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The Relationship between Dynamic Capabilities, Competitive Advantage & Organizational Performance

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Abstract: **Our paper discusses the importance of dynamic capabilities which is a growing area of research and fits into the rapidly changing dynamic business environment. It is drawing the attention of the researchers and is an area which is being studied further to understand its implications across industries. This paper reviews the evolution of the dynamic capabilities approach from the resource based view over the years and how it is apt for the firms to survive in the dynamically ever-changing environment. It also draws attention on how resources and capabilities in the internal environment help build-up the dynamic capabilities and its component factors and help to create competitive advantage. The swiftness with which the firm successfully addresses the challenges that it faces in the external environment by adjusting its internal resources and capabilities works to its advantage and thereby leading to the attainment of organizational performance. The science and knowledge driven Indian pharmaceutical industry is an example which is experiencing this dynamic environment and some examples have been cited.**

Keywords: **Dynamic Capabilities, Competitive Advantage, Organizational Performance, Adaptive Capability, Absorptive Capability, Innovative Capability.**

1. INTRODUCTION

Environmental turbulence, a challenge for the marketers, is a result of the changes in consumer's demands, technological advances and new regulations, [1]. Organizational performance may get affected because of these developments and may cause competitive advantage to lose its sheen and may even cause it to become redundant. Therefore, the onus lies on the marketers to reexamine capabilities such as new product development and marketing. [2], [3].

Let us have a peek at the Indian Pharmaceutical industry that has been witnessing changes over the past few years. Post the reimplementation of the product patent law in India, there has been a shift in the approach of the pharmaceutical marketers, wherein the launch of new products has slowed down and is not the same it used to be during the pre-patent era. Various other issues have influenced the pharmaceutical industry like the price capping on the pharma products, which was enforced by DPCO (Drug Price Control Order) and the NPPA (National Pharmaceutical Pricing Authority) on selected products. Other issues such as the trimming down of the irrational combinations in the market by the DCGI (Drug Control General of India), control on the marketing spend due to the directives through the UCPMP guidelines by MCI (Medical Council of India), and the recent introduction of the GST (Goods & Service Tax), that has resulted in a challenging situation for the pharmaceutical industry.

Zott argues that some firms are better at dealing with the environmental turbulence compared to other firms and it is of interest to understand and identify such factors which result in the performance differentials [4]. Primarily the performance differential has been associated with either the industry [5] or the organization [6], [7], [8]. As other industries, this holds true for the pharmaceutical industry as well.

Based on the resource based view of the firm, resources such as inputs and infrastructure for the manufacturing of goods and the provision and facilities for providing services and the organizational capabilities that can be described as the intangible assets which are mainly dependent on the skills, learning and the knowledge in deploying resources can be sources of competitive advantage. In order to become so, both the resources and the capabilities need to be Valuable, Rare, Inimitable and Non-Substitutable [9], [10], [11].

A lot of interest has been generated in the Strategy Literature regarding how a firm achieves and maintain Competitive Advantage. The Resource Based View (RBV) highlights that the Competitive Advantage of the firm originates from the unique assets and the capabilities that the firm has [10], [12].

A distinctive approach to strive and build a sustained competitive advantage is based on the internal resources, which can be done through securing the entrepreneurial rents that arises out of the firm level efficiency advantage. These approaches are the (RBV) Resource based view and DC (Dynamic Capabilities) which are related. These approaches came to the forefront between 1990s and 2000s and are trend topics in strategic management, which has caused a disruption in the way of conceiving the firm [13].

There is an important question that comes up, as to why RBV and DC hold a greater importance in strategy? On a broader level if we look, Strategic Management models have generally described different strategies on the basis of products and market positioning, finding a “blue ocean strategy” [14], with the aim of creating a unique value through differentiation. A long lasting competitive advantage compared to the traditional product market approach can be created with a focus on the internal resource and capabilities with the help of the resource based view and dynamic capability strategies. We shall further see that the RBV of the firm holds a critical position in strategic management to generate competitive advantage and as a harbinger to new and important fields as dynamic capabilities and knowledge based view, [13].

