

Value Creation Versus Value Capture: Towards a Coherent Definition of Value in Strategy¹

Cliff Bowman and Véronique Ambrosini

Cranfield School of Management, Cranfield University, Bedford MK43 0AL, UK

Resource-based theory has tended to focus on the development and protection of valuable resources. What determines a valuable resource has received less attention. This paper addresses three related issues concerning value and valuable resources: what is value? how is it created? and who captures it? We have tried here to integrate different strands of the literature to address these questions. First, we argue that a distinction needs to be made between use value, which is subjectively assessed by customers, and exchange value, which is only realized at the point of sale. Second, we argue that the source of new use values is the labour performed by organizational members, and that firm profits can be attributed to this labour. Profit differences between competing firms derive from labour performing heterogeneously across firms. Finally, we argue that value capture is determined by the perceived power relationships between buyers and sellers.

Introduction²

The resource-based theory of the firm (RBT) (Peteraf, 1993; Wernerfelt, 1984) argues that an organization can be regarded as a bundle of resources (Amit and Schoemaker, 1993; Rumelt, 1984), and that resources that are valuable, rare, imperfectly imitable and imperfectly substitutable (Barney, 1991) are an organization's main source of sustainable competitive advantage. However, whilst most of the contributions to this view have focused on the ease with which valuable resources can be imitated, less consideration has been paid to what makes particular resources valuable in the first instance. Most contributors start from an assumption of a resource's value, and then

proceed to consider issues of imitability. As Miller and Shamsie (1996, p. 539) recently remarked 'after years of interesting conceptual work, we are still at an early stage in knowing what constitutes a valuable resource, why and when'. This paper suggests that, in order to progress RBT, a more precise and rounded underpinning theory of value is required to help us identify 'valuable resources'.

Accordingly, the paper addresses the following questions: what is 'value'? how is it created? and who captures it? It opens with a review of 'value' in RBT, then, some reflections about the nature of value are proposed, which in turn leads into a reconsideration of resource-based arguments about value creation. A theory of value generation is set out which concludes that the source of value and hence profits (as the proportion of value captured by the firm) is the combination and deployment of labour with other resources. The paper then addresses the distinction between value creation and value capture. Here it is argued that although value is created by organizational members, value capture is determined by the perceived power relationships between economic actors.

¹ The authors would like to thank the following for their comments: Dr Lívía Markóczy, Stephen Regan, Professor Gerard Hodgkinson, Dr Richard Whittington and two anonymous *British Journal of Management* reviewers.

² A glossary of the main terms used in the paper can be found in the Appendix on p. 15.

What is 'value'?

'Value' in resource-based theory

The major contribution of RBT has been the exploration of heterogeneous resource endowments and how these can be the source of advantage if competing firms are unable to imitate these resources (Amit and Schoemaker, 1993; Black and Boal, 1994; Mahoney and Pandian, 1992). In most contributions to the perspective, resources are *assumed* to be valuable (one exception being maybe Wernerfelt (1984) who defines resources as anything which could be thought of as a strength or a weakness of a given firm), and attention has been focused on isolating mechanisms that prevent rival firms from replicating the desired resource bundles (Rumelt, 1984). When the issue of valuing a resource is addressed, it tends to be discussed in broad, general terms. The few authors that have attempted to define the term 'valuable' tend to argue that resources are valuable in relation to a specific market environment (Amit and Schoemaker, 1993). To cite Barney (1991, p. 105) a resource is valuable if 'it exploits opportunities and/or neutralises threats in a firm's environment'. A resource has also been defined as valuable if it either enables customer needs to be better satisfied (Bogner and Thomas, 1994; Verdin and Williamson, 1994), or if it enables a firm to satisfy needs at lower costs than competitors (Barney, 1986a; Peteraf, 1993). Barney (1991, p. 106) also suggests that resources are valuable 'when they enable a firm to conceive of or implement strategies that improve its efficiency and effectiveness'.

Conner (1991, p. 132) argues that, from a resource-based perspective 'obtaining [above normal] returns requires either that (a) the firm's product be *distinctive in the eyes of buyers* (e.g. the firm's product must offer to consumers a dissimilar and attractive attribute/price relationship in comparison to substitutes), or (b) that the firm selling an identical product in comparison to competitors must have a low cost position'.

The argument that resources have value in relation to their ability, *inter alia*, to meet customers' needs is consistent within RBT (see Aaker, 1989; Aharoni, 1993; Prahalad and Hamel, 1990, 1994; Williams, 1992). This then begs the question: how do customers judge the extent to which an existing product meets their needs, or whether a new product on the market would better meet their

needs? In other words, how do consumers make judgements about the value, to them, of alternative products?

Assessing value

Traditionally when looking at value and consumer behaviour, economists tend to refer to utility theory and to the notion of marginal utility. The theory states, essentially, that consumers spend their income so as to maximize the satisfaction they get from products. Total utility refers to the satisfaction deriving from the possession of a commodity and marginal utility refers to the satisfaction that people receive from possessing one extra unit of a good or the satisfaction lost by giving up one unit. Early neo-classical economists assumed that people were rational (the economic man) and as such assessed systematically and carefully the different available options before purchasing. However this position has been softened and it is generally held that 'by and large, people spend their money on what they expect will give them most satisfaction' (Bach *et al.*, 1987, p. 92).

One issue then, is how do people develop their expectations, how do they judge the utility they are going to get, i.e. how do they judge the value of a product? The potential purchasers have to judge how the product's attributes will satisfy their needs. Judgements are made in advance of the consumption of the product, so customers have to make inferences about the range of products on offer based on a variety of cues. Customers' perceptions of the value of a good are based on their beliefs about the goods, their needs, unique experiences, wants, wishes and expectations. In other words, customers assess the overall value of a product on the perceptions of what is given and what is received (Zeithaml, 1991).

