value chain) look like? What role does your company play in it? How do your products reach their customers (the downstream value chain)? Your final diagram models only this single customer’s value chain and it represents virtually everything the customer does to add significant value. If your relationship with the customer permits a candid exchange of information, have the customer validate the value chain you have created.

As an example of how the diagnostic process works, consider how a supplier to Wal-Mart might learn to enhance its value. The objective of creating both internal and external value chains is to understand Wal-Mart well enough to be able to discern its implicit and explicit strategic concerns. Exhibits 3 and 4 depict preliminary pictures of Wal-Mart’s internal and external value chains. Getting to this initial stage is relatively easy – adding more detail, nuance, and understanding takes more time, involves interviewing Wal-Mart executives, and more closely observing how the firm operates.

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**Exhibit 2**  Porter’s original value chain extended in upstream and downstream directions (bold font)

**Exhibit 3**  Wal-Mart’s internal value chain
A more sophisticated analysis of Wal-Mart’s internal value chain reveals:

- It is very aggressive with respect to technology (one of the support activities) and was the first retailer to use bar codes. It uses satellite linkages to communicate with all its stores. It has integrated its POS, inventory-control, RFID, and other logistical technologies to speed product delivery, improve security (including merchandise shrinkage), and reduce costs.
- It has developed regional procurement centers in addition to its legendary center in Bentonville, Arkansas (known as “Vendorville”). It even has one just outside Shenzhen, China. Suppliers set up satellite offices next door to the most convenient procurement center. For example, Procter and Gamble, Wal-Mart’s largest supplier, has 300 employees full time in Bentonville.
- It focuses on the complete “customer experience” – having someone welcome each customer to the store, helping them find what they are looking for, taking returns, and carrying merchandise to the customer’s car.

Because Wal-Mart is a retailer, not a manufacturer, its external value chain is extremely simple. It deals with a variety of vendors and sells to customers. But the secret to discovering what makes Wal-Mart great lies in examining its internal value chain.

What is Wal-Mart’s strategy? It is the low-cost leader among mass merchandisers and operates on a scale that dwarfs its competitors. It continues to expand internationally. Its strategic activities include (1) aggressive deployment of systems and technologies that help it reduce shrinkage and internal costs, (2) its relationships with suppliers and the enormous economies of scale it achieves through hard bargaining and purchasing in large quantities, and (3) enhancing its customers’ experience in the store. Any B2B service provider that can help Wal-Mart strengthen those strategic activities will get its attention and is more likely to get its business. Such an approach will help a potential supplier convince Wal-Mart that it isn’t just another vendor selling wholesale merchandise at a rock-bottom price. This example illustrates the process of learning one’s customer’s key strategic issues and, over time, confirming and refining this understanding.

**Step 3: Inferring the customer’s business strategy**

Even long-time suppliers have trouble distinguishing critical customer activities from sometimes urgent but ultimately nonstrategic ones. Understanding your customer’s business strategy is therefore crucial. [7]
Value-chain analysis helps a supplier distinguish between the activities of the customer’s firm that directly support its competitive strategies – for its products and for enhancing key capabilities – and ordinary operations. For example, routine operations like billing customers or servicing the fleet of company vehicles must be done, and done well. But there is little if any competitive advantage to be gained from the superior execution of such activities. Nor are they likely to provide an opportunity for gaining new sources of revenue and profit. It is the customers’ strategic activities and projects that offer the potential for future profits and command the attention of your customers’ senior management. So by supporting strategic activities, B2B service providers stand to gain the high-margin work they hunger after, the work that produces the highest returns, and the work that should be their constant priority.

The Fluor case

Fluor Corporation is a global engineering and construction company providing major capital facilities for a vast range of industrial clients in many vertical markets. With as many as 2,000 projects under construction employing 40,000 workers in more than 50 countries at any time, Fluor operates in all geographic regions of the globe and in all parts of its customers’ supply chains, delivering engineering and construction management services – in sum, a full range of B2B services. The questions of where Fluor should concentrate its resources to meet its customers’ most urgent needs can become enormously complex. To rationalize this process, Fluor must determine which customer projects – the ones that address its customers’ greatest strategic needs and, hence, have potentially the greatest margins – have the highest value.

For many years, Fluor has known the critical importance of understanding every one of its B2B customers’ businesses. But that was not enough. The questions for Fluor’s marketing team became, “How can we learn each customer’s business strategy and strategic needs?”