If we look at RBV & DC, they correlate to the creation of strategic and sustainable competitive advantage which has its focus on the internal resources and synergizes the focus on the industry structure, that has been highlighted by Porter over the years, [13], [15].

2. THE RESOURCE BASED VIEW (RBV)

The resource based view highlights that the firm owns resources, a subset that helps them to achieve competitive advantage, and a further subset that is aimed towards achieving superior long-term performance [10], [16]; [17]; [18]. Differences between the firms in the same industry have been observed in empirical studies that have used RBV [19], as well as within the limited boundaries of different groups within industries [20]. This proves that there can be significant effect on the firm performance because of the individual, firm specific resources, [21].

It has been a challenging task for the RBV theorists to define resource. Different terms have been used to define resources by both researchers and practitioners which include competencies [22], skills [16], strategic assets [9], assets [23], and stocks [24], [25].

It was Penrose who initially brought the attention towards a resource perspective of the firm, but the RBV (Resource based view) was mainly highlighted by Warnerfelt [18] and thereafter got popularized by Barney’s work [10], [17]. It was because of the contribution of many authors that led to a significant conceptual development [26], [27]; [28]; [21]; [29]; [30], [31]; [32], [33]; [36]; [37]; [38]; [39], [25].

As the external environment is constantly & rapidly changing due to customer’s preference, product/ market orientation is not much suitable presently. This has led RBV to have a major influence on strategy. We would be in a better position if we understand this and make the necessary changes in our internal environment w.r.t the resources & capabilities rather than trying to change the external environment on which we have a limited control, [13].

V.R.I.N. has been defined by Barney [10] with the following characteristics: 1) V – the resource must be valuable enough to leverage and exploit upon the opportunities and counter the threats 2) R – it should be rare enough so that the resource will be difficult to locate in competing firms. 3) I – it should be imperfectly imitable 4) N – it must be non-substitutable, which signifies that sustained competitive advantage may be achieved by rare and valuable resources only. These characteristics play an important role in achieving Competitive advantage, [13].

RBV was challenged in the early 1990's as being static and the neglect that it caused to market dynamism because of the rapidly changing business environment, [29], [32], [33]. Dynamic capabilities that encompassed the development of resources and capabilities, rose to augment RBV [34]; [35]; [29]; [38].

3. DYNAMIC CAPABILITY (DC)

Dynamic capabilities are a part of the overall resource base of the organization. The concept of dynamic capabilities has been strongly supported by research to analyze the organizational capabilities. Dynamic capabilities as defined by Teece *et al*. [34] is "the firm's ability to integrate, build, and reconfigure internal and external competences to address rapidly changing environments",[40]. Dynamic capabilities are associated with "change" which is in contrast to ordinary capabilities, [39] and has been applied in various fields like marketing [41], sales [42], entrepreneurship, service innovation, business network and relationships and supply chain [43].

The definition of Dynamic Capabilities has been postulated by multiple researchers out of which we have one that was defined by Eisenhardt & Martin, 'A set of specific and identifiable processes that are embedded in firms' [29]. Another definition is "the firm's processes that use resources—specifically the processes to integrate, reconfigure, gain and release resources—to match and even create market change' that has also been shared by them. The implication of these definitions is that DC is aimed at developing unique values to tackle the external business environment. Although, quite a few definitions exist, but Ludwig & Pemberton [44] had mentioned, that it is important to develop a process of building actual dynamic capabilities, rather than generating further abstract definitions based on empirical studies.