At this point it is worth noting that there are definitional problems emerging here because of a tendency in the literature to use the term 'value' to refer to different phenomena. We suggest that some clarification can be achieved by employing the distinction between *use value* and *exchange value* made by classical economists. Use value refers to the specific qualities of the product perceived by customers in relation to their needs: e.g. the acceleration and styling of the car, the taste and texture of the apple, etc. So judgements about use value are subjective, they pertain to the individual consumer. In other words, use value is

perceived by the customer. Exchange value refers to price. It is the monetary amount realized at a single point in time when the exchange of the good takes place.

Use value perception applies to all purchases, not just those of final consumers. The same type of judgement, a subjective judgement, is made by a manager when procuring inputs like machines, and components, as by an individual when buying a fridge or a car. In a 'consumer' purchase, the need may be fairly easy to define. In an organization the need for a purchase may not be that clear, indeed it could be argued that the 'need' that is to be met with the purchase is 'profit making' (Besanko *et al.*, 1996). This seems rational and logical, but it requires the purchaser to have great insight into the cause-effect linkages between the use value of the resource and the ultimate delivery of profit. More reasonably, the procuring agent has to have some belief that the procured resource will contribute to the profitability of the firm, and this belief will be rooted in a wider set of beliefs about how the firm competes, which may be further bounded by an industry recipe (Huff, 1983; Johnson, 1987; Spender, 1989).

Perceived use value can be translated into monetary terms: it can be defined as the price the customer is *prepared* to pay for the product if there is a single source of supply (Collis, 1994). This judgement is based on the assessment of the product's value, coupled with the individual's willingness to pay. These monetary judgements

cannot, therefore, be made in isolation from the wider needs and economic circumstances of the customer, or from the consumer's awareness of competing offerings.

Only in the rare instance of a monopoly supplier, who is cognisant of the customers' valuation, and who can price discriminate, will the price the customer is prepared to pay equate to the price the customer actually pays. We term this price *total monetary value*. In all other circumstances, the price paid will be *less* than the total monetary value perceived by the customer. The difference between the customer's valuation of the product, and the price paid is 'consumer surplus'. Expressed differently, the price the customer is prepared to pay is price + consumer surplus. Consumer surplus (Bach *et al.*, 1987; Whitehead, 1996) is what consumers colloquially refer to as 'value for money'.

Customers choose the good that will confer on them the largest consumer surplus (see Figure 1). The chosen product must therefore be differentiated in ways which are valued by the customer, it must deliver more consumer surplus than alternatives. Consumer surplus (CS) can be increased by enhancing the perceived use value of the good (and thereby increasing its total monetary value, the amount the customer would be prepared to pay for it), whilst keeping the price at the same level (product B in Figure 1), or by keeping the total monetary value constant but reducing the price (product C), or by doing both simultaneously (product D). Product D would be selected

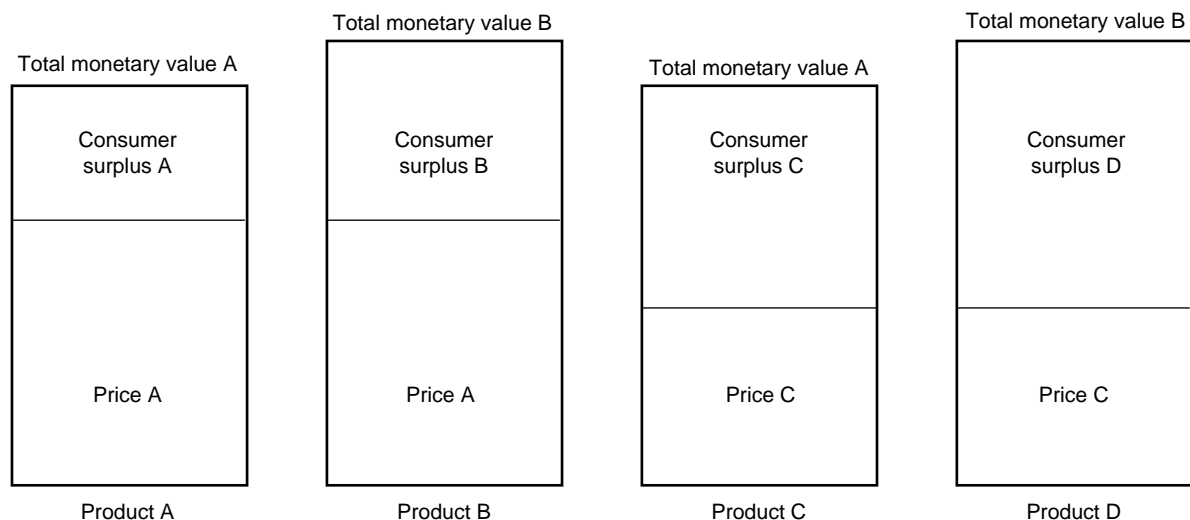


Figure 1. Total monetary value, price and consumer surplus

by this consumer as it confers the most consumer surplus: (CSD > CSB > CSA).

The amount of consumer surplus that a customer can enjoy can only be assessed at the point of sale; it is at this point that the customer knows the selling price and can evaluate the product in relation to competing offerings, and decide then whether it is worth buying. Customers can only value what they perceive, this implies for instance that they are unable to value most *inputs* to the production process. This means that customers cannot consciously 'reward' or compensate any inputted resources, or any suppliers of those resources (we take up this point later). We could note here that this argument differs from other approaches, notably Hunt's (1995, p. 323), who states that perceived value 'depends on (a) the tastes and preferences of consumers in the segment and (b) *the resources that produce the offering*' (emphasis added).