Some of the many different sources of information about a customer’s strategy are:

- **Marketing communications including printed materials** (brochures and advertisements), media communications (press releases) and marketing websites reveal new product directions and customer targeting; these provide insights into market positioning and marketing strategy.
- **Financial-community reports** (annual reports, SEC filings, as well as meetings with financial analysts) shed light on internal strategic initiatives in addition to market-positioning moves. Annual reports form the basis of this Fluor case study, but 10Ks and analysts’ reports could prove equally useful.
- The academic literature is replete with surgical dissections of strategically successful companies and industries. Business-school cases abound featuring companies like Apple and industries like automobiles. Wal-Mart, for one, has been the focus of many Harvard Business School cases.[8]
- Many companies make their published strategic plans available to interested parties. For example, British Petroleum has published its strategy on its corporate website since 2000.
- Consultants that specialize in competitive intelligence.
- Face-to-face conversations with your customers.

Once information about your customer’s strategic processes is obtained, it can be graphically mapped in a way that shows the full spectrum of customer activities. Such a map should clearly distinguish between strategic and routine operations.

**Step 4: Discovering the customer’s strategic needs**

Strategic activities are the activities a firm must implement in order to realize its strategy or strategies. Every strategy has such a set of activities. Insofar as a company finds doing any of these activities difficult, potential suppliers have been trained to see these as “needs.” But, suppliers need to differentiate between operations that are difficult and ones that are
“A value-chain analysis . . . is a useful way of discovering areas of B2B customers’ strategic needs and hence creating new business that will not only get a receptive audience but also command premium margins.”

strategic. For example, an innovation strategy requires a system for generating ideas and picking the best ones, cost estimating, engineering, R&D, prototype construction and testing, and market-acceptance testing. The pharmaceutical industry relies on a great many B2B service providers to support its new-drug-development programs in the drug-formulation (R&D) stage and also B2B service providers that develop new systems to expedite regulatory approval. Value-chain analysis identifies both as key strategic functions.

Michael Porter developed the concept of activity maps and famously applied it to companies like Southwest Airlines and IKEA.[9] Such maps highlight the salient activities of a company, with various activities linked to one another. Using Wal-Mart as an example,[10] the high-leverage tactics it employs – such as hard bargaining with suppliers, cross-docking, logistics management, shrinkage control, and the like – all seem to cluster around and support the larger strategic themes of Wal-Mart, which are to continuously reduce the cost of goods sold, squeeze the retail margin, and end up with a respectable net profit. Wal-Mart’s high-leverage activities and tactics are aligned with its low-cost-leadership strategy, one of the main reasons it is so successful.

Three other examples – Nike, Mondavi and Chevron Corp – help explain how to identify a company’s strategic activities.

**Nike.** The value chain as a strategic-analysis tool emerged when Nike set a precedent in the athletic-footwear industry by outsourcing the manufacturing and assembly of athletic shoes. In the 1980s, Nike learned that manufacturing had become a commodity that could be outsourced for less cost and better quality than Nike could achieve with its internal resources. Nike realized that its core competences were in product development and marketing, and so management grew the company around a strategy of designing innovative products that met evolving customer needs.

The value chain in Exhibit 5 shows a simplified view of the athletic-shoe industry. Nike owns and controls just two elements: product development and its branded retail stores. Both
serve Nike’s strategic purpose: by owning and operating its branded stores the firm obtains valuable feedback directly from customers, which drives new product development. For B2B service-providers seeking to do business with Nike, this suggests that some of the most lucrative opportunities are in supporting new-product development (shoe design and materials technologies), branded-store architecture, and choosing store locations.

Mondavi. In the wine industry, some producers have made the aging of wine in oak barrels an important supply-chain ingredient (“The Trademark of Mondavi”).[11] The suppliers that offer the highest oak-barrel quality will be rewarded for helping firms like Mondavi that differentiate itself in this way to gain competitive advantage, while commodity oak-barrel suppliers will find lesser profits in supplying those wineries that differentiate their products somewhere else in the value chain. The wine-industry value chain, Exhibit 6, indicates that Mondavi makes its money in the strategic processes of aging wine and marketing it, especially through the customer education that occurs during wine tours. By encouraging connoisseurship through such marketing, Mondavi can charge $7 for a $3 bottle of wine, a margin far exceeding those of commodity competitors.