Dynamic capabilities are deeply entrenched in the firm's resources which is dependent on the product or service that they offer and must have different capabilities to differentiate them. It is based on Dynamic Capabilities that a firm will achieve its performance, competitive and temporary advantages. Organizational and strategic routines are driven by dynamic capabilities, wherein decision makers acquire, discard or replace resources, they integrate or recombine the resources to adjust the resource base to create and add value to the strategies. Marketing dynamic capabilities, superior product development, decision making at a strategic level and alliancing processes are some examples of Dynamic Capabilities [43]. Dynamic capabilities are effective routines that are adaptive to the changing market situation in high velocity business environments. It becomes essential for the firms to deploy or discard practices in high velocity markets, swiftly without even thinking of following the existing pattern of practices. It becomes even more challenging for the firms to continuously keep adapting to survive [43].

For example, some pharmaceutical companies, swiftly changed their marketing strategies, when the DPCO announced the price sealing for some of the products that they were marketing, as well as DCGI announced the cancellation of few of the irrational FDC (Fixed dose combinations) in the market few months back. Some withdrew their products, others, shifted their promotional budgets, so that they could maintain their growth and stay afloat.

There is a commonality in the dynamic capabilities within the firms that have a reputation for demonstrating superior performance, specifically in their observed feature that is also termed as "best practices", [29]. They represent the firm's ability to efficiently and swiftly respond to the external market dynamics [45], [43]. In other words, the firms that are able to sense and act upon to grab the opportunities, or moreover by swiftly reconfiguring, its resources and capabilities with the changing environment are equipped to develop and sustain competitive advantage, [46], [47].

Based on empirical findings Wang & Ahmed [48] identified three main component factors of dynamic capabilities which are adaptive capability, absorptive capability and innovative capability. Below are the definitions of these components:

Adaptive capability

Definition of adaptive capability according to Miles and Snow [49]; Chakravarthy [50]; Hooley *et al*. [68] is a *"firm's ability to identify and capitalize on emerging market opportunities"*. Chakravarthy [50] helped distinguish between Adaptive capabilities and adaptation, wherein the former targets mainly on an effective search and balancing exploration and building on exploitation strategies [51], whereas the later explains an optimal end state of the firm's survival. The progress of adaptive capability is generally followed by the evolution of the organizational forms.

Absorptive capability

Cohen and Levinthal [52] defined absorptive capacity as "*the ability of a firm to recognize the value of new, external information, assimilate it, and apply it to commercial ends … the ability to evaluate and utilize outside knowledge is*

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largely a function of the level of prior knowledge." Firms demonstrating higher absorptive capability have greater ability to learn from partners, they do well at integrating external information which is converted to firm embedded knowledge. Absorptive capability is a multidimensional construct and consists of for component factors knowledge acquisition, assimilation, transformation and exploitation, as established by Zahra and George [38].

Innovative capability

Wang and Ahmed [53] defined innovative capability as the "ability to develop new products and/or markets, through aligning strategic innovative orientation with innovative behaviors and processes". According to the definition there are multiple dimensions that are encompassed in innovative capabilities, which have been highlighted in previous research conducted, eg. new production methods, mapping new markets, exploring new suppliers, and advancing on new organizational forms.

The above three factors as highlighted by Wang & Ahmed [48], are the most important component factors of Dynamic capabilities as a concept, and that they help in building a firm's ability to integrate, reconfigure, renew and recreate its resources and capabilities to address the changes in the external environment. These component factors are correlated to each other but distinct. Each of these components have some specific functions such as Adaptive capabilities, though the flexibility and alignment of its resources, focuses on the firm's ability to adapt itself in a timely manner to address the environmental changes.

This brings in an alignment between the internal and the external environment. Absorptive capability focuses on bringing in external knowledge and amalgamating with the existing firm's knowledge and using it internally by absorbing it. Innovative capabilities focus on the linkage between the firm's internal resources such as the inherent innovativeness advantage and the market place based advantage with respect to the new products-market [48]. The above three component factors together lead to the linking of the organization's internal resource with the external market environment based competitive advantage. Let us understand what is competitive advantage and the importance of its sustenance.

4. COMPETITIVE ADVANTAGE (CA)

The concept of sustained competitive advantage has been gaining the attention of both the researchers and academicians, as the average timespan of the firms to sustain the competitive advantage is on a decrease. In one of the studies by Li and Liu's [54], it was observed that dynamic capabilities had a significant positive influence on the competitive advantage, and this was driven by environmental dynamism, [47].