One consequence of this argument is that we have to be careful when discussing how 'value' can be 'passed on' in the production process. Use value is perceived by the customer at a point in time, it is assessed at the point of decision to purchase. The product at the time of sale has both an *exchange value* and a perceived *use value*. This applies to all types of purchases. For example, the exchange value of a computer controlled lathe, a desk, or a truck is realized at the point of sale. However, *exchange value* is not transferred into the organization's production or distribution process, only use value is. It is an accounting convenience to assume that the prices of inputs are aggregated in some way and passed on to customers. In reality many purchased resources do not 'add value' in ways that a customer can perceive. That is not to say that the purchased input was not valued. It was. It was assessed as a *use value* by the manager who decided to buy it on behalf of the firm. But as soon as the machine was bought, all the *exchange value* was realized by the seller of the machine. Once the machine enters into the production process it is impossible to apportion elements of its purchase price to various products produced with the machine. The subsequent exchange value of that machine would only be realized if the machine was subsequently resold.

Another implication here is that any firm that is able to sell something, is, in the eyes of its customers at one particular time, supplying a

unique and superior package of value for money, i.e. customers at this point in time perceive that this firm's product allows them to enjoy the largest amount of consumer surplus. From the customer's perspective the selected item offers more consumer surplus than any other. For these customers, the competitors are not supplying an equivalent product/price combination. In this restricted technical sense, each firm is a monopoly supplier to its customers at the time of the sale. Hence, it could be said that any firm that sells anything has a temporary 'competitive advantage'.

Clearly, some customers will have found it quite difficult to make a choice, there may be products on offer which offer very similar amounts of consumer surplus to the chosen product. These suppliers of close substitutes would constitute the direct competitors to the firm. However, products offering significantly lower consumer surplus could not be classed as close substitutes, and are therefore not credible competitors. This view of 'value' helps us define competitors, and hence markets and industries. This may lead to quite different industry definitions from those derived from conventional, product-based approaches. Markets are never static. They exist at a moment in time when a transaction takes place. Indeed, it may be unhelpful to conceive of 'markets' at all as this can imply some permanence or stasis in what is a dynamic, atomistic and continuing evolving set of individual transactions.

In what follows we shall concentrate on how organizations create perceived use value and how they capture exchange value, but let us summarize what we mean by these two terms. In short, value has two main components:

- *Perceived use value*, i.e. value is subjective, it is defined by customers, based on their perceptions of the usefulness of the product on offer. Total monetary value is the amount the customer is *prepared* to pay for the product.
- *Exchange value* is realized when the product is sold. It is the amount paid by the buyer to the producer for the perceived use value.

Exchange value is realized when a sale is made.³ Sales are achieved when customers view that a

³ The exchanges of valuable goods that do not involve a monetary transaction are without the scope of most forms of economic enquiry.

product confers more consumer surplus than other feasible alternatives. So firms create perceived use value, and through the sale of products, exchange value is realized.

How is value created?

We now turn our attention to the processes inside the firm that create use value and subsequently, realize exchange value. Inanimate resources purchased as inputs to the production process, whether they be machines, buildings, steel, computers, or flour, are incapable of transforming themselves into anything other than what they are. They need to be activated, *worked on* before they can contribute to the production of new use values. The tangible inputs into the production process, i.e. the use values acquired by an organization, are inert. The intervention of people is necessary to create new use values from the acquired resources. The same argument applies to less tangible resources like information and brands. Brands do not add value by themselves; they have to be associated with produced products or services, and if they are not actively developed by creative marketing efforts, their use value will decline. Similarly, a resource like a brand could be traded, and in the hands of the acquiring firm it could be used to create greater levels of perceived use value in the eyes of customers. So, new use value creation derives from the actions of people in the organization working on and with procured use values (Lado and Wilson, 1994; Pfeffer, 1995; Wright *et al.*, 1994).

New use value is created by the actions of organizational members, who combine to transform the use values that the organization has acquired. This, however, does not mean that organizational members, when producing new use values, necessarily produce products that can realize added *exchange* value (that is the realization of exchange value superior to the costs of the resource inputs, including wage costs). How much exchange value has been added can only be determined when the newly created use value is sold. At this later point in time this use value will be compared by potential customers with competing products, and only where a customer perceives superior consumer surplus accruing will the customer buy that particular product (as in the case of Product D in Figure 1). So the amount of exchange value the

organization can capture is known only at the time of sale, that is the organization will not know what the newly created use value is worth until it is exchanged. So we cannot assert that, in the process of new *use* value creation, ‘value’ has been added. *Different* use value has been created which may or may not yield added exchange value.

Exchange value and profit

Profit is made if the amount of exchange value realized on sale is superior to the sum of the prices of the inputted resources (including wage costs). This profit can only be attributed to the actions of organizational members as their labour is the only input into the production process that has the capacity to create new use values, which are the source of the realized exchange value. So, to summarize, labour performed by organizational members is the source of the firm’s profit.

Profit differentials between firms

Both resource-based theory and theories of competitive strategy deriving from industrial organization (IO) economics (Porter 1980, 1985) are concerned to explain the nature and source of super-normal profits. These are usually defined in relation to some notion of a cost of capital, and the view taken is that ‘true’ profits only exist when the firm achieves an overall profit performance in excess of its cost of capital. ‘Strategy’ can be conceived of as a search for long-lived rents, or competitive advantage, which are relative concepts. Therefore, we need to address this requirement for comparisons between firms if our approach is to contribute to the strategy field. The important point here is that both RBT and IO argumentation requires the existence of benchmarks for comparison, whether these be ‘cost of capital’ benchmarks, or competing firms in the same industry, or the opportunity costs of a resource. But we believe that in many cases these benchmarks are arbitrarily defined, where like is often not being compared with like. Moreover, we do not subscribe to the accepted notion of a ‘cost’ of capital as a concept or a benchmark (see the later section of value capture by suppliers of capital).

Using RBT arguments, if all inputted resources are homogeneous, and freely traded, competing firms will produce identical products, incurring identical costs of production. All firms in this

market would produce identical perceived use values and identical amounts of exchange value, and profit, would be realized. This equates with neo-classical perfect competition.

