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## **A Guide to Understanding the Value Chain**

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The value chain can be a very useful conceptual tool when trying to understand the factors that impact the long-term profitability of your business and when developing a successful strategic plan for your business. The value chain can be thought of as a set of activities, services, and products that lead to a product or service that reaches the final consumer.

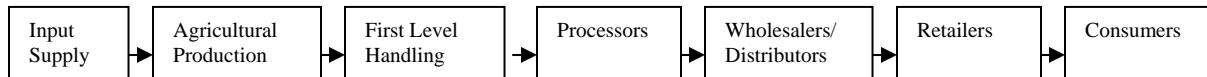
The value chain can help you answer questions regarding:

- 1) how the products you produce reach the final consumer;
- 2) the structure (economic relationships) between players in the chain;
- 3) how this structure is likely to change over time;
- 4) the key threats to the entire value chain;
- 5) the key determinants of your share of the profits created by your chain.

Agribusinesses that focus only on the firms nearest to them in the value chain are not likely to anticipate major structural changes that can dramatically impact their profitability. In order to understand your value chain, begin by drawing a simple diagram that shows the key processes and inputs that contribute to the final product. In general,

the value chain of most agribusinesses looks like Figure 1. Your job is to replace the generic boxes with more detail where appropriate.

**Figure 1. A typical value chain for agricultural products.**



The amount of detail that you include in your value chain depends in part upon the final product that you most identify with. For many producers, this is a difficult question. Just identifying where the product goes after it leaves your business is an important first step. Ask yourself, how and in what ways your production finally reaches the consumer. This question can have very different answers depending where you are located in the value chain. Grain producers will likely have many different ways in which the product reaches the final consumer and may have little control over where or how their product reaches the consumer. For these producers, it is key to identify the major channels or classes of products that reach the consumer. For instance, grains are often converted to manufactured cereal products, feed and feed products, ethanol, etc.. On the other hand, fresh fruit or vegetable growers may have a great deal of control over how their product reaches the consumer. These growers will likely want to be much more explicit with respect to the final product that they produce, i.e., fresh apples sold at roadside stand, apples picked by consumers in the orchard, apples put in storage and sold in a retail outlet, and apples processed for juice.

The key is to identify the various ways in which your product reaches the consumer. The amount of detail that you use in constructing the value chain will depend in large part upon the degree of **differentiation** that exists between you and your competitors. By simply considering the alternative ways in which your product reaches the final consumer, you can begin looking for ways to differentiate yourself from your direct competitors and making your product more attractive to members of certain value chains. For instance, look for ways to add value not only to the businesses you directly supply but to their customers as well. Also, you may begin to see opportunities for end markets that play to your strengths.

The next key factor to consider is the **economic relationship** between the various parties in your value chain. The **number and size** of the competitors at a particular stage of the value chain can have important consequences for other members of the chain. A dominant player at one stage in the chain can place many demands on smaller players with many competitors. Often, stages near the dominant player will react by trying to match the dominators size and influence. Sometimes this involves consolidation or forming cooperatives.

Another factor to look for at any stage is the importance of **economies of scale**. These are typically important in the processing stages. Economies of scale can dictate how processors want to interact with other players. Often, they will want to insure that product continues to flow through their plants. Food safety and contamination risk are even more important when a player has large economies of scale. A contamination can be very costly for any player, but one with large economies of scale and thus volume is especially at risk. Look for these firms to be very sensitive to the quality and origin of the product coming into their plants.

**Biological production risk and perishability** are frequently important characteristics of agricultural value chains. Biological production uncertainty can have important implications for the consistency of supply to supply chain members. This is especially important when there are economies of scale present. Perishability can have important impacts on the logistics and handling of food products. It will also influence the responsiveness of supply and will limit the amount of substitution that can take place when a weather event reduces production.

You will often want to examine the **economic relationships that govern the transactions** taking place at each stage of the value chain. These factors can be especially important because they can make price discovery difficult and can limit access to a value chain. For instance, many retailers and branded product manufacturers are moving toward networks of preferred suppliers. These networks do not operate like traditional agricultural markets which are open to everyone. In order to participate, the supplier must typically qualify or meet certain production standards. In many cases, the manufacturers and retailers are looking to reduce rather than expand their supplier networks.

Finally, you want to be aware of key **consumer trends and key technological advances**. In agriculture, the development of biotechnology has the potential to dramatically change value chains because the technology has important implications at both ends of the value chain. Consumer attitudes toward biotechnology will create new niche markets for value chains which either do or do not use biotechnology. Likewise, new products will be developed and potentially create new value chains. Further, biotechnology will impact the role of food processors in the food system as food products are refined at the genetic rather than the plant level.

Understanding these factors will enable you to understand where the pressures that are likely to influence your profitability will likely come from. It will also allow you to understand how you can add additional value to your specific value chain. Ask yourself, what chain are you most suited to participate in, how can you deliver the most value to that chain, what relationships are necessary to successfully compete in your chosen value chain, what key factors can destabilize or adversely affect the value chain.

The structure of the value chain will have a direct impact on you and your direct competitors' profitability. Remember that to a large extent, the amount of profit that can be obtained by you is dependent upon the final value that your entire value chain delivers to the consumer. It is also important to realize that your value chain also competes against other value chains which may be delivering products and services to the same customers that your chain delivers to.

**"Smart Marketing"** is a monthly marketing newsletter for extension publication in local newsletters and for placement in local media. It reviews the elements critical to successful marketing in the food and agricultural industry. Articles are written by faculty members in the Department of Applied Economics and Management at Cornell University.

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