Definitions of competitive advantage have been explained by varied researchers. Fahey [69] defined competitive advantage as "as whatever differentiates an organization or what it produces or markets from its contemporaries". Following this Barney [10] differentiated dynamic capabilities as the "implementation of a value-creating strategy which is not simultaneously being implemented by any current or potential competitors." These strategies which the competitors are unable to implement is the sustained competitive advantage, [55].

Another definition by Kay [56] that is most widely accepted is "an advantage, one firm has over a competitor or group of competitors in a given market, strategic group or industry". The core competence of the firm results in competitive advantage, that helps to differentiate with competitors. [57] highlighted a few characteristics of competitive advantage that are customer focus, brand equity, product quality, research and focus on development, [55]. To understand it better, we further highlight its relationship with Dynamic capabilities.

5. DYNAMIC CAPABILITY & COMPETITIVE ADVANTAGE - THE RELATIONSHIP

Literature in the field of Strategic Management have largely discussed three complimentary theories which are a) the Resource based view b) the evolutionary theory of the firm and c) Dynamic capabilities view. These theories have highlighted how capabilities are adopted and developed by firms to sustain competitive advantage over competition, [58]. Literature has also highlighted that Dynamic capabilities of the firm are the fundamental source of competitive advantage, [59] and that they are instrumental in determining the capacity of the firm to successfully implement actions that shall result in sustained competitive advantage [60]. Various studies have discussed the direct effect of Dynamic Capabilities on the firm's competitive advantage, (e.g., [61], [59]; [62], [55] According to a study by Aguirre [58] on Mexican firms it was concluded that “dynamic capabilities and competitive advantage are likely to be essential to the survival of firms in markets characterized to be innovative and in rapid technological change. It is argued that local firms ought to stimulate their dynamic capabilities to compete in markets successfully". Hence, it will be wise to say that Dynamic Capabilities and Competitive Advantage go hand in hand, since the firms build on their capabilities to address the new environmental capabilities. But still, even after a lot of research effort has gone behind in analyzing the relationship between the two, there is still a dearth of in-depth empirical studies, which establishes a clear relationship between the two, [55].

Every organization, around the world is continuously reviewing their performance, with the rapidly changing economic situation. As the competition is intense many companies look for ways to survive for which they are trying to expand to newer geographies and access new markets, develop and market new products, offer attractive prices, enhance customer satisfaction and experiences and develop newer strategies. To do so managers and executives evaluate the internal and external costs of their products and services, gather market information, conduct market research to understand the needs and wishes of their customers, work on their production costs, forecast and evaluate the organizational performance, and attain competitive advantage in their operational activities, [63]. The Indian pharmaceutical industry has been quite successful in overcoming these challenges that they have faced from time to time by changing their approach and adapting to the situations to emerge as one of the global leaders in the pharmaceutical space.

Ofoegbu, and Akanbi [64] defined Organizational performance as “The extent to which an organization meets the needs of its stakeholders and also fulfills its own needs for survival” which is of immense interest in the field of management and business research [65]. This can facilitate the achievement of corporate strategic goals and mission & values [66] through activities that are aimed at achieving, evaluating and fine tuning the ways to achieve the organizational goals [67].

6. CONCLUSION

All the studies from various researchers highlight that dynamic capabilities is an area of study which is based on the firm’s internal resources and capabilities and is essential for the survival of the firms. The building up of these resources and capabilities are important for the firms to address the challenging external environment and leads to a competitive advantage. This competitive advantage that the firms creates for itself is a foundation for the organizational performance and has significant relation to it. Though lot of researchers have discussed the significant positive relationship between individual component factor and dynamic capabilities, or dynamic capabilities and competitive advantage or competitive advantage and organizational performance, but the relation as a whole is an area that needs further study to understand its implication and the relationships between them holistically.

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