However, as argued above, in order for a firm to sell anything, there must be some buyers that rate the firm's offering as providing superior consumer surplus than competing firms. So even if the prices are identical, in order to make a sale there must be some perceived differences in the products on offer (e.g. comparing Products A and B in Figure 1). This might have to do with the product surround rather than the product itself (i.e. the product is readily available locally, it is marketed more attractively, etc.). Alternatively, one can have more consumer surplus because of a lower price (comparing Product C with Product A), and to sustain lower prices the firm must be able to produce the same products as competitors but at lower cost.

This implies that the source of differential profits between firms is located somewhere within the firm's transformation processes. If we assume factor markets are homogeneous, this can only occur if certain resource inputs are capable of performing *heterogeneously* within the production process, otherwise we have to relax our assumptions of perfect factor markets. Proponents of RBT argue that human or 'cultural' resources are the sources of above normal returns, and not the purchasable and tradable physical assets (Barney, 1986a; Castanias and Helfat, 1991; Wernerfelt, 1989). This suggests that when we explore why some firms outperform others, we will discover that these differences derive from resources that are capable of performing variably within the firm. This rules out any inert resource inputs, which we have seen are incapable of displaying heterogeneous performance on their own. The only resource that is capable of performing heterogeneously across competing firms is people. Even though labour may be traded assuming its homogeneity, it is capable of performing heterogeneously when put in motion.

However, not all labour is a source of added exchange value and profits. Obviously all labour is not heterogeneous, idiosyncratic to the organization. We can suggest three main categories of labour, *generic*, *differential* and *unproductive*, which can only be defined *in relation to* labour performing in a closely competing firm. We shall now explore these three categories.

Generic labour

The output of the work of organizational members can be generic, i.e. homogeneous across competing firms. Some skills are generic, are easily understandable, where the routines performed are codifiable and can be imitated. Generic labour is necessary to create new use values, but it cannot be a source of profit differentials between competing firms, as all firms employ the same performing labour. This labour is essential, it is a necessary requirement to be a player in the industry, but it does not create superior profits. A subset of this category is supervisory labour. The role of this labour is to preserve the exchange values of purchased inputs, through the avoidance of unnecessary costs, defined as costs that have not been incurred by equivalent competing firms.

Differential labour

Labour can be differential, i.e. heterogeneous across competing firms. It is the source of an organization's uniqueness, and its superior profits. Examples could be the special talent of a designer, the unique way a particular salesman sells, or the energy and enthusiasm of a dealing room. A subset of heterogeneous labour is entrepreneurial labour. This is the labour of organizational members who direct and deploy purchased inputs with homogeneous and heterogeneous labour in unique ways, that enable the firm to realize superior profits. Entrepreneurial labour is concerned with the achievement of superior profits relative to competing firms. We will develop this concept of entrepreneurial labour in what follows.

Unproductive labour

Labour can be unproductive, i.e. it destroys value. Where labour is performed which is not required in comparison to competing firms, it is unproductive labour. Unproductive labour can be found at all levels of the hierarchy, where, in comparison to the most competitive firm in the market, the organization engages in unnecessary supervision, or pays salaries to management levels that add nothing to use value production (including corporate level staff). Other examples of unproductive labour would be staff employed that produce scrap, or that produce product features that are not valued by customers, or that are engaged in

excessive re-working, or after sales repair work. Firms become less competitive as this category of labour increases, and at some point the volume of unproductive labour overwhelms the productive labour and the firm ceases to exist.

Exploring heterogeneous and entrepreneurial labour

Now that we have established that it is labour performing heterogeneously across organizations that creates superior profits, the problem we now have to deal with, is how we can judge which sources of heterogeneity are valuable? There is ample evidence of firms with strong cultures, with powerful and idiosyncratic 'ways of doing things' that have failed (Peters, 1988). Indeed 'organizational inertia' (Collis, 1991) and most of the blockages to strategic change seem to stem from the embedded routines and culture that have, in effect, become 'core rigidities' (Leonard-Barton, 1992) of the organization. This may suggest that what ultimately matters most in organizations are the insights into knowing which use values to acquire, and how these should be deployed and combined through the actions of labour.

This skill of knowing how to direct the transformation of use value inputs, i.e. of knowing how to deploy *artfully* resource inputs, is the essence of entrepreneurial labour. To use Miller and Shamsie's vocabulary (1996) it is a 'systemic knowledge-base resource' or to use Black and Boal's (1994) term, it is a 'system resource'. Entrepreneurial labour is involved in directing labour with use value inputs to create new use values. It enables the organization to offer more consumer surplus than competing organizations and/or to lower its relative costs. In many respects this is in the spirit of Penrose (1959), which has been highlighted recently by Tsoukas (1996) and by Grant (1996) who emphasized that what mattered was coordination to achieve knowledge integration. Penrose explains that 'it is never the resources themselves that are the inputs to the production process, only the services that the resources can render' (Penrose, 1959, p. 25), i.e. it is the *use values* of the resources that matter.

The deployment of use values with labour can be carried out either explicitly or tacitly within the organization. An individual may have a clear understanding of a business opportunity, and know how to exploit it. This could include for

instance the deployment of differential capabilities in resource procurement, which maybe enables the firm to buy cheaper, or resource deployment (how the resources are managed, how they are combined more efficiently, or effectively).

Alternatively, inputted use values and labour can be deployed in effective and efficient ways, but this skilful performance may not be the result of a consciously developed strategy, nor may it result from a set of clearly understood organizational routines (Nonaka, 1991, 1994; Reed and DeFillipi, 1990). Here the firm just happens to be doing the right things, no single individual has the insight to know exactly what causes the firm's success. In other words the relation between its actions and its performance is causally ambiguous even to insiders (Lippman and Rumelt, 1982). This could be due to chance (Barney, 1986b), or to deeply embedded cultural know-how that no-one is able to explicitly recognize or articulate (Nelson and Winter, 1982; Spender, 1994). The entrepreneurial labour is here tacit.

In all firms there are probably elements of explicit and tacit entrepreneurial behaviour. In older, well established firms, where the original founders have long since left the scene, the use value creation process may consist of some cultural momentum built up over the years (Fiol, 1991). The more tacit the process the more secure the firm is in one sense: if the firm's management themselves do not understand what makes them successful, then other firms are less able to imitate them. As Lippman and Rumelt (1982, p. 420) argue causal ambiguity 'acts as a powerful block on both imitation and factor mobility'. However, the *management* of the firm becomes riskier. If the senior management of an organization do not know how they generate superior use values, it may inadvertently change something that is critical, e.g. through delayering, downsizing, or the crude imposition of business process reengineering. Similarly, if they are not knowledgeable of sources of past success, and of impediments to future success, it cannot know either what to change, or what to change it to.

So, because of causal ambiguity, it could be that the demise of firms is more to do with not knowing exactly what to change and what to change it to, than with any structural, or cultural rigidities. It takes a confident and knowledgeable executive to challenge and change embedded routines. Executives developed through the firm's culture

may not have the level of insight to do this with confidence; it is difficult for an insider to realize what they, or their firm as a whole, takes for granted. For this reason, executives that emerge from within are unlikely to be fully aware of the causes of the firm's success, and hence may find it difficult to manage its evolution. This may partly explain why, when faced with a downturn in performance, the typical 'knee-jerk' reaction is to cut costs (Bowman and Ambrosini, 1996). Cost cutting is often a programmed response to a crisis, taken without accounting for the true sources of the firm's current and possible future profit.

Moreover, if tacit entrepreneurship is at the origin of the firm's advantage then crude cost cutting runs the risk of destroying the very sources of future profitability. There are cases where the incumbent executives, 'managerially' competent but lacking flair and insight, are incapable of making the difficult entrepreneurial decisions required, or other cases where quite the wrong understanding of the source of advantage prevailed, as when Coca Cola launched their new formula Coke.

Before proceeding further and turning our attention to the issue of who captures the exchange value that is realized, let us summarize the value creation process (see Figure 2).

New perceived use values are created by the actions of organizational members. The use value of the other inputs into the production process are incapable of transforming themselves into new perceived use values. New use value is produced by combining acquired use values with labour. Exchange value is realized at the time of sale. Added exchange value (profit) is only created where the exchange values realized on sale of

the new use values sums to more than the cost of inputs. We shall now turn our attention to the capture of *exchange value*.

Who captures exchange value, and why?

The resource-based perspective on value capture

Peteraf (1994, p. 156) distinguishes between the existence of rents and economic profits: 'the existence of Ricardian rents is not sufficient for the firm to earn above average returns. . . . If the resource is not owned by the firm and the firm cannot appropriate some of the rents only the resource owner will benefit'. This neatly juxtaposes the difference between value creation and value capture. Resources may be capable of producing profits, but if the resource owner, not the firm, is able to capture this exchange value, firm profitability will suffer.

Despite this important distinction between creation and capture, most contributors to the resource-based school focus their attention on barriers to imitation at the level of competing firms, rather than on the problems of retaining value *within* the firm. Their main concern is with the processes of capturing value from customers. Rumelt's isolating mechanisms (1984), Dierickx and Cool's (1989) time compression diseconomies to imitation, and the increasing returns to the cumulative magnitude of the stock of the input, and Lippman and Rumelt's (1982) causal ambiguity are all addressing the problems of value capture from customers. But, as Peteraf (1994) points out, there is no benefit to the firm if the value captured from customers is lost through resource

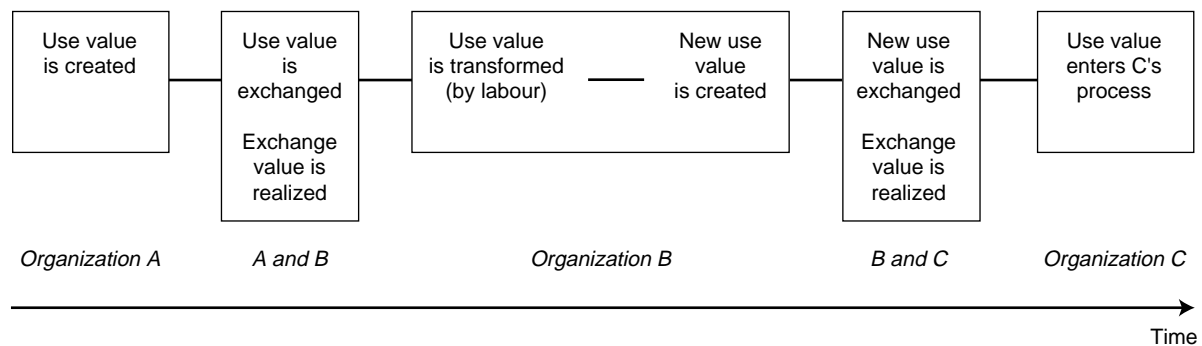


Figure 2. The process of value creation

suppliers bidding up the price of their resources to the point where they capture the differential value won from customers.

Porter (1991, p. 108) addresses this issue: 'successful firms are successful because they have unique resources. They should nurture these resources to be successful. But what is a unique resource? What makes it valuable? Why was a firm able to create or acquire it? Why does the original owner or current holder of the resource not bid the value away?' Barney's (1986b) response to this last question is to suggest that, in strategic factor markets, firms competing for strategic resources have different expectations about a resource's value. As a result they will be prepared to pay different amounts for the resource. The 'special insights into the future value of strategies' (Barney, 1986b, p. 1232) that the bidding firm has, enables it to acquire valuable resources at low prices; or alternatively, through good fortune ('luck'), the firm happily discovers that a resource has considerably more value than anticipated when it was purchased.

Value capture and perceived power relationships

The amount of profit realized cannot be determined solely from an examination of processes *within* the firm. Although the source of differences in products produced (and their production costs) across firms is attributable to the particular deployment of resources peculiar to that firm, the amount of profit realized on exchange of those products is determined by:

- (1) comparisons customers make between the firm's product, their needs, and feasible competing offerings from other firms;
- (2) comparisons resource suppliers make between the deal they have struck with this firm, and possible deals they could make with alternative buyers of their resource.

So in determining value capture, by the firm from customers, and by resource suppliers from the firm, comparisons are made with other suppliers and buyers. Profits will be determined through the exchanges the firm makes with these resource sellers (including sellers of labour) and customers. These exchanges are a function of the perceived bargaining relationships between buyers and sellers. So whereas RBT stresses the need to

explore the *internal* idiosyncrasies in the resource bundles possessed by firms in order to explain superior profit performance, and, in contrast, whereas IO theorizing stresses the *external* relationships of the firm with suppliers and buyers, we can now see that each approach explains half of the story of profit differences. RBT explains the source of the firm's ability to bargain with customers from a position of strength, which derives from the firm's ability to offer superior consumer surplus. IO theorising explains how this bargaining strength possessed by the firm influences value capture.

So we argue that value capture, the realization of exchange value, is determined by the bargaining relationships between buyers and sellers. The customer's bargaining power is enhanced by the presence of close viable substitutes, combined with low switching costs (Porter, 1980), which reduces the buyer's ability to capture exchange value in the form of high prices.

The availability of close substitutes reduces prices, and thereby increases consumer surplus. The ease with which other firms can compete, by offering products conferring similar quantities of consumer surplus, will depend upon how easily they can imitate and surpass the firm's temporary competitive advantage. And as we have argued above, these sources of advantage derive from the entrepreneurial deployment of labour.

How much of the exchange value captured from the customer is *retained* by the firm in the form of profit? This depends upon the perceived bargaining relationship between the resource supplier and the firm. If suppliers are cognisant of the firm's dependence on their supplied resource, and they can 'hold up' the firm, then they are able to capture a larger share of value (Kotowitz, 1989; Williamson, 1975). Porter (1991, p. 108) argues as follows: '... valuable resources, in order to yield profits to the firm, have been acquired for less than their intrinsic value due to imperfections in input markets'.

Some resource suppliers will find themselves in a powerful bargaining position which enables them to capture a large proportion of the exchange value won from the firm's customers, whereas other resource suppliers will find themselves capturing far less exchange value, because of their weak bargaining power. There is *no relationship* between the nature of the use value supplied by the resource supplier, the role of this use value in the production

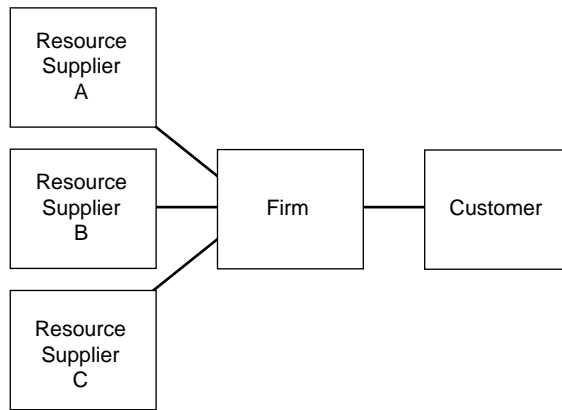


Figure 3. Bargaining relationships and the capture of exchange value

process, and the amount of exchange value that the resource supplier captures. Even where a particular employee or group of employees can be seen to be critical to the creation of exchange value, or where a particular inert use value is a vital element in the process, the sellers of these resources may capture minuscule amounts of exchange value, due to their weak bargaining power. The carving up of exchange value captured from customers is purely a function of the perceived bargaining relationship between resource supplier and resource buyer (see Figure 3). We shall now examine relationships between the firm and two resource suppliers: suppliers of labour and suppliers of capital.

Value capture: suppliers of labour

Although the actions of labour are the sole source of new use values, and hence profits (Pfeffer, 1995), employees do not capture the full exchange value that they create. This is because of the nature of the market for most types of labour. If it is in abundant supply, i.e. there are many very close substitute suppliers, then the bargaining power of the individual seller of labour is negligible. However, although both the seller and buyer of labour may perceive that the purchased contribution is homogeneous, as we have argued, the labour in action in the specific context of the firm can become heterogeneous (Conner, 1991). This masks the true contribution of some employees. It also explains why labour *power* is the resource that is sold by the employee; labour is sold in a form which may disguise its unique,

heterogeneous contribution. The employer contracts to hire labour hours, a fixed amount that can be priced (per hour, day, week, month etc.). Once hired, the variable contribution of labour is manifested. So what was in appearance a contract to supply a fixed amount of labour, becomes in essence an opportunity for the firm to extract a variable contribution to exchange value.

'Hold up' does not occur usually because the contribution of specific labour is obscured. Tushman and Nelson (1990, p. 1) explain that 'technological change operates to fragment work, deskill labour, and reinforce the power of the existing bureaucracy'. The division of labour and the globalization of production render it almost impossible to draw links between the actions of the individual seller of labour and a value generating output. As Blaug (1985, p. 243) argues: 'the employment contract under capitalism is in fact "incomplete" in the sense that it stipulates the rate of pay for labour, and the hours of work of labour, but fails to lay down the intensity or quality of the labour that is to be performed. Given the character of productive processes, it is only rarely that it is possible to attribute output to individual workers; hence time wages are much more common than piece wages'. But the contract to supply labour power is *necessarily* incomplete. Leaving deliberately vague the contributions of the seller of labour power allows other interpretations of the essential relationships between the employer and the employee.

There are circumstances where the seller of a particular type of labour is aware of its uniqueness and is conscious of the lack of perceived close substitutes. Examples would be filmstars, key sales people, top foreign exchange dealers and soccer players. In these cases the seller of labour is in a strong position to bargain up the price of their labour.