Fluor and Chevron. Chevron is a 100% vertically integrated oil-industry client of Fluor, the engineering/construction business-services provider.

In the B2B world, engineering/construction services have become commoditized. This is inherent in the nature of any industry where contracts are awarded through competitive bidding. This means that, all other things being equal, winners are selected on the basis of price. So engineering/construction-industry players need to seek ways to “de-commoditize” their industry. Clearly it’s in Fluor’s best interest to identify Chevron’s strategy and develop ways to support it.

Today, there are only four such giant companies not owned or operated by a government: British Petroleum, Royal Dutch Shell, Exxon/Mobil, and Chevron. The appetite for production capacity and capital spending by the major oil companies is enormous. These four firms together report annual capital expenditures in excess of $56 billion. Projects are spread all over the world from the hot arid deserts of the Middle East, to frigid wind-swept plains east of the Canadian Rockies, to the jungles of Peru. Because of the number, scale, and complexity of their activities, distinguishing projects that are strategic to an oil company’s future from those that aren’t is difficult yet crucial to business-service providers like Fluor.

Chevron Corporation, an important Fluor client, discloses considerable strategic information in its annual report. Specifically, Dave O’Reilly’s annual letter to shareholders (see Box) provides valuable insight into Chevron’s strategy. The issues that are high on O’Reilly’s mind are emphasized in the letter. These include crude oil and natural gas from offshore regions...
To our stockholders

2006 was an exceptional year for our company. We continued to deliver value to our stockholders and to make strategic investments that will drive sustained, superior performance over the long term.

We reported record net income of $17.1 billion on sales and other operating revenues of approximately $205 billion. For the year, total stockholder return was 33.8 percent, which was more than double the rate of return delivered by the S&P 500. Return on capital employed was a strong 22.6 percent. We continued to return cash to stockholders through our stock buyback program, purchasing $5 billion worth of shares in the open market, and we increased our annual dividend for the 19th year in a row. We are committed to exercising the capital discipline necessary to balance current returns with investments for future profitable growth.

DELIVERING RESULTS: We completed the successful integration of Unocal after acquiring the company in 2005 and reached a number of milestones for our major capital projects, including first production at fields in Angola, Azerbaijan, Trinidad and Tobago, and the United Kingdom. Overall, we increased year-over-year production volumes by nearly 6 percent.

Our exploration program in 2006 was outstanding, reflecting the discipline and efficiency of our processes. We announced a number of discoveries, most notably in Australia, Nigeria and the US Gulf of Mexico. We achieved our fifth successful year of exploration results and added more than 1 billion barrels of potentially recoverable oil and gas resources.

In the US Gulf of Mexico, we completed the Jack well test, which set more than a half-dozen world records for pressure, depth and duration in the deep water. Jack clearly demonstrates the power of advanced technology to discover significant new energy resources. Chevron is one of the largest leaseholders in the deepwater Gulf of Mexico and is competitively positioned to benefit as the long-term potential of this frontier area for crude oil and natural gas exploration plays out.

In Australia, where we hold the leading natural gas resource position, significant steps were made toward securing environmental regulatory approvals necessary for the development of the Greater Gorgon Area natural gas project. We also delivered the first commissioning cargo of Australian liquefied natural gas to China aboard the Chevron-operated Northwest Swan vessel.

Our global refining operations delivered record earnings in 2006, due in part to high reliability and utilization. We completed a major expansion at our Mississippi refinery that increased gasoline production capacity by approximately 10 percent, and we acquired an interest in a large new export refinery under construction in India, enhancing our presence in the fast-growing Asia-Pacific region.

We set a new safety record in 2006, our fifth consecutive year of improvement. However, we will never be satisfied until we reduce the number of safety-related incidents to zero.

CHEVRON’S ENERGY PORTFOLIO: We expect global demand for energy to continue growing. At the same time, increased competition for resources and heightened geopolitical risks are challenging customary supply growth options. In this kind of environment, energy portfolio diversification is an increasingly important means for supplying consumers around the globe with affordable, reliable energy.

Our current asset and investment portfolio is diverse. We have a strong queue of capital projects in progress, and our capital and exploratory budget for 2007 of $19.6 billion reflects the concentrated development phases of many of these key projects. Our investments are focused on creating new legacy positions in key conventional energy basins, expanding our assets and capabilities in unconventional resources, and investing in emerging sources of energy such as gas-to-liquids and biofuels. This portfolio, with investments balanced by location, by energy source and by time to first production, offers a strong foundation for sustained growth in even the most challenging of environments.