However, in many cases the contribution of sellers of labour is not easily visible. This is notably the case for individuals that work as part of a team, where the combined result of individuals' contributions is greater than the sum of each contribution. This means that use value is created by the team and not by the individuals as such. It is difficult for individual organizational members to see and show that their contribution is a differential ability.

So to summarize, it is the nature of the employment relationship, the trading of employee's labour

power not labour output, and the appearance of homogeneity of labour power that enables the firm owners to capture value created by employees. Maybe it is worth commenting that according to Aoki (1990) in some Japanese corporations the value contribution of employees is seen in balance with that of resource suppliers, which could indicate that a shift from appearance to essence, i.e. to true relationships, may be possible. Moreover, where extensive downsizing has occurred the contribution to profits that particular groups or individuals make becomes more transparent. This may alter the perceived bargaining power of these employees.

It is important to note here that we are not making any distinctions between different classes of labour output. Whether the labour power being sold is unskilled, skilled, managerial, involving physical work or 'knowledge' work is not important. The important relationship is between the seller of labour power and the purchaser of that labour power. The purchaser ultimately is the firm owner (or the shareholders), who may use hired agents (managers) to recruit, direct and control employees.

Value capture: suppliers of capital

In mainstream economics texts the suppliers of capital capture a share of value either in the form of interest payments, or in the form of dividends or growth on their equity shareholdings. Various theories have been advanced to explain how and why these suppliers of capital receive their share of value. Samuelson and Nordhaus (1985, p. 660) neatly, though perhaps inadvertently, summarize the confusion: 'to the economist, profits are a hodgepodge of different elements'.

Profits are viewed variously, as follows: they are implicit returns (rents, rentals and wages due to resources owned by the firm), a reward for risk bearing (default risk, and pure statistical risk), a reward for innovation and enterprise or monopoly returns (the excess return gained by someone who has market power) (Samuelson and Nordhaus, 1985). Similar lists are proffered by other texts (e.g. Baumol and Blinder, 1985). McGuigan *et al.* (1996) add friction theory, 'the inability of our economic system to adjust instantaneously to changes in market conditions' (McGuigan *et al.*, 1996, p. 7) and they also add that profits are rewards to exceptional management

skills. Profits have also been explained in the past as rewards for abstaining from current consumption.

In most mainstream texts there is no attempt to evaluate these competing theories of profit. They are typically dealt with in an additive way. In other words, all these theories are deemed to be correct in that they 'explain' different portions of profit. This projects a very confused picture.

A common theme in these theories is the need to explain profits as some sort of reward for something that is done for the good of economic society. Who consciously gives the reward is unclear, as the only source of cash to fund the rewards flows from customers. Perhaps they are rewarding on behalf of 'society'. None the less, even if we accepted the notion of profits as a 'reward', and if we agreed that it was paying customers that conferred the reward, how can this come about? Customers can only reward what they perceive. They only usually perceive the finished product, the resources that were combined to deliver it are usually invisible, so they cannot be consciously rewarded. Moreover, are we rewarding the resource itself (the machine), the owner of the resource (the 'firm', or the shareholders?), the money capital that was loaned to buy the machine (loan finance), or the person who loaned the money? The notion of an inanimate object being 'rewarded' does however seem absurd.

Within resource-based theory the language used takes the form of 'rents' rather than 'profits' (Rumelt, 1987). If we were hoping for some clarity in this stream of contributions we would be disappointed because the meaning of 'rent' differs across authors (Schoemaker, 1990) and for instance, Peteraf (1994) lists ten different types of rents: pure economic, quasi, appropriable quasi, Ricardian, land, inframarginal, efficiency, differential, entrepreneurial and managerial.

Do we need to distinguish between capital that is advanced as an equity stake from that advanced in the form of fixed interest earning debt? Both suppliers of capital can capture a share of exchange value; the difference is the lenders of debt who more or less know their share in advance. For instance, firm owners can borrow all their capital from banks, which is why interest can be regarded as a deduction from the 'profits' of enterprise (Blaug, 1985). So the financing structure has an impact on value capture but not on value creation.

Although the physical contribution of money capital is homogeneous, its restricted supply gives its owners power to bargain and capture a share of the value created by the firm.

Value capture: normal and super-normal profits

RBT focuses on *economic* profits. These are profits that are in excess of those levels that are deemed ‘normal’. Normal profits include returns to suppliers of capital (i.e. interest payments and the ‘normal’ cost of equity capital). These rewards to suppliers of capital must be sufficient to persuade the owners not to take their capital elsewhere. Super-normal profits are usually judged in relation to competing firms, whereas economic profits would be benchmarked against some risk adjusted ‘cost of capita’. Clearly, super-normal profits can only be defined relatively, whereas *profits* could be defined absolutely, they are either realized or they are not realized. Here we get another source of confusion. Because super-normal profits are a relative concept, we need to have some benchmark to assess them against. The concern initially amongst industrial economists was to assure themselves that allocative efficiency across society was being achieved. This theorising relies on the neo-classical assertion that an efficient allocation of resources occurs where price is equated with marginal cost. Any market structures where this does not persist are *ergo* inefficient, hence to find these markets we need to define the

boundaries of an industry. We also need to be able to measure firm performance in a way that reveals exploitative levels of profit. Often the convenient industry definitions chosen for these industry studies are product driven, but they would not necessarily make sense in the subjectively defined market environments we defined earlier in this paper.

Thus, with regard to suppliers of capital, the essence of the relationship with the firm is that they supply a completely homogeneous resource, which is not capable of generating new use values. However, because the resource they provide is in scarce supply, they are able to bid up the price of capital and capture a proportion of the exchange value created by the employees. The appearance is that suppliers of money capital create value. This appearance is compounded by the notion of *risk* and ‘rewards’ for risk bearing, and the concept of a ‘cost of capital’. But there are few *personal* risks involved, even if the investments yield nothing. The *money* is risked, the person who loans or invests it usually has other sources of income, and a varied portfolio of investments.

Summary

The contribution of this paper is an integration of several extant bodies of theory into a coherent explanation of value creation and value capture (see Figure 4). We have tried to clarify a theory of

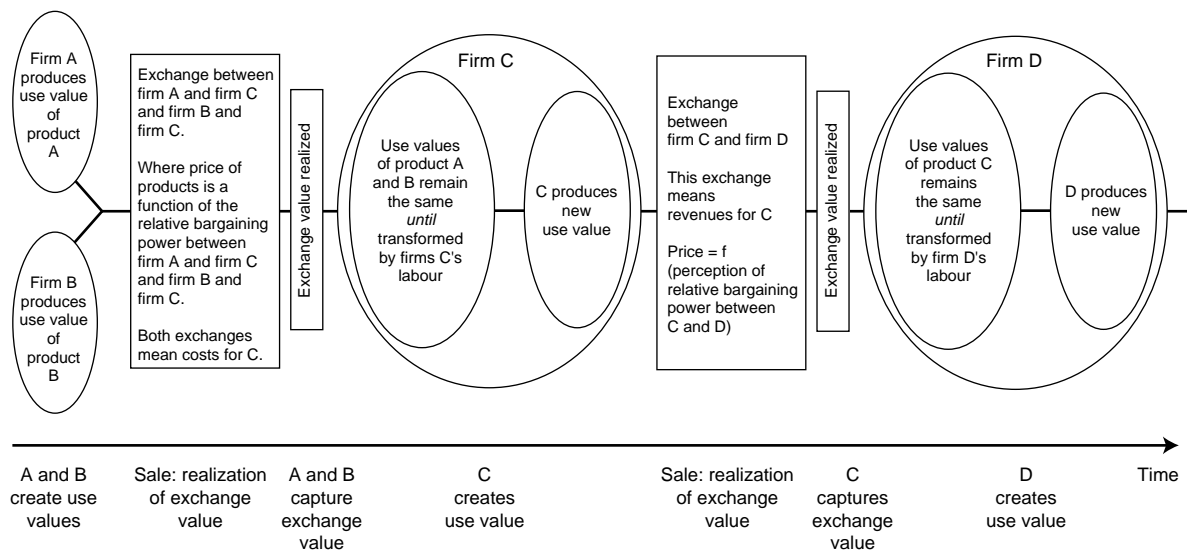


Figure 4. The process of value creation and value capture: summary

value, and by distinguishing between the creation of value, and the capture of value we have developed further insights into the resource-based perspective. We argued that ‘value’ takes the form of:

- perceived use value that is subjectively assessed by the customer who uses consumer surplus as the criterion in making purchase decisions; and
- exchange value, that is the price paid for the use value created, which is realized when the sale takes place.

We have also argued that it is the idiosyncratic ways of doing things in the organization and notably entrepreneurial, labour that allows an organization to offer more consumer surplus than its competitors, and that may permit it to achieve above average profits.

Markets are dynamic and unpredictable. As information becomes more widely available, competitors can expand their domains at the expense of the firm, through imitation, or by exploiting new innovations. This implies that entrepreneurial labour, a sub-set of our differential labour category, has to be dynamic in order to help the firm adapt to changing conditions. Where this labour is tacit the firm is at risk of either unwittingly destroying a source of value, or it is at risk because of managements’ inability to know what to change, and what to change it to.

Although labour is the source of value, bargaining relationships determine the capture of value. Profit is value captured by the firm. This includes economic profit (supernormal) profit, and interest. Although it is the employees who produce valued products which are the source of profits, they only capture a proportion of the added exchange value they create.

Conclusion

The strength of the preceding arguments lies in the fact that economic decisions are made on the basis of knowledge which it is reasonable to assume each actor might possess. The use value of products is assessed subjectively, based on the buyers’ perceptions of their needs and the extent to which alternative products might meet those needs. Decisions about the procurement of inputs into a production process are based on beliefs

about the usefulness of the resource in the use value creation process. And value capture is determined by a subjective assessment of the relative bargaining powers of buyer and seller.

These propositions are in contrast to other forms of theorizing. Neo-classical economics requires us to assume that entrepreneurs are cognisant of their firms’ cost curves, and the demand schedules of the customers in a market place. Transaction cost economics suggests that decision-makers are aware of the relative costs of performing activities within hierarchies, or to establish market-based contractual arrangements. Experience of managers and executives operating in the real world strongly suggests that these assumptions may not hold. We believe that the synthesis set out in this paper might provide an alternative theory-base for researching strategy.

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Appendix. Glossary of the terms used in this paper

Term	Definition
Resources in RBT	Any inputs into the production process
Total utility	Satisfaction deriving from the possession of a commodity
Marginal utility	Satisfaction that people receive from possessing one extra unit of a good or the satisfaction lost by giving up one unit
Use value	Customers' perceptions of the usefulness of the product on offer, equivalent to 'total utility'
Exchange value	The amount paid by the buyer to the seller for the use value
Total monetary value	The price the customer is prepared to pay
Consumer surplus	The difference between the total monetary value and the price paid (exchange value)
New use value	It is the outcome of the actions of employees who combine and transform acquired use values
Added exchange value	The amount by which the realization of exchange value is superior to the costs of the resource inputs, including wage costs (equivalent to profit)
Generic labour	Homogeneous labour across competing firms
Differential labour	Heterogeneous labour across competing firms
Entrepreneurial labour	Heterogeneous labour which directs and deploys purchased inputs with homogeneous and heterogeneous labour in a unique way, that enables the firm to realize superior profits
Unproductive labour	Labour that is performed which, in comparison to competing firms, is not required and which incurs higher relative costs
Value capture	The realization of exchange value by economic actors (firms, customers, resource suppliers, employees)
Super normal profit	Profits earned that are superior to equivalent competing firms