HUMAN ENERGY: At the center of our energy portfolio are the men and women of Chevron, our “human energy.” They run our operations safely, reliably and efficiently, in even the toughest conditions. They develop technology that improves our operations today and creates new business opportunities for tomorrow. They ensure we contribute to a better quality of life in every community where we operate.

The people of Chevron have a pioneering and ingenious spirit that enables the company to continue expanding the boundaries of energy. They understand the importance of energy to global economic growth and human progress, and they are committed to securing the energy the world needs in innovative and value-creating ways. I am proud to be part of the team.

DAVE O’REILLY
Chairman of the Board and Chief Executive Officer
February 28, 2007

The people of Chevron have a pioneering and ingenious spirit that enables the company to continue expanding the boundaries of energy.
(especially deepwater projects where project risks are disproportionately large) in geographically dispersed locales. In the annual report the importance of these issues are designated by little Chevron logos (see Exhibits 7 and 8).

What is also worth noting is what is not highlighted in O'Reilly's letter. Companies as immense as Chevron have ongoing projects everywhere that don’t occupy the primary attention of senior leadership. One example is Chevron’s refinery operations in California, which continually require environmental upgrades. When engineering/construction providers pursue such projects, they are likely to find, that the margins are not as great as on projects that supply a strategic need.

**Step 5: Making value-chain analysis a strategic capability of the marketing department**

Engineering/construction companies have developed at least two approaches to break the forces of commoditization in their industry:

1. **Project screening and selectivity.** Not all projects are created equal or represent equal opportunity. Service providers should select projects on the basis of projected margin, not projected revenue. They must pursue projects that build on their strengths and core competences, projects where they can apply their best talents to serve their customers. This is done by first serving customers’ commodity work to position them to then pursue customers’ strategic opportunities. This is the approach used in the Fluor example.

2. **Become selected customers’ strategic business partner.** Such practice puts the business-services provider right in the customers’ lap, a decidedly advantageous position to be in when strategic opportunities are brewing. It also leads to many sole-source or noncompetitive-bid opportunities and, potentially, to higher margins.

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**Exhibit 7** Strategic depiction of Chevron’s value chain
Both approaches require an investment of marketing resources. An account-management approach places significant demands on a provider’s marketing resources and budgets, and selectivity demands that market analysts be assigned to the selection process. But the traditional, undisciplined bidding process in the engineering and construction business can be even more expensive. In fact, so-called “pursuit” costs involve technical proposals and cost quotations at times exceeding several thousand pages at costs stretching into millions of dollars. Worse, the batting average in this free-for-all is about .300, meaning that more than two-thirds of these cost-proposal efforts are in vain, that two-thirds of the marketing-pursuit budgets are wasted. This dilemma calls to mind the time-honored adage of retailer John Wannamaker: “I know half my advertising budget is wasted. I just don’t know which half.”

Continuing to serve the routine operating needs of customers is what service-providers all too frequently do, with disappointing results. Market share may be maintained and even grow while margins remain unchanged or, worse, decline. A value-chain analysis, combined with other kinds of information, is a useful way of discovering areas of B2B customers’ strategic needs and hence creating new business that will not only get a receptive audience, but also command premium margins. From Chevron’s point of view, getting its most urgent projects done in record time not only means that it is willing to pay a premium to achieve such results, but also strengthens its relationship with Fluor. Chevron continues to be a very satisfied client, and Fluor’s ongoing value-chain analysis increases the likelihood that Chevron will someday become a strategic partner.

“It is the customers’ strategic activities and projects that offer the potential for future profits and command the attention of your customers’ senior management.”
Notes

1. In this article, we focus exclusively on B2B customers. The method described in the article is based on actual experience of one author when he worked for Fluor Corp.


6. The supplier could have many other customers, and could replicate this process with those other customers. Typically, doing such an analysis would be reserved for the supplier’s top 3-5 customers.

7. The authors found little in the literature about B2B marketing practices based on knowledge of the customer’s value chain and business strategy.

8. See, for example Harvard Business School Case #9-794-024, “Wal-Mart Stores, Inc.,” August 6, 1996, which provides a thorough review of Wal-Mart’s business practices up to its international (horizontal) expansion.


10. HBS Case #9-794-024, op. cit